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Subject: Ed Morrow on *Summa Holdings Inc. v. Commissioner*: 6th Circuit Properly Rejects IRS and Tax Court Substance Over Form Attack on IRAs Owning IC-DISCs, But the IRS Missed the Prohibited Transactions

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It's a welcome and well-reasoned decision that checks an ill-considered expansion of the substance over form doctrine and will likely be quoted often in years to come. That said, the taxpayers should never have gotten away with it. Not because of the trumped up substance over form argument, but because of the prohibited transaction rules staring them in the face.

If followed, the case effectively allows taxpayers with closely held exporting businesses to indirectly contribute via gift to children's (or other relatives or even their own) Roth IRAs and circumvent the requirements that contributions be limited to earned income and phased out for those with higher income. It would raise the de facto Roth IRA contribution limit from a mere $5,500 or $6,500/year to qualifying export income – potentially tens of millions."

In Employee Benefits & Retirement Planning Newsletter #670, **Michael Geeraerts**, **Paul Vecchione** and **Jim Magner** provided members with **LISI**'s first newsletter on *Summa*. Because of the significance of the *Summa* decision, we promised that we would provide members with follow-up commentary on *Summa*, the first by **Ed Morrow** in this newsletter, with **Peter Melcher** and **Grant Keebler** having the final word on *Summa* in a future newsletter.

As **Steve Gorin** recently pointed out in an email to us, *Summa* is actually the IRS' third loss on DISCs. In addition to *Hellweg*, there is *Swanson v. Commissioner* (106 T.C. 76, 1996; formation of DISC by traditional IRA was not a prohibited transaction; taxpayer awarded legal fees because IRS' position wasn't substantially justified), both discussed by Ed in this newsletter. As Steve noted in his email, with *Summa* the IRS thought, "The third time's the charm," but instead the result was, "Three strikes and you're out!"

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Now, here is Ed's commentary:

EXECUTIVE SUMMARY:

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IC-DISCs are a no-brainer for companies who significantly export. Further, Roth IRAs can legitimately own IC-DISCs, which often have outrageous "returns on investment", if you can even use that term in this context. But practitioners, even in the 6th Circuit, should not take this decision as a green light to use Roth IRAs to own IC-DISCs (or other closely held related entities such as captive insurance companies), except in narrow cases, because some day the IRS and courts may wake up and realize they used the wrong weapon to fight this particular battle.

COMMENT:

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IC-DISCs are a no-brainer for companies who significantly export. Further, Roth IRAs can legitimately own IC-DISCs, which often have outrageous "returns on investment", if you can even use that term in this context. This may be done directly, or through a blocker corporation to avoid UBTI. But practitioners, even in the 6th Circuit, should not take this decision as a green light to use Roth IRAs to own IC-DISCs (or captives or other related companies), except in narrow cases, because some day the IRS and courts may wake up and realize they used the wrong weapon to fight this particular battle.

The 6th Circuit opinion provides plenty of useful ammunition to combat abusive IRS allegations of "substance over form" or "sham transaction" that advisors fear may be raised as a last-ditch line of attack against a myriad of planning techniques – from backdoor Roth IRAs to BDITs. It has lessons for investing in self-directed IRAs, blocker corporations, avoiding unrelated business income tax (UBIT), exploiting IC-DISCs, triggering statutes of limitation, assigning income and avoiding gift tax. Perhaps most important, however, it is a great encouragement to defend the proper application of the tax law (even with atrocious facts).

This newsletter will first describe the transaction at issue, then give some explanatory background on the odd but lucrative tax world of IC-DISCs before turning to the tax court decision, the 6th Circuit's reversal and its stunning rebuke of substance over form arguments. Second, we'll explore why prohibited transactions, which were not discussed in this case, should have been the focus of the IRS attack. Third, we'll briefly explore the application of gift tax to such a transaction, which the cases also neglected to discuss. Finally, we'll summarize what we can learn from the case to keep self-directed IRAs qualified and protected from creditors and to legitimately maximize a business owner's use of the IC-DISC tax incentives.

The Transaction (and Legitimately Perceived Abuse) in Question

Summa Holdings Inc. is an Ohio holding company whose subsidiaries manufacture a variety of industrial products. Its two largest shareholders at the time were James Benenson, Jr. (who owned 23.18%) and the James Benenson III and Clement Benenson Trust (which owned 76.05%). James Benenson, Jr. and his wife served as the trustees, and their children, James III and Clement, are the beneficiaries of the Trust.

In 2001, James III and Clement Benenson each established a Roth IRA and contributed $3,500 apiece. Just weeks after they set up their accounts, each Roth IRA paid $1,500 for 1,500 shares of stock in JC Export, Inc. a newly formed corporation that timely and correctly elected to be treated as an IC-DISC. The IRS never challenged the valuation of the shares. To prevent the Roth IRAs from incurring any tax-reporting or shareholder obligations by owning JC Export directly, the Benensons formed another corporation, JC Export Holding, Inc. which purchased the shares of JC Export from the Roth IRAs. From January 31, 2002 to December 31, 2008, each Roth IRA owned a 50% share of JC Export Holding, which was the sole owner of JC Export (the IC-DISC).

Summa Holdings paid commissions to JC Export, which distributed the money as a dividend to JC Holding, its sole shareholder. JC Holding paid a 33% income tax on the dividends, then distributed the balance as a dividend to its shareholders, the Benensons' two Roth IRAs. From 2002 to 2008, the Benensons transferred $5,182,314 from Summa Holdings to the Roth IRAs in this way, including $1,477,028 in 2008. By 2008, each Roth IRA had accumulated over $3.1 million. As we'll see in the next section, this is not at all like someone (or their IRA) investing in the next Facebook or Uber, where the stock grows because of a fortuitous investment – IC DISCs receive commissions because the operating company simply agrees to make a gratuitous transfer.

What's an IC-DISC?

An interest charge domestic international sales corporation (IC-DISC) is a Congressionally-created corporate homunculus whose sole purpose is to promote exports through the tax code. In its most common form, it has no real economic substance, no business purpose aside from tax savings, no profit motive or real risk of loss, no employees, no payroll – it simply processes a payment from the parent operating company, pays a dividend to shareholders, sometimes makes a loan back to the operating company and pays some minimal legal and accounting fees to keep the company active and file tax returns. It's a paper company (if you even have to have paper nowadays), a shell. But that's what Congress intended to create in the tax code.[4]

No one would ever establish an IC-DISC without the tax incentive. Nor, for that matter, would anyone establish a Roth IRA. Both are tools created by Congress to encourage exports and saving for retirement respectively.

A company is allowed to pay a deductible "commission" to an IC-DISC attributable to qualifying exports, which reduces its income (or, for pass through entities, its owners' income via K-1). The IC-DISC, despite having to be a C corporation, does not pay an entity level tax, but dividends eventually paid to shareholders are taxable. Provided the stock is held for the minimal number of days, dividends may be "qualified" and eligible for lower tax rates (0% for lower brackets, 15% for middle brackets, 20% for top bracket, plus 3.8% surtax when MAGI exceeds $200,000/$250,000 single/married filing jointly).[5] C corporations, however, do not receive this lower rate and do not receive the dividends received deduction, so IC-DISCs for closely held C corps are often established as brother/sister rather than subsidiary companies.[6] There is no limit to the tax savings through this arbitrage, other than the qualifying export income of the operating company, despite a slight mischaracterization on this point by the 6th Circuit– there is indeed a $10 million limit but this only pertains to amounts accumulated in the IC-DISC and thus subject to the "interest charge".

Unlike S corporations, for example, there are few restrictions on whom or what kinds of entities can own IC-DISC stock – a Roth IRA is an eligible shareholder, but charities and IRAs may have to pay unrelated business income tax.[7] For more detail about IC-DISCs and how they work, see the presentation appended to this newsletter.

The IRS Argument and Initial Tax Court Decision in Favor of the IRS

In 2012, the IRS issued notices of deficiency to Summa Holdings, the Benensons, and the Benenson Trust for the 2008 tax year (not going back further), arguing that the "substance-over-form" doctrine enabled it to reclassify the payments to JC Export as dividends from Summa Holdings to its major shareholders. As recast, the transfers did not count as deductible commissions from Summa Holdings to JC Export. That meant Summa Holdings had to pay income tax on the DISC commissions it deducted, and JC Holding obtained a refund for the corporate income tax it had paid on its dividend from JC Export. The commissions became dividends to Benenson Jr. and the Trust, all in proportion to their ownership shares. The IRS determined that each Roth IRA received a contribution of $1,119,503. Because James III and Clement both made over $500,000 in 2008, they were not eligible to contribute anything to their Roth IRAs, much less over a million dollars. The IRS imposed a six-percent excise tax penalty on the contributions and a $56,182 accuracy-related penalty on Summa Holdings.

The 6th Circuit Decision

The 6th Circuit’s introduction about substance over form should buoy the spirits of tax professionals who prefer to rely on the law, rather than use a Ouija board to predict how the IRS and courts will interpret a transaction [emphasis added]:

> Caligula posted the tax laws in such fine print and so high that his subjects could not read them. Suetonius, The Twelve Caesars, bk. 4, para. 41 (Robert Graves, trans., 1957). That's not a good idea, we can all agree. How can citizens comply with what they can't see? And how can anyone assess the tax collector's exercise of power in that setting? The Internal Revenue Code improves matters in one sense, as it is accessible to everyone with the time and patience to pore over its provisions.

> In today's case, however, the Commissioner of the Internal Revenue Service denied relief to a set of taxpayers who complied in full with the printed and accessible words of the tax laws. The Benenson family, to its good fortune, had the time and patience (and money) to understand how a complex set of tax provisions could lower its taxes. Tax attorneys advised the family to use a congressionally innovated corporation—a "domestic international sales corporation" (DISC) to be exact—to transfer money from their family-owned company to their sons' Roth Individual Retirement Accounts. When the family did just that, the Commissioner balked. He acknowledged that the family had complied with the relevant provisions. And he acknowledged that the purpose of the relevant provisions was to lower taxes. But he reasoned that the effect of these transactions was to evade the contribution limits on Roth IRAs and applied the "substance-over-form doctrine," to recharacterize the transactions as dividends from Summa Holdings to the Benensons followed by excess Roth IRA contributions. The Tax Court upheld the Commissioner's determination.
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> **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 these terms 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.**
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> As it turns out, the Commissioner does not have such sweeping authority. And neither do we. Because Summa Holdings used the DISC and Roth IRAs for their congressionally sanctioned purposes—tax avoidance—the Commissioner had no basis for recharacterizing the transactions and no basis for recharacterizing the law's application to them. We reverse.

As to the IRS' allegations that the transaction had no economic substance, the 6th Circuit rightfully retorted that “By congressional design, DISCs are all form and no substance, making it inappropriate to tag Summa Holdings with a substance-over-form complaint with respect to its use of DISCs." As to the IRS allegations that Congress did not intend such a terrible tax policy, the court admitted that,

> …permitting these DISC—Roth IRA arrangements amounts to dubious tax policy. But the substance-over-form doctrine does not give the Commissioner a warrant to search through the Internal Revenue Code and correct whatever oversights Congress happens to make or redo any policy missteps the legislature happens to take. Congress created the DISC and empowered it to engage in purely formal transactions for the purpose of lowering taxes. And Congress established Roth IRAs and their authority to own shares in corporations (including DISCs) for the purpose of lowering taxes. That these laws allow taxpayers to sidestep the Roth IRA contribution limits may be an unintended consequence of Congress's legislative actions, but it is a text-driven consequence no less.

We can't ask for a more taxpayer-friendly characterization of the substance over form doctrine than this.

Might the IRS Soon Be Dealt a Second Blow?

The 6th Circuit Summa Holding decision dealt with case law developed around "substance over form." It did not address IRC §7701(o), which recently codified the economic substance doctrine (the transactions occurred prior to the effective date of the provision - March 30, 2010).[8] This codification was part of all the Affordable Care Act legislation, which Republicans are currently chomping at the bit to repeal. Query whether Congress will repeal §7701(o) as well.

Prohibited Transactions and Taxable Gifts – What the IRS, Tax Court and 6th Circuit *Should Have Been* Analyzing

Neither the tax court nor the 6th Circuit decision discussed prohibited transactions, other than the tax court's brief reference to the Hellweg case, which we'll discuss shortly. Yet it is crucial to address here, lest we take dangerously misleading lessons from the case. Prohibited transaction rules are set out in two (mostly) similar and overlapping sections of the law – the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code ("IRC").[9] This newsletter will mostly discuss the latter, since this case involved IRAs not governed by ERISA.[10]

IRC §4975 imposes a penalty tax on "disqualified persons" engaged in specified transactions with qualified plans, IRAs and similar accounts. If timely corrected within the taxable period, the tax is 15% for each year.[11] If not timely corrected, the tax becomes confiscatory, similar to UBIT on CRTs – it's 100% (no, that is not a typo).[12] The IRS may assess the tax not only against the owner, but any disqualified person involved as a party in the transaction (with exceptions for fiduciaries acting only as such).[13] So, this could extend to a corporation such as Summa Holding Inc. that might be involved in a transaction, not just the owner of the IRA.

For most prohibited transactions involving IRAs, IRC §4975(c)(3) will exempt an IRA owner from the 15%/100% tax, although the tax exemption (usually along with the creditor and bankruptcy exemption in most states) and the account's status as an IRA is lost as of the first day of the taxable year of the initial transaction, so this disqualification is usually "in lieu" of the 15%/100% penalty that might apply to other retirement plans.[14]

Although there is no provision in the Internal Revenue Code that defines permissible investments,[15] IRC §4975(c)(1) defines and addresses what is a prohibited transaction and includes [emphasis added]:[16]

> **(A) sale or exchange, or leasing, of any property between a plan [note: a "plan" includes an IRA][17] and a disqualified person**;
> (B) lending of money or other extension of credit between a plan and a disqualified person;
> **(C) furnishing of goods, services, or facilities between a plan and a disqualified person**;
> (D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
> (E) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or

> (F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.(emphasis added)

“Disqualified persons” includes fiduciaries, such as the IRA owner or custodian (e.g. the Benenson children) but including board members of the IC-DISC that have discretionary authority over investments of the IRA (the Benenson children and their father),[18] any family member,[19] a corporation owned 50% or more by a fiduciary, directly or indirectly (Summa Holdings Inc., since it is owned by the father and the children’s irrevocable trust),[20] certain officers and directors of companies (such as JC Export, JC Holding, Summa Holding).

These actions are “prohibited” under § 4975 regardless of whether they are prudent investments.[21] With the above in mind, let’s revisit what the Berensons did in this transaction:

1. Each Roth IRA paid $1,500 for 1,500 shares of stock in JC Export, a newly formed IC-DISC.
2. They formed another corporation, JC Holding, Inc. which purchased the shares of JC Export from the Roth IRAs. The 6th Circuit implies that this was done by the Benensons but the tax court decision states that it was formed by the Benensons’ IRAs directly.
3. The Benensons served on the board of directors for JC Export and JC Holdings along with another party, with their father added to one board. Thus, they decided when dividends would be paid from JC Export to JC Holding as its sole shareholder, and when dividends would be paid from JC Holding to the two IRAs as its only shareholders.
4. Summa Holdings pays millions in commissions from 2002-2008 to JC Export, Inc., the IC-DISC. It is unclear from the record when (or if) the parent company, Summa Holdings, Inc., contracted with JC Export. Usually practitioners execute a simple contract known as a commission agreement between the operating company and the IC-DISC, which establishes that the IC-DISC is entitled to a commission on the operating company’s qualified export receipts.

Regarding steps 1 and 2 above, while there is a slim possibility of there being a prohibited transaction due to unclear facts, these steps are probably **not** an issue. Self-directed IRAs can safely establish and form a corporation, and that corporation can in turn have a subsidiary. Provided they did not fund the corporation personally and then have their IRAs buy it from them (or engage in loans, take a salary from the corporations, etc.), but had the IRA custodian engage in these subscriptions and incorporations directly, this would not be a prohibited transaction.[22]

Regarding step 3 above, the fact that the Benenson children and their father were on the board of directors is ordinarily a yellow flag. If a disqualified person furnishes services to an IRA it can be a prohibited transaction.[23] Taking any stipend, salary or bonus from the corporation certainly would be.[24] However, it's unlikely any services were furnished by the Benensons here, other than the ministerial hiring of an attorney and/or accountant to do the tax return or Delaware Secretary of State filing, and it's unlikely the Berenson children or their father took any payment for service. There was no active business at all – it's not like the expertise and valuable efforts of the board somehow led to the success of the IC-DISC – payments to it were purely voluntary on the part of the parent company. The companies and the family board members are clearly disqualified persons, but it does yet not follow that simply serving on a board and paying a dividend to shareholders is a prohibited transaction, since the dividends would benefit the IRA owner, as they should.[25]

It's this last step #4 that is problematic and provides the most intriguing question that somehow failed to interest the IRS or courts – the commission agreement between the operating company and the IC-DISC and more importantly the payments from the operating company to the IC-DISC. It is essentially an exchange or, more likely, a "furnishing of goods" by the operating company, Summa Holdings, Inc., which is a disqualified person as to the Benensons' IRAs, to the IRAs, albeit indirectly through the IC-DISC, JC Export, and blocker holding company, JC Holdings, which are also disqualified persons.[26]

But most of the prohibited transaction rules (including subparagraphs A and C bolded above, which would be the most likely to apply here) involve dealings between the plan [IRA] and a disqualified person, not two disqualified persons. This begs the question – can we simply get around most of the prohibited transaction rules (not to mention IRA restrictions on investing in life insurance and collectibles and loan dealings) by establishing and inserting a blocker corporation owned by an IRA, which can then engage in whatever investments and transactions it wants to with other disqualified persons? Did Congress mean to prohibit such transactions, but only unless someone pays $100 to set up a corporation to get around them? Such an interpretation would render all these rules meaningless, just as applying substance over form or economic substance doctrine in broad fashion would render IC-DISCs a nullity. Moreover, such an interpretation has a much greater danger for abuse, because, while IC-DISCs are an increasing but still relatively small part of the economy (only 1,209 returns filed in 2006, with only $1.7 billion income in 2006, rising to 3,922 returns filed in 2012 with $6.7 billion income in 2012),[27] IRAs are over $7.8 *trillion*.[28]

Make no mistake – what the IRS and courts is missing here goes well beyond the rarefied world of IC-DISCs. Imagine a very similar scenario without an IC-DISC, but the Benenson's father simply gifted $6 million into a corporation owned by the Benenson children's Roth IRA. We should not have to resort to "substance over form" here, when it's clear that Congress intended prohibited transaction rules to apply here, even though technically this transaction is not between a disqualified person and a plan, it's between two disqualified persons.

This is quite a different question from the initial IRS and tax court argument that sought to disregard a transaction because it had no economic substance aside from tax savings, when that's exactly what Congress intended by establishing Roth IRAs and IC-DISCs. If, reader, you or I caused our Roth IRA to buy a 5% share of Summa Holdings and its IC-DISC, whether through a blocker corporation or not, there should be no assignment of income, substance over form, or prohibited transaction. But *Summa Holdings* did not involve unrelated parties.

While it's obvious that Congress intended to override assignment of income, economic substance and inter-company pricing principals by establishing IC-DISCs, there is no indication it intended to override gift tax and prohibited transaction law.

But a “plan” does not act, nor does an “IRA”. It is the fiduciary who acts on behalf of a plan or IRA. So we must ask: who are the fiduciaries to the Benensons’ Roth IRAs? Is it only the Benensons or does it include their Roth IRAs’ wholly owned subsidiaries? “Fiduciaries” specifically include any person who--

> (A) exercises any discretionary authority or discretionary control respecting management of such plan **or exercises any authority or control respecting management or disposition of its assets.**[29] (emphasis added)

Regulations can shed a bit more light on the above in regards to IRA-owned entities such as JC Export and JC Holding. The two regulations below are from Title 29, issued by the Department of Labor (“DOL”), which has co-jurisdiction with the IRS in policing prohibited transactions. The term “party in interest” is used in place of “disqualified persons” – this is just the language used in the ERISA parallel to §4975 mentioned earlier.

> 29 CFR § 2510.3-101 **Definition of "plan assets" -- plan investments.**
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> (a) In general. (1) This section describes what constitute assets of a plan with respect to a plan's investment in another entity for purposes of subtitle A, and parts 1 and 4 of subtitle B, of title I of the Act [ERISA, which includes prohibited transactions under 29 U.S.C. §1106, the analog to IRC §4975] **and section 4975 of the Internal Revenue Code [prohibited transactions].**
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> ***
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> (2) Generally, when a plan invests in another entity, the plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity. **However, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 its assets include both the equity interest and an undivided interest in each of the underlying assets of the entity,** unless it is established that--

(i) The entity is an operating company, or
(ii) Equity participation in the entity by benefit plan investors is not significant.

Therefore, any person who exercises authority or control respecting the management or disposition of such underlying assets, and any person who provides investment advice with respect to such assets for a fee (direct or indirect), **is a fiduciary of the investing plan.**

29 CFR §2509.75-2 **Interpretive bulletin relating to prohibited transactions.**

On November 13, 1986 the Department published a final regulation dealing with the definition of "plan assets". See § 2510.3-101 of this title. Under that regulation, **the assets of certain entities in which plans invest would include "plan assets" for purposes of the fiduciary responsibility provisions of the Act.**

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Moreover, notwithstanding the foregoing, if a transaction between a party in interest and a plan would be a prohibited transaction, then such a transaction between a party in interest and such corporation or partnership will ordinarily be a prohibited transaction if the plan may, by itself, require the corporation or partnership to engage in such transaction.

Similarly, if a transaction between a party in interest and a plan would be a prohibited transaction, then such a transaction between a party in interest and such corporation or partnership will ordinarily be a prohibited transaction if such party in interest, together with one or more persons who are parties in interest by reason of such persons' relationship (within the meaning of section 3(14)(E) through (I)) [author note: this refers to 29 U.S.C. § 1002(14)(E-I), which is the ERISA analog to the IRC §4975(e)(2) definition of disqualified persons] **to such party in interest may, with the aid of the plan but without the aid of any other persons, require the corporation or partnership to engage in such a transaction.** However, the

> preceding sentence does not apply if the parties in interest engaging in the transaction, together with one or more persons who are parties in interest by reason of such persons' relationship (within the meaning of section 3(14)(E) through (I)) to such party in interest, may, by themselves, require the corporation or partnership to engage in the transaction. (emphasis added)

An IC-DISC and holding company are hardly "operating companies", and equity had nothing to do with how much in commissions the IRA received through the two companies. Thus, you can't simply use controlled companies to get around prohibited transaction rules – normally in situations like this the wholly owned companies are going to be considered plan fiduciaries themselves.

Curiously, the IRS had consulted with the DOL and had foreseen this possibility when it added similar transactions to its Listed Transactions in Notice 2004-8, but two adverse cases in particular, Swanson and Hellweg, may have caused them to learn the wrong lesson and use the wrong weapon in this battle. Let's explore a few pertinent cases:

In Swanson v. Comm'r, we have a very odd case for precedent. The tax court was merely reviewing a case in which the IRS had caved in for a later determination of an award of attorney fees. Not only did the taxpayer establish an IC-DISC with his IRA, but he also established a Foreign Sales Corporation with another IRA. The tax court did not find it to be a reasonable litigating position that the IRA owner committed a prohibited transaction when he had his IRA establish and purchase stock in an IC-DISC and cause the IC-DISC to pay dividends to it.[30] Swanson was correct on that portion of the transactoin – it is quite a common self-directed IRA transaction. The mere establishment of a corporation or LLC should not be a prohibited transaction, nor should causing such a corporation or LLC to pay dividends to its IRA owner be a problem (it would be more problematic if it didn't). The Swanson decision did not address or question, however, whether the commission agreement and payments from the operating company to the IC-DISC could be a prohibited transaction. In short, the IRS in Swanson sought to penalize the legitimate part of the transaction and the tax court held them to task for an unreasonable litigating position and awarded attorney fees for 166 hours of time. It is easy to misread this case as a wholesale blessing of the structure and one can see why the IRS subsequently sought other means to attack IC-DISC/Roth IRA structures.

In Ellis v. Comm'r, the tax court held that when an IRA established an LLC, the LLC was a “disqualified person” but the mere incorporation and investment was not a prohibited transaction. However, the LLC later paying the IRA owner $9,754 in compensation was a prohibited transaction,for reasons similar to the rationale stated herein, but coming under §4975(c)(1)(D) and (F) since it was a direct payment to a disqualified person.[31] The Ellis court got the analysis correct.

In Hellweg v. Comm’r, the IRS tried to use an economic substance and assignment of income arguments to attack an IRA owning an IC-DISC structure, claiming it could not get around the excise tax on excess contributions to an IRA. The tax court found that the assignment of income and inter-company pricing issues were overridden and governed by the IC-DISC rules established by Congress and therefore the commission was not a contribution to the IRA for excise tax purposes.[32] This was basically echoing a prior IRS TAM holding.[33] Hellweg was properly decided on this narrow issue raised, just as Swanson, but it did not address any prohibited transaction arguments, merely citing to the Swanson case for the reason that this was not addressed.

In Ohsman v. Comm'r, a Roth IRA owner had established a foreign service corporation (a similar structure to IC-DISCs later repealed).[34] Following Hellweg, the tax court found that the commission payments did not cause excess Roth IRA contribution. The tax court rebuked the IRS for a “substance over form” argument and the decision did not even discuss prohibited transactions.

Thus, while the taxpayers have some significant case law backing up the transactions, none of these cases have truly addressed the most important issue and the reliance on their holdings should not be taken as gospel on the entire transaction.

Statute of Limitations on Prohibited Transactions; Importance of IRS Form 5329 and Form 5330; Differing Penalties for IRAs (Usually)

Experts in this area have long recommended prophylactically filing IRS Form 5329 to start the statute of limitations running against imposition of the 50% excise tax for failure to take IRA required minimum distributions or the 6% excise tax on excess IRA contributions (the latter being an issue in this case).[35] Perhaps the same can be said for filing Form 5330 for any retirement plan owner (or other parties) who engages in "unique" and potentially "prohibited" transactions such as this. IRS Form 5330 is the form on which to report prohibited transactions.[36] Generally, for the statute of limitations to run against the IRS the appropriate tax return must be filed.[37] As of the date of the tax court decision at least, the taxpayers in *Summa Holdings* had not yet filed Form 5329, and both decisions were silent regarding the filing of Form 5330 by any party – presumably they did not.[38]

If the IRA owner or beneficiary engages in a prohibited transaction, the IRA is disqualified as of the beginning of the tax year.[39] But it's not clear that the IRA owners in this case (each of the Benenson children) directly engaged in the prohibited transaction here. The transaction that should have been prohibited was the transaction between Summa Holdings, Inc. and JC Export Holding, Inc., not the initial funding/establishment of the IC-DISC by the IRA owner. While both are disqualified persons and the latter is also a fiduciary of the plan, they are *not* the IRA owner, though ultimately a court may find the owner acted through his participation on the company's board or otherwise. Unlike the prohibited transaction statute and regulations quoted above which speak to actions by and through a *disqualified person*, the statute under which an IRA is disqualified rather than be subject to the 15%/100% tax penalty requires action by the "individual" owner, with no mention of disqualified persons or fiduciaries.[40] When a disqualified person other than the IRA owner commits a prohibited transaction, the 15% per year/100% tax scheme of IRC §4975 applies in lieu of disqualification.[41] The liability for this tax is not duplicative when multiple parties are involved, but joint and several.[42] Although the DOL has to be notified, a determination by the DOL is not necessary for the IRS to proceed and assess tax.[43]

Penalties can be much nastier still if a court finds the transactions to be unreported listed transactions, some of which occurred after IRS Notice 2004-8. Such penalties can be up to $100,000 for individuals and $200,000 for corporations, per transaction.[44] It is unclear from the cases whether this reporting was done.

Gift Tax Ramifications

As if the ramifications of prohibited transactions were not bad enough, it's highly unlikely that the IC-DISC rules override the gift tax rules. One PLR stated "we believe that DISC rules, requiring that the substance of the transaction be disregarded for income tax purposes, do not affect the characterization of the transaction for gift tax purposes."[45] The IRS subsequently issued a revenue ruling to this effect, explaining that DISC payments are not in the ordinary course of business and are gratuitous without any consideration received and that, while Congress overrode assignment of income tax concepts, payments to a DISC (if the ownership is different from Parent Co.) are still taxable gifts.[46]

Thus, while it is not discussed in either the tax court or the appellate case, the $6 million or so in commission payments during the period in question were potentially taxable gifts. In this case, however, a portion of the gift may have come from the IRA owners themselves. When someone gifts through a corporation (or LLC, trust, etc.) to another corporation, as here, the equitable ownership of each determines the donor and donee of the gift. Thus, if the father owns 23.18% of the company which makes a gratuitous transfer of $6 million, the taxable gift should be $1,390,080, which would probably not qualify for the annual exclusion due to the fettered access by the children through the multiple structures. Since the siblings were also apparently equitable owners of the corporation through their trusts which owned 76.05% of Summa Holdings, there may also be some cross-gift on their part, but any portion deemed coming from themselves to themselves should of course be excluded from being a taxable gift. The gift tax consequences of this portion of the transfer is more complicated to assess, since we do not have details from the case on the nature of the trust.

Conclusion

The 6th Circuit came to the right decision, with a heartening vim and vigor, on the substance over form argument, but the parties missed the main problematic feature of the Roth IRA/IC-DISC transactions – the prohibited transaction rules (not to mention the gift tax). Many accounting and law firms have advocated the related party Roth IRA/IC-DISC structure (and others, such as private placement life insurance holding DISCs or Roth IRAs owning captive insurance companies) even before the Summa Holdings case. This use may understandably explode as a result of this case and the press it has already gotten and is sure to receive.[47]

Resist the urge to follow this trend, even if case law thus far is positive. IC-DISCs and Roth IRAs are great tax planning tools. IC-DISCs can not only reduce tax on export income, but legitimately be used to shift income that would ordinarily be an assignment of income. In rare instances, IC-DISCs and Roth IRAs can even go together legitimately, but many cases will involve related parties and prohibited transactions. Don't assume that your client can have their IRA engage in prohibited transactions by simply establishing a controlled corporate entity to do so.

Treasury should focus its efforts on implementing and interpreting the code and regulations already governing this area, rather than sprinkling "substance over form" pixie dust to make their cases fly.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Ed Morrow

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[1] *Summa Holdings, Inc. v. Comm'r*, T.C. Memo. 2015-119, available at http://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=1009.

[2] *Summa Holdings, Inc. v. Comm'r*, 2017 U.S. App. LEXIS 2713 (6th Cir. Feb. 16, 2017). The appeals for the two sons were held in abeyance in the First and Second Circuit pending resolution of the 6th Circuit case.

[3] These normal IRA contribution limits are in IRC §219(b)(5). More might be contributed indirectly by establishing/funding a qualified plan or SEP/SIMPLE IRA and then converting to a Roth IRA, but these have their own caps and SIMPLE IRAs have a special two year rule. How the limits for qualifying IC-DISC commissions are calculated is discussed later in this article and the attached presentation, but there is no dollar cap on commissions. In the last year IRS statistics are available (2012), the 136 largest IC-DISCs reported $4.7 billion in qualified export receipts (which are usually close to commissions received), averaging about $34 million, but a portion of these are probably widely held corporations that would find it practically difficult to use the Roth IRA strategy. https://www.irs.gov/uac/soi-tax-stats-fscs-ic-discs

[4] IRC §991 et seq. It is often still referred, even in the *Summa* opinion, as simply a DISC, but the "interest-charge" component was added in 1984 by Congress in response to potential arguments by WTO/GATT of unfair tax subsidy. The tax rate arbitrage did not occur until 2003 with the Bush tax cuts on qualified dividends, so it was initially seen as more of a tax deferral mechanism than a reduction in tax rate.

[5] IRC §1(h).

[6] IRC §246(d).

[7] IRC §993(g).

[8] It's hard to see how IC-DISCs would be allowed *at all* if IRC §7701(o) were followed, since they have no economic substance or business purpose other than tax savings. Courts should assume Congress did not mean to repeal IC-DISCs.

[9] IRC §4975, 29 U.S.C. §1106 (ERISA §406).

[10] This was not a SEP or SIMPLE IRA, which are employer sponsored plans subject to ERISA, but which are not afforded creditor/anti-alienation protection under ERISA §4(b) and §201.

[11] IRC §4975(a).

[12] IRC §4975(b).

[13] IRC §4975(a) and (b).

[14] IRC § 4973(c)(3), IRC § 408(e)(2). For a 50 state chart with hyperlinks to state statutes such as Ohio, Illinois or Florida that may keep protections for IRAs that lose their tax qualification, see *Ed Morrow's 50 State Exemption Chart on IRAs, Non-ERISA 403(b) Plans & Roth Variants*, LISI Asset Protection Planning Newsletter #256, (August 7, 2014)

[15] Although IRAs are prohibited from owning insurance and collectibles per IRC §408(a)(3) and §408(m).

[16] IRC §4975(c)(1)(A) and (C).

[17] IRC §4975(e)(1)(A). While this code section only mentions "an individual retirement account described in section 408(a)" and does not mention Roth IRAs which are under section 408A, IRC §408A(a) provides that "Except as provided in this section, a Roth IRA shall be treated for purposes of this title [Title 26, which would include §4975] in the same manner as an individual retirement plan." IRC § 7701(a)(37) of the Code defines the term "individual retirement plan" to mean: (A) an individual retirement account described in section 408(a)". So, don't think you can avoid PTs with Roth IRAs just because they're not explicitly mentioned in §4975. Congress intended them to be included.

[18] IRC §4975(e)(2)(A) and §4975(e)(3)(A).

[19] IRC §4975(e)(2)(F) and §4975(e)(6).

[20] IRC §4975(e)(2)(G).

[21] *Leib v. Commissioner*, 88 T.C. 1474 (T.C. 1987), *Rollins v. Comm'r*, T.C. Memo 2004-260 (T.C. 2004).

[22] E.g., *Ellis v. Comm'r*, T.C. Memo 2013-245 aff'd 787 F.3d 1213 (8th Cir. 2015); *Swanson v. Commissioner*, 106 T.C. 76 (T.C. 1996), the mere funding of a newly incorporated business by an IRA is not a prohibited transaction; *In re Nolte*, 2015 Bankr. LEXIS 1524 (Bankr. E.D. Va. 2015), investing in a closely held LLC not a prohibited transaction.

[23] IRC §4975(c)(1)(C).

[24] E.g., *Ellis*, fn 22, discussed later in the paper.

[25] *Swanson v. Commissioner*, 106 T.C. 76 (T.C. 1996) held that when an IRA owner who served on a board of an IC-DISC owned by the IRA caused it to pay a dividend to an IRA, this was not a prohibited transaction. The IRS in the *Swanson* case missed an important argument, however, that will be discussed later in this article.

[26] IRC §4975(e)(2)(G) defines corporate disqualified persons as "a person who is--

(A) a fiduciary;

***

(G) a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of--

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership, or

(iii) the beneficial interest of such trust or estate,

is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

****

(3) Fiduciary. For purposes of this section, the term "fiduciary" means any person who--

(A) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,

***

[27] See the IRS Tax Stats at https://www.irs.gov/uac/soi-tax-stats-fscs-ic-discs

[28] Source: ICI, at https://www.ici.org/research/stats/retirement/ret_16_q3

[29] IRC § 4975(f)(1)

[30] *Swanson v. Comm'r*, 106 T.C. 76 (T.C. 1996)

[31] *Ellis v. Comm'r*, T.C. Memo 2013-245 (T.C. 2013)

[32] *Hellweg v. Comm'r*, T.C. Memo 2011-58

[33] IRS TAM 8136005.

[34] Ohsman v. Comm'r, T.C. Memo 2011-98 (T.C. 2011)

[35] *The Care and Feeding of Large IRAs*, Trusts and Estates, December 2016, by Warren Baker and Natalie Choate.

[36] See lines 3-4 and Schedule C on IRS Form 5330 at https://www.irs.gov/pub/irs-access/f5330_accessible.pdf.

[37] IRC §6501(a), (c)(3), *Paschall v. Comm'r*, 137 T.C. 8 (T.C. 2011).

[38] *Summa Holdings, Inc. v. Comm'r*, T.C. Memo. 2015-119, at pages 8-9.

[39] IRC § 408(e)(2)(A), Treas. Reg. §1.408-1(c)(2)

[40] IRC § 408(e)(2)(A): "(2) Loss of exemption of account where employee engages in prohibited transaction
(A) In general If, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or his beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year."

[41] Treas. Reg. §1.408-1(c)(3)

[42] IRC § 4975(f)(1).

[43] IRC §4975(h) requires the IRS to give the DOL the opportunity to comment prior to sending a notice of tax deficiency for any 15%/100% tax under §4975(a) or (b) (but not IRA disqualification, which is under (c)), but any DOL decision to proceed or not is irrelevant to any tax determination. *O'Malley v. Commissioner of IRS*, 972 F.2d 150, 154 (7th Cir. 1992), *Baizer v. Commissioner*, 204 F.3d 1231 (9th Cir. 2000).

[44] See IRS Form 8886 and instructions and IRC §6607A.

[45] PLR 8130620.

[46] Rev. Rul. 81-54.

[47] E.g. *The Secret to Avoiding Taxes on $6 Million: Exports and an IRA,* by Laura Saunders, Wall Street Journal, Feb 24, 2017