LAW OFFICE OF GERALD R. NOWOTNY, PLLC

It Never Rains in Southern California – Introducing the Malta Freeze

While growing up in the Panama Canal Zone, I lived on the Pacific side of the Canal Zone, e.g. on the Pacific Ocean side. The main town on the Pacific side was Balboa named after the Spanish explorer Vasco De Nunez Balboa. California has multiple places named after Balboa. However, unlike Panama where it always rains, it never rains in Southern California. Daughter #2 and my twin grandchildren live in Southern California and but for the Pandemic, I love to visit California. The natural beauty of the State is simply amazing. Everything is groovy there!

I have written extensively on Malta Pension Plans ("Plan"). In many respects, the Plan has many similarities to a Roth IRA except that the Plan has no contribution limits and is not restricted to cash contributions. As a result, a high net worth taxpayer can contribute appreciated assets to the Plan without triggering taxation on the contribution. The investment advisor within the Plan can sell appreciated capital assets within the Plan without taxation. The investment earnings within the Plan can be reinvested within the Plan and accrue on a tax-deferred basis. The Plan offers the participant various methods of distributing tax-deferred benefits on a mostly tax-free basis like a Roth IRA.

The Plan offers a participant who is at least age 50 to distribute up to 30 percent of the account value on a tax-free basis. The Plan offers the participant the ability to take additional lump sum distributions up to 50 percent of the account value, three years after the lump sum distribution and every year thereafter. The Plan may always make taxable distributions to the participant. The Plan is treated as a foreign grantor trust for tax purposes. Appreciated assets are subject to a one-time mark-to-market tax under IRC Sec 684 at the participant's death. The tax basis of Plan assets is increased by the amount of taxes paid under IRC Sec 684. The Plan death benefit to beneficiaries receives tax-free treatment. The Plan assets are included in the taxable estate of the participant.

This article focuses introduces the Malta Freeze. The Malta Freeze addresses the problem that all deferred compensation benefits provide to taxpayers. Deferred compensation benefits such as qualified plan, non-qualified, and IRA benefits subject the taxpayer to income and estate taxation on deferred benefits. This tax erosion can dissipate 70-80 percent of the deferred compensation benefits. It has been my experience implementing Malta Pension Plans that many high net worth taxpayers already have ten lifetimes worth of deferred income benefits. Consequently, a significant planning opportunity exists to restructure Plan benefits so that the growth of Plan benefits is controlled or effectively frozen using a Freeze Partnership.

The Plan's assets are typically held in a wholly owned limited partnership or limited liability company within the Plan. The wholly owned investment company within the Plan is reorganized providing preferred and common equity benefits. Following the reorganization, the Plan owns preferred interests. The preferred interests feature a preferred cumulative investment return with a liquidation preference. The preferred interests can be voting or non-voting. The preferred interests can be designed to convert some of the preferred interests into common equity interest.

The excess investment growth associated with the common equity interests above the preferred interests are owned by the taxpayer or even better, a family trust. These common interests provide for investment accumulation outside of the Plan and outside of the participant's taxable estate. These assets may be further structured within a PPLI policy owned within the Trust. The Trust may be structured to provide asset protection and income tax-free benefits for the participant. In summary, the Malta Freeze Partnership may provide tax-deferred benefits within the Plan and income and estate tax-free benefits within the Trust.

Case Study

Joe Smith, age 50, is an investor who has accumulated a substantial investment portfolio over several years. He made several speculative investments that have performed well resulting in initial public offerings. The portfolio has a basis of $2 million and a market value of $20 million. As a resident of California and with personal investment income over $1 million per year, Joe will be in the top bracket for federal and state income tax purposes. The portfolio is owned within Acme, LLC and managed by Joe.

Joe creates a new Malta Pension Plan which is administered by Dominator Fiduciary Services, a Malta pension administrator. The Trust is treated as a foreign grantor trust for U.S. tax purposes. Joe assigns all his interests to the Plan. Prior to the transfer, Joe resigns as Manager of the LLC and appoints his CPA and friend, Mike Jones, as the successor Manager of the LLC.

The Class A units are owned outside of Joe’s taxable estate and beyond the reach of personal creditors.

Following the transfer, Acme is reorganized into a Freeze Partnership. The Plan will exchange its interest for a 90 percent Class B voting, preferred interest which has a par value equal to the contribution. The Class B interest has a par value equal to the initial contribution. The preferred return is cumulative and equal to 3 percent of the par value of the Class B interests. The Class B units have a liquidation preference equal to its par value plus any accrued income.

The Class A member interests are equal to 10 percent of the LLC interests. The Class A units are purchased by the trustee of the Smith. Any investment income more than the Class B members' preferred return will accrue for the Class A members. The Class A units are outside of Joe's taxable estate and beyond the reach of any personal or business creditors.

Conclusion

The Malta Pension Plan has unfairly suffered from the dual maladies of "Not invented Here" and "Too good to be true." Fortunately, it is true! The Malta Freeze maximizes benefits for the high net worth taxpayer providing tax deferred benefits up to a "cap" level and pushing the excess investment growth income and estate tax-free outside of the Malta Pension Plan for the benefit of the participant.