Using DISCs to Avoid Roth IRA Limits: An Overlooked Fact in *Summa*

by Vorris J. Blankenship

Vorris J. Blankenship is a retired attorney and CPA. He is the author of the treatise *Tax Planning for Retirees*, published by LexisNexis. His website is retirement-taxplanning.com.

Blankenship discusses *Summa Holdings*, in which the Sixth Circuit held that a taxpayer may use a domestic international sales corporation to transfer funds to a Roth IRA, regardless of IRA contribution limits. He argues that an overlooked fact appears to undermine the court's decision.

The Sixth Circuit recently allowed taxpayers to use a domestic international sales corporation to transfer funds from the taxpayers' corporation to their Roth IRAs in amounts exceeding Roth IRA contribution limits. In *Summa Holdings*,[1] individual members of a family and a family trust (collectively, taxpayers) owned nearly all the capital stock of Summa Holdings Inc., a corporation engaged in the manufacture and sale of products to both domestic and foreign customers. Some of the individual taxpayers owned Roth IRAs. The Roth IRAs owned all the capital stock of a holding company (Roth Holding) that in turn owned all the capital stock of a DISC (Summa DISC).

Summa Holdings deducted commissions paid to Summa DISC based on Summa Holdings' foreign sales. Summa DISC did not pay tax on the commissions because DISCs are tax exempt. Immediately after the receipt of each commission payment, Summa DISC distributed the payment to Roth Holding. Roth Holding was subject to tax on income at corporate tax rates. Roth Holding distributed each payment (less corporate income taxes) to the Roth IRAs.

The IRS attacked these transactions as lacking substance, asserting that the payments instead constituted dividends from Summa Holdings to taxpayers and contributions by taxpayers to the Roth IRAs. Consequently, the IRS asserted income deficiencies against Summa Holdings and the taxpayers and asserted that the owners of the Roth IRAs owed excise taxes for excess contributions to the Roth IRAs.[2]

The Sixth Circuit rejected the IRS position, holding that the substance-over-form doctrine was inapplicable. The court said the words of the statute allowed taxpayers to do what they did and that Congress designed DISCs to reduce or defer income tax on exporters, even if the DISCs lack economic substance. The court was satisfied that Roth IRAs may own DISCs and that Congress designed both DISCs and Roth IRAs to lower taxes. Thus, the court concluded that the taxpayers' characterization of the transactions did not distort the meaning of the code.

An Overlooked Fact

However, a problem remains. The Sixth Circuit either overlooked or considered irrelevant a significant fact in the case. The lower court said the Summa DISC distributed each of its

[1] *Summa Holdings Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017).

[2] Although not discussed by the *Summa* court, Summa Holdings and the Roth IRAs were owned by the related taxpayers in different proportions. Consequently, ownership of the Summa Holdings payments (or distributions) shifted between the taxpayers en route from Summa Holdings to the Roth IRAs. This ownership shift gave rise to gifts subject to gift tax, regardless of the way the transactions are ultimately characterized for income tax purposes. *See* Rev. Rul. 81-54, 1981-1 C.B. 476.

commission payments immediately after receiving it.[3] Consequently, contrary to the appellate court's apparent belief, the Summa DISC did not take advantage of the tax deferral benefits Congress provided for DISC income. As the court acknowledged, Congress provided those deferral benefits to encourage taxpayers to invest in export property and increase export sales.

Congress provided that a DISC may accumulate DISC income tax free.[4] It may use that income by investing it in export property,[5] including loans to affiliated taxpayers.[6] The DISC shareholders need only pay interest to the government on the amount of tax deferred at a low T-bill rate.[7] The taxpayers, however, did not take advantage of any of these DISC benefits.

Congress also originally allowed most taxpayers to avoid the corporate-level tax on DISC income. That is, an exporter could deduct commission payments made to a DISC, and the DISC itself would be tax exempt.[8] Thus, as originally enacted, the statute imposed tax only on distributions of DISC income to its shareholders at tax rates applicable to the shareholders.[9] Consequently, DISC income distributed to individual shareholders was taxed only as a dividend (and is now taxed only at the low rates applicable to qualified dividends).[10] On the other hand, DISC income distributed to tax-exempt entities (including IRAs) was originally not taxable at any level.

Apparently, elimination of tax on DISC income received by tax-exempt entities seemed overly generous. So Congress later classified distributions of DISC income to exempt entities (including IRAs) as unrelated business taxable income[11] taxed at corporate rates.[12] In *Summa Holdings*, the situation was slightly different. Roth Holding received the DISC distributions and paid the corporate-level tax to spare the Roth trustees the administrative inconvenience of having to pay the tax on UBTI. Thus, the Roth IRAs did not enjoy, and could not have enjoyed, the benefit of avoiding the corporate-level tax on DISC income — unlike individual DISC shareholders.

Gregory v. Helvering

Thus, a strong argument can be made that the substance-over-form doctrine should apply because the taxpayers' actions were inconsistent with the DISC statutory scheme. The *Summa Holdings* situation is similar in this respect to the landmark Supreme Court case *Gregory v. Helvering*.[13] In that case, the taxpayer wanted to take a dividend of property owned by her corporation (Corp 1) and sell the property, but she did not like the resulting tax consequences. So to reduce her tax burden on the transaction, the taxpayer had Corp 1 transfer the property to a new corporation (Corp 2), which issued its shares to her, all purportedly under the tax-free reorganization provisions of the code. Then, three days later, the taxpayer liquidated Corp 2 and sold the distributed property. The IRS, however, treated the transactions as in substance a sale of the property by Corp 1 and a dividend of the sales proceeds to the taxpayer.

The Supreme Court agreed with the taxpayer that she had satisfied every element of the reorganization provisions but nevertheless held that the reorganization was without substance. The Court accepted the reasoning of the lower court that the taxpayer's actions lacked substance

[3] *Summa Holdings Inc. v. Commissioner*, T.C. Memo. 2015-119.

[4] Section 991.

[5] Section 993(b).

[6] Section 993(d). Loans to affiliated taxpayers must be at an arm's-length interest rate. Reg. section 1.993-4(a)(4).

[7] Section 995(f).

[8] Sections 991 and 994.

[9] Sections 995 and 996.

[10] Section 1(h)(1)(D), (h)(3), and (h)(11)(B).

[11] Section 995(g), added by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, section 1012(bb)(6)(A), as amended by the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, section 7811(i)(12).

[12] Sections 511(a)(1) and 408(e)(1).

[13] *Gregory v. Helvering*, 293 U.S. 465 (1935). For an analysis of the application of the substance-over-form doctrine to various types of rollovers to Roth IRAs, see Vorris J. Blankenship, "Rollovers to Roth IRAs Are Complicated by Substance-Over-Form Doctrines," 93 *Taxes* 43 (Sept. 2015).

"even though the facts answer the dictionary definitions of each term used in the statutory definition."[14] The Supreme Court said Congress intended the reorganization provisions to apply to transfers made pursuant to a plan or reorganization of corporate business. But the taxpayer did not use the reorganization provisions for a corporate or business purpose. The taxpayer's new Corp 2 was a mere contrivance to use the reorganization provisions for an unintended purpose. The transactions were merely masquerading as a reorganization.

Similarly, it can be said in *Summa Holdings* that the use of the DISC was without substance even though every element of the arrangement satisfied the express language of the statute. Congress gave taxpayers the special tax benefits unique to DISCs as an inducement for increasing export sales. However, the taxpayers in *Summa Holdings* did not use their DISC for that purpose, but rather established the DISC only to avoid Roth IRA contribution limits.[15] Thus, it can be said, as in *Gregory*, that the DISC was a mere contrivance to use the DISC provisions of the code solely for an unintended purpose.

Although the Summa DISC may have satisfied the statutory definition of a DISC, it was a DISC in name only. It is true that Congress provided that a DISC need not have any nontax economic substance,[16] but Congress contemplated that it would be used for its intended purpose of providing incentives to increase export sales. Although the incentives provided by Congress to promote that purpose are tax benefits, those benefits confer measurable savings that themselves have economic consequences. They give substance to an arrangement that is within the statutory scheme. However, that substance was totally lacking in the instant case.

In *Gregory*, the taxpayer had used her newly formed corporation as a meaningless, near-instantaneous conduit for the transfer of property masquerading as a reorganization. Similarly, in *Summa Holdings*, the taxpayers used their DISC as a meaningless, instantaneous conduit for payments masquerading as DISC commissions. The taxpayers did not use the Summa DISC for any of the tax benefits intended to promote export sales. It can be said, of course, that the taxpayers were interested in using their Roth IRAs for benefits that may incidentally promote export sales. But Congress's enactment of the Roth IRA provisions had nothing to do with the promotion of export sales.

Conclusion

The Sixth Circuit's opinion in *Summa Holdings* provided a solid analysis for a hypothetical case. That hypothetical case would involve a DISC that is actually used to reap the tax benefits intended for promotion of export sales. Unfortunately, though, *Summa Holdings* is not such a case. Nor would it seem that a similar arrangement should survive scrutiny merely by using DISC tax benefits that are de minimis. It is unclear, however, how much "tax substance" the DISC should have to survive scrutiny. ■

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

[15] In fact, the parties stipulated in the lower court that the taxpayers' sole reason for the entire arrangement was to transfer funds into Roth IRAs. *Summa Holdings*, T.C. Memo. 2015-119.

[16] Reg. section 1.994-1(a)(2); *Thomas International Ltd. v. United States*, 773 F.2d 300 (Fed. Cir. 1985); *Foley Machinery Co. v. Commissioner*, 91 T.C. 434 (1988).