SUMMA HOLDINGS, INC. V. COMM'R

Authors
Galia Antebi
Rusudan Shervashidze

Tags
Roth I.R.A.
D.I.S.C.
Notice 2004-8

On June 29, 2015, the Tax Court held that payments made under an agreement to a company that was owned by Roth individual retirement accounts ("Roth I.R.A.'s.") and had elected to be treated as a Domestic International Sales Corporation ("D.I.S.C."), were not D.I.S.C. commissions but rather dividends to the shareholders of the payor corporation followed by the contributions to the Roth I.R.A.'s.

FACTS

Summa Holdings, Inc. ("Summa") was a C corporation incorporated in Delaware. A husband and wife, together with a family trust ("Benenson Trust"), owned shares of Summa. The couple's two children were the beneficiaries of the the Benenson Trust. In 2001, each of the two children established a Roth I.R.A. account and both I.R.A.'s purchased stocks in J.C. Exports Inc. ("J.C. Exports"), a Delaware corporation that made an election to be treated as D.I.S.C. Summa entered into a series of agreements with J.C. Exports under which subsidiaries of Summa paid J.C. Exports millions of dollars. J.C. Exports in turn paid most of the amounts received to the two I.R.A.'s.

Neither the parents nor the two children reported any dividends on their returns. Summa deducted the payments made to J.C. Exports on its corporate tax returns as D.I.S.C. commissions. J.C. Exports filed Form 1120-IC-DISC reflecting income received from commission sales and the dividend distribution to the I.R.A.'s.

The Internal Revenue Service ("I.R.S.") argued that the payments from Summa were not D.I.S.C. commissions but dividend distributions to the shareholders followed by contributions to the Roth I.R.A.'s. The I.R.S. issued a notice of deficiency for unreported dividends to the shareholders and for the excise tax due for the excess contribution made to the Roth I.R.A.'s.

D.I.S.C.

In 1971, Congress enacted a law to stimulate U.S. exports in the form of a tax benefit to companies that elected to be treated as D.I.S.C.'s. Under this tax regime, a D.I.S.C. was exempt from tax at the corporate level and the shareholders were taxed currently on a portion of the D.I.S.C.'s earnings in the form of distributions, whether or not they were actually distributed. The tax on the remaining portion was deferred until the actual distribution, the disposition of the D.I.S.C. shares in a taxable transaction, or the company no longer qualified as a D.I.S.C.

The European Community argued that the D.I.S.C. tax regime was in violation of the General Agreement on Tariffs and Trade, and as a result, in 1984, Congress replaced the D.I.S.C. tax regime with an Interest Charge D.I.S.C. ("I.C.-D.I.S.C.") tax

regime for taxpayers having gross receipts of $10 million or less. At the same time, Congress also enacted the Foreign Sales Corporation ("F.S.C.") tax regime, which was designed to encourage U.S. exports for taxpayers having gross receipts in excess of $10 million. The F.S.C. was subsequently repealed, and the I.C.-D.I.S.C. is the only tax incentive remaining that offers tax benefits to U.S. companies with relatively small export gross receipts.

A D.I.S.C. is a company organized to conduct specific export activities. Usually, it is organized as an affiliate of a U.S. exporter for the purpose of either buying or reselling the exporter's products or acting as a commission sales agent. The U.S. exporter deducts payments made to the D.I.S.C. as commission and the D.I.S.C. is not subject to tax on its income. While the shareholders are subject to tax on the D.I.S.C. earnings and profits, they may defer the tax liability. Unlike the old D.I.S.C. regime, to the extent the shareholders defer their U.S. income tax liability, an interest charge is applicable to offset the benefit of the tax deferral. D.I.S.C. income exceeding $10 million is deemed immediately distributed and is not eligible for income tax deferral. The I.R.S. annually announces the interest rate for this purpose in a revenue ruling.

ROTH I.R.A.'S

A Roth I.R.A. is an individual retirement plan, which offers tax advantages. Unlike a traditional I.R.A., contributions made to a Roth I.R.A. are not deductible. All earnings in an I.R.A. accumulate free of U.S. tax, and while distributions from a traditional I.R.A. are taxable, qualified distributions made from a Roth I.R.A. can be made tax free. Annual contributions to Roth I.R.A.'s are limited and excess contributions are subject to excise tax.

A self-directed I.R.A. can invest in most assets other than life insurance and collectibles. Therefore, combining D.I.S.C.'s with Roth I.R.A.'s created a very powerful planning tool because dividends paid on stock held by a Roth I.R.A. were not considered contributions by the holders of the I.R.A., but rather viewed as earnings of the I.R.A. itself. This allowed taxpayers to avoid the limitations on contributions to Roth I.R.A.'s. Additionally, the I.R.A. could continue to grow the amounts received indefinitely and distribute them tax-free.

While Congress limited taxpayers' ability to hold shares of a D.I.S.C. through tax-exempt entities and avoid paying tax on deemed dividends,[1] avoiding the contribution limitation was not addressed until the I.R.S. issued Notice 2004-8,[2] in which it identified tax-avoidance type transactions in which pre-existing businesses enter into transactions with corporations owned by the taxpayer's Roth I.R.A. and where the transactions have the effect of shifting value into the Roth I.R.A. The Notice described three ways in which the I.R.S. would challenge such transactions:

(1) Apply Code §482 to allocate income from the corporation to the taxpayer, the pre-existing business, or other entities under the control of the taxpayer;

---

1 Under Code §995(g) deemed dividends paid by a D.I.S.C. to a tax-exempt entity are treated as unrelated business taxable income.

2 Notice 2004-8, 2004-1 C.B. 333.

(2) Assert that under Code §408(e)(2)(A), the transaction gives rise to one or more prohibited transactions between a Roth I.R.A. and a disqualified person described in Code §4975(e)(2); and

(3) Assert that the substance of the transaction is that the amount of the value shifted from the pre-existing business to the corporation is a payment to the taxpayer, followed by a contribution by the taxpayer to the Roth I.R.A. and a contribution by the Roth I.R.A. to the corporation.[3]

"The Tax Court found that there was no business purpose or economic benefit from the transactions between Summa and J.C. Exports. Further, the court determined that the transactions were designed to shift funds into the Roth I.R.A.'s."

THE *SUMMA* CASE

The Tax Court applied the substance over form doctrine to analyze the payments made by Summa to J.C. Exports. The court looked to determine whether there was any substance to the transactions other than to transfer money to the Roth I.R.A.'s and accumulate and distribute income tax free.

The Petitioners argued the I.R.S. did not have a reason to disallow the deduction of the D.I.S.C. commissions or to reclassify the commissions as dividends because the three possible grounds for adjustment identified in Notice 2004-8 are not applicable to their facts. They relied on *Hellweg v. Comm'r*,[4] where under similar facts the Tax Court ruled in favor of the taxpayer. In *Hellweg*, the taxpayer argued that payment of D.I.S.C. dividends to a Roth I.R.A. cannot be treated as excess contributions because Congress allowed I.R.A.'s to own D.I.S.C.'s in Code §995(g), and that reclassifying the transactions under the substance over form doctrine was improper because it would result in disregarding the D.I.S.C.

The Tax Court distinguished the *Summa* case from *Hellweg* and ruled for the I.R.S. In *Hellweg*, the I.R.S. argued that the transaction lacked substance for excise tax purposes only. The Tax Court held that a transaction that is valid for income tax purposes must also be valid for excise tax purposes. The court further clarified that their "decision does not prevent the I.R.S. from recharacterizing the transaction consistently for income tax and excise tax purposes." And in fact, in *Summa*, the I.R.S. argued that the transactions were invalid for both income and excise tax purposes and that the transactions should be recharacterized to prevent tax abuse. The court also noted that the I.R.S. was not seeking to disregard the D.I.S.C. itself, but rather argued that a transaction involving a D.I.S.C. should be recharacterized.

The Tax Court found that there was no business purpose or economic benefit from the transactions between Summa and J.C. Exports. Further, the court determined that the transactions were designed to shift funds into the Roth I.R.A.'s, and therefore, it is appropriate to apply the substance over form principle and recharacterize the transaction. The court also pointed out that the reason Congress did not determine transactions between a D.I.S.C. and a Roth I.R.A. to be abusive is because the Roth I.R.A. provision was enacted ten years after Code §995(g).

---

[3] *Id.*

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