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THE MALTA PATENT BOX

2019

A. INTRODUCTION

In order to further develop and motivate the creation of new knowledge, intellectual capital must be protected and nurtured. To this effect, Intellectual Property (IP) development has warranted that such IP rights lead to economic earnings to the owner and also ensures that the knowledge is utilised and exploited. Malta has taken advantage of IP rights in a successful attempt to transform the island into a royalty holding jurisdiction, notably for Patents under the new rules and provide an exemption on royalties and similar income derived from patents and inventions.

Malta's system of refunds afforded to the shareholder of a Malta IP Holding Company help to further make Malta even more interesting in the scenarios where royalty income does not qualify for the above schemes. This comprises income derived from patents, copyright and trademarks.

As a whole, this ideal environment has helped Malta to develop into an IP Holding jurisdiction, with companies holding rights in a variety of IP fields, ranging from patents covering computer software designs, remote gaming software, pharmaceutical products to simple royalty routing structures dealing with copyright.

B. WHAT ASSETS QUALIFY UNDER THE PATENT BOX?

The Patent Box does not apply to all Intellectual Property, but to a specific group of "Qualifying IP". The laws have defined Qualifying IP as meaning:

1. Patents whether issued or applied for.
2. Assets in respect of which protection rights are granted under national, EU or international law, including those relating to:
    a. Plants, genetic material and
    b. Plant or crop protection products
    c. Orphan drug designation
    d. Utility models
    e. Software protected by copyright by law
3. In respect of small entities, other IP assets having features similar to those of patents. Small entities mean beneficiaries which over an average 5 year period:
    a. Have total group turnover of not more than €50 million; and
    b. Less than €7.5million gross revenue from all IP assets

In any case, marketing-related IP assets (including brands, trademarks and trade-names shall not constitute a qualifying IP)

C. CRITERIA FOR TAX DEDUCTION

In order for the Company holding the IP asset (i.e. the beneficiary) to claim a tax deduction, all the following conditions must be satisfied:

1. Research, processing and any activity leading to creation, development, improvement or protection of the Qualifying IP have to be carried out either wholly or in part by the beneficiary, either solely or together with any other person, whether these are resident in Malta or otherwise.

   The law also allows for the following activities to be included:

   a. Functions carried out by employees of other enterprises actin under specific directions of the beneficiary in a manner equivalent to that of employees of such benefiiciary.
   b. Functions carried out through a Permanent Establishment situated in a different jurisdiction from that of the residence of the beneficiary, provided that such permanent establishment derives income subject to tax in the jurisdiction of residence of the beneficiary.
2. The beneficiary has to be the owner of the Qualifying IP, or the holder of an exclusive license of such a Qualifying IP.
3. The Qualifying IP is granted legal protection in at least one jurisdiction.
4. The beneficiary maintains sufficient substance in terms of physical presence, personnel, assets as is commensurate with the type and extent of activity being carried out in the relevant jurisdiction in respect of the Qualifying IP.
5. In case that the beneficiary is a Company, it must be specifically empowered to receive such income.
6. The beneficiary applies with the Maltese authority that is administering the Patent Box Regime, i.e. Malta Enterprise.
7. The beneficiary specifically requests the Patent Box Regime deduction in the annual tax return.

D. CALCULATION OF TAX DEDUCTIONS OF THE PATENT BOX

The Patent Box Regime deduction shall be calculated on the basis of the following formula:

$$95\% \times \left(\frac{\text{Qualifying IP Expenditure}}{\text{Total IP Expenditure}} \times \text{Income or Gains derived from Qualifying IP} \right)$$

The above terms are defined as follows:

(I) <u>Qualifying IP Expenditure</u>

Costs shall be established at the time when they are incurred and shall consist in the following:

(a) Expenditure incurred directly by the beneficiary for or in the creation, development, improvement or protection of the Qualifying IP.

(b) Expenditure incurred by the beneficiary for activities related to the creation, development, improvement and protection of Qualifying IP subcontracted to persons which are not related to the beneficiary which by law means any of the following:

1. Beneficially owned directly or indirectly to more than 25%;
2. Individual related to another if he is related to certain family members as defined by law;
3. Two entities are related if they are directly or indirectly controlled or beneficially owned by more than 25% by the same individuals.

(c) If expenditure does not fall under (a) or (b), there is an amount equivalent to the *<u>lower</u>* of:

1. Costs actually incurred in the acquisition, creation, development, improvement or protection of the Qualifying IP (excluding expenditure mentioned in paragraphs (a) and (b)); AND
2. 30% of the total of amounts referred to in (a) and (b).

Importantly, in no case shall the Qualifying IP Expenditure mentioned in (a), (b) and (c) exceed the Total IP Expenditure.

In addition, expenditure that is attributable to a permanent establishment of a beneficiary situated in a jurisdiction other than that in which the beneficiary has its head office shall not be deductible against income earned by that beneficiary which is attributable to its head office, unless the permanent establishment to which the income is attributable is in operation at the time that the beneficiary earns the income.

(II) **Total IP Expenditure**

This comprises expenses directly incurred in acquisition, creation, development, improvement or protection of the Qualifying IP, being the sum of:

(a) Expenditure actually incurred by the beneficiary and constituting Qualifying IP expenditure

(b) Other expenditure incurred by any other person which would constitute Qualifying IP expenditure had it been incurred by the beneficiary.

(c) Acquisition costs and expenditure for outsourcing activities made to related parties.

(III) **Income or Gains derived from Qualifying IP**

This shall comprise in the following in all income derived from the use, enjoyment and employment of the Qualifying IP, including royalties, and monies paid for the grant of license, compensation for infringements as well as gains on disposal of Qualifying IP.

In all cases, the determination of the above-mentioned income or gains has to be made on the basis of a Transfer Pricing method based on the OECD model.

E. CALCULATION OF LOSSES

Whenever a beneficiary incurs a loss in respect of the qualifying IP and he is allowed to set-off against his income or gains in terms of the law, he can elect any of the following:

a) A deduction of 5% of the loss

b) A deduction corresponding to the full amount of the loss incurred which would have been available as a deduction in terms of the ITA. Provided that in this case:

   - the Beneficiary will not be entitled to claim the deduction provided for in paragraph (a) in subsequent years; and
   - the amount of loss claimed as a deduction in terms of paragraph (b) shall be set-off against any Income or Gains Derived from Qualifying IP in any subsequent year.

F. DETERMINATION OF ELIGIBILITY AND RETENTION OF DOCUMENTS

In order to benefit from the IP Box Scheme, the applicant must beforehand -

- apply to Malta Enterprise for each separate licensing agreement;
- attach with the application any supporting documentation which may be requested by Malta Enterprise;
- submit the following documentation along with the application, i.e. -
    - Documentation confirming the eligibility of the IP Asset as defined on B above
    - A breakdown of the total and eligible costs as certified by an independent Certified Public Auditor that the claimed costs represent the actual costs incurred in creating the IP Asset
    - Sample documentation showing that the applicant undertook a structured research and development methodology in achieving the IP Asset. This should include sample reports of tests carried out during the research cycle

Upon approval, Malta Enterprise shall issue a 'Determination of Eligibility Certificate' which stipulates the eligibility of the IP and the qualifying expenditure.

Such a certificate will be valid for a maximum of five (5) years depending on the protection period of the IP. Also the determination shall never exceed the beneficiary's legal rights over the IP.

The holder of the Determination of Eligibility may, on an annual basis, request a revision to the value of qualifying expenditure if additional qualifying costs in relation to the IP were incurred.

Documentation related to the IP Asset (including documentation on the eligible cost and documentation related to the utilisation of the provision) must be maintained for at least 10 years after the Year of Assessment in which the beneficiary has benefited from the Patent Box Regime.

The above documentation must be retained as indicated above irrespective of any events related to the IP Asset (such as disposal or sale).

G. INTELLECTUAL PROPERTY COMPANIES

The above schemes can also be availed of by IP Holding Companies which are resident in Malta. In fact, these attractive schemes have noticeably attracted foreign companies to relocate to Malta.

Coupled to the above, Malta also boasts the following fiscal pluses –

- The distribution of the particular profits by way of dividend by the Malta company shall also be exempt from tax in the hands of the shareholders;
- No withholding taxes on outbound dividends, interest or royalties paid from a Malta IP Company;
- Under the Interest/Royalties Directive or under of Malta's tax treaties, there is the possible mitigation of source country withholding taxes on royalties paid to Malta;
- Capital gain exemption upon the disposal of intellectual property in an intra-group transfer.

H. ALTERNATIVE STRUCTURES TO THE IP BOX

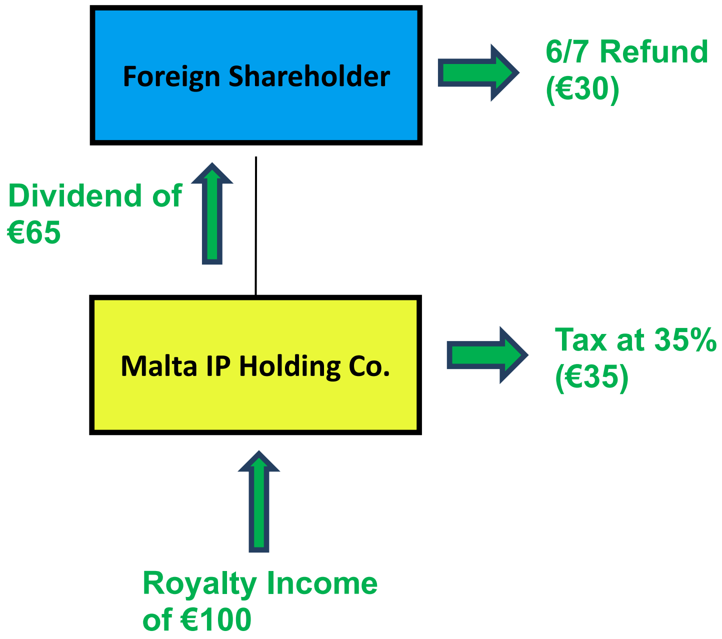
As mentioned above, the royalty income from Patents or Copyright is not automatically exempt from Maltese income tax. Such and income must be *qualifying royalty income.* Whenever the IP Box criteria are not satisfied, Maltese companies may also benefit from the advantageous fiscal treatment wherein following a dividend distribution, a shareholder of the Maltese company may apply for refunds equivalent to 6/7th of the income tax paid at corporate level, leaving the tax leakage at 5% for trading income. This scenario however does not apply in the occurrence of 'Passive Interest and Royalties'.

The term 'Passive Interest and Royalties' has been defined as interest or royalty income which is not derived, directly or indirectly, from a trade or business, where such interest or royalties have not suffered or suffered any foreign tax, directly, by way of withholding, or otherwise, at a rate of tax which is less than 5%.

In the scenario that the income is deemed to be passive interest or royalties, the refund rate is of 5/7th of the Malta tax paid. Hence the effective tax rate will be of 10%.

The above is explained in the following graphical representation -

Basic IP Holding Structure



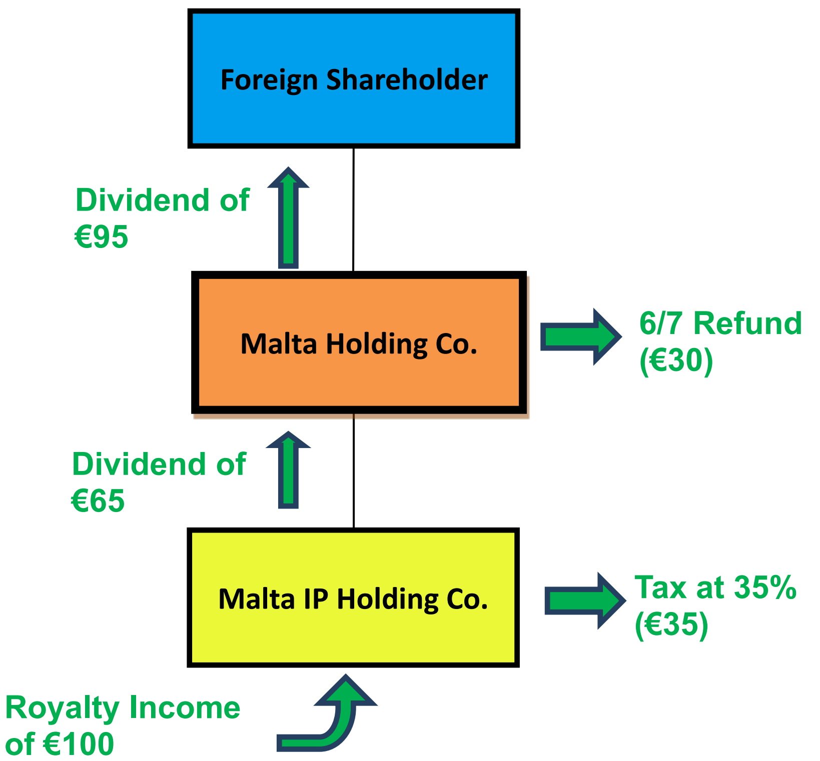
The structure on the left will feature the following –

- Malta IP Holding Co is the holder of a royalty-generating right that does not qualify under the IP Box
- Malta Tax of 35% on the royalty income
- Upon a distribution of dividends, the foreign shareholder may claim a 5/7 refund of Malta tax paid by the company
- No Malta tax is imposed on the dividend
- No Malta WHT on dividends
- Malta Tax leakage – maximum of 5% in case of active royalties

A Maltese Holding Company can be inserted on top of the Malta IP Holding Co. in the above scenario in order for the Maltese Holding Company to be able to claim the refunds itself (as opposed to the foreign shareholder).

This is reflected in the two-tier structure that is explained in the following diagram:

Two-Tier IP Structure



The structure on the left will feature the following –

- Malta IP Holding Co is the holder of a royalty-generating right that does not qualify under the IP Box
- Malta Tax of 35% on the royalty income
- Upon a distribution of dividends, the shareholder, i.e. the Malta Holding Co. may claim a 6/7 refund of Malta tax paid by the company
- No Malta tax is imposed on the dividend
- No Malta WHT on dividends
- Malta Tax leakage – maximum of 5% in case of active royalties

I. SERVICES

We provide support and assistance by:-

- Giving preliminary advice on the scheme and structuring;
- Liaising and meeting with the Malta Enterprise officials;
- Incorporating and administrating the Maltese legal entity;
- Corporate, Tax, Accounts and VAT services to the Maltese legal entity;
- Any related assistance.

J. CONCLUSION

The Malta tax refund mechanism has resulted in the lowest corporate tax rate in the whole of the EU. In addition, the introduction of the IP Box gives unsurpassable benefits to qualifying Patents and Copyrights as it totally exempts such from income tax in Malta.

K. DISCLAIMER

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