Recent Court of Appeals Decision Provides Hope for Taxpayers Fighting for Congressionally Sanctioned Tax Benefits

Skadden

2/23/17

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Christopher P. Bowers
Washington, D.C.
202.371.7060
chris.bowers@skadden.com

David W. Foster
Washington, D.C.
202.371.7626
david.foster@skadden.com

Armando Gomez
Washington, D.C.
202.371.7868
armando.gomez@skadden.com

Raj Madan
Washington, D.C.
202.371.7020
raj.madan@skadden.com

Alan J.J. Swirski
Washington, D.C.
202.371.7610
alan.swirski@skadden.com

Nathan P. Wacker
Washington, D.C.
202.371.7182
nathan.wacker@skadden.com

For the second time in just over a year, the U.S. Court of Appeals for the Sixth Circuit reversed the United States Tax Court and affirmed the right of a taxpayer to structure its affairs in a manner that takes into account tax advantages or benefits conferred by the plain text and meaning of the Internal Revenue Code (Code).

In *Summa Holdings, Inc. v. Commissioner*, the Sixth Circuit made clear that there are limits to the judicially created substance-over-form doctrine, rejecting an effort by the IRS to apply the doctrine to alter a result that both parties agreed was permitted by the plain language of the Code. The decision was issued just 13 months after a different panel of the Sixth Circuit reached a similar conclusion in *Wright v. Commissioner*. It seems clear that several judges on the Sixth Circuit are unlikely to be swayed by policy arguments when the plain text of the Code permits taxpayers to claim benefits that may not specifically have been contemplated by Congress. These are not outlier decisions. In 2015, the Fifth Circuit reversed the Tax Court in *Pilgrim's Pride Corp. v. Commissioner*, utilizing a similar text-based approach to the interpretation of the Code. And in 2001, the Supreme Court applied a plain reading of the Code to reverse the Tax Court and the Tenth Circuit in *Gitlitz v. Commissioner*. Although it remains to be seen whether the more recent decisions, such as *Summa Holdings*, will lead the IRS to be more cautious when advancing judicial doctrines to challenge tax-motivated transactions, these decisions should be viewed as a rebuke, both to recent attempts by the IRS to disregard the clear language of the Code to collect more revenue, and to lower courts that might be inclined to follow the IRS' lead. Decisions like *Summa Holdings* can be expected to provide taxpayers and their advisers with additional confidence when structuring business transactions, for they confirm a proposition that has been under siege in recent years but was once taken for granted — that the text of the Code matters.

In *Summa Holdings*, two individuals established Roth IRAs, and subsequently caused the IRAs to acquire stock of a domestic international sales corporation (DISC). Each year, the DISC paid substantial dividends to the IRAs. Pursuant to Section 995(g) of the Code, the IRAs were required to pay unrelated business income tax on the amounts of the dividends. However, the balance of the amounts received would be permitted to be invested and accumulate tax-free within the IRAs, and then could be distributed without further taxation when permitted under the rules applicable to Roth IRAs. The IRS challenged this structure, attacking it as a "listed transaction" described in Notice 2004-8. The taxpayers readily conceded that the purpose of the transaction was to enable the Roth IRAs to accumulate income that could later be distributed free from tax. Without questioning the validity of the transaction under the technical provisions of the Code, the IRS invoked the substance-over-form doctrine to challenge what the IRS claimed was an inappropriate effort to circumvent the annual limitation on the amount that an individual can contribute to a Roth IRA each year. This was necessary, the IRS argued, in order to respect "overarching ... principles of federal taxation."

Although the Sixth Circuit made clear that the labels used by taxpayers do not control the substance of what was done, and that courts may properly consider the economic substance of a transaction, the court would not allow the IRS to use a judicial "doctrine" to override a tax benefit that the Code clearly permits. The court explained that cases like *Commissioner v. Court Holding Co.* do not give the commissioner *carte blanche* to recast any transaction that he does not like, stating, "What started as a tool to prevent taxpayers from placing labels on transactions to avoid tax consequences they don't like runs the risk of becoming a tool that allows the Commissioner to place labels on transactions to avoid textual consequences he doesn't like." Instead, the court held that the substance-over-form doctrine should only be applied "when the taxpayer's formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process."

Recognizing that Congress has populated the Code with provisions whose purpose is to permit taxpayers to avoid taxes, the court made clear that "[t]he Commissioner may not place ad hoc limits on them by invoking a statutory purpose (maximizing revenue) that has little relevance to the text-driven function of these portions of the Code (minimizing revenue)." The court's conclusion sums it all up, saying that "[t]he last thing the federal courts should be doing is rewarding Congress's creation of an intricate and complicated Internal Revenue Code by closing gaps in taxation whenever that complexity creates them."

Summa Holdings is well worth reading for both tax planners and those who handle tax controversies. Related appeals of the Tax Court's decision in *Summa Holdings* are pending in the First and Second Circuits; those appeals were stayed pending action by the Sixth Circuit, and presumably will now move forward. No doubt the government will say that this is just one decision, but coming on the heels of the Sixth Circuit's 2016 decision in *Wright* and the Fifth Circuit's 2015 decision in *Pilgrim's Pride*, not to mention the Supreme Court's similar reasoning in *Gitlitz*, this case provides an important reminder that text matters when it comes to interpreting the tax law.

1440 New York Avenue, N.W. / Washington, D.C. 20005 / 202.371.7000

Four Times Square / New York, NY 10036 / 212.735.3000