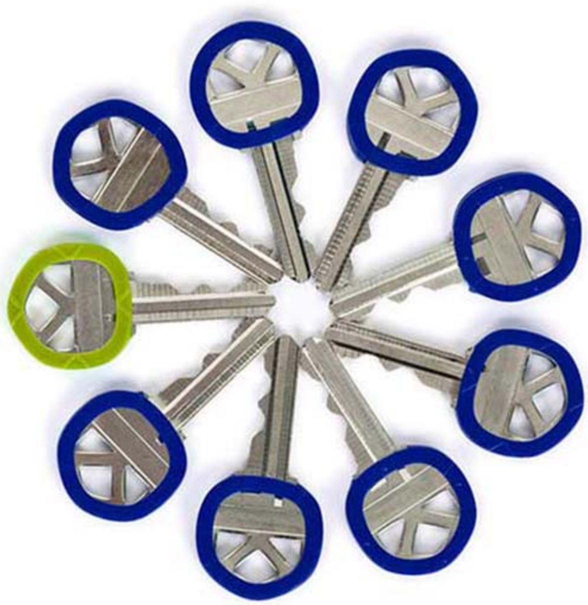

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The Sixth Circuit Court of Appeals Limits IRS' Use of Substance over Form Doctrine

In *Summa Holdings, Inc. v. Comm'r.*, No. 16-1712 (Feb. 16, 2017), the Sixth Circuit Court of Appeals reversed a Tax Court decision allowing the IRS to reclassify certain transactions under the substance over form doctrine. In its reversal, the Sixth Circuit held that since the taxpayers followed the applicable Internal Revenue Code ("Code") provisions, in both substance and form, the IRS could not utilize the substance over form doctrine to disregard the structure regardless of the tax minimizing impact.

Summa Holdings, Inc. and its subsidiaries are a manufacturing business (collectively "Summa"), which is ultimately owned by a member of the Benenson family or related trust. In 2001, two of the members of the Benenson family, James III and Clement, each established a Roth IRA (collectively "Roth IRAs") by contributing $3,500. Shortly thereafter, each Roth IRA purchased shares in JC Export, Inc. ("JC Export"), a newly formed DISC. Pursuant to a series of stock transactions, JC Export ultimately became wholly owned by JC Holdings, Inc. ("JC Holdings"), which in turn was owned 50% by each Roth IRA.

During 2002 – 2008, Summa made periodic payments to JC Export, which then distributed these amounts to its sole shareholder, JC Holdings. Upon receipt, JC Holdings calculated and withheld the estimated tax and then distributed the remaining amounts as a dividend to its shareholders, the two Roth IRAs. By 2008, each of the Roth IRAs had balances of over $3 million.

Tax Year 2008

In 2008, the year at issue in the case, Summa paid $2,237,923 to JC Export. These funds were then distributed to JC Holdings, and ultimately a portion was paid to the Roth IRAs as dividends. JC Export filed a Form 1120-IC-DISC, *Interest Charge Domestic International Sales Corporation Return*, which reported the dividend distributions for tax year 2008. Similarly, JC Holdings filed a Form 1120, *US Corporation Income Tax Return*, which reported the received dividends as gross income, and distributions to the Roth IRAs, and paid any applicable tax. Summa claimed a deduction for the amounts paid to JC Export as DISC commissions on its Form 1120 for tax year 2008.

The IRS examined Summa's 2008 tax year and sought to re-characterize its payments made to JC Export. In 2012, the IRS issued Notices of Deficiency to Summa, James III and Clement Benenson and the Benenson Trust for tax year 2008 asserting: (1) Summa's DISC deduction was not allowed, (2) Summa's owners were the proper recipients of the dividends and (3) Summa's shareholders, in essence, contributed these amounts directly to the Roth IRAs, which triggered an excise tax deficiency due to exceeding IRA limits.[1] The Tax Court agreed with the IRS assessment on the grounds of substance over form, but did not uphold the accuracy-related penalty imposed upon Summa.

Sixth Circuit Court of Appeals Decision

The Sixth Circuit reversed the Tax Court's decision and held that the substance over form doctrine was not applicable in this situation. In its analysis, the Sixth Circuit first noted that the Taxpayers had followed the form of the statutory provisions relating to DISCs and IRAs.

The court next evaluated whether the substance over form doctrine should be used to re-characterize the transactions pursuant to the established structure. The court noted that the substance over form doctrine is generally used to determine economic realities of the situation, as compared to the label placed on it by the taxpayer. The court pointed to several examples where the substance over form doctrine is applicable, for example, a taxpayer cannot change the character of an item of income under the Code merely by attaching a different label to that item. Similarly, in a business transaction context, the IRS may disregard an otherwise independent entity, if the label is designed to obscure the entity's substance or economic reality.[2]

The Sixth Circuit Court of Appeals contrasted the cited examples with the current situation, whereby, Summa, JC Export, JC Holdings and the Benenson family (collectively "Taxpayers") utilized the DISCs and Roth IRAs in a manner consistent with the statutes, i.e., to minimize the Taxpayer's tax liability. As noted by the court, DISCs were statutorily designed to be "shell corporations" that can receive commissions and pay dividends, while Roth IRAs are specific tax benefit instruments. The court also referenced the fact that the Code specifically allows Roth IRAs to hold shares in a DISC. Thus, according to the court, the Taxpayers had utilized the DISC and Roth IRAs properly under the relevant provisions of the Code.

The court declined to extend the substance over form doctrine to this situation, whereby, a taxpayer has two otherwise valid alternatives in structuring a transaction, but one alternative would result in a higher tax. While recognizing the potential difficulty in distinguishing between an improper transaction and a proper tax minimizing transaction, the court rejected the IRS' assertion that taxpayers must select the highest tax alternative or allow the IRS to utilize the substance over form doctrine to choose that alternative. The Sixth Circuit stated, "The substance-over-form doctrine, it seems to us, makes sense when it holds true to its roots – when the taxpayer's formal characterization of a transaction fails to capture the economic reality and would distort the meaning of the Code in the process." As the IRS' proposed actions did not capture the economic reality of the situation more appropriately than the parties' established structure, the Sixth Circuit held that the substance over form doctrine was not applicable.

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[1] The Sixth Circuit opinion notes that the Internal Revenue Code imposes certain contribution limits on IRAs, which was $5,000 for tax year 2008. However, this amount is subject to reduction for Roth IRAs based upon income of the taxpayer. The opinion cites to I.R.C. Section 219(b)(5)(A); I.R.C Section 408A(c)(2) – (3), Internal Rev. Serv., Publication 590, Individual Retirement Arraignment (IRAs), at 2 (2008).
[2] *Citing to Wells Fargo v. US*, 641 F.3d 1319 (Fed. Cir. 2011).

Lastly, the court evaluated the IRS' assertion that the benefits obtained by the Taxpayers through utilizing this type of structure could not have been anticipated or intended by Congress. The Sixth Circuit noted that many of the provisions of the Code are mechanisms to lower taxes or shelter income over time, which were congressional designed benefits. The court stated, "The best way to effectuate Congress's nuanced policy judgments is to apply each provision as its text requires – not to elevate purpose over text when taxpayers structure their transactions in unanticipated tax reducing ways." The court also noted that even if the tax benefits were unanticipated, this issue should be resolved legislatively.

The Sixth Circuit ultimately concluded that the Taxpayers had properly used the DISC and Roth IRAs in the established structure and transactions. Therefore, it held that the IRS could not apply the substance over form doctrine to disallow the structure, regardless of the tax benefits recognized by the Taxpayers.

District Court Follows Third Circuit Precedent in Finding Reasonable Cause for the Failure to Timely File an Estate Tax Return Based on Reliance on an Advisor

A District Court recently had occasion to apply precedent from the Third Circuit with respect to the reasonable cause defense for the penalty for the failure to timely file an estate tax return. In *Hake v. Commissioner*,[3] two executors of their mother's estate filed suit seeking a refund of a penalty that was assessed under IRC § 6651(a)(1) after they were late in filing the estate's federal tax return. The executors had no experience with probate law or federal estate tax obligations, and therefore engaged a law firm to advise them on all tax matters and related estate administration, including the calculation, preparation, and payment of the estate taxes, and filing of the estate tax returns.

The estate's lawyer advised the executors to seek extensions of time to file the estate tax return and pay the taxes owed. One of the estate's lawyers prepared and the other of the estate's lawyers filed a Form 4768 seeking an extension of time to file the return and pay the taxes. After the extension form was filed, the estate's lawyer informed the executors that the deadline to both pay and file had been extended for one year. The lawyer's advice was incorrect, however, as the extension to file had been granted for only six months.

The executors made a payment in excess of the eventual estate tax liability before the payment due date, and with the payment included a letter informing the IRS that the filing date for the estate tax return had been extended by one year. The executors then filed the estate tax return one year after the original due date, and the IRS assessed penalties for the failure to timely file. The executors paid the penalty and then filed an administrative claim for refund. The IRS denied the claim, and the executors filed a refund suit.

The District Court explained that the sole question was:

> When an executor relies upon inaccurate advice from legal and tax counsel regarding the extended deadline for filing an estate tax return, in a factual context where determination of filing and payment deadlines are governed by a series of mandatory and discretionary rules which may vary depending upon the residence status of the taxpayer, does that reliance upon professional advice constitute reasonable cause to avoid the assessment of late filing penalties and interest?

The court found that the process for determining the due dates of an estate tax return and the estate tax payment required a subtle, multi-faceted analysis. First, the court explained, an executor must determine the initial filing and payment deadlines, which vary depending on the residence of the decedent. Then the executor must negotiate a series of deadline extension rules, which differ depending on whether the extension is sought for the filing of the tax return or the payment of the taxes. Finally, to add confusion to the extension process, some of the extensions are automatic, whereas others are discretionary.

The District Court acknowledged the precedence of the preeminent Supreme Court case *United States v. Boyle*,[4] in which the Court found that an executor did not have reasonable cause when he relied on a lawyer to file the estate tax

[3] No. 1:15-CV-1382, 2017 US Dist. LEXIS 19020 (Feb. 10, 2017).
[4] 469 US 241 (1985).

return. However, the court also looked to the precedential case of *Estate of Thouron v. United States*[5] out of the Third Circuit, in which that court read *Boyle* to have identified three distinct categories of late-filing cases.

The first category consists of situation in which taxpayers delegated the task of filing a return to an agent, only to have the agent file the return late or not at all. In *Boyle*, the Supreme Court held that, in such cases, reliance upon a lawyer to file a timely tax return was not reasonable cause to excuse the late filing. The second category of late-filing cases identified in *Boyle*, as that decision is construed by the Third Circuit in *Estate of Thouron*, involves a taxpayer who, in reliance on the advice of a lawyer, files a return after the actual due date, but within the time that the taxpayer's lawyer advised was available. Finally, the third category are those cases where an attorney advises a taxpayer on a matter of tax law.

The District Court explained that the facts of *Boyle* fit into the first category, but that the situation in this case was different than a simple delegation of the duty to file the estate tax return. The Supreme Court in *Boyle* had recognized a split of authority regarding the second category of cases, where an estate either paid or filed late, but did so before the timeframe, based upon the taxpayer's facts, that the estate's lawyer had advised the taxpayer was applicable. The Third Circuit in *Estate of Thouron* noted that it had previously held that a taxpayer could show reasonable cause where he or she filed within the timeframe that he or she was erroneously advised was the deadline. As a result, the District Court found that the Third Circuit had limited the application of *Boyle* to only cases in which a taxpayer had delegated the duty to file the return, and therefore the holding in *Boyle* did not apply in this case.

Based upon the "unique and uniquely compelling" facts in this case, the court held that the executors had reasonable cause for the late-filing of the estate tax return, however, it cautioned that its ruling had a very narrow scope, and that it was simply following the precedent established by the Third Circuit in *Estate of Thouron*.

IRS Large Business & International Division Releases Initial Campaigns

On January 31, 2017, the Internal Revenue Service (IRS) announced the initial 13 campaigns for the Large Business & International (LB&I) Division ("Announcement"). These campaigns cover a diverse range of topics and are part of the IRS' shift to a more proactive, issue-focused examination process.[6] The Announcement specifies the initial campaigns, provides a short summary of each campaign, identifies potential treatment avenues and sets forth the practice area of the IRS' LB&I division with jurisdiction over the campaign.

The initial campaigns, as grouped by LB&I practice area, are as follows:

- Enterprise Activities
  - IRC 48C Energy Credit
  - Domestic Production Activities Deduction, Multi-Channel Video Program Distributors ("MVDPs") and TV Broadcasters
  - Micro-Captive Insurance
  - Related Party Transactions
  - Deferred Variable Annuity Reserves & Life Insurance Reserves IIR
  - Basket Transactions
  - Land Developers – Completed Contract Method ("CCM")
- Pass-through Entities
  - Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") Linkage Plan Strategy
  - S Corporation Losses Claimed in Excess of Basis
- Cross-border Activities
  - Repatriation
  - Form 1120-F, US Income Tax Return of Foreign Corporation, Non-Filer
- Treaty and Transfer Pricing Operations

[5] 752 F.3d 311 (3d Cir. 2014).
[6] *See* Large Business and International Launches Compliance Campaigns, IRS Announces Initial Rollout of Campaigns, located at https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns.

- Inbound Distributors
- Withholding & International Individual Compliance
    - Offshore Voluntary Disclosure Program (“OVDP”) Declines – Withdrawals

The Announcement also indicates that future campaigns will be identified and launched in the upcoming months.