North Carolina Central Law Review

Volume 11
Number 1 *Volume 11, Number 1*

Article 11

10-1-1979

Dittler Brothers, Incorporated v. Commissioner: The Effect of the New Internal Revenue Code 7477 Declaratory Judgment Provision on a 351 Exchange under 367

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Dittler Brothers, Incorporated v. Commissioner: The Effect of the New Internal Revenue Code § 7477 Declaratory Judgment Provision on a § 351 Exchange Under § 367.

The Tax Reform Act of 1976 significantly changed the section 367 treatment of exchanges and transfers involving foreign corporations.[1] Section 367 provides, in part, that in determining the extent of gain for an exchange described in section 351, a foreign corporation is "not to be considered as a corporation" unless it establishes to the satisfaction of the Internal Revenue Service that the exchange is "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal Income Taxes."[2] As section 351 provides for non-recognition of gain in connection with the transfer of property to a corporation controlled by the transferor(s) immediately after the exchange, in exchange for stock or securities in the same corporation, corporate status is essen-

1. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1042, 90 Stat. 1520. The Act made two significant changes to section 367 transfers beginning after October 9, 1975. Prior to that time the non-recognition of gain was predicated upon the receipt of a favorable advance ruling from the Internal Revenue Service with respect to all transfers of property (outbound, inbound, and exclusively foreign) involving foreign corporations. Now there are separate rules for two fundamentally different groups of transactions.

I.R.C. § 367(a)(1) retains the need for a favorable ruling with respect to outbound transactions. However, the requirement for an advance ruling has been replaced by the requirement that the application be made as late as 183 days after the beginning of the transfer. *See* Rev. Proc. 77-5, 1977-1 C.B. 536.

I.R.C. § 367(a)(2) gives authority to the Service to designate by regulation those transactions where no ruling would be required; that is, where tax avoidance is clearly not in issue or where it is possible to ascertain a toll charge. The purpose of the toll charge is to neutralize the potential for tax avoidance. Absent the taxpayer's agreement to pay the specified amount assessed by the Service, the Service has the right to issue an adverse ruling even though the specific guidelines have been met. *See* Temp. Regs. § 7.367(a)-1(b)(5).

I.R.C. § 367(b) eliminates the ruling requirement entirely for all other transfers (repatriating, inbound, and those exclusively foreign in effect). It gives authority to the Service to promulgate regulations to determine when a corporation is to be considered a corporation for purposes of nonrecognition of gain.

2. I.R.C. § 367. For purposes of the Dittler Brothers exchange, the policy justification for § 367 is to prevent the taxpayers from expatriating what is or could be domestically generated income. Prior to the enactment of what is now § 367 of the Code, it was possible for property to be transferred to foreign corporations without recognition of gain under the exchange and reorganization sections of the then existing Code. By organizing a corporation in a country that imposed no tax on the sale of capital assets, by transferring unrealized profits in securities to that corporation, and by subsequently selling these assets in the foreign country, the entire tax on capital gain could be avoided. It was for this reason that transactions involving foreign corporations were withdrawn from the operation of nonrecognition sections, unless the Commissioner first determined that the transaction was not primarily motivated by a plan to avoid taxes. *See* 1931-1 C.B. 471.

tial to the tax-free exchange.[3] A failure to satisfy the section 367 requirements results in recognition of gain.[4]

Prior to the 1976 Act, the taxpayer had no effective way to appeal an adverse decision to the courts as the statute required the Commissioner's, not the court's, satisfaction that one of the principal purposes of the exchange was not the avoidance of taxes.[5] The Tax Reform Act of 1976 provides, in the form of declaratory judgment, a remedy for the taxpayer whose section 367 transfer does not initially qualify for tax free transfer status.[6] As a result, the Tax Court, in a declaratory judgment action, must consider the concept of tax avoidance as applied to a section 367 transaction. For while the Internal Revenue Service will continue to make an initial determination as to the tax status of a section 367 outbound transfer, it is now possible for the taxpayer to litigate that determination in the Tax Court when there is an actual controversy as to whether the transaction has as one of its principal purposes the avoidance of federal income taxes.

In the past, the Internal Revenue Service has based its determination with respect to the tax status of a section 367 transfer upon guidelines issued under that section.[7] When the taxpayer's plan does not meet the

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3. I.R.C. § 351. The basic premise of § 351 is that the transfer effects a change in form only and is therefore not an occasion for determining gain or loss on the transferred property.
The three major requirements of § 351 are:
1. That one or more persons transfer "property" to a corporation.
2. That the transfer be solely in exchange for stock or securities in the transferee corporation.
3. That the transferor(s) be "in control" of the corporation immediately after the exchange. "Property" includes money (recognizing the cash needs for working capital), as well as "know-how," marketing information and other intangibles. *See* Rev. Rul. 64-56, 1964-1 C.B. 133; Rev. Proc. 69-19, 1969-2 C.B. 301.

4. The section requires more than proof of a necessary and legitimate business purpose for a transfer to a foreign corporation of intangibles ("tainted assets"), which can be and are expected to be used in connection with a domestic business and which are therefore categorized upon transfer as an attempt to "farmout" domestically generated income. Under these circumstances there is a rebuttable presumption that one of the principal purposes for the exchange is tax avoidance. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶¶ 17.40, .41 (4th ed. 1979).

5. Upon failure to obtain a ruling, however, the taxpayer could appeal an assessment of deficiency against him based on an argument that § 367 did not apply to the transaction. *See* Abegg v. Comm'r, 429 F.2d 1209 (2d Cir. 1970).

6. I.R.C. § 7477 provides for the creation of a remedy in the form of a Declaratory Judgment action:

> [I]n a case of actual controversy involving a determination by the Secretary that an exchange described in § 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, or of the terms and conditions pursuant to which an exchange described in § 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.

The remedy is also available upon the failure of the Secretary to make a determination.

7. *See* I.R.C. § 367. *See also* Rev. Proc. 68-23 § 3.02(1), 1968-3 C.B. 239. The guidelines described the various attributes necessary for a transaction to ordinarily receive a favorable ruling when it involves a § 351 exchange. The guidelines are intended to protect the tax interest embodied in § 61 of the Code which defines gross income as "all income from whatever source derived."

criteria for a favorable ruling under the guidelines,[8] it is predictable that the Service will continue to issue an adverse ruling. Therefore, the new declaratory judgment code provision is significant in two respects. When the taxpayer contemplates an exchange, subsequent to an IRS adverse ruling, yet prior to the consummation of the exchange, the taxpayer can petition the Tax Court for a declaratory judgment. In effect, the exchange must be begun but need not be completed in order for the taxpayer to take advantage of section 7477. The opportunity to secure a final and binding determination in advance of total commitment under a section 367 exchange has obvious advantages, especially when the taxpayer has conditioned transfer of assets upon a favorable outcome of the litigation.[9] Should the Service fail to make a determination within 270 days from the date of the request for a ruling, the taxpayer is deemed to have exhausted his administrative remedies and may petition the Tax Court.[10] In addition, the new code provision provides the taxpayer with an opportunity to have an initial adverse determination reversed by the Tax Court subsequent to the consummation of the exchange.

In *Dittler Brothers, Incorporated v. Commissioner of Internal Revenue*,[11] the Tax Court had its first opportunity to review the Service's adverse ruling with respect to an outbound transfer to a foreign corporation. At the time of the petition Dittler Brothers had completed the transaction.[12] The Court agreed with the petitioners, Dittler, that the avoidance of federal income taxes was not one of the principal purposes for the exchange, thus permitting a non-recognition of gain on the transfer.[13]

To gain access to major overseas markets, Dittler Brothers, a corporation engaged in the production and distribution of lottery tickets, agreed to enter into a series of agreements with Norton & Wright Group Limited, a British based corporation with a Dutch subsidiary. The agreements were structured to enable Norton to obtain substantial tax benefits under British and Dutch law through the use of their Dutch Netherlands Corporation (hereinafter referred to as NWBV), and

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It is only when a legitimate business reason exists for dealing through a foreign corporation that the Service will surrender full United States tax jurisdiction. *See* C. Kingson, *Section 367: Theory and Practice*, N.Y.U. 37th Inst. on Fed. Tax. Section 22.01-Section 22.02.

8. The guidelines recommend that the property which is transferred to a foreign corporation be devoted to the active conduct of a trade or business by the transferee corporation. In addition, "It is contemplated that the transferee foreign corporation . . . will have need for a substantial investment in fixed assets in such business or will be engaged in the purchase or sale abroad of manufactured goods." Rev. Proc. 68-23, 1968-1 C.B. 821.

9. 1976-3 C.B. 239 [hereinafter cited as Committee Report].

10. *Id.*

11. 72 T.C. No. 77 (Aug. 27, 1979).

12. *Id.*

13. *Id.*

through the establishment of a Netherlands Antilles operating company (hereinafter referred to as OLINV).[14]

Dittler Brothers agreed to transfer cash and property ("know-how" of their rub-off method for lottery tickets), while Norton agreed to transfer cash and marketing information. The transfers were made to Stansfield Security N.V. (hereinafter referred to as SSNV), the holding company, which in turn transferred the marketing and "know-how" information and all except a small portion of the cash to OLINV in return for 100% of the OLINV stock. During the operation of the agreements, seventy-five percent of the net profits from OLINV (received primarily from the work of its independent contractors, Norton and Dittler) were paid to the holding company, SSNV.[15] SSNV, in turn, passed fifty percent of those profits to Norton and Dittler respectively.[16]

Dittler was subject to federal income tax in the United States on its share of the repatriated earnings, but the twenty-five percent of earned income retained by OLINV was not subject to tax.[17] The Service viewed the twenty-five percent retention as a potential for tax avoidance since it would result in the accumulation of earnings and profits in OLINV not subject to federal income taxes. Where the potential tax avoidance exists, the burden is on the taxpayer to establish that tax avoidance was not one of the principal purposes for the transaction.[18]

In June 1976, Dittler requested a determination that the transfer of cash and "know-how" to a foreign corporation in exchange for stock did not have as one of its principal purposes the avoidance of tax. It was not until July 1, 1977 that Dittler received its initial adverse ruling.[19] Exigent business circumstances forced Dittler to unconditionally consummate the exchange on July 8, 1977. Dittler appealed the initial ruling on August 10, 1977, and on March 31, 1978, the Service issued

14. *Id.*

15. *Id.*

16. *Id.*

17. I.R.C. § 882(b). In the case of a foreign corporation, gross income includes only (1) gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States; (2) gross income which is effectively connected with the conduct of a trade or business within the United States. OLINV's income was not derived from services within the United States or connected with the United States, and was therefore not subject to United States corporate tax. As the 25% portion of Dittler's earned income was retained by OLINV, and "fed back" into the corporation as working capital, it did not qualify as dividends for which Dittler would have individual tax liability. The Service will not, however, surrender its full United States tax jurisdiction unless a legitimate business reason exists for dealing through a foreign corporation. Thus earned income retained by a foreign corporation is subject to United States tax at corporate rates where tax avoidance motives are present.

18. T. Ct. R. Proc. & P. 217(c)(2)(i).

19. 72 T.C. No. 77 (Aug. 27, 1979).

its final adverse ruling.[20]

The grounds for the ruling were two-fold. First, the transfer did not meet the requirements of section 3.02(1) of Rev. Proc. 68-23[21] that the transferee devote the property transferred to the active conduct of a trade or business. (OLINV had only one employee whose duties were largely ministerial). Second, income from the exploitation of Dittler's manufacturing "know-how" would be diverted to a passive recipient in a benign foreign tax country (a foreign country with favorable tax laws), thereby creating the potential for tax avoidance. The Service concluded that there was a lack of any distinct purpose for the transaction other than tax avoidance.[22] On May 24, 1978, Dittler petitioned the Tax Court for a declaratory judgment.[23]

The Tax Court, in reviewing Dittler's position, first determined its scope of review under section 7477. The court drew a distinction between section 7477 and other code provisions relating to declaratory judgments, most significantly pointing out that the scope of review afforded under sections 7428[24] and 7476[25] are characterized as *de novo* determinations,[26] while section 7477, by its language, limits the court to a redetermination.[27] Thus the function of a section 7477 declaratory judgment action is to determine whether the Secretary's ruling is reasonable.

After rejecting the broader *de novo* determination, the court considered the Service's request for a narrow "arbitrary and capricious" test and concluded that such a test would essentially negate any advantage afforded the taxpayer under the new declaratory judgment provision. In effect the test would grant the Service almost unlimited power subject only to the most cursory review by the court. The Tax Court instead chose to adopt a "substantial evidence" test as an appropriate middle ground on which to base its review. As defined by the Supreme Court, the substantial evidence rule requires "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion."[28] The court noted that the rule had been held an appropriate measure of

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20. *Id.*
21. Rev. Proc. 68-23, 1968-1 C.B. 821.
22. 72 T.C. No. 77 (Aug. 27, 1979).
23. *Id.*
24. I.R.C. § 7428 deals with declaratory judgments relating to the status and classification of organizations under I.R.C. § 501(c)(3). Section 501(c)(3) lists organizations exempt from taxation, which include corporations organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.
25. I.R.C. § 7476.
26. The critical language in each section is "the [court] may make a declaration with respect to such initial qualification."
27. The scope of the declaration shall be ". . . whether or not such determination is reasonable." I.R.C. § 7477(a)(2)(A).
28. Consolo v. Federal Maritime Comm'n, 383 U.S. 620 (1966).

review for administrative findings of fact.[29]

In determining the tax status of Dittler's overseas transaction, the Service had measured the facts and circumstances of the transaction against its section 367 guidelines. The court readily admitted that, were the guidelines the sole standard, the Secretary's adverse ruling would have been sustained. The court noted, however, that while providing some measure of certainty to the treatment of transactions under section 367, the pre-1976 amendment guidelines were, under the amendment policy, primarily of value in enabling the taxpayer to determine his own tax status.[30] The taxpayer might determine, for example, that he falls within the guidelines (to the extent that a request for clearance may not be necessary); or that the specific facts of the transaction do require a determination of the amount of tax which must be paid to protect against tax avoidance.[31]

The Tax Court, in recognizing the shortcomings of the guidelines with respect to their determination under section 7477, undertook an independent review of the facts in the case as measured against the critical words of the section 367 provision "that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes."[32] After rejecting their interpretation of principal purpose in an analogous provision under section 269,[33] the

29. *See* Abbott Laboratories v. Gardner, 387 U.S. 136 (1967); United States v. First City Nat'l Bank, 386 U.S. 361 (1967).

30. Committee Report, *supra* note 9.

31. The taxpayer may contemplate a third alternative, that of failing to secure a ruling for purposes of having the Service view the transaction as a recognition event in order to realize losses on the exchange. Where, for example, the fair market value of the property exchanged is less than its adjusted basis, it would be to the taxpayer's advantage to utilize its failure to secure a § 367 clearance, technically adverting the non-recognition of the § 351 gain or loss provision, and thereby realizing a loss on the exchange.

The Service, however, has concluded that § 367 of the Code applies only to those transactions upon which a gain is realized. Failure to obtain a ruling will not result in a recognition of loss under the provision of § 351. *See* Rev. Rul. 67-192, 1967-2 C.B. 140.

Consistent with this approach, the Service has also ruled that a domestic corporation is not entitled to utilize to its advantage a failure to secure a § 367 clearance to obtain a stepped-up basis for assets of a foreign corporation acquired in exchange. Its position is unequivocal: The provisions of what is now § 367 "were not intended to afford taxpayers an option to escape the tax consequences which would follow from that section . . . . Statutory requirements intended solely for the protection of the government may be invoked only at the instance of the government." Rev. Rul. 64-177, pt. 1, 1964-1, C.B. 141.

32. I.R.C. § 367.

33. I.R.C. § 269 deals with acquisitions made to evade or avoid income tax. The language of that section reads: "If any person or persons acquired . . . control of a corporation, or any corporation acquired . . . property of another corporation . . . and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax . . . then the Secretary may disallow such deduction." Section 269 was "designed to put an end promptly to any market for, or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability." H. REP. No. 871, 78th Cong., 1st Sess. 49 *reprinted in* 1944 C.B. 901, 938. If the acquisition secures the benefit of a deduction, credit, or other allowance which the person or corporation would not otherwise enjoy, and the

court adopted the plain meaning of the term "principal purpose" defined in *Webster's New Collegiate Dictionary* as first in rank, authority, importance or degree.[34]

The issue then was whether Dittler's exchange of manufacturing "know-how" and cash was in pursuance of a plan having as one of its "first in importance" purposes the avoidance of federal income taxes. Dittler contended there was insubstantial evidence to support an affirmative finding on this issue. The court agreed that Dittler's decision to expand its operation to gain access to foreign markets was for sound business purposes: it was at Norton's insistence that the joint venture was located in the Netherlands Antilles based on certain tax advantages which Norton perceived for itself; Dittler controlled neither the form nor structure of the transaction; evidence in the record established that OLINV's need for working capital justified its retention of 25% of the earnings.[35]

The Tax Court properly concluded that the appropriate scope of review under the new 7477 provision is the substantial evidence rule. That test, in fact, comes closer to the scope of review under the declaratory judgment provisions, sections 7428 and 7476, than the court was willing to recognize. The distinction between those provisions, which provide that the court is to review decisions *de novo*, and the section 7477 provision, which calls only for a redetermination, is one of theoretical rather than practical import. Under all three provisions, the taxpayer must first exhaust all administrative remedies prior to petitioning for declaratory judgment. As a result, in rendering judgments under sections 7428 and 7476, the courts have, in the majority of cases, relied on administrative records to determine whether the Service's ruling was correct; they have narrowed their scope of review from *de novo* to a review based on evidence contained in such records and to whether, in view of the facts and circumstances of the case, the Service's adverse ruling should be sustained or reversed.[36]

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principal purpose of the acquisition was to secure such benefit, the deduction, credit, or other allowance may be disallowed. *See* Vulcan Materials Co. v. United States, 446 F.2d 690 (1971).

34. Malat v. Riddell, 383 U.S. 569, 571 (1966).

35. 72 T.C. No. 77 (Aug. 27, 1979).

36. *See* I.R.C. § 7428, McGovern, *The New Declaratory Judgment Provision for § 501(c)(3) Organizations: How it works*, 47 J. TAX. 222 (1977). The author writes in part:

> The Tax Court Rules Committee, in commenting on Rule 217, leaves little doubt on the intended scope of review: ". . . there do not appear to be at this time any circumstances under which a trial will be held except as to disputed jurisdictional facts or to resolve disagreements between the parties as to the contents of the administrative record. It is expected that the Court's function will be merely to adjudicate whether the Commissioner's determination is erroneous . . . upon the basis of the materials contained in the administrative record upon which the determination of the Commissioner was based."

See, e.g., Big Mama Rag, Inc. v. United States, 44 A.F.T.R. 2d 79-5053 (D.C. Cir. Apr. 30, 1979) (review only of evidence contained in the administrative record.); Houston Lawyer Referral Serv. v. Commissioner, 69 T.C. 570, 573 (1978) (focus of I.R.C. § 7478 is on review of IRS determina-

The Service's argument that the language of section 367 should be interpreted to afford the Secretary with broad discretionary powers in making his initial determination and therefore subject to the most limited review is without merit. Legislative history bears out this conclusion.[37] While it is likely that the courts will follow the *Dittler* precedent and apply the substantial evidence rule in subsequent cases that they are asked to review under section 7477, this court has clearly confined its decision on the issue of scope of review to this particular case.[38]

The function of the Tax Court is, therefore, to review whether the Secretary's determination is reasonable.[39] The reasonableness of an Internal Revenue Service determination, within the confines of the substantial evidence rule, is to be measured against the substantiality of evidence which supports the Service's finding.[40] The evidence will consist of facts and circumstances leading up to and including the transaction as found in the administrative record.[41]

As set out in Rule 217(c)(2)(i) Tax Court Rules of Practice,[42] the taxpayer has the burden of proof as to the facts and circumstances on which he relies as evidence of the unreasonableness of the Service's determination. Absent a substantial business purpose and given the result of income tax avoidance, the court will uphold an adverse determination that the transaction had as one of its principal purposes the avoidance of federal income taxes within the meaning of section 367.

In rejecting the section 367 guidelines as the sole standard for determining the tax status of an exchange or transfer to a foreign corporation, the Tax Court recognized the obvious—that the guidelines are not the law. The court also recognized that the guidelines have been criticized as being overly strict and inflexible where mitigating or unusual circumstances may prevail.[43] The court established that it will be incumbent on future courts when dealing with a section 7477 review to make an independent determination from the facts and circumstances

tion only). *See* I.R.C. § 7476, *ERISA - Tax Court Declaratory Judgments, Tax Mgmt. Mem.*, Jan. 5, 1976. The court's role under § 7476 is limited to a redetermination of the IRS determination as opposed to a general examination of the plan or trust. The court's decision is made on the basis of the administrative record and only in rare instances will a party be allowed to introduce new evidence.

37. Committee Report, *supra* note 9.

38. The court writes: "We think the substantial evidence rule can be viewed as falling somewhere between the arbitrary and capricious test and a simple redetermination, and that it is the proper test for us to use *in the instant case*." (emphasis added). 72 T.C. No. 77 (Aug. 27, 1979).

39. Committee Report, *supra* note 9.

40. 72 T.C. No. 77 (Aug. 27, 1979).

41. Committee Report, *supra* note 9.

42. T. Ct. R. Proc. & P. 214(c)(2)(i).

43. Special Committee on Section 367 Policies, *Comments on Guidelines for Rulings under Section 367 Concerning Foreign Corporations: An Analysis of Revenue Procedure 68-23*, 23 TAX LAW. 151 (1969).

of the case as set forth in the administrative record, and to give, on a case-by-case basis, a more extensive consideration than heretofore to those situations which fall outside the scope of the guidelines. Such an independent determination is in keeping with the spirit of the new provision[44] as long as the Internal Revenue Service continues to confine its favorable rulings to those cases falling squarely within the guidelines.[45]

The "first in importance" interpretation given to "principal" is neither significant nor subject to controversy. The court's consideration of section 269[46] with respect to a basis for its interpretation is useful only as a comparison of the degree of subjective tax avoidance motive required by each section. Obviously a greater degree of motive is required in section 269 where the principal purpose for which an acquisition is made is to avoid tax. The tax avoidance purpose must exceed in importance any other purpose. As section 367 only requires a showing that one of the principal purposes for the exchange was tax avoidance, the court is not dealing with a vertical hierarchy with a tax avoidance motive at the top, but with a horizontal plane including several "first in importance" motives, only one of which needs to be tax avoidance. Nevertheless, it is important to note that section 367 requires considerably more than a showing that the transaction will result in tax avoidance or the potential of tax avoidance. The presence of tax avoidance motives will not negate an otherwise bona fide transaction.[47]

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44. Committee Report, *supra* note 9.

45. *See* Letter Rul. 7944053 (Aug. 1, 1979). Based on Rev. Rul. 78-201, 1978-1 C.B. 91, in which a favorable ruling was conditioned upon the transferor's recognizing as gain on the transfer an amount equal to the sum of the losses previously deducted by the transferree, the Service issued an adverse ruling on the following set of facts: Corporation *B* was a subsidiary of Corporation *A*, engaged in the exploration, production, and marketing of oil and gas. Corporation *D*, a Canadian Corporation, was owned by *C*. *B* purchased *C*, whose termination of corporate status as a domestic corporation under § 1504(d) is treated as an exchange. Hence, there was a constructive transfer of *C*'s interest in *D*, a foreign corporation, to purchaser *B*. *B*'s position was that the principal purpose of the deemed transfer, resulting from the purchase by *B* of stock in *C*, was not due to the nature or value of the assets of *D*, which were insignificant in comparison to the nature and value of other assets in *C*. *B* refused to comply with a condition similar to that imposed in Rev. Rul. 78-201, 1978-1 C.B. 91 in that the Service required that *D*'s prior losses, deducted when *D* was treated as a United States corporation, be restored to taxable income at transfer. It appears that *B*'s position with regard to the absence of any tax avoidance motive is well-supported. In fact, the guideline criteria were essentially met. The Service based its decision on the fact that the potential income from oil and gas production (*D* is not yet at the producing stage) was not to be included in the amount of worldwide income of *D* subject to tax. The toll charge would, in effect, neutralize this potential for tax avoidance, if tax avoidance was, in fact, one of the principal purposes for the exchange. Under the *Dittler* standards, it is entirely possible that the Tax Court would find the Service's condition unreasonable.

46. I.R.C. § 269; T. Ct. R. Proc. & P. 217(c)(2)(i).

47. In Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) Justice Learned Hand stated: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *See also* Atlantic Coast Line v. Phillips, 332 U.S. 168, 172-73 (1947):

> As to the astuteness of taxpayers in ordering their affairs so as to minimize taxes, we have said that 'the very meaning of a line in the law is that you intentionally may go as close to it as you

While it is yet unclear whether the Internal Revenue Service will relax its standards for issuing a favorable ruling under the 367 Code provision, it is likely the Service will, in future determinations, include conditions upon which the Tax Court might rely should that court find the Service's initial ruling unreasonable. The court held in *Dittler Brothers* that, in the absence of prior enumerated conditions specifically attached to the exchange, the Tax Court would not impose conditions on its own initiative.[48] Thus, by rejecting Dittler's offer, as a condition to a favorable ruling, that it would insure OLINV's annual distribution of seventy-five percent of its earnings, the Service lost the opportunity to impose that condition once the Tax Court ruled in Dittler's favor.

In a transaction as proposed by *Dittler Brothers*, it is possible to include as taxable gains under section 367 what would otherwise be excluded under section 351. The effect of section 367 is to prevent tax-free transfers of property out of the United States unless the taxpayer first obtains a ruling. The taxpayer who is contemplating an outbound transfer to a foreign corporation must secure a favorable IRS ruling that the foreign corporation to which the transfer will be made qualifies as a corporation within the meaning of section 367. In order to qualify the taxpayer must show the existence of non-tax motives, while the tax benefits must be either non-existent, incidental, or so unimportant as to negate the existence of a principal tax avoidance motive.

As Dittler Brothers received their initial adverse ruling from the IRS subsequent to the enactment of the Tax Reform Act of 1976, and that determination reflected a traditional adherence to the section 367 guidelines, the effect of the Tax Court's reversal of that determination is significant. Granted the authority under section 7477 to determine the reasonableness of an adverse ruling, the Tax Court established a procedural mechanism and an evidentiary standard which results in a less arbitrary and ultimately in a more equitable result.

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can if you do not pass it.' (Citation omitted) This is so because 'nobody owes any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions.'

48. The remedy created under § 7477(a)(1)(A)(i) is available in cases where the determination is made by the IRS that an exchange is one in pursuance of a plan with one of the principal purposes being tax avoidance. The remedy created under § 7477(a)(1)(A)(ii) is one available to review determinations where terms and conditions are imposed.

Should the court find the determination unreasonable under § 7477(a)(1)(A)(i), it may then consider whether the terms and conditions set forth by the IRS under § 7477(a)(1)(A)(ii) are reasonable. Where no issue exists under that section, that is, where no conditions have been set forth, the court's declaration will apply only to the reasonableness of the IRS ruling.