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GMS Flash Alert

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United States/Malta - Competent Authorities in New Arrangement Clarify "Pension Fund"

On December 21, 2021, the U.S. Internal Revenue Service (IRS) announced that a competent authority arrangement ("CAA") was signed by the competent authorities of the United States and Malta.[1] The CAA clarifies the definition of a "pension fund" for purposes of paragraph 1(k) of Article 3 of the income tax treaty between the United States and Malta ("the Treaty") by providing that such term does not include a fund, scheme, or arrangement that allows participants to contribute property other than cash, or does not limit contributions by reference to income earned from personal services (including self-employment) of the participant or the participant's spouse.

As personal retirement schemes established in Malta under the Retirement Pensions Act of 2011 contain the above features, the CAA clarifies that such schemes are not considered "pension funds" for purposes of paragraph 1(k) of Article 3, and thus, do not qualify for any of the benefits granted to a "pension fund" under the Treaty, including the benefits conferred by Articles 17 and 18.

WHY THIS MATTERS

As detailed below, Articles 17 and 18 of the Treaty contain unique language that could be interpreted to exempt a U.S. citizen or resident from both U.S. and Maltese income tax on the earnings of, and distributions from, certain personal retirement schemes established in Malta. Due to the potential tax savings provided to U.S. citizens and residents by the Treaty language, many media outlets, as well as financial advisers, have marketed Maltese personal pensions and retirement schemes as potential tax-efficient savings vehicles for U.S. citizens and residents, even though the IRS previously stated that it was looking into whether such an interpretation of the Treaty language was an abusive use of the Treaty.[2]

Per the CAA, the IRS has made it clear that the above interpretation of the Treaty language does not reflect the original intent of the Treaty, as the CCA provides that U.S. citizens and residents may not claim benefits under either Article 17, paragraph 1(b), or Article 18 of the Treaty, with respect to personal retirement schemes established in Malta under the Retirement Pensions Act of 2011, as such schemes are not considered "pension funds" for purposes of paragraph 1(k) of Article 3.

Thus, by clarifying the limited scope of the definition of "pension fund" for purposes of the Treaty, the U.S. and Malta have confirmed that taxpayers cannot interpret Articles 17 or 18 of the Treaty to apply to certain personal retirement schemes established in Malta.

Context

Similar to many other income tax treaties, the Treaty contains various provisions applicable to pension funds, including a provision that governs the taxation of distributions from pension funds. While both Article 18, which provides that a resident of a country, as determined under the Treaty, who participates in a pension fund established in the other country will not be subject to tax on income from the pension fund in the taxpayer's country of residence until a distribution is made from the pension fund, and paragraph 1(a) of Article 17, which grants the taxpayer's country of residence, as determined under the Treaty, the exclusive right to tax pension fund distributions, are common provisions found in income tax treaties, paragraph 1(b) of Article 17 contains an unusual exception to the country of residence's right to tax a pension distribution.

Under paragraph 1(b) of Article 17, the country of residence must exempt from tax any amount of such pension distribution that would be exempt from tax in the country in which the pension fund is established if the recipient were a resident of that country. Thus, if a U.S. citizen or resident who is a resident of the United States under the Treaty receives a distribution from a pension fund in Malta, the U.S. citizen or resident would be exempt from tax in the United States to the extent the distribution would be exempt from tax in Malta if the taxpayer were a resident of Malta at the time of distribution. Furthermore, while the Treaty contains the typical "saving clause" found in income tax treaties that allows the U.S. to tax its citizens and residents as if the Treaty never came into effect, both Article 18 and paragraph 1(b) of Article 17 are explicitly excepted from the saving clause, thus allowing U.S. citizens and residents to claim the benefits provided by the aforementioned provisions. Therefore, if a U.S. citizen or resident taxpayer is a U.S. resident under the Treaty and participates in a pension fund that is a resident of Malta, the taxpayer would not be subject to tax with respect to the income earned by the pension fund until it is actually distributed. Furthermore, if the same taxpayer receives a distribution from a pension fund in Malta that would not be subject to tax in Malta if the taxpayer were a resident of Malta, the Treaty would exempt the distribution from both U.S. and Malta income tax, as the U.S. would not tax the distribution per paragraph 1(b) of Article 17 and Malta would not have a right to tax the distribution received by a U.S. treaty resident under paragraph 1(a) of Article 17.

Definition of Pension Fund for Treaty Purposes

The benefits conferred by Article 17 and Article 18, as well as the other articles that address pension funds, only apply if the scheme or arrangement in question meets the definition of a "pension fund" under paragraph 1(k) of Article 3. Paragraph 1(k) of Article 3 states in relevant part that a "pension fund" means:

> any person established in a Contracting State that is:
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> i) in the case of pension funds established in the United States, generally exempt from income taxation, and in the case of pension funds established in Malta, a licensed fund or scheme subject to tax only on income derived from immovable property situated in Malta; and

ii) operated principally either:

A) to administer or provide pension or retirement benefits; or

B) to earn income for the benefit of one or more persons meeting the requirements of subparagraph i) and clause A) of this subparagraph.:

While the Treasury Department's Technical Explanation of the Treaty provides a list of the U.S. plans that meet the above requirements to be considered a "pension fund" under paragraph 1(k) of Article 3, it is silent as to which Maltese plans qualify as a "pension fund" under paragraph 1(k) of Article 3. However, under paragraph 3 of Article 25 of the Treaty, the competent authorities may resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Treaty.

As there were questions pertaining to whether certain personal retirement schemes in Malta were considered "pension funds" under paragraph 1(k) of Article 3, and thus, eligible for the benefits provided to "pension funds" under the Treaty, the CAA clarifies that:

> a fund, scheme, or arrangement established in a Contracting State that, except in the case of a qualified rollover from a pension fund established in the same Contracting State,
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> (a) is allowed to accept contributions from a participant in a form other than cash, or
>
> (b) does not limit contributions by reference to earned income from personal services (including self-employment) of the participant or the participant's spouse,
>
> is not operated principally to administer or provide pension or retirement benefits within the meaning of paragraph 1(k) of Article 3 of the Treaty, and is therefore not a "pension fund." The competent authorities therefore also confirm that distributions from this type of fund, scheme or arrangement are not "pensions or other similar remuneration" in consideration of past employment for purposes of paragraph 1(b) of Article 17 of the Treaty. This type of fund, scheme, or arrangement includes a personal retirement scheme established in Malta under the Retirement Pensions Act of 2011.
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> Accordingly, U.S. citizens and residents may not claim benefits under paragraph 1(b) of Article 17 and Article 18 of the Treaty with respect to the type of fund, scheme, or arrangement described in the paragraph immediately above, including a personal retirement scheme established in Malta under the Retirement Pensions Act of 2011.

FOOTNOTES:

1 Announced in IR-2021-253 (December 21, 2021).

2 See IR-2021-144 (July 1, 2021).

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