CLIENT ALERT

Recent *Illinois Tool* Case Provides Useful Guidance Concerning Intercompany Debt Documentation

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Monday's decision of the Tax Court in *Illinois Tool Works v. Commissioner*, T.C. Memo 2018-21, provides a useful reminder of the Internal Revenue Service's stringent attitude towards documentation of intercompany debt. While the holding of the case might be said to accord with reason and good sense in documenting intercompany debt, the litigating position of the IRS calls for a different approach, indicating that intercompany debt instruments need to look more like what a third-party lender would expect.

At issue in *Illinois Tool* was a planning strategy in which (a) a foreign subsidiary borrowed $356 million on an intercompany basis from an affiliate, following which (b) the foreign subsidiary distributed the loan proceeds as a non-taxable return of capital to its U.S. domestic parent. In addition to challenging the debt status of the borrowing – which would have eliminated the tax benefits of the transaction – the IRS asserted an accuracy-related penalty.

The challenge to debt status was based on a claimed failure to satisfy most if not all of the elements of the multi-factor test for distinguishing corporate debt from equity – but the government's argument relative to one factor in particular – the ability to obtain loans from third-party creditors – bears mention: the note was documented on one page and apparently included as terms little more than a requirement of principal repayment at the end of five years and a provision for simple interest. The government's expert said that the note did not contain restrictive covenants typically found in publicly issued, investment-grade debt instruments, such as restrictions on investment activities, restrictions on payment of dividends, and negative pledges of assets. For that reason, the expert opined that "a third party would have been unwilling to extend credit to the [subsidiary borrower] on the terms set forth in the . . . note." Elsewhere, the court noted that the IRS also found shortcomings in the note's failure to require maintenance of working capital, and the absence of provisions restricting mergers and sales of assets, or restricting future issuance of senior debt.

Judge Lauber rejected the government's position regarding the terms of the documentation, saying that the absence of debt covenants such as those identified "is not surprising" in the intercompany setting. Therefore, because he concluded that a third-party creditor would have loaned the borrower the same amount on the same economic terms, he held that the factor referring to the borrower's ability to obtain loans from third parties favored debt characterization.

The decision ultimately upheld debt status of the note as well as the transaction structure, thus giving the taxpayer a complete win. But a reader of the opinion can't help but take away the fact that a key element of the IRS case focused on the adequacy of the loan documentation. A similar argument had been made and rejected by the Tax Court in *Nestle Holdings Inc. v. Commissioner*, T.C. Memo 1995-441 (1995), *rev'd in part on other grounds*, 153 F.3d 83 (2d Cir. 1998). Conceivably, loss of the argument a second time in *Illinois Tool* could cause the IRS to re-think its view but it would seem risky to assume that. Somewhat interestingly, the documentation rules of Treas. Reg. Sec. 1.385-2 were not particularly stringent, essentially requiring only an enforceable obligation to repay, but those regulations have been suspended until January 1, 2019, and are slated for extinction in a proposed regulation now pending before the Office of Management and Budget.

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