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I. Introduction

The taxing jurisdiction of the United States reaches the worldwide income realized by a U.S. resident taxpayer. Similarly, losses experienced by a U.S. resident taxpayer anywhere in the world reduce U.S. income, and these foreign losses are often utilized to reduce U.S. taxes on domestic income. As a consequence, U.S. companies interested in entering foreign markets but aware that start-up expenses might render initial years of operation unprofitable, in many cases, have commenced operations abroad in branch form and utilized foreign losses generated to reduce domestic income subject to U.S. taxation. After the foreign operation became profitable, the U.S. company typically would transfer the assets based abroad, in a tax-free exchange,[1] to a wholly-owned foreign subsidiary not subject to U.S. taxation. Thus, the U.S. tax on the foreign income earned by the foreign subsidiary would be deferred until the repatriation of earnings and profits through dividends payable to the U.S. parent company. Furthermore, because it was dealing with a foreign subsidiary, the parent could receive foreign earned income through the payment of dividends and have full recourse to the foreign tax credit for foreign income taxes paid.[2] If the U.S. company chose to continue foreign operations in the branch form, the foreign tax credit would again

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[1] I.R.C. § 351(a) provides: "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in Section 368(c)) of the corporation."
This important non-recognition section can pertain to incorporations of foreign branch operations or, for example, to the transfer of foreign assets for stock in a U.S. corporation. For purposes of this article, however, we refer to § 351 as it applies to the incorporation of a U.S. foreign branch.

[2] I.R.C. §§ 901, 902. *See also id.* § 960. Extensive discussion of the foreign tax credit is beyond the scope of this article. However, recently promulgated regulations under I.R.C. § 901(a) have created a significant controversy. See Proposed Treas. Regs. §§ 1.901-2, 1.903-1, 44 Fed. Reg. 36071 (1979). For a discussion of the foreign tax credit, *see generally* W. STRENG, INTERNATIONAL BUSINESS TRANSACTIONS TAX AND LEGAL HANDBOOK 313-326 (1978); 2 R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 5.01 (1979); GEEN & SCHREYER, 5-4th TAX MANAGEMENT, FOREIGN TAX CREDIT—QUALIFICATION AND COMPUTATION (1979).

enable the parent to avoid double taxation and insulate the previous foreign losses from any form of recapture. The U.S. Congress and the Internal Revenue Service have been concerned about this result for several years as many have considered that the scheme just described confers benefits upon taxpayers engaged in international operations which are not available to solely domestic business operations.[3] This concern has been translated into far-reaching remedial legislation and IRS administrative action which may alter materially the methods U.S. businesses use to operate abroad.

In the Tax Reform Act of 1976,[4] Congress addressed the so-called problem of "double benefits" by amending the foreign tax credit limitation provisions to require the recapture of "overall foreign loss."[5] These recapture provisions reduce the tax credits available for foreign taxes paid until all overall foreign losses are absorbed and impose gain upon the disposition of certain foreign assets.[6] In 1978 the IRS issued Revenue Ruling 78-201,[7] which has had a significant effect on the recapture of foreign losses and on the operation of section 367, the provision that enables the Service to scrutinize foreign incorporations and reorganizations for tax avoidance motives.[8]

While Congress responded to the double benefits problem through the foreign tax credit limitation provisions,[9] the IRS response was to assign a new function and responsibility to the section 367 ruling request procedure[10] to negate the possibility of the U.S. resident taxpayer retaining any tax benefits at the very onset of foreign subsidiary operations.

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[3] See H.R. Rep. No. 658, 94th Cong., 2d Sess. 225 (1975), *reprinted in* [1976] U.S. CODE CONG. & ADMIN. NEWS at 2897, 3120.

[4] Pub. L. No. 94-455, 90 Stat. 1520 [hereinafter cited as T.R.A. 1976].

[5] I.R.C. § 904(f)(2).

[6] I.R.C. §§ 904(f)(1)-904(f)(3).

[7] Rev. Rul. 78-201, 1978-1 C.B. 91.

[8] I.R.C. § 367(a)(1) provides:

> 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 183d day after the beginning of such transfer . . ., it is established to the satisfaction of the Secretary that such an exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

[9] *See* I.R.C. §§ 904(f)(1), 904(f)(2). The congressional enactments regarding the recapture of foreign losses, or "resourcing" of foreign source income for purposes of reducing the allowable foreign tax credit, are closely related in their effects to Revenue Ruling 78-201. However, in order to meaningfully analyze the ruling, a distinction must be made between the Service's response and the congressional response to the problem of foreign losses. While the Service clearly has made a distinction between foreign losses presented in the ruling and the losses recapturable under § 904(f), it has done so based upon its interpretation of legislative intent found in the recent amendments to § 904. *See* text accompanying notes 42-45 *infra*. However, this article will make extensive reference to these amendments but will do so in order to explain the possible rationale behind the subject ruling and its possible conflict with § 367(a)(1).

[10] The Service issued Revenue Procedure 68-23, 1968-1 C.B. 821 [hereinafter referred to as

Specifically, Revenue Ruling 78-201 requires that, in order to be granted a favorable section 367 ruling request for incorporation of a branch operation, all previous foreign losses must be taken into income in the year of the transfer.[11] This result, the Service has stated, is based upon the authority of the Commissioner to disapprove of any plan which has as one of its principal purposes the avoidance of federal taxation.[12]

The Tax Reform Act of 1976, however, injected an additional factor into the question of obtaining section 367 rulings. A declaratory judgment procedure was provided whereby taxpayers could appeal adverse rulings or onerous conditions imposed upon favorable rulings to the United States Tax Court.[13] This procedure creates a forum for the reconciliation of the congressional and IRS responses to foreign loss recapture which had not previously existed.

This article will review Revenue Ruling 78-201 in the context of the historical purpose of section 367 and the congressional response to the question of foreign losses. The effects of the ruling and the likelihood of its success will also be examined, particularly in light of a recent Tax Court decision, *Dittler Brothers, Inc. v. Commissioner*,[14] a case of first impression under the declaratory judgment provisions[15] relating to ruling requests under section 367(a)(1).

II. Section 367 and the Ruling Request Procedures Set Forth in Revenue Procedure 68-23

Section 367(a)(1) of the Internal Revenue Code provides that, prior to transferring U.S. assets to a foreign corporation, a favorable ruling must be obtained from the Internal Revenue Service that such transfer does not constitute a plan having as one of its principal purposes the avoidance of U.S. tax.[16] The standard of review established by the statute is that the taxpayer must establish "to the satisfaction of the Secretary" that such exchange is not in pursuance of a plan of tax avoidance.[17] If tax avoidance is found to be a principal purpose of the transfer, then the Service may deny a favorable ruling and not deem the foreign corporation a "corporation" for purposes of non-recognition of gain,[18] thereby triggering gain on the transfer. While section 367 encom-

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Guidelines], in order to provide guidance to taxpayers concerning the Service's criteria for the issuance of favorable § 367 rulings.

[11] Rev. Rul. 78-201, 1978-1 C.B. at 92.

[12] The *Guidelines* provide that despite the taxpayer's compliance with the criteria for favorable rulings, under § 2.02 the Service reserves the right to nonetheless issue adverse rulings based upon "all facts and circumstances" presented in the ruling. This obviously provides the Service with a great deal of flexibility to determine how it shall be "satisfied" as provided in § 367(a)(1).

[13] I.R.C. § 7477.

[14] 72 T.C. 77 (1979).

[15] I.R.C. § 7477.

[16] *See* note 7 *supra*.

[17] *Id.*

[18] I.R.C. §§ 332, 351, 354-356, 361.

passes numerous non-recognition provisions, we are concerned only with section 351 transfers as they apply to section 367 because a section 351 transfer was at issue in Revenue Ruling 78-201.

Section 367 rulings are typically required whenever a U.S. taxpayer intends to transfer assets to a foreign corporation which is not subject to U.S. taxation. The ruling request procedure of section 367 is mandatory and its avoidance triggers either gain recognition or an IRS redetermination of the tax effects of the transaction on a post-effective basis most beneficial to the Service.[19]

In 1968 the Internal Revenue Service promulgated Revenue Procedure 68-23,[20] which provides guidance concerning under what conditions the Service will provide a favorable or unfavorable ruling in a foreign transfer. With respect to the section 351 transfers, the Revenue Procedure lists the preconditions for obtaining a favorable ruling under section 367: the property transferred to the foreign corporation is to be devoted to the active conduct, in any foreign country, of a trade or business; and the transferring corporation will either (1) have need for substantial investment of fixed assets or (2) be engaged in the purchase and sale abroad of manufactured goods.[21]

The Revenue Procedure excludes certain transfers of specified property from the non-recognition benefits of section 351. Such property includes inventory, accounts receivable, installment obligations, and certain other intangible assets such as trademarks and patents.[22] These types of property are excluded because transfer of such property to a foreign corporation might divert to a foreign taxing jurisdiction gain that would otherwise be subject to U.S. taxation but for the transfer.[23] The Revenue Procedure also provides that in cases where the Service discerns tax avoidance as one of the principal purposes of a transfer, "toll charges," or limited impositions of gain, may be imposed in order to purge the transaction of its avoidance characteristics to the satisfaction of the Commissioner.[24]

The toll charge procedure generally was implemented with reference to the nature of the property transferred. The Service felt that cer-

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[19] The failure to apply for or obtain a § 367 ruling does not relieve the taxpayer from compliance with the terms of § 367. *See Guidelines, supra* note 10, at § 2.02; Rev. Rul. 64-177, 1964-1 C.B. 141.

[20] *See* note 10 *supra.*

[21] *See Guidelines, supra* note 10, § 3.02(1).

[22] *Id.* §§ 3.02(1)(a)(i), 3.02(1)(a)(ii).

[23] I.R.C. § 367, as amended, was first inserted into the Code by the Revenue Act of 1932. Prior to 1932, the non-recognition provisions of the Internal Revenue Code applied to foreign reorganizations and incorporations as well as to domestic. Consequently, U.S. taxpayers could, for example, transfer appreciated assets to a foreign subsidiary tax-free under § 351, then liquidate and sell the shares in the company at capital gain rates, or without payment of tax, and liquidate the corporation tax free under the predecessor of § 332. This clearly operated to the detriment of the domestic taxpayers and the Service's revenue collection activity and the congressional response in 1932 was, of course, reasonable.

[24] *Guidelines, supra* note 10, § 5.02.

tain assets such as accounts receivable or "know how" were inherently low basis assets with much appreciation potential and, despite the usual application of section 351, some gain had to be recognized in order not to remove the revenue potential that asset possessed forever from U.S. taxation.[25] Based upon the authority of Revenue Procedure 68-23, the Service also reserved the right to issue an adverse ruling if "all the facts and circumstances" of the ruling request did not dispel the potential for tax avoidance despite technical compliance with the Revenue Procedure.[26] In so doing, the Service apparently felt obliged to permit the taxpayer the same option to establish that, based on all the facts and circumstances, a favorable ruling under section 367 of the Code should be issued, notwithstanding a contrary statement or implication contained in the guidelines.[27]

After the extensive revision of section 367 in the 1976 Tax Reform Act, the section 351 outbound transfer is now the subject of section 367(a)(1). Despite the revisions, the effect on the substantive aspects of the section 351 transfer remains largely unchanged.[28] Consequently, the Tax Reform Act did not significantly alter section 367 as it pertains to the transfer of branch assets to a foreign subsidiary as described in Revenue Ruling 78-201.

However, an adverse determination was issued by the Service under its residuary authority in Revenue Procedure 68-23 "to issue an adverse ruling if, based on all the facts and circumstances of a case, it is determined that the taxpayer has not established that tax avoidance is not one of the principal purposes of the transaction."[29] Despite the fact that the transfer described in Revenue Ruling 78-201 apparently complied with all the other requirements of Revenue Procedure 68-23 for a favorable ruling and that in all probability the taxpayers whose situation prompted the ruling did not expect the adverse determination, the Service nonetheless felt that it had the necessary congressional support to finally register its disapproval of the retention of tax benefits heretofore present upon the incorporation of a branch which had experienced foreign losses not recoverable by the amendments to the foreign tax credit limitation provisions.

III. Foreign Loss Recapture and Section 904(f): The Congressional Response

Internal Revenue Code section 904 was amended by the Tax Reform Act of 1976 to provide for the "recapture of overall foreign loss."[30] The term "overall foreign loss" is defined as "the amount by which the

[25] *See id.* § 3.02.
[26] *Id.* § 2.02.
[27] *Id.*
[28] *See* I.R.C. § 367(a)(1), *et seq*; *See also* Temp. Treas. Regs. § 7.367(a), *et seq.*
[29] *Guidelines*, *supra* note 10, at § 2.02.
[30] I.R.C. § 904(f).

gross income for the taxable year from sources without the United States (whether or not the taxpayer chooses the benefits of this subpart for such taxable year) for such year is exceeded by the sum of the deductions properly apportioned or allocated thereto."[31] This recapture is to occur whenever the taxpayer's overall foreign losses have been instrumental in reducing U.S. taxable income of the taxpayer in prior years. Recapture occurs upon the initiation of two transactions: (1) upon the election of foreign tax credit relief in connection with the repatriation of foreign earnings pursuant to IRC sections 901 and 902;[32] and (2) upon the sale or disposition of trade or business property utilized abroad by the taxpayer.[33]

The credits for foreign taxes paid on foreign income subject to U.S. taxation, provided for in section 901, are limited by the operation of section 904(a), which provides that the allowable credit may not exceed "the same proportion of tax against which such credit is taken which the taxpayer's taxable income from sources without the United States . . . bears to his entire taxable income for the same taxable year."[34] This limitation is summarized in the following computation:

$$\text{Foreign Tax Credit} = \frac{\text{U.S. tax on}}{\text{worldwide income}} \times \frac{\text{foreign source income}}{\text{worldwide income}}$$

The purpose for this proportional limitation is to limit the foreign tax credit to an amount equal to or less than the amount of tax the United States would levy on the foreign income, at the individual or corporate tax rates. The rationale for this limitation is that it would be detrimental to U.S. revenue collection to permit the taxpayer to use foreign tax credits to reduce U.S. tax on U.S. domestic income.[35]

The scope of section 904(a) has been enlarged by reducing the allowable credit based upon the amount of overall foreign loss derived pursuant to section 904(f)(1). This is done by providing that foreign source income earned by a taxpayer which has generated overall foreign loss will be treated as "income from sources within the United States."[36] Therefore, overall foreign loss, or a proportion thereof, shall, on a dollar-for-dollar basis, reduce the amount of foreign source income for purposes of computing the section 904(a) limitation on credit. This process will recur in every taxable year that tax credit is elected until all overall foreign losses have been recaptured. The end result of this section is, therefore, to remove the double benefits which Congress believed existed under prior law by, for a time, "double-taxing" certain foreign source income.

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[31] I.R.C. § 904(f)(2).

[32] I.R.C. § 904(f)(1).

[33] I.R.C. § 904(f)(3).

[34] I.R.C. § 904(a).

[35] *See generally* Dale, *The Reformed Foreign Tax Credit: A Path through the Maze*, 33 TAX L. REV. 175, 180 (1978).

[36] I.R.C. § 904(f)(1).

In addition, new section 904(f)(3) seeks to recapture overall foreign loss by requiring the taxpayer who wishes to remove his property which has been used predominantly abroad from the taxing jurisdiction of the U.S. Government to recognize gain on the transfer. Section 904(f)(3) provides:

> (i) the taxpayer, notwithstanding any other provision of this chapter (other than paragraph 1), shall be deemed to have received and recognized a taxable income from sources without the United States in the taxable year of the disposition, by a reason of such disposition, in an amount equal to the lesser of the excess of the fair market value of such property over the taxpayer's adjusted basis in such property or the remaining amount of the overall foreign losses which were not used under paragraph 1 for such taxable year or any prior taxable year, and (ii) paragraph 1 shall be applied with respect to such income by substituting "100%" for "50%."[37]

Congress saw fit to provide some explanation for the operation of this section:

> The bill . . . provides for the recapture of a loss where property which was used in a trade or business, and which is used predominantly outside of the United States, is disposed of prior to the time the loss has been recaptured under the rules discussed above. These rules are to apply regardless of whether gain is otherwise recognized. In cases where gain would otherwise not be recognized, the taxpayer is to be treated as having received gain which is to be recognized in the year the taxpayer disposes of the property.[38]

While much needed regulations have not been issued by the Internal Revenue Service in regard to these new recapture rules, the apparent effect of section 904(f)(3) is that taxpayers having incurred overall foreign losses will no longer be able to transfer assets to a foreign corporation in a tax-free exchange pursuant to section 351 and section 367(a)(1). The incorporation of a foreign branch which has generated losses that reduced U.S. income will hereafter be a taxable event, at least to the extent of the taxpayer's overall foreign losses.

IV. Revenue Ruling 78-201

The fact situation set forth in Revenue Ruling 78-201 is as follows.[39] In 1975, P, a domestic corporation, commenced business operations in country A. The business consisted of the manufacture and sale of plastic components for the radio and television industries. Business was also conducted in two other foreign countries and, for various business reasons not referred to in the ruling, the branch form of business was used in all three. In the three years of foreign operation, only the operation in country A lost money. In fact, from 1975 to 1977, P earned foreign source income exceeding losses despite the fact that country A never had any earnings.

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[37] I.R.C. § 904(f)(3).

[38] H.R. Rep. No. 658, 94th Cong., 1st Sess. 229 (1975).

[39] Rev. Rul. 78-201, 1978-1 C.B. at 91.

From the start of the country A operation, P incurred deductions under section 167 and other sections of the Code for losses incurred by the foreign branch. However, during each of the three years, P's other foreign branches received income in excess of the losses of the branch in country A. In 1977, P transferred the assets of the branch in country A to a wholly-owned foreign subsidiary in a conventional section 351 outbound exchange of assets for stock. The transfer was one which would ordinarily receive a favorable ruling under section 3.02 of Revenue Procedure 68-23 in that "it is contemplated that the transferee foreign corporation, in addition to the active conduct of a trade or business, will have need for a substantial investment in fixed assets in such business . . . ."[40]

The Service pointed out, however, that despite general compliance by P, under its authority to review and weigh "all the facts and circumstances,"[41] it found that tax avoidance was present and a favorable ruling would not be issued. By virtue of this discretionary authority, the Service held that losses incurred abroad and deducted by a U.S. taxpayer must be recognized as ordinary income to the extent that such losses exceeded foreign income during the time of branch operation in order to satisfy the Service as to the absence of tax avoidance motive.

While the Service has provided one explanatory Revenue Ruling[42] and several private letter rulings[43] reasserting the rationale set forth in Revenue Ruling 78-201, none to date has attempted to correlate the recapture of loss required in the Revenue Ruling with the other recapture provisions of section 904(f) of the Internal Revenue Code. While a recent private letter ruling does indicate the Service is cognizant of the interrelation of Revenue Ruling 78-201 and the section 904(f)(3) disposition rules,[44] the Service has yet to rule with regard to that section or issue much needed regulations under the new tax credit limitation provisions.

As previously noted, the congressional response to recapturing foreign losses was to reduce the foreign tax credit available when the taxpayer earned foreign source income by an amount equal to the "overall foreign loss" incurred by that taxpayer since the effective date of the Tax

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40 *Guidelines*, *supra* note 10, § 3.02.

41 *Id.*

42 Rev. Rul. 80-163, 1980 C.B. —. The Service amplified Revenue Ruling 78-201 by noting that the income recognizable under the ruling was not limited by the amount of gain which would be recognizable under I.R.C. § 351. The rationale for this position was succinctly stated to be that:

> [since] such a limitation [to the gain on the transfer] would not take into account the full amount of the losses associated with the transferred assets that P used to reduce its income subject to federal income taxation, and therefore would not prevent the potential mismatching of related income and losses, the tax avoidance at which Rev. Rul. 78-201 is directed.

It might be argued that any such "mismatching" is the precise subject of the I.R.C. § 904(f) recapture provisions.

43 *See, e.g.*, I.R.S. Let. Rul. Rep. 7909102 (Dec. 1, 1978).

44 *Id.*

Reform Act of 1976.[45] In addition to reducing the allowable foreign tax credit, Congress provided that when foreign assets are sold, transferred, or disposed of, with limited exceptions, gain results to the extent of the overall foreign loss previously incurred by the taxpayer, or the amount of gain the disposition would generate, whichever is less.[46] Consequently, the non-recognition provisions of section 367 would appear to be substantially unavailable to a taxpayer with overall foreign losses who desires to transfer assets abroad.

The situation presented in Revenue Ruling 78-201 is one in which the taxpayer had not incurred "overall foreign loss." Foreign income had, on an overall basis, exceeded the losses sustained in country A. Therefore, the "tax benefit" derived from a reduction in foreign source income subject to U.S. taxation as a result of losses in country A would not be recaptured by either of the section 904(f) provisions. The Service, however, armed with the congressional intent manifest by the 1976 adoption of the section 904 recapture provisions, most likely concluded that its utilization of the section 367 ruling request and toll charge procedure to recapture foreign losses was a reasonable response to a situation Congress had not anticipated.

The Service's approach may have misread congressional intent, however, and its application of section 367 and the guidelines found in Revenue Procedure 68-23 to the recapture of "non-overall foreign loss" may not be justifiable or sustainable. While the Service is not restricted to the purely logical extrapolations of legislative intent, it is limited in its authority by the "plain meaning" of the statutes upon which it purports to issue Revenue Ruling 78-201, in this case sections 351 and 367. These code sections work in tandem to provide for the non-recognition or recognition of gain in certain situations.

The guidelines set forth in Revenue Procedure 68-23 have heretofore been concerned with taxing an asset's appreciation in value which might otherwise escape U.S. tax by virtue of the Service's inability to tax the income or capital gain of a foreign corporation. The avowed purpose of the section 367 ruling request and toll charge procedure is to prevent the removal of certain assets, through section 351, in which inherent and intangible appreciation in value may indicate an intention by the taxpayer to avoid U.S. tax. Limitation of such transfers is achieved by taxing the *gain* which would otherwise not be recognized pursuant to section 351. The international application of section 351 is impaired by the practice whereby various countries, by treaty or otherwise, mutually refrain in some situations from imposing tax upon the residents of the other. The congressional response has been to remove non-recognition of

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[45] *See* text accompanying note 30 *supra*.

[46] I.R.C. § 904(f)(3). The congressional response would appear to seriously contradict the Service's position in Revenue Ruling 80-163. *See* note 42 *supra*.

gain in reference to these certain assets.[47] The guidelines set forth in Revenue Procedure 68-23 reflect this awareness and implement congressional purpose.[48] Revenue Ruling 78-201, however, arguably alters the purpose of section 367 so that it no longer operates in terms of asset appreciation and gain, but rather as a "tax benefit" rule in the extreme.[49] As such, the ruling may not only be inconsistent with the legislative intent expressed in section 367(a)(1) and the foreign loss recapture provisions of the 1976 Tax Reform Act, but also inconsistent with the Service's long standing application of Revenue Procedure 68-23. In fact, the Service implicitly emphasizes the basic inconsistency between Revenue Ruling 78-201 and section 367(a)(1) and the guidelines by noting that its decision in Revenue Ruling 78-201 is not based upon the type of property conveyed, but rather on the Service's authorization to issue adverse rulings based upon "all facts and circumstances" of the particular case.[50] It is questionable whether the Service's discretion to remove tax avoidance potential under section 367(a)(1) can reasonably extend to imputing income to a taxpayer which is not "gain" within the meaning of section 351.

Recently, a commentator has asserted that Revenue Ruling 78-201 does in fact "supplement" section 367 and the foreign tax credit limitation provisions.[51] Revenue Ruling 78-201 may recapture a tax benefit in the situation where branch losses, despite overall foreign source income, reduce U.S. tax liability in a given year and reduce the credits available, but these losses have, by reducing U.S. tax liability, the indirect effect of increasing unused tax credits generated in profit countries available to be carried forward. This analysis may justify some mechanism designed to expend credits by an amount equal to the "tax benefit" noted above, but this should be done by amendment of the carry forward provisions relating to tax credits.[52] It is questionable, however, whether sections 367 and 351 can be stretched to produce this desired result.

V. Judicial Review of Section 367 Ruling Request Denials: The *Dittler* Case

Prior to the Tax Reform Act of 1976, a taxpayer who received an adverse ruling under section 367 and Revenue Procedure 68-23 had no further remedy. Newly enacted section 7477, however, provides that an adverse section 367(a)(1) ruling by the Internal Revenue Service, or the

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[47] I.R.C. §§ 367, 904(f)(3).

[48] *See Guidelines, supra* note 10, § 1.01.

[49] *See* note 42 *supra*. The amplification of Revenue Ruling 78-201 occasioned by Revenue Ruling 80-163 removes much doubt as to the intent of the Service.

[50] *Id.* § 2.02.

[51] *See* Comment, 32 TAX LAW. 850 (1979).

[52] Such a response would, for example, more neatly be inserted into the statutory scheme created by Congress in TRA of 1976. A regulation under § 904(c) to the effect that credits be lifted to the extent of non-overall foreign loss would be far more direct and positive response rather than the use of the time-worn § 367 ruling procedure.

failure of the Service to rule, is now reviewable by the Tax Court.[53] The first decision under section 7477 has recently been rendered. In light of the fact that the result reached in Revenue Ruling 78-201 is now apparently being litigated pursuant to section 7477, the result in *Dittler Brothers, Inc.*,[54] is germane to any speculation as to the longevity of Revenue Ruling 78-201.

In *Dittler Brothers*, the petitioner had sought an advance ruling that its intention to transfer cash and "know how" to a Netherlands Antilles corporation in a section 351 transfer was not in pursuance of a plan having as one of its principal purposes the avoidances of U.S. tax. An adverse ruling was issued by the Internal Revenue Service.[55]

The petitioner failed to meet several of the standards set forth in Revenue Procedure 68-23.[56] Nonetheless, the petitioner argued that under section 2.02 of the Revenue Procedure, the same section relied upon by the Service in Revenue Ruling 78-201, the Service should hold that it was not a principal purpose of the transaction, based on "all the facts and circumstances," to avoid U.S. tax.[57]

After extensively reviewing the facts of the case and the various business purposes for the transfer, the Tax Court first addressed the ques-

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[53] "I.R.C. § 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,

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 issues set forth in subparagraph (A)(ii) of paragraph (1), and

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

[54] 72 T.C. 77 (1979).

[55] *Id.* at 492-93.

[56] *Id.* at 508-09. The Netherlands Antilles corporation neither required substantial investment in fixed assets nor would engage directly in the purchase and sale abroad of manufactured goods.

[57] *Id.* at 502.

tion of what the proper standard should be for review of section 367(a)(1) cases under section 7477. The court noted that under section 7477 it was to determine whether or not the Service's determination was reasonable. In determining "reasonableness," the petitioner argued that the enacting legislation called for the application of the "substantial evidence rule," while the Service argued for a narrower test which would vest a greater degree of discretion in the Commissioner. A review of the legislative history, however, prompted the Tax Court to refer to the following congressional directive:

> The 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 upon any new matter which the Service may wish to introduce at the time of trial. The Tax Court judgment, however, is to be based upon a *redetermination* of the Internal Revenue Service *determination*.[58]

After comparing the standards set forth under other declaratory judgment sections, and mindful of the Service's great discretionary role in this area, the Tax Court determined that it should adopt the "substantial evidence rule" as the appropriate standard for section 7477 actions.[59]

The court then proceeded to review the purpose of section 367(a)(1), defining for the first time the meaning of "principal purpose" as found in that section. The Tax Court determined that "principal purpose" in section 367 should be construed in accordance with its "ordinary meaning" and with due regard for section 367, which represented "positive law," while the guidelines of Revenue Ruling 68-23 were "merely official interpretations of the law." The court said: "[T]he proper inquiry hereunder is whether the exchange of manufacturing know-how was in pursuance of a plan having as one of its "first-in-importance" purposes the avoidance of federal income taxes."[60]

The court went on to hold that, despite the Service's position that the transaction had little identifiable purpose other than tax avoidance, it was the impression of the court that the arrangement was the result of the interests of the other parties involved rather than the desire of Dittler to remove taxable income from U.S. jurisdiction. The Tax Court also found that ministerial functions which would be performed in the Netherlands Antilles were not a sham and that bookkeeping and ordering procedures were not so passive a function as to negate the existence of the office in the Netherlands Antilles.[61] The court held that, based upon all the surrounding facts and circumstances, the Service's adverse determination must fail for lack of substantial evidence that tax avoidance was a principal purpose of the transaction.[62]

While the *Dittler Brothers* case is significant on its own facts, in that a

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[58] *Id.* at 500 (emphasis added).
[59] *Id.*
[60] *Id.* at 503.
[61] *Id.* at 504.
[62] *Id.*

Netherlands Antilles corporation withstood Service objection on facts indicating the tax avoidance purpose may well have been present, the case foreshadows the intention of the Tax Court to carefully review the Service's position in future section 367(a)(1) rulings and require "substantial evidence" to sustain the Service's findings. Such a standard of review may place the Service in a difficult position in the factual situation presented by Revenue Ruling 78-201. In that ruling, the Service so clearly circumvented its own usual criteria for the issuance of adverse rulings that it may be hard pressed to bring forward "substantial evidence" based upon its previous positions in order to sustain the subject ruling. Also, the Tax Court's apparent reluctance to readily sustain the Service's interpretation of section 367 contained in Revenue Procedure 68-23 indicates a determination on the part of the Tax Court to begin its review by analyzing section 367 and the business purposes for the transfer. The result in Revenue Ruling 78-201 ignored business purpose, the purpose and effects of section 367(a)(1), and the fact that the situation presented by the ruling request largely satisfied the Revenue Procedure's requirements. The Tax Court's willingness to "redetermine" the Service's position in section 367(a)(1) rulings may pose serious questions as to the long term application of the subject ruling.

In conclusion, the problems presented by the interrelation of the Service's treatment of the recapture of foreign losses and the congressional response will again foster uncertainty and hesitation among taxpayers contemplating incorporation of branch activities. The hope expressed by Congress in enacting the Tax Reform Act of 1976, to bring both equity and predictability to the taxation of foreign operations, remains largely unrealized.