Narrowing I.R.S. Discretion: Standard of Review under I.R.C. 7477

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The evolution of complex multinational corporate combinations has made transfers between domestic and foreign corporations commonplace. This evolution has triggered the development of an equally complex tax structure to protect the right of the country of the transferor corporation to tax gains realized by the transferor on these transfers. In particular, section 367 of the Internal Revenue Code (IRC or Code) governs the tax treatment of gains resulting from transfers from domestic to foreign corporations. Section 367 provides that the Internal Revenue Service (IRS or Service) must deny nonrecognition treatment of a gain resulting from such transfers if it determines that the exchange is in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.


2. Section 367 of the Internal Revenue Code provides in pertinent part:
(a) Transfers of Property From the United States.—
   (1) General rule.—If, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, there is a transfer of property (other than stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization) by a United States person to a foreign corporation, for purposes of determining the extent to which gain shall be recognized on such transfer, a foreign corporation shall not be considered to be a corporation unless, pursuant to a request filed not later than the close of the 183rd day after the beginning of such transfer (and filed in such form and manner as may be prescribed by regulations by the Secretary), it is established to the satisfaction of the Secretary that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

I.R.C. § 367(a)(1).

3. Id.

4. SEC. 7477. DECLARATORY JUDGMENTS RELATING TO TRANSFERS OF PROPERTY FROM THE UNITED STATES.
(a) Creation of Remedy.—
   (1) In general.—In a case of actual controversy involving—
      (A) a determination by the Secretary—
         (i) that an exchange described in section 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, or
         (ii) of the terms and conditions pursuant to which an exchange described in section 367(a)(1) will be determined not to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, or
      (B) a failure by the Secretary to make a determination as to whether an exchange described in section 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes,
Tax Court for a declaratory judgment regarding the reasonableness of an adverse IRS ruling under section 367. The standard of review applicable to section 7477 litigation is the subject of this Note.

The Note examines the circumstances leading to the most recent section 367 amendments and to the addition of section 7477 to the IRC. It then discusses the controversy regarding the proper standard applicable to the review of both tax and non-tax administrative rulings. The Note then analyzes Ditler Brothers, Inc. v. Commissioner, the only case arising to date under section 7477, and discusses the standard that the Tax Court found applicable in that case. Finally, the Note suggests potential ramifications of the Ditler Brothers opinion.

upon the filing of an appropriate pleading, the Tax Court may make the appropriate declaration referred to in paragraph (2). Such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

(2) Scope of declaration.—The declaration referred to in paragraph (1) shall be—

(A) in the case of a determination referred to in subparagraph (A) of paragraph (1), whether or not such determination is reasonable, and, if it is not reasonable, a determination of the issue set forth in subparagraph (A)(ii) of paragraph (1), and

(B) in the case of a failure described in subparagraph (B) of paragraph (1), the determination of the issues set forth in subparagraph (A) of paragraph (1).

(b) Limitations.—

(1) Petitioner.—A pleading may be filed under this section only by a petitioner who is a transferor or transferee of stock, securities, or property transferred in an exchange described in section 367(a)(1).

(2) Exhaustion of administrative remedies.—The Tax Court shall not issue a declaratory judgment or decree under this section in any proceeding unless it determines that the petitioner has exhausted administrative remedies available to him within the Internal Revenue Service. A petitioner shall not be deemed to have exhausted his administrative remedies with respect to a failure by the Secretary to make a determination with respect to whether or not an exchange described in section 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes before the expiration of 270 days after the request for such determination was made.

(3) Exchange shall have begun.—No proceeding may be maintained under this section unless the exchange described in section 367(a)(1) with respect to which a decision of the Tax Court is sought has begun before the filing of the pleading.

(4) Time for bringing action.—If the Secretary sends by certified or registered mail to the petitioners referred to in paragraph (1) notice of his determination with respect to whether or not an exchange described in section 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes or with respect to the terms and conditions pursuant to which such an exchange will be determined not to be made in pursuance of such a plan, no proceeding may be initiated under this section by any petitioner unless the pleading is filed before the 91st day after the day after such notice is mailed to such petitioner.

I.R.C. § 7477.

5. 72 T.C. 896 (1979).
I

THE 1976 TAX REFORM ACT AMENDMENT OF SECTION 367 AND THE ADDITION OF SECTION 7477

A. SECTION 367: FOREIGN CORPORATIONS

Internal Revenue Code sections 332, 351, 354, 355, 356 and 361 provide for the nonrecognition treatment of gains realized by a corporation upon certain exchanges of property with another corporation. If the transferee in any of these exchanges is a foreign corporation, the exchange must also meet the requirement of section 367. Section 367 provides that, for tax purposes, a foreign corporation shall not be considered to be a corporation unless the domestic transferor establishes that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes. Because corporate status is a prerequisite to nonrecognition treatment, a corporation's failure to satisfy this section 367 requirement necessarily results in a recognition of gain on the transaction.
Section 367 has undergone two major revisions since its enactment in 1932.\textsuperscript{15} Prior to the Revenue Act of 1962,\textsuperscript{16} section 367 applied only to exchanges by parties subject to immediate U.S. tax liability on the resulting gain.\textsuperscript{17} For example, assume that two foreign corporations exchanged stock in a Type-B reorganization.\textsuperscript{18} If U.S. taxpayers owned stock in those foreign corporations, the exchange would have had future U.S. tax consequences. Yet, because these tax consequences were not immediate, no section 367 ruling was required.\textsuperscript{19}

In section 957 of the Revenue Act of 1962,\textsuperscript{20} Congress introduced the concept of the "controlled foreign corporation,"\textsuperscript{21} which extended the application of section 367 to situations in which exchanges between foreign corporations may only have future U.S. tax consequences.\textsuperscript{22} This concept, however, produced great dissatisfaction because many U.S. taxpayers were prejudiced, not because their foreign exchange could not pass the section 367 test, but because they failed to realize that a section 367 ruling was required.\textsuperscript{23} Although the Service published guidelines describing the

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17. Pugh & Samuels, supra note 1, at 267.
18. A Type-B reorganization occurs when one corporation acquires the stock of another corporation solely in exchange for the former's voting stock if, immediately after the transfer, the acquiring corporation has control of the acquired corporation. Pugh & Samuels, supra note 1, at 267. For an extensive discussion of reorganizations, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 14-1 to 14-192 (1979).
19. Pugh & Samuels, supra note 1, at 268.
21. A controlled foreign corporation is a foreign corporation of which more than half the total combined voting power of all classes of voting stock is owned directly, indirectly, or constructively by five or fewer U.S. shareholders. I.R.C. § 957(a). "U.S. shareholders" are defined as U.S. persons who own 10 percent or more of the corporation's total combined voting power. I.R.C. § 951(b).
22. For example, unless a prior section 367 ruling was obtained, what might previously have been a nonrecognition transaction involving only foreign corporations could be, after the Revenue Act of 1962, currently taxable subpart F income under section 1248, which provides for the imposition of U.S. income tax on accumulated profits earned abroad. Pugh & Samuels, supra note 1, at 268.
23. Id. This problem was well-stated by the Senate Committee on Finance in its report accompanying the proposed Tax Reform Act of 1976:
[A] number of cases have arisen where a foreign corporation was involved in an exchange within the scope of the section 367 guidelines without the knowledge of its U.S. shareholders, and thus no request for prior approval was made. In a case of this type, an otherwise tax-free transaction becomes a taxable transaction, and if a second or lower tier foreign subsidiary is involved the U.S. shareholders of the controlled foreign corporation may be taxed under the subpart F rules. This can occur under the Service's section 367 guidelines despite the fact that a favorable ruling would clearly have been issued by the Internal Revenue Service had it been requested prior to the transaction.
transactions in which a favorable ruling under section 367 would normally be issued, complaints persisted.

Two particular aspects of the pre-1976 section 367 faced prolonged attack. First, section 367 required the taxpaying corporation to obtain clearance from the IRS for the proposed transaction prior to its consummation. This advance ruling requirement often resulted in undue delays for taxpayers attempting to consummate perfectly proper business transactions. Second, the taxpayer was provided with no opportunity for judicial review of an unfavorable IRS determination under section 367. Even when the taxpayer believed that the IRS exercised its discretion arbitrarily, the taxpayer had no effective means of challenging the Service’s determination that one of the principal purposes of the transaction was tax avoidance. The Tax Reform Act of 1976 amended section 367 by replacing the advance ruling requirement with the requirement that the taxpayer request clearance from the IRS within 183 days after the beginning of the exchange. Although this amendment eliminates unnecessary delays in the consummation of proper business transactions, it creates a risk that the IRS will hold an exchange taxable long after the exchange has begun. Congress confronted the other deficiency of section 367, the unfairness of the total discretion vested in the IRS, by adding section 7477 to the Code.

B. SECTION 7477: DECLARATORY JUDGMENTS ON SECTION 367 RULINGS

Section 7477 provides the taxpaying corporation the right to a declaratory judgment by the Tax Court with respect to an unfavorable section 367 ruling. If the court finds the decision unreasonable,
it must prescribe the terms and conditions of the exchange that would be reasonable in order to prevent tax avoidance. Section 7477 also allows the taxpayer to petition the Tax Court to make its own section 367 determination of whether the exchange is in pursuance of a plan having as one of its principal purposes the avoidance of income taxes if the IRS has refused to make such a determination.

The petitioner must fulfill certain prerequisites before he is entitled to a declaratory judgment. The petitioner must first exhaust all available administrative remedies. If the IRS has made an adverse section 367 ruling, the taxpayer’s administrative remedies are set forth in Revenue Procedure 77-5. The taxpayer may file a protest with the Office of the Assistant Commissioner. An ad hoc advisory board will then make a decision with respect to the protest. In addition, the taxpayer may request a conference with the ad hoc board to explain his position. A failure to make such a request, however, does not constitute a failure to exhaust all administrative remedies. If the IRS has failed to make a section 367 ruling, the taxpayer must wait 270 days from the date on which he requested the ruling before he is deemed to have exhausted his administrative remedies.

In addition to exhausting all available administrative remedies, the taxpayer must begin the exchange in controversy before he becomes eligible for judicial review. Finally, he must file the petition for review with the Tax Court within ninety days of the unfavorable ruling.

32. I.R.C. § 7477(a)(2)(A). The Tax Court must likewise prescribe reasonable terms and conditions if the taxpayer requested the declaratory judgment under section 7477(a)(1)(A)(ii) with respect to the terms and conditions prescribed by the Service. See note 31 supra.
34. I.R.C. § 7477(b)(2).
36. The application for protest must include: (1) a copy of the IRS’s ruling letter; (2) the taxpayer’s reasons for his protest (restricted to factual material submitted to and considered by the Service when making its original determination); (3) the taxpayer’s request for a conference, if one is desired (see text accompanying note 38 infra); and (4) the names of the parties that will attend the conference on behalf of the taxpayer. Id. § 4.01.
37. Id. § 4.02.
38. Id.
39. Id. § 4.03.
40. I.R.C. § 7477(b)(2). For a discussion of the special problems introduced by the 270-day requirement, see Santi, supra note 30, at 639.
41. I.R.C. § 7477(b)(3). See notes 113-115 infra and accompanying text for a discussion of the risks inherent in this requirement. It has been suggested that this requirement is a means to insure that a real controversy is present. If the exchange has not begun, the Tax Court would be acting in an advisory capacity. See Pugh & Samuels, supra note 1, at 271.
42. I.R.C. § 7477(b)(4).
The scope of the Tax Court’s review under section 7477 is limited to a determination of whether the Service’s finding of a tax avoidance purpose was, based on the administrative record, reasonable. This differs from the scope of review allowed the Tax Court under section 7428, another declaratory judgment section of the Code. Section 7428 allows the taxpayer to petition the Tax Court for review of an IRS determination under IRC sections 501(c)(3), 170(c)(2), 509, and 4942(j)(3), with respect to the classification of an organization as tax exempt. Unlike section 7477, section 7428 provides for a de novo review of the IRS ruling in controversy.

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43. The Tax Court promulgated Rules 210-218 to set forth procedures to follow when issuing declaratory judgments. Rule 217(a) provides that a declaratory judgment will ordinarily be made on the basis of the administrative record. T.C.R. 217(a).


45. I.R.C. § 7428. Section 7428, like section 7477, was added to the Code by the Tax Reform Act of 1976. Section 7428 provides in pertinent part:

(a) CREATION OF REMEDY.—In a case of actual controversy involving—

(1) a determination by the Secretary—

(A) with respect to the initial qualification or continuing qualification of an organization as an organization described in section 501(c)(3) which is exempt from tax under section 501(a) or as an organization described in section 170(c)(2),

(B) with respect to the initial classification or continuing classification of an organization as a private foundation (as defined in section 509(a)), or

(C) with respect to the initial classification or continuing classification of an organization as a private operating foundation (as defined in section 4942(j)(3)), or

(2) a failure by the Secretary to make a determination with respect to an issue referred to in paragraph (1),

upon the filing of an appropriate pleading, the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia may make a declaration with respect to such initial qualification or continuing qualification or with respect to such initial classification or continuing classification. Any such declaration shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Court of Claims, as the case may be, and shall be reviewable as such. For purposes of this section, a determination with respect to a continuing qualification or continuing classification includes any revocation of or other change in a qualification or classification.

I.R.C. § 7428(a).

46. Section 501(a) provides that an organization described in section 501(c) shall be exempt from Federal income taxation. Section 501(c)(3) prescribes the conditions that an organization must fulfill in order to qualify for such tax exempt status as a charitable, religious, or educational organization. I.R.C. § 501(c)(3).

47. Section 170(c)(2) defines the type of organization to which a donation will qualify as a charitable contribution. I.R.C. § 170(c)(2).

48. Section 509 sets forth the requirements that an organization must fulfill in order to qualify as a tax exempt private foundation. I.R.C. § 509.

49. Section 4942(j)(3) sets forth the requirements that an organization must fulfill in order to qualify as a tax exempt operating foundation. I.R.C. § 4942(j)(3).

50. The critical language of section 7428 from which it is apparent that Congress intended a de novo review is, “the [court] may make a declaration with respect to such initial qualification.” I.R.C. § 7428(a)(2). In other words, the operation of section 7428 grants no respect to the discretion of the IRS. If the Tax Court finds that the administrative ruling was erroneous after an examination of the administrative record, the Court
The legislative history of the Tax Reform Act of 1976 blurs the difference between the scope of review allowed the Tax Court under these two sections. When describing the scope of review allowed the Tax Court under section 7428, the Senate Committee on Finance stated, "[t]he court is to base its determination upon the reasons provided by the Internal Revenue Service in its notice to the party making the request for a determination, or based upon any new argument which the Service may wish to introduce at the time of the trial." Surprisingly, the committee used this identical de novo language when describing the scope of review allowed the Tax Court under section 7477. In addition, when discussing section 7477, the committee added, "[t]he Tax Court judgment, however is to be based upon a redetermination of the Internal Revenue Service's determination." This language clearly indicates that Congress intended the Tax Court to conduct a de novo review under section 7477 as well as under section 7428. After all, there is no apparent reason for according section 501(c)(3) rulings a different scope of review than section 367 rulings. Perhaps the incorporation of the reasonableness limitation on the Tax Court review of a section 367 ruling was merely the result of sloppy draftsmanship. The resolution of this problem is left to the Tax Court upon the adjudication of future cases arising under section 7477.

II
STANDARDS OF REVIEW FOR ADMINISTRATIVE FINDINGS

A. COMPARISON OF THE STANDARDS

When scrutinizing the findings of fact of administrative tribunals, courts generally apply one of three standards of review. The will reverse that ruling. Conversely, section 7477, in effect, creates a presumption that the IRS ruling was not erroneous as long as the Tax Court finds that ruling to be reasonable.

52. Id. at 266. The language in the report discussing section 7477 differs from the quoted language of the discussion of section 7428 in one respect — the word "argument" in the latter was replaced by the word "matter" in the former. This difference, however, is insignificant to the scope of review issue.
53. Id.
54. The Tax Court, in Dittler Brothers Inc. v. Commissioner, interpreted this statement by the legislative committee to indicate a congressional intent totally opposite to the intent that the author interprets the statement to indicate here. 72 T.C. 896 (1979). The court, however, then contradicted itself by conducting the equivalent of a de novo review. See notes 106-112 infra and accompanying text.
55. For a general discussion of standards of review and their application in the review of non-tax administrative findings, see K. Davis, Administrative Law of the Seventies 646-87 (1976).
The toughest standard is the "clearly erroneous" test under which the court will overrule an administrative finding if that finding is clearly in error.\textsuperscript{56} Under the most lenient standard, the "arbitrary and capricious" test, an administrative finding survives judicial review unless the court finds that the administrative determination amounts to an abuse of discretion.\textsuperscript{57} Under the intermediate standard, the "substantial evidence" test, the administrative finding will not be overruled as long as the court finds "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion."\textsuperscript{58}

Section 7477 does not specify what standard of review the Tax Court should employ to determine whether the IRS section 367 ruling was reasonable. An examination of the standards applied by courts when reviewing non-tax administrative rulings provides little guidance. Courts have not agreed as to what standard should apply in given types of cases. Furthermore, even when the applicable standard is undisputed, courts have defined and applied that standard inaccurately and inconsistently.\textsuperscript{59} The U.S. Supreme Court provided a good illustration of this confusion in \textit{Consolo v. Federal Maritime Commission}.\textsuperscript{60} When scrutinizing a finding of the Federal Maritime Commission, the Court decided that the substantial evidence standard should govern its review.\textsuperscript{61} The Court, however, then described the standard that it used as giving "proper respect to the expertise of the administrative tribunal . . . . By giving the agency discretionary power to fashion remedies, Congress places a premium upon agency expertise, and, for the sake of uniformity, it is usually better to minimize the opportunity for reviewing courts to substitute their discre-

\textsuperscript{56} Id. at 646-47. The clearly erroneous test appears to have no application to section 7477 proceedings. In \textit{Dittler Brothers}, neither party requested the use of this standard and the court did not even consider the possibility of its application. 72 T.C. at 909. Therefore, the clearly erroneous standard will not be discussed further in this Note.

\textsuperscript{57} See \textit{K. Davis}, supra note 55, at 647. The standard was defined by the U.S. Supreme Court in \textit{Camp v. Pitts}, 411 U.S. 138, 142 (1973) (review of decision by the Comptroller of the Currency denying a national bank charter).


\textsuperscript{59} One prominent commentator claims that the U.S. Supreme Court has introduced confusion into the standard of review issue by its own inconsistency:

[Its contribution to the new law of scope of review of rulemaking seems to be less than zero. The Supreme Court has done more to confuse than to clarify the law on the question whether the standard of substantial evidence may govern scope of review . . . . The Court said no in 1971, it said yes in 1972 without referring to its 1971 holding, and then it said yes in 1973 without referring to its 1972 holding.


\textsuperscript{60} 383 U.S. 607 (1966)

\textsuperscript{61} Id. at 620.
tion for that of the agency."62 That description defines equally well the arbitrary or capricious test.63 At best, this indicates that the standard of review issue is unsettled.64

B. TAX COURT APPLICATION OF STANDARDS

The Tax Court has often been faced with the standard of review problem when scrutinizing IRS rulings. *Schering Corp. v. Commissioner*65 expresses the Tax Court’s view on this issue. In *Schering*, a case involving an IRS reallocation of income ruling under section 482,66 the court acknowledged that the IRS should be allowed broad discretion, and hence, the arbitrary and capricious standard should apply.67 The court then noted that the IRS would have abused their discretion if it “made a determination which is arbitrary, capricious or unreasonable.”68 In other words, a finding of unreasonableness is the equivalent of a finding of arbitrariness or capriciousness.69 It follows that when the Tax Court faces the task of determining whether the IRS ruling was reasonable, the arbitrary or capricious

62. *Id.* at 620-21.

63. The Supreme Court provided another example of this confusion in *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402 (1971). In reviewing a decision made by the Secretary of Transportation, the Court determined that it would test the Secretary’s decision under the arbitrary or capricious standard. The Court stated that “[t]he ultimate standard of review is a narrow one. The Court is not empowered to substitute its judgment for that of the agency.” *Id.* at 416. The Court then stated, however, that “the court must consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.” *Id.* One commentator pointed out that the Court’s selection and application of the standards as such are contradictory: A court probably goes further toward substitution of judgment in deciding “whether there has been a clear error of judgment” than it does in deciding whether the administrative judgment is reasonable. The prevailing assumption has long been that “the clearly erroneous test” involves broader review than “the substantial evidence test.”

K. DAVIS, supra note 55, at 659.

64. One question that is particularly one of scope of review is whether more than a verbal difference ever existed between the two standards of review (substantial evidence and arbitrary-capricious) . . . . The fundamental has remained stationary that courts may not substitute judgment for that of the agencies as to the content of legislative rules but are limited into inquiring into reasonableness; that fundamental has always been the main part of both tests. Beyond that fundamental, the law has been blurred.

*Id.* at 288 (1980 Supp.).


66. Section 482 allows the IRS to allocate income, deductions, and credits among organizations, trades, or businesses when such allocation “is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.” I.R.C. § 482.

67. 69 T.C. at 604.

68. *Id.* (emphasis added).

standard must apply. Accordingly, because this is the task that section 7477 sets before the Tax Court,\textsuperscript{70} \textit{Schering} would indicate that the arbitrary and capricious standard should apply in all section 7477 cases. Because section 367 only requires the IRS to determine whether tax avoidance was "one of [the] principal purposes"\textsuperscript{71} of the exchange, it would be very difficult, if not impossible, for the taxpayer to prove that the IRS abused its discretion if the exchange had \textit{any} tax avoidance consequences. Hence, application of the arbitrary and capricious standard to review section 367 rulings would be fatal to the taxpayer. Yet, this was the state of the law when the Tax Court, on August 27, 1979, in \textit{Dittler Brothers, Inc. v. Commissioner},\textsuperscript{72} heard its first case under section 7477.

### III

**THE DITTLER BROTHERS CASE**

#### A. Statement of Facts

Dittler Brothers, Inc., a Georgia corporation, was engaged in the printing business for more than seventy years solely in the United States.\textsuperscript{73} The corporation began printing rub-off lottery tickets by a secret process in 1974. In 1975, when the United Kingdom liberalized its lottery laws, Norton & Wright Group Limited (Group), a United Kingdom holding company, proposed to form a joint venture with Dittler in which the latter's know-how regarding the printing of rub-off lottery tickets could, through Group's marketing expertise, be exploited in the United Kingdom and other parts of the world.\textsuperscript{74} Group requested that the joint venture corporation be operated in the Netherlands Antilles, an arrangement through which Group would realize substantial tax benefits. Netherlands tax law provides that if a corporation qualifies as a holding company, dividends paid to it by a subsidiary are tax exempt.\textsuperscript{75} Furthermore, a Netherlands corporation owned by a Netherlands holding company enjoys very low corporate income tax rates.\textsuperscript{76} Group already owned Norton & Wright B.V. (NWBV), a holding company in the Netherlands.\textsuperscript{77} If NWBV owned Group's share of the joint venture, the dividend exemption together with the low corporate income tax rates

\textsuperscript{70} See note 44 supra and accompanying text.
\textsuperscript{71} I.R.C. § 367(a)(1).
\textsuperscript{72} 72 T.C. 896 (1979).
\textsuperscript{73} Id. at 897.
\textsuperscript{74} Id.
\textsuperscript{75} Id.
\textsuperscript{76} Id.
\textsuperscript{77} Id.
would result in high after-tax earnings for Group. Dittler agreed to Group's request.

Dittler and Group organized a Netherlands corporation, Stansfield Security N.V. (SSNV), owned fifty percent by Dittler and fifty percent by NWBV. In exchange for the SSNV stock, Dittler and NWBV each contributed one-half of the initial operating capital. In addition, Dittler transferred its secret process for printing rub-off tickets and NWBV transferred its marketing and customer information. The parties then created another Netherlands corporation, Opax Lotteries International N.V. (OLINV), a wholly owned subsidiary of SSNV. Through OLINV, SSNV would manage the manufacture and sale of the lottery tickets. SSNV immediately transferred the know-how and cash to OLINV for 100 percent of the latter's stock, thereby qualifying as a holding company under Netherlands Antilles tax law.

The parties agreed that OLINV would distribute its seventy-five percent of net after-tax profits as dividends to SSNV. OLINV would retain the remaining twenty-five percent of after-tax profits to meet capital needs. SSNV would, in turn, pay the dividends to Dittler and NWBV. This arrangement would subject OLINV to very low tax rates. Furthermore, dividends paid first to SSNV, and second to Dittler and NWBV, would be tax exempt.

Because Dittler's transfer of the secret process was a transfer to a foreign corporation, Dittler was required to request a ruling under section 367 that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax. If the IRS would grant such a ruling, any gain on the transfer would merit nonrecognition treatment under section 351. The IRS, however, ruled that the transfer did not satisfy section 367. Dittler appealed this ruling, but on March 31, 1978, the Commissioner issued an adverse final determination letter. Dittler then petitioned the Tax Court for a declaratory judgment under section 7477.

B. STANDARD OF REVIEW AND ITS APPLICATION

On appeal, the Tax Court faced the issue of what standard of review it should use to determine the reasonableness of the IRS's
section 367 ruling. Because *Dittler Brothers* was the first case arising under section 7477, the Tax Court’s approach to the standard of review issue may indicate the course it will follow in the future. After reviewing the legislative history of section 7477,84 and other judicial reviews of administrative findings of fact,85 the Tax Court adopted the substantial evidence rule as the appropriate standard of review for section 7477 actions.86

To apply the substantial evidence standard of review, the court turned to Revenue Procedure 68-23,87 in which the IRS formulated guidelines for section 367 rulings. Section 2.02 of that Revenue Procedure provides that the determination of whether an exchange involving a foreign corporation has tax avoidance as one of its principal purposes depends upon an examination of all the facts and circumstances of the case.88 Accordingly, the court stated that Dittler’s burden of proof was “to establish from all the underlying facts and circumstances of the case that [the Service’s] determination was not responsible in that . . . there existed insubstantial evidence to support [the Service’s] determination.”89

The court then attempted to examine all the facts and circumstances that would prove or disprove the existence of a tax avoidance purpose. The court first considered whether there were any identifiable purposes for the exchange other than tax avoidance.90 Pointing out that “it was Group . . . who demanded that the situs for the transferee corporation be located in the Netherlands Antilles . . . for economic reasons based upon certain tax advantages that Group perceived for itself,”91 the court agreed with Dittler that the “principal purpose for making the exchange was to participate in a promis-

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84. For a discussion of the court’s review of the legislative history, see notes 106-112 *infra* and accompanying text.
85. The Tax Court discussed a number of cases in which courts have found the substantial evidence test to be the appropriate measure of review for administrative findings of fact. 72 T.C. at 910.
86. Judge Forrester, speaking for the majority, stated:
   It is not as narrow and restricted a review as under the arbitrary and capricious test, which would grant respondent an almost unbridled power to misuse or abuse his discretion. . . . We think the substantial evidence rule can be viewed as falling somewhere between the arbitrary and capricious test and a simple redetermination, and that is the proper test for us to use in the instant case.
   *Id.*
87. Rev. Proc. 68-23, 1968-1 C.B. 821. The purpose of Revenue Procedure 68-23 was to set forth guidelines for taxpayers with respect to the factors that the IRS will consider when making an advance ruling under section 367.
88. *Id.* § 2.02. For a further discussion of the guidelines set forth by Revenue Procedure 68-23, see notes 116-118 *infra* and accompanying text.
89. 72 T.C. at 915.
90. *Id.* at 915.
91. *Id.* at 916.
ing joint venture with a very favorable partner.”

Second, the court attempted to determine whether Dittler received any actual tax benefits from the exchange from which the court could infer a tax avoidance purpose. Although Dittler would receive favorable tax consequences in the Netherlands Antilles, Dittler would still be subject to U.S. income tax on its share of the seventy-five percent of OLINV's distributed earnings. Hence, no tax avoidance would result with respect to this distribution. The Service then argued that the transaction was, in effect, a license arrangement whereby Group was granted a license to manufacture rub-off lottery tickets. Dittler merely “opted for the form of the transaction hereunder to avoid Federal income taxes.” The court concluded that insubstantial evidence existed to show that Dittler would receive a greater after-tax earnings if the transaction were construed as a licensing arrangement. Therefore, no actual tax avoidance consequences were achieved.

Third, the court considered whether the transaction created a potential for tax avoidance in future years. The IRS argued that OLINV's retention of twenty-five percent of its earnings was not motivated by a legitimate business purpose and would result in future avoidance of U.S. income taxes. The court ruled that this retention of earnings was necessary to satisfy OLINV's need for working capital and, therefore, no potential for future tax avoidance existed to support a finding of a present tax avoidance purpose.

Fourth, the court examined the functions that OLINV performed. Presumably, if OLINV was a mere “file drawer” investment corporation ensconced in a foreign country, and performed only passive functions, its creation was unnecessary and could only have been motivated by tax avoidance purposes. The IRS argued that because OLINV planned to conduct most of its manufacturing during the start-up period through independent contractors, OLINV

92. Id.
93. Id.
94. See note 81 supra and accompanying text.
95. 72 T.C. at 915.
96. Id.
97. We are in agreement with respondent that in determining whether the prescribed purpose exists at the time of the transfer, the “potential” for tax avoidance in further years should be an element to be considered. This is because respondent has no other statutory means with which to attack an abusive situation that may arise in future years.
98. Id.
99. Id.
100. Id. at 918.
could not be considered an operating company. The court found that OLINV performed many active functions, including ordering, disbursing, bookkeeping, supervision of manufacturing, and developing new business. Furthermore, the employment of independent contractors was justified by a valid business purpose — the reduction of start-up costs.

Finally, the court considered Group's contribution to the joint venture. If such contribution was minimal, the court could have more easily found that the joint venture was motivated by a tax avoidance purpose because the foreign corporation's participation was unnecessary. The court found that Group had the marketing information, contacts, and experience that were "so vital to the success of this joint venture." This analysis, therefore, yielded no grounds upon which to infer a tax avoidance purpose. After examining all these facts and circumstances, the Tax Court concluded that Dittler's transfer satisfied the section 367 requirement and that the IRS determination was unreasonable.

C. CRITIQUE OF TAX COURT'S OPINION

Despite the similarities in the legislative histories of sections 7477 and 7428 discussed above, the Tax Court in Dittler Brothers emphasized their differences. It concluded that while Congress intended the court to conduct a de novo review in a section 7428 case, the court was not to conduct such a broad review under section 7477. Surprisingly, however, the court's thorough analysis of the facts and circumstances of the case was, in effect, a de novo review. The court's holding was that Dittler's transfer "was clearly not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes. It follows, therefore, that respondent's determination to the contrary was not reasonable." Such

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101. Id.
102. Id. at 905, 918.
103. Id. at 918.
104. Id. at 919.
105. Id.
106. See notes 51-54 supra and accompanying text.
107. 72 T.C. at 908-09. The court paid particular attention to the statement, contained in the Senate Finance Committee's discussion of section 7477, that "[t]he Tax Court judgment, however, is to be based upon a redetermination of the Internal Revenue Service's determination." S. Rep. No. 94-938, 94th Cong., 2d Sess. 266 (1976). This statement was not included in the discussion of section 7428. The court interpreted this statement to be an indication of the congressional intent that the court should not conduct a de novo review under section 7477. As noted in notes 53-54 supra and accompanying text, this statement could be interpreted to indicate a totally contrary congressional intent.
108. 72 T.C. at 909.
109. Id. at 919.
language indicates that the court concluded that the IRS's ruling was unreasonable only after first making its own section 367 determination, based on all the facts and circumstances, that no tax avoidance motive existed. 110 The court's analysis clearly focused on the issue of whether the transfer met the section 367 test, not whether the IRS determination was reasonable. 111 In this way, the court contradicted its own findings based on its analysis of the legislative history. Although its "substantial evidence" analysis is valid and persuasive, the Tax Court could have bolstered its arguments by emphasizing the similarities among the legislative histories of the declaratory judgment sections, rather than dwelling on their differences. 112

IV
RAMIFICATIONS OF DITTLER BROTHERS

A. Less Risk to the Taxpayer

Section 7477 requires the taxpayer to begin the exchange before requesting a declaratory judgment. 113 This requirement creates the risk that the IRS will require a taxpayer to recognize gain on an exchange after it has begun. 114 To reduce this risk, Congress suggested in the legislative history that the taxpayer can fulfill the requirement by transferring assets pursuant to an agreement containing a stipulation that if the IRS subsequently renders an unfavorable section 367 ruling, the assets are to be returned. 115 While reducing the risk to the U.S. corporation, however, such a stipulation increases the risk to the other party to the transaction. In light of this risk, the foreign corporation may refuse to accept the condition. Even if the foreign corporation does agree to the stipulation, such agreement would probably cost the U.S. corporation something in the bargaining process, thereby lessening its overall income from the venture.

The application of the substantial evidence standard and the focus on all the facts and circumstances of a case will not eliminate this risk. Nevertheless, under the substantial evidence standard, the U.S. taxpayer faces less risk than he would face under the arbitrary and capricious standard. The taxpayer is now assured that the court will not submit entirely to IRS discretion. The taxpayer is further 110. In other words, the court made the same determination that section 7428 requires the court to make. See notes 51-54 supra and accompanying text.
111. See notes 87-105 supra and accompanying text.
112. See notes 51-54 supra and accompanying text.
113. 1.R.C. § 7477(b)(3).
114. See note 29 supra and accompanying text.
assured that the court will look to more than the mere existence of minimal tax consequences when making its ruling. One pro-tax avoidance consequence will not alone disqualify the transaction from nonrecognition treatment. Rather, that consequence will merely be one factor weighed against the legitimate business purposes of the transaction. In addition, the factors examined by the court in *Dittler Brothers* provide the U.S. corporation contemplating a transfer to a foreign corporation with a useful gauge against which it can compare the characteristics of its own transfer. Such comparison helps the corporation determine in advance its chances of succeeding upon judicial review.

Overall, after *Dittler Brothers*, the taxpayer faces a much better chance of receiving a favorable decision from the reviewing court. This lesser risk will make the U.S. corporation more willing to pursue a good business opportunity abroad. In addition, the U.S. corporation will have a firmer bargaining position with the other party to the proposed transaction because the latter will also face less risk. This improved bargaining position should increase the corporation's income from the venture because the corporation will have to give up less to persuade the other party to accept the lesser risk.

**B. Emphasis on the Whole Fact Situation**

Another aspect of the *Dittler Brothers* opinion favorable to the taxpayer is the movement away from strict "by the book" criteria for determining whether a tax avoidance purpose is present. The court must look at the *whole* fact situation, weighing all the underlying facts and circumstances together. Taxpayers who, therefore, fail to meet the specific requirements of Revenue Procedure 68-23 will not necessarily be precluded from qualifying for tax-free treatment. For example, Revenue Procedure 68-23 recommends that to pass the section 367 test, the foreign corporation should either have a substantial investment in fixed assets in the joint venture or be engaged in the purchase and sale of manufactured goods abroad.\(^\text{116}\) OLINV had no such assets and engaged in no such activities. Nevertheless, the Tax Court stated that "failure to meet that provision of section [3.02(1)] will not, ipso facto, result in an unfavorable ruling."\(^\text{117}\) Consequently, Dittler was allowed tax-free treatment of the transfer despite its inability to meet the Revenue Procedure guidelines. The court emphasized that Revenue Procedures are not enactments of law but merely official interpretations to be used as guidance by the

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117. 72 T.C. at 913.
taxpayer. The court explained that only by looking at all the reasons for, and circumstances surrounding, the transfer, can it reach a fair decision as to what constituted a "principal purpose" within the meaning of section 367. This emphasis on the whole fact situation gives the taxpayer more flexibility when making transfers to foreign corporations.

C. VIABILITY OF THE DITTLER BROTHERS PRECEDENT

Seven of sixteen Tax Court judges dissented from the Dittler Brothers majority opinion, on the basis of the standard of review applied by the majority. In writing for the dissent, Judge Dawson stated, "[I]n view of the discretion . . . given to the Commissioner, any attack on his standards or application of those standards must show an abuse of discretion." Judge Dawson then applied what he considered to be the appropriate test — the arbitrary and capricious standard. He concluded that Dittler failed to satisfy its burden of proving that the Commissioner acted unreasonably by denying a favorable determination.

The dissent points to three facets of the transaction to uphold its conclusion. First, Dittler could have licensed its process and manufacturing know-how rather than forming a new corporation in the Netherlands Antilles. Because the transaction contemplated that only the subsidiaries of Group would actually manufacture and sell the lottery tickets, petitioner's input amounted to nothing more than a license to utilize its know-how. The dissent concluded, therefore, that avoidance of tax must be one of the principal purposes of the transaction.

Second, twenty-five percent of OLINV's profits were to be withheld for capital expenditures, subjecting only seventy-five percent of its profits to tax in the United States. Although the dissent considered this accumulation a basis for a finding of tax avoidance in and of itself, it also tied that accumulation to a third tax avoidance possibility. The Commissioner has no assurance that the parties will not agree in the future to reduce the dividend distribution to less than seventy-five percent. Tax avoidance in the future is, therefore, a real possibility. Applying the arbitrary and unreasonable standard to

118. Id. at 914.
119. Id. at 923, 929. It is also interesting to note that in a separate dissenting opinion, Judge Tannenwald claimed that he was not convinced that there was any difference between the standard of review articulated in the majority opinion and that in the dissent. He summed up by saying, "[t]he bricks of the house may be the same; only the mortar may be different." Id. at 931.
120. Id. at 923.
121. Id. at 929.
122. Id. at 928.
these facts, Judge Dawson concluded that the IRS determination against the taxpayer was reasonable.\(^{123}\)

Because the majority was slight, a domestic corporation wishing to rely on *Dittler Brothers* as precedent should do so with caution. Favorable tax consequences of the transaction, to the extent that they exist at all, must be minimal to *insure* a favorable ruling. If the overall appearance of the transaction is not tax-oriented, however, the Tax Court will probably allow nonrecognition of gain on the transfer.

**CONCLUSION**

The enactment of section 7477 remedied a long-standing unfairness in the Code by creating a check on the IRS's total discretion with respect to the tax treatment of transfers from domestic to foreign corporations. Congress, however, did not specify what standard the Tax Court should employ to review the Service's section 367 rulings. In *Dittler Brothers*, the first case arising under section 7477, the Tax Court adopted the substantial evidence test as the appropriate standard for judicial review. The use of this test greatly lessens the risk to the U.S. corporation desiring to make a transfer to a foreign corporation. It also improves the domestic corporation's bargaining position with respect to the foreign corporation. Furthermore, the focus on the whole fact situation, including non-tax as well as tax factors, makes it easier for a transfer with minimal favorable tax consequences to be accorded nonrecognition treatment. Such a result is consistent with the congressional intent to remove the total discretion previously vested in the IRS with respect to section 367 decisions.

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\(^{123}\) *Id.* at 929.