In *Illinois Tool Works, Inc. & Subsidiaries v. Commissioner*,¹ the United States (US) Tax Court held that a series of transactions involving an upstream loan from a lower-tier controlled foreign corporation (CFC) with current and accumulated earnings and profits (E&P) to an upper-tier CFC with no current or accumulated E&P and subsequent distribution of the loan proceeds from the upper-tier CFC to its US shareholders resulted in no taxable income to the US shareholders. In a memorandum opinion (the Opinion), the Tax Court found that the upstream loan constituted bona fide debt and that the US shareholders had sufficient basis in the upper-tier CFC to treat the distribution as a nontaxable return of capital.

The case has been closely monitored by taxpayers and practitioners alike because it involved a distribution funded entirely by an upstream loan, thus implicating certain common tax-planning transactions.

**Abbreviated facts from the Opinion**

Illinois Tool Works (ITW), a publicly held Illinois C corporation, is the parent of a global business with more than 100 companies that manufacture industrial products and equipment. ITW is a calendar-year taxpayer and the common parent of an affiliated group of US corporations that files a consolidated US federal income tax return (the ITW US Group). In 2005, Paradym Investments Ltd. (Paradym), which was originally organized in Bermuda, became a domestic corporation and a member of the ITW US Group. Paradym was the sole...
shareholder of CS (Europe) Holdings Ltd. (CSE), a Bermuda corporation, and the top holding company in ITW's super holding company structure. CSE, in turn, was the sole shareholder of CS (Australasia) Holdings, Ltd. (CSA). Each entity (i.e., CSE and CSA) was a holding company with no active business operations, with CSA directly and indirectly holding stock in about 100 foreign operating companies. Each entity was also a CFC within the meaning of Internal Revenue Code § 957(a) with respect to which members of ITW's US Group were US shareholders within the meaning of Section 951(b).

The repatriation transactions
In December 2006, ITW implemented a plan to repatriate funds from ITW's CFCs in order to pay down outstanding short-term commercial paper (CP) obligations, fund new acquisitions and increase guarantees for European borrowings while not incurring US federal income tax. Under the plan, (1) CSA transferred approximately US$357 million to CSE under the 2006 CSE Note (described later); (2) CSE transferred the $357 million proceeds to Paradym, and the proceeds were used to pay down ITW's outstanding CP balance prior to 31 December 2006. The parties intended the transfer from CSA to CSE to be respected as debt, such that CSE's E&P would not increase on the receipt of the loan proceeds, and CSE's distribution to Paradym to be respected as a nontaxable distribution under Section 301(c)(2).

The terms and repayment of the CSE Note
After considering current market rates for similar intercompany debt, the officers and directors of CSE and CSA authorized CSE to borrow approximately $357 million from CSA at 6% simple interest with repayment in five years. The upstream loan was documented in a one-page promissory note (the 2006 CSE Note), which described the interest rate and term and specified that no principal or interest payments were due until maturity. The 2006 CSE Note stipulated that CSA could enforce payment of principal and interest, made no provision for subordinating the debt to CSE's other obligations, and stated that Delaware law would govern its interpretation. The 2006 CSE Note was recorded on the books of both companies as an intercompany note, and the note and associated interest was included in the Form 5471 filings for the companies.

Because ITW's examination was still pending as of November 2012, CSA and CSE agreed to extend the maturity date by another year - with CSE executing a new one-year promissory note (the 2012 CSE Note) with a principal amount of approximately $327 million (the then outstanding principal amount of the 2006 CSE Note, as periodic interest payments, although not required, had been made). The 2011 CSE Note bore interest at a rate of 90-day LIBOR plus 20 basis points, reset quarterly. All other terms of the 2011 CSE Note mirrored the terms of the 2006 CSE Note. The 2011 CSE Note was recorded on the books of both companies as an intercompany note, and the note and associated interest was included in the Form 5471 filings for the companies.

In December 2013, CSE received a capital contribution from Paradym and paid off the outstanding principal balance of the 2012 CSE Note. Although the terms of the 2006, 2011 and 2012 CSE Notes did not require periodic interest payments, CSE and CSA did report annual payments and receipts of interest on their respective books each year while the notes were outstanding.

The contentions of the Service
On examination, the Service first determined that the December 2006 transfer from CSA to CSE was a dividend rather than a loan, that a corresponding amount of CSA's E&P “tiered up” to CSE, and that CSE's distribution to Paradym was therefore taxable as a dividend under Sections 301(c)(1) and 316. Alternatively, if not a dividend, the Service contended that the distribution from CSE to Paradym gave rise to taxable

Internal Revenue Service (IRS or Service) began examining the 2006 repatriation transaction. In December 2011, when the 2006 CSE Note was due, ITW's examination was pending with the IRS Appeals Office. Consequently, CSE decided not to repay the 2006 CSE Note while the transaction was under consideration by the Service, and CSA and CSE agreed to extend the maturity date by one year - with CSE executing a new one-year promissory note (the 2011 CSE Note) with a principal amount of approximately $357 million (the then outstanding principal amount of the 2006 CSE Note, as periodic interest payments, although not required, had been made). The 2011 CSE Note bore interest at a rate of 90-day LIBOR plus 20 basis points, reset quarterly. All other terms of the 2011 CSE Note mirrored the terms of the 2006 CSE Note. The 2011 CSE Note was recorded on the books of both companies as an intercompany note, and the note and associated interest was included in the Form 5471 filings for the companies.

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During 2007-2011, CSE considered various options for repaying the 2006 CSE note, including third-party borrowing, intercompany borrowing, and the issuance of capital market debt or equity instruments. In 2008, the
Treatment of the CSE Notes as bona fide debt

The Tax Court noted that an appeal of the case would fall to the US Court of Appeals for the Seventh Circuit. Accordingly, in determining whether the transfer should be treated as a loan or dividend, the Court applied factors set forth by the Seventh Circuit in *Busch v. Commissioner*, supplemented with certain factors listed in *Dixie Dairies Corp. v. Commissioner*.

The Tax Court stated that the factors are not mechanically counted, but considered on the whole. The Court concluded that 9 of the 14 factors analyzed favored debt treatment, four were neutral, and only one favored dividend treatment. Moreover, the Tax Court weighed four of the factors (which it concluded favored debt treatment) more heavily in its analysis - evidence of the intent to repay, the borrower's ability to repay, the existence of all conventional indicia of debt, and the borrower's ability to borrow from third parties on similar economic terms. Accordingly, the Tax Court held that the CSE Notes were bona fide debt. The Tax Court's analysis of each factor is discussed further below.

1. Stated intent to repay. The Court determined that this factor strongly suggests that ITW intended to create bona fide debt. The Court noted that the promissory notes were legally binding documents, approved and executed by the companies' boards, and required repayment of interest and principal at fixed maturity dates. The Court further noted that CSE made interest payments each year, which were properly recorded on its books and on CSA's books and that CSE repaid the loan in full via cash transfers in 2012 and 2013. While acknowledging that it is difficult to prove intent to repay when the borrower is the sole shareholder of the lender, the Court considered persuasive that the ITW group had a good track record of repaying intercompany loans. The Court did not consider the extension/refinancing of the loan to be evidence of lack of intent to repay.

2. Extent of shareholder control. The Court found that the extent of shareholder control (CSE was the sole shareholder of CSA) favored treating the transfer as a dividend. However, the Court accorded this factor somewhat less weight. The Court considered relevant that ITW is a publicly traded corporation (not a private shareholder using funds for personal purposes) and that steps were taken to establish bona fide indebtedness, including preparing legally binding promissory notes. The Court further noted that the directors of CSA had a fiduciary duty to demand repayment from CSE, which carried legal repercussions under Bermuda and US law.

3. Retained earnings and dividend history. The Court determined that CSA had paid substantial dividends to CSE in the years 2002-2012, thereby supporting the characterization of the transfer as bona fide debt. The Court did not consider particularly relevant that dividends were not paid in 2006, the year of the transaction at issue, noting that many corporations do not pay dividends in every year of their existence.

4. Size of the advance. The Court stated that the size of the advance (approximately $357 million) was not that large compared to the $6 billion equity cushion that had been calculated by ITW's expert witness. Consequently, the Court determined this factor to be generally neutral.

5. Conventional indicia of debt. The Court concluded that this factor favored debt treatment, because the parties “strictly adhered to all loan formalities” by: (a) executing legally binding promissory notes, which required payments of interest and principal upon maturity of the loan and granted CSA the ability to enforce payment of interest and principal; and (b) paying all interest on an annual basis and recording such payments as interest on the companies' books. The Court found credible ITW's expert testimony that the notes were enforceable under Bermuda law. In analyzing this factor, the Court drew a distinction between CSA's legal ability to enforce repayment and how CSE might choose to fund the repayment, disregarding the Service's argument that CSA had no practical ability to enforce repayment because CSE had few assets apart from its ownership of CSA. Instead, the Court noted that companies often borrow against their capital assets, including stock of their subsidiaries. The
Court determined that, like any holding company borrower, CSE could repay the debt with earnings from lower-tier subsidiaries, a capital contribution or by refinancing the debt with a third party.

6. Treatment of advances in corporate records. The Court noted that CSA and CSE recorded the transfer as debt in their books, thereby supporting debt treatment. The Court dismissed the Service’s argument that the absence of a documented plan for repayment at maturity was relevant to this determination.

7. Repayment history and source. The Court determined that this factor favored debt treatment based on its conclusion that CSE’s projected cash flow would easily enable it to repay the loan and that CSE had actually paid all interest and principal due on that loan. In reaching this conclusion, the Court reasoned that an intermediate holding company can incur genuine intercompany indebtedness and rejected two related arguments by the Service. First, the Court rejected the Service’s argument that interest payments made by CSE were “circular” because they were ultimately funded by dividends from CSA’s subsidiaries. Second, the Court rejected the Service’s argument that interest payments were “circular” because they were ultimately funded by dividends from CSA’s operating subsidiaries. The Court stated that the immediate use of the funds had the feel of a dividend but the ultimate use might suggest a transaction driven by operational business necessities. The Court noted that it was not clear how these facts should be evaluated, concluding (on balance) that the factor was neutral and, in any case, not entitled to great weight.

9. Participation in management. The Court determined that this factor, which considers whether an advance entitles the transferor to greater participation in management of the transferee, was not relevant to the case because CSA’s advance could not entitle it to participate in the management of CSE.

10. Status of advances relative to other debt. The Court first noted that the CSE Notes were not subordinated to the rights of CSE’s other creditors. Although the Service argued that CSA’s right to repayment was structurally subordinated to any debt of CSA’s operating subsidiaries, the Court did not consider this particularly relevant, noting that such subordination arises automatically and therefore does help assess whether the parties intended to create genuine indebtedness. The Court accepted ITW’s expert testimony that CSA and its operating subsidiaries had very low indebtedness during the relevant period and thus found that the structural subordination of the CSE notes “would not meaningfully impact CSA’s getting repaid.” Accordingly, the Court determined that this factor supports debt characterization.

11. Adequacy of capitalization. Because CSE was strongly capitalized, the Court stated that this factor supported debt treatment. The Court found credible ITW’s expert testimony establishing that CSE had billions of dollars of equity and debt-to-capital ratios of 6% at the time of the advance and 4% at the time of original maturity.

12. Risk involved in making advances. Similar to the previous factor, with risk of non-repayment considered low, the Court determined this factor supported debt treatment. The Court also noted that the use of five-year intercompany debt to repay short-term CP obligations reduced the risk profile of the ITW worldwide group.

13. Identity of interest between creditor and shareholder. As the borrower was the shareholder of the lender, the Court considered this factor to be neutral and not particularly relevant.

14. Ability to obtain outside loans. Concluding that a third-party lender would have extended credit to CSE on essentially the same economic terms as CSA, the Court found this factor supported bona fide debt treatment. The Court found credible ITW’s expert testimony that CSE could have easily obtained outside financing based on its “excellent capital structure, low debt profile, strong historical and projected earnings, and eligibility for an investment grade credit rating.”
Consistent with prior authority, the Court determined that an intercompany note need not have the same robust terms often seen in third-party credit agreements.

**Application of anti-tax avoidance doctrines**

The Service argued that the Court should use judicial anti-tax-avoidance doctrines of economic substance, step transaction and conduit to recharacterize the repatriation transaction as a dividend. ITW argued that, once the court has determined that the debt was bona fide, the substance of the transaction is established and cannot be recharacterized using common law theories. The Court agreed with ITW.

The Court concluded that the economic substance doctrine was satisfied, describing the economic reality of the overall transaction as a loan from CSA to CSE followed by a distribution from CSE to Paradym. The Court viewed the pair of transactions as meaningfully changing the entities' economic positions. The Court further determined that the loan from CSA to CSE had a valid nontax business purpose of “securing funds for appropriate corporate use”, i.e., paying down outstanding CP obligations of the ITW US Group. The Court also determined that the step transaction doctrine could not be applied to collapse the transaction into a dividend from CSA to Paradym because Paradym was not a shareholder of CSA. The Court analogized ITW's transaction to *Falkoff v. Commissioner* in which the Seventh Circuit rejected application of the doctrine. The Court similarly respected the separate existence of CSE as a shareholder of CSA and dismissed the Service's conduit theory.

Finally, the Service argued that ITW should not be permitted to repatriate foreign earnings and avoid US income taxation under Subpart F. The Court swiftly dismissed that the Subpart F regime required recharacterization of the CSE Note absent a clear statutory directive.

**Tax consequences of the distribution**

In 2006, CSE distributed approximately $357 million to Paradym. The Court determined that no portion of this distribution was a dividend under Section 301(c)(1) in light of CSE's lack of E&P. Under Section 301(c)(2), the portion of a distribution that is not a dividend “shall be applied against and reduce the adjusted basis of the stock.” Section 301(c)(3) requires the portion of a distribution that is not a dividend, “to the extent that it exceeds the adjusted basis of the stock, [to] be treated as gain from the sale or exchange of property.” The Court stated that these provisions require it to determine Paradym's basis in its CSE stock.

For this analysis, the Court considered a basis study using various business records to document 34 different transactions relevant in determining Paradym's basis in CSE. The Court found that three of the transactions generated sufficient basis to cover the distribution at issue, and therefore did not consider the other 31 transactions.

Therefore, the Court held that Paradym had sufficient basis in CSE to treat the entire distribution as a nontaxable return of capital under Section 301(c)(2). Having concluded that ITW was not liable for any deficiency for 2006, the Court further held that ITW was not liable for any accuracy-related penalty under Section 6662 for that year.

**Implications**

The case represents a significant development in the tax analysis of upstream loans. In particular, the Court's willingness to respect the in-form debt instrument when the borrower's sole source of earnings would be future dividends from the lender is noteworthy. In so holding, the Court appeared to apply general debt-equity principles in the intercompany loan context without placing additional scrutiny on whether the debtor's intent to repay was real. Rather, the Court found that CSE's intent to pay was supported by the facts that the debt instrument legally required the repayment of the debt, the debtor had the economic ability to repay (whether via earnings from its subsidiary lender, a third-party refinance or a capital contribution), and that ITW as a worldwide group had a sufficient history of repaying its intercompany debts. As the Service offered no specific evidence indicating that CSE's intent to pay was illusory or that the funds lent by CSA had been permanently distributed from CSA, the Court upheld debt treatment. The Service had argued that the incurrence of indebtedness by a holding company like CSE creates an “implied liability” that burdens its subsidiaries and rendered CSA's loan to CSE circular. In response, the Court stated that “the upshot of respondent's argument is that an intermediate holding company cannot incur genuine intercompany indebtedness. We find no support in law or logic for that theory.”

In addition, the case solidifies the view that intercompany debt should be respected notwithstanding that the loan terms are not as robust as would be needed in a third-party loan agreement. Instead, as long as the hallmarks of debt are included (i.e., an unconditional promise to pay a sum certain on demand or on a specified date and creditor's rights) and
the debtor has the economic ability to support the debt, the debt generally should be respected for US federal income tax purposes.

Less significantly, but worth noting nonetheless, is the Court’s apparent endorsement of the basis recovery principles of Johnson. Tax advisors are not uniform in following the holding of Johnson – specifically, that Section 301(c)(2) and (3) apply separately across stock blocks rather than through an aggregation of the blocks – and, while dicta, this case intimates a lack of debate around the block-by-block approach of Johnson.

Additionally, the case reaffirms and expands the decision made in the case of Falkoff v. Commissioner (604 F.2d 1045 (7th Cir. 1979), reversing and remanding T.C. Memo. 1977-93, 36 T.C.M. (CCH) 417). Despite several material factual differences - (1) the CSE distribution in this case was financed through a loan from a wholly owned subsidiary while the distributing corporation (P) in Falkoff borrowed directly from a bank; and (2) the transaction in this case was completed within a single tax year whereas the transaction in Falkoff (a loan, followed by a return of capital distribution by P, followed by a sale of assets by a subsidiary and loan to P) was completed in two separate tax years - the Tax Court maintained its position that form should be respected in this case and rejected the application of the step transaction doctrine to collapse the transactions.

The decision expressed in the court opinion will become final 90 days from the date the decision is entered unless the Service files a notice of appeal. If the Service appeals this case, it will be heard by the Seventh Circuit.

Endnotes

2. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
3. Currency references in this Alert are to US$.
4. The opinion describes the distribution proceeds as having been transferred directly to Paradym’s parent for currency conversion reasons but no further discussion of this fact is provided.
5. The movement of funds was accomplished via a notional cash pool arrangement with Bank Mendes Gans N.V., (BMG), a third party Dutch bank. However, the use of a notional cash pool did not play a role in the analysis and thus no implication can readily be drawn as to the tax treatment of notional cash pools as a result of the case.
6. 728 F.2d 945, 948 (7th Cir. 1984), aff’g T.C. Memo. 1983-98.
7. 74 T.C. 476, 493 (1980).
9. 604 F. 2d 1045 (7th Cir. 1979), rev’g and remanding T.C. Memo. 1977-93, 36 T.C.M. (CCH) 417.
10. The Court also noted that, if the documentation supporting basis were deemed inadequate in certain respects, the so-called Cohan rule may apply to estimate basis. See Cohan v. Commissioner, 39 F.2d 540 (2nd Cir. 1930).
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EGY no. 010449-18Gbl
1508-1600216 NY
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