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IRS Shuts Down US-Malta Treaty-Based Pension Tax Shelter

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Over the years, tax shelter ideas have occasionally arisen in connection with the interpretation of some of the pension provisions found in US tax treaties, encouraged, perhaps, by the lack of guidance on many treaty provisions.

One such idea was that a US taxpayer could contribute appreciated assets to a personal Maltese pension fund, then the assets could be sold without tax (since in a tax exempt pension fund), with the proceeds distributed to the US taxpayer tax-free to the extent the distribution would be tax-free if the person were a resident of Malta. This strategy was generally based on Articles 17 and 18 of the US–Malta tax treaty, which had provisions indicating that a US taxpayer would not be subject to US tax on income in a Maltese pension fund until it was distributed to them, and also that a distribution from a Maltese pension fund that would be tax exempt to a resident of Malta would also be tax exempt if distributed to a US taxpayer. Notably, the definition of "pension fund" in the US-Malta tax treaty was looser regarding Malta pension funds than is typical in many other tax treaties, where it is limited to tightly regulated funds similar in nature to US 401(a) plans. In addition to whether this was a proper interpretation, the idea also raised FATCA, FBAR, and Code section 409A issues.

Now, in a competent authority arrangement ("CAA") between the US and Malta, this interpretation has effectively been shut down. The CAA does so by stating that it is the understanding of both countries' tax authorities that a fund, scheme or arrangement is not operated principally to provide pension or retirement benefits, and thus not a pension fund for treaty purposes, if it allows participants to contribute property other than cash, or does not limit contributions by reference to income earned from employment and self-employment activities. Maltese personal retirement schemes generally contain these features, so they are not properly treated as a pension fund for treaty purposes and distributions from these funds are not considered pension distributions for tax purposes and the application of Articles 17 and 18 of the US-Malta tax treaty.

If you have any questions, please do not hesitate to contact your regular Groom attorney or the authors listed below:

David Powell
dpowell@groom.com
(202) 861-6600

Kevin Walsh
kwalsh@groom.com
(202) 861-6645

Jeanne Klinefelter Wilson
jwilson@groom.com
(202) 861-6613

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The IRS release announcing the CAA (IRS Ann. 2021-19) indicates that the IRS is actively examining taxpayers who have set up these arrangements and that such taxpayers should consult an independent tax advisor prior to filing their 2021 tax returns and take appropriate corrective actions on prior filings.

If you have any questions regarding the treatment of pension funds under US tax treaties, please contact David Powell or your regular Groom attorney.

The CAA may be found online here.

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