taxnotes® international

Volume 111, Number 28 ■ July 10, 2023

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Reprinted from *Tax Notes International*, July 10, 2023, p. 169

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IRS Calls Treaty-Based Positions For Malta Pensions Listed Transactions

by Hale E. Sheppard

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In this article, Sheppard explores recent developments in the IRS's treatment of Malta pension plans, including efforts to make them listed transactions, and potential paths for affected taxpayers.

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I. Introduction

For lovers of tax controversy, upcoming disputes between taxpayers and the IRS over Malta pension plans should be legendary. The battles will be based on the following foundation:

- the U.S. law regarding taxation and information reporting of foreign retirement plans is complex and unclear;
- the United States and Malta have a bilateral agreement (the Malta-U.S. treaty)[1] featuring special rules for certain plans;
- practitioners used the express terms of the treaty to formulate a position allowing U.S. individuals to defer or avoid U.S. income tax on property transferred to, income accruing within, and distributions from Malta pension plans;
- the IRS became aware of the position and took early steps to halt the practice, including placing it on the notorious "Dirty Dozen" list;[2]
- U.S. and Maltese officials signed a competent authority arrangement (CAA) designed to stop, retroactively, what they call abusive interpretations of the treaty; and
- the IRS upped the ante by issuing proposed regulations (REG-106228-22) labeling Malta plans and related treaty positions "listed transactions," thereby triggering new duties and potential penalties for participants, material advisers, and others.

In short, it appears that taxpayers followed the letter of the law (that is, the treaty), the IRS detested the result, and now the IRS is implementing aggressive measures, including some that supposedly have retroactive effect, to combat behavior it considers improper.

This article explores general U.S. tax treatment of foreign retirement plans, key concepts of the treaty, favorable positions claimed by U.S. taxpayers with Malta pension plans, initial enforcement actions by the IRS, the significance of the CAA, the effect of the proposed regulations on various persons, and potential paths for taxpayers at this juncture.[3]

II. Treatment of Foreign Retirement Plans: Generally

A recent study by the Government Accountability Office (GAO report) concluded that the U.S. tax rules regarding workplace foreign retirement plans are complex, obscure, and

[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" (Aug. 8, 2008).

[2] IRS, "IRS Wraps Up Its 2021 Dirty Dozen Scams List With Warning About Promoted Abusive Arrangements," IR-2021-144 (July 1, 2021).

[3] For previous coverage of these issues, see Hale E. Sheppard, "The Rise and Fall of Malta Pensions: Taxpayer Positions, IRS Enforcement, and Remaining Solutions," *Tax Notes Federal*, June 27, 2022, p. 2005.

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inconsistent.[4] The GAO report explained that, in the United States, contributions by employees, contributions by employers, and passive earnings within a qualified retirement plan generally are not taxed until the taxpayer receives actual distributions from the plan.[5] Foreign retirement plans are not ordinarily considered qualified plans for U.S. purposes. Thus, depending on the characteristics of the plans, local law, and terms of any applicable treaty, U.S. individuals who participate might be *currently* taxed on contributions to the plans, undistributed passive income accruing within the plans, transfers of assets between plans, and actual distributions.[6] The GAO report underscored that this is true even if the foreign plans are considered tax-deferred in the country in which they were established, and even if the plans are similar to section 401(k) profit-sharing plans in the United States.[7]

Likewise, the IRS has explained that individual savings and retirement plans are entitled to favorable tax treatment in the United States only if they meet all the requirements to be an individual retirement account. Those instruments offer various benefits, including the deductibility of contributions, tax deferral on passive earnings, and exclusion from income on certain distributions. Many individual plans abroad, including those in Malta, do not satisfy IRA requirements.[8]

The GAO report clarified that the IRS sticks to its normal mantra when it comes to international tax issues, which is that taxpayers are ultimately liable for getting things right — despite the complexity of issues and lack of IRS guidance. Here is how the IRS sees things: "Taxpayers are responsible for understanding their filing requirements and for determining how to correctly file their tax returns, regardless of whether they live in a foreign country or the United States."[9]

III. Foreign Retirement Plans: Treaty Benefits

Favorable U.S. tax treatment of foreign retirement plans often depends on whether the relevant foreign country has a treaty with the United States and, if so, the specifics of that treaty.

A. Key Provisions

An overview of the most relevant aspects of the Malta-U.S. treaty follows.[10]

1. Definitions: Article 3.

Article 3 of the treaty explains that the term "pension fund" encompasses (1) any person (including a trust, partnership, or company) established in Malta, (2) which is a licensed fund or scheme subject to tax only on income from immovable property located in Malta, and (3) operated principally to either administer or provide pension or retirement benefits, or to earn income for the benefit of one or more of those arrangements.[11]

2. Article 17: Private pensions.

Article 17 generally states that distributions from "pensions" that are beneficially owned by a resident of either the United States or Malta will be taxed only by the country in which the beneficiary resides.[12] The technical explanation of the treaty clarifies that the phrase "pensions and other similar remuneration" covers both lump sum payments and periodic payments.[13] It also indicates that the distributions must be "in consideration of past employment."[14]

The treaty features an exception. It states that, despite the general rule above, any amount arising in the United States or Malta that would be

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[4] Government Accountability Office, "Workplace Retirement Accounts: Better Guidance and Information Could Help Plan Participants at Home and Abroad Manage Their Retirement Savings," GAO-18-19 (Jan. 31, 2018); *see also* Veena K. Murthy, "Selected Cross-Border Equity and Deferred Compensation Issues With Fund Foreign Plans," 42 *Compensation Plan. J.* 67 (Apr. 2014); Lawrence J. Chastang and Steve Yeager, "Foreign Pensions and Florida Practitioners," *Florida CPA Today* (May/June 2013); Cynthia Blum, "Migrants With Retirement Plans: The Challenge of Harmonizing Tax Rules," 17(1) *Fla. Tax Rev.* (2015).

[5] GAO, *supra* note 4, at 11-12.

[6] *Id.* at 12-14.

[7] *Id.* at 38-39.

[8] REG-106228-22.

[9] GAO, *supra* note 4, at 39-40.

[10] Malta-U.S. treaty.

[11] *Id.*, article 3(1)(k), article 4(2)(a); Department of the Treasury, "Technical Explanation of the 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," at 11-12.

[12] Malta-U.S. treaty, article 17(1)(a).

[13] Treasury, technical explanation of the Malta-U.S. treaty, at 52.

[14] *Id.* at 53.

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exempt from tax in the United States or Malta if the beneficiary were a resident there will also be exempt in the country in which the beneficiary is actually a resident.[15] The technical explanation offers the following illustration of this concept:

> 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.[16]

3. Article 18: Pension funds.

Article 18 of the treaty provides that when a resident of the United States or Malta is a member of, the beneficiary of, or a participant in a pension fund that is a resident of the other country, the income earned by the pension fund may be taxed only when, and to the extent, the income is paid to the individual (or for the benefit of the individual) from the pension fund.[17]

The technical explanation unpacks that language. It states that if a resident of the United States or Malta participates in a pension fund established in the other country, then the country of residence will not tax the appreciation within the pension fund until the individual receives a distribution.[18] The technical explanation provides the following example:

> If a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in Malta, Article [18] prevents Malta from taxing currently the plan's earnings and accretions with respect to that individual. When the resident receives a distribution from the pension fund, that distribution may be subject to tax in Malta [under] Article 17.[19]

B. Maltese Law Regarding Pensions

This article is not a comprehensive analysis of Maltese law regarding pensions. It suffices to summarize the tax positions previously advanced by various U.S. practitioners, which highlight several characteristics of the law. First, contributions do not need to be in cash; they can be any property, including appreciated capital assets, such as securities. Second, because a pension fund is treated as a foreign grantor trust for U.S. tax purposes, the contribution of assets, even appreciated ones, does not trigger immediate capital gain for the participant. Third, there is no cap on the amount of contributions that a participant can make to a pension fund, annually or overall. Fourth, appreciation within the pension fund is tax-deferred so that no taxation occurs until a distribution is made. Finally, even when distributions occur, only a portion is hit with taxes. On this last point, Maltese law allows a participant to take distributions from a pension fund as early as age 50. A participant, upon reaching that milestone, can take a tax-free lump sum payment of up to 30 percent of the total value. He can enjoy the same tax exemption on similar payments later, as long as he waits another three years after the initial one. Required periodic payments are taxable in Malta, and thus in the United States, but these are linked to a minimum wage and are generally insignificant.[20]

C. Applying the Treaty and Maltese Law

Perhaps the best way to show the benefits that certain U.S. individuals claim under the treaty is through illustrations. A few scenarios provided by practitioners are featured below. The first scenario is general:

> A U.S. resident with a highly appreciated capital asset contributes it to a qualified

[15] Malta-U.S. treaty, article 17(1)(b).

[16] Treasury, technical explanation of the Malta-U.S. treaty, at 53.

[17] Malta-U.S. treaty, article 18.

[18] Treasury, technical explanation of the Malta-U.S. treaty, at 55.

[19] *Id.*

[20] *See, e.g.*, Gerald Nowotny, "Maltcoin — Using Malta Pension Plans to Manage Bitcoin and Crypto Currency Investments," 2019 Westlaw News Room 25622126 (Aug. 22, 2019); Nowotny, "Parts Unknown! The Benefits of Malta Pension Schemes for U.S. Taxpayers," 36 *J. Tax'n Inv.* 25 (Winter 2019); Jeffrey L. Rubinger, "Will Malta Become the 'New' Ireland in International Tax Planning?" 85 *Fla. Bar J.* 32 (March 2011); Rubinger and Summer Ayers LePree, "Using Income Tax Treaties to Convert Taxable Income Into Nontaxable Distributions," 92(1) *Fla. Bar J.* 49 (Jan. 2018); William D. Lipkind and Adam Buchwalter, "Benefits for U.S. Retirement Plan Participants in the Malta-U.S. Tax Treaty," *Tax Notes Int'l*, Oct. 26, 2020, p. 517; Robert Goulder, "Maltese Pension Plans: The Impermanence of Clever Things," *Tax Notes Int'l*, Feb. 7, 2022, p. 741.

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> Maltese fund, which is neither taxable nor deductible. The fund, in turn, would sell or exchange the asset in a transaction that would normally trigger capital gains, but does not because the treaty says that the IRS can't tax the gain unless Malta is prepared to tax it, and Malta won't be taxing it under the local rules that permit an exemption.[21]

The next scenario underscores the supposed benefits of contributing appreciated cryptocurrency to a Malta pension fund:

> Bob Smith, age 50, began buying Bitcoin in 2010. He is a resident of California and would be subject to a combined federal and marginal tax on the capital income in the sale of his cryptocurrency portfolio. He purchased 10,000 coins in 2010 for $1,000. The current value of the coins is $101.1 million. As the price has begun to stabilize, Bob has concluded that it might be prudent to realize some of the gains within the portfolio. Bob creates a Malta Pension Plan administered by Acme Trust in Malta. The plan is a single-participant plan. Bob transfers his entire portfolio to the plan on a tax-free basis. The portfolio is held within a Delaware LLC that is wholly owned within the plan. The manager of the LLC is Bob's best friend and CPA. The LLC's "wallet" is the same "wallet" that Bob has had for the last nine years. The entire portfolio is sold, and Bob recognized gain on approximately $101 million. Bob is able to claim treaty benefits for the entire gain on IRS Form 8833 ["Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)"]. The proceeds are reinvested without taxation. The investment income and gains will remain tax-deferred. Bob is able to take a lump-sum distribution of $30 million at age 50, which is non-taxable for both Malta and U.S. purposes.[22]

Another scenario focuses on contributing stocks whose value has skyrocketed:

> Enterprising Johnny (age 45) has a direct investment of $1 million in a technology company that undergoes an IPO. The expectation is that the value of Johnny's shares will appreciate to $11 million following the IPO. Following the IPO, Johnny plans to sell the shares for $11 million. Once that's done, Johnny would like to reinvest his proceeds in a managed account. He is a U.S. citizen, a resident of New York City, and is married with two children. To accomplish his goal, Johnny transfers the shares to the [Malta Pension] Plan tax free. Following the IPO, the shares are sold, and the resulting proceeds are reinvested in the Plan. Johnny's Plan account achieves a 7.5 percent return (net of fees) for a 10-year period. The Plan account has grown to $19 million when, at age 55, Johnny decides to begin distributions from the Plan. The Plan account is made up of three components: (1) the initial contribution ($1 million); (2) the untaxed sales proceeds ($10 million); and (3) $8 million of untaxed portfolio gains from the date of the sale. Johnny is eligible to take 30 percent of the account value ($5.7 million) as a tax-free distribution. The balance of the funds remain available to provide periodic retirement payments of $465,000 per year. In this situation, $35,000 is treated as a return of principal, and the balance of each payment, $430,000, is taxable at ordinary income rates for Malta and U.S. purposes. Beginning in Year 4, Johnny is able to take additional lump-sum distributions equal to 50 percent of the excess value above the lump-sum value necessary to provide periodic payments. The projected value of the amount necessary to provide the annual annuity is $10.1 million. The excess amount is $8.9 million. Fifty percent of the excess eligible amount for tax-free treatment is $4.45 million. The total

[21] Goulder, *supra* note 20, at 743.

[22] Nowotny, "Maltcoin," *supra* note 20.

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amount of tax-free distributions in the example is $10.15 million.[23]

IV. Initial Enforcement Actions

The IRS has already taken various enforcement actions regarding Malta pension plans, with more to come.

A. Placement on 'Dirty Dozen' List

The IRS first featured misuse of Malta pension plans in its "Dirty Dozen" list for 2021.[24] It did not fully condemn the practice that year; rather, the IRS simply indicated that it was giving the situation some hard thought: "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."[25] The IRS's vacillation did not last long. It soon declared Malta pension plans a full-fledged member of the "Dirty Dozen." The IRS described the supposed problem as follows:

> These arrangements involve U.S. citizens or residents who attempt to avoid U.S. tax by contributing to foreign individual retirement arrangements in Malta (or potentially other host countries). The participants in these transactions typically lack any local connection to the host country. By improperly asserting the foreign arrangement as a "pension fund" for U.S. tax treaty purposes, the U.S. taxpayer misconstrues the relevant treaty provisions and improperly claims an exemption from U.S. income tax on gains and earnings in and distributions from the foreign individual retirement arrangement.[26]

B. Competent Authority Arrangement

About six months after its initial warning to taxpayers about potential improprieties, the IRS announced that U.S. and Maltese officials had signed the CAA confirming their mutual understanding about the functioning of the treaty.[27]

On what grounds did the two governmental authorities issue this new guidance? The treaty expressly empowers the competent authorities of both countries to resolve "any difficulties or doubts arising as to the interpretation or application" of the treaty, including "the meaning of any term."[28] The technical explanation adds that:

- agreements reached by the competent authorities are not required to conform to the internal laws of the United States or Malta;
- the intent is to permit the competent authorities to implement the treaty in a manner that is consistent with its general purpose; and
- the competent authorities are empowered "to deal with cases that are within the spirit of [the treaty] but not specifically covered" by it.[29]

The CAA makes several important points. For instance, it explains that a fund, scheme, or other arrangement established in Malta that can accept contributions of something other than cash or that does not limit contributions by reference to income earned by a participant is not "operated principally to administer or provide pension or retirement benefits" under article 3 of the treaty.[30] Therefore, it does not meet the definition of pension fund and cannot provide the tax-deferral benefits of the treaty under article 18.[31] The CAA further indicates that distributions from this type of fund, scheme, or arrangement are not

[23] Nowotny, "Parts Unknown!" *supra* note 20.

[24] IRS, *supra* note 2.

[25] *Id.*; *see also* Michael Smith, "U.S. Cracking Down on Maltese Pension Schemes," *Tax Notes Federal*, Jan. 3, 2022, p. 112.

[26] IRS, "IRS Wraps Up Dirty Dozen List; Reminds Taxpayers and Tax Pros to Be Wary of Scams and Schemes, Even After Tax Season," IR-2023-71 (Apr. 5, 2023).

[27] IRS, "United States, Malta Sign a Competent Authority Arrangement Confirming Pension Fund Meaning," IR-2021-253 (Dec. 21, 2021).

[28] Malta-U.S. treaty, article 25(3).

[29] Treasury, technical explanation of the Malta-U.S. treaty, at 84; the federal government has CAAs in place with many countries. *See* IRS, "Competent Authority Arrangements" (last updated May 23, 2023).

[30] IRS, *supra* note 27; Announcement 2021-19, 2021-52 IRB 912.

[31] IRS, *supra* note 27; Announcement 2021-19.

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"pensions or other similar remuneration" made "in consideration of past employment" under article 17.[32] Because the personal retirement plans established in Malta by U.S. persons do not satisfy articles 3, 17, and 18 of the treaty, the CAA concludes that they cannot be used to access treaty benefits.

Importantly, the CAA states that the preceding interpretations by the competent authorities "reflect the original intent" of the United States and Malta, presumably going back approximately 15 years, when the treaty was signed in 2008.[33] The CAA, in other words, contemplates retroactive rules and enforcement.

C. Warnings and Threats

The IRS, in news releases issued in conjunction with the CAA, admonished U.S. taxpayers that it was coming for them. Specifically, the IRS announced that it put taxpayers on notice in mid-2021 about potential violations associated with Malta pension plans, as it was "actively examining taxpayers who have set up these arrangements," and expected taxpayers to get things right for all years in which they were involved.[34] On this last point, the IRS directed taxpayers to "take appropriate corrective actions on prior filings."[35]

The IRS also revealed that taxpayers might be taking advantage of the treaty with Malta, as well as arrangements with other countries containing similar language about pension plans. It cautioned taxpayers against entering into "any substantially similar arrangements that would seek to misconstrue the provisions of a bilateral income tax treaty."[36]

Lastly, the IRS ominously indicated that both its civil and criminal divisions are committed to pursuing people who participated in, or in any way promoted, the abusive application of the treaty.[37]

[32] *Id.*

[33] *Id.*

[34] IRS, *supra* note 27.

[35] *Id.*

[36] *Id.*

[37] *Id.*

V. Newest Enforcement Tool

The most recent weapon brandished by the IRS is a set of proposed regulations issued in June 2023 making some Malta pension plans listed transactions, with all that entails.[38]

A. Description of Tax Aspects

The proposed regulations explain that the IRS is aware of transactions in which U.S. citizens or residents "misconstrue" the treaty, taking the position that it allows them to avoid paying U.S. income tax on the built-in gain of appreciated property transferred to Malta pension plans, passive income accumulating within those plans, and distributions from those plans. The proposed regulations also note that most U.S. persons involved "generally lack any connection to Malta other than their participation in these arrangements."[39]

The proposed regulations feature the following illustration. A U.S. individual taxpayer establishes a Malta pension plan. In the first year, he transfers cash, appreciated property (for example, securities, virtual currency, and partnership interests), or both to the plan under the theory that this transfer does not trigger any gain on which the IRS can tax him. In the second year, the taxpayer takes the position on his Form 1040, "U.S. Individual Income Tax Return," that neither the sale of the appreciated property that he previously transferred to the plan nor the passive income generated within the plan is subject to U.S. income tax because it is considered a "pension plan" under the treaty. In the third year, the taxpayer receives a distribution from the Malta pension plan, again claiming on his Form 1040 that this amount is not subject to U.S. income tax thanks to the treaty.[40]

B. Shortcomings Alleged by the IRS

The problem, explains the IRS in its proposed regulations, is that the tax positions described above are incorrect for several reasons. First, tax benefits in the treaty do not apply because Malta

[38] REG-106228-22.

[39] *Id.*, Background — Section V.

[40] *Id.*

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pension plans are not "pension funds" and their distributions are not "pensions or other similar remuneration," as these terms are defined in the treaty. Second, key concepts that are not specifically defined in the treaty, namely "pension" and "retirement," must be interpreted under U.S. tax law. The IRS says that Malta pension plans are not "pensions" and do not provide "retirement benefits" under U.S. law. Third, in some circumstances, the transaction, when viewed as a whole, may be disregarded by the IRS under the step transaction doctrine, substance-over-form doctrine, and/or assignment of income doctrine. The IRS claims that essentially ignoring the transaction in appropriate situations will uphold the treaty's purpose of mitigating double taxation "but not improperly create instances of non-taxation, especially in cases in which the person establishing the [Malta pension plan] has no other connection" to Malta.[41]

C. Information Reporting Duties

In addition to not paying appropriate U.S. income taxes, the proposed regulations explain that participants normally have various information reporting obligations with the IRS. They must, for instance, file Form 8938, "Statement of Specified Foreign Financial Assets"; Form 3520, "Annual Return to Report Transactions With Foreign Trusts"; and Form 3520-A, "Annual Information Return of Foreign Trust With U.S. Owner."[42]

The IRS issued Rev. Proc. 2020-17, 2020-12 IRB 539, in March 2020.[43] Its primary purpose was to create an exemption from filing forms 3520 and 3520-A for some U.S. individuals for their ownership of, and transactions with, certain types of foreign trusts.[44] Meeting the eligibility criteria was critical, of course. Among other things, the foreign trust in question had to satisfy the definition of "tax-favored retirement trust." For purposes of Rev. Proc. 2020-17, that term meant (1) a trust, plan, fund, scheme, or other arrangement (2) created, organized, or otherwise established under the laws of a foreign country (3) to operate exclusively (or almost exclusively) to provide pension or retirement benefits, (4) that meets a long list of requirements established under local law.[45] The local requirements included that contributions to the trust must derive from income earned by the taxpayer from performing personal services, and contributions to the trust cannot exceed a percentage of income earned by the participant, an annual amount, or a lifetime cap.[46]

The proposed regulations underscore that taxpayers are not exempt from filing forms 3520 and 3520-A for Malta pension plans under Rev. Proc. 2020-17. This is because those plans do not meet all the criteria to be considered a "tax-favored retirement trust" — namely, contributions do not necessarily consist of earned income, and they are not restricted in amount.[47]

D. Details About the Transaction Under Fire

The proposed regulations explain that the "Malta personal retirement scheme transaction" (Malta pension transaction) is comprised of the following elements: (1) a U.S. citizen or resident, (2) directly or indirectly, (3) transfers cash or other property to a personal retirement plan established under Malta's Retirement Pension Act of 2011, *or* receives a distribution from that plan, and (4) takes the position on a Form 1040 or Form 1040X, "Amended U.S. Individual Income Tax Return," that gain realized by, income earned in, or distributions from the plan are exempt from U.S. income tax under the treaty.[48] Any transaction that is the same as, or substantially similar to, a Malta pension transaction will be treated as a listed transaction.[49]

[41] *Id.*

[42] *Id.*, Background — Section IV.

[43] Annagabriella Colón, "IRS Guidance Eases U.S. Taxpayers' Information Reporting Duty," *Tax Notes Federal*, Mar. 9, 2020, p. 1647.

[44] Rev. Proc. 2020-17, section 1.

[45] Rev. Proc. 2020-17, section 5.03.

[46] Rev. Proc. 2020-17, sections 5.03(3) and 5.03(4).

[47] REG-106228-22, Background — Section IV.

[48] Prop. reg. section 1.6011-12(b)(1). In this context, indirect transfers include transfers by any person to whom a U.S. person transfers property, if that transfer is made in accordance with a plan that has a principal purpose of avoiding U.S. taxes. *See* REG-106228-22, Explanation of Provisions — Section I.

[49] Prop. reg. section 1.6011-12(a).

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E. Substantially Similar Transactions

As noted, the proposed regulations state that they cover not only the Malta pension transaction, but also any transaction that is "substantially similar" thereto.[50] In this context, the term substantially similar includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on a similar tax strategy.[51] The term "substantially similar" must be broadly construed in favor of disclosure to the IRS.[52] Moreover, a transaction may be substantially similar to another, even though it involves different entities or applies different tax provisions.[53] The IRS has issued regulations, private letter rulings, field service advisories, general counsel memos, and other guidance over time concluding that particular transactions are substantially similar to one reportable transaction or another.[54] The courts, likewise, have expansively interpreted the concept in upholding penalties for nondisclosure.[55]

The proposed regulations clarify that the IRS is focused only on Malta for the moment. They state that a transaction will not be deemed substantially similar unless it involves a retirement plan in Malta and tax positions claimed under the treaty.[56] The proposed regulations warn, however, that the IRS is aware that taxpayers might attempt to engage in analogous transactions in other foreign countries with the goal of achieving similar tax avoidance. Consequently, the IRS is analyzing whether transactions linked to foreign countries other than Malta should be listed transactions, too.[57]

F. Exception to Listed Transaction Status

The proposed regulations explain that the IRS knows that the United Kingdom permits tax-deferred transfers from U.K. pensions and other retirement plans to "qualified recognized overseas pension schemes," including Malta pension plans. Thus, the IRS concluded that certain U.S. individuals should not be treated as participating in Malta pension transactions. Individuals in this favored category are those who transferred their U.K. pensions or other plans to a Malta pension plan in accordance with U.K. law and claimed an exemption from U.S. income tax for contributions to, earnings in, or distributions from the plan on a Form 1040 or Form 1040X filed before the IRS published the proposed regulations.[58]

The IRS then got more specific, explaining that an individual will not be considered to have participated in the Malta pension transaction if:

- the U.S. citizen or resident funded the Malta pension plan with a transfer or rollover of a pension or other retirement plan established in a country other than Malta or the United States (for example, the United Kingdom) in compliance with the laws of that foreign country;
- at the time that the pension or other plan was formed and the rollover occurred, the individual was a resident of the foreign country under its internal tax laws and any applicable treaty (for example, a tax resident of the United Kingdom); and
- the contributions by the individual to the pension or plan consisted solely of cash linked to the income earned from performing personal services.[59]

The proposed regulations caution that the preceding exception does not apply to U.S. individuals who take the position of nontaxability on a Form 1040 or Form 1040X filed after the date

[50] REG-106228-22, Background — Section II; prop. reg. section 1.6011-12(a).

[51] Reg. section 301.6011-4(c)(4).

[52] *Id.*

[53] *Id.*

[54] *See, e.g.*, reg. section 301.6011-4(c)(4), examples; LTR 201017076 (substantial similarity to Notice 95-34, 1995-23 IRB 1); FSA 200218014 (substantial similarity to Notice 2001-16, 2001-09 IRB 1); chief counsel advice ILM 200712044 (substantial similarity to Notice 2005-13, 2005-1 C.B. 630); chief counsel advice ILM 200929005 (substantial similarity to Notice 2004-8, 2004-1 C.B. 333).

[55] *See, e.g.*, *Polowniak v. Commissioner*, T.C. Memo. 2016-31 (substantial similarity to Notice 2004-8); *Blak Investments v. Commissioner*, 133 T.C. 431 (2009) (substantial similarity to Notice 2000-44, 2000-36 IRB 1); *Our Country Home Enterprises Inc. v. Commissioner*, 145 T.C. 1 (2015) (substantial similarity to Notice 2007-83, 2007-45 IRB 960); *Turnham v. United States*, 383 F. Supp. 3d 1288 (M.D. Ala. 2019) (substantial similarity to Notice 95-34).

[56] Prop. reg. section 1.6011-12(a).

[57] REG-106228-22, Explanation of Provisions — Section I.

[58] *Id.*, Explanation of Provisions — Section II.

[59] *Id.*; prop. reg. section 1.6011-12(b)(2).

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on which the IRS published the proposed regulations.[60] This is because the IRS has placed taxpayers and their advisers on notice that it intends to make the Malta pension transaction a listed transaction.[61]

G. Effective Date

To the chagrin of the IRS, the proposed regulations do not have immediate effect. They acknowledge that the Malta pension transaction and anything substantially similar will not become a listed transaction until the date on which the proposed regulations become final (finalization date).[62] There is no certainty about the timeline, but logic dictates that the finalization date will not occur until well after September 1, 2023. Why? The IRS has scheduled a public hearing about the proposed regulations on that date, and it must give adequate consideration to all written and oral comments before issuing final regulations.[63]

H. Effect on Participants in Prior Years

Taxpayers must file a Form 8886, "Reportable Transaction Disclosure Statement," with the IRS for each year in which they participate in the Malta pension transaction after the finalization date. That should surprise no one.

However, the proposed regulations also state that taxpayers must file Form 8886 for past years in situations in which:

- they filed a Form 1040 or Form 1040X before the finalization date showing participation in the Malta pension transaction;
- they have not entered into a settlement agreement with the IRS; and
- the tax assessment period for any year during which they participated in the Malta pension transaction has not expired before the finalization date, taking into account both voluntary and involuntary extensions of the assessment period.[64]

In these circumstances, the taxpayer must file a Form 8886 with the Office of Tax Shelter Analysis for each pertinent past year within 90 days of the finalization date.[65]

The proposed regulations offer an example to put the tricky assessment period issues into perspective. Readers need some back story before getting to that. The general rule is that the IRS has three years from the time a taxpayer files a tax return to identify it as problematic, conduct an audit, and issue a final notice proposing adjustments.[66] There are various exceptions to the normal three-year rule, including the one found in section 6501(c)(8). This provision says that if a taxpayer does not file a required international information return (such as a Form 8938), then the assessment period never starts to run.[67] The IRS, therefore, has an endless opportunity to audit not only unfiled international information returns, but also the tax returns to which they should have been attached in the first place. Section 6501(c)(8) essentially prevents taxpayers with international noncompliance from running out the clock with the IRS.

Now, returning to the proposed regulations, the example indicates that a taxpayer who filed a Form 1040 claiming an exemption from U.S. income taxes thanks to a Malta pension transaction before the finalization date and who failed to file forms 3520 and 3520-A faces an endless assessment period under the special rule in section 6501(c)(8). Thus, the assessment period for all prior years will remain open as of the finalization date. The consequence is that the taxpayer must file a Form 8886 with the Office of Tax Shelter Analysis for each prior year of participation within 90 days of the finalization date.[68]

I. Effect on Material Advisers in Prior Years

Material advisers for the Malta pension transaction generally must file Form 8918, "Material Advisor Disclosure Statement," with

[60] *Id.*

[61] REG-106228-22, Explanation of Provisions — Section II.

[62] Prop. reg. section 1.6011-12(b)(3)(i).

[63] REG-106228-22, Comments and Public Hearing.

[64] REG-106228-22, Explanation of Provisions — Section III; prop. reg. section 1.6011-12(b)(3)(ii).

[65] REG-106228-22, Explanation of Provisions — Section III; reg. section 1.6011-4(e)(2)(i).

[66] Section 6501(a).

[67] Section 6501(c)(8).

[68] REG-106228-22, Explanation of Provisions — Section III.

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the IRS going forward. Again, prospective obligations are expected.[69] The proposed regulations indicate that material advisers might have retroactive duties, too. Specifically, a material adviser who made a tax statement within six years before the finalization date must file Form 8918 with the Office of Tax Shelter Analysis.[70]

VI. Effects of Proposed Regulations

The CAA and proposed regulations will have both immediate and future effects on various parties associated with Malta pension transactions, including participants, material advisers, and return preparers.

A. Effects on Participants

Taxpayers who have participated or continue to participate in Malta pension transactions will confront the following.

1. Immediate effects.

Items on which taxpayers must reflect right away, even before the finalization date of the proposed regulations, follow.

a. Income taxes.

U.S. persons, including U.S. citizens and U.S. residents, generally must pay federal income tax on all income derived, regardless of where it originates.[71] In other words, U.S. persons face a system of worldwide taxation, requiring them to declare to the IRS on Form 1040 all income, whether it was earned, obtained, received, or accrued in the United States or a foreign country. Based on the positions set forth in the CAA and proposed regulations, the IRS will argue that the treaty does not apply to the Malta pension transaction, such that taxpayers owe U.S. income taxes on the transfer of appreciated property to a Malta pension plan, passive income accruing within the plan, or distributions from the plan, as appropriate.

b. Tax-related penalties.

Taxpayers who omit foreign income confront U.S. tax liabilities, as well as sizable tax-related penalties. Examples include negligence penalties equal to 20 percent of the tax debt, penalties rising to 40 percent of the tax debt in situations involving undisclosed foreign financial assets, and penalties reaching 75 percent if the IRS can prove civil fraud.[72] The IRS is likely to assert one of these penalties.

c. Information reporting penalties.

The IRS indicated in the proposed regulations that forming Malta pension plans imposes an obligation on taxpayers to report them annually on Form 8938, Form 3520, and Form 3520-A. Nondisclosure will trigger penalties on the following terms:

- If a taxpayer fails to file a proper Form 8938, then the IRS can assert a penalty of $10,000 per violation.[73] The penalty increases to a maximum of $50,000 when the taxpayer does not rectify the problem quickly after IRS contact.[74]
- The penalty for not filing a timely, complete, accurate Form 3520 (pertaining to responsible parties and beneficiaries of foreign trusts) is either $10,000 or 35 percent of the so-called gross reportable amount, whichever is larger.[75] If the violation involves Form 3520-A (pertaining to owners of foreign trusts), the penalty decreases from 35 percent to 5 percent.[76] Importantly, unlike the long list of penalties that are linked to tax returns, Form 3520 and Form 3520-A penalties are "assessable" ones. This means that the IRS immediately imposes them and starts collection actions, and the normal deficiency procedures do not govern.[77]

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[69] Prop. reg. section 1.6011-12(b)(3)(iii); section 6111(a).

[70] REG-106228-22, Explanation of Provisions — Section III; prop. reg. section 1.6011-12(b)(3)(iii); reg. section 301.6111-3(b)(4)(i).

[71] Section 7701(a)(30)(A); reg. section 301.7701(b)-1; section 61(a) and reg. section 1.61-1(a) both provide that "gross income" generally means "all income from whatever source derived."

[72] Section 6662; section 6663.

[73] Section 6038D(d)(1); reg. section 1.6038D-8(a).

[74] Section 6038D(d)(2); reg. section 1.6038D-8(c).

[75] Section 6677(a).

[76] Section 6677(b).

[77] Section 6677(e).

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d. FBAR penalties.

Congress enacted the Bank Secrecy Act in 1970.[78] One purpose of this legislation was to require the filing of certain reports, like Financial Crimes Enforcement Network Form 114, "Report of Foreign Bank and Financial Accounts," when doing so would be helpful to the federal government in carrying out criminal, tax, and regulatory investigations.[79] The relevant authorities generally require the filing of an annual FinCEN Form 114 in cases in which (1) a U.S. person, including U.S. citizens, U.S. residents, and domestic entities, (2) had a direct financial interest in, had an indirect financial interest in, had signature authority over, or had some other type of authority over (3) one or more financial accounts (4) located in a foreign country (5) whose aggregate value exceeded $10,000 (6) at any point during the year at issue.[80] Though this issue is not explicitly addressed in the CAA and proposed regulations, the IRS might contend that foreign accounts associated with Malta pension transactions necessitate a FinCEN Form 114.

Congress enacted stronger sanctions in 2004.[81] Since then, the IRS may penalize any U.S. person who fails to file a FinCEN Form 114 when required, period.[82] For non-willful violations, the maximum penalty is $10,000 per year.[83] Higher penalties apply when willfulness exists. In particular, in situations in which a taxpayer deliberately fails to file a FinCEN Form 114, the IRS can assert a penalty equal to $100,000 or 50 percent of the balance in the account at the time of the violation, whichever amount is larger.[84] This financial hit can be enormous when it comes to unreported foreign accounts holding large amounts, including, perhaps, those affiliated with Malta pension transactions.

2. Future effects.

The IRS will likely add the following items to its enforcement arsenal targeting participants after the finalization date of the proposed regulations.

a. Form 8886 penalties.

The proposed regulations indicate that taxpayers who "participate" in a Malta pension transaction or a substantially similar one will need to file Form 8886 after the finalization date. Form 8886 contains some questions that participants are reluctant to answer for obvious reasons. Here is a notable one:

> Further describe the amount and nature of the expected tax treatment and expected tax benefits generated by the transaction for all affected years. Include facts of each step of the transaction that related to the expected tax benefits, including the amount and nature of your investment. Include in your description your participation in the transaction and all related transactions, regardless of the year in which they were entered into. Also, include a description of any tax result protection with respect to the transaction.[85]

For purposes of Form 8886, a taxpayer has "participated" when his tax return reflects the tax consequences or the tax strategy of the Malta pension transaction.[86] If a reportable transaction results in a loss that is carried back to a previous year, then the taxpayer must include Form 8886 with the application for tentative refund or amended return for the earlier year.[87] Conversely, if a taxpayer participates one year and carries forward a portion of the tax benefits, then he would be "participating" in the later years and would thus need to file Form 8886.

If participants fail to timely file Form 8886, the IRS can generally assert a penalty equal to 75

[78] P.L. 91-508, Title I and Title II (Oct. 26, 1970).

[79] *Id.*, at section 202.

[80] 31 U.S.C. section 5314; 31 C.F.R. section 1010.350(a).

[81] American Jobs Creation Act, P.L. 108-357 (Oct. 22, 2004).

[82] 31 U.S.C. section 5321(a)(5)(A).

[83] 31 U.S.C. section 5321(a)(5)(B)(ii). The IRS cannot assert penalties when violations are the result of "reasonable cause."

[84] 31 U.S.C. section 5321(a)(5)(C)(i). As of May 2018 there is uncertainty regarding the maximum FBAR penalty, as a district court issued an opinion stating that the willful FBAR penalty was capped at $100,000 per violation because the IRS failed to update the operable regulations after Congress amended the law to increase penalties. *See United States v. Colliot*, No. 1:16-cv-01281 (W.D. Texas May 16, 2018).

[85] Form 8886, line 7e (rev. Dec. 2019).

[86] Reg. section 1.6011-4(e)(1).

[87] Reg. section 301.6707A-1(c)(1) and (c)(2), Example 3.

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percent of the tax savings resulting from their participation.[88] For a listed transaction, like a Malta pension transaction, the maximum penalty for individual taxpayers is $100,000, while the maximum for entities is $200,000.[89]

Importantly, the IRS does not have authority to rescind or abate the penalty once imposed, there is no "reasonable cause" exception, and the penalty is immediately "assessable."[90] Thus, if the IRS assesses a Form 8886 penalty, then the participant cannot fight it as he would other penalties, by filing a protest letter and addressing matters with the Appeals Office or by filing a petition with the Tax Court. Rather, he must dispute the penalty through the collection process or by paying it, submitting a claim for refund, and, if the IRS ignores or rejects the claim for refund, filing a refund suit in federal court.[91]

b. Reportable transaction penalties.

If a taxpayer participates in a Malta pension transaction and the IRS disallows the benefits claimed, the IRS can assess a penalty equal to 20 percent of the tax increase simply because it is attributable to a reportable transaction.[92] This rate increases to 30 percent if the participant does not file a Form 8886.[93]

c. Expanded assessment periods.

When a participant in a Malta pension transaction fails to include Form 8886 with his Form 1040, then the assessment period for the entire Form 1040 remains open until one year after the participant eventually files the Form 8886 or a material adviser provides the IRS certain data in response to a written request, whichever happens first.[94] The regulations explain the types of taxes, penalties, and interest that the IRS might assess in situations involving listed transactions and the absence of Forms 8886:

> If the period of limitations on assessment for a taxable year remains open under [section 6501(c)(10)], the [IRS] has authority to assess *any tax* with respect to the listed transaction in that year. *This includes, but is not limited to, adjustments made to the tax consequences claimed on the return plus interest, additions to tax, additional amounts, and penalties that are related to the listed transaction or adjustments made to the tax consequences. This also includes any item to the extent the item is affected by the listed transaction even if it is unrelated to the listed transaction.*[95] [Emphasis added.]

d. Record-keeping duties.

When it comes to a listed transaction, like a Malta pension transaction, participants must retain a copy of "all documents and other records" concerning the transaction that "are material to an understanding of the tax treatment or tax structure of the transaction."[96] The participant needs to keep the materials until the assessment period for the last year of participation has expired, which could be a long time.[97] The materials to be safeguarded consist of:

- marketing materials;
- written analyses used in decision-making;
- correspondence and any agreements between the taxpayer and any adviser, lender, or other party to the transaction;
- documents discussing, referencing, or demonstrating the purported tax benefits of the transaction; and
- documents referring to the business purposes for the transaction.[98]

B. Effects on Material Advisers

The finalization date for the proposed regulations will have significance for material advisers to Malta pension transactions, too.

[88] Section 6707A(a), (b); reg. section 301.6707A-1(a).

[89] Section 6707A(b)(2); reg. section 301.6707A-1(a).

[90] Section 6707A(d)(1).

[91] *See, e.g.*, *Barzillai v. United States*, 137 Fed. Cl. 788, 121 AFTR 2d 2018-1582 (Apr. 30, 2018); *Larson v. United States*, 888 F.3d 578 (2d Cir. Apr. 25, 2018).

[92] Section 6662A(a).

[93] Section 6662A(c).

[94] Section 6501(c)(10).

[95] Reg. section 301.6501(c)-1(g)(7); *see also* reg. section 301.6501(c)-1(g)(8), Example 14.

[96] Reg. section 1.6011-4(g)(1).

[97] *Id.*

[98] *Id.*

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1. Key definitions.

The IRS, unsurprisingly, defines the term "material adviser" broadly. It generally means a person who provides material aid, assistance, or advice for organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and who derives a certain amount of gross income for doing so.[99]

A person has material involvement in this context if he (1) makes or provides a "tax statement," (2) either directly to, or for the benefit of, certain taxpayers or other material advisers, (3) before the first tax return reflecting the benefits of the reportable transaction has been filed with the IRS, and (4) derives a specific amount of income for doing so.[100] A "tax statement" means any statement, oral or written, that relates to a tax aspect of a transaction that causes it to be a reportable transaction.[101]

2. Form 8918 filing duties and penalties.

Material advisers normally must file Form 8918 to alert the IRS to their involvement.[102] As explained earlier, Form 8918 must be lodged with the Office of Tax Shelter Analysis by the last day of the month after the end of the calendar quarter in which an adviser became a material adviser for a reportable transaction.[103]

Form 8918 contains some information requests that most material advisers are not keen to answer, particularly under penalties of perjury. These include the following two:

> Provide a brief description of the type of material aid, assistance, or advice you provided.[104]

> Describe the reportable transaction for which you provided material aid, assistance, or advice, including, but not limited to, the following: the nature of the expected tax treatment and expected tax benefits generated by the transaction for all affected years, the years the tax benefits are expected to be claimed, the role of the entities and individuals mentioned . . . and the role of the financial instruments mentioned. . . . Explain how the Internal Revenue Code sections listed . . . are applied and how they allow the taxpayer to obtain the desired tax treatment. Also, include a description of any tax result protection with respect to the transaction.[105]

The IRS asserts penalties when violations occur, of course. For a listed transaction, like a Malta pension transaction, the penalty for an unfiled Form 8918 is $200,000, or 50 percent of the gross income that the material adviser obtained, whichever amount is larger.[106] The penalty increases when an intentional failure occurs. In these situations, the penalty equals the greater of $200,000 or 75 percent of the gross income.[107] Once the IRS assesses a Form 8918 penalty for a listed transaction, it does not have authority to rescind it.[108]

3. List maintenance duties and penalties.

In addition to filing Form 8918, material advisers must maintain for each transaction a list of information about their clients, the transactions in which they participated, the amounts they invested, the tax benefits they derived, and so on.[109] Material advisers must retain these lists for seven years and provide them to the IRS upon written request.[110] If any material adviser fails to supply the list within 20 days of a written request, then the IRS ordinarily can assert a penalty of $10,000 per day.[111]

C. Effects on Return Preparers

In addition to pursuing the logical targets (that is, participants and material advisers), the IRS might impose penalties on other "persons involved in" Malta pension transactions or

[99] Reg. section 301.6111-3(b)(1).

[100] Section 6111(b)(1)(A); reg. section 301.6111-3(b)(2)(i).

[101] Reg. section 301.6111-3(b)(2)(ii).

[102] Section 6111(a); reg. section 301.6111-3(a); reg. section 301.6111-3(d)(1); reg. section 301.6111-3(g).

[103] Reg. section 301.6111-3(e).

[104] Form 8918, line 6a (rev. Nov. 2021).

[105] *Id.*, line 13.

[106] Section 6707(a), (b)(2); reg. section 301.6707-1(a)(1)(ii)(A).

[107] Section 6707(a), (b)(2); reg. section 301.6707-1(a)(1)(ii)(B).

[108] Section 6707(c); reg. section 301.6707-1(e)(1)(i).

[109] Section 6112; reg. section 301.6112-1.

[110] Section 6112(b)(1); reg. section 301.6112-1(b), (d), and (e).

[111] Section 6708(a)(1); reg. section 301.6708-1(a).

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substantially similar ones, according to the proposed regulations. Expressly mentioned are penalties under section 6694 against accountants, enrolled agents, or others serving as return preparers.[112]

The IRS can generally penalize a return preparer in situations in which all the following factors are met:

- the return preparer put together a tax return or refund claim;
- it contains a position that results in an understatement of the taxpayer's liability;
- the return preparer knew, or reasonably should have known, about the position;
- the position relates to a tax shelter or a reportable transaction, which includes listed transactions; and
- it was not reasonable for the return preparer to believe that the position would more likely than not be upheld if the IRS were to challenge it.[113]

The penalty for violations equals the larger of $1,000 or 50 percent of the income that the return preparer derived (or will derive) for the relevant tax return or refund claim, whichever amount is larger.[114] However, the IRS cannot assert a penalty if the return preparer demonstrates that there was reasonable cause for the tax understatement and he acted in good faith.[115] The penalty increases to $5,000 or 75 percent of the income derived in cases in which the return preparer willfully understates the tax liability or recklessly or intentionally disregards the rules and regulations.[116]

VII. Conclusion

The IRS previously announced that it was actively auditing taxpayers who took favorable treaty positions regarding Malta pension funds. It expected taxpayers to proactively correct matters for past years and planned to dispatch personnel from its civil and criminal divisions to ensure compliance.[117] The IRS then issued proposed regulations in June 2023, expanding its rationale for why the treaty positions on which Malta pension transactions rely are incorrect, and announcing its plan to make them listed transactions.

The most pressing question is what all those involved with Malta pension transactions should do now. Each person has different options and will come to a unique conclusion, depending on their precise role, risk tolerance level, financial situation, and other factors.

As indicated earlier, participants, relying on their advisers, claimed favorable tax positions on their Form 1040 based on the explicit terms of the treaty and disclosed those positions to the IRS. Their likely stance, therefore, is (1) that they were (and are) legally entitled to the tax benefits of the Malta pension transaction, (2) the law cannot be changed retroactively using the CAA, (3) the government must amend the treaty if it wants to effectuate changes prospectively, and, (4) in all events, the IRS cannot penalize participants because they had a solid legal basis for their tax positions, reasonably relied on their advisers, and acted in good faith.

Participants might prevail with that line of reasoning. Many in the tax community, particularly those in favor of strict constructionism, are rooting for that outcome. Still, participants should consider their options in light of the IRS's recent announcement that it "will take the position that taxpayers are not entitled to the purported tax benefits" of Malta pension transactions.[118] Taxpayers might wait for an IRS audit and then aggressively defend their positions before the Appeals Office or the Tax Court, apply to affirmatively resolve matters with the IRS through one of the "streamline" disclosure procedures, or take another path altogether.

The IRS already possesses lots of information about Malta pension transactions, and it will acquire considerably more when the proposed regulations are finalized and forms 8886 and 8918 start flowing in. This, in all likelihood, will lead to

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[112] REG-106228-22, Explanation of Provisions — Section III.

[113] Section 6694(a)(1); section 6694(a)(2).

[114] Section 6694(a)(1).

[115] Section 6694(a)(3).

[116] Section 6694(b)(1) and (2).

[117] IRS, *supra* note 27.

[118] REG-106228-22, Explanation of Provisions — Section III.

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increased audits of participants, along with promoter investigations of material advisers. Given this reality, participants and material advisers would be wise to engage qualified tax counsel soon to start exploring options, arguments, and strategies. ■

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