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IRS Challenges Characterization of Distribution as a Return of Basis

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A foreign holding company owned by Illinois Tool Works (ITW) borrowed funds from a subsidiary and distributed the funds to its U.S. parent. The foreign holding company had no earnings and profits, and thus the U.S. parent reported the distribution as a nontaxable return of basis. In *Illinois Tool Works Inc. v. Commissioner*,¹ the IRS asserts that the foreign holding company's distribution to its shareholder is taxable as a dividend.

Section 301(c) prescribes the tax treatment for a corporate distribution to a shareholder. A distribution is a dividend to the extent of the corporation's current and accumulated earnings and profits.² A distribution in excess of the corporation's earnings and profits is applied against and reduces the basis in the shareholder's stock (and is not subject to taxation). The portion of the distribution that is not a dividend, to the extent it exceeds the shareholder's basis in the stock, is treated as gain from the sale or exchange of property.³

To illustrate, assume that a U.S. company (USP) owns all of the stock of a foreign holding company ("Foreign HoldCo"). Foreign HoldCo owns the stock of a foreign finance company, which in turn owns the stock of a number of foreign operating subsidiaries.

Assume further that USP has a basis in the stock of Foreign HoldCo of \$1 billion. The basis may have resulted from a purchase of the stock and from contributions of assets to Foreign HoldCo (e.g., cash, stock in subsidiaries, or other assets).⁴

Foreign HoldCo borrows \$350 million and distributes the same amount to USP. If Foreign HoldCo does not itself have any current or accumulated earnings and profits, the distribution is a nontaxable return of basis.⁵ In other words, the distribution represents a return to USP of a portion of its \$1 billion investment in Foreign HoldCo. After the distribution, USP would have a \$650 million basis in the stock of Foreign HoldCo.

A number of years ago the IRS challenged the treatment of a corporate distribution as a nontaxable return of basis where the distribution was made with bor-

⁴ USP's basis in Foreign HoldCo would also be increased for any amounts included in USP's income under Subpart F with respect to Foreign HoldCo and its direct and indirect foreign subsidiaries, to the extent the previously taxed earnings have not been distributed to USP. §961.

⁵ Under certain circumstances where a shareholder holds shares in a corporation with different bases, a question can arise concerning whether basis is recovered in the aggregate or on a share-by-share basis. See *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971). Proposed regulations would adopt a share-by-share rule on a prospective basis, but the Preamble to those proposed regulations acknowledges that "[t]he tax law does not provide rules concerning whether a shareholder recovers its stock basis in the aggregate, or alternatively, whether a shareholder is required to recover stock basis share-by-share." REG-143686-07, 74 Fed. 3509, 3510 (Jan. 21, 2009). See also PLR 201014048 (addressed §301 distributions in redemption of specific shares, treating the amount distributed to redeem each particular share as reducing the basis in that share).

¹ T.C. Dkt. No. 10418-14.

² See §316 (definition of a dividend).

³ See also Reg. §1.301-1, §1.301-2.

rowed funds. The courts rejected the IRS's arguments, holding for the taxpayers.

In *Commissioner v. Gross*,⁶ several corporations with minimal earnings and profits made distributions to their shareholders. The corporations developed property that was financed through mortgages. The cash for the distributions came mainly from mortgage proceeds. The IRS argued that the anticipatory distribution of future profits should be taxed as ordinary income because a distribution after the profits are realized is taxed as ordinary income. The Tax Court and Second Circuit rejected this argument, holding that to the extent the distributions exceeded the earnings and profits of the corporation, they would reduce basis in the stock, with any excess being capital gain.⁷

In *Falkoff v. Commissioner*,⁸ a corporation owned by a partnership borrowed funds from a bank and repaid certain loans owed to the partnership, and also distributed funds with respect to the stock held by the partnership. The taxpayers (partners in the partnership) reported the distribution as a nontaxable return of basis to the extent the amount distributed exceeded the corporation's earnings and profits.

The IRS argued that the current-year distribution should be taxable as a dividend, not because the distribution was in anticipation of future earnings (it had acquiesced in the *Gross* case), but rather based on the substance of the various transactions and the step transaction doctrine. The IRS pointed out that a subsidiary of the corporation had negotiated a deal to sell certain property that had substantially appreciated and it was expected that such subsidiary would distribute the proceeds to the parent corporation in a subsequent year to repay the bank loan, and this expected distribution would generate earnings and profits in the parent corporation.

The Tax Court rejected the step transaction argument, relying on *Gross*, and held that "[u]nquestionably, [the corporation] had the right to pay a dividend out of borrowed funds in the taxable year ending September 30, 1969, in anticipation of the realization of a gain which would cover the distribution in the subsequent year." The Tax Court held, however, that "where the stockholders themselves provide the funds through a bank loan, the distribution may lack both business purpose and economic substance." The Tax Court concluded that the bank did not make a loan to the corporation on the full faith and credit of the corporation itself but rather the loan

was made to the partnership, so that any repayment of the loan by the corporation should be treated as a constructive dividend to the partnership.

The Tax Court's decision was reversed by the Seventh Circuit, which held that the distribution constituted a return of basis. The Court of Appeals stated that the fact that the taxpayer's purpose was to avoid taxation does not necessarily mean that it should be recast,⁹ and found that the transactions did have economic substance. The Seventh Circuit stated that "[a]fter examining the record, we believe that the Tax Court's conclusion that the loan was made on the strength of the assets pledged by the partnership and that this made the partnership in effect the borrower is clearly erroneous." The Court of Appeals further determined that "[w]e cannot conclude that this is a case where the shareholder provided funds enabling the corporation to make a sham distribution back to the shareholder. Instead, this is a case where a corporation without accrued or present earnings and profits borrowed against its own appreciated assets and made a distribution in anticipation of future profits. As the Tax Court itself recognized, such a distribution does not result in taxable income to the shareholder."¹⁰

Therefore, case law clearly establishes that a corporation can borrow funds to make a return-of-basis distribution to its shareholders and that §301(c) will treat a distribution as a dividend only to the extent of the earnings and profits of the corporation as of the end of the year in which the distribution is made. The distribution will be treated as a return-of-basis even if the corporation anticipates earnings in a subsequent year to repay the loan (including dividends from its subsidiaries), and even if the transactions are structured to reduce taxes.

In the Tax Court filings in *ITW*, the IRS asserts that the loan from the subsidiary to the foreign holding company was in substance a distribution subject to §301. In such case, the earnings and profits of the foreign subsidiary making the loan would move up to the foreign holding company, causing the distribution by the foreign holding company to its shareholder to be

⁹ *Id.* at 1048 ("There is ample reason to suppose that one of the purposes of the transaction was to avoid taxes and that there was little if any valid business purpose for the Corporation taking out the \$18 million loan. . . . The taxpayer's purpose to avoid taxation alone does not provide a sufficient basis for reshaping the transaction to change its tax repercussions.").

¹⁰ *Id.* at 1050. *Cf. Kraft Foods Co. v. Commissioner*, 232 F.2d 123 (subsidiary's distribution of its own note to its shareholder respected as a distribution under §301); *Shield Co. v. Commissioner*, 2 T.C. 763 (1943) (respected distributions funded by loans from the shareholder).

⁶ 23 T.C. 756 (1955), *aff'd*, 236 F.2d 612 (2d Cir. 1956), *acq.* 1957-2 C.B. 6.

⁷ See also *Wilson v. Commissioner*, 25 T.C. 1058 (1956) (similar holding rejecting the IRS's assertion that *Gross* was wrongly decided).

⁸ 604 F.2d 1045 (7th Cir. 1979), *rev'd*, 36 T.C.M. 417 (1977).

a dividend under §301(c) to the extent of the earnings and profits of the foreign subsidiary.¹¹

There are a few cases that have considered whether a loan from a subsidiary to a parent corporation should be treated as a dividend. The cases treat such loans as in substance loans when the loan formalities are documented and then executed properly.

Courts have only rarely held that a purported loan from a subsidiary to its parent was in substance a dividend, and only where the documentation and execution did not support loan treatment. Under the facts of one case, *Alterman Foods, Inc.* was the parent of an affiliated group.¹² It paid most of the operating expenses of its subsidiaries but collected substantially all of their operating proceeds over a period of years. These transfers were recorded on the books of the subsidiaries and parent as debts outstanding, and resulted in increasing balances due from the parent to its subsidiaries. Both the Fifth Circuit and Court of Claims, dealing with different taxable years of the same taxpayer, held that these transfers were in substance dividends rather than bona fide loans. While the cash advances were shown on the books as debts outstanding, there were no interest charges, no set maturity date, no notes of indebtedness, nor any apparent legal compulsion to repay the amounts outstanding. There was no repayment of the advances except to the extent the parent corporation paid expenses of the subsidiaries.¹³

In contrast, the court in *Troop Water Heater v. Binger*,¹⁴ respected a subsidiary's loans to a corporate shareholder that owned 81% of its stock. The advances were documented by notes, and reported on the parent's books as loans payable. Several notes were demand notes and several were 12-month installment notes. The notes bore interest which was regularly paid, and principal repayments were made. There was an expectation of repayment even though the borrower was currently incurring operating losses. The court held that the loans from the subsidiary to its corporate shareholder were in substance loans.¹⁵

¹¹ See Sheppard, *Intercompany Debt Used to Distribute Earnings Challenged*, 144 Tax Notes 1223 (Sept. 15, 2014); Chase & Goldman, *Borrowing From the Kids: Potential Perils of Subsidiary Loans*, 144 Tax Notes 467 (July 28, 2014).

¹² *Alterman Foods, Inc. v. United States*, 505 F.2d 873 (5th Cir. 1974); *Alterman Foods, Inc. v. United States*, 611 F.2d 866 (Ct. Cl. 1979).

¹³ See also *Peoplefeeders Inc. v. Commissioner*, T.C. Memo 1999-36 (intercompany transfers by a subsidiary to its parent were not loans but dividends; the transfers were not evidenced by promissory notes, and no maturity dates, interest, repayment terms, or repayment amounts were agreed).

¹⁴ 234 F. Supp. 642 (W.D. Pa. 1964).

¹⁵ For a thorough treatment of the cases considering debt-vs.-

Similarly, in *Page v. Haverty*,¹⁶ a parent corporation made distributions to its shareholders, which it funded with loans from its subsidiaries. The parent corporation had no earnings and profits, and thus the distributions were reported as a return of basis. The government argued that the loans made to the parent were in reality dividend payments, and therefore should be treated as earnings and profits of the parent. The Fifth Circuit rejected the government's argument, stating that the loans were in substance loans, and could not be recharacterized as dividends giving rise to earnings and profits.

The Tax Court filings in the *ITW* case state that the loan from the subsidiary to the foreign holding company had a five-year term and a fixed rate of interest at 6%, and was not subordinated. The loan was memorialized and reported consistently on the financial records, and interest was paid annually in accordance with the terms of the loan. The loan was refinanced after five years, but subsequently was repaid in full. Based on the above authorities and the available facts, the loan from the subsidiary to the foreign holding company should be respected as a loan.¹⁷ Treating the subsidiary's loan as in substance a loan means that the earnings and profits of the subsidiary should not be taken into account for purposes of applying §301 to the distribution by the foreign holding company to its shareholder, in which case the distribution should be treated as a return of basis.¹⁸

The Obama Administration has proposed to change the rules to eliminate the return-of-basis distribution

equity issues, see Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369 (1971).

¹⁶ 129 F.2d 512 (5th Cir. 1942).

¹⁷ Two recent debt-vs.-equity cases state that tax planning is not determinative of whether an instrument is debt or equity, in both cases treating hybrid instruments as reported by the taxpayer and rejecting the IRS's contrary assertions. *Pepsico Puerto Rico Inc. v. Commissioner*, T.C. Memo 2012-269, at p. 88 ("Petitioners, engaging in legitimate tax planning, designed the advance agreements with an expectation that the instruments would be characterized as equity for Federal income tax purposes and as debt under Dutch tax law."); *NA Gen. P'ship & Subsidiaries v. Commissioner*, T.C. Memo 2012-172, at p. 25 ("Respondent posits that NAGP had tax avoidance motives indicating that the advance was really an equity investment. NAGP's desire to minimize tax is not conclusive, however, of the characterization of the advance as debt or equity. Indeed, tax considerations permeate the decision to capitalize a business enterprise with debt or equity." (Citations omitted)).

¹⁸ *ITW* states that the U.S. shareholder had \$1.1 billion of basis in the stock of the foreign subsidiary. As an alternative argument, the IRS asserts that *ITW* did not establish the basis the U.S. parent had in the stock of the foreign holding company, and thus if the foreign holding company had no earnings and profits, the distribution would be taxable gain under §301(c)(3)(A).

result under certain circumstances.¹⁹ The proposal would apply where one foreign corporation funds a related corporation with a principal purpose of avoiding dividend treatment on a distribution to a shareholder. The effect would be to prevent the shareholder's basis in the foreign company from being taken into account for purposes of applying §301, causing the parent to recognize gain under §301(c)(3).²⁰

¹⁹ See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* (Mar. 2014), p. 55 ("Green Book").

²⁰ See Yoder, *Obama Administration's FY 2013 Budget Targets Return-of-Basis Distributions*, 38 Int'l Tax J. 3 (May-June 2012). A recent regulation would apply §1248 to the gain, causing the gain to be treated as a dividend to the extent of the earnings and profits of the foreign subsidiaries of the distributing company.

In sum, current law firmly supports return-of-basis planning, and case law consistently has rejected IRS attacks. Additional comfort is provided by the current Administration's proposal, which indicates that a legislative change is necessary to override the return-of-basis result under current law.²¹

Reg. §1.1248-1(b), T.D. 9585 (Apr. 24, 2012). This regulation was promulgated as a temporary regulation in 2009. T.D. 9444 (Feb. 11, 2009).

²¹ Green Book, at p. 55 ("Under current law, the earnings and profits of a foreign corporation can be repatriated without being characterized as a dividend by having such corporation fund a distribution from a second, related foreign corporation that does not have earnings and profits, but in which the distributee shareholder has sufficient tax basis to characterize the distribution (in whole or substantial part) as a return of stock basis under the ordering rules of section 301").