

IRS Criminal Probe Spells Uncertainty For Malta Pension Plans

By **Michael Sardar, Don Fort and Caroline Ciruolo** (July 28, 2023)

Malta pension plan arrangements under the U.S.-Malta income tax treaty have been a focus of the Internal Revenue Service and U.S. Department of the Treasury for more than two years.

That focus intensified recently as special agents from the IRS' Criminal Investigation division contacted numerous individuals and entities involved in Malta pension plan arrangements in what appears to be a coordinated task force-type criminal investigation.

In addition to seeking — and in some cases, obtaining — interviews, the IRS-CI issued a flurry of administrative summonses in person and by mail to taxpayers, professional advisers, promoters and third-party record-keepers.

As explained below, while clearly strategic, the IRS approach in this investigation is unusual, aggressive and likely subject to challenge.

Background

Under the plain reading of the U.S.-Malta income tax treaty,^[1] U.S. taxpayers can establish tax-favorable pension plans in the island jurisdiction.

Promoters of Malta pension plans have used the treaty to structure pensions for wealthy U.S. taxpayers that allow for significant tax savings.

The structures operate by directing the U.S. taxpayer to establish a pension plan that qualifies as a resident of Malta. The U.S. taxpayer then contributes appreciated assets to the pension plan.

When the assets are sold by the pension plan, the gains are not subject to tax in Malta or in the U.S.

Further, distributions out of the pension plan may not be subject to tax when paid out to the plan participants.

Too Good to Be True?

While the language of the treaty and Maltese law — upon which certain treaty benefits hinge — seems to allow for this result, the IRS and Treasury Department assert this interpretation of the language was not intended by the treaty drafters and is simply too good to be true.

The IRS' first salvo on this front was adding the Malta pension plan arrangement to its "Dirty Dozen" list of abusive tax schemes in July 2021:

Some U.S. citizens and residents are relying on an interpretation of the U.S.-Malta Income Tax Treaty (Treaty) to take the position that they may contribute



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appreciated property tax free to certain Maltese pension plans and that there are also no tax consequences when the plan sells the assets and distributes proceeds to the U.S. taxpayer. Ordinarily, gain would be recognized upon disposition of the plan's assets and distributions of the proceeds. The IRS is evaluating the issue to determine the validity of these arrangements and whether Treaty benefits should be available in such instances and may challenge the associated tax treatment.

It is important to note that, at this point, the IRS did not say that all Malta pension plans were abusive.

In December 2021, the Treasury Department published a competent authority arrangement, or CAA,[2] purportedly reflecting the mutual understanding of the U.S. and Malta of the term "pension fund" for purposes of the treaty.[3]

Treasury took the position that the CAA reflected the original intent of the U.S. and Malta, implying that the CAA's limitations would apply retroactively.

In announcing the CAA, the IRS noted that

U.S. taxpayers with no connection to Malta were misconstruing the pension provisions of the Treaty to avoid income tax on the earnings of, and distributions from, personal retirement schemes established in Malta.[4]

The CAA, if valid, severely narrows the definition of what qualifies as a pension and thus the overall tax benefits possible under the treaty.

In early June, the IRS and Treasury issued proposed regulations that designate Malta pension plan arrangements as listed transactions.[5] The public comment period closes on Aug. 7.

If the regulations are finalized as proposed, Malta pension plan arrangements will be subject to the same additional scrutiny applicable to all listed transactions, including certain disclosure requirements, increased penalty exposure, and record-keeping requirements for material advisers.

The New Criminal Investigation

In late June, the IRS enforcement efforts with respect to Malta pension plans shifted from primarily civil actions to a wave of criminal enforcement actions when IRS-CI special agents began contacting taxpayers and advisers to conduct interviews and issuing criminal administrative summonses.

The IRS-CI selected recipients of the contacts and summonses based on references to Malta in their U.S. tax filings, resulting in a percentage of false positives, where summons recipients have no connection to Malta pension plans. In those cases, when the error is brought to the attention of the IRS-CI, summonses have been rescinded.

Notwithstanding these false positives, the active involvement of the IRS-CI confirms that the IRS views many Malta pension plan arrangements as illegal schemes to evade paying U.S. taxes.

The IRS-CI's Use of Administrative Summonses

The IRS-CI is using its summons authority to seek testimony and records regarding Malta pension plans. Under Section 7602 of the Internal Revenue Code, the IRS may "examine any books, paper, records or other data" that may be relevant to determine or collect tax due, and issue an administrative summons to compel a taxpayer or third party to produce such documents or testimony.

If a summonsed party fails to comply, the IRS can move to enforce the summons in U.S. federal court pursuant to IRC Sections 7402(b) and 7604(a).

If the court orders enforcement and the recipient still refuses to comply, the summonsed party can face being held in civil or criminal contempt.

To obtain court enforcement of an administrative summons, the IRS must make a prima facie showing of what have become known as the Powell factors after the U.S. Supreme Court's U.S. v. Powell decision^[6] in 1964. The factors require that:

- The summons relates to an investigation being conducted for a legitimate purpose;
- The information summoned may be relevant to the investigation;
- The information sought is not already within the IRS' possession; and
- The IRS has complied with the administrative steps set forth in the IRC.

While most IRS-CI summonses — even those issued to third parties — identify a taxpayer as the subject of the inquiry, many of the summonses issued in connection with the Malta pension plans investigation do not identify a subject taxpayer.

Rather, it appears that the IRS is using its summons authority to obtain general information about taxpayers, advisers and others involved in these transactions. This use of the IRS' summons authority is atypical; however, it does not appear to violate IRC Section 7602.

If the IRS satisfies the Powell factors, the burden shifts to the party challenging the summons to set forth reasoning as to why the summons should not be enforced. It is at this point where thorny issues of privilege will likely arise.

While materials covered under the attorney-client communication privilege may not be discoverable, where and how to draw the line raises difficult and complex questions, including whether the communications constitute legal advice or nonprivileged business advice.

Using the administrative criminal investigation process appears to be a strategic move by the IRS to avoid the restrictions of a federal grand jury investigation.

For example, an IRS-CI special agent has far more discretion over the summons process, which requires no further authorization beyond the agent level. This differs markedly from a grand jury subpoena that requires the approval of a federal prosecutor.

In addition — and perhaps more telling in this wave of enforcement actions — is that the use of the criminal administrative process, unlike grand jury proceedings, allows the IRS-CI to share information with IRS civil operating divisions, such as the Large Business and International Division, without a court order granting such disclosures.

Additionally, the Malta pension plans investigation may be a joint administrative investigation involving the IRS-CI and the Large Business and International Division, as outlined in the Internal Revenue Manual.[7]

Joint investigations are a relatively new and potentially powerful tool that leverages civil and criminal resources within the IRS to pursue suspected tax evasion, willful failure to file tax returns, or willful failure to collect or pay over tax due.[8]

Finally, in the Malta pension plans investigation, many of the summonses issued to third-party record-keepers and professional advisers resemble John Doe summonses under IRC Section 7609(f), where no particular taxpayer is identified.

The IRS may serve a John Doe summons only after receiving judicial approval based on evidence that the summons relates to the investigation of an ascertainable group or class of persons; there is a reasonable basis for believing that such group or class may have violated internal revenue laws; and the information sought is not readily available from other sources.[9]

Here, there has been no indication that the IRS sought or obtained such judicial approval.

Undercover Operations or Other Covert Investigative Techniques

The Malta pension plans investigation may also include undercover operations, described in the Internal Revenue Manual as

an investigative technique in which an operative of the IRS, either an undercover agent who assumes a covert identity or purpose, or a cooperating private individual who takes action to gain evidence or information which would be unavailable but for the target's reliance on the operative's covert role.[10]

In addition to undercover operations, the IRS-CI has other investigative tools at their disposal, including the use of informants and whistleblowers and consensually monitored conversations.

The use of these special investigative techniques has proven valuable to the IRS-CI in past investigations.

Potential Targets

The IRS appears to be casting a wide net in its investigation into Malta pension plans by contacting and issuing summonses to taxpayers, lawyers, accountants, promoters and third-party record-keepers. Exactly who will ultimately be classified as a target of a criminal investigation remains to be seen.

Historically, the government has focused its criminal investigations involving allegedly illegal tax shelters on the professional enablers who design and promote the abusive structures, recognizing that the taxpayer clients will often raise the defense of good faith reliance on counsel or other professional advisers.

Such defenses create a substantial hurdle for the government in proving beyond a reasonable doubt that the taxpayer committed a crime by intentionally violating a known legal duty.

The issuance of the CAA may complicate the government's efforts to prosecute both taxpayers and their professional advisers with respect to the Malta pension plans. One can argue that the government implicitly acknowledged that, absent the CAA, the U.S.-Malta Treaty allowed for the claimed tax benefits, or at least was ambiguous enough so as to allow for such an interpretation.

Again, because the government is required to prove an intentional violation of a known legal duty — i.e., willfulness — to bring a successful criminal prosecution, its efforts may be undermined by arguments that the treaty allows for the tax benefits at issue, or at a minimum, was ambiguous enough to require the issuance of clarification in the form of the CAA.

The Road Ahead

The road ahead will not be smooth and steady for anyone involved with Malta pension plans.

The government will face opposition to its interpretation of the treaty and to its recent enforcement efforts, including the summonses issued. It will likely be an uphill battle for the government to establish the requisite criminal intent without clear and direct evidence of evasion.

Meanwhile, taxpayers and their advisers will be faced with the unenviable task of deciding whether they should discontinue or unwind their Malta pension plans, amend related income tax returns to reverse previously claimed tax benefits, initiate a voluntary disclosure or pursue other avenues to mitigate their exposure.

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Disclosure: Kostelanetz represents taxpayers and professional advisers in connection with the Malta pension plans investigation.

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[1] Convention between the Government of the United States of America and the Government of Malta for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed on August 8, 2008, and entered into effect on January 1, 2011 ("Treaty").

[2] A Competent Authority Arrangement is a bilateral agreement between the United States and the treaty partner to clarify or interpret treaty provisions. See IRS Website – Competent Authority Agreements, <https://www.irs.gov/individuals/international-taxpayers/competent-authority-arrangements#:~:text=A%20Competent%20Authority%20Arrangement%20is,clarify%20or%20interpret%20treaty%20provisions>, (last viewed Jul. 20, 2023).

[3] Ann. 2021-19, 2021-52 I.R.B. at 912 (Dec. 27, 2021).

[4] IR 2021-253 (Dec. 21, 2021).

[5] 88 Fed. Reg. 37186, 37187, FR Doc No. 2023-11861 (Jun. 7, 2023) ("A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction.").

[6] United States v. Powell, 379 U.S. 48, 58 (1964).

[7] IRM 25.1.4 (06-11-2021).

[8] IRM 25.1.4.2 (06-11-2021).

[9] See IRC 7609(f).

[10] IRM 9.4.8.1 (09-04-2019).