Fun with Roth IRAs: New Sixth Circuit Decision Blesses Aggressive Tax Planning

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A recent decision by the Federal *Sixth Circuit* Court of Appeals expands the potential for Roth IRAs to be used to protect income from corporate and shareholder level tax.[1]

In general, a corporation can elect to be treated as an “interest charge domestic international sales corporation” (DISC) under the Internal Revenue Code if it meets certain requirements.[2] Although a detailed description of a DISC is beyond the scope of this Alert, a DISC generally allows owners of a related domestic manufacturer to reduce their tax burden attributable to foreign sales. Dividends received by an individual from a DISC are generally taxable as “qualified dividends.” Thus, the individual shareholders of the DISC usually must pay federal income tax on a DISC’s dividends at up to a 23.8% rate. Dividends received by an IRA (including a Roth IRA) from a DISC are generally taxable as “unrelated business taxable income” (UBTI).

Summa Holdings involved a DISC that was owned by a holding company (a domestic C corporation) that in turn was owned by some Roth IRAs. Although all the dividends paid by the DISC were subject (in the hands of the holding company) to federal income tax at normal corporate rates, the IRS argued that this structure allowed the beneficiaries of the IRAs to evade the contribution limits that apply to Roth IRAs. The shares of the DISC that were owned by the Roth IRAs were purchased for $3,000 and produced dividends aggregating more than $5 million over six years under the special transfer pricing rules that apply to DISCs. The Sixth Circuit case was appealed from a decision of the Tax Court. The Tax Court sustained the IRS’ use of the “substance over form” doctrine to effectively blow up the structure.

In reversing the Tax Court, the Sixth Circuit said:

> “the [Internal Revenue] Code authorizes investors to avoid significant taxes on capital gains and dividends by using their Roth IRAs in all manner of tax-avoiding ways, including by buying shares in promising new companies whose share prices may rise considerably over time or which may pay out large dividends over time.”

The court held that the IRS could not deploy the “substance over form” doctrine to plug a loophole expressly authorized by statute. Indeed, Sections 995(g) and 408(e) of the Internal Revenue Code sanction the ownership of a DISC through IRAs (but not expressly Roth IRAs) by treating a DISC’s dividends to an IRA as UBTI.

In view of the Sixth Circuit’s decision, it would appear that other tax-advantaged companies also could be owned through Roth IRAs. For example, a “captive insurance company” with $2.2 million or less of annual gross premiums (a “small captive”) is generally not subject to federal income tax on its underwriting income (which is determined after taking into account deductions for claims paid and deductions for insurance reserves).[3] This federal tax exemption can result in large increases in the value of the shares of the small captive and in large dividend payments to the holders of the captive’s stock. Because of this exemption and the *Summa Holdings* decision, a small captive may be a particularly good candidate to be held in Roth IRAs.

Another tax-advantaged vehicle that might be an attractive candidate for ownership by a Roth IRA is a foreign corporation that is not subject to significant tax in its home country or in the United States. Even if the income earned by the foreign corporation is “Subpart F income,” it does not appear that such income would be treated as UBTI to the Roth IRA or otherwise result in federal income taxation of the Roth IRA.

Even though it appears that the Sixth Circuit has blessed the use of Roth IRAs with tax-advantaged vehicles, the path is not entirely clear. The IRS may seek Supreme Court review of *Summa Holdings*. However, the Supreme Court need not hear the case, and the Supreme Court rarely takes up tax cases. In addition, another case could arise in a different jurisdiction. For example, the Ninth Circuit generally has looked favorably on the government’s tax positions. It is possible that another, future Tax Court decision under substantially similar facts to *Summa Holdings* could be appealed to the Ninth Circuit, or any other circuit outside of the Sixth Circuit, and such other circuit could rule in favor of the government’s position. In such event, there would be a “split” between the circuits. Furthermore, the Tax Court might continue to sustain the IRS’ arguments in Roth IRA cases involving taxpayers who reside outside the Sixth Circuit.

Moreover, a taxpayer still must establish a legitimate business purpose for forming the tax advantaged vehicle. For example, if a taxpayer formed a Cayman Islands corporation to simply shelter income from foreign sales, we have no doubt the IRS could successfully challenge the corporation as lacking “economic substance.”

Finally, Section 4958 of the Internal Revenue Code imposes up to a 225% excise tax on certain related party transactions with Roth IRAs (commonly referred to as “intermediate sanctions”) where such transactions are not “arm’s length.” Accordingly, where Section 4958 may apply, taxpayers must take extra care to ensure that the terms of any agreements are market-based.

1 *Summa Holdings, Inc. v. Comm’r*, 119 AFTR 2d 2017-787 (6th Cir. 2017).

2 *See* Internal Revenue Code Section 992.

3 *See* Internal Revenue Code Section 831.

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