ROTH REDUX: THE TAX COURT AND SUBSTANCE OVER FORM

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Last year, the Sixth Circuit issued an opinion that upheld a taxpayer's use of a domestic international sales corporation ("DISC") to avoid the contribution limits on Roth IRAs. *See Summa Holdings, Inc. v. Comm'r*, 848 F.3d 779 (6th Cir. 2017). There, the shareholders of an existing business set up a DISC, and then sold shares of the DISC to newly-formed Roth IRAs, which subsequently transferred them to a related holding company. 848 F.3d at 783. With that structure in place, over the next six years, the business paid commissions to the DISC, which then paid dividends that ultimately reached the Roth IRAs. As a result, the Roth IRAs, which had been established with a few thousand dollars, quickly grew to $3,000,000. *Id.* at 784. The Sixth Circuit ruled that the arrangements complied with the language of the Internal Revenue Code and that the IRS could not recharacterize them solely because they served to reduce the taxes that might otherwise have been due. *Id.* at 787-90.

Earlier this month, the Tax Court addressed another Roth IRA case, and a divided court held that the IRS had properly recast dividends paid to a foreign sales corporation ("FSC") affiliated with an existing business as excess contributions to a Roth IRA. *Mazzei v. Comm'r*, 150 T.C. No. 7, 2018 U.S. Tax Ct. LEXIS 7 (March 5, 2018). *Summa Holdings* was not controlling in the case because any appeal would be heard in the Ninth Circuit, not the Sixth, but it influenced both the majority and dissenting opinions.

The majority opinion focused primarily on the question whether the Roth IRAs were, in substance, the owners of the FSC stock and concluded that they were not. Although the transaction had been structured as a purchase of shares for $500, an associated shareholders' agreement provided that the price for any subsequent sale would be $1.00. *Mazzei*, 2018 U.S. Tax Ct. LEXIS 7 at *34. The majority derived two conclusions from that fact: First, that the bulk of the $500 "purchase price" was actually a fee payable to the entity that set up the FSC, and second, that the Roth IRAs had negligible risk exposure, giving their purchase of the shares for the nominal amount of $1.00. The majority also saw little opportunity for profit for the Roth IRAs because the related business controlled the extent to which dividends would be paid; in fact, the commission agreement allowed the operating entity to reclaim dividends *after they were paid* to the FSC. *Id.* at *37 & n.38. In the majority's view, "no independent holder of the FSC stock could realistically have expected to receive any benefits (before or after tax) due to its formal ownership of the FSC stock." *Id.* at *37.

The only reason that the transaction made sense was that the taxpayers controlled the operating business and could therefore assure that the FSC received commissions that would ultimately flow through to the Roth IRAs. Given their overall control, along with the limited risk and reward associated with the FSC shares, the majority concluded that the taxpayers were the actual owners of the FSC shares, which meant that the payments that flowed into the Roth IRAs were contributions subject to excise tax, not dividends.

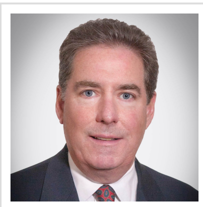
The majority did not ignore *Summa Holdings*; instead, it noted that the Sixth Circuit had only technically addressed whether the commissions paid to the DISC were deductible or were more properly considered dividends paid to its shareholders. *Mazzei*, 2018 U.S. Tax Ct. LEXIS 7 at *40. While literally true, as the individual taxpayers had appealed to different circuits, the fact is that the Sixth Circuit's opinion plainly validated the entire structure at issue in the case. The majority also indicated that there were structural differences between FSCs and DISCs but its discussion of the point was less than compelling; the court quickly shifted back to its core point that the individual taxpayers owned the FSC shares in substance. *Id.* at *40-*41.

There is a spirited dissent from Judge Holmes that rests primarily on the Sixth Circuit's opinion in *Summa Holdings*. In his view, both DISCs and FSCs "aren't meant to do anything except transfer value to get tax benefits." *Mazzei*, 2018 U.S. Tax Ct. LEXIS 7 at *65 (Holmes, J., dissenting). Judge Holmes then largely followed the *Summa* Court's analysis.

When two cases with highly similar facts generate different results, it is worth pausing to consider what is at work. The answer, at least in part, is supplied by a brief concurrence, which simply focuses on the specific facts that supported the majority's conclusion "that in substance petitioners, who retained substantive control throughout all aspects of this transaction, owned the FSC." *Mazzei*, 2018 U.S. Tax Ct. LEXIS 7 at *62 (Paris, J. & Pugh, J. concurring). That focus on the facts suggests that if the transaction had been structured more artfully, it might have been respected.

Another lesson from the case is that *Summa Holdings* should not be read broadly as an indictment of substance over form and economic substance arguments, a point that was apparent from the Sixth Circuit's own opinion and becomes clearer as courts distinguish *Summa*. It is also possible that the approach of the IRS changed after the loss in *Summa*, leading it to focus more on transactional specifics and less on sweeping theories.

The case also emphasizes what we already knew: Cases that involve judicial doctrines such as substance over form are difficult to predict, which is part of what makes them interesting.



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