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Summa Holdings: Form Is Substance When It Comes to Law

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In this article, Metcalf and Handzo discuss the Sixth Circuit's language in *Summa Holdings*, comparing it with other substance-over-form and economic substance cases.

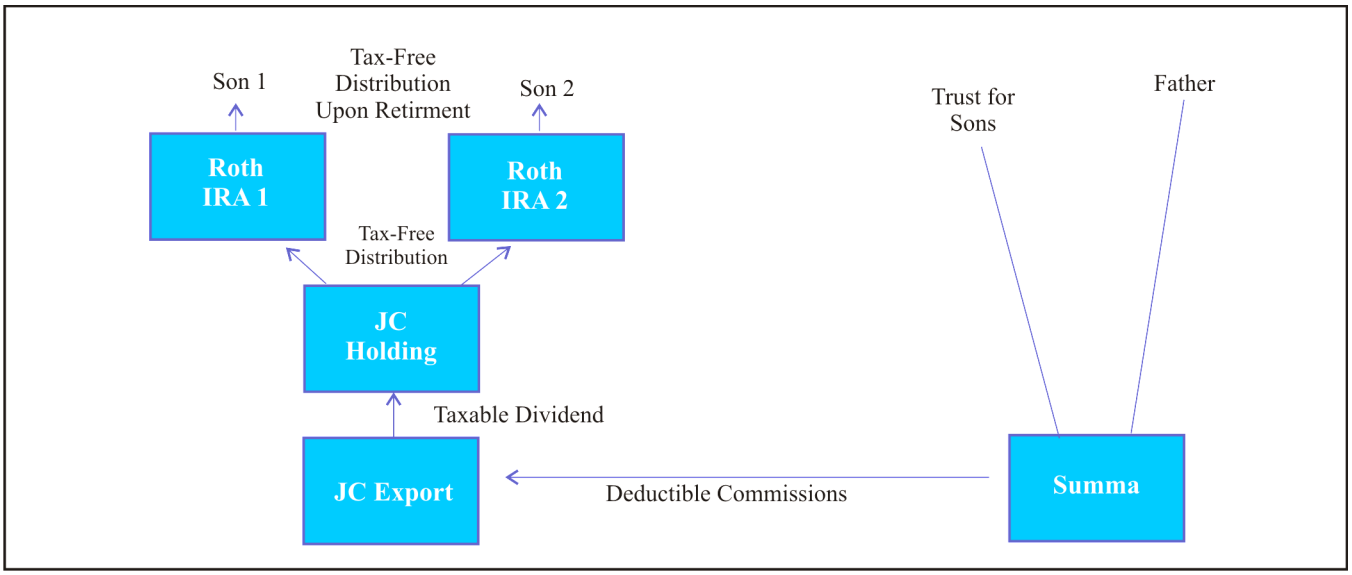
The substance-over-form and economic substance doctrines — generally referred to as the common law antiabuse doctrines — allow the IRS to deny benefits to a taxpayer if the underlying transactions are "shams" or have no "purpose, substance, or utility apart from their anticipated tax benefits."[1] In its recent opinion in *Summa Holdings*, the Sixth Circuit rejected the IRS's substance-over-form arguments and found that the commissioner's position regarding statutory substance could not be invoked to overcome the textual meaning of a statute.[2] The Sixth Circuit's strong language and ultimate holding were more taxpayer-favorable than recent decisions in other circuits that have addressed these doctrines. And if other circuits adopt the Sixth Circuit's rationale, application of these doctrines could be narrowed.

The Summa Holdings Structure

In *Summa Holdings*, the Benenson family owned Summa Holdings Inc., which manufactured products for export. Through a series of transactions, profits from Summa

[1] *Goldstein v. Commissioner*, 364 F.2d 734, 740 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965); *see also Gregory v. Helvering*, 293 U.S. 465 (1935) (introducing the basis for the antiabuse doctrines). In 2010 Congress codified the economic substance doctrine under section 7701(o), though the codification affects only transactions entered into after March 31, 2010. *See* Health Care and Education Reconciliation Act of 2010 (HCRA), H.R. Rep. No 111-443, pt. 2, section 1409(e)(1) (2010). While the "economic substance" and "substance-over form" doctrines are separate and distinct common law doctrines (see, *e.g.*, *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425, 448 n.50 (3d Cir. 2012)), courts, the IRS, and litigants often blur the distinctions between these doctrines and discuss them interchangeably. *See, e.g.*, Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the 'Reconciliation Act of 2010,' as Amended, in Combination With the 'Patient Protection and Affordable Care Act,'" JCX-18-10, at 142-156 (Mar. 21, 2010) (discussing how distinctions between the doctrines are not always recognized). Although different circuits apply slightly different tests, the economic substance doctrine generally applies to deny tax benefits that are comparatively large compared with the relatively insignificant economic or business purpose of a transaction. *Historic Boardwalk Hall*, 694 F.3d at 448 n.50 (citations omitted). On the other hand, the substance-over-form doctrine allows courts to recharacterize a transaction when its substance is inconsistent with the taxpayer's chosen form. *Id.*

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



Holdings were shifted into Roth IRAs for the benefit of the Benensons' two sons. In 2001, the two Benenson sons each formed Roth IRAs with initial contributions of $3,500. The Roth IRAs then formed JC Export Inc., an interest charge domestic international sales corporation.[3] Finally, the Roth IRAs exchanged their shares of JC Export for shares of another newly formed entity: JC Holding Inc. This holding company structure was established so that the Roth IRAs "would avoid unrelated business income and associated tax-reporting obligations."[4]

Starting in 2002 JC Export entered into a series of agreements with Summa Holdings, which was owned almost entirely by the father and a trust for the benefit of the sons.[5] JC Export received commissions from Summa Holdings based on its exports.[6] Under the mechanical DISC rules, JC Export effectively retained a percentage of the profit from Summa Holdings' exports even though JC Export did not perform any functions or services. JC Export then paid dividends to JC Holding, which paid dividends to the Roth IRAs. These dividends greatly exceeded the annual contribution limits on Roth IRAs. For the tax year ending on April 30, 2008, each Roth IRA received approximately $740,000 in dividends from JC Holding. By the end of 2008, each Roth IRA had a year-end value of approximately $3.1 million, even though the sons had not made any contributions to the Roth IRAs other than the initial $3,500 contributions in 2001.[7] The IRS did not challenge those transactions until the 2008 tax year, and it never challenged the valuations underlying the 2001 and 2002 transactions.[8]

The diagram above illustrates the *Summa Holdings* structure.

The tax consequences sought by the taxpayers were as follows: DISC commissions are deductible by an exporter, but are not includable in income by the DISC. Dividends from the DISC, however, are includable in income by the dividend recipient.[9] Moreover, although Congress initially established DISCs in the 1970s to subsidize exports by permitting DISCs to accumulate tax-deferred earnings,[10] after a trade dispute in the 1980s, Congress eliminated the favorable treatment of DISCs by imposing an

[3] *Id.* Each Roth IRA purchased half of JC Export's shares for $1,500.

[4] *Id.* at 783.

[5] Summa Holdings was the parent of a consolidated group of corporations that manufactured a variety of industrial products.

[6] *Summa Holdings Inc. v. Commissioner*, T.C. Memo. 2015-119. JC Export received commissions based on the qualified export property commission formula set forth in section 993.

[7] *Id.*

[8] *Summa Holdings*, 848 F.3d at 784.

[9] *See* sections 1(h)(1)(D), 1(h)(3), 1(h)(11)(B), 264(d), and 995(b)(1).

[10] Section 991.

interest charge on distributions from a DISC to offset the benefit of income deferral.[11] While Congress eliminated the export subsidy element of the DISC rules, it retained the framework of the rules. It is critical that DISCs do not need to perform functions to justify the commissions they receive because, under the statute, they are deemed to earn the commissions.[12]

A Roth IRA is funded with after-tax contributions.[13] The earnings on Roth IRA accounts and withdrawals upon retirement are generally tax-free.[14] The code restricts this benefit by imposing yearly contribution and income eligibility limits.[15] Congress imposed these limits because it intended Roth IRAs to provide tax-efficient retirement savings to middle- and low-income taxpayers.[16]

The IRS Deficiency and the Tax Court Decision

The IRS challenged the transactions for the 2008 tax year by recharacterizing them under the substance-over-form doctrine to more accurately reflect economic reality.[17] The IRS argued that the transactions should be recharacterized as deemed dividends paid by Summa Holdings to its shareholders, followed by $1.1 million contributions from each son to his respective Roth IRA.[18] Once recharacterized, these contributions were well in excess of the applicable $5,000 annual contribution limit for Roth IRAs.[19] The IRS asserted that these excessive contributions triggered yearly excise tax penalties under section 4973 that amounted to $67,170 for 2008 alone.[20] Also, the IRS alleged that Summa Holdings was liable for a penalty of $56,182 under either section 6662 or 6662A for its 2008 tax year.[21]

The Tax Court agreed with the IRS. The Tax Court and both parties acknowledged that there was no nontax business or economic purpose for the transactions.[22] Regarding the substance-over-form doctrine, the Tax Court agreed with the IRS's characterization and held that the true transaction was a dividend to Summa Holdings' shareholders followed by Roth IRA contributions exceeding the allowable limit. Therefore, the Tax Court granted the IRS's motion for partial summary judgment and denied the taxpayers' cross-motion for summary judgment.

The Sixth Circuit Reversal

The Sixth Circuit reversed the Tax Court and held that the transactions could not be recharacterized under the substance-over-form doctrine.[23] In so holding, the Sixth Circuit noted that the transactions produced the taxpayers' intended results under a technical reading of the code, stating, "If this case dealt with any other title of the United States Code, we would stop there, end the suspense, and rule for Summa Holdings and the Benensons."[24] But because of the common law antiabuse doctrines, the Sixth Circuit was obligated to consider the merits of the IRS's arguments. The Sixth Circuit rejected the IRS's arguments under the antiabuse doctrines, holding that neither the commissioner's perception of the transactions' substance nor congressional intent could justify recharacterizing the original transactions.

First, the Sixth Circuit held that the IRS's proposed recharacterization did not capture economic reality any better than the taxpayers' actual transactions — it just produced a higher amount of tax. The Sixth Circuit acknowledged that there were legitimate situations in which the antiabuse doctrines could apply. But the Sixth Circuit emphasized that these antiabuse doctrines cannot override the actual text of the statute because "'form' *is* 'substance' when it comes to

[11] Section 995; *Summa Holdings*, T.C. Memo. 2015-119.

[12] *Summa Holdings*, 848 F.3d at 786; *see* reg. section 1.994-1(a).

[13] Section 408A(c).

[14] Section 408A(d).

[15] Sections 219 and 408A(c)(2)-(3).

[16] *Id.* The Sixth Circuit in *Summa Holdings* disagreed with this supposition, citing section 408A(d)(3) for support. *Summa Holdings*, 848 F.3d at 789. This provision allows traditional IRA owners (who can make contributions regardless of their income) to roll their IRAs over into Roth IRAs. *Id.* It is worth noting that traditional IRAs have yearly contribution limits, even though they do not have income eligibility limits. Sections 219 and 408.

[17] *Summa Holdings*, T.C. Memo. 2015-119.

[18] *Id.*

[19] Sections 219 and 408A.

[20] *Summa Holdings*, 848 F.3d at 784.

[21] *Id.*

[22] *Summa Holdings*, T.C. Memo. 2015-119.

[23] *Summa Holdings*, 848 F.3d at 779.

[24] *Id.* at 784.

law."[25] Because the statutory text was unambiguous and the taxpayers complied with the statute, the Sixth Circuit held that neither the IRS nor the judiciary had any authority to alter the tax consequences of the transactions by applying antiabuse doctrines.

Second, the Sixth Circuit held that the IRS's proposed recharacterization could not be justified by the legislative history of the applicable provisions. The IRS argued that Congress did not intend for taxpayers like the Benensons to combine the DISC and Roth IRA provisions to achieve the results that they did. The Sixth Circuit disagreed, explaining that even if the taxpayers were using the DISC provisions to sidestep Roth IRA contribution limits in a manner that Congress had not contemplated, "the substance-over-form doctrine does not give the commissioner a warrant to make or redo any policy missteps the legislature happens to make."[26] The Sixth Circuit pointed to the history and content of both the Roth IRA and DISC code sections to support this conclusion. The Sixth Circuit noted that Congress created DISCs and Roth IRAs to lower taxes through transactions that do not require economic substance. Further, Congress specifically contemplated that IRAs could hold DISC shares.[27] Thus, the Sixth Circuit held that the use of these two provisions to reduce the Benensons' tax burden did not frustrate congressional intent. The Sixth Circuit was not persuaded that the commissioner had the power to place ad hoc limits on these transactions "by invoking statutory purpose (maximizing revenue) that has little relevance to the text-driven function of these portions of the code (minimizing revenue)."

Comparison With Other Cases

The Sixth Circuit in *Summa Holdings* used more taxpayer-favorable language than some other circuits that have recently discussed the substance-over-form and economic substance doctrines, and taxpayers have already cited *Summa Holdings* in appellate court pleadings. For instance, in the latest structured trust advantaged repackaged securities (STARS) transaction case, *Santander*, the taxpayer filed a petition for a writ of certiorari, arguing a circuit split regarding how courts interpret the antiabuse doctrines and the role of the judiciary in applying common law to the provisions of the code.[28] The taxpayer argued that some circuits apply the antiabuse doctrines using a more restrictive text-bound analysis that allows the judiciary to deny tax benefits only when that denial is "consistent with other canons of statutory construction."[29] Under this approach, the taxpayer argued that the economic substance doctrine does not deny tax benefits based on the "'economic reality' of a transaction, or attempt to divine the 'overarching' purpose of the code," but rather looks to the purpose behind the "specific provisions of the code that the government seeks to override."[30] This approach, the taxpayer asserted, clashed with that of other circuits which apply the economic substance doctrine as a freestanding common law rule to deny tax benefits whenever a transaction lacks "'economic reality.'"[31] The taxpayer in *Santander* argued that these approaches produce different outcomes in factually comparable situations.[32]

The underlying issue in *Santander* gives context to the taxpayer's argument. The First

[25] *Id.* at 782.

[26] *Id.* at 790.

[27] Sections 246(d) and 995(g); *see also Summa Holdings*, 848 F.3d at 782.

[28] Petition for writ of certiorari, *Santander Holdings USA Inc. v. United States*, No. 16-1130 (Mar. 16, 2017). The taxpayer in *Santander* argued this circuit split, in addition to the more well-known circuit split, regarding whether foreign taxes are expenses when determining whether a transaction that generates foreign tax credits has pre-tax profit. *See, e.g.*, *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) (finding foreign taxes were not an expense when determining whether a transaction had pre-tax profit potential); *IES Industries Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001) (same); *Santander Holdings USA Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016) (finding foreign taxes were an expense when determining whether a STARS transaction had pre-tax profit potential), *cert. denied*, No. 16-1130 (June 26, 2017); *Bank of New York Mellon Corp. v. Commissioner*, 801 F.3d 104 (2d Cir. 2015) (same); and *Salem Financial Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015) (same).

[29] Petition for writ of certiorari, *Santander*, No. 16-1130, at 25.

[30] *Id.* (quoting *Summa Holdings*, 848 F.3d at 788).

[31] Petition for writ of certiorari, *Santander*, No. 16-1130, at 24 (quoting *Coltec Industries Inc. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006)).

[32] Petition for writ of certiorari, *Santander*, No. 16-1130, at 24.

Circuit denied the taxpayer's foreign tax credits that were created through arrangements that entitled the taxpayer to the credits under a technical reading of the relevant code provisions and regulations.[33] The First Circuit held that the transactions lacked pre-tax profit potential and, therefore, economic substance.[34]

On one hand, given the differences between the *Summa Holdings* and *Santander* transactions, the disparate conclusions reached by the First and Sixth Circuits may not actually reflect broad disagreement. The *Santander* transaction concerned foreign tax credits, which are core revenue provisions intended to avoid double taxation of income and to maintain neutrality between domestic and foreign investments in the face of a complex international tax scheme. *Summa Holdings* involved provisions the Sixth Circuit found were intended to reward favored behavior — retirement savings and exports — through tax savings.[35] These provisions are different in kind from the core revenue provisions that cover income measurement, recognition, and categorization. And those core revenue provisions are what the common law antiabuse doctrines were designed to interpret. Thus, the textualist approach taken by the Sixth Circuit in *Summa Holdings* may be especially appropriate given that the provisions at issue were intended to achieve nontax policy objectives.

But the language and analysis in *Summa Holdings* is more taxpayer-favorable than other recent case law discussing the antiabuse doctrines. For instance, the Federal Circuit has described economic substance as a prerequisite to any deduction (or, presumably, other tax benefit) offered by the code, and the Second Circuit has described the economic substance doctrine as a "second look" that allows courts to ensure that specific uses of statutory provisions provide the tax benefits that Congress intended.[36] The Second Circuit has also applied antiabuse principles to reverse a district court opinion in part because one of the district court's conclusions "depended on the fictions projected by the partnership agreement, rather than on assessment of the practical realities."[37] Finally, the Third Circuit has described the antiabuse doctrines as tools the judiciary may use to judge the substance of a transaction to determine when tax benefits should be rightfully denied.[38] It is likely that the textualist approach used by the Sixth Circuit would produce different results in any of these circuit court decisions.

The Sixth Circuit is not the only court that has declined to use an antiabuse doctrine to deny a benefit provided by the plain language of a statute. For instance, in *Gitlitz*,[39] the IRS argued that a discharge of indebtedness was not an "item of income" because section 108(a) excluded the discharge of indebtedness from gross income. The IRS made this argument because if the taxpayers' discharge of indebtedness was characterized as an item of income, but not gross income, the taxpayers would receive a windfall — their bases in their S corporation stock would be increased even though the taxpayers did not recognize

[33] *Santander*, 844 F.3d at 22-26.

[34] *Id.* In making its pre-tax profit determination, the First Circuit treated the foreign taxes paid as expenses that reduced profit. *Id.* The taxpayer argued that this method conflicted with that of other circuits and "stacks the deck against finding a transaction profitable and directly affects the viability of a wide range of international transactions by U.S. companies." Petition for writ of certiorari, *Santander*, No. 16-1130, at 3-4 (citing *Compaq*, 277 F.3d 778, and *IES Industries Inc.*, 253 F.3d 350).

[35] Even though the DISC export incentives have been eliminated, the code still allows DISCs to "receive commissions and pay dividends that have no economic substance at all." *Summa Holdings*, 848 F.3d at 786.

[36] *Bank of New York Mellon Corp.*, 801 F.3d at 113 (denying foreign tax credits derived from a STARS transaction that the court held had no economic substance despite otherwise complying with the code); and *Salem Financial*, 786 F.3d at 941 (same). Both examples were cited in the taxpayer's petition for writ of certiorari in *Santander*, No. 16-1130, at 20.

[37] *TIFD III-E Inc. v. United States*, 459 F.3d 220, 234 (2d Cir. 2006) (holding a bank had no bona fide equity participation interest in a partnership despite the terms of the partnership agreement because it did not have any meaningful upside or downside risk). This case is commonly referred to as *Castle Harbour*.

[38] *See Historic Boardwalk Hall*, 694 F.3d at 448-449, 448 n.50 (denying historic rehabilitation credits to an investor in a partnership, concluding, as a matter of substance, that the investor did not have any meaningful upside or downside risk and, therefore, was not a bona fide partner).

[39] *Gitlitz v. Commissioner*, 531 U.S. 206 (2001).

gross income.[40] Despite this windfall, the Supreme Court denied the IRS's theories and arguments regarding policy concerns and held that the plain language of section 108(a) was unambiguous — it required the relevant discharge of indebtedness to be treated as an item of income.[41] The Supreme Court's textualist approach to an unambiguous statute adds further support to the Sixth Circuit's rationale in *Summa Holdings*.[42]

Although the circuits apply slightly different tests for the antiabuse doctrines, the fundamental difference being analyzed is not the tests themselves — it is how these doctrines interact with the text of underlying statutes. Every circuit imposes limits on the antiabuse doctrines where Congress clearly intended a benefit. For instance, there is no requirement to show profit potential or other nontax business purpose when shareholders elect for a company to be treated as an S corporation rather than a C corporation, or finance that company with debt rather than equity.[43] The legislative history to the economic substance codification is relevant and also supports limitations on the antiabuse doctrines by citing situations in which the doctrines should apply to deny tax benefits.[44] Perhaps the question is whether *Summa Holdings* signals a more tax-favorable line demarcating the doctrines' applicability, narrowing the category of cases to which they apply.

It is likely that the Sixth Circuit's analysis will have to be addressed by at least two other circuits. The taxpayers in *Summa Holdings* lost in the Tax Court, but each taxpayer — Summa Holdings, the trust, and the Benensons — filed appeals to different circuits. The Sixth Circuit was the first to consider the issue for Summa Holdings, but the other taxpayers have related appeals pending before the First and Second circuits.[45] These appeals will provide an opportunity for the First and Second circuits to revisit their prior holdings and possibly adopt the Sixth Circuit's language and taxpayer-favorable result. If the circuits disagree, this issue could be taken to the Supreme Court.

Conclusions and Future Considerations

The broad language used by the Sixth Circuit in *Summa Holdings* will likely continue to be cited by taxpayers to support textual arguments. While there is risk associated with such reliance — the fact pattern in *Summa Holdings* was unique — other circuits could adopt this approach to more narrowly interpret the substance-over-form and economic substance doctrines. To the extent that this language and analysis is adopted in other circuits and applied to other types of transactions, it will provide fortuitous benefits to taxpayers. But it is too early to determine the impact of *Summa Holdings*. ■

Correction

Ian Fontana Brown's special report "The UP-C IPO and Tax Receivable Agreements: Legal Loophole?" *Tax Notes*, Aug. 14, 2017, p. 859, mischaracterized the views of Phillip Gall and Robert Willens that were expressed in the prior *Tax Notes* article cited in footnote 8 by Amy S. Elliott, "IPO Agreements That Shift Basis Step-Up to Sellers Proliferate," *Tax Notes*, July 25, 2011, p. 334. Their views were in no way supportive of the notion that UP-C transactions and tax receivable agreements are questionable from a legal or ethical perspective. The special report has been corrected.

Tax Analysts regrets the error.

[40] *Id.* at 207.

[41] *Id.* at 207, 213-214. In addressing a separate but related issue, the Supreme Court also stated: "Courts have discussed the policy concern that, if shareholders were permitted to pass through the discharge of indebtedness before reducing any tax attributes, the shareholders would wrongly experience a 'double windfall.' . . . Because the code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." *Id.* at 219-220.

[42] *See also Horn v. Commissioner*, 968 F.2d 1229, 1232 (D.C. Cir. 1992) ("The principal problem that we find with the commissioner's argument is that it takes the sham transaction doctrine too far. . . . In this case, the plain meaning of the statute authorizes the claimed deductions, and the commissioner has utterly failed to provide any other colorable interpretation.").

[43] JCT, "Technical Explanation of the Revenue Provisions," *supra* note 1, at 152-153; *see also* Notice 2014-58, 2014-44 IRB 746 (providing guidance as to how to apply the codified version of the economic substance doctrine).

[44] *See* JCT, "Technical Explanation of the Revenue Provisions," *supra* note 1.

[45] *Summa Holdings*, 848 F.3d at 784; *see also Benenson v. Commissioner*, No. 16-2066 (1st Cir. Aug. 19, 2016); *Benenson III v. Commissioner*, No. 16-2067 (1st Cir. Aug. 19, 2016); and *Benenson v. Commissioner*, No. 16-2953 (2d Cir. Aug. 19, 2016).