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TaxNewsFlash

United States

No. 2018-305
August 6, 2018

U.S. Tax Court: Repatriation allowed using plan of intercompany debt with return-of-capital distribution

The U.S. Tax Court today released a memorandum opinion finding for the taxpayer with respect to its repatriation in 2006 of $356.8 million from its European affiliates by using a plan that combined intercompany debt with a return-of-capital distribution.

The case is: *Illinois Tool Works Inc. v. Commissioner,* T.C. Memo 2018-121 (August 6, 2018). Read the Tax Court's 75-page **opinion** [PDF 265 KB]

The purpose of this report is to provide text of the Tax Court memo opinion released this afternoon.

Tax Court's opinion

The worldwide corporate group headed by the taxpayer had on its balance sheet in September 2006 about $618 million of cash, held mostly by European affiliates. The taxpayer wanted to bring a portion of this cash back to the United States. To do so, it employed a plan that combined intercompany debt with a return-of-capital distribution.

The repatriation plan worked as follows:

- One of the taxpayer's lower-tier controlled foreign corporations (CFCs) lent money to an upper-tier CFC.
- The upper-tier CFC was a holding company with no current or accumulated earnings and profits (E&P).
- The upper-tier CFC then distributed the loan proceeds of approximately $356.8 million to one of the taxpayer's domestic subsidiaries, which reported the distribution as a non-taxable return of capital.

The IRS attacked this strategy on two grounds.

- First, the IRS contended that the loan between the CFCs was actually a dividend. Thus, the IRS asserted the E&P of the lower-tier CFC would move to the upper-tier CFC, and the distribution by the upper-tier CFC would be taxable as a dividend under section 301(c)(1).

- Second, if the form of the intercompany loan were respected, the IRS contended that the domestic parent had insufficient basis in the upper-tier CFC to absorb the distribution as a return of capital and that a portion of the distribution would be taxable as capital gain under section 301(c)(3).

The IRS determined an income tax deficiency of over $70 million with respect to the taxpayer's federal income tax for 2006, and also asserted the taxpayer was liable for an accuracy-related penalty of $14 million under section 6662(a).

The Tax Court examined the following questions in the opinion: (1) whether the loan from the lower-tier CFC to the upper-tier CFC was to be treated as bona fide debt; (2) if the loan was bona fide debt, whether it nevertheless ought to be recharacterized, under one or more judicial anti-tax-avoidance doctrines, as a dividend to the upper-tier CFC or to petitioner; (3) if the loan was not recharacterized as a dividend, whether the domestic parent had sufficient basis in the upper-tier CFC to treat the entirety of the distribution as a return of capital; and (4) finally whether the taxpayer was liable for an accuracy-related penalty.

The Tax Court resolved all of these questions in the taxpayer's favor.

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