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More About Tax "Substance": *Hellweg v. Commissioner*

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Holding property in Individual Retirement Accounts and Roth IRAs (collectively, "IRAs") is increasingly popular as a means of permitting income and gains to accumulate in a tax-deferred, and sometimes completely tax-exempt manner. In order to preserve the integrity of our tax system, the Internal Revenue Code imposes numerous restrictions on the use of IRAs, including limitations on the amounts that may be contributed to them; amounts contributed in excess of the statutory limits are subject to a significant excise tax.[1]

Unsurprisingly, some creative efforts by individuals to increase the value of their IRAs, beyond what might be expected from ordinary returns on investment, have met with push-back from the Internal Revenue Service. In a recent Tax Court memorandum decision, Roth IRAs owned equity interests in a domestic international sales corporation (DISC),[2] and various individuals who established those Roth IRAs successfully countered assertions that payments of commissions by a business controlled by them to the DISC lacked substance for purposes of an excise tax imposed on excess IRA contributions and should be treated as excess contributions subject to that tax.

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While the facts of the case may seem to be off the beaten path, the Tax Court opinion is in fact of interest, not only for its conclusions regarding how to determine the proper tax analysis of a complicated transaction, but also for its highlighting of how decisions made by the IRS in auditing a matter may affect the Commissioner's ability to explore issues through discovery and at trial.

Hellweg v. Commissioner

The petitioners in *Hellweg* were four individuals (referred to below individually as an Owner and collectively as the Owners) who held ownership interests in and controlled American Dehydrated Foods, Inc. (ADF), an S corporation that made ingredients for the pet food and specialty feed industries.

Each Owner had established a Roth IRA. Contributions to a Roth IRA are nondeductible, but income earned from property held by the IRA is generally not taxable either when earned or when distributed to an IRA beneficiary as a "qualified distribution."[3]

Each Roth IRA subscribed for 25% of the stock of ADF International Sales Co. (ADF International), which elected to be taxed as a domestic international sales corporation (DISC). The DISC regime permitted deferral of a portion of the Federal income tax on income from exports.[4] This deferral was accomplished by permitting an exporter who paid "commissions" to a DISC to deduct those amounts, even though the DISC was not currently taxable on the commission income. It was not necessary that the DISC actually perform any services for the exporter in order for commissions, up to a statutory safe harbor amount, paid to the DISC to be deductible.

Each Roth IRA then contributed its stock in ADF International to a C corporation (that is, a corporation which is not an S corporation) in exchange for all of the C corporation's stock, so that the four C corporations (each owned by one of the Roth IRAs) collectively owned all the stock of ADF International.

During the years at issue (2004 to 2006), ADF paid sales commissions to ADF International and deducted the amounts of those commissions. ADF International in turn was deemed under the DISC rules to have distributed a portion of its income attributable to those commissions to its four corporate shareholders, and also made actual distributions to its shareholders of income attributable to the commissions.

Following audits of the tax returns of ADF and the Owners for the years at issue, the IRS did not challenge the deduction of the commissions by ADF but did issue notices of deficiency to the Owners, on the basis that the DISC's commission income should be viewed as having been (i) distributed by each C corporation to the Owner whose Roth IRA owned that C corporation, and then (ii) contributed by that Owner to his or her Roth IRA. The Service concluded that the resulting deemed contributions

were greater than the statutory limits on contributions to a Roth IRA and should be treated as "excess contributions" subject to the excise tax imposed by Code section 4973. The IRS further asserted that the Owners were liable for penalties and additions to tax.

Summary Judgment Motion

The Owners filed petitions with the Tax Court for review of the IRS determinations, and moved for summary judgment.

The Commissioner opposed the motion, asserting that there were issues of material fact for trial -- for example, as to whether the petitioners' purpose in arranging the transactions was to avoid the limit on IRA contributions. The court concluded, however, that, since the IRS had not challenged on audit the treatment of the transactions for income tax purposes, the Commissioner could not now contend that the transactions lacked a business purpose.[5]

The Commissioner further asserted that there were material factual issues as to whether the commission payments were qualified DISC commissions and whether the commissions could be characterized as excess contributions to the Roth IRAs. The Commissioner was not specific as to what those facts were and claimed to be unable to be specific because he had not had a reasonable opportunity for discovery.

The court concluded, however, that the Commissioner's asserted need for discovery was "nothing more than a fishing expedition," and cited an earlier Tax Court decision which warned that "tax cases are to be thoroughly investigated before -- rather than after -- the notice of deficiency is issued".[6] The court concluded that there was no issue of material fact that would preclude the case from being decided on the basis of the motion for summary judgment.

Excess Contributions

With respect to whether the excise tax imposed on excess contributions to IRAs was applicable, the court rejected certain of the arguments offered by each side. The Owners asserted that the excess contributions characterization by the Commissioner was inappropriate because Congress, in enacting a provision (Code section 995(g)) that imposed the tax on unrelated trade or business income on income inclusions by a tax-exempt shareholder attributable to the ownership of shares of a DISC, indicated its approval of the ownership by an IRA of a DISC. The court concluded that it could not infer from section 995(g) that Congress had considered whether or how the excess contributions excise tax should or might apply in such circumstances.

The court also rejected the Commissioner's contention that the excess contributions tax should apply under the reasoning of IRS Notice 2004-8.[7] In Notice 2004-8 the IRS identified as "listed transactions" a type of transaction in which a corporation, owned by a Roth IRA under common control with a business, entered into transactions with the business that had the effect of transferring value to the corporation, for example, through (i) the acquisition by the corporation of accounts receivable from the business for less than fair market value or (ii) the transfer of intangible property or other property to the corporation as a contribution by a person other than the Roth IRA without a commensurate receipt of stock ownership.

Notice 2004-8 observed that, depending on the circumstances, Code section 482 might be applied to allocate income from the corporation to the individual who controlled the business or someone else, and that the excise tax on excess contributions may also apply. The court in *Hellweg* noted that IRS notices do not carry the force of law but further concluded, somewhat surprisingly, that the transactions before it were not within the scope of the Notice. Specifically, the court construed Notice 2004-8 as indicating that there would be an income tax adjustment in any situation in which the Notice applied. Because no section 482 adjustment, other reallocation of income, or other recharacterization for income tax purposes was asserted by the government in the circumstances before the court, the court concluded that the situation before it did not fall within the scope of the Notice.

The court characterized the Commissioner's position in *Hellweg* as being that the transactions were valid for income tax purposes but lacked substance for excise tax purposes only, and observed that this position "seems rather incongruous."

The Commissioner argued that the position that the transactions lacked substance for excise tax purposes only was appropriate here because the income tax and excise tax regimes were completely independent of each other, and apparently referred the court to Rev. Rul. 81-54,[8] in which commission payments to a DISC owned by trusts for the benefit of family members of the owners of a business were deemed to result in gifts as commissions were earned and paid. The ruling thus concluded that the transactions gave rise to potential gift tax obligations, but did not address whether there would be a recharacterization of the form of the transactions for income tax purposes.

The court in *Hellweg* observed that, while it was well established a transaction might be treated differently for income tax purposes on the one hand and for estate and gift tax purposes on the other, the excise tax on excess contributions was determined by reference to income tax concepts. For example, in the context of a traditional IRA, the excess contribution is defined by section 4973(b) as, in general, the excess of the amount contributed over the amount allowable as a deduction under Code section 219. The court ultimately concluded that the Commissioner, having not attacked or otherwise contested the treatment of the transactions for income tax purposes or convinced the court that the excise tax was not intended to be construed in a manner based on income tax principles, could not inconsistently characterize the transactions as contributions for purposes of the section 4973 excise tax.

In granting summary judgment to the Owners on the excise tax issue (and dismissing the penalties and additions to tax), the court observed that its decision would not prevent the IRS from contending that an excess contribution was made to the Roth IRAs when the

Roth IRAs acquired the stock of ADF International, if the stock of ADF International were undervalued. The opinion observes in a footnote that, given that ADF International received hundreds of thousands of dollars in commissions each year from a well-established business, its shares should have been worth a large amount.

Assuming, however, that ADF did not enter into a long-term contract with ADF International that provided ADF International with an irrevocable right to receive such commissions, it is difficult to see how the IRS could reasonably assert that ADF International had substantial value at the time the Roth IRAs acquired ownership interests in that corporation, merely by reason of the expectation that it would be paid commissions.

Observations

On the one hand, *Hellweg* may be viewed as an appropriate judicial refusal to permit selective recharacterization of transactions by the IRS for some purposes, but not others, where the IRS does not approve of the intended result. Given that Congress clearly intended that commissions paid to a DISC in compliance with the DISC rules be deductible for income tax purposes, as a means of reducing the tax burden on businesses engaging in export transactions (and without regard to whether the DISC provided services of equivalent value), it would be somewhat odd to recharacterize the commissions as (non-deductible) distributions to shareholders and contributions for a different federal tax purpose, at least without an express provision mandating such different treatment.

Conversely, however, the transactions before the court, taken as a whole, appeared to enable the Owners to add to the value of their Roth IRAs on the basis of what were in substance non-arm's length transactions and in a manner in excess of what the statutory limitations on Roth IRA contributions would otherwise permit. Taking that into account, it seems likely that this issue will be further contested by the government, either in the courts or, possibly, through a proposal for changes to the relevant statutory provisions.

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[1] See IRC §§ 219, 408, 408A, and 4973.

[2] *Hellweg v. Commissioner*, T.C. Memo 2011-58 (March 9, 2011). *See also Ohsman v. Commissioner*, TC Memo 2011-98 (May 3, 2011) (reaching the same conclusion as in *Hellweg* in a similar situation involving payments to a foreign sales corporation or "FSC"). The definition and tax treatment of a DISC are addressed by IRC §§ 991-997.

[3] IRC §408A(b).

[4] The DISC regime was largely superseded by the Foreign Sales Corporation (or "FSC") regime through amendments to the Internal Revenue Code (Code) by the Tax Reform Act of 1984 (P.L. 98-369), but in a manner that permitted the continued deferral of income previously deferred under the DISC regime.

[5] A potential issue which the opinion does not seem to address is whether the concept of "business purpose" is relevant in the context of determining the treatment of commission payments to a DISC for income tax purposes, or for excise tax purposes where the DISC is owned directly or indirectly by an IRA.

[6] *See Westreco, Inc. v. Commissioner*, 60 TCM 824 (1990), at 835.

[7] 2004-1 C.B. 333.

[8] 1981-1 C.B. 476.

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