Forbes

How Big Is Sixth's Circuit's Attack On IRS Substance Over Form Rule?

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Summa Holdings, a Sixth Circuit opinion written by Judge Jeffrey Sutton is causing a bit of a stir in the tax world. The gimmick that the Berenson family's attorneys were defending, using a corporate tax break for export companies to pump millions into a Roth IRA (which allows for exempt investment earnings for a very long time)is not something very many people are in a position to do and there can be an upfront income tax bite. So having the Sixth Circuit bless this arrangement in spite of what IRS and the Tax Court think of it is really not of that much interest outside of a very small circle. What is exciting is the reasoning that the court uses. The Sixth Circuit has challenged the venerable "substance over form doctrine".

Each word of the "substance-over-form doctrine," at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. "Form" is "substance" when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern "over" the written form of the law—and to call it a "doctrine" no less.

As it turns out, the Commissioner does not have such sweeping authority. And neither do we. Because Summa Holdings used the DISC and Roth IRAs for their congressionally sanctioned purposes—tax avoidance—the Commissioner had no basis for recharacterizing the transactions and no basis for recharacterizing the law's application to them.

How Venerable?

Have you ever heard the expression"the greatest thing since sliced bread"? We use it to indicate an arbitrarily long period of time. Well according to this story in The Atlantic by Art Molella on the origin of that expression:

The first effective bread-slicing machine was invented by Iowa-born Otto Frederick Rohwedder and put into service in 1928 by the Chillicothe (Missouri) Baking Company

Searching for substance over form, I found allusions to the concept as early as 1918. So there was talk of substance versus form before there was sliced bread. That's venerable.

Letter Of The Law

My piece on the decision last week drew comments applauding the holding of the IRS to the letter of the law. Billy G. wrote:

The US is supposed to be a nation of laws, not of men. If the IRS can just ignore what the law says then we don't have laws, we have a tyranny. The IRS, nor anyone else, does not get to ignore the laws because they object to the outcome. They can petition to have the law changed but they cannot ignore it.

The Cato Institute had a similar reaction with a post titled Court: IRS, Unlike Caligula, May Punish Only Under Well-Proclaimed Law.

On Lexology Ronald Levitt and David Wooldridge wrote:

At least for now, the Sixth Circuit's view of substance-over-form may put a chill on how the IRS attacks congressionally mandated tax structures in the future, at least in the Sixth Circuit and maybe in others. We will see how the broad language of this case is used by taxpayers who are defending the use of transaction structures that Congress has mandated to provide a tax savings incentive to encourage certain types of activities.

On RSM Anne Bushman wrote:

Nonetheless, the Court decided that the labels the Summa taxpayers used are consistent with the economic reality and with transactions that are addressed in the statute so the IRS is not correct to relabel them as something else. This decision, therefore, may end up having a larger implication for taxpayers and the IRS by reshaping the substance over form doctrine.

Stu Bassin was real excited at Procedurally Taxing referring to the decision as a bomb-shell:

Read broadly, the Summa decision is a bomb-shell; it breaks a decade-long string of Service victories in appellate cases which rest upon application of judicial doctrines like the substance-over-form rule to undo transactions which the taxpayer designed to comply with the literal language of the Code (the most recent taxpayer victories were in 2001 in the 5th Circuit Compaq Computer v Commissioner and 8th Circuit in IES Industries v US). In almost all of the cases where the government prevailed, the taxpayer argued that it had complied with the Code and that it was inappropriate to invoke judicial doctrines or to judicially legislate based upon a judge's gut reactions to particular transactions. While most of the appellate courts have sided with the Service, the opinion of the Sixth Circuit emphatically rejected the Service's position—complete with an allusion to Caligula.

Barry Weisman of Anchin, Block & Anchin responded for my request for a comment as follows:

Few tax decisions contain references to both Caligula and Guy Helvering (Commissioner of Internal Revenue from 1933-1943). This unanimously-decided (Cincinnati based) Sixth Circuit case is less about Domestic International Sales Corporations (a fictional Congressional creation without any economic substance) and Senator William Roth's eponymous legacy (aside from his hair piece) then it is about the "substance over form" doctrine. As with the "step doctrine", substance over form has been an ingrained concept of jurisprudence and tax administration—except when the IRS or practitioners are displeased with the result and argue the other way.

Judge Jeffrey Sutton's decision stressed the overriding economic foundation of substance over form. Absent economics, "substance over form" becomes merely a tool for arbitrary and capricious administration without Congressional consent. Similar to Justice Scalia's dissent in King v. Burwell, Judge Sutton refused to rewrite the law the way the IRS wanted it to be and looked instead to the originalist meaning of the statute's words. If the IRS can't live with a result in which the taxpayer adhered to each related statute, then it should ask Congress to change the law and not have the courts and agencies act as parallel legislatures.

Either Judge Sutton or his clerk paid close attention in law school to probably their only tax course involving fundamental concepts of taxation. His survey decision contains some of the classic cases and the almost obligatory quotes from Learned Hand and Oliver Wendell Holmes forming the basis of tax doctrine and statutory construction: Gregory v. Helvering (1935) and Court Holding Co.(1945). It also demonstrates how District Court and Court of Appeals judges sometimes take a much broader view of statutory construction and legal principles than Tax Court judges.

This is an important decision because it provides a clear statutory construction framework for analyzing substance over form. Whether the IRS will appeal this case to the Supreme Court may depend on how it fares in two related cases in the First (Boston) and Second (New York) Circuits. This is a nebulous area in which asking for clarity from the tax-adverse Supreme Court may create even greater uncertainty

But Maybe Not That Big A Deal?

In commenting on my coverage Joe Kristan wrote:

I don't expect "wholesale" repudiation of "substance over form." It has a long pedigree. For example, I don't think the IRS will have to recognize sham "loans" to C corporation owners that are really dividends. This decision could narrow the scope of the doctrine, requiring Congress to be more careful in enacting tax goodies.

Len Burman seemed to join in the excitement tweeting:

This is an odd decision. If upheld, it will be a boon to the tax shelter industry.

When I checked with him, he indicated that there may be cause to be less excited:

Hi Peter. Thanks for checking. Several people who know the law (unlike me) made revealing comments in response. Andy Grewal (law prof at U. Iowa) said that this decision isn't likely to set a precedent since it wasn't the whole circuit court that considered the case and the IRS was

unlikely to press the matter. Another tax lawyer, Wade Sutton, said that the decision wasn't that important since a new code section (7701(o)) supersedes the one at issue in this case. So the issues are more complex than I made them out to be.

I have to admit that I was not that familiar, familiar at all really, with 7701(o), which was added in 2010. My excuse is that I have not been involved in designing sketchy tax shelters and 7701(o) has not been around long enough to show up in a lot of case law, since it is only applicable to post enactment transactions. 7701(o) codifies the economic substance doctrine indicating that a transaction will not be recognized unless it changes a taxpayer's economic position in a meaningful way beyond tax savings and has a substantial purpose beyond income tax effects.

I think it is possible that Summa would have stood up to the economic substance standard since it moved assets out of corporate solution and into retirement savings.

Things That Should Not Work But Do

There are a number of tax techniques that rely on the letter of the law that really don't make much sense. This DISC/Roth deal, which does not have broad applicability joins the ranks of such hallowed techniques as the defective grantor trust and discounts for interests in freshly created family limited partnerships. I fear my negative reaction to DISC/Roth is that I don't know anybody that I can recommend it to.