Fisher Broyles

CLIENT ALERT
June 17, 2021

Follow the Internal Revenue Code Precisely, and You will be Fine: Taxpayers Win in *Mazzei*

On June 2, 2021, the Ninth Circuit in *Mazzei v. Commissioner,* No. 18-72451 (9th Cir. June 2, 2021) reversed a ruling from the Tax Court that held the Mazzei family was liable for excise taxes for excess contributions[1] to their Roth Individual Retirement Accounts (IRAs). The *Mazzei* decision joins the First, Second and Sixth Circuits[2] in rejecting the use of the economic substance doctrine to the circumstances where taxpayers followed precise provisions found in the Internal Revenue Code ("Code").[3]

The Ninth Circuit noted that foreign sales corporations ("FSCs") are creatures of statute and are shell companies that the Code allows, even though FSCs have the feel of a tax shelter. "The taxpayers used what is essentially a shell corporation to engage in arbitrarily priced, self-dealing transactions that lacked economic substance and then funneled those proceeds as 'dividends' to a tax-free Roth IRA," the court said. Id at 12. Nonetheless, the court continued:

> It may have been unwise for Congress to allow taxpayers to pay reduced taxes, and pay out dividends, 'through a structure that might otherwise run afoul of the Code. . . . But it is not our role to save the Commissioner from the inescapable logical consequence of what Congress has authorized. Id at 19.

"The substance-over-form doctrine 'is not a smell test,' it is a tool of statutory interpretation,'" the court said, quoting *Benenson*. Id at 19.

The Mazzei's used their Roth IRAs to buy equity in a foreign sales corporation (FSC) that they had newly formed under the former Code § 921.[4] Consequently, the Roth IRAs were shareholders in the FSC. When the FSC received revenue, it in turn paid dividends to its shareholders. With the receipt of the dividends, the Roth IRAs paid no tax on such receipt (as earnings inside a Roth IRA are tax-free) and, with the IRA being a Roth, the Mazzei's did not have to pay income on their distributions/withdrawals.

The Tax Court, using substance-over-form principles, upheld the IRS's excise tax finding that the Mazzei's – and not their Roth IRAs – were the true owners of the FSC. The Ninth Circuit concluded, however, that the Tax Court erred by disallowing what the Code allowed. The Ninth Circuit concluded that the Tax Court (and the Internal Revenue Service) could not use substance-over-form principles to reverse the congressional judgment on tax provisions available to taxpayers under the Code. The court was quite clear:

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[1] IRC §4973

[2] S*umma Holdings, Inc. v. Commissioner,* 848 F.3d 779 (6th Cir.2017), rev'g 109 T.C.M. (CCH) 1612 (2015) which dealt with the use of a Roth IRA as a shareholder of an IC-DISC; *Wright v. Commissioner,* which dealt with the question whether an over-the-counter option is a foreign currency contract under §1256(g)(2); and *Benenson v. Commissioner*, 887 F.3d 511 (1st Cir. 2018) dealt with a Roth IRA owning a Domestic International Sales Corporation (DISC).

[3] The Internal Revenue Code of 1986, as amended.

[4] This specific Code § 921 for FSCs was repealed; however, the repeal is not relevant here.

the Roth IRAs, not the Mazzei's individually, are considered owners of the FSC. The court continued that, if the Mazzei's are not the FSC owners, it cannot be said that the Mazzei's individually received the (large) dividends, which the Mazzei's, in turn, contributed to the Roth IRAs. (Such large dividends would be considered "excess" contributions that purportedly circumvented the then $2,000 annual contribution limit to a Roth IRA.) Consequently, the Mazzei's were not responsible for any excise tax for excess contributions, because it was the Roth IRAs – and not the individuals – who received the dividends from the FSC.

In both *Summa Holdings* and *Wright*, the Sixth Circuit held that the taxpayers had reasonably interpreted the relevant statutes, and consequently, recharacterization pursuant to a judicial doctrine was unwarranted. In *Berenson v. Commissioner*[5], the First Circuit similarly held for the taxpayers and reversed the Tax Court, concluding that the Roth IRA owners did not owe excise tax on excess Roth IRA contributions as a result of the transactions at issue. The First Circuit stated that the substance-over-form doctrine "is not a smell test," rather, it is "a tool of statutory interpretation[6].

Implications to Other Perceived Tax Shelters

The *Summa Holdings* line of cases could apply to other areas of the Internal Revenue Code where using funds inside of an IRA could support certain strategies.

Consider Code § 831(b) dealing with Microcaptives. A Microcaptive allows an operating business to pay a property and casualty insurance premium to a wholly-owned (or commonly owned) captive insurance company provided that the captive insurance policy(ies) issued meets the definition of "insurance" for Federal income tax purposes. The taxpayer then elects to treat the captive insurance company as a "small insurance company" under §831(b) of the Code which provides that so long as the premiums paid to the captive insurance company are less than $2.4 million[7] in which case its "underwriting income " is not taxable. For a number of years, Microcaptives have been listed on the IRS's "Dirty Dozen List of Tax Scams." Further, in 2016 the IRS issued Notice 2016-66 causing Microcaptive transactions to be "transactions of interest" requiring the taxpayer, captive insurance promoter, and "material" advisers to file a Transaction of Interest Report, annually, with the IRS.

By enacting §831(b) of the Code, Congress expressly intended and provided that Microcaptives would not be subject to federal income tax on underwriting profits if premiums paid to the captive is less than $2.4 million[8]; consequently, those premiums could be used as dividends to the captive's shareholders. Notwithstanding recent IRS victories in the Tax Court on cases[9] that dealt with egregious facts, so long as the captive insurance company is properly formed, that the elements of risk-shifting and risk-distribution are present and that adequate capitalization and licensing are present, the *Summa Holdings* line of cases should apply to hold the captive insurance as a valid tool sanctioned by Congress.

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[5] 1st Cir., No. 16-02066 (Apr. 6, 2018). Summa Holdings was limited to the treatment of the commission payments the Summa Holdings subsidiaries made, whereas the Tax Court addressed the entire case, including the application of the excise tax on excess Roth IRA contributions to the Roth Beneficiaries who resided in the First Circuit.
[6] *Benenson v Commissioner*, 887 F. 3d 511 (1st Cir. 2018), 523.
[7] Rev .Proc. 2020-45; 2020 IRB 1016.
[8] In 2016, Congress increased the premium limit to $2.2 million (subject to annual inflation adjustment) from $1.2 million.
[9] *Caylor Land & Development Inc. v. Commissioner*, T.C. Memo. 2021-30; *Syzygy Insurance Co. Inc. v. Commissioner*, T.C. Memo, 2019-34; *Reserve Mechanical Corporation v. Commissioner*, T.C. Memo, 2018-86; and *Avrahami v. Commissioner*, 149 T.C. 144 (2017).

As these various cases illustrate, invoking the economic substance doctrine is unwarranted where the interpretation of the statutes in question was reasonable and consistent with Congressional intent.

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