

Tax Insights & Commentary
Aug. 28, 2023, 4:45 AM

IRS Doesn't Have It Easy With Malta Pension Enforcement Efforts

The IRS should consider options other than criminal investigation for examining Malta's pension plans, say Kostelanetz's Caroline Ciruolo, Don Fort, and Ian Weinstock.

High-net-worth US taxpayers, working with professional advisers, have transferred assets into personal retirement plans established in Malta to limit and potentially eliminate tax on distributions. These so-called Malta pension plans rely on a specific interpretation of the US-Malta tax treaty.

This interpretation hasn't been tested in the courts, but the IRS expressly rejected it in its clarification of the treaty in December 2021.

The Malta pension plan purportedly allows US taxpayers to transfer unlimited retirement funds and other assets—including appreciated assets—into a personal retirement plan established in Malta without triggering any recognition of gain. The plans are designed to defer tax on income earned within the plan, allow for distributions at age 50, and avoid tax on most distributions, all while providing asset protection.

In sum, the plans purport to offer the benefits of a US personal retirement plan with far fewer restrictions. It therefore should come as no surprise that the Malta pension plan landed on the IRS annual Dirty Dozen list.

After several years of warning taxpayers away from these plans, the IRS Criminal Investigation Division has initiated investigations into their potential abuse. However, in seeking to hold taxpayers and their advisers accountable for illegal conduct, the IRS faces substantial hurdles.

The Hurdles

While the IRS has grave concerns regarding the tax benefits associated with Malta pension plans, its interpretation of the treaty hasn't yet been the subject of litigation, and tax professionals are preparing to defend these arrangements.

Perhaps recognizing this, the IRS has stopped short of calling all Malta pension plans abusive, possibly leaving room for a more nuanced approach. For example, a US person who worked abroad and has a legitimate non-US pension might well have believed that a rollover into a Malta pension plan was an unremarkable and unobjectionable transaction.

In seeking to prosecute those involved in forming and advising on the use of Malta pension plans, the IRS must also navigate the complexity and lack of clarity in international tax laws. These plans involve the interaction of tax regulations from multiple jurisdictions, creating legal gray areas.

Different definitions of retirement plans and different reporting requirements across borders make it difficult to determine whether individuals are trying to exploit the system or attempting to use these plans for legitimate retirement purposes.

This complexity may also support a taxpayer's claim of reasonable good faith reliance on professional advisers, a strong defense to any allegation of willful conduct. And even though IRS-CI is the best in the business at analyzing complex financial transactions, finding evidence of criminal intent may nonetheless remain a challenge when a Malta pension plan may arguably be a legitimate entity.

In pursuing criminal charges against individuals involved in Malta pension plans, the IRS will likely also face challenges specifically associated with cross-border investigations, including securing cooperation from foreign governments. Such cooperation isn't guaranteed and historically hasn't been provided with any regularity. Tax authorities must follow information sharing protocols and defuse resistance from government agencies in the jurisdictions where these individuals may hold accounts or have investments.

The IRS continues to operate with limited resources as Congress battles over future IRS funding under the Inflation Reduction Act. In this environment, pursuing complex investigations that require significant labor, expertise, and advanced technology becomes even more difficult. Though high-income tax evaders appear to be an easy target, this new initiative may not find widespread congressional support.

Finally, in any criminal prosecution involving the Malta pension plans, the government must overcome the presumption of legitimacy associated with the tax professionals who recommended the arrangements. Many taxpayers also properly reported the Malta pension plans to the IRS on the appropriate tax forms and have been completely transparent about their investments.

Simply establishing that the Malta pension plans are much more advantageous than US personal retirement plans won't suffice. Rather, the government must establish beyond a reasonable doubt that the individuals involved intentionally sought to violate a known legal duty. Many taxpayers may not have known there was anything problematic about Malta pensions plans—and even for the ones who did know, proving it may well be challenging for the government without a smoking gun.

Though IRS-CI appears to be aggressively pursuing these matters through a joint investigation with the IRS Large Business and International Division, overcoming these challenges requires more than just close collaboration with international tax authorities and a cooperative jury. The government will need a bit of luck and favorable court rulings that would allow prosecutions to proceed. Whether the government will be able to satisfy its burden to substantiate criminal tax charges remains to be seen.

An Alternative

Criminal investigations require substantial resources, and choosing one target often means walking away from another. The government is receiving numerous leads on clear criminal violations in other areas of tax law from the IRS Whistleblower Office, cooperators, and other informants. Many go unaddressed due to staffing and budgetary constraints, not to mention what seems to be an inexplicable bias against whistleblowers.

In this environment, the IRS should consider an alternative approach. In lieu of the broad criminal investigation underway involving hundreds of summonses issued to taxpayers and professional advisers, some of whom have never participated in a Malta pension plan, a reasonable settlement initiative would prompt participants to come forward quickly, address any noncompliance, and pay any tax due.

To achieve this result, the IRS would need to suppress the urge to impose penalties, much less the egregious penalties currently assessed with respect to certain delinquent international tax forms that could arguably apply in this context.

A settlement initiative will also leave the resolutions in the hands of LB&I, which is equipped to address complex, international issues through civil enforcement mechanisms, and allow IRS-CI to pursue unrelated criminal cases that involve fewer hurdles and uniformly egregious conduct. Time will tell if the IRS has the appetite for this kind of program, but history and experience suggest that it would be beneficial if they do.

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