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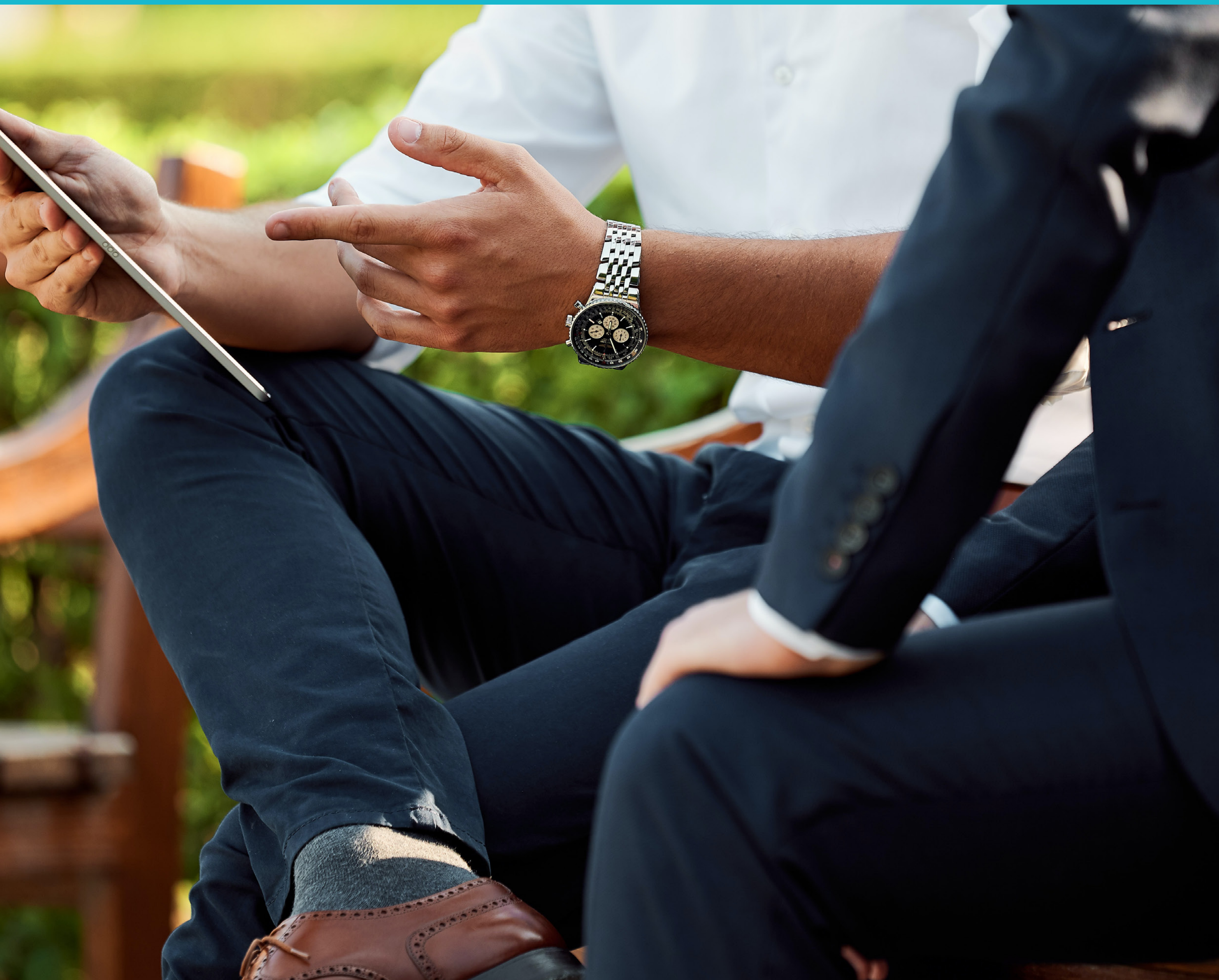
TECHNICAL DOCUMENT RELEVANT TO SHARE OPTIONS



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Technical Document relevant to Share Options

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What is a share option? Why offer share options?

Providing long-term incentive-based pay into an employee's remuneration package has proved to provide various benefits for both parties. As a result of this, employees will feel more committed and incentivised to work whilst management and shareholders will gain tremendously from the better performance of their employees. Employee share options are a common example of long-term based incentives.

What is a share option?

A share option is a long-term incentive plan granted to employees by giving them the right to acquire shares in a company. Such employees are given the option to buy or subscribe to shares in the company, or in an associated company, in their own name after a particular time frame at a stipulated date in the future and a specified price. The share option is exercised after a stipulated time period, -known as also the lock-in period, in order to instil in the employees a sense of commitment towards the company.

What is a share option? Why offer share options?

This option is a right to acquire shares in the company at a given date in the future however it is not an obligation and the employee may choose not to exercise such right. The employee also has the right to exercise the option at the time when the value of those shares may have increased, as long as this is exercised within the particular time frame.

The shares allocated to a share option scheme are usually a specified class carrying different rights to the other classes (usually bearing limited voting rights).

Why offer share options?

There are a number of other reasons why share options are offered:

- Interests of key employees and that of shareholders are aligned;
- Offering cost effective performance-based remuneration packages which are attractive;
- Increase staff retention for a period of time before and after the option is exercised.

Taxability of share options at the level of the employee

In terms of the Fringe Benefit Rules, the granting of an option by a company to its employees or to the employees of an associated company to acquire shares does not make the option a benefit, however, it shall be deemed to be a benefit once the option is exercised by the employee. Hence, every time the employee exercises the option and acquires the shares in the company, the said company will be treated as providing a fringe benefit. The said fringe benefit is brought to charge to tax in terms of Article 4 of the Maltese Income Tax Act ('ITA'), and thus deemed to be a taxable fringe benefit.

Rule 37 of the Fringe Benefit Rules states that the taxable value of such fringe benefit "shall be the excess, if any, of the price which the shares in question would fetch if sold in the open market on the date when the benefit is provided over the price paid or payable by the beneficiary for those shares".

Taxability of share options at the level of the employee

The tax rate of such taxable value is charged at the special flat rate of 15%. Such taxable value is treated as income that is separate and distinct from the beneficiary's other income and treated as income in the following instances:

i. At the time when the employee acquires the shares; and
ii. As arising in the country where the services in terms of the relative contract of employment or office are wholly or principally performed.

Hence, that makes part of the value of the shares issued or transferred to an employee under a share option scheme, exempt from Maltese Income Tax. The portion of the value of such shares which is exempt from Maltese Income Tax is only the price paid or payable by the beneficiary for those shares

Tax and stamp duty implications at the level of the existing shareholder/s

What is value shifting?

Value shifting occurs when the market value of shares held by the existing shareholders in the company changes due to a change in the shares issued by the company. This could be due to a new share issue, an allotment of shares, reduction in the share capital, alteration of voting rights or a conversion of securities.

Value shifting provisions in terms of Article 5 (13)(b)(ii) of the ITA and in terms of Article 42B of the Duty on Documents and Transfers Act ('DDTA') apply in instances where the market value of shares held by the transferor in a company has been reduced as a result of (i) "a change in the issued share capital of the same company" or (ii) a "change in the rights attached to those shares", and the said value by which the market value of those shares is being reduced is shifted to the transferee.

In these cases, it is deemed that the transferor made a transfer of such value to the transferee, and hence could be subject to capital gains tax and stamp duty in terms of Maltese law. The scope of these provisions is to bring to charge to tax and duty the said transfer of value in the same way as a traditional transfer of shares would.

Tax and stamp duty implications at the level of the existing shareholder/s

Market value determination

The formula used to determine the real/market value transferred/acquired ('Y') is **$Y = (A – B) + C – D$**, where:

- **'A'** is the market value of the shares held in the company immediately before the change
- **'B'** is the market value of the shares held in the company immediately after the change
- **'C'** is the consideration paid for the acquisition of shares or additional shares issued by the company, where the change consists of an issue of share capital for consideration; and
- **'D'** is the amount paid by the company in respect of a cancellation of shares, where the change consists of a reduction of share capital of the company."

Tax and stamp duty implications at the level of the existing shareholder/s

Maltese Income Tax Act ("ITA") considerations

Article 5(13)(b)(ii) of the ITA

Article **5(13)(b)(ii)** ITA provides basis for which it gives rise to taxation on the shift of value from the transferor to the transferee. Gains or profits made from such a transaction are calculated as the difference between the market value of shares held immediately before and after the change in value.

However, no gain or profits shall be deemed to arise in the following instances:

- If the transaction "does not produce any change in the individual direct or indirect beneficial owners of the said company and in the proportion in the value of the said company represented by the shares owned beneficially directly or indirectly by each such individual:'
- "where the change in the issued share capital consists of an allotment of shares in a company as a result of an exchange of shares on a restructuring of holdings exempt from tax under the provisions of sub-article (14)"

Tax and stamp duty implications at the level of the existing shareholder/s (continued)

However, no gain or profits shall be deemed to arise in the following instances (continued):

- "where the said company is a company whose securities are listed on a stock exchange recognised under the Financial Markets Act:"
- "where the transfer of value is made by the transferor to a person referred to in sub-article(2)(e)(i):"
- "where the said company is not a "property company" and it can be shown to the satisfaction of the Commissioner that the said change is effected for bona fide commercial reasons and does not form part of a scheme or arrangements of which the main purpose, or one of the main purposes is avoidance of liability to tax. For the purpose of this paragraph the proviso to the definition of ''property company" in article 2(1) shall not apply."

Tax and stamp duty implications at the level of the existing shareholder/s

Maltese stamp duty considerations

Article 42B(1) of the DDTA

Article 42B(1) DDTA also gives basis for charging stamp duty on documents on such value shifting. In such instances the stamp duty is calculated as the difference between the market value of shares held immediately before and after the change in value.

Certain exceptions or exemptions from stamp duty may apply in the following instances:

- "the change in the issued share capital or change in voting rights does not produce any change in the individual, direct or indirect, beneficial owners of the said company and in the proportion in the real value of the said company represented by the shares owned beneficially, directly or indirectly, by each such individual; or

- the change in the issued share capital consists of an allotment of shares in a company, as a result of an exchange of shares from one company to another exempt from duty under the provisions of article42(1); or

Tax and stamp duty implications at the level of the existing shareholder/s (continued)

Certain exceptions or exemptions from stamp duty may apply in the following instances (continued):

- the transfer of value is the result of a change in voting rights and such transfer is made by the transferor to a person referred to in paragraph (i) of article 5(2)(e) of the Income Tax Act; or

- the said company is a company whose securities are listed on a stock exchange recognised under the Financial Markets Act; or

- the said company is not a "property company" and it can be shown to the satisfaction of the Commissioner that the said change is effected for bona fide commercial reasons and does not form part of a scheme or arrangements of which the main purpose, or one of the main purposes is avoidance of liability to duty. For the purpose of this paragraph "property company" shall have the same meaning assigned to it in article 2(1) of the Income Tax Act but the provisos to the said definition shall not apply."

Concluding & Additional Remarks

Circumstantial
An opportunity to make a Case

Depending on the circumstances of the scenario at hand, and despite the fact that certain direct provisions refer to the taxable nature of particular share option plans, parties may be able to activate a direct communication channel with the Maltese tax authorities via a written formal case report to determine whether the nature and structure of their particular share option plan is eligible for an exemption in terms of **Article 5(13)(b)(ii)** of the **ITA** and **Article 42B(1)** of the **DDTA**.

Depending on the feedback provided by the Commissioner for Revenue, the relevant traditional share allotment (or transfer) documents must be drafted and submitted for the transaction to the processed by the relevant authorities.

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Interreg Italia-Malta I KNOW

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