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Ninth Circuit: FSC used to transfer funds from family business into Roth IRAs (Tax Court reversed)

The U.S. Court of Appeals for the Ninth Circuit today reversed a “reviewed decision” of the U.S. Tax Court that had applied substance-over-form principles in determining who owned a foreign sales corporation (FSC) that was used to transfer funds from a family business into Roth IRAs.

The Ninth Circuit found that the Tax Court—which had set aside the Roth IRAs’ formal ownership of the FSC’s shares—erred in applying the substance-over-form principles.

The case is: *Mazzei v. Commissioner*, No. 18-72451 (9th Cir. June 2, 2021). Read the Ninth Circuit’s [decision](#) [PDF 302 KB]

Background

The taxpayers entered into a prepackaged plan to save taxes by routing funds from their family business through a Bermuda-based foreign sales corporation (FSC) and then into Roth IRAs created for this purpose. Pursuant to this plan, in 1998 each taxpayer directly contributed \$2,000 (the applicable contribution limit) to his or her newly created Roth IRA, which then paid a nominal amount for stock in the FSC.

From 1998 to 2002, the taxpayers routed payments of over \$533,000 from their family business, through the FSC, and into their Roth IRAs. Thus, with these transactions, payments from the taxpayers’ business to the FSC were followed by payments of dividends by the FSC to the Roth IRAs.

The IRS contended that the payments from the FSC to the Roth IRAs represented, in substance, contributions from the taxpayers to their Roth IRAs and that because these payments exceeded contribution limits for the Roth IRAs, the taxpayers were liable for excise taxes under section 4973.

The taxpayers filed a petition with the Tax Court which, in a March 2018 [reviewed opinion](#) [PDF 6 MB], held that the taxpayers—and not their Roth IRAs—were the owners, for federal tax purposes, of the FSC stock. The Tax Court concluded that in substance the FSC dividends were income to the taxpayers who contributed the funds to their Roth IRAs. Thus, the Tax Court found the taxpayers were liable for excise taxes on excess contributions to their Roth IRAs.

The taxpayers appealed to the Ninth Circuit.

Ninth Circuit

The Ninth Circuit today reversed the Tax Court and concluded that because of the unusual statutory provisions at issue here, the Tax Court erred by invoking substance-over-form principles to effectively reverse the statutory regime and to disallow what the statute plainly allowed.

With this decision, the Ninth Circuit joined three other circuits that have similarly disallowed the invocation of substance-over-form principles to undo the congressionally authorized separation of substance and form that is involved in an entity similar to the FSC at issue in this case.

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