

FORM REMAINS IMPORTANT: THE SIXTH CIRCUIT REJECTS THE APPLICATION OF SUBSTANCE-OVER-FORM DOCTRINE IN A ROTH IRA CASE

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Taxpayers often find creative ways to avoid taxes. As a consequence, various common law doctrines have developed that permit the IRS to recharacterize transactions for tax purposes, including the substance-over-form doctrine, the economic substance doctrine, and the step transaction doctrine.

Under the economic substance doctrine, courts examine whether transactions had a business purpose beyond achieving tax benefits and whether they had a realistic prospect of generating profits. Recently, [the First Circuit applied the economic substance doctrine to invalidate a foreign tax credit shelter. *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15, 22-24 \(1st Cir. 2016\)](#). The economic substance doctrine is quite flexible, and some judges have expressed concern that it amounts to little more than a smell test: “I can’t help but suspect that the majority’s conclusion . . . is, in its essence, something akin to a ‘smell test.’ If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to ‘put one over.’” *ACM P’ship v. Comm’r*, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J. dissenting).

Last week, the Sixth Circuit considered the substance-over-form doctrine, and refused to apply it to a group of transactions that appeared to comply with the structure of the Internal Revenue Code. [Summa Holdings v. Comm’r](#), No. 16-1712, 2017 U.S. App. LEXIS 2713 (6th Cir. Feb. 16, 2017). The case involved the transfer of funds from businesses owned by the Benenson family to Roth IRAs through a domestic international sales corporation. *Id.* at *2.

A domestic international sales corporation or DISC is a tax-advantaged mechanism designed to stimulate exports. An exporter pays a commission to a DISC, which pays no tax on its income. I.R.C. § 991. The DISC shareholders may receive a deemed distribution that is treated as a dividend under certain circumstances; they may also pay interest on any deferred tax liability. I.R.C. § 995(b)(1), (f). Significantly, “[t]he DISC may be no more than a shell corporation, which performs no functions other than to receive commissions on foreign sales made by its parent.” *Thomas Int’l Ltd. v. United States*, 773 F.2d 300, 301 (Fed. Cir. 1985).

Under a Roth IRA, contributions are non-deductible; the earnings of the IRA, however, are not taxed, and qualified distributions are not taxed. I.R.C. § 408A(a), (c)(1), (d)(1). While there are contribution limits, earnings of assets, such as dividends, are not considered contributions. Although the owner of a Roth IRA that receives dividends from a DISC would need to pay unrelated business income tax at the same rate as a corporation, the dividends received will grow on a tax-free basis; they can be reinvested, and no tax will be due on any associated capital gains. See *Summa Holdings*, 2017 U.S. App. LEXIS 2713 at *6-*7.

Summa Holdings was a corporation that controlled a group of companies engaged in manufacturing. The two largest shareholders were James Benenson, Jr., who owned a 23.18% stake, and a trust established for two of his sons, which held a 76.05% stake. Mr. Benenson and his wife were the trustees for the trust. *Id.* at *7. In 2001, the Benensons established Roth IRAs for the two sons, and the two IRAs purchased shares in a DISC, JC Export. *Id.* These shares were then exchanged for stock in a newly-formed holding company, JC Holding, which became the sole owner of JC Export. Under this structure, the Benenson family arranged for *Summa Holdings* to pay commissions to JC Export, which would distribute that payment to JC Holdings as a dividend. JC Holdings then paid the unrelated business income tax on that dividend and distributed the balance to the Roth IRAs. *Id.* at *8. Between 2002 and 2008, the Roth IRAs received over \$5,000,000 through this mechanism. *Id.*

In 2012, the IRS issued a series of deficiency notices for the 2008 tax year. *Summa Holdings* was advised that the payments to JC Export were being reclassified as dividends to its major shareholders; this meant that its deduction for the commissions paid to the DISC was disallowed. *Id.* at *9. Because the dividends were now deemed to have been paid to the shareholders, the funds that flowed through to the Roth IRAs were treated as contributions; since neither account holder could contribute due to their income levels, the IRS assessed an excise tax of six percent on the contribution. *Id.* The taxpayers challenged the deficiencies before the Tax Court, which sustained the government's position for the most part, although it did reject an accuracy-related penalty that was assessed against *Summa Holdings*.

The Sixth Circuit opened its opinion with a reference to the Emperor Caligula, and, from the government's perspective, things went downhill from there. Concerning the "substance-over-form doctrine," the court observed as follows:

Each word of the "substance-over-form doctrine," at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making [the Code] accessible to the taxpayer and binding on the tax collector is. "Form" is "substance" when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern "over" the written form of the law—and to call it a "doctrine" no less.

Id. at *3.

The Court of Appeals commenced its analysis by noting that each of the transactions involved complied with the requirements of the Code: "Both sides to this dispute . . . agree that these transactions, as consummated, complied in full with the Internal Revenue Code." *Id.* at *10. Turning to the "substance-over-form" doctrine, the court expressed the view that the IRS had taken that doctrine too far:

It's one thing to permit the Commissioner to recharacterize the economic substance of a transaction—to honor the fiscal realities of what taxpayers have done over the form in which they have done it. But it's

quite another to permit the Commissioner to recharacterize the meaning of statutes—to ignore their form, their words, in favor of his perception of their substance.

Id. at *11. Elaborating, the Sixth Circuit observed that the substance-over-form doctrine was properly applied to deal with factual characterizations of taxpayers, observing that a taxpayer “cannot . . . claim that the label he affixes on the transaction precludes it from being ‘income’ under the Code or precludes courts from treating it as ‘income’ under the Code.” *Id.* at *12.

In contrast, the Sixth Circuit considered the Benenson’s transactions to be consistent with Congressional intent. The court noted that Congress had enabled exporters to create DISCs that were shells, thereby reducing their tax liability, and had also designed Roth IRAs for tax reduction purposes. *Id.* at *14. Against that background, the court indicated that the government was essentially asserting that the substance-over-form doctrine allowed the IRS to recharacterize tax-advantaged transactions as their less tax-efficient economic equivalent. *Id.* at *15. In the Sixth Circuit’s view, such an application of the substance-over-form doctrine was inconsistent with the Supreme Court’s focus on the plain language of legislation in statutory construction cases. *Id.* at *17. While acknowledging that it was at times difficult to draw a line between transactions that lack economic substance and transactions that are tax-advantaged in compliance with the Code, the Court of Appeals concluded that “the transactions in this case are clearly on the legitimate side of the line.” *Id.* at *19.

The implications of *Summa Holdings* are difficult to assess. The court’s opinion contains a fair amount of provocative language concerning the IRS’s attempt to apply the substance-over-form doctrine. By the same token, the Sixth Circuit plainly acknowledged that the substance-over-form doctrine and related concepts, such as the economic substance doctrine continue to have a role to play. It will be interesting to see whether this opinion is an influential one or merely an anomaly.



By: **Jim Malone**

Jim Malone is a tax attorney in Philadelphia. A Principal at Post & Schell, he focuses his practice on federal, state and local tax controversies. [Learn more about Post & Schell’s Tax Controversy Practice >>](#)

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