TAXATION — BONA FIDE DEBT — TAX COURT HOLDS IN FAVOR OF TAXPAYER ON LOAN BETWEEN FOREIGN SUBSIDIARIES. — *Illinois Tool Works Inc. v. Commissioner*, 116 T.C.M. (CCH) 124 (2018).

Tax law struggles to distinguish debt from equity.[1] Yet the distinction has far-reaching consequences, particularly for corporate taxation.[2] Critically, because corporations can generally deduct interest payments on debt[3] but cannot deduct dividend payments to equity holders, firms have a distorted incentive to raise capital through debt.[4] For the same reason, firms strive to classify nonstandard financial contracts as debt rather than equity. Recently, in *Illinois Tool Works Inc. v. Commissioner*[5] (*ITW*), the U.S. Tax Court held that a transaction between two foreign subsidiaries was a loan, not a dividend, for tax purposes.[6] In reaching its conclusion, the court applied a fourteen-factor test for ascertaining whether a loan should be treated as "bona fide debt,"[7] and declined to invoke a series of "judicial anti-tax-avoidance doctrines."[8] Although the court analyzed the transaction appropriately, its reasoning highlights several problems of theory and practice associated with distinguishing debt from equity. To ameliorate these problems, Congress should jettison the debt-equity distinction.

Illinois Tool Works Inc. (ITW) is a publicly traded Fortune 500 corporation that, along with its many subsidiaries, manufactures industrial

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[1] Robust definitions of "debt" and "equity" are elusive. That said, a traditional bond typifies debt — when a corporation sells a bond, it obligates itself to pay the money back, generally with interest. *See* MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY 386–97 (4th ed. 2009). Stock typifies equity — stockholders "own" the corporation and receive discretionary dividend payments. *Id*.

[2] *See* William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 371–404 (1971) (cataloguing the distinction's impacts). This comment focuses on Subchapter C corporations. *Cf.* Martin J. McMahon, Jr. & Daniel L. Simmons, *When Subchapter S Meets Subchapter C*, 67 TAX LAW. 231, 232–37 (2014) (outlining the differences between S Corporations and C Corporations).

[3] *See* I.R.C. § 163(a) (2012). *But see id.* § 163(j) (2012 & Supp. V 2017) (limiting the interest deduction for many businesses to thirty percent of "adjusted taxable income").

[4] *See* Deen Kemsley & Doron Nissim, *Valuation of the Debt Tax Shield*, 57 J. FIN. 2045, 2047 (2002) (estimating the value of the "debt tax shield" at ten percent of firm value); *see also* JASON J. FICHTNER & HUNTER COX, MERCATUS ON POLICY: THE ROLE OF THE INTEREST DEDUCTION IN THE CORPORATE TAX CODE 3 (2018), https://www.mercatus.org/system/files/fichtner_and_cox_-_mop_-_the_role_of_the_interest_deduction_in_corporate_tax_code_reform_-_v1.pdf [https://perma.cc/S4JZ-F6TH] (finding that nonfinancial corporations paid over $445 billion in interest in 2016).

[5] 116 T.C.M. (CCH) 124 (2018).

[6] *Id.* at *72. Although the court mentioned that this was not a standard "debt/equity case," *id.* at *43, the distinction was implicated because the determination that the loan was bona fide debt meant that it was not a dividend resulting from an equity relationship.

[7] *Id.* at *27; *see also id.* at *27–30.

[8] *Id.* at *3.

products and equipment.[9] In 2006, ITW pursued a plan to repatriate funds from certain of its controlled foreign corporations[10] (CFCs) to finance its "strategy of growth through acquisitions."[11] Three subsidiaries in particular were crucial to ITW's plan: (1) a lower-tier CFC, CS (Australasia) Holdings, Ltd. (CSA); (2) an upper-tier CFC, CS (Europe) Holdings, Ltd. (CSE), a holding company with no "earnings and profits" from which to pay a dividend;[12] and (3) a domestic subsidiary, Paradym Investments Ltd. (Paradym), which fully owned CSE.[13] At its core, ITW's plan involved CSA lending $356,778,000 to CSE,[14] after which CSE distributed the funds to Paradym,[15] "which reported the distribution as a *nontaxable return of capital*."[16] The net effect of these transactions was to make foreign capital fully available to ITW for domestic acquisitions without any tax being due.

After ITW filed its 2006 tax return, the Internal Revenue Service (IRS) issued a notice of deficiency for $70,174,594 in connection with the repatriation transactions.[17] Subsequently, ITW "petitioned [the U.S. Tax Court] for redetermination."[18] In its answer to ITW's petition, the IRS further asserted an accuracy-related penalty of $14,034,919.[19] The IRS based its determination that ITW owed taxes on three main theories. First, the Service argued that the transfer of funds between CSA and CSE was a *dividend* payment, rather than a loan that created bona fide debt.[20] If that were the case, the subsequent distribution from CSE to Paradym would be a taxable dividend under sections 301(c)(1) and 316 of the Internal Revenue Code.[21] Second, the IRS insisted that, even if the transaction did involve bona fide debt, the court should use existing anti-tax-avoidance doctrine to recharacterize the transaction and

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[9] *Id.* at *3–4; *see 204: Illinois Tool Works*, FORTUNE, http://fortune.com/fortune500/illinois-tool-works/ [http://perma.cc/2Y7A-9B27].

[10] The Internal Revenue Code defines a controlled foreign corporation as a foreign corporation in which United States shareholders (as defined in the Code) own more than fifty percent of the stock or the voting power. I.R.C. § 957(a) (2012 & Supp. V 2017).

[11] *Ill. Tool Works*, 116 T.C.M. (CCH) at *4; *see also id.* at *9–14.

[12] I.R.C. § 312; *see also id.* § 316(a) (2012). Dividends are payments to *equity* investors. *See supra* note 1.

[13] *See Ill. Tool Works*, 116 T.C.M. (CCH) at *4–5. A lower-tier subsidiary is one that is owned by an upper-tier subsidiary of a parent corporation; in other words, a lower-tier subsidiary is further down the chain of corporate ownership. *See* Subchapter S Subsidiaries, 65 Fed. Reg. 3843, 3855 (Jan. 25, 2000).

[14] *Ill. Tool Works*, 116 T.C.M. (CCH) at *2, *13.

[15] For currency conversion reasons, the payment was actually made indirectly to Paradym's parent company. *Id.* at *13.

[16] *Id.* at *2 (emphasis added); *see also* I.R.C. § 301(c)(2).

[17] *Ill. Tool Works*, 116 T.C.M. (CCH) at *1–2, *19–20.

[18] *Id.* at *20.

[19] *Id.* at *2, *20; *see also* I.R.C. § 6662(a).

[20] *Ill. Tool Works*, 116 T.C.M. (CCH) at *20.

[21] *Id.*

prevent tax avoidance.[22] Finally, it contended that ITW had not proven that the payment from CSE to Paradym was a tax-free return of capital, and that the court should therefore treat it as a (taxable) capital gain.[23]

In a memorandum opinion, the U.S. Tax Court ruled in favor of ITW, holding that the company did not owe any taxes in connection with the repatriation transactions.[24] Judge Lauber began his analysis by briefly explaining that taxpayers generally have the burden of proving the IRS's determinations incorrect.[25] He then turned to the key question of the case: whether the loan from CSA to CSE (the "CSE Note") was bona fide debt, which was a question of the company's true intent.[26]

To answer the question of ITW's intent, Judge Lauber relied on precedent to construct a fourteen-factor test to determine whether a payment from a corporation to its shareholders ought to be treated for tax purposes as a loan or a dividend.[27] Because the Seventh Circuit would be the forum for any appeal of the decision,[28] Judge Lauber took eight of the factors directly from a Seventh Circuit case, *Busch v. Commissioner*.[29] The additional six factors came from a Tax Court decision, *Dixie Dairies Corp. v. Commissioner*.[30] The factors directed the court to analyze, among other things, the taxpayer's *stated* intention to repay; the relationship and history between the shareholder and the corporation; "the presence of conventional indicia of debt"; how the transaction was recorded in the company's records; and the size and riskiness of the transfer.[31] Ultimately, the court used the factors to determine "whether the taxpayer intended to create a debt with a reasonable expectation of repayment and (if so) whether that intent comports with creating a debtor-creditor relationship."[32]

Judge Lauber worked methodically through every factor, turning to precedent and expert testimony to decide whether each factor supported ITW's or the IRS's position.[33] While careful to explain that the analysis must not turn "on a mechanical counting of factors,"[34] Judge Lauber

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[22] *Id.*

[23] *Id.* Specifically, the IRS challenged whether Paradym had enough basis in CSE to "treat the entirety of the distribution as a return of capital." *Id.* at *3; *see also id.* at *20.

[24] *Id.* at *73.

[25] *Id.* at *26.

[26] *Id.* at *27.

[27] *Id.* at *28–30.

[28] *Id.* at *28; *see also* Golsen v. Comm'r, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

[29] 728 F.2d 945 (7th Cir. 1984); *see Ill. Tool Works*, 116 T.C.M. (CCH) at *28–29.

[30] 74 T.C. 476, 493 (1980); *see Ill. Tool Works*, 116 T.C.M. (CCH) at *28–30. The *ITW* court applied these additional factors "to the extent the Seventh Circuit has suggested . . . that such additional factors merit discussion." *Id.* at *28.

[31] *Ill. Tool Works*, 116 T.C.M. (CCH) at *29. The remaining factors were also described on this page of the opinion. *Id.*

[32] *Id.* at *27.

[33] *See id.* at *30–51.

[34] *Id.* at *51.

noted that nine of the factors favored debt treatment whereas only one — the extent of control that CSE exerted as CSA's sole shareholder — favored dividend treatment.[35] In considering the entirety of the transaction, Judge Lauber found that the CSE Note was bona fide debt.[36]

Judge Lauber then responded to the IRS's argument that the court should invoke "judicial anti-tax-avoidance doctrines to recharacterize the repatriation transaction as a dividend," notwithstanding the court's determination that the CSE Note was bona fide debt.[37] Four such doctrines were considered; none were utilized.[38] The court deemed the economic substance doctrine — which permits courts to disregard form in favor of substance when analyzing transactions — inapplicable because the court had already determined that the loan constituted bona fide debt.[39] Similarly, the court declined to deploy either the step transaction or conduit doctrines, both of which examine whether using intermediaries serves any legitimate business purpose.[40] Finally, the court dismissed the IRS's policy-driven argument that a fundamental purpose of the United States' international tax laws — to ensure taxation on repatriation of funds — would be subverted by allowing ITW to avoid taxation by using this structure.[41] Unpersuaded, Judge Lauber preferred to leave such a determination to the legislature.[42]

Finally, relying on an accountant's testimony, the court determined that ITW properly treated the payment from CSE to Paradym as a nontaxable return of capital.[43] Therefore, ITW had no tax deficiency. It followed directly that there could be no accuracy-related penalty.[44]

The court in *ITW* applied the proper doctrinal framework for analyzing the debt-equity distinction, but the case demonstrates that a new approach is needed. Historically, Congress and the Treasury have been unable to provide clear rules for distinguishing debt from equity. *ITW* shows the impossible challenge that courts face given this lack of guidance. With no branch competent to set the boundary, Congress should respond by eliminating the line-drawing problem entirely — that is, it should tax debt and equity equivalently. Doing so would align tax law with financial and legal theory and end the tax code's illogical subsidy for debt.

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[35] *Id.* at *51–52. Judge Lauber found four of the factors to be "neutral or unhelpful" as applied to the transaction. *Id.* at *52.

[36] *Id.* at *52.

[37] *Id.*

[38] *See id.* at *52–64.

[39] *Id.* at *54.

[40] *See id.* at *55–62.

[41] *Id.* at *62–64.

[42] *See id.* at *63–64.

[43] *See id.* at *65–73.

[44] *See id.* at *73.

Congress and the Treasury have been unable to draw a clear line between debt and equity. Congress has offered no meaningful guidance,[45] preferring instead to grant broad authority to the Treasury to develop regulations.[46] On the regulatory front, in the early 1980s the Treasury and the IRS published a comprehensive series of regulations "relating to the treatment of certain interests in corporations as stock or indebtedness."[47] But, after much condemnation, the Treasury eventually withdrew them before they went into effect.[48] Commentators argued that the regulations were overly complex and that they attempted to create too many bright-line rules for distinguishing debt from equity instead of focusing on providing the flexibility necessary to uncover the economic reality of a given arrangement.[49] The IRS issued new regulations in 2016,[50] but they, too, faced harsh criticism and are among the regulations the Trump Administration has identified for possible revocation.[51]

As *ITW* demonstrates, courts cannot salvage the situation for three reasons. First, courts have been (unsurprisingly) incapable of articulating a principled theory for treating interest payments and dividends differently.[52] To be fair, doing so is not necessarily the judiciary's prerogative, given that Congress mandates the difference in the tax code. However, the court in *ITW* did not even gesture at the theoretical reasons for *why* it was conducting its analysis.[53] The court retreated to a multifactor test without grappling with this fundamental question. In the end, it is unlikely that courts will be able to develop a sound theory where Congress and the Treasury have not.

Second, *ITW* highlighted the current framework's problems of judicial administrability. Critics have lambasted balancing tests in several legal contexts, including taxation.[54] Professor David Weisbach has persuasively argued "that line drawing in the tax law can and should be

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[45] The term "debt" is undefined in the Internal Revenue Code. Plumb, *supra* note 2, at 369.

[46] *Id.* at 370; *see* I.R.C. § 385(a) (2012).

[47] Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 Fed. Reg. 20,912, 20,912–13 (Apr. 8, 2016).

[48] *See* Alexander Lewitt, Note, *The Debt-Equity Labyrinth: A Case for the New Section 385 Regulations*, 74 WASH. & LEE L. REV. 2281, 2297–98 (2017).

[49] *See, e.g.*, *id.* at 2288, 2297–98.

[50] Treas. Reg. §§ 1.385-1 to 1.385-4T (as amended in 2017).

[51] *See* Britt Haxton & Andrew R. Roberson, *The Slow Death of the Section 385 Regulations*, TAX CONTROVERSY 360 (Nov. 9, 2017), https://www.taxcontroversy360.com/2017/11/the-slow-death-of-the-section-385-regulations/ [http://perma.cc/5CAN-RLAR].

[52] *See* Plumb, *supra* note 2, at 370 ("The Supreme Court has declined every subsequent opportunity to clarify (or perhaps to add to) the confusion . . . ."); *see also In re* Submicron Sys. Corp., 432 F.3d 448, 455–56 (3d Cir. 2006) (claiming that courts can separate debt from equity based on the "commonsense conclusion" that the capital comes from a party acting "as a banker . . . or as an investor," *id.* at 456).

[53] *See Ill. Tool Works*, 116 T.C.M. (CCH) at *26–30.

[54] *See, e.g.*, Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838 (7th Cir. 1999) ("The [seven-factor] test [the Tax Court] applied does not provide adequate guidance to a rational decision.").

based on . . . efficiency."[55] On that front, the *ITW* court's balancing test fails. The test promoted an expensive battle of the experts.[56] Four of the factors offered Judge Lauber no guidance.[57] Many of the factors were redundant, making the final balance difficult. For example, "extent of the shareholder's control of the corporation" overlaps substantially with "the identity of interest between the creditor and the shareholder."[58] As in *ITW*, factors rarely point in one direction and assigning respective weights to each is by its nature opaque.[59] Moreover, factor-based analysis can act as a mere cloak for a judge's intuition about a transaction.[60] That, in turn, creates a barrier to meaningful appellate review.[61]

Third, the *ITW* approach does not provide proper guidance to affected parties. In the world of corporate tax, predictability is valuable.[62] But ITW could not have foreseen that the court would develop a new fourteen-factor test. Moreover, despite Judge Lauber's assiduous effort, potential litigants have little assurance that the factors will be weighed similarly in future cases.[63] Even if the balancing test yielded perfectly predictable results, other doctrinal hurdles could get in the way. Given that judicial anti-tax-avoidance doctrines can override the multifactor approach, clarifying the balancing test fails to resolve the predictability issue. Furthermore, the tests are inconsistent across circuits,[64] meaning that the federal taxation law is applied differently depending on the forum of litigation. On a more practical level, the current model lets taxpayers alter their behavior to comport with certain factors without altering the substance of their transactions. For example, a well-advised taxpayer will be sure to record a loan as debt in its corporate books so as to satisfy the corporate-records part of the test.

Congress should recognize these institutional failures and eliminate the debt-equity distinction. The elimination is warranted as a matter of

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[55] David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1627 (1999).

[56] *See Ill. Tool Works*, 116 T.C.M. (CCH) at *21–26, *74–75 (listing six experts, including several noted academics).

[57] *Id.* at *52; *see also supra* note 35.

[58] *Ill. Tool Works*, 116 T.C.M. (CCH) at *29.

[59] Plumb, *supra* note 2, at 408.

[60] *See id.* at 409–10 ("[T]he taxpayer's pocketbook and the power of the government to block abuses are both at the mercy of the particular trial judge's 'experience with the mainsprings of human conduct,' the acuity of his sense of smell, and the degree of his commitment to the established system of double taxation of corporate income." (footnotes omitted) (quoting Comm'r v. Duberstein, 363 U.S. 278, 289 (1960))).

[61] *See id.* at 409.

[62] *See* Santiago Díaz de Sarralde et al., *Tax Certainty*, G20 INSIGHTS (Jan. 11, 2018) https://www.g20-insights.org/policy_briefs/tax-certainty/ [http://perma.cc/X2V4-5JJU].

[63] Plumb, *supra* note 2, at 408.

[64] *See, e.g.*, Bauer v. Comm'r, 748 F.2d 1365, 1368 (9th Cir. 1985) (eleven factors); Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972) (thirteen factors); Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968) (sixteen factors).

theory. Despite its 100-year history, the corporate interest deduction lacks a normative basis. Congress initially conceived of the deduction as temporary but later retained it without explanation.[65] A fundamental tenet of corporate finance holds that a firm's value does not depend on the choice to finance through debt or equity (at least in a stylized setting — including one without the distorting effects of the tax treatment of interest payments).[66] Nevertheless, the classic *legal* thinking persists that equity investors are "adventurer[s] in the corporate business," whereas lenders are "to be paid independently of the risk of success."[67] But the notion that an equity investor invariably receives more of the "entrepreneurial gain" is unfounded.[68] Fundamentally, both equity and debt investors provide capital in exchange for a return that is based on the corporation's risk profile. Indeed, a debt investor who buys a bond may be taking great risk in many circumstances (such as in the case of junk bonds) and collecting a commensurately higher interest rate precisely to compensate her adventurousness given the corporation's idiosyncratic risk.[69] The idea that all interest payments, unlike all dividends, constitute an "ordinary and necessary"[70] business expense collapses upon consideration of the fundamental economic arrangement between investor and firm. Both debt and equity investors receive risk-adjusted returns on their investments.

Furthermore, as a matter of policy, the debt-equity distinction promotes dysfunctional corporate conduct. It encourages companies to borrow excessively — which contributes to economy-wide instability.[71] It also cultivates a wasteful industry of engineering hybrid financial products that will be taxed as debt.[72] Because the IRS cannot scrutinize every questionable transaction,[73] many corporations evade appropriate taxation.

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[65] *See* Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1585–86 (1974).

[66] *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 268, 272 (1958).

[67] Plumb, *supra* note 2, at 404 (quoting Comm'r v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935)).

[68] Adam O. Emmerich, Comment, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118, 123 (1985).

[69] *See id.* at 122–24 ("[T]he difference between creditor and shareholder is . . . one of degree only." *Id.* at 122.).

[70] I.R.C. § 162(a) (2012 & Supp. V 2017).

[71] *See* Mark J. Roe & Michael Tröege, *Containing Systemic Risk by Taxing Banks Properly*, 35 YALE J. ON REG. 181, 185 (2018) ("[C]urrent tax rules work against financial stability by penalizing equity and favoring debt.").

[72] Weisbach, *supra* note 55, at 1639 ("Given the lack of definitive rules and the economic similarity between debt and equity, designing instruments to skirt the border has become one of the most active practices in tax planning.").

[73] *Nearly Half of Corporate Giants Escape IRS Audit in 2017*, TRAC: IRS (Apr. 9, 2018), https://trac.syr.edu/tracirs/latest/507/ [https://perma.cc/7W5E-5K59].

Critics have proposed several alternatives to the current approach to taxing debt and equity, including a repeal of the interest deduction;[74] allowing deductions only for interest payments on instruments close to "true" debt;[75] and focusing on drawing the most efficient line possible between debt and equity.[76] Any solution needs to focus on equalizing the treatment of debt and equity.[77] This would have three effects: (1) obviating the need to inquire into whether a particular instrument is one or the other; (2) eliminating the distorted incentive for taxpayers to prefer one over the other for tax reasons; and (3) increasing predictability and consistency in the application of the tax law. Congress could reach this result in several ways. Most apparently, it could eliminate the deductibility of interest or allow for deductibility of dividends. But it need not choose between the two extremes of all (eliminating the interest deduction) or nothing (allowing for deduction of dividends).

A middle-ground approach might involve taxing *all* corporate returns based on their riskiness. Several reform proposals along these lines have been suggested.[78] A forthcoming paper by Professors Thomas Brennan and Robert McDonald suggests effectuating this policy by allowing corporations to take a fixed-rate deduction equal to the risk-free rate.[79] After the deduction, only the risky portion of returns on capital would be left subject to taxation.

In corporate taxation, a stark split in the treatment of debt and equity has proven, over decades, to be untenable. As *ITW* shows, courts (along with Congress and the Treasury) labor to draw reasoned, consistent distinctions. As a result, taxpayers lack certainty. Rather than continue on the path highlighted in *ITW*, Congress should update the tax code to eliminate the debt-equity distinction and to tax returns on corporate capital consistently.

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[74] *See* Warren, *supra* note 65, at 1619.

[75] Emmerich, *supra* note 68, at 148.

[76] *See* Weisbach, *supra* note 55, at 1675–76.

[77] *But see* Emmerich, *supra* note 68, at 139 (suggesting that equalizing treatment of debt and equity would result in an "abolition of the corporate income tax itself"). Adam Emmerich's conclusion might be warranted if Congress allowed deductibility for dividends because corporations could then distribute earnings free of taxation. *See* Warren, *supra* note 65, at 1609. But other methods of equalization (including eliminating the interest deduction) would not lead to a de facto elimination of the corporate income tax.

[78] *See, e.g.*, OECD TAX POLICY STUDIES, FUNDAMENTAL REFORM OF CORPORATE INCOME TAX: NO. 16, at 9–12 (2007) (presenting various proposals, including the allowance for corporate equity (often shortened to ACE) and the comprehensive business income tax (often shortened to CBIT)). Additionally, comprehensive reforms would likely need to account for taxation at the level of the corporate investor. *Cf.* Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Shareholder Taxes*, 69 NAT'L TAX J. 677, 677–78 (2016).

[79] Thomas J. Brennan & Robert L. McDonald, Debt and Equity Taxation: A Combined Economic and Legal Perspective 1 (Mar. 1, 2018) (unpublished manuscript) (on file with the Harvard Law School Library). Brennan and McDonald's proposal stands out for its practicability and because it taxes *all* risky returns, not just those above a firm's financing costs.