The Malta Pension Plan – A Supercharged, Cross-Border Roth IRA

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Relevant US Tax Principles

In the cross border setting, two of the principal goals in international tax planning are (i) deferral of income earned offshore and (ii) the tax efficient repatriation of foreign profits at low or zero tax rates in the United States. For U.S. taxpayers investing through foreign corporations, planning around the controlled foreign corporation (CFC) rules typically achieves the first goal of deferral, and utilizing holding companies resident in treaty jurisdictions generally accomplishes the second goal of minimizing U.S. federal income tax on the eventual repatriation of profits (for U.S. corporate taxpayers, the use of foreign tax credits may be used to achieve this latter goal).

In a purely domestic setting, limited opportunities exist to defer paying U.S. federal income tax on income or gain realized through any type of entity, and fewer opportunities, if any, exist for the beneficial owners of such entities to receive tax-free distributions of the accumulated profits earned by these entities. A Roth IRA may be the best vehicle available to achieve these goals.

A Roth IRA (hereafter, "Roth") is a type of tax-favored retirement account, under which contributions to the Roth are not tax deductible (like contributions to a traditional IRA would be), but all earnings of the Roth accumulate free of U.S. tax. In addition, qualified distributions from a Roth are not subject to U.S. federal income tax. In other words, once after-tax funds are placed in a Roth, those funds generally are not taxed again. As with traditional IRAs, however, the tax benefits of Roth IRAs are restricted to certain taxpayers who fall below certain modified adjusted gross income thresholds, and even then, such persons are limited in the amounts that can be contributed each year. Additionally, those who are eligible to contribute to such Roth accounts are limited to a maximum contribution of $5,500 per year ($6,500 for taxpayers age 50+). Any "excess contributions" beyond the stated limitations trigger an annual 6 percent excise tax until the excess contributions are eliminated. Finally, because of the "prohibited transaction" provisions, it is not possible for U.S. taxpayers to transfer property (whether appreciated or not) to a Roth without triggering certain taxes (i.e., excise tax as well as income tax on any built-in gain). Therefore, while the benefits of Roths are significant, they are not widely available, particularly to high-income taxpayers.

Relevant Maltese Principles Relating to Malta Pensions

Since 2002, Maltese legislation has been in existence which allows for the creation of cross-border pension funds (although these pension funds have become more relevant to U.S. taxpayers since the effective date of the U.S.-Malta income tax treaty (the "Treaty") in November of 2010). In contrast to the stringent limitations imposed on contributions to Roths under U.S. law, unlimited contributions may be made to a Malta pension plan. This is true also for U.S. citizens and tax residents, regardless of whether such persons are resident in or have any connection at all to Malta (though no U.S. deduction is permitted for contributions to such Maltese plans). A Maltese pension plan generally is classified as a foreign grantor trust from a U.S. federal income tax perspective because of the retained interest of the grantor/member in the pension fund. Thus, contributions to such a pension fund (including contributions of appreciated property) generally are ignored from the U.S. income tax perspective and should not trigger any adverse U.S. tax consequences.[1]

There also appears to be almost no limitation on what types of assets can be contributed tax-free to a Malta pension, including, for example, stock in private or publicly-traded companies (including PFICs), partnership and LLC interests (including so-called "carried interests"), and interests in U.S. or non-U.S. real estate. While the specific terms of each pension plan vary, Malta law generally permits distributions to be made from such plans beginning at age 50.

The relevant Maltese pension rules allow an initial lump sum payment of up to 30% of the value of the member's pension fund to be made free of Maltese tax. This initial payment must be made within the first year of the retirement date chosen by that member. Additional periodic payments generally must then be made from the pension at least annually thereafter, and while such payments may be taxable to the recipient, they are usually significantly limited in amount (generally being tied to applicable minimum wage standards in the recipient's home jurisdiction). Beyond those minimum wage amounts, excess lump sum distributions of up to 50 percent of the balance of the plan generally can be made free of Malta tax.

U.S.-Malta Income Tax Treaty Provisions

As noted above, when the Treaty became effective in late 2010, Maltese pension plans became more attractive to U.S. taxpayers. The Treaty contains very favorable provisions that can result in significant tax benefits to U.S. members of a Maltese pension. In order for such U.S. members to take advantage of these benefits, the pension must qualify as a resident of Malta under the Treaty and also satisfy the limitation on benefits (LOB) article of the Treaty.

Article 4, paragraph 2 of the Treaty provides that a pension fund established in either the United States or Malta is a "resident" for purposes of the Treaty, despite that all or part of the income or gains of such a pension may be exempt from tax under the domestic laws of the relevant country. Under Article 22(2)(e) of the Treaty, a pension plan that is resident in one of the treaty countries satisfies the LOB provision as long as more than 75% of the beneficiaries, members, or participants of the pension fund are individuals who are residents of either the Unites States or Malta.[2]

Thus, as long as a Maltese pension is formed pursuant to relevant Maltese law and more than 75% of its members are U.S. and/or Maltese residents, the pension plan should be eligible for Treaty benefits.

Pursuant to Article 18 of the Treaty, income earned by a Maltese pension fund cannot be taxed by the United States until a distribution is made from that fund to a U.S. resident. This article of the Treaty contains no restrictions on the types of income that are covered, and thus is generally believed to apply broadly to all income (including, for example, income arising in connection with interests in U.S. real estate, PFIC stock, and assets connected to a U.S. trade or business).[3]

Article 17(1)(b) of the Treaty further provides that distributions from a pension arising in one country, and which would be exempt from tax in that country if paid to a resident of that country, must also be exempt from tax in the other country when paid to a resident of the latter country. The U.S. Treasury's Technical Explanation to the Treaty further clarifies that, for example, "a distribution from a U.S. Roth IRA to a resident of Malta would be exempt from tax in Malta to the same extent the distribution would be exempt from tax in the United States if it were distributed to a U.S. resident."[4]

As mentioned above, pursuant to Maltese law, the initial lump sum payment from a Maltese pension (up to 30% of the value of the relevant pension fund) generally is not taxable in Malta. Thus, based on Article 17(1)(b) of the Treaty, such amounts likewise must not be taxed in the United States when made to a U.S. resident beneficiary. Additionally, this same Maltese exemption generally applies to further lump sum payments received by Maltese resident beneficiaries in certain subsequent years (generally, such distributions may be made tax-free beginning three years after the initial lump sum distribution is received). Notably, any required annual (or more frequent) periodic payments would be taxable in Malta if made to a Maltese resident, and therefore also are taxable in the United States under Section 72 when received by a U.S. resident member of the pension fund.[5]

Finally, while under the so-called "savings clause" the United States generally reserves the right under its income tax treaties to tax its citizens and "residents" as though the treaty did not exist, this savings clause contains certain exceptions. Under the Treaty, Article 1(5) provides that Articles 17(1)(b) and 18 are excepted from the savings clause (found at Article 1(4)). Consequently, the savings clause of the Treaty should not prevent a U.S. citizen or resident member of a Maltese pension from qualifying for Treaty benefits under relevant provisions of Articles 17 and 18.

Example

Assume a U.S. resident individual 49-years of age owns both highly-appreciated U.S. real estate and founders' shares of a technology start-up that is about to go public. In combination, the interests are worth approximately $100 million, and the aggregate tax basis of the assets is $10 million. As part of her retirement planning, this U.S. individual decides to contribute these assets to a Maltese pension fund.[6] During this same tax year, the real estate is sold for fair market value and the technology company goes public, though she is required to hold the shares for at least six months before disposing of them. During the following tax year, after her lockup period expires, she sells her shares for fair market value, leaving her portion of the pension plan holding proceeds of $100 million. Since at this time she is at least 50 years of age, assuming the terms of the pension plan permit her to begin withdrawing assets at age 50, the U.S. individual can cause the pension plan to distribute to her during that tax year $30 million of the pension plan funds without the imposition of any tax, either in Malta or the United States.

At this point, the pensioner would need to wait until year 4 to be able to extract additional profits tax-free (pursuant to Maltese law, three years must pass after the initial lump sum distribution before additional lump sum distributions could be made to a resident of Malta tax-free). Thus, in year 4, additional assets can be distributed to the member without triggering tax liability. To calculate how much can be distributed free of tax, it is necessary to first determine the pension holds "sufficient retirement income." This amount in turn is based, pursuant to Maltese law, on the "annual national minimum wage" in the jurisdiction where the member is resident. To the extent the pension plan balance exceeds the member's "sufficient retirement income" (on a lifetime basis), 50% of the excess can be withdrawn tax-free each year. Assuming the $70 million remaining assets (after accounting for the initial lump sum distribution) had increased in value to $85 million by year 4, and further assuming it was determined that the individual needed $1 million as her sufficient retirement income, 50% of the $84 million excess, or $42 million, could be distributed to her that year free of tax. Such calculations could likewise be performed in each succeeding tax year, with 50% of the excess being available for tax-free receipt by the beneficiary each year. Consequently, while it is not possible to distribute 100%

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of the proceeds of such a pension tax-free, a substantial portion of any income generated in the pension (including gains realized with respect to appreciation accrued prior to contribution of assets to the pension fund) may be distributed without any Maltese or U.S. tax liability.

Conclusion

Some commentators have suggested that the purported benefits of Maltese pensions in this context were not intended by Treasury in negotiating the Treaty and that therefore the use of such pensions in this manner is "too good to be true." The underlying legal principles, however, are not so different from those that apply to Roths in the United States. Like participants in Roths, participants in Maltese pensions can contribute after-tax dollars to the plan and never pay future tax on profits realized with respect to assets held in the plan. Admittedly, the biggest differences relate to the unlimited amounts that may be contributed to Maltese pensions and the fact that prior appreciation in assets that are contributed to the plan also may avoid being subjected to any U.S. tax. Regardless, these distinctions result from features of domestic Maltese law (not U.S. law), and make the use of such pension plans by U.S. residents so potentially attractive.

[1] Note, however, that U.S. information filing obligations may be triggered to the U.S. transferor member pursuant to Section 6048. Unless otherwise noted, all Section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated under the Code.

[2] For this purpose, the term resident includes a U.S. citizen. Article 4(1) of the Treaty.

[3] It should be noted that the FIRPTA provisions of Section 897 and Section 1445 should not be applicable because the pension plan is treated as a foreign grantor trust for U.S. federal income tax purposes.

[4] Treasury Technical Explanation of the U.S.-Malta Income Tax Treaty, signed 8/8/2008, Article 17, paragraph 1.

[5] Under Section 72, a portion of each payment represents tax-free return of basis.

[6] Note that, as discussed above, there should be no U.S. tax implications on contribution of the assets (for example, under Section 684), as the pension plan should be classified as a grantor trust for U.S. federal income tax purposes.

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