Dittler Bros. , Inc. v. Commissioner, 72 T. C. 896 (1979)

The Tax Court may review the reasonableness of the IRS's determination that a transfer of property to a foreign corporation is in pursuance of a tax avoidance plan, applying a substantial evidence standard.

Summary

Dittler Bros. , Inc. sought a declaratory judgment on whether its transfer of manufacturing know-how to a Netherlands Antilles corporation was in pursuance of a tax avoidance plan. The IRS had denied a favorable ruling under section 367, arguing the transfer did not involve active business conduct and had tax avoidance as a principal purpose. The Tax Court, applying a substantial evidence standard, found the IRS's determination unreasonable. The court emphasized the business purpose of the transaction, the lack of control over its structure by Dittler, and the operational activities of the foreign entity, concluding the transfer was not primarily for tax avoidance.

Facts

Dittler Bros. , Inc. , a U. S. corporation, entered into a joint venture with Norton & Wright Group Ltd. to exploit Dittler's manufacturing know-how for rub-off lottery tickets in international markets. The venture formed two Netherlands Antilles corporations, Stansfield Security N. V. (SSNV) and Opax Lotteries International N. V. (OLINV), with Dittler and Norton & Wright each owning 50% of SSNV, which in turn wholly owned OLINV. Dittler transferred its manufacturing know-how to SSNV in exchange for stock. Norton & Wright insisted on the Netherlands Antilles location due to favorable tax laws. The IRS issued an adverse determination under section 367, asserting the transfer was in pursuance of a tax avoidance plan.

Procedural History

Dittler requested a ruling from the IRS under section 367 for its proposed transaction. After receiving an adverse determination, Dittler appealed to the IRS's National Office and subsequently filed a petition for declaratory judgment in the Tax Court, challenging the reasonableness of the IRS's determination.

Issue(s)

1. Whether the IRS's determination that Dittler's transfer of manufacturing know-how to a foreign corporation was in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes was reasonable.

Holding

1. No, because the court found that the IRS's determination was not supported by substantial evidence, given the business purpose and operational activities of the

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foreign entity.

Court’s Reasoning

The court adopted the substantial evidence rule for reviewing the IRS’s determination, as it strikes a balance between the arbitrary and capricious test and a de novo redetermination. The court analyzed the facts and circumstances of the case, noting that Norton & Wright, not Dittler, controlled the transaction’s structure, including the choice of the Netherlands Antilles. The court found that OLINV engaged in active business operations through independent contractors, which was a valid business reason for the transfer. The court also considered the potential for tax avoidance but found that Dittler’s repatriated earnings were subject to U. S. tax and that the retention of earnings by OLINV was for legitimate business needs. The court concluded that the IRS’s determination lacked substantial evidence that tax avoidance was a principal purpose of the transfer.

Practical Implications

This decision clarifies that the Tax Court will apply a substantial evidence standard when reviewing IRS determinations under section 367. It emphasizes that the court will consider the facts and circumstances of each case, including the business purpose and operational activities of the foreign entity, when determining whether tax avoidance is a principal purpose of a transfer. This case may encourage taxpayers to challenge adverse IRS determinations under section 367 by demonstrating valid business reasons for their transactions. It also highlights the importance of documenting the business rationale behind transactions involving foreign entities to support a non-tax avoidance purpose. Subsequent cases have applied this ruling to assess the reasonableness of IRS determinations regarding foreign transfers.

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