No. 18-72451

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

CELIA MAZZEI; ANGELO L. MAZZEI; MARY E. MAZZEI,

Petitioners-Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

ON APPEAL FROM THE DECISIONS OF
THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

RICHARD E. ZUCKERMAN
Principal Deputy Assistant Attorney General

TRAVIS A. GREAVES
Deputy Assistant Attorney General

GILBERT S. ROTHENBERG **(202) 514-3361**
TERESA E. MCLAUGHLIN **(202) 514-4342**
JUDITH A. HAGLEY **(202) 514-8126**
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases: **Page(s)**

Cases (cont'd): **Page(s)**

Cases (cont'd): **Page(s)**

Statutes:

Statutes (cont'd): **Page(s)**

Notices, Rules & Regulations:

Miscellaneous:

Miscellaneous (cont'd): **Page(s)**

GLOSSARY

Add.	addendum attached to appellants' opening brief
Br.	opening brief filed by appellants
DISC	domestic international sales corporation
ER	excerpts of record filed by appellants[1]
FSC	foreign sales corporation
Roth IRAs	Roth individual retirement accounts
SER	appellee's supplemental excerpts of record
Taxpayers	appellants Angelo, Mary, and Celia Mazzei

[1] Cites to appellants' excepts of record (ER) follow the convention used in their opening brief: the number before the colon refers to the tab number in the excerpts of record and the number after the colon refers to the page number within that tab. For example, "ER169:5" refers to excerpts of record Tab 169 (the Tax Court's opinion), page 5. The Commissioner's supplemental excerpts of record (SER) are paginated consecutively and do not utilize tabs.

JURISDICTIONAL STATEMENT

The Commissioner agrees with appellants' jurisdictional statement.

STATEMENT OF THE ISSUE

Earnings on investments in Roth individual retirement accounts (Roth IRAs) can accumulate and eventually be distributed tax-free, but only a limited amount ($2,000 during 1998-2001) can be contributed to a Roth IRA annually. From 1998-2001, more than $530,000 was shifted from appellants' family-owned business to appellants' individual Roth IRAs. These transfers took the form of dividend payments from a foreign sales corporation (FSC) that the Roth IRAs purportedly owned. Although nominally owned by the Roth IRAs, the FSC was controlled by appellants through a number of agreements that they entered into when the Roth IRAs purportedly purchased the FSC stock.

The question presented is whether the Tax Court correctly applied the substance-over-form doctrine to treat funds shifted to the Roth IRAs as distributions from the FSC to appellants, followed by excess contributions by appellants to the Roth IRAs.

APPLICABLE STATUTES AND REGULATIONS

The relevant statutes and regulations are included in the addendum to appellants' opening brief.

STATEMENT OF THE CASE

A. Procedural overview

This case involves a marketed tax-avoidance scheme designed to circumvent Congress's strict limits on annual contributions to Roth IRAs. Appellants — Angelo and Mary Mazzei and their daughter, Celia (collectively, taxpayers) — embraced the scheme and transferred more than $530,000 from their highly successful family business to their own individual Roth IRAs during 1998-2001. The scheme — which used an entity designed by Congress to reduce corporate income tax on qualifying export sales (referred to as a FSC) — operated to circumvent the statutory Roth IRA contribution limits. Pursuant to those limits, taxpayers were entitled to contribute only $2,000 to their Roth IRAs in 1998 and $0 the remaining years. If the scheme succeeded, the more than $530,000 transferred, as well as investment earnings thereon, could eventually be distributed to taxpayers tax-free.

The Commissioner determined that the transaction's true substance was the payment of distributions to taxpayers, followed by

their contribution of those funds to the Roth IRAs. The Commissioner further determined that, because those contributions greatly exceeded the statutory contribution limits, taxpayers were liable for the excise tax on excess contributions under I.R.C. § 4973. Taxpayers challenged the Commissioner's determinations in the consolidated proceeding below.

After a trial, the Tax Court upheld the Commissioner's determinations. The court agreed with the Commissioner that the substance-over-form doctrine applied, but it applied the doctrine more narrowly than the Commissioner had proposed. Rather than disregard the FSC's involvement altogether, the court instead focused on the substance of a single step of the transaction: the purported purchase of FSC stock by the Roth IRAs. It held that when viewed together with agreements entered into by the parties, taxpayers, not their Roth IRAs, were the owners of the FSC stock. Taxpayers now appeal.

B. Background

1. Roth IRAs and the abusive transactions addressed in Notice 2004-8

The case involves a special kind of retirement account, known as a Roth IRA, which provides several tax benefits to taxpayers. *See* I.R.C.

§ 408A. Funds contributed to Roth IRAs accrue earnings tax-free, and qualified distributions to Roth IRA beneficiaries are not included in their gross income.[2] Because of these "significant tax benefits" and the "potential for abuse, Congress enacted certain restrictions." *Polowniak v. Commissioner*, 111 T.C.M. (CCH) 1132, at *6 (2016). Congress has strictly limited the amount that may be contributed to a Roth IRA in any given year. I.R.C. §§ 219(b)(5), 408A(c)(2). During the years at issue (1998-2001), taxpayers under 50 (like taxpayers here) could contribute no more than $2,000 annually to a Roth IRA.[3] *Id.* As income increases, moreover, the amount a taxpayer may contribute decreases, and taxpayers whose income exceeds certain limits cannot contribute at

[2] Contributions to the Roth IRA are not tax deductible. In contrast, contributions to a traditional IRA are deductible, but distributions to its beneficiaries are taxable. I.R.C. §§ 219(b)(5), 408(d)(1).

[3] This contribution limitation does not apply to qualified rollover contributions from another Roth IRA or eligible retirement plan, contributions to which were previously subject to annual limitations. *See* I.R.C. § 408A(e). But such amounts are not at issue here.

all. I.R.C. § 408A(c)(3). "Excess contributions" to Roth IRAs are subject to an annual 6% excise tax until they are eliminated.[4] I.R.C. § 4973(f).

By 2004, the IRS had become aware of transactions "that taxpayers [we]re using to avoid" Roth IRA contribution limits. Notice 2004-8, 2004-1 C.B. 333. Major shareholders of operating businesses were circumventing the contribution limits by shifting income to related entities that, in turn, were nominally owned by Roth IRAs belonging to the major shareholders (or members of their families). *Id*. To illustrate, a taxpayer owning a pre-existing business sets up a new Roth IRA and a new corporation, which operates as an intermediary. The taxpayer directs his Roth IRA to purchase shares in the intermediary corporation. He directs his pre-existing business to funnel funds to the intermediary corporation, which then distributes those funds to the Roth IRA as dividends. The taxpayer contends that the "dividend" payments to the Roth IRA were "investment" earnings from the

---

[4] The Code does not directly prohibit contributions in excess of the yearly limit. Instead, Section 4973 imposes a 6% tax on the lesser of excess contributions remaining in a Roth IRA or the fair market value of the account at the end of the taxable year. The tax applies for the year the excess contribution is made and continues to apply for each year until the amount corresponding to the excess contribution is removed. I.R.C. § 4973(b)(2).

intermediary corporation, not contributions from his pre-existing business. Notice 2004-8 warned that these and substantially similar transactions were "tax avoidance transactions" that the Commissioner would challenge in several ways, including by scrutinizing the Roth IRA's purported investment in the intermediary corporation and recasting the transaction to comport with its true substance under the substance-over-form doctrine.

The substance-over-form doctrine is one of the common-law tax doctrines utilized by Treasury and the courts to protect the public fisc from abusive tax-avoidance schemes. Under these doctrines, the "tax consequences of a transaction depend upon its substance, not its form." *Robino, Inc. Pension Tr. v. Commissioner*, 894 F.2d 342, 344-345 (9th Cir. 1990). That longstanding principle — implemented by the substance-over-form doctrine and the related, but distinct, economic-substance doctrine — is the "'cornerstone of sound taxation.'" *Southgate Master Fund, LLC v. United States*, 659 F.3d 466, 479 (5th Cir. 2011) (citation omitted). These "judicial doctrines empower the federal courts to disregard the claimed tax benefits of a transaction — even a transaction that formally complies with the black-letter provisions of

the Code and its implementing regulations — if the taxpayer cannot establish that 'what was done, apart from the tax motive, was the thing which the statute intended.'" *Id.* (quoting *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)). So, for example, if a taxpayer controls a piece of property, and has invested funds in that property that are at risk, then he will be treated as the owner for tax purposes under the substance-over-form doctrine, even if another person holds formal title to the property. *E.g.*, *Robino*, 894 F.2d at 344-345 (disregarding formal ownership of property by a trust because (among other things) the trust lacked "control" of the property).

Congress is aware of IRS efforts to utilize these judicial doctrines to shut down "abusive Roth transactions." Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2009 Budget Proposal*, JCS-1-08, at 17-18 & n.31 (2008) (citing Notice 2004-8). As the Joint Committee described the abuse, "[t]ax free distributions from Roth IRAs have created an incentive for some taxpayers to transfer value into a Roth IRA that is not legitimately characterized as return on investment for the assets held by the Roth IRA but rather is a disguised additional contribution."

Id.; *accord* Joint Committee on Taxation, *Present Law & Background Relating to Tax-Favored Retirement Savings*, JCX-98-14, at 60 & n.179 (2014) (citing Notice 2004-8 and observing that the Tax Court has upheld the Commissioner's "imposition of the excise tax on excess IRA contributions based on being a disguised excess contribution" generated in "abusive Roth transactions").

For the most part, the IRS's attempt to enforce Congressional contribution limits in Notice 2004-8 transactions has been successful. *See Repetto v. Commissioner*, 103 T.C.M. (CCH) 1895 (2012) (holding that taxpayer's purported payments to an intermediary corporation owned by taxpayer's Roth IRA were, in substance, disguised excess contributions to the Roth IRA); *Polowniak*, 111 T.C.M. (CCH) 1132 (same); *Block Developers, LLC v. Commissioner*, 114 T.C.M. (CCH) 68 (2017) (same, except the intermediary entity was a partnership). In each of these cases, the court found that payments to the intermediary entity lacked any substance and disregarded them accordingly.

One such enforcement effort, however, was rejected at the appellate level. *See Summa Holdings, Inc. v. Commissioner*, 109 T.C.M. (CCH) 1612 (2015), *rev'd by* 848 F.3d 779 (6th Cir. 2017) and *rev'd sub*

nom. Benenson v. Commissioner, 887 F.3d 511 (1st Cir. 2018) and 910 F.3d 690 (2d Cir. 2018).[5] There, the intermediary entity was a domestic international sales corporation (DISC) under I.R.C. §§ 991-997, designed to subsidize certain export sales. The Tax Court disregarded the payments to the DISC in its recharacterization of the transaction under the substance-over-form doctrine. The appellate courts reversed, reasoning that, under the DISC statutory scheme, payments to a DISC did not require any substance. Those courts did not, however, address the question presented in this appeal: whether the purported ownership of the intermediary entity by the Roth IRAs requires any substance.

2. FSCs: Taxpayers' chosen intermediary

In this case, the intermediary entity used to disguise excess contributions as a return on investment for stock nominally owned by a Roth IRA is a foreign sales corporation (FSC) under I.R.C. §§ 921-927 (repealed 2000), which, like a DISC, was designed to subsidize export

[5] The Notice 2004-8 transaction in *Summa Holdings* generated three separate appeals because the case involved multiple taxpayers residing within the jurisdiction of different circuits when the Tax Court petitions were filed.

sales. By way of brief background, Congress has long provided various tax incentives to U.S. corporations in an effort to encourage U.S. manufacturing and export sales. *Ford Motor Co. v. United States*, 908 F.3d 805, 806 (Fed. Cir. 2018). In 1971, Congress provided "special tax treatment for export sales made by an American manufacturer through a subsidiary that qualified as a '[DISC].'" *Boeing Co. v. United States*, 537 U.S. 437, 440 (2003). The DISC provisions allowed U.S. manufacturers to assign a portion of their income from export sales to a DISC by paying the DISC commissions, even if the DISC did not engage in any genuine business activity that would justify paying the commissions under normal tax rules. The DISC did not pay any U.S. tax, which allowed U.S. corporations to defer taxation until the DISC's income was distributed. Several U.S. trading partners complained that DISC treatment resulted in export subsidies that violated international law. *Id*. at 442.

In response, Congress largely scaled back the DISC regime in 1984 with provisions involving foreign sales corporations (FSCs), the

entity at issue in this case.[6] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 801(a), 98 Stat. 494; *see* I.R.C. §§ 921-927 (prior to 2000 repeal). FSCs were designed to reduce a U.S. manufacturer's corporate income tax on qualifying export sales.[7] *Ford*, 908 F.3d at 807. To achieve that tax benefit, the FSC provisions (i) allowed U.S. corporations to assign part of their income from export sales to a FSC under terms that might otherwise be disregarded as being non-economic, I.R.C. § 925, and (ii) exempted a portion of that assigned income from the corporate income tax, I.R.C. § 921(a). Then, when the FSC returned the income to the corporate parent as dividends, those dividends would not be subject to corporate income tax. I.R.C. § 245(c). Taken together, these provisions allowed a U.S. manufacturer to reduce

---

[6] The FSC provisions have been repealed. FSC Repeal & Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, § 2, 114 Stat. 2423.

[7] Sections 924 and 927 and the related regulations provided detailed rules regarding the types of property and transactions eligible for FSC treatment, but because those details are irrelevant to the appeal, we refer to qualifying transactions simply as "export sales." In addition, to qualify as a FSC, a corporation had to satisfy several organizational and operational requirements. I.R.C. §§ 922, 924. Those requirements were relaxed for so-called "small FSCs." I.R.C. § 922(a)(1), (b); Treas. Reg. § 1.921-2(b). It is undisputed that the corporation at issue here qualified as a small FSC. (ER169:34 n.28.)

its corporate income tax on export sales by approximately 15%. *See* I.R.C. §§ 923(a)(3), 925(a)(2); Treas. Reg. § 1.923-1T(b)(1).

To implement the FSC regime, Congress relaxed, for export sales, the transfer-pricing rules under I.R.C. § 482, which generally require related-party transactions to reflect arm's-length pricing. I.R.C. § 925. But under the relaxed rules, a U.S. corporate supplier of export goods could sell its goods to its FSC, or pay its FSC a commission for export-selling services, at non-arm's-length prices based on statutory formulas. I.R.C. § 925(a)(1) & (2), (b)(1). *See* ER169:30-33 (detailing FSC transfer-pricing rules).

By providing a corporate tax reduction for export sales, "Congress did not intend to grant 'undue tax advantages' to firms" utilizing FSCs. *Boeing*, 537 U.S. at 456 (citation omitted). Accordingly, Congress limited the tax benefits that FSCs could generate. Other than the special tax rules that applied to their receipt of qualifying export commissions (or their purchase of export products) and the reduced corporate income tax for such qualifying export income, FSCs were subject to the same tax rules applicable to other corporations. I.R.C. § 921(d); Joint Committee on Taxation, *Description & Analysis of*

Present-Law Tax Rules Relating to Income Earned by U.S. Businesses from Foreign Operations, JCS-20-95, at 40-43 (1995).

C. Taxpayers' Notice 2004-8 transaction

For more than 40 years, and for the entire time the FSC regime was in effect, taxpayers have owned and operated a business that manufactures certain products (injectors). (ER169:6-7; ER138:133-134.) The operating entity was an S corporation (Injector Corp.) from 1989 to 1998 and a partnership (Injector Co.) beginning in 1998. (ER169:7, 10.) Since 1984, as part of the business, the operating entity sold injectors overseas, relying on several foreign distributors. (ER169:7; ER156:7.)

Because taxpayers operated the business through pass-through entities and thereby avoided the corporate income tax altogether, they were not in a position to benefit from the reduction in corporate income tax offered by the FSC regime. (ER169:7 n.3, 9-10; ER138:136.) They became interested in FSCs in 1997, when they learned about a scheme designed to allow them to use a FSC to fund Roth IRAs to avoid the applicable contribution limits. (ER169:8-9; ER138:1.)

The scheme was promoted to them by a trade association that Angelo Mazzei had joined in the late 1970s, Western Growers

Association. (ER169:7-9.) A variation on the Notice 2004-8 transaction, the Western Growers' scheme was promoted as a "way to build up your IRA savings by letting your company's export profits feed it." (SER5.) Western Growers created and sold interests in FSCs to its members, emphasizing that the structure would offer tax benefits without any loss of control over the underlying business. (ER169:9; ER138:2.)

In early 1998, Injector Co. joined the Western Growers' FSC program, and taxpayers established self-directed Roth IRAs. (ER169:10; ER138:136.) Shortly thereafter, each taxpayer (i) contributed $2,000 to a Roth IRA,[8] and (ii) directed the Roth IRA to buy one-third of the FSC established for taxpayers' use.[9] (ER169:10-

---

[8] As noted above, Congress has limited the amount that can be contributed in any given year to a Roth IRA, an amount that decreases as the taxpayer's adjusted gross income increases. I.R.C. § 408A(c)(3). Based on their annual income, taxpayers' contribution limit for years before and after 1998 (the year that they entered into the FSC/Roth program) was $0. (ER169:9-10.) For 1998, taxpayers artificially lowered their income by restructuring their business so as to be eligible to contribute $2,000 to a Roth IRA that year. (ER169:9-10.) The details of how that was accomplished (described at ER169:10 n.6) are not in dispute.

[9] Technically, taxpayers' FSC was a separate account within a single "small FSC" shared by multiple Western Growers members. (ER169:11.) For simplicity, we refer to it simply as a FSC.

11.) The formal purchase price for all of taxpayers' shares in the FSC was $500. (ER169:11.)

To implement their Notice 2004-8 transaction, taxpayers entered into a number of agreements. (ER169:12-14.) Two of the agreements were offsetting: a Commission Agreement whereby Injector Co. would pay the FSC a commission to perform a number of export-related activities, and a Services Agreement whereby all of the activities contracted to the FSC were delegated back to Injector Co. (ER169:12-13; SER40-57.) Under these agreements, Injector Co. retained control over the business, including the right not to make commission payments to the FSC. (ER169:14-15.) The parties also entered into a Shareholders' Agreement that restricted the ability of the Roth IRAs to sell their stock in the FSC. (ER169:14; ER138:3-11.) Among other things, the sale price for the stock was limited to the shareholder's paid-in capital amount. (ER169:14; ER138:7.) Under the terms of this Agreement, only $1 of the $500 formally paid for the stock was treated as paid-in capital. (ER169:14; ER138:4.)

When the Roth IRAs purchased the FSC stock, the parties expected Injector Co. to make large commission payments based on its

prior record of, and established capacity to continue, extensive export sales. (ER169:50 & n.39, 75.) At that time, taxpayers' business was very profitable, and foreign sales accounted for one-third of its profits. (ER169:7; ER138:134; SER73-74.) During 1998-2001, taxpayers transferred more than $530,000 to their Roth IRAs by using the FSC scheme.[10] (ER169:35-36.) During that time period, Injector Co. (as a related supplier) made regular commission payments to the FSC, transferring $558,555 to it. (ER169:16.) The FSC, in turn, transferred the bulk of those payments to taxpayers' Roth IRAs ($533,057), after paying a reduced amount of corporate income tax ($25,499) on the commissions it received from Injector Co. (ER169:16.)

Taxpayers took the position that the funds transferred to the Roth IRAs represented a return on the Roth IRAs' investment in the FSC, rather than contributions by taxpayers to their Roth IRAs that exceeded the applicable contribution limits.[11] (ER169:18-19.) If the

---

[10] The repeal of the FSC provisions effectively ended Western Growers' FSC program by 2002. (ER169:16.)

[11] As noted above, during 1998-2001, the annual contribution limit for each taxpayer was $0, except for 1998 (when it was $2,000). (ER169:20.)

transferred funds were viewed as an investment return, then the Roth IRAs obtained a return of more than 30,000% on their $500 payment. (ER138:138-139.)

Pursuant to Notice 2004-8, which required taxpayers to report entering into any transaction substantially similar to the one described in the Notice, taxpayers disclosed their transaction on subsequent income tax returns. (ER169:17-18; SER1-2.) Upon audit, the Commissioner determined that taxpayers had made excess contributions to their Roth IRAs and determined deficiencies in their excise tax liabilities under Section 4973 for 2002-2007.[12] (ER169:18.)

D. Tax Court proceedings

During the Tax Court proceedings, the parties disputed the proper treatment of the FSC's payments to the Roth IRAs. Relying on the

---

[12] Although they disclosed their transaction, taxpayers did not file IRS Form 5329, as is required for taxpayers making excess contributions to Roth IRAs. (ER169:18.) Accordingly, the statute of limitations for the excise tax imposed by Section 4973 was never triggered and remained open for each year during which the excess contributions remained in the accounts, including the earlier tax years (1998-2001). Pursuant to IRS policy, however, the Commissioner imposed an excise tax on the excess contributions for only the most recent 6-year period (2002-2007). *See* Internal Revenue Manual 1.2.14.1.18(5) (2006) (Policy Statement 5-133).

transaction's form, taxpayers contended that the payments constituted a return on the Roth IRAs' investment in the FSC. The Commissioner, relying on the transaction's substance, contended that the payments were contributions by taxpayers to their Roth IRAs. Taxpayers argued that the form of their transaction must be respected because the substance-over-form doctrine does not apply when Congressionally sanctioned tax-saving entities (like FSCs or Roth IRAs) are utilized. (ER169:22-23.) The Commissioner argued that taxpayers had used the FSC to provide an unintended tax benefit as an end-run around the Code's strict Roth IRA contribution limits, converting their current business earnings from their injector business into a purported return on investment by the Roth IRAs. In arguing that the purported investment return should be recharacterized as excess contributions from taxpayers, the Commissioner applied the substance-over-form doctrine to recharacterize the entire transaction so as to disregard the FSC's involvement, including the commissions paid to it. (ER169:22.)

The Tax Court, in a 12-4 decision, agreed with the Commissioner that the substance-over-form doctrine applied to taxpayers' transaction. The court, however, rejected the Commissioner's request for a complete

recharacterization of the entire transaction and narrowly focused on whether taxpayers — rather than their Roth IRAs — were the substantive owners of the FSC stock. (ER169:23.) The majority concluded that taxpayers were indeed the owners in substance of the FSC stock. As a result, it determined that the payments from the FSC to the Roth IRAs were, in substance, income to taxpayers, rather than to their Roth IRAs, and then excess contributions by taxpayers to their Roth IRAs. (ER169:23.)

The Tax Court majority first observed that it was bound to analyze the objective economic realities of taxpayers' transaction, rather than the particular form that the related parties employed. (ER169:24-26.) The narrow question before the court — who owned the FSC's income for tax purposes — turned on who owned and controlled the FSC in substance. (ER169:39-41.) Applying that principle to the facts before it, the majority concluded that taxpayers, rather than the Roth IRAs, were the true owners of the FSC's income. (ER169:41-50.)

The majority's conclusion was based on several findings. It found that taxpayers, not the Roth IRAs, controlled every aspect of the FSC through the contractual powers retained by their pass-through

company, Injector Co. (ER169:46-49 & n.37.) As the majority pointed out, taxpayers continued to control the income after the FSC received it from Injector Co. because the Commission Agreement allowed Injector Co. to retrieve any commission even after it had been paid to the FSC. (ER169:48-49 & n.38.) The majority further found that the Roth IRAs were exposed to no real risk beyond the negligible $500 purchase price, whereas taxpayers were at all times exposed to the underlying business risk to their decades-long investment in their export business. (ER169:43-47 & n.37.) Indeed, it found that only $1 of the purchase price was invested in the stock, and the remaining $499 was a fee for Western Growers' tax-avoidance scheme. (ER169:45-46.) Finally, the majority found that there was a mismatch between the form and the substance of the purchase price. (ER169:50.) It observed that, in form, the Roth IRAs could expect no upside from the FSC, while the parties agreed that the stock was almost worthless, valuing it at no more than $100 when it was purchased by the Roth IRAs. (ER169:45-49.) In substance, however, the stock was quite valuable, because, as the court found, the parties expected taxpayers to direct large sums of money

from their export business to the Roth IRAs by paying large commissions to the FSC. (ER169:50 & n.39.)

Having found that, in substance, taxpayers owned the FSC, the majority further found that the dividends from the FSC to the Roth IRAs were properly recharacterized as dividends from the FSC to taxpayers, followed by taxpayers' contributions of those amounts to their respective Roth IRAs. (ER169:50.) It was undisputed that those contributions exceeded each of taxpayers' respective contribution limits for the years at issue. (ER169:20, 50-51.) The majority therefore upheld the Commissioner's determination of excise taxes under Section 4973.

The majority rejected the argument pressed by taxpayers and the dissenting judges that the FSC statutory provisions precluded the court's substance-over-form analysis. (ER169:36-38, 60-63.) As the court explained, no part of the FSC statutes or regulations provided, or even implied, that issues related to FSC ownership were exempt from normal tools of statutory interpretation such as the substance-over-form doctrine. (ER169:37, 60-63, 68.) To the contrary, the court further explained, Section 925 "by its own terms" does "not apply to FSC stock

purchase transactions," but merely allowed "a limited safe harbor" from the ordinary transfer-pricing rules contained in Section 482 for the commission payments made to the FSC by the related supplier. (ER169:37, 62.) The majority also rejected the related argument that its substance-over-form analysis frustrated Congressional intent underlying the FSC provisions. It explained that the only purpose of those provisions was to provide a "lower corporate rate for qualifying export-related income," and that determining who in substance owned the FSC had no impact whatsoever on that legislative purpose. (ER169:57.)

The majority also rejected the reliance by taxpayers and the dissenting judges on the Sixth Circuit's opinion in *Summa Holdings*, which also involved a Notice 2004-8 transaction, albeit one utilizing a DISC as the intermediary. (ER169:51-53, 59.) In applying the substance-over-form doctrine to the transaction in that case, the Commissioner had disregarded commissions paid to the DISC. The Sixth Circuit rejected the Commissioner's position, holding that commissions paid to the DISC had to be respected for tax purposes, even if they lacked substance. The Tax Court majority explained that

the Sixth Circuit's opinion was inapposite to the issue presented in the case at bar. It pointed out that the Sixth Circuit had not addressed the ownership of the DISC stock for tax purposes, but only whether the commission payments to the DISC had to be respected for tax purposes. (ER169:52-53.) The Tax Court emphasized that it did not disregard the commissions paid to the intermediary entity (as it had done in *Summa Holdings*), but only analyzed the purported purchase by the Roth IRAs of the intermediary's stock. (ER169:59.) And that narrow analysis was limited to the specific facts of taxpayers' transaction, a point emphasized by a concurring opinion.[13] (ER169:74-76.)

Taxpayers filed a motion for reconsideration and a motion to vacate, which the Tax Court denied. (ER179:1-6.) In so ruling, the court noted that the First Circuit had issued its opinion in *Benenson*

---

[13] The Tax Court also held that taxpayers were not liable for penalties. (ER169:69-73.) The Commissioner has not appealed that ruling. The court entered decisions enforcing the tax deficiencies determined by the Commissioner. (ER170.) Although the dollar figures in the decisions were accurate, the court's description of the deficiencies as being "income tax due" (ER170) is erroneous. As the court correctly noted in its opinion, the deficiencies determined by the Commissioner were "excise tax deficiencies." (ER169:5-6; *see* ER1:16, 46.) That typographical error in the Tax Court's decisions should be corrected in a limited remand.

and had "distinguished" the original *Mazzei* opinion from the Tax Court opinion under review in *Benenson* and *Summa Holdings*. (ER179:5.)

SUMMARY OF ARGUMENT

This case involves a variation of the Notice 2004-8 transaction, an abusive tax shelter designed to circumvent strict limits imposed by Congress on annual contributions to Roth IRAs. As Congress has explained, the transaction is "abusive" because taxpayers attempt to "transfer value into a Roth IRA that is not legitimately characterized as return on investment for the assets held by the Roth IRA but rather is a disguised additional contribution." JCS-1-08, at 17-18 & n.31 (citing Notice 2004-8).

The facts in this case bear out the abuse. In form, Injector Co. paid commissions to the FSC, which then passed as dividends to taxpayers' Roth IRAs. But, in substance, taxpayers had complete control over the FSC, and the Roth IRAs had no genuine attributes of ownership beyond formal title to the FSC stock. Relying on the form of the transaction, taxpayers shifted hundreds of thousands of dollars from their profitable family business to the tax-free investment vehicle of Roth IRAs — circumventing the statute restricting annual Roth IRA

contributions to $2,000. Consistent with Notice 2004-8 and precedent addressing ownership for tax purposes, the Tax Court correctly applied the substance-over-form doctrine to recharacterize the Roth IRAs' purported investment in the FSC as disguised excess contributions from taxpayers, and held taxpayers liable for excise taxes on excess contributions.

Unable to disturb the Tax Court's detailed factual analysis, taxpayers instead press two threshold issues in an attempt to bypass review of the Tax Court's substance-over-form ruling. Neither has merit. They first contend that this Court should simply follow the appellate decisions in *Summa Holdings* and *Benenson* because they decided the "same issue" as the Tax Court. That is incorrect, as those decisions acknowledged when distinguishing the Tax Court's analysis in this case here from the analysis that they adopted. The Tax Court here decided whether the Roth IRAs' formal ownership of the FSC stock should be respected for tax purposes. The decisions in *Summa Holdings* and *Benenson*, in contrast, did not address the ownership question, and they shed no light on the distinct, fact-intensive issue decided by the Tax Court here.

Similarly lacking merit is taxpayers' contention that transactions involving FSCs are wholly immune from the substance-over-form doctrine. As the Tax Court correctly concluded after a searching review of the text and history of the FSC provisions, Congress did not immunize questions regarding FSC ownership from the operation of normal tax principles. Rather, Congress only intended to allow taxpayers to transfer income from qualifying export sales to a FSC, even if the FSC has not in substance earned that income, so as to reduce the corporate income tax otherwise due on such income. But in all other respects, Congress intended that normal tax rules — including the substance-over-form doctrine and Roth IRA contribution limits — would apply to transactions involving FSCs.

Applying that doctrine to the specific facts of this case, the Tax Court correctly concluded that, in substance, it was taxpayers — not the Roth IRAs — who owned the FSC and the income that it generated. As the court found, and the record fully supports, taxpayers retained complete control over whether commission payments (and the amount thereof) would ever be paid to, or retained by, the FSC, and the Roth IRAs effectively paid nothing for the FSC stock, put nothing at risk, and

they could not have expected any benefits as an objective matter. Taxpayers have identified no error — let alone clear error — in the court's factual analysis.

Finally, taxpayers have failed to demonstrate that their Roth-funding Notice 2004-8 transaction is what Congress intended when it enacted the FSC provisions. Nor could they. Taxpayers did not use the FSC for its statutory purpose of subsidizing exports through a corporate tax reduction on export sales. Rather, they used it in an attempt to undermine a wholly different statutory scheme — the contribution limits set by Congress on Roth IRAs.

ARGUMENT

The Tax Court correctly disregarded the form of a transaction designed to fund taxpayers' Roth IRAs with payments that greatly exceed the statutory contribution limitations, and correctly determined that taxpayers were liable for excise taxes on their excess contributions

Standard of review

The "general characterization of a transaction for tax purposes is a question of law subject to [*de novo*] review," and the "particular facts from which the characterization is to be made are not so subject."

Frank Lyon Co. v. United States, 435 U.S. 561, 581 n.16 (1978). The clearly erroneous standard of review applies to the Tax Court's findings even if (as here) the Tax Court judge who decided the case is not the same judge who originally presided over the trial. *Stewart v. Commissioner*, 714 F.2d 977, 990 n.17 (9th Cir. 1983).

A. Introduction: The substance-over-form doctrine

This case concerns an attempt by taxpayers to circumvent strict limits imposed by I.R.C. § 408A on annual contributions to Roth IRAs by directing hundreds of thousands of dollars from their wholly owned Injector Co. to their Roth IRAs. During 1998-2001, when taxpayers funneled more than $530,000 into their Roth IRAs, the annual contribution limit for each taxpayer was $0, except for 1998 (when it was $2,000). (ER169:20.) They achieved this result by entering into a widely marketed transaction (the Notice 2004-8 transaction) in which a taxpayer disguises contributions to a Roth IRA as a purported investment return from a company controlled by the taxpayer and thereby circumvents the strict annual limits Congress imposed on contributions to Roth IRAs. The Commissioner determined that the purported investment returns were, in substance, contributions by

taxpayers to their Roth IRAs. Taxpayers bore the burden of demonstrating that the Commissioner's determination was erroneous, as the Tax Court held and taxpayers do not dispute. (ER169:19.) To satisfy that burden, taxpayers must demonstrate that their Roth IRAs were in substance the owners of the FSC shares.

Before addressing taxpayers' Roth-funding transaction, we first provide some background regarding the substance-over-form doctrine, because taxpayers have misconstrued its role in tax enforcement and its relationship to Congressional intent. That doctrine, along with the related, but distinct, economic-substance doctrine, enforces the fundamental principle of tax law that the minimization of tax liabilities may not be accomplished through form alone, except to the extent expressly provided by the Internal Revenue Code. *Brown v. United States*, 329 F.3d 664, 671-672 (9th Cir. 2003). Although taxpayers are free to minimize their tax bill by any lawful means, they cannot claim tax benefits not expressly conferred by Congress by setting up sham transactions that lack any legitimate business purpose, *Reddam v. Commissioner*, 755 F.3d 1051, 1059-1062 (9th Cir. 2014) (applying economic-substance doctrine), or by affixing labels that do not

accurately reflect the transaction's true nature, *Brown*, 329 F.3d at 671-672 (applying substance-over-form doctrine).

In applying the substance-over-form doctrine, the Supreme Court has "looked to the objective economic realities of a transaction rather than to the particular form the parties employed," and "has never regarded 'the simple expedient of drawing up papers' as controlling for tax purposes when the objective economic realities are to the contrary." *Frank Lyon*, 435 U.S. at 573 (citation omitted). Under this doctrine, courts examine a transaction's formal steps and determine whether the transaction's form reflects its true substance, as well as whether the transaction effectuates — or thwarts — Congressional intent. *Id.* Where the form and substance of a transaction are in conflict, the substance is controlling. As this Court has emphasized, it is "not only the prerogative but the duty of the Commissioner and the Tax Court to carefully examine the transaction behind its formal facade to be certain that it is what it purports to be and that the substance of the transaction is within the governing statute." *Hollenbeck v. Commissioner*, 422 F.2d 2, 4 (9th Cir. 1970).

Although taxpayers refer to Congressional intent throughout their brief (*e.g.*, Br. 8, 15, 24, 31, 40), they fail to appreciate how the judicial doctrines enforce that intent. The judicial doctrines "'resemble a preamble to the Code, describing the framework within which all statutory provisions are to function'" and operating as a principle of statutory construction. *Stewart*, 714 F.2d at 988 (citation omitted). They serve to "prevent taxpayers from subverting the legislative purpose of the tax code." *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1353 (Fed. Cir. 2006). When drafting tax rules, Congress and the Treasury Department generally assume that the form of the underlying transaction matches its substance (unless the relevant tax rules expressly provide otherwise). The substance-over-form doctrine tests that assumption. If the assumption proves to be false, then the transaction is recharacterized for tax purposes. For example, if Congress provides a tax benefit that is predicated on property ownership, the substance-over-form doctrine functions to ensure that the party claiming ownership is the genuine owner. *E.g., Frank Lyon*, 435 U.S. at 572-573; *Exelon Corp. v. Commissioner*, 906 F.3d 513, 523-528 (7th Cir. 2018).

Taxpayers' insistence that their transaction "worked under the Code" (Br. 23-24) misses the mark. Virtually all sophisticated tax shelters like the Notice 2004-8 transaction are designed to satisfy the relevant tax rules set forth in the Internal Revenue Code and Treasury regulations. In the seminal decision in *Gregory v. Helvering*, the Supreme Court disregarded a transaction that complied with "every element required by" the relevant law. 293 U.S. at 468. The taxpayer there had created a corporation for the sole purpose of transferring valuable stock to herself at the preferential capital gains tax rate, rather than at the higher rate applicable to ordinary income. *Id*. at 467. The Court disregarded the corporation, holding that it "was nothing more than a contrivance," and not "the thing which the statute intended." *Id*. at 469. Later, in *Frank Lyon*, the Supreme Court reiterated that the form of a transaction will not be respected if it lacked economic reality, even if that form is in compliance with the Code. 435 U.S. at 572-573.

Applying the Supreme Court's general guidance in *Gregory* and *Frank Lyon* to unique and ever-changing tax-avoidance schemes, the courts of appeals have repeatedly rejected or recharacterized

transactions that comply with technical tax rules but defy economic reality. *E.g., Brown*, 329 F.3d at 671-672 (recharacterizing intra-family transfer); *Southgate*, 659 F.3d at 491-492 (recharacterizing purported partnership investment as a sale); *BB&T Corp. v. United States*, 523 F.3d 461, 472-474 (4th Cir. 2008) (recharacterizing ownership of leasehold interest). As those decisions show, the inquiry under the substance-over-form doctrine is separate and distinct from the inquiry under the technical tax rules.

Although taxpayers seek to downplay their importance (Br. 24), judicial anti-abuse rules, including the substance-over-form doctrine, are the "'cornerstone of sound taxation.'" *Southgate*, 659 F.3d at 479 (citation omitted); *see* Bittker & Lokken, *Federal Tax'n of Income, Estates & Gifts* ¶4.3.1 at 4-27 (3d ed. 1999) (describing how "extremely important" the judicial doctrines are to effective tax enforcement). Judicial doctrines are rightly deemed essential to full and fair tax enforcement because "[e]ven the smartest drafters of legislation and regulation cannot be expected to anticipate every device" crafted to avoid tax. *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505, 513 (D.C. Cir. 2000) (rejecting transaction that complied with

partnership tax rules). Indeed, Congress has repeatedly emphasized the crucial role that judicial doctrines play in disallowing abusive transactions before (and whether or not) Congress stamps them out with legislation. *E.g.*, Joint Committee on Taxation, *Report of Investigation of Enron Corp.*, JCS-3-03, at 128 (2003); H.R. Rep. No. 111-443, at 295 (2010). As Congress has explained, "[a] strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences." *Id.*

Taxpayers' description of their Notice 2004-8 transaction as providing "Congressionally-intended benefits" (Br. 24) is wholly unfounded. By enacting the FSC provisions, Congress did not intend to relax the standards for tax ownership so that taxpayers could fund their Roth IRAs in amounts that exceeded the Code's contribution limits. *See*, below, §§ C, D.3. To the contrary, Congress intended Treasury and the courts to enforce the strict contribution limits on Roth IRAs, and that is exactly what happened in this case. As noted above, Congress is aware of IRS efforts to utilize the substance-over-form doctrine to shut down what the Joint Committee on Taxation has described as "abusive

Roth transactions." JCS-1-08, at 17-18 & n.31 (citing Notice 2004-8). The Committee's description of the problem reflects the facts of this case: "[t]ax free distributions from Roth IRAs have created an incentive for some taxpayers to transfer value into a Roth IRA that is not legitimately characterized as return on investment for the assets held by the Roth IRA but rather is a disguised additional contribution." *Id.*; *accord* JCX-98-14, at 60 & n.179. To be sure, Congress to date has not enacted a categorical prohibition on the scheme. But this does not mean that Congress has blessed the Notice 2004-8 scheme, as taxpayers repeatedly suggest. (Br. 50, 59, 72.) Instead, Congress has simply opted to let the IRS challenge the abusive Notice 2004-8 scheme on a case-by-case basis, utilizing the substance-over-form doctrine. *See*, below, pp. 69-71.

Taxpayers' related contention that there is no express "statutory prohibition" of their transaction (Br. 34, 69) is beside the point. The same could be said in every case decided against a taxpayer under one of the judicial doctrines. If there were a statutory prohibition, there would be no need for the substance-over-form doctrine in the first place. Tax exemptions are a matter of legislative grace and, as such, are

narrowly construed, allowable only to the extent expressly provided. *United States v. Wells Fargo Bank*, 485 U.S. 351, 354 (1988). In claiming a tax exemption, taxpayers must do more than point to an *absence* of prohibitive language in the Code. Rather, "exemptions from taxation are not to be implied; they must be unambiguously proved." *Id.* Taxpayers have failed to do that here.

In this case, the parties to the Notice 2004-8 transaction papered the arrangement so that the Roth IRAs appeared to own the FSC stock. The Tax Court, however, correctly pierced through that façade by examining all of the facts and the terms of the related agreements. Those agreements essentially stripped the Roth IRAs of any genuine indicia of ownership. As demonstrated below, the Tax Court's findings are fully supported by the record, and taxpayers' challenges to the court's analysis cannot withstand scrutiny. *See*, below, § D. Before turning to that analysis, we first address taxpayers' threshold arguments and explain (i) that the *Summa Holdings* and *Benenson* decisions did not address the "same issue" as under review here (*see*, below, § B) and (ii) that transactions involving a FSC are not immune from the substance-over-form doctrine (*see*, below, § C).

B. Contrary to taxpayers' contention, the appellate decisions in *Summa Holdings* and *Benenson* did not address the "same issue" decided by the Tax Court here

Taxpayers seek to head off review by this Court by suggesting that the First, Second, and Sixth Circuits have already reviewed, and rejected, the "same issue" decided by the Tax Court here (Br. 25-26). That is incorrect. Rather, as the Tax Court correctly recognized — and taxpayers ignore — the appellate courts that reviewed the Tax Court's S*umma Holdings* decision addressed an issue different from the Roth IRA ownership question presented in this appeal. (ER169:51; ER179:5.) Accordingly, the Commissioner does not ask this Court to "disagree[ ] with three other Circuits," as taxpayers contend (Br. 42 n.21), but to consider a distinct issue that the other circuits did not consider.

In *Summa Holdings*, the Tax Court addressed a Notice 2004-8 transaction in which the intermediary company was a DISC. 109 T.C.M. (CCH) 1612. The court concluded that the export company's commission payments to the DISC were a sham and recharacterized them for tax purposes as dividends from the export company to its shareholders, followed by excess contributions to the Roth IRAs, thus disregarding the DISC altogether. The court did not address the

separate question addressed by the Tax Court here regarding the bona fides of the purchase of DISC stock by the Roth IRAs. In reversing the Tax Court's *Summa Holdings* decision, the appellate courts focused on whether the payments to the DISC could be disregarded and concluded that they could not. The courts held that "Congress left no room for the Commissioner to recharacterize the payments [to the DISC] as something other than commissions." *Benenson*, 910 F.3d at 697, 701 (declining to recharacterize "Summa's DISC commission payments as constructive dividends to its shareholders" by disregarding the DISC under the substance-over-form doctrine); *accord Summa Holdings*, 848 F.3d at 789 (same); *Benenson*, 887 F.3d at 522 (same).

The Tax Court here approached the Notice 2004-8 transaction from a different angle. It focused on the Roth IRAs' purported ownership of the FSC stock, rather than the commissions that Injector Co. paid to the FSC. Neither the First, Second, nor Sixth Circuit addressed the separate question as to who — in substance — owned the intermediary company (*i.e.*, the DISC in *Summa Holdings* and

Benenson or the FSC in this case).[14] That distinct question was dispositive in this case, which allowed the Tax Court to avoid the issue decided in the *Summa Holdings* appeals.

Moreover, none of the appellate courts disagreed with the Tax Court's analysis in this case. The Sixth Circuit issued its opinion before the instant case was decided and therefore had no occasion to address the decision of the Tax Court in this case.[15] The other circuits — which

---

[14] In distinguishing the appellate decisions in *Summa Holdings* and *Benenson*, we (like the Tax Court below) do not rely on the differences between FSCs and DISCs. *See* ER179:5 (explaining in reconsideration order that the court did not rely on distinction between FSCs and DISCs). We note, however, that the two entities have different textual schemes. In particular, I.R.C. § 995(g) requires tax-exempt entities like IRAs and Roth IRAs to pay tax on dividends received from a DISC. There is no similar provision applicable to dividends received from a FSC. In reversing the Tax Court's *Summa Holdings* decision, the First, Second, and Sixth Circuits all relied heavily on Section 995(g) and the fact that tax had been paid on the dividends by the DISC's shareholder. *See Benenson*, 910 F.3d at 704; *Benenson*, 887 F.3d at 521; *Summa Holdings*, 848 F.3d at 784.

[15] In any event, ownership of the DISC was irrelevant to the question before the Sixth Circuit — whether the export company (Summa Holdings) had properly claimed deductions for the commissions paid to the DISC. We note, however, that the Sixth Circuit observed that a "DISC's shareholders often will be the same individuals who own the export company." *Summa Holdings*, 848 F.3d at 782; *accord* JCS-20-95, at 40 ("Typically, a FSC is a company owned by a U.S. company, such as manufacturer, that produces goods in the United States."). That typical situation is consistent with the Tax

issued decisions after the initial opinion in this case was issued — distinguished the Tax Court's opinion in this case. The First Circuit expressly addressed the Tax Court's decision herein and distinguished it as involving a different, narrower issue than the one before the court. *Benenson*, 887 F.3d at 522-523 n.10. Accordingly, the First Circuit stated that it "therefore express[ed] no view on whether such a challenge [to the stock ownership] would be successful or would change our analysis." *Id.* at 523 n.10. The Second Circuit did not expressly refer to the decision of the Tax Court in the case at bar. It noted, instead, that the court was not addressing the issue decided in this case, *i.e.*, the wholly separate question whether the Benensons' Roth IRAs had "acquired a true investment interest" in the DISC. *Benenson*, 910 F.3d at 702 n.10. As the Second Circuit explained, the "Commissioner has not challenged [the] acquisition of the DISC's shares." *Id.* at 704. In this case, by sharp contrast, the acquisition of the FSC's shares is the sole target of the Tax Court's substance-over-form analysis.

Court's recharacterization here, treating the individuals who own the export company as the true owner of the FSC.

Importantly, nothing in the *Summa Holdings* and *Benenson* decisions requires the formal ownership of FSC stock to be respected for tax purposes merely because the underlying FSC itself is respected for that purpose. The fact that part of a transaction has substance, or does not require substance — such as the payment of DISC commissions in *Summa Holdings* — does not mean that the Court cannot recharacterize another aspect of the transaction under the substance-over-form doctrine. *Cf. Bank of N.Y. Mellon Corp. v. Commissioner*, 801 F.3d 104, 122-124 (2d Cir. 2015) (disregarding trust transaction even though a related loan transaction was respected under the economic-substance doctrine); *Rogers v. United States*, 281 F.3d 1108, 1113-1118 (10th Cir. 2002). For example, a court may recharacterize or disregard a party's purported purchase of a partnership investment, even though the underlying partnership is respected and not treated as a sham. *E.g., Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 191-196 (D. Conn. 2004) (rejecting purported partnering between foreign entity and U.S. taxpayer under the substance-over-form doctrine), *aff'd by summary order*, 150 F. App'x 40 (2d Cir. 2005); *Santa Monica Pictures, LLC v. Commissioner*, 89 T.C.M. (CCH) 1157, at *84

(2005) (same). Taxpayers' contrary contention (Br. 68) that a court "cannot sham the ownership of a FSC's stock without thereby shamming the FSC" is baseless.

C. The Tax Court correctly determined that it was appropriate to evaluate whether the Roth IRAs owned the FSC stock in substance because such entities are not immune from the operation of fundamental tax principles

The Tax Court correctly rejected taxpayers' claim that, because they utilized a FSC in their Notice 2004-8 transaction, the court was prohibited from examining the substance of "any part" of their transaction. (ER169:28.) In particular, nothing in the FSC or Roth IRA provisions provides that formal ownership of FSC stock "governs" the economic realities of the transaction (Br. 70). *See* I.R.C. §§ 408A, 921-927. This attempt to rewrite the Code was correctly rejected by the Tax Court.

To begin with, as the Tax Court correctly concluded (ER169:60), there is no "textual evidence [in the Code] to support the notion that a discrepancy between substance and form in the purchase of FSC stock should be ignored." Section 925 provides precisely worded exceptions to normal transfer-pricing rules that allow a related supplier to make

export sales, or pay export commissions, to a FSC under circumstances that would not pass muster under normal substance doctrines. (ER169:61-62 & n.44.) In other words, taxpayers may transfer export-sales income to a FSC in order to obtain the corporate tax reduction provided by the FSC provisions, even if the FSC does nothing to "earn" that income. But, by its own terms, Section 925 and its relaxed substance rules do not extend to purchases of FSC stock. That provision applies *only* to transactions between FSCs and their related supplier regarding qualifying export sales. Similarly, Section 921's special corporate tax reduction applies only to a FSC's foreign trading gross receipts. All other income generated by the FSC is subject to ordinary rates and rules of corporate tax. I.R.C. § 921(d). Insofar as the FSC does anything else beyond participating in export sales with its related supplier, it is treated no differently for tax purposes from the way it would be treated if it were an ordinary C corporation.

The Treasury regulations emphasize this point. The regulations provide that Section 925's special pricing methods (which relax ordinary substance rules) apply "only" to the "pricing" of transactions that give rise to "foreign trading gross receipts." Treas. Reg. § 1.925(a)-1T(b)(1),

Add.36. The special pricing methods do not apply to purchases of FSC stock. *See also* Treas. Reg. § 1.922-1(g), Add.29 (ruling that certain formalities regarding FSC shareholders "will be disregarded" if they have "the effect of avoidance of Federal income tax").

The fact that the Treasury regulations permit "family-related entities [such] as an estate and the beneficiaries of a trust" to hold FSC stock (Br. 32) does not mean that dividends paid to that entity will automatically be respected for tax purposes as earnings from a genuine investment. To the contrary, it has long been understood that formal stock ownership of a FSC may be disregarded for tax purposes and that the FSC's earnings may be attributed to the taxpayer who controls the flow of funds to the FSC. Indeed, the IRS made this clear in 1981, when it issued a gift-tax ruling in the context of a DISC. Rev. Rul. 81-54, 1981-1 C.B. 476. In that ruling, the taxpayers owned a manufacturing business that utilized a DISC to reduce corporate income tax on its export sales. The taxpayers created trusts for their children, but before transferring the DISC stock to the trusts, they entered into an agreement between the manufacturing business and the DISC, both of which they then controlled. Under the agreement, the taxpayers

retained the right to determine if and when the DISC would receive commission payments on the export sales. Based on the taxpayers' "dominion and control," the IRS ruled that the commission payments that would otherwise flow to the manufacturing business in the absence of the agreement with the DISC were gifts from the taxpayers to the beneficiaries of the trusts. *Id.* As the Tax Court correctly recognized (and taxpayers ignore), this longstanding ruling — which predates the enactment of FSCs in 1984 and Roth IRAs in 1997 — supports the decision here. (ER179:2.)

Congress has confirmed Treasury's and the Tax Court's reading of the FSC provisions. In explaining how FSCs operate, the Joint Committee on Taxation observed that FSCs are subject to "the present-law rules generally applicable to taxpayers other than FSCs." JCS-20-95, at 43. It is only the FSC's "exempt foreign trade income" that is subject to special tax rules designed to reduce corporate income tax on qualifying export sales. *Id.* at 40-43. *Cf. Advance Int'l, Inc. v. Commissioner*, 91 T.C. 445, 460 (1988) (holding that Congress's "emphasis on relaxed standards for corporate substance does not carry over to the other DISC qualification provisions"). Issues beyond a FSC's

exempt foreign trade income — such as issues related to the ownership of the FSC — are outside the scope of Section 925 and are subject to all normal tax rules, including the judicial tax doctrines.

Contrary to taxpayers' suggestion (Br. 8), the fact that a transaction uses a tax-minimizing statute does not preclude the application of the substance-over-form doctrine. To the contrary, the doctrine is most "crucial" in such circumstances. *Brown*, 329 F.3d at 672 (recharacterizing transfer between husband and wife, even though transfer related to tax-saving "election" provided in the Code).[16] As this Court has explained, it is "common for Congress to create, and taxpayers to exploit, various tax planning incentives," *id.*, such as the incentives for exports and retirement saving involved here. Indeed, the substance-over-form doctrine was properly applied in *Block Developers*,

---

[16] *E.g., Jacobs Eng'g Group, Inc. v. United States*, 168 F.3d 499 (9th Cir. 1999) (applying substance-over-form doctrine even though the transaction "technically complied" with regulatory exemption from tax) (unpublished); *Exelon*, 906 F.3d at 523-528 (same, with regard to scheme that sought to expand tax deferral for like-kind exchanges under I.R.C. § 1031); *Commissioner v. Estate of Sanders*, 834 F.3d 1269, 1282 (11th Cir. 2016) (same, with regard to tax exemption for Virgin Islands residents); *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425, 462 (3d Cir. 2012) (same, with regard to tax credit enacted to incentivize historic restoration).

Polowniak, and *Repetto* to determine whether purported dividends paid to a Roth IRA were in substance excess contributions. *See*, above, p. 8. As those decisions demonstrate, the fact that Roth IRAs are designed to reduce an individual's taxes in order to encourage retirement savings does not mean that every transaction involving a Roth IRA is immune from the substance-over-form doctrine. The question in every case is whether the underlying facts of a transaction — not just the labels used by the parties — fall within the intended scope of the Code. *Brown*, 329 F.3d at 671-672; *accord Sacks v. Commissioner*, 69 F.3d 982, 991-992 (9th Cir. 1995).[17]

---

[17] Although taxpayers cite *Lazarus v. Commissioner*, 513 F.2d 824, 828 (9th Cir. 1975) (Br. 70) to support the proposition that "form governs" (Br. 70) whenever a Congressionally authorized tax-saving plan is utilized, that decision actually held to the contrary. In that case, the Tax Court held — and this Court affirmed — that the taxpayer's transaction should be taxed according to its "substance" rather than its form. As this Court emphasized, "[i]n determining whether petitioners have structured a valid annuity plan or have simply transferred property in trust and reserved a life estate therein, *substance and not form is controlling*." *Id.* (emphasis added). The fact that the case involved a Congressionally authorized tax-saving annuity plan did not preclude the Court from applying the substance-over-form doctrine to determine if the specific transaction before the Court was outside the scope of Congressional intent.

To be sure, as taxpayers point out, the FSC itself was merely "an ongoing book entry" (Br. 57) that required "no economic purpose *other* than tax reduction" (Br. 71). But it does not follow that *all* transactions involving the FSC — including ownership of the FSC stock — can defy economic reality. *E.g.*, Treas. Reg. § 1.922-1(g), Add.29; Rev. Rul. 81-54. Utilizing a FSC in a transaction does not grant a taxpayer license to engage in all manner of tax avoidance, but only the specific limited corporate tax reduction for qualifying export sales expressly provided in the FSC provisions. *See*, below, § D.3. Taxpayers' suggestion to the contrary conflicts with binding precedent. In *Samueli v. Commissioner*, 661 F.3d 399, 412 (9th Cir. 2011), this Court rejected the form of taxpayer's transaction that did not serve Congress's "explicit goal" for the provision at issue, even though the provision was designed to permit tax avoidance on certain loan transactions, because it "clearly was not 'the thing which the statute intended'" (*id.*, quoting *Gregory*, 293 U.S. at 469).

To hold otherwise would render the Treasury vulnerable to untenable abuse. For example, under taxpayers' theory, they could transfer their home to a FSC and thereby transform non-deductible

personal expenses related to maintaining the home into business expenses of the FSC. *Cf. Neely v. United States*, 775 F.2d 1092, 1094 (9th Cir. 1985) (holding that a "trust arrangement may not be used to turn a family's personal activities into trust activities, with the family expenses becoming expenses of trust administration"). To guard against such exploitation, courts properly utilize judicial doctrines to scrutinize transactions involving tax-advantaged devices to ensure that the intended tax incentive is not stretched beyond Congressional design. *See Brown*, 329 F.3d at 672 (applying substance-over-form doctrine to prevent taxpayers from "exploit[ing]" statutory "tax planning incentives").

Finally, the fact that "two" tax-saving devices (FSCs and Roth IRAs) (Br. 40, 61, 64) are involved in this Notice 2004-8 transaction in no way immunizes the transaction from scrutiny under the substance-over-form doctrine. Taxpayers are not free to manufacture super-tax benefits by combining two separate tax-saving devices in any manner that they choose. *See Taproot Admin. Servs., Inc. v. Commissioner*, 679 F.3d 1109, 1113 (9th Cir. 2012) (rejecting taxpayer's attempt to combine two tax-saving devices — an S corporation and a Roth IRA — even

though no law "explicitly prohibited" a traditional or Roth IRA from owning S corporation stock). If the transaction utilized to meld two unrelated tax benefits together lacks substance, then the taxpayer's attempt to manufacture the claimed tax benefit will be disallowed. *See Exelon*, 906 F.3d at 523-528 (applying substance-over-form doctrine to thwart taxpayer's attempt to use a tax-exempt entity in a tax-advantaged like-kind exchange under I.R.C. § 1031); *Paschall v. Commissioner*, 137 T.C. 8, 19-20 (2011) (applying substance-over-form doctrine to thwart taxpayer's attempt to circumvent Roth IRA contribution limits by using an IRA).

D. The Tax Court correctly determined that the Roth IRAs were not in substance owners of the FSC

The substance-over-form question decided by the Tax Court here was a narrow one: who in substance owned the FSC stock and the related dividend income generated by the FSC? (ER169:23.) It is undisputed that if taxpayers are determined to be the substantive owners, then they made excess contributions to their Roth IRAs and owe the excise tax at issue. (ER169:20-21.)

The Roth IRAs held legal title to the FSC stock, but "[o]wnership for tax purposes is not determined by legal title." *Exelon*, 906 F.3d at

524-526 (disregarding taxpayer's formal ownership of property based on the transaction's objective "reality"). Rather, ownership for tax purposes is determined by the "economic reality" regarding who controls the subject property and its attendant benefits or has funds at risk in the property. *Sollberger v. Commissioner*, 691 F.3d 1119, 1123-1124 (9th Cir. 2012); *see Robino*, 894 F.2d at 345 (recharacterizing ownership of property where the taxpayer "retained complete control over the property"); *BB&T*, 523 F.3d at 473 (recharacterizing ownership of property interest where taxpayer had no funds at risk).

In cases addressing whether a taxpayer owns an expected income stream, the "crucial question" is whether the taxpayer "retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes." *Commissioner v. Sunnen*, 333 U.S. 591, 604 (1948); *see also Commissioner v. Banks*, 543 U.S. 426, 434-435 (2005) (holding that "attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question" or "income-generating asset"); Rev. Rul. 81-54, 1981-1 C.B. 476 (ruling that, for gift-tax purposes, DISC's income should be attributed to

taxpayers who controlled the income flowing into the DISC, rather than the trust that formally owned the DISC stock).

Taxpayers complain (Br. 41, 67) that the substance-over-form precedent cited by the Tax Court involved different fact patterns other than one involving a FSC. That complaint is misconceived. The general principles underlying the substance-over-form precedent cited by the court provide instructive "guideposts" regarding property ownership for cases involving different fact patterns. *Sunnen*, 333 U.S. at 606. "'There is no simple device available to peel away the form of [a] transaction and to reveal its substance.'" *Sollberger*, 691 F.3d at 1123 (quoting *Frank Lyon*, 435 U.S. at 576) (alteration in original). To determine true ownership, this Court applies "a flexible, case-by-case analysis of whether the burdens and benefits of ownership have been transferred," keeping in mind that for "'tax purposes,'" ownership is an "'economic rather than a formal concept.'" *Id.* at 1123-1124 (citation omitted).

Consistent with controlling precedent, the Tax Court examined "who had power and control over the FSC or over receipt of the dividend income," recognizing that the "formal purchase" of the FSC stock by the

Roth IRAs did not make them owners for tax purposes of the FSC's income. (ER169:40 (citing *Sunnen*).) As demonstrated below, the court's conclusion that taxpayers owned and controlled the FSCs in substance (ER169:41-50, 74-76) is based on several findings, all supported by the record. *See*, below, § D.1. Taxpayers have failed to identify any error — let alone clear error — in the court's factual analysis. *See*, below, § D.2. Nor can they demonstrate that the form of the transaction "'fall[s] within the intended scope of the Internal Revenue provision at issue.'" *Brown*, 329 F.3d at 672 (citation omitted). *See*, below, § D.3.

1. The Tax Court's findings regarding the Roth IRAs' lack of genuine ownership of the FSC are supported by the record

The Tax Court concluded that the Roth IRAs did not own the FSC in substance because (i) taxpayers' business retained complete control over whether commission payments would ever be paid to, or retained by, the FSC, and (ii) the Roth IRAs effectively paid nothing for the FSC stock, put nothing at risk, and could not have expected any benefits as an objective matter. (ER169:44-50, 74-76; ER179:4.) The discrepancy between the stock's *de minimis* formal value and its astronomical

substantive value — providing the Roth IRAs with a more than 30,000% return on their $500 payment (ER138:138) — signified to the court that the Roth IRAs' purported stock investment lacked "economic reality." (ER169:65, 75.) Each of these facts is fully supported by the record.

Critical to the Tax Court's factual analysis was the inquiry as to who controlled the cash flows. (ER169:47-49.) Questions of control are especially relevant where (as here) the case involves "intra-family" transfers of rights to receive income, which are subject to "special scrutiny" given the related parties' unique ability to label a transaction in a manner that masks its economic reality. *Sunnen*, 333 U.S. at 605; *see Brown*, 329 F.3d at 673 (applying "a heightened level of skepticism to transactions between related parties").

Sunnen is particularly instructive here. There, the taxpayer had entered into agreements with a corporation that he controlled that allowed the corporation to use the taxpayer's patents to manufacture and sell certain goods in exchange for specified royalties. 333 U.S. at 593-594. The taxpayer then transferred his interest in the agreements to his wife, and the couple reported the income therefrom as hers. *Id*. at

595. The Court held that the royalties paid to the wife were, in substance, paid to the husband, because the husband retained the ability to control whether and to what extent any royalties were paid. *Id.* at 608-609. As the Court emphasized, the agreements with the corporation "specified no minimum royalties and did not bind the corporation to manufacture and sell any particular number of devices," allowing the taxpayer-husband to "increase or lower the royalties" or "stop [them] completely." *Id.* at 609. Applying this precedent to the facts of this case, the Tax Court found that taxpayers (through their pass-through entity, Injector Co.) "retained complete control over whether any of its export receipts would flow to the FSC in any year." (ER169:47.) As in *Sunnen*, that control highlights that the income generated by the FSCs properly belonged to taxpayers rather than to their Roth IRAs.

The Tax Court's finding regarding taxpayers' control is fully supported by the record. The marketing materials emphasized that taxpayers would retain total control over the payment of commissions to the FSC. (SER3.) According to those materials, "FSC commissions are elective," and therefore, taxpayers "can manage the timing and the

amount of the dividend each year." (SER3.) Taxpayers — and not their Roth IRAs — had the sole "discretion" regarding how much money to shift to the FSC and, thus, into the Roth IRAs. (ER138:1.) Indeed, the letter that taxpayers received from the scheme's promoter described the substance of the transaction, informing them that *they* could "fund [their] IRA accounts" by sending money to the FSC management company. (ER169:15; SER70-71.) In that candid assessment of the transaction's economic reality, the Roth IRAs' purported ownership of the FSC is ignored altogether. *See BB&T*, 523 F.3d at 469 n.10 (relying on party's candid assessment of transaction in determining that transaction's substance did not match its form); *ASA Investerings*, 201 F.3d at 509 (same).

The transaction documents further support the Tax Court's finding. Consistent with the promoters' marketing materials, those documents provide total control over the FSC and its income to taxpayers rather than to their Roth IRAs. The Commission Agreement between taxpayers' business and the FSC provided: "At all times [Injector Co.] shall have the discretion as to when and how much it wishes to pay FSC and no account receivable shall ever exist between

FSC and [Injector Co.]." (SER46.) The Agreement further provided (i) that Injector Co. had the discretion to determine whether an "overpayment" had been made to the FSC and that the "FSC will at no time have any ownership rights in said overpayment," and (ii) that Injector Co. "shall have the final decision as to whether FSC is considered as having solicited or promoted a transaction with a customer and may prospectively or *retroactively* add or delete transactions entitling FSC to a commission." (SER45-46 (emphasis added).) As the court correctly concluded, this language allowed Injector Co. to "reach into the FSC and take back any payments that had already been made." (ER169:48.) The Roth IRAs, for their part, had no control whatsoever over the FSC or its ability to generate benefits for them. Indeed, the Shareholders' Agreement between the FSC and the Roth IRAs precluded the Roth IRAs from benefiting by selling their FSC stock, limiting the stock's market value to $1. (ER138:3-7.) Given these contractual provisions, the Roth IRAs — like the wife in *Sunnen* — could not reasonably expect any benefit from the FSC based on their formal ownership of the FSC stock. (ER169:49.)

Further supporting the Tax Court's finding that the Roth IRAs did not own the FSC in substance is the fact that they were exposed to no real risk. (ER169:43-47.) Bearing risk with regard to property is a hallmark of ownership for tax purposes. For example, in *Frank Lyon*, the Supreme Court concluded that a taxpayer that held formal title to the subject property also owned it as a substantive matter because (among other things) the taxpayer had undertaken "substantial risk" in the underlying property. 435 U.S. at 577. In sharp contrast, in *Swift Dodge v. Commissioner*, 692 F.2d 651, 654 (9th Cir. 1982), this Court denied certain tax benefits that were predicated on the taxpayer's ownership of the subject property because the taxpayer had not "assumed the risk of depreciation" with regard to that property. Here, the Roth IRAs were exposed to no real risk with regard to the FSC because they had "invested" almost nothing in the FSC, paying only the initial $500 charge for engaging in the FSC/Roth program. (ER169:44.) As the Tax Court correctly concluded, that amount was at most a *de minimis* risk, insufficient to give substance to the Roth IRAs' purported ownership of the FSC stock. (ER169:44.)

Finally, the Tax Court correctly found that the stark discrepancy between the nominal price for the FSC stock ($500) and its attendant cash flows (exceeding $530,000) further indicated that the transaction lacked economic reality. (ER169:49-50, 63-65, 75-76.) Indeed, the actual payment for the stock itself was even less. Although the Roth IRAs paid $500 to engage in the transaction, the court found that only $1 was invested in the stock, and the remaining $499 was a fee for the tax-avoidance plan. (ER169:45-46.) Although taxpayers protest the finding (Br. 54), it is fully supported by the record. *See* ER138:4, 7 (Shareholders' Agreement specifies that only $1 of the $500 paid by the Roth IRAs is deemed to be "paid-in capital" and $1 was the "purchase price" of the stock if sold). But whether the purchase price was $1 or $500, it was a *de minimis* amount compared to the cash flows that the related parties expected to flow from Injector Co. to the Roth IRAs. (ER169:50 & n.39.) Indeed, to view the funds that flowed to the Roth IRAs as "dividends" from the FSC would mean that the Roth IRAs received more than a 30,000% return on their purported $500 "investment." (ER138:138-139.) Such an astronomical return is a red flag that the Roth IRAs' purported investment was not genuine.

2. Taxpayers have identified no flaw in the Tax Court's factual analysis

Taxpayers do not dispute the Tax Court's finding that they controlled all of the cash flows, acknowledging that the "allocation [of income to the FSC] was entirely discretionary with [taxpayers]" (Br. 41). Given that undisputed critical fact, taxpayers are properly deemed the owners of the FSC, just as the taxpayer-husband in *Sunnen* was deemed the owner of the income-generating asset that he had nominally transferred to his wife. Although they deny that the FSC is an income-generating asset (Br. 41-42), they fail to account for the undisputed fact that, as the Tax Court correctly observed (ER169:40 n.34), the FSC generated dividends — that is, income — which, in form, were paid to the Roth IRAs. Indeed, taxpayers' entire theory of the case is predicated on viewing the dividend payments as "income" from the FSC rather than "contributions" from taxpayers. If taxpayers are correct that the FSC does not generate income, that circumstance only further confirms the Commissioner's position, because it would mean that the dividends are something other than the investment income that Congress intended Roth IRAs to earn.

The fact that the FSC could generate that income, and pay a reduced corporate tax rate on that income, without engaging in any substantive business activity (Br. 43) sheds no light on which party is properly viewed as owning the FSC for tax purposes. The Tax Court respected the FSC's role in the transaction, thereby setting this case apart from the *Summa Holdings* and *Benenson* decisions, where the DISC's involvement was disregarded. It concluded instead that, in substance, the FSC was owned by taxpayers, rather than the Roth IRAs.

Taxpayers contend (Br. 45) that the Tax Court erred in considering risk as a factor for determining whether the Roth IRAs had a genuine investment in the FSC. But risk is a relevant factor when analyzing property ownership, as *Frank Lyon* and *Swift Dodge* make clear. Alternatively, taxpayers contend (Br. 45-46) that the Roth IRAs were at risk because any benefit from the FSC stock depended on the success of taxpayers' underlying export business. That contention misses the mark. The potential depreciation of the underlying export business is not a risk that the *Roth IRAs* bore, given that they had invested no time, energy, or money in that business. Rather, it was a

risk that *taxpayers* bore, based on their decades-long investments in the business. Focusing on the risk related to the underlying business further supports the Tax Court's finding that taxpayers — not the Roth IRAs — were the true owners of the FSC stock.

Taxpayers further contend (Br. 50-54) that the Tax Court's "valuation" of the FSC stock was flawed. This argument, again, misses the mark. The court did not question taxpayers' claimed fair market value of the FSC stock. As the court emphasized in rejecting taxpayers' motion for reconsideration, the court "did not adjust the value of the FSC stock" (ER179:4), which the parties agreed to be no more than $100 (Br. 53).[18] Rather, the court examined the "disconnect" between that claimed value and the substantive value of the same stock, taking into consideration the undisputed facts that taxpayers controlled every aspect of the transaction, that they had the established capacity to make large payments to the FSC, and that they intended to transfer huge sums of money into the FSC for the benefit of their Roth IRAs. (ER169:63-65.) As the court explained, on the basis of the formal

---

[18] Taxpayers critique the Commissioner's expert (Br. 51-53), but he did not "put a value on the FSC shares" (ER157:30).

paperwork executed by the parties, the stock was essentially worthless because there was "no chance" that commission payments would be made in the absence of related-party control, given that the contracts do not require or even incentivize Injector Co. to make commission payments. (ER169:64.) In contrast, if the transaction's economic reality were taken into account, the stock's value was "extremely high at the moment of purchase," well beyond the price actually paid for the stock (whether viewed as $500 or $1). (ER169:65.) In short, as the court properly recognized, the formal documents that supported taxpayers' *de minimis* valuation of the FSC stock did not reflect the transaction's economic reality and thus cannot justify the tax treatment predicated on the transaction's form. Although they criticize the court for discussing the stock's value, taxpayers do not deny that the stock's formal value did not even come close to reflecting the economic reality of the stock's expected cash flows.

Unable to disturb the Tax Court's actual factual analysis, taxpayers attempt to sidestep the court's reasoning by misconstruing what the court did. The court did not recharacterize their transaction because it was "too good to be true." (Br. 57-60.) Nor did the court

recharacterize the transaction because the statutory provisions "worked too well" or provided a "tax double windfall." (Br. 8, 64.) Rather, the court carefully evaluated taxpayers' Notice 2004-8 Roth-funding transaction. It examined numerous factors, including that the transaction documents vested all control in taxpayers rather than the Roth IRAs, and concluded that the FSC's income was properly attributable to taxpayers. Accordingly, cases permitting tax windfalls in situations where a transaction's substance was not in question, such as *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), and similar cases cited by taxpayers (Br. 64-65), shed no light on the Tax Court's opinion here.

3. Taxpayers' Notice 2004-8 transaction was outside the scope of Congressional intent

The Tax Court correctly determined that taxpayers' attempt to utilize the mismatch between their transaction's form and its substance to defeat the Code's contribution limits for Roth IRAs lacked any textual support and thwarted Congressional intent. (ER169:67.) In creating Roth IRAs as a tax-saving device to encourage retirement accounts, Congress intended Treasury and the courts to enforce the strict contribution limits contained in the Roth IRA provisions. I.R.C. § 408A(c). Investments held by a Roth IRA could appreciate and be

distributed tax-free, but only a limited amount of funds could be contributed by a taxpayer to a Roth IRA in any given year (other than rollover contributions, *see*, above, n.3), and only by taxpayers whose adjusted gross income was below a certain level. *Id.* Preventing excess contributions disguised as investment returns implements the Congressional intent behind Section 408A(c) to limit the cost of Roth IRAs to the public fisc. *See* JCS-1-08, at 17-18; JCX-98-14, at 60. Taxpayers have not — and cannot — demonstrate that Congress intended Roth IRAs to be used to divert unlimited business funds into tax-sheltered vehicles. Although taxpayers purport to bring their appeal in the name of "textual primacy" (Br. 60-61), they disregard the critical textual provision — Section 408A(c) — that the Tax Court properly enforced.

Nor can taxpayers establish that their Notice 2004-8 transaction is within the scope of Congressional intent with regard to FSCs. Although FSCs are "designed to promote foreign sales through tax incentives" (Br. 13), as taxpayers observe, the tax incentive crafted by Congress is the reduction of corporate income tax on export sales, not individual-income tax savings for retirement income. (ER169:57, 61.)

The language of the Code provides a very specific tax benefit — a limited reduction of corporate income tax on qualifying export income. I.R.C. §§ 921-927. In this regard, Section 925 allows a U.S. corporation to assign part of its income from export sales to a FSC — even if the FSC does nothing substantive to earn that income — and Section 921(a) excludes part of the assigned income from the FSC's tax base, resulting in an effective corporate tax cut for income from export sales. As the Tax Court correctly concluded, the FSC provisions relax the normal tax rules *only* for the specific transactions between the FSC and its related supplier and *only* for the purpose of computing the corporate income taxes of the FSC and its related supplier. (ER169:36-37, 61.)

Nothing in the FSC provisions suggests that Congress intended to provide an exemption from the Code's Roth IRA contribution limits. To the contrary, as the Supreme Court explained in *Boeing*, "Congress did not intend to grant 'undue tax advantages' to firms" when it enacted the "DISC and FSC statutes," but only those expressly delineated in the Code. 537 U.S. at 456 (citation omitted); *see Abbott Labs. v. United States*, 573 F.3d 1327, 1331 (Fed. Cir. 2009). "FSCs solely existed to provide tax benefits to parent corporations," *Ford*, 908 F.3d at 812, not

to benefit related Roth IRA beneficiaries by circumventing Section 408A(c)'s contribution limits. Accordingly, the "tax loss" that Congress intended the Treasury to bear in order "to subsidize foreign trade" (Br. 49) was the reduction of corporate tax on export income. Any other tax loss — such as that generated by circumventing contribution limits on Roth IRAs — is properly rejected because it "clearly was not 'the thing which the statute intended.'" *Samueli*, 661 F.3d at 412 (citation omitted); *accord Brown*, 329 F.3d at 672.

Taxpayers have identified nothing in the text or legislative history that indicates that the purpose of the FSC provisions was to provide any other tax benefit beyond a lower corporate tax rate for qualifying export-related income. (ER169:57.) That purpose is served by respecting the commissions that flow into the FSC and does not depend on respecting the Roth IRAs' formal ownership of the FSC. Whether or not the Roth IRAs are deemed to own the FSC stock, the FSC is entitled to pay a reduced corporate income tax on the qualifying export income allocated to it. In short, neither the text nor the history of the FSC provisions evidences any purpose to allow taxpayers to use FSCs to

defeat a Code provision wholly unrelated to FSCs, including the Roth IRA contribution limits contained in Section 408A(c).

Tellingly, taxpayers did not even use the FSC for its intended tax purpose. Congress enacted the DISC provisions, and later the FSC provisions, to reduce corporate income tax on export sales. *See* S. Rep. No. 92-437, at 90 (1971) (enacting DISCs to "remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations"). The provisions were not designed to benefit pass-through entities like partnerships and S corporations that are not subject to the corporate income tax in the first place. As noted above (p. 13), taxpayers operated their business using pass-through entities and therefore were not subject to the corporate income tax prior to engaging in the Notice 2004-8 transaction. By entering into that transaction, taxpayers created a second level of corporate taxation where previously one did not exist. Although taxpayers used the FSC to generate a different tax benefit — elimination of an individual's tax on excess contributions to a Roth IRA — that benefit is outside the scope of the FSC provisions and in contravention of the Roth IRA contribution limits.

Left with no textual, historical, or policy support for their position, taxpayers are forced to rely on their "assumption" that Congress intended the tax benefits generated by their Notice 2004-8 transaction due to what they term legislative "inaction." (Br. 72.) That reliance is ill-founded. First of all, Congress was aware of the Notice 2004-8 transactions. Far from confirming any intent to bestow the tax benefits generated by the transactions, it considered them to be "abusive Roth transactions." JCS-1-08, at 17-18 & n.31 (citing Notice 2004-8). Congress also fully understood that Treasury was using the substance-over-form doctrine to preclude taxpayers, like taxpayers here, from "transfer[ring] value into a Roth IRA that is not legitimately characterized as return on investment for the assets held by the Roth IRA but rather is a disguised additional contribution." *Id.*; *see also* JCX-98-14, at 60 & n.179.

Moreover, even apart from Congress's express disavowal of the transaction, legislative "inaction" cannot bear the weight that taxpayers place on it. As noted above, judicial doctrines operate as the preamble to the Internal Revenue Code, alleviating the need for Congressional "action" in the form of new legislation. Congress frequently relies on

Treasury's ability to use judicial anti-abuse doctrines to enforce the Code provisions, as it has done here. In many cases, the doctrines preempt the need for a legislative fix. *E.g.*, *United States v. Woods*, 571 U.S. 31, 36-37 (2013) (describing abusive partnership transaction that the IRS has rejected under the economic-substance doctrine, despite the fact that Congress never changed the partnership rules and upholding the imposition of penalties). For example, in *Brown*, there was no need for Congress to legislatively prohibit the intra-family transaction that lacked economic reality there because the IRS was able to utilize the substance-over-form doctrine to prevent the taxpayers from circumventing the relevant Code provision. 329 F.3d at 673-677; *accord Reddam*, 755 F.3d at 1057 (rejecting mass-marketed "OPIS" transaction under economic-substance doctrine, even though Congress never expressly prohibited it). So, too, here. In other cases, Congress steps in to prophylactically stamp out a tax shelter by enacting a new rule, leaving it to the IRS to challenge pre-enactment transactions under judicial doctrines. *E.g., Wells Fargo & Co. v. United States*, 641 F.3d 1319, 1323 (Fed. Cir. 2011) (disregarding tax benefits generated by SILO shelter under substance-over-form doctrine even though Congress

eliminated SILOs legislatively for subsequent tax years). As the Supreme Court long ago made clear, a transaction cannot avoid scrutiny under judicial doctrines merely because the transaction predates a statute targeting the specific abuse. *See Knetsch v. United States*, 364 U.S. 361, 367-368 (1960) (holding that prospective change in statute disallowing certain interest deductions created no inference that Congress intended to bless sham interest transactions entered into before the amendment's effective date).

CONCLUSION

The Tax Court's decision should be affirmed, with a limited remand to allow the court to correct a typographical error in its decisions. *See*, above, n.13.

Respectfully submitted,

RICHARD E. ZUCKERMAN
Principal Deputy Assistant Attorney General

TRAVIS A. GREAVES
Deputy Assistant Attorney General

/s/ Judith A. Hagley

GILBERT S. ROTHENBERG (202) 514-3361
TERESA E. MCLAUGHLIN (202) 514-4342
JUDITH A. HAGLEY (202) 514-8126
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

MARCH 2019

STATEMENT OF RELATED CASES

Pursuant to Ninth Circuit Rule 28-2.6, counsel for the Commissioner respectfully inform the Court that they are not aware of any cases related to the instant appeal that are pending in this Court.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Form 8. Certificate of Compliance for Briefs

Instructions for this form: http://www.ca9.uscourts.gov/forms/form08instructions.pdf

9th Cir. Case Number(s) 18-72451

I am the attorney or self-represented party.

This brief contains 13,917 **words**, excluding the items exempted by Fed. R. App. P. 32(f). The brief's type size and typeface comply with Fed. R. App. P. 32(a)(5) and (6).

I certify that this brief *(select only one)*:

- (•) complies with the word limit of Cir. R. 32-1.
- ( ) is a **cross-appeal** brief and complies with the word limit of Cir. R. 28.1-1.
- ( ) is an **amicus** brief and complies with the word limit of Fed. R. App. P. 29(a)(5), Cir. R. 29-2(c)(2), or Cir. R. 29-2(c)(3).
- ( ) is for a **death penalty** case and complies with the word limit of Cir. R. 32-4.
- ( ) complies with the longer length limit permitted by Cir. R. 32-2(b) because *(select only one):*
  - ( ) it is a joint brief submitted by separately represented parties;
  - ( ) a party or parties are filing a single brief in response to multiple briefs; or
  - ( ) a party or parties are filing a single brief in response to a longer joint brief.
- ( ) complies with the length limit designated by court order dated _____.
- ( ) is accompanied by a motion to file a longer brief pursuant to Cir. R. 32-2(a).

Signature s/Judith A. Hagley **Date** Mar 6, 2019

*(use "*s/[typed name]*" to sign electronically-filed documents)*

Feedback or questions about this form? Email us at forms@ca9.uscourts.gov

CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing brief with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on March 6, 2019. I further certify that counsel for the appellant were served by the Court's CM/ECF system

/s/ Judith A. Hagley
JUDITH A. HAGLEY
Attorney for appellee Commissioner