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Loan v. Distribution: "Illinois Tool Works v. Commissioner"

By: Elliot Pisem and David E. Kahen

Where funds are to be transferred from a corporation to its sole shareholder, the circumstances may provide flexibility to make the transfer as a loan rather than a distribution, and transferring the funds as a loan may be more attractive from a tax perspective at least in the near term. A distribution by a C corporation on its stock will generally be a dividend to the extent of its current and accumulated earnings and profits, and that dividend may in turn result in a current tax to the shareholder. A loan, on the other hand, if respected for tax purposes, will generally not result in an immediate tax. If there are no current and accumulated earnings and profits, a distribution of cash will generally be nontaxable to the extent of the shareholder's stock basis, but a distribution in excess of that basis will generally result in the recognition of gain under Section 301(c)(3) of the Internal Revenue Code (Code).

As indicated by cases cited in the recent Tax Court decision discussed below, the IRS has often asserted that a purported loan by a corporation to its sole shareholder should be characterized as a disguised distribution, alleging that the shareholder did not intend to repay the loan and that it was most unlikely that the corporation would choose to demand payment and attempt to enforce the debt against its own shareholder. In appropriate circumstances, however, the courts have held that such a loan should be respected (see, e.g., *Wiese v. Commissioner*, 93 F.2d 921 (8th Cir. 1938)), even where the decision to effect the transfer as a loan was likely to have been influenced by tax considerations. *Illinois Tool Works Inc. v. Commissioner* (TC Memo 2018-121) provides welcome support for this result and guidance as to the factors likely to influence a court in distinguishing a loan from a distribution.

Facts in Illinois Tool Works

Illinois Tool Works Inc. (ITW) was a publicly traded corporation that manufactured industrial products and equipment in North America and elsewhere through numerous subsidiaries. During a ten-year period that included the year at issue (2006), ITW completed various acquisitions and a stock buy-back that substantially increased its short-term debt, with its outstanding commercial paper increasing from $20 million in June 2006 to $770 million by December.

ITW had substantial available funds in its non-US operations as conducted through foreign holding companies which in turn held shares in numerous foreign operating companies. Some of ITW's direct foreign holding company subsidiaries did not have "earnings and profits," but its indirect foreign operating company subsidiaries did. ITW decided in September 2006 to use funds in the non-US subsidiaries to pay down the ITW commercial paper and to make further acquisitions.

If the funds had been distributed from the operating companies to the foreign holding companies and then from those holding companies to ITW, the result would have been a taxable dividend, taking into account earnings and profits of the lower tier subsidiaries that would flow up the corporate chain with the distributions. If the funds had been lent directly by a foreign operating subsidiary to ITW, then, taking into account the status of the foreign subsidiaries as "controlled foreign corporations," a loan from a foreign subsidiary with current or accumulated earnings to ITW would have resulted in subpart F income to ITW under Code Section 956.

Instead, an intermediate tier foreign holding company lent $356,778,000 to its shareholder, an upper tier foreign subsidiary that had no current or accumulated earnings and profits. The loan was documented through a one-page promissory note that provided for interest to accrue at 6% per annum and for the principal and interest to be repaid after five years. That subsidiary in turn distributed the funds to a domestic subsidiary of ITW, which distribution was reported as a nontaxable return of capital. The funds were ultimately used by ITW to pay down its commercial paper.

Following an audit, the IRS asserted that the transfer of funds to the U.S. subsidiary was taxable, under the rationale that the purported loan was a dividend to

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***Elliot Pisem** and **David E. Kahen** are partners in the law firm of Roberts & Holland LLP.*

the foreign subsidiary that in turn made the distribution to the U.S. subsidiary.

Taking into account that proposed tax adjustments based on recharacterization of the loan as a distribution were pending at IRS Appeals at the time the five-year note became due, ITW found it advisable to extend the maturity date by one year through a one-year note. In 2012 the principal was paid down by roughly 10% but, with the issue still pending before Appeals, the loan was extended for an additional year. The sales of various businesses in 2012 and 2013 generated sufficient cash to fund a capital contribution to the borrowing subsidiary that permitted it to make full payment of the note in December 2013.

Discussion

An appeal of the Illinois Tool Works case would generally lie to the Court of Appeals for the Seventh Circuit. Citing and discussing the analysis in *Busch v. Commissioner* (728 F.2d 945 (7th Cir. 1984)), a Seventh Circuit case that addressed the loan versus distribution issue, the Tax Court said that whether or not the loan should be respected as such ultimately turns on whether, at the time the loan was made, the taxpayer intended to repay it—a question of fact.

Most of the factors discussed in the decision supported treatment as a loan. There was a promissory note that was executed contemporaneously, as well as two additional notes that extended the time to repay by one year intervals, and each was reviewed and approved by the board of directors of the borrowing and lending corporations.

Recurring loans to shareholders without the payment of any dividends may suggest that loans should be recharacterized as dividends. Here, however, the distributing corporation had paid substantial dividends during the four years preceding the year at issue, as well as in six subsequent years. The court therefore found that there was a substantial history of dividend payments, notwithstanding that no dividend was paid by the lending corporation during the year at issue.

The court also noted that the amount of the loan was modest in relation to the value of the equity of the borrowing corporation, and that there was substantial cash flow from which the loan could be repaid.

Each note had the usual indicia of debt for tax purposes, including a stated maturity date, stated interest, and fixed principal amount, and testimony to the court supported that each loan was legally enforceable. There was also credible testimony from ITW employees that ITW had followed a "live by the agreement" principle for repaying intercompany debt.

The government argued that the creditor had no practical means to enforce payment because the borrower had no operating assets, but rather only stock of its subsidiary. The Tax Court refused to give weight to this argument, however, reasoning that the borrowing corporation would have three potential sources of funds for the repayment of the loan: distributions of earnings from lower tier subsidiaries; borrowings from third parties; and capital contributions from its shareholder.

The loan was not subordinated to other debt by its terms, and the subsidiaries had very low debt levels in relation to the value of their equity and substantial available cash flows for the repayment of debt. The government argued that the debt was structurally subordinated to any debt of the subsidiaries, in the sense that creditors of those subsidiaries would have first call on the subsidiaries' assets before distributions could be paid. The court observed that such subordination would arise automatically in any holding company structure, and therefore was of little relevance in determining intent to repay the loan.

Based on expert testimony, the borrower's overall financial condition was such that it could have obtained such a loan from a third party on substantially similar terms.

The government noted that the notes lacked "standard" provisions and covenants that a third party lender would typically demand. In particular, the first note did not provide for periodic payments of interest, and did not restrict dividends, require maintenance of working capital, or restrict future mergers or other transactions. However, the court concluded that the failure to provide for periodic payments of interest and the absence of such covenants, while potentially of concern to investors, were not surprising in this related party context, given the reasonable expectation of the lender that the ultimate parent corporation would not allow the borrower to take steps that would endanger the payment of the loan. The relevant question was whether the borrower could have secured credit from an unrelated lender on substantially the same economic terms.

It was also noted that the corporate records of the parties to the loan properly identified the loan as debt. Although the loan was not identified as a loan to or from shareholders on the IRS Forms 5471 filed by each corporation, the court described this as a minor discrepancy that did not support an inference that the note was a disguised distribution.

The government argued that the circumstance that the loan was extended twice, for one year intervals, before being repaid by cash transfers in 2012 and 2013, weighed against a finding that it was indebtedness for tax purposes. The court found that, under the circumstances, the delay in payment while the issue was pending before IRS Appeals did not undercut the intent to repay.

The government also asserted that the use of the proceeds of the loan to fund a further distribution, which was then used, ultimately, to pay down debt of the ultimate parent, indicated that the funds were not used in the business of the borrower, and cited this as an indicator of a disguised distribution rather than a loan.

Where, as in *Busch*, funds of a corporation were made available to an individual shareholder for use at least in part for personal purposes, this was found to suggest that the loan should be characterized as a distribution. That was not the case in *Illinois Tool Works*, however, and the decision indicates that the use of funds to repay debt incurred by the ultimate parent to fund acquisitions suggested that the loan was motivated by operational needs (without dwelling on the large stock buyback by ITW in August 2006). The court concluded that this factor was "best regarded as neutral" and not entitled to great weight in any event.

The court also rejected the government's policy-based argument to the effect that the loan should be recharacterized, possibly under conduit principles, as a direct dividend from the lending foreign subsidiary to a U.S. shareholder, because the taxpayer should not be allowed to avoid the purposes of subpart F of the Code by repatriating earnings of foreign subsidiaries without tax. The court described this as an extraordinary recharacterization that it declined to impose absent a clear statutory directive. The court also concluded that the loan had a nontax business purpose and that the step transaction doctrine had no application, finding that the government was not attempting to collapse unnecessary steps but rather to recharacterize one step as a dividend rather than a loan.

Observations

In light of changes included in the tax legislation enacted last year to the treatment of dividends from a foreign corporate subsidiary to a U.S. parent entity, the steps taken by ITW may be less likely to be repeated in the future in similar circumstances. However, the dividend versus loan issue will surely continue to arise in other contexts. While this particular taxpayer victory should be welcomed, a corporation considering a loan to its shareholder should take into account the potential for treatment of the loan as such to be challenged by the IRS, and weigh the factors cited by the court in *Illinois Tool Works* in reaching its pro-taxpayer outcome.