

Circuit Courts Reject Commissioner's Substance Over Form Argument Regarding DISC-Roth Transactions

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In April 2018, the First Circuit rejected the IRS's attempt to recharacterize transactions between a domestic international sales corporation (DISC) and a Roth IRA using the substance-over-form doctrine.¹ This decision is in line with a related Sixth Circuit decision involving the same taxpayers and DISC-Roth transactions.² There is also a third related case pending with the Second Circuit.³ All three cases involve a family that used a DISC in an effort to transfer money from its family business to Roth IRAs owned by the sons. The IRS argued that the substance over form doctrine prevents a taxpayer from using the DISC to circumvent the Roth IRA contribution limits, which would have asserted a 6% excise tax had the sons attempted to contribute the money directly. The taxpayer in the Sixth Circuit case is the family business, while the taxpayers in the First Circuit and Second Circuit cases are the two sons and the father, respectively.

Background

Congress designed DISCs to incentivize companies to export their goods by deferring and lowering taxes on export income. The exporting company pays a commission to the DISC of up to 4% of gross receipts or 50% of net income from qualified exports. The DISC pays no tax on commission income up to \$10 million.⁴ DISCs may be owned by corporations and other entities, including IRAs.⁵ When the DISC distributes money to a corporate shareholder, there is corporate level tax, while a tax-exempt shareholder will pay unrelated business income tax on the distribution.⁶ However, once the distribution is made to a Roth IRA shareholder and the tax on such distribution is paid, the Roth account holder may invest those proceeds tax-free like any other asset of the Roth, and there is also no tax when the assets are distributed up to the account holder at the requisite retirement age.⁷ Additionally, this structure provides a path for high-income taxpayers to utilize Roth accounts who are otherwise prohibited from making direct contributions.⁸

Summa Holdings v. Commissioner

In 2017, the Sixth Circuit rendered its opinion in *Summa Holdings v. Commissioner*. Summa Holdings was the parent corporation of a group of family companies owned by the Benensons. In 2001, the Benenson sons each set up a Roth IRA and made a nominal contribution. The Roths then purchased stock in a newly formed DISC, which they

continued to hold through a holding company. Summa Holdings paid commissions to the DISC that distributed the money up the chain to the Roth. By 2008, each Roth IRA had accumulated more than \$3 million.

The IRS asserted that the substance-over-form doctrine should apply to reclassify the payments as dividends from Summa Holdings up to its shareholders, followed by a contribution into the Roth accounts. Recasted, the transfers would not count as commissions to the DISC, meaning that Summa Holdings would pay income tax on the DISC commissions it had deducted and the holding company would obtain a refund for the corporate income tax it had paid on the dividend from the DISC. The Benenson sons would be ineligible to make Roth contributions since their income was so high and would thus be subject to a 6% excise penalty. The IRS also asserted an accuracy-related penalty on Summa Holdings.

The Tax Court upheld the IRS's recharacterization, but not the accuracy-related penalty. Summa Holdings appealed to the Sixth Circuit, which reversed the Tax Court's decision. In its discussion, the Court emphasizes that Congress designed DISCs to enable exporters to defer corporate income tax. By design they are all form and no substance, since they essentially operate as shell corporations that receive commissions and pay dividends. Similarly, a Roth IRA is designed with the purpose of tax reduction. And Roths are allowed to own DISC shares pursuant to the Code. Since pursuant to tax law, the intended purpose of these structures is tax avoidance and deferral, it cannot be said that the taxpayer followed a "devious path" to avoid the tax consequences of a "straight path." The Court concluded that it was unwilling to use the substance-over-form doctrine to restructure a transaction where the Code sections at play have the sole purpose of tax avoidance. If such results were unintended, it was within Congress' power to correct it.

Benenson v. Commissioner

While *Summa Holdings* was appealed to the Sixth Circuit, the First Circuit heard the sons' cases, since they resided in Boston, Massachusetts. In *Benenson v. Commissioner*, the First Circuit largely aligned its reasoning with the Sixth Circuit's analysis. In its view, both the Roth and the DISC Code sections are tax reduction provisions and as such the transaction does not violate the plain intent of the relevant statutes.

However, the First Circuit also had to distinguish a recent similar Tax Court case that was decided after *Summa Holdings*. In *Mazzei v. Commissioner*, the Tax Court again attempted to apply substance over form to a Roth IRA transaction.⁹ In this case, which involved the use of a foreign sales corporation (FSC) rather than a DISC, the Tax Court examined who had control over the income of the FSC to determine whether dividends were properly attributable to the Mazzeis or to the Roth. Although the taxpayer argued that the Roth purchased the FSC stock and therefore acquired the right to receive dividends, the Court found that the Roths did not have any downside risk nor any upside benefits since the Mazzeis controlled whether the operating company made commission payments to the FSC. As such, the dividends to the Roths were recharacterized as dividends to the taxpayers followed by a contribution to the Roth (which carried with it the 6% excise penalty since such contributions were in excess of the contribution limits). Fortunately for the Benensons, the IRS did not assert this challenge in *Summa Holdings*, so it was not an issue addressed by the First or Sixth Circuits. *Mazzei* is appealable to the Ninth Circuit.

Conclusion

The recent circuit court decisions appear to bless the Roth-DISC transaction structure at least where there is not a challenge to the valuation of the underlying stock and who is considered the appropriate owner of the underlying DISC/FSC stock. Yet, the Tax Court is sticking to its guns that this type of transaction violates substance over form. Time will tell whether the Second Circuit falls in line with the First and Sixth Circuits on the DISC-Roth transactions and whether the Ninth Circuit deviates, given the IRS's new approach regarding the ownership and value of the FSC stock in a FSC-Roth transaction.

¹ *Benenson v. Comm'r*, 887 F.3d 511 (2018).

² *Summa Holdings, Inc. v. Comm'r*, 848 F.3d 779 (2017).

3 *Summa Holdings, Inc. v. Comm’r*, 109 T.C.M. (CCH) 1612 (2015), appeal filed, *Benenson v. Comm’r*, Docket No. 16-2953 (Aug. 19, 2016).
4 Sections 991; 995(b)(1)(E).
5 Sections 246(d); 995(g).
6 Sections 246(d); 511; 995(g).
7 Section 408A(c)(1); (d)(1).
8 Section 408A(c)(3).
9 *Mazzei v. Comm’r*, 150 T.C. No. 7 (Mar. 5, 2018).

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