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Cross-Border Financing: Taxpayer Wins on Characterization of Intercompany Debt Transaction

Certainty regarding characterization of intercompany transactions remains a priority after US tax reform, opinion highlights importance of established pattern of conduct.

On August 6, 2018, the US Tax Court decided *Illinois Tool Works Inc. & Subsidiaries v. Comm'r*,[1] upholding the taxpayer's characterization of a cross-border, intercompany financing transaction as a loan creating a bona fide debt obligation, and thus supporting the taxpayer's overall international tax structure and planning.[2] *Illinois Tool Works* is the latest volley in an argument over the characterization of related-party financial instruments that has been running between IRS and taxpayers for over 60 years, and which will likely continue. The decision is a resounding taxpayer victory, provides valuable insight with respect to the planning and execution of cross-border intercompany transactions, and serves as a reminder that the choice by multinationals to use equity or debt for cross-border, intercompany financing still matters.

Characterization of Intercompany Transactions Post-US Tax Reform and Regulatory Change

While the characterization of an intercompany arrangement as debt or non-debt for US federal income tax purposes has been part of the international planning lexicon for decades, two major developments over the last two years have changed some of the dynamics while at the same time reinforcing the importance of careful planning, such as that undertaken by the taxpayer in this case. Those two developments are the major US tax reform signed into law in 2017, and the IRS regulations issued in 2016 to address certain intercompany financings. The following outline of these two developments provides helpful background to the case.

Tax Cuts and Jobs Act

While the Tax Cuts and Jobs Act[3] (TCJA), itself the subject of a detailed Latham & Watkins *White Paper*, has changed many of the dynamics around intercompany financing and capitalization decisions for both US-based and non-US-based groups, the issue of whether or not a transaction is treated as debt remains at the forefront of planning considerations. Following enactment of the TCJA, considerations relevant to cross-border financing transactions include:

- **Participation exemption:** US-parented multinationals receive a 100% foreign-source dividends received deduction, subject to minimum ownership, holding period, and other requirements. But the deduction is not available for RICs, REITs, partnerships, S corporations or individuals or applicable to "hybrid dividends" (*i.e.*, distributions treated as a dividend for US tax purposes but as a payment for which a deduction may be taken by the payer).

- **Deduction for business interest expense limited:** Subject to exceptions, interest expense deductions are limited to the sum of the taxpayer's business interest income plus 30% of its adjusted taxable income, but unused interest expense can generally be carried forward.

- **Base Erosion and Anti-Abuse Tax (BEAT):** Deductible interest payments made by a US corporation to a foreign related party are generally treated as base erosion payments for purposes of the BEAT.

- **Hybrid arrangements:** Disallowance of deductions for certain related-party amounts paid or accrued in hybrid transactions (*i.e.*, transactions for which payments are treated as interest or royalties for US tax purposes but not by the tax laws of the country in which the payer is resident) or with hybrid entities (*i.e.*, entities that are fiscally transparent in one jurisdiction but not the other).

In addition, many pre-TCJA considerations remain relevant today, such as:

- **Section[4] 956:** A US shareholder of a controlled foreign corporation (CFC) generally must include in its income an amount equal to the earnings of the CFC that are invested in certain US property, including loans and credit support to debt of a related US borrower.

- **Withholding:** Rates of withholding, including treaty rates and qualification therefor, may vary depending on whether payments are dividends or interest.

- **Tax Rates:** Similarly, rates of taxation may vary depending on whether payments are dividends or interest.

- **CFC-status:** CFC status of a foreign corporation is generally dependent on the status of equity investors and the stock ownership attribution rules, not lenders.

Section 385 Regulations

As reviewed in a previous Latham & Watkins *Client Alert*, on October 13, 2016, the US Department of the Treasury (Treasury) and the IRS issued final and temporary regulations under Section 385 regarding the characterization of certain related-party debt instruments as equity. Nevertheless, the non-statutory, multifactor debt/equity (and bona fide debt) analysis remains as relevant as ever.

The Section 385 regulations contain documentation and reclassification rules, generally limited to related-party debt issued by a US entity. Broadly, the documentation rules require documentation establishing (i) an unconditional obligation to pay a sum certain on demand or on one or more fixed dates, (ii) typical creditor's rights to enforce payment; (iii) a reasonable expectation of repayment; and (iv) evidence of a debtor-credit relationship, such as timely payments or the exercise of creditor's rights. However, the implementation of the documentation requirements has been delayed until 2019,[5] and Treasury and the IRS are reportedly considering a proposal to revoke or revise them.[6] The reclassification rules treat covered debt instruments as stock if the debt instrument is issued: (i) in a distribution; (ii) to acquire stock of a member of the issuer's expanded group (*i.e.*, a transaction that would be subject to Section 304); or (iii) as consideration in certain internal asset reorganizations.

Intercompany debt transactions not reclassified under the Section 385 regulations remain subject to reclassification under traditional federal income tax principles, including the time-honored factors discussed in *Illinois Tool Works*.

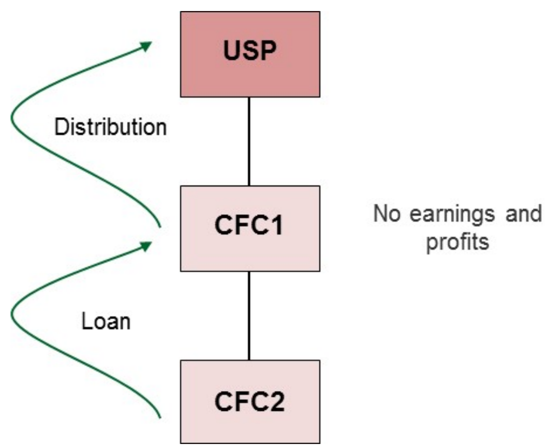
The *Illinois Tool Works* Transaction

Simplified Description

In this case, US Parent (USP) owned CFC1, a holding company that owned CFC2. CFC1 had no accumulated earnings and profits, but CFC2 did.

CFC2 made a loan to CFC1, using their accounts in a notional cash pool. The debt instrument had a five-year term and paid simple interest at 6% per year. The instrument did not require any payments of principal until maturity, and there was no premium or penalty for early payment. Additionally, the instrument contained no restrictive covenants regarding payment of dividends, maintenance of working capital, mergers or asset sales, or future issuances of senior debt. Under the note, CFC2 could enforce payment of principal and interest, and there was no provision subordinating the debt to CFC1's other obligations. Delaware law governed its interpretation.

CFC1 distributed the loan proceeds to USP. USP received the distribution as a return of capital not in excess of its basis in its CFC1 shares and used the cash to repay outstanding commercial paper.



IRS Characterization of Transaction

The IRS attacked the transaction using three theories:

- The loan from CFC2 to CFC1 was not bona fide debt and should be characterized as a dividend.
- If the loan from CFC2 to CFC1 was bona fide debt, it should nevertheless be recharacterized as a dividend to either CFC1 or USP under one or more judicial anti-tax-avoidance doctrines.[7]
- If the loan from CFC2 to CFC1 was not recharacterized at all, USP did not have sufficient basis to absorb the entire distribution from CFC1 as a tax-free return of capital.

The IRS also asserted penalties under Section 6662(a). The court rejected all of the IRS theories and its assertion of penalties against the taxpayer, finding the relevant factors overwhelmingly favored the taxpayer.

Highlights of the Court's Analysis

The bulk of the opinion focuses on a traditional, non-statutory, multifactor analysis to determine whether the transaction between CFC2 and CFC1 created bona fide debt or a dividend. But certain aspects of the analysis merit attention, because they may reflect noteworthy developments in how the court engages in that analysis.

The court undertook a 14-factor analysis. Nine factors favored debt characterization, four were neutral or unhelpful, and only one favored dividend characterization.

Debt	Neutral/Unhelpful	Dividend
• Stated intent to repay • Retained earnings and dividend history of lender • Conventional formal indicia of debt (*e.g.*, promissory note) • Treatment of advances in corporate records • Repayment history and source • Status of advances relative to other debt • Adequacy of capitalization • Risk involved in making advances • Ability to obtain outside loans	• Size of the advance • Use of advanced funds • Participation in management • Identity of interest between creditor and shareholder	• Extent of shareholder control over lender

Established Pattern of Conduct

The court's decision that the upper-tier CFC intended to repay the advance from the lower-tier CFC may have depended as much on the behavior of Illinois Tool Works and its subsidiaries (the ITW Group) with respect to the group's other intercompany debt obligations as it did on the ITW Group's behavior with respect to the particular obligation at issue in this case. The taxpayer showed a meticulous course of conduct in properly documenting and following the terms of the intercompany instruments issued in its group.

The court recognized that during the relevant time period, the ITW Group had as many as 122 other outstanding intercompany debt instruments with an aggregate face value of US$74.5 billion. In discovery, the taxpayer provided information about a representative sample of 48 such obligations. The court observed that 33 were fully repaid, three were discharged in a merger or acquisition, and 12 remained outstanding. The court also highlighted credible testimony from employees of the ITW Group that the taxpayer always followed a "live by the agreement" principle for repaying debt, including intercompany debt.

Live by the Agreement

The court's opinion demonstrates that ensuring that a borrower strictly follow the terms of a relatively abbreviated loan document may be more important than creating a comprehensive loan document resembling a bank credit agreement but whose terms the borrower might only loosely observe.

Not only was the ITW Group's documentation of the transaction in order, but also the ITW Group ensured that it adhered to the formalities of the structure that the documentation created, including the regular payment of interest. The loan document in this case was a one-page promissory note containing the terms described above, which the court found sufficient. The documentation did not include financial and non-financial restrictive covenants that often appear in third-party borrowing agreements, including limitations on the payment of dividends, requirements for the maintenance of working capital, limitations on future issuances of senior debt or on mergers and asset sales, and the requirement to provide quarterly financials.

However, in light of the ITW Group's behavior with respect to the obligation at issue in this case, its pattern of behavior with respect to its other intercompany obligations, and the assessment of the upper-tier CFC's ability to pay and hypothetical credit rating (provided by the taxpayer's experts), the court was not particularly troubled by the fact that the terms of the promissory note were considerably shorter than those that might appear in a bank credit agreement, which typically contains dozens of pages of terms and conditions.

Rejection of IRS Arguments

Finally, the court's opinion is notable for its dismissal of what might be considered the IRS' "go-to" arguments against a taxpayer's treatment of an intercompany transaction as creating bona fide debt.

In this case, as it has in others, the IRS contended that the upper-tier CFC lacked an independent ability to pay interest or repay the loan because the upper-tier CFC was a holding company and relied on the operations of its subsidiaries to provide cash. The court flatly rejected that argument, observing that a potential creditor would evaluate a holding company's ability to pay by taking into account the assets and future cashflows of its operating subsidiaries. The court noted that the IRS' position would appear to make a holding company incapable of incurring genuine intercompany debt and the court stated that it was aware of no legal support for that theory.

The IRS' arguments for the application of a variety of judicial anti-abuse doctrines all essentially centered on the argument that the form of the ITW Group's transaction should not be respected because the ITW Group could have obtained the cash to repay its commercial paper through alternative transactions that did not involve the tax-free repatriation of foreign earnings. The court had no trouble rejecting the invitation to apply any of the doctrines that the IRS offered, noting specifically that for the taxpayer to have obtained the funds using a transaction that minimized its tax costs was not improper.

Final Thoughts

Given the inherently factual nature of this case, and the thorough and well-reasoned opinion of the Tax Court, it is difficult to see a path forward for a government appeal. The *Illinois Tool Works* decision will present a valuable piece of guidance for taxpayers with respect to a quintessentially fact-intensive inquiry. The insight it provides will undoubtedly be relevant for both taxpayers planning new intercompany transactions, as well as taxpayers who may be engaged in disputes about the characterization of prior intercompany transactions.

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Endnotes

1 T.C. Memo. 2018-121 (Aug. 6, 2018).

2 Latham's Tax Controversy Practice successfully defended a US$4.9 billion cross-border intercompany financing transaction in *NA Gen. P'ship & Subsidiaries v. Comm'r*, T.C. Memo. 2012-172 (June 19, 2012), a Tax Court decision liberally cited throughout the Tax Court's opinion in *Illinois Tool Works*.

3 Public Law No. 115-97. Shortly before final Congressional approval of the TCJA, the Senate parliamentarian ruled that the previously attached short title, the "Tax Cuts and Jobs Act," violated procedural rules governing the Senate's consideration of the legislation. Accordingly, the TCJA no longer bears a short title, although commentators likely will continue to refer to it as the Tax Cuts and Jobs Act.

4 All references to "Section" are references to sections of the Internal Revenue Code of 1986, as amended.

5 IRS Notice 2017-36, 2017-33 IRB 208.

6 Steven T. Mnuchin, US Dep't of the Treasury, Second Report to the President on Identifying and Reducing Tax Regulatory Burdens 7 (Oct. 2, 2017); *see also* Stephanie Cumings, *Treasury Moves to Withdraw Debt-Equity Documentation Rules*, 160 Tax Notes 122 (July 2, 2018) (confirming that proposed regulations withdrawing the documentation requirements are pending review at the Office of Management and Budget).

7 The doctrines were: the economic substance doctrine, the step-transaction doctrine, the conduit doctrine, and what the court termed "Subpart F Avoidance."