Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter Archive Message #670

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Subject: Michael Geeraerts, Paul Vecchione & Jim Magner on *Summa Holdings v. Commissioner*: IRS Often Argues Substance-Over-Form, But Sometimes Form Is Substance

“Tax practitioners are familiar with the substance-over-form doctrine and the IRS’s zeal to try to apply it whenever possible. However, as the Sixth Circuit eloquently held in Summa Holdings, there are sections of the Code and certain transactions that require form-over-substance. Domestic International Sales Corporations (DISCs) are one area of the Code that are clearly form-over-substance, thus, the Sixth Circuit held that it was not appropriate for the IRS to argue substance-over-form when DISCs are all form and no substance. The benefit of creating a DISC is to lower an export company’s taxes on export income, which is a way that Congress incentivizes United States companies to export their goods.

The way DISCs work is that an export company will pay a deductible commission to the DISC, which is not subject to income taxes. The DISC pays dividends to its shareholders, who are taxed at the long-term capital gain tax rate on qualified dividends. The end result is that the owners of the export company get to deduct the commissions, possibly at a marginal income tax rate of 39.6%, and receive that same money as a dividend taxed at 15% or 20%. DISCs do not even need to have employees or offices and do not have to negotiate sales. Tax savings seems to be the driving force. This is what Congress enacted and is all form and no substance.

Individual retirement accounts are also congressionally sanctioned tax-savings vehicles. Combining DISCs with Roth IRAs, as was done in Summa Holdings, can be a very powerful tax-savings play, which of course the IRS does not like. Nonetheless, the Code is what it is, and the IRS cannot obvert the text of the statutes to get to a conclusion it desires, especially when Congress blessed certain transactions knowing they are really more form than substance.”

In their commentary, **Michael Geeraerts**, **Paul Vecchione** and **Jim Magner** discuss *Summa Holdings* and how the IRS was unsuccessful in claiming that a series of transactions where a DISC was purchased by two Roth IRAs ran afoul of the substance-over-form doctrine. As the Sixth Circuit pointed out in *Summa*, certain transactions are blessed by Congress and the Code's text as form-over-substance. Because of the significance of the *Summa* decision, **LISI** will provide members with follow-up newsletters on *Summa*, the first by **Ed Morrow**, with **Peter Melcher** and **Grant Keebler** having the final word.

Michael Geeraerts, CPA, JD, CGMA®, CLU® is an advanced planning consultant at **The Guardian Life Insurance Company of America**.[i] Prior to joining Guardian, Michael was a manager at PricewaterhouseCoopers LLP and a tax consultant at KPMG LLP. Michael's experiences range from preparing tax returns for middle market companies, auditing billion dollar mutual funds' financial statements, to researching unique tax savings strategies for various companies. Michael has written articles for numerous national publications and has delivered continuing education courses to CPAs and attorneys on a variety of estate, business and income tax planning strategies.

Paul Vecchione is a **Partner** of **EisnerAmper Insurance & Financial Services, LLC** and head of their succession planning practice. For more than a decade Paul has specialized in both personal and corporate financial engineering. Paul's areas of concentration are pension and retirement planning, executive benefits and estate & succession planning. As a Partner of the firm, Paul has assisted in transitioning several clients' closely held businesses, and has guided CEOs and Human Resource Directors through the maze of corporate and employee benefit planning, handling the most complex issues and budgetary concerns. Paul has chaired AALU's Qualified Plans Committee for three years, and is a member of AALU's Business Insurance and Estate Planning Committee. EisnerAmper is one of the largest accounting firms in the nation with nearly 1,300 employees, including 180 partners. The firm offers responsive accounting, tax and consulting services with an entrepreneurial focus, providing clients with smart, analytical insights delivered in an approachable style.

Jim Magner is an advanced planning attorney at **The Guardian Life Insurance Company of America**. Prior to joining Guardian, Jim was General Counsel for a national broker dealer/brokerage general agency. Jim previously worked as an Attorney-Advisor in the IRS's Office of Chief Counsel, in Washington, DC. While with the Office of Chief Counsel, Jim wrote private and public rulings on estate, gift, GST and charitable remainder trust issues. Jim's articles have appeared in such publications as Estate Planning, Tax Notes, the Journal of Financial Service Professionals and Steve Leimberg's newsletters. Jim has coauthored a number of books on estate and insurance planning topics, including Estate and Personal Financial Planning and Tools & Techniques of Life Settlement Planning.

Here is their commentary:

EXECUTIVE SUMMARY:

Congress passed the DISC laws to incentivize United States companies to export their goods by allowing them to defer and lower their income taxes on export income. The export company avoids income tax by paying the DISC "commissions" of up to 4% of gross receipts or 50% of net income from qualified exports and the DISC pays no income tax on the commissions. The DISC's shareholders can defer the income tax attributable to $10 million or less of qualified export receipts, subject to an interest charge. The DISC may distribute money and other assets to its shareholders as dividends, which are eligible for qualified dividend tax treatment – individuals pay tax on qualified dividends at their long-term capital gain tax rate.

Roth IRAs allow taxpayers to contribute after-tax dollars to the account and take tax-free qualified distributions, allowing for the account to grow tax-free. Both traditional IRAs and Roth IRAs may own shares in DISCs and there was a time when IRA owners paid nothing on DISC dividends, enabling owners of export companies to shield business income from taxation by assigning DISC shares to IRAs. Congress closed this gap in 1989 and required tax-exempt entities to pay an unrelated business income tax on DISC dividends, making it less attractive for IRAs to own shares in a DISC, especially traditional IRAs due to distributions being subject to ordinary income taxes.

However, owning DISC shares in a Roth IRA is not the same as a traditional IRA because of the way the Roth IRA works. While the Roth IRA account owner would have to pay unrelated business income tax on DISC dividends received by the IRA, the dividends could be invested freely – all tax-deferred and possibly tax-free when distributed. With a traditional IRA, the money would grow tax-deferred but definitely not tax-free when distributed.

Summa Holdings dealt with two individuals' Roth IRAs owning, through a holding company, shares in a DISC that their family's export company paid commissions to. The individuals' modified adjusted gross incomes were above the threshold for being able to make contributions to a Roth IRA in the years the DISC paid dividends. The IRS viewed the series of transactions—the DISC was created and each of the individuals' Roth IRAs purchased, for $1,500 each, 50% of the shares in the DISC—as a circumvention of the rules, relying on the substance-over-form doctrine. The Tax Court agreed with the IRS, however, the Sixth Circuit reversed and made clear that some Code sections are form-over-substance.

FACTS:

Background on DISCs

As noted in the *Summa* opinion, Congress designed domestic international sales corporations (DISCs) to incentivize United States companies to export their goods by deferring and lowering their taxes on export income. In the 1980s, several foreign countries argued that DISCs were an illegal export subsidy in violation of trade law, so the United States abandoned DISCs by creating foreign sales corporations (FSCs), which acted as replacements for DISCs.[ii] FSCs were similarly criticized as violating trade law, resulting in the Code sections that created FSCs being repealed.[iii] When the United States abandoned DISCs and created FSCs, it did not repeal the relevant DISC Code sections.[iv] Currently, the only DISC used is the interest-charge DISC, governed by Sections 991–997.[v]

The following is a brief description of DISC requirements and the tax incentives.

A DISC is a corporation that has:

- 95% or more of its gross receipts from qualified export receipts;

- 95% or more of its adjusted basis in all assets from qualified export assets;
- One class of stock and the par value of its outstanding stock is at least $2,500 on each day of the year; and
- Made an election to be treated as a DISC.[vi]

Exports seem to be a simple enough concept, but note that "qualified export receipts" and "qualified export assets" are defined in the Code for purposes of DISCs.[vii] Discussing these definitions is beyond the scope of this article.

A DISC can be set up in two ways: (1) a buy/sell DISC, which is where the DISC actually takes title to the goods it resells outside of the United States, or (2) a commission DISC, which is where the DISC is treated as a commission agent for the exporting company.[viii] The commission DISC is more popular.[ix] DISCs do not need employees or offices and do not have to negotiate sales.[x]

The exporter avoids income tax by paying the DISC "commissions" of up to 4% of gross receipts or 50% of net income from qualified exports.[xi] The DISC pays no tax on its commission income,[xii] but if the DISC does not distribute its income to its shareholders, the DISC shareholders must pay an interest charge on the deferral of the tax payment.[xiii] The charge will be based on the tax otherwise due if the deferred income were distributed.[xiv] The DISC's shareholders can defer the income tax attributable to $10 million or less of qualified export receipts, subject to the interest charge.[xv] Once the DISC has assets at its disposal, it can invest them, including through low-interest loans to the export company.[xvi]

The DISC may distribute money and other assets to its shareholders as dividends, which are eligible for qualified dividend tax treatment. The Code taxes qualified dividends paid to individuals at the long-term capital gain tax rate.[xvii] The DISC dividends would also be subject to the 3.8% net investment income tax if the tax is imposed on the individual.[xviii] A DISC's shareholders are often the same individuals who own the export company (although this is not a requirement). In those cases, the net effect of the DISC is to transfer export revenue to the export company's owners as a dividend without taxing it first as the export company's income. For example:

	No DISC	DISC
Net Export Income	$5,000,000	$5,000,000
Commission Deduction (using 50% of net income from qualified exports)	$0	($2,500,000)
Taxable Income	$5,000,000	$2,500,000
Federal Income Tax on Taxable Income (using top individual rate of 39.6%, which would apply to pass-through entities)	**$1,980,000**	**$990,000**
Federal Income Tax on Dividend from DISC (using 23.8% – 20% long-term capital gain tax rate plus 3.8% net investment income tax)	$0	$595,000
Total Federal Income Taxes	**$1,980,000**	**$1,585,000**
Federal Income Tax Savings		**$395,000**

Note that the DISC shareholders are not required to be the same as the owners of the export company. Therefore, DISC shares could be used to reward key employees or transferred into trusts for estate planning purposes. Clients considering DISCs should also check if their states grant tax-exempt status to DISCs because not all states do.

DISCs Owned by IRAs

Corporations and other entities, including IRAs, may own shares in DISCs.[xix] A corporation that owns DISC shares still has to pay the full corporate income tax on any dividends because there is no dividends received deduction for DISC dividends, which cancels out any tax savings.[xx] Unlike individuals, corporations do not enjoy a preferential long-term capital gain tax rate.[xxi]

There was a period of time when tax-exempt entities paid nothing on DISC dividends, which enabled export companies to shield active business income from taxation by assigning DISC stock to controlled tax-exempt entities, such as pensions, profit-sharing plans, and IRAs. But Congress closed this gap in 1989 and required tax-exempt entities to pay an unrelated business income tax, set at the same rate as the corporate income tax, on DISC dividends.[xxii]

With Section 995(g), Congress made it less attractive for an IRA to own shares in a DISC.[xxiii] As members know, investment earnings (including dividends) generally accumulate tax-free in IRAs. But DISC dividends are subject to the unrelated business income tax when they go into an IRA and, like all withdrawals from a traditional IRA, are subject to personal income tax when they come out.[xxiv]

The same considerations do not apply to the Roth IRA, which Congress created in 1997. With traditional IRAs, savers deduct contributions and pay income tax on withdrawals, including accrued gains in their accounts. Roth IRAs work in the other direction: Savers cannot deduct their contributions, but qualified distributions, including accrued gains, are tax-free.[xxv]

The Code imposes contribution limits on traditional and Roth IRAs. The maximum annual contribution to IRAs (traditional and Roth, collectively) in 2017 is $5,500 (plus $1,000 as a catch-up contribution for those age 50 and over). Also, the maximum annual contribution to a Roth IRA decreases as an individual's income increases. In 2017, single filers who have $133,000 of modified adjusted gross income cannot make any contributions to a Roth IRA. The phase-out amount is $196,000 if married filing jointly in 2017.

As the court in *Summa* noted, one can begin to see why the owner of a Roth IRA might add shares of a DISC to his or her account. The owner of a closely held export company could transfer money from the company to the DISC, as the Code encourages, and the DISC can pay some (or all) of that money as a dividend to its shareholders, allowing the money to enter the Roth IRA and grow there.[xxvi]

The IRA account holder, it is true, would have to pay the unrelated business income tax when the DISC dividends go into the IRA. But once the Roth IRA receives the money, the account holder could invest it freely without having to pay capital gain taxes on increases in the value of each share or income taxes on the dividends received, just like other Roth IRA owners who buy shares of stock in companies that generate considerable dividends and rapid growth in share value. As with all Roth IRAs, the owner would not have to pay any income taxes on qualified distributions (i.e., account open for five years and age 59 ½).[xxvii]

The Summa Transaction

Summa Holdings was the parent corporation of a group of companies that manufacture a variety of industrial products. Summa Holdings was taxed as a C corporation and its two largest shareholders were James Benenson, Jr. (who owned 23.18% of the company in 2008) and the James Benenson III and Clement Benenson Trust (which owned 76.05% of the company in 2008). James Benenson, Jr. and his wife served as the trustees of the trust and their children, James III and Clement, were the beneficiaries.

In 2001, James III and Clement each established a Roth IRA and contributed $3,500 to their respective IRAs. Just weeks after the Benensons set up their accounts, each Roth IRA paid $1,500 for 1,500 shares of stock in JC Export, a newly formed DISC. The Commissioner did not challenge the valuation of these shares.

To prevent the Roth IRAs from incurring any tax-reporting or shareholder obligations by owning JC Export directly, the Benensons formed another C corporation, JC Holding, and transferred the JC Export stock to JC Holding in exchange for stock in JC Holding. From January 31, 2002 to December 31, 2008, each Roth IRA owned 50% of JC Holding, which was the sole owner of JC Export (the DISC).

Summa Holdings paid commissions to JC Export, which distributed the money as a dividend to JC Holding, its sole shareholder. JC Holding paid 33% in income taxes on the DISC dividends and 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 million.

In 2012, the Commissioner issued notices of deficiency to Summa Holdings, the Benensons, and the Benenson Trust for the 2008 tax year, but did not do so for the earlier tax years. The Commissioner informed Summa Holdings that he would apply the "substance-over-form" doctrine and reclassify the payments from Summa Holdings to JC Export as dividends from Summa Holdings to its major shareholders. Therefore, the payments would not count as commissions from Summa Holdings to JC Export, meaning that Summa Holdings would have to pay income tax on the DISC commissions it deducted and JC Holding would obtain a refund for the corporate income tax it paid on the dividend from JC Export. The DISC commissions were recharacterized as dividends paid by Summa Holdings to Benenson Jr. and the Trust in proportion to their ownership percentages.

The Commissioner 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 because of the modified adjustment gross income phase-out. The Commissioner imposed a six-percent excise tax penalty on the contributions.[xxviii] The Commissioner also imposed a $56,182 accuracy-related penalty on Summa Holdings.[xxix]

Summa Holdings and the Benensons challenged the Commissioner's action in Tax Court, which upheld the Commissioner's recharacterization of the transactions, but not the accuracy-related penalty. Summa Holdings, which has its principal place of business in Ohio, appealed the Tax Court decision to the Sixth Circuit.[xxx]

The Substance-Over-Form Doctrine

The substance-over-form doctrine is a judicial creation. It is often raised by the IRS when taxpayers enter into a series of transactions seemingly for pure tax avoidance. The argument is simply that the law requires a valid relationship between the desired tax benefit and some non-tax benefit. The often cited Supreme Court case of *Gregory v. Helvering* put it as follows:

> Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.[xxxi]

The IRS can argue that the substance of a transaction or series of transactions should control, but on the other hand, form does matter and often has substantive consequences in itself. In *Summa*, the IRS was arguing that, *in substance*, the taxpayers engaged in the series of transactions—DISC created and sold to Roth IRAs—as a way for the sons to indirectly contribute large amounts to their Roth IRAs because they could not directly make those large contributions. It was not an argument as to whether *form* was followed—because it was. The IRS viewed these transactions, *in substance*, as a preconceived plan and contrivance to reduce the parties' income taxes.

The Tax Court's Opinion

In *Summa Holdings*,[xxxii] the Tax Court agreed with the Commissioner and recharacterized the deductible commission payments made to the DISC as nondeductible dividend payments to the shareholders, followed by contributions made by those shareholders to the Benensons' Roth IRAs.[xxxiii] Of particular interest in the Tax Court's opinion was the fact that the Tax Court noted that there was "no nontax business purpose or economic purpose for establishing" the DISC and the Tax Court has consistently held that "[a] DISC may be no more than a shell corporation, which performs no functions other than to receive commissions on foreign sales . . . ."[xxxiv] As previously noted, a DISC requires no nontax business purpose, and almost by definition exists only for tax reasons. In fact, it was stipulated by the parties that the "sole reason for entering into the transaction at issue was to transfer money into the Benenson Roth IRAs so that income on assets could accumulate and be distributed tax free."[xxxv]

The Sixth Circuit's Opinion

The Sixth Circuit's *Summa* opinion comes right out of the gate to suggest where the court is headed:

> 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.[xxxvi]

In reversing the Tax Court, the Sixth Circuit reasoned that applying the substance-over-form doctrine to DISCs makes no sense because "DISCs are all form and no substance, making . . . [the] substance-over-form" argument inapplicable.[xxxvii] In fact, Treas. Reg. § 1.992-1(a) states "The rules contained in this paragraph constitute a relaxation of the general rules of corporate substance otherwise applicable under the Code."[xxxviii]

Also, the Sixth Circuit stated that Roth IRAs are congressionally "designed for tax-reduction purposes."[xxxix] Some have argued that allowing Roth IRAs to own DISCs is a result of the timing of enactment of DISC legislation and Roth IRA legislation,[xl] however, the statutes are what they are.

The Sixth Circuit was not moved by the Commissioner's arguments because DISCs are form-over-substance so one cannot apply the substance-over-form doctrine to them and Roth IRAs are congressionally sanctioned tax-savings vehicles. The Commissioner tried to argue that Roth IRAs are intended for middle-class people because of the contribution and income limits, but, as the court noted, there is no data to support this and Congress allows people to contribute to a non-deductible traditional IRA and then convert to a Roth IRA regardless of income (the so-called "backdoor Roth IRA").[xli]

The Sixth Circuit took a textualist approach and stated that "it's odd to reject a Code-compliant transaction in the service of general concerns about tax avoidance. Before long, allegations of tax avoidance begin to look like efforts at text avoidance."[xlii] And, as well all know, "one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury."[xliii]

COMMENT:

The authors have been in and around this space longer for than they would care to admit, and have read their share of opinions; in many cases "slogged through" would be a better description. That said, the writing in the Sixth Circuit's *Summa* opinion is right out of the top drawer. Members who "do" Heckerling know from past newsletters that **LISI** authors like to compile particularly memorable quotes from that meeting. That said, consider these choice nuggets from the *Summa* opinion:

- 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.[xliv]

- 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.[xlv]

- Note that this broad recharacterization power travels along a one-way street. To our knowledge, the Commissioner has never used this power to reclassify the form of a taxpayer's Code-compliant transaction to *reduce* his tax liabilities in the service of broader purposes of the Code. But if this were a legitimate doctrine, why wouldn't it run in both directions? Many provisions of the Code owe their existence solely to tax-reducing purposes: to lower current taxes or to shelter income from taxes over time.[xlvi]

- Only a parody of a purpose-based approach to interpretation, unanchored to statutory text, could justify a one-way use of this power. A broad recharacterization power runs in one direction only if we pitch the Internal Revenue Code's purpose at an Emperor's level of generality—that the "overarching" purpose of the Code, Appellee's Br. 39, is to increase revenue to the government. Then and only then could we say: When a taxpayer structures a business transaction in order to lower his tax bill, he undermines the revenue-increasing purposes of the Code and thus invites the Commissioner to recharacterize the transaction.[xlvii]

- But if there is one title of the United States Code most deserving of attention to text, it is Title 26. These are not the sparing terms of the Sherman Antitrust Act. This is the highly reticulated Internal Revenue Code, which uses language, lots of language, with nearly mathematic precision. Is there any other title of the United States Code that has devoted more carefully drawn words to reducing its purpose to text? Perhaps the Commissioner's approach made some sense decades ago, when the Code was simpler, and before Congress decided to pursue a wide range of policy goals through a complicated set of tax credits, deductions, and savings accounts. But today, of all areas of law that should resist judicial innovation based on misty calls to higher purposes, this would seem to be it.[xlviii]

Notice 2004-8 on Abusive Roth IRA Transactions

The IRS issued Notice 2004-8[xlix] to address a variation of the transaction that the Benensons were using to avoid Roth IRA contribution limits. That Notice said that where a taxpayer's pre-existing business enters into transactions with a corporation owned by the taxpayer's Roth IRA, in certain cases "the acquisition of shares, the transactions, or both are not fairly valued and thus have the effect of shifting value into the Roth IRA."

The Notice went on to identify a number of these transactions as "listed transactions" and described three approaches the IRS could use to attack them:

- Using Section 482 to attempt to allocate income from the Roth IRA to the taxpayer, the preexisting business, or other entities under the control of the taxpayer;
- Using Section 408(e)(2)(A), on the grounds that the transaction generated one or more prohibited transactions between a Roth IRA and a "disqualified person"; and
- By asserting that the substance of the transaction was that the amount of the value shifted from the business to the Roth IRA is a payment to the taxpayer, followed by a contribution by the taxpayer to the Roth IRA and a contribution by the Roth IRA to the corporation.

Hellweg v. Commissioner

In *Hellweg*,[l] the Tax Court ruled in favor of the taxpayers in a case involving a DISC that was indirectly owned by Roth IRAs when the IRS tried to impose excise taxes and penalties. In *Hellweg*, four taxpayers owned an S corporation, ADF. The taxpayers each established a Roth IRA and funded their IRAs with small contributions. The IRAs purchased previously unissued stock of a DISC, after which each of the IRAs transferred the DISC stock into a C corporation holding company. ADF then paid deductible commissions to the DISC, which were in turn paid by the DISC to the holding company that paid corporate income tax on the dividends. The holding company then made a distribution of the after-tax balance as dividends to the Roth IRAs.

The Service audited ADF and its shareholders, issuing each a notice of deficiency on the basis that the payments from ADF to the DISC and then to the Roth IRAs shifted value to the IRAs in excess of the IRA contribution limits, with the result being that the excise tax would apply to the excess contributions. The IRS wanted to recast the transactions as distributions from ADF to the shareholders, and then from the shareholders to their IRAs. The shareholders argued that the payment of DISC dividends to Roth IRAs could not be treated as excess contributions because Congress assented to the ownership of a DISC by an IRA when it passed Section 995(g). In holding for the shareholders, the Tax Court pointed out that the IRS could have used Notice 2004-8 as the basis to attack the transaction, but chose not to.

Conclusion

Advisors who work with export companies should be aware of DISCs and the tax savings they can provide. For every dollar of income that can be shifted from the export company to the DISC, approximately 20 cents will be saved (about 40% tax for the export company versus about 20% tax for the DISC shareholders receiving dividends, plus any state income tax savings, if applicable). The great thing with DISCs is that clients should not have to worry about the substance-over-form doctrine, unlike some other tax planning strategies.

DISCs do not have to be owned by the owners of the export company, so there could be estate and income tax planning opportunities. For example, a DISC could be owned by the children of the owner of the export company as part of an estate plan to shift wealth to the next generation. Also, if the children are in a lower income tax bracket than their parents, there could be some real tax leverage because the children may only have to pay 15% on the dividends from the DISC (for children who are in the 10% or 15% marginal ordinary income tax bracket, the dividends would be tax-free).[li]

A trust could also own a DISC to accumulate wealth for the next generation. DISC qualified dividends paid to a grantor trust would be taxed to the grantor at the grantor's long-term capital gain tax rate (plus the 3.8% net investment income tax, if applicable). For a non-grantor trust, the truncated trust income tax rates would most likely result in the trust paying 23.8% on the dividends, unless the trust distributed and deducted the dividends to the trust beneficiaries, which would result in the trust beneficiaries being taxed on the dividends. Trust beneficiaries who are in lower tax brackets would provide more overall tax leverage because they would likely avoid the 3.8% net investment income tax and would probably be subject to a 15% long-term capital gain tax rate (maybe even the 0% tax rate).

Despite the *Summa* decision, advisors should remember that the substance-over-form doctrine is still an arrow in the IRS's quiver. But when it comes to certain areas of the Code, such as DISCs, the *Summa* decision is a reminder that the substance-over-from doctrine may not apply because in those situations it is form-over-substance. One could ask, isn't the Code all form(alities)?

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

Michael Geeraerts

Paul Vecchione

Jim Magner

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[ii] *Summa Holdings v. Comm'r*, T.C.M. 2015-119, n.7, *rev'd*, 2017 WL 631663 (6th Cir. 2017).

[iii] *Id.*

[iv] *Id.*

[v] *Id.* "The 1984 modification continued to provide for income deferral through the use of the DISC as a tax favored vehicle but only if the DISC shareholders paid an interest charge for the right to defer the income. This new DISC entity was therefore called an IC-DISC. Most of the IRC and regulations have not been amended to reflect this change, as such references to DISC should be read as IC-DISC." IRS IC-DISC Audit Guide, Section II ¶ 1, *available at* https://www.irs.gov/businesses/international-businesses/ic-disc-audit-guide.

[vi] IRC § 992(a)(1). Note that DISCs cannot be a tax-exempt entity, personal holding company, bank or trust company, insurance company, regulated

investment company, certain China Trade Act corporations, and S corporations. IRC § 992(d). An election to be treated as a DISC is made on IRS Form 4876-A, Election To Be Treated as an Interest Charge DISC.

[vii] IRC § 993.

[viii] IRS IC-DISC Audit Guide, Section II ¶ 1, *available at* https://www.irs.gov/businesses/international-businesses/ic-disc-audit-guide.

[ix] *Id.*

[x] "DISC is not concerned about performance of any activities and, therefore, does not need employees or office space and does not have to actually participate in the soliciting, negotiating or concluding of any sales contract or perform any economic functions to earn a commission." IRS IC-DISC Audit Guide, Section II ¶ 3, *available at* https://www.irs.gov/businesses/international-businesses/ic-disc-audit-guide.

[xi] IRC § 994.

[xii] IRC § 991. A DISC files IRS Form 1120-IC-DISC, Interest Charge Domestic International Sales Corporation Return.

[xiii] IRC § 995(f). A DISC shareholder files IRS Form 8404, Interest Charge on DISC-Related Deferred Tax Liability, if there is an interest charge.

[xiv] IRC § 995(f)(2). The interest rate used to determine the interest charge is the T-bill rate. IRC § 995(f)(1)(B).

[xv] IRC § 995(b)(1)(E).

[xvi] Treas. Reg. § 1.993-4.

[xvii] IRC § 1(h)(1)(D), 1(h)(3), 1(h)(11)(B).

[xviii] IRC § 1411.

[xix] IRC §§ 246(d) & 995(g).

[xx] IRC § 246(d) (no dividends received deduction for corporations receiving dividends from DISCs).

[xxi] IRC §§ 1 & 11.

[xxii] IRC §§ 511 & 995(g).

[xxiii] "Thus, the bill clarifies that if for example an individual retirement account were to own stock in a DISC, such an account being subject to the unrelated business income tax pursuant to section 408(e)(1), then that account would be subject to tax on income from the DISC in the same manner as if the account were instead a pension plan trust described in section 401(a). Similarly, under the bill any other person of any description that owns DISC stock and is subject to the tax on unrelated business income must treat any DISC-related income as income from the conduct of an unrelated trade or business in the same manner as would a pension plan, charity, or other organization exempt from taxation by reason of section 501(a)." H. Rep. No. 101-247 (PL 101-239), at 1425 (1989).

[xxiv] IRC § 408(d)(1).

[xxv] IRC§ 408A(c)(1), (d)(1).

[xxvi] "Section 995(g) was enacted in 1988, almost 10 years before the enactment of the Roth IRA provisions, which were enacted as part of the Taxpayer Relief Act of 1997, sec. 302. They became effective for tax years beginning after December 31, 1997. *Id.* sec. 302(f), 111 Stat. at 829. Congress could not have been aware of the type of abusive transaction involving Roth IRAs at issue here at the time of enactment of section 995(g)." *Summa Holdings v. Comm'r*, T.C.M. 2015-119, *rev'd*, 2017 WL 631663 (6th Cir. 2017).

[xxvii] IRC § 408A(d)(1)-(2).

[xxviii] IRC § 4973.

[xxix] IRC §§ 6662 & 6662A.

[xxx] The Sixth Circuit's opinion noted that the Benensons and the Trust have related appeals pending before the First and Second Circuits.

[xxxi] *Gregory v. Helvering*, 293 US 465 (1935).

[xxxii] *Summa Holdings v. Comm'r*, T.C.M. 2015-119, *rev'd*, 2017 WL 631663 (6th Cir. 2017).

[xxxiii] *Id.* at *9.

[xxxiv] *Id.* at *5.

[xxxv] *Id.* at *7.

[xxxvi] *Summa Holdings v. Comm'r*, 2017 WL 631663, at *1 (6th Cir. 2017).

[xxxvii] *Id.* at *4.

[xxxviii] *See also* IRS IC-DISC Audit Guide, Section II ¶ 3, *available at* https://www.irs.gov/businesses/international-businesses/ic-disc-audit-guide ("On the surface the DISC appears to violate our general rules relating to corporate substance.").

[xxxix] *Summa Holdings v. Comm'r*, 2017 WL 631663, at *5 (6th Cir. 2017).

[xl] See endnote xxvi. "Whether Congress's decision to permit Roth IRAs to own DISCs was an oversight makes no difference. It's what the law allowed." *Summa Holdings v. Comm'r*, 2017 WL 631663, at *5 (6th Cir. 2017).

[xli] *Summa Holdings v. Comm'r*, 2017 WL 631663, at *8 (6th Cir. 2017).

[xlii] *Id.* at *6.

[xliii] *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

[xliv] *Summa Holdings, Inc. v. Comm'r*, 2017 WL 631663, at *1 (6th Cir. 2017).

[xlv] *Id.*

[xlvi] *Id.* at *7.

[xlvii] *Id.*

[xlviii] *Id.*

[xlix] 2004-1 C.B. 333.

[l] *Hellweg v. Comm'r*, T.C.M. 2011-58.

[li] IRC § 1(h)(1).