Characterization and Imputed Interest in Shareholder Settlements

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Many companies of all sizes routinely face litigation and routinely resolve it. Litigation arises in many substantive areas, from employment, contract and intellectual property disputes to government investigations, environmental and shareholder litigation. The list is almost endless.

For companies that engage in M&A activity, disputes commonly arise. Litigation may be pursued by a party to the transaction, a shareholder, a competitor or the government. It may occur before the transaction is consummated relating to fairness, terms or competing offers.

Litigation may also occur in the aftermath of the transaction. This is particularly true where it appears that the deal once consummated did not prove to be as fruitful as had been hoped. In that factual setting, tax advisors may focus solely on the question of whether the settlement payment (along with counsel fees) can be deducted or must be capitalized.

As important as this deduct-versus-capitalize dichotomy can be, it may lull one into thinking that the precise character of the payment is unimportant. Understandably, it can seem that a deduction is what counts most. However, other issues worth considering may present themselves for both payor and payee.

For example, a recent case from the Court of Federal Claims reminds us that characterization issues abound in litigation. The case arose out of a short-form merger. Statutes enabling short-form mergers are designed expressly to avoid disputes. In this case, though, the dispute that arose was about the fairness of the transaction, and then later about taxes.

In *Colorcon Inc.*, FedCl, 2013-1 USTC ¶50,310 (2013), Colorcon started corporate life as

Berwind Pharmaceutical Services Incorporated. It had made a payment to the David Berwind Trust, a minority shareholder, to settle two lawsuits related to its 1999 short-form merger. Under the applicable Pennsylvania short-form merger statute, a parent can eliminate minority shareholder interests.

Any disaffected minority shareholders generally have no right to obtain an injunction preventing the merger unless they can show fraud or fundamental unfairness. The Berwind Trust sued for a statutory appraisal of its Berwind Pharmaceutical shares. It also prayed for damages for claimed breaches of fiduciary duty. The Berwind Trust even sought an injunction against the merger and a declaration it was void.

The litigation eventually settled, and the settlement agreement required Colorcon to pay the Berwind Trust $191 million in 2002. Colorcon paid the amount in 2002 and capitalized the majority of the payment as an acquisition cost. It did, however, deduct the imputed interest portion of the settlement payment on its 2002 return.

The IRS challenged the deduction, claiming that the dispute between Colorcon and its former shareholder arose out of a redemption. According to the IRS, there should be no interest deduction in that context.

Imputed Interest

Tax advisors and business people alike can understand the broad theory of imputed interest. Imputed interest is part of our common understanding that money paid over time has either an implicit or explicit interest component. The tax law gives form and function to this notion.

In general, when property is sold *via* a deferred payment arrangement that provides for no interest or inadequate interest, interest is attributed. A portion of each payment under the contract is considered to consist of a portion of the total imputed interest. The seller must include the unstated interest amount in income as interest. [Internal Revenue Code Section ("Code Sec.") 483(a); Reg. §1.483-2(a)(1).]

In *Colorcon*, the IRS argued that the company had no unconditional and legally enforceable obligation to pay the former shareholder the principal sum of any "indebtedness" under Code Sec. 163. The IRS also argued that since Colorcon did not have a contract to purchase Berwind Pharmaceutical stock from the Berwind Trust, Code Sec. 483 also did not apply.

Rather than contesting the adjustment in Tax Court, Colorcon paid the tax and penalties the IRS had asserted and sued for a refund. The first question before the court was whether a short-form merger (which after all had been the subject of a suit for rescission) should be treated as consummated as of the date of the merger for purposes of Code Sec. 483. The alternative was to treat the deal as consummated on the date the suit for rescission was settled.

The second question was whether the settlement payment resolved Berwind Pharmaceutical's obligation to pay the fair value of the Berwind Pharmaceutical shares held by the Berwind Trust. However, was there was a genuine dispute as to how the $191 million settlement payment should be allocated in the consolidated suits?

Origin of the Claim

Colorcon argued that it was required to impute interest on the settlement payment. This requirement followed from the fact that the short-form merger amounted to a contract for a sale or exchange, Colorcon contended. Colorcon found support in *L.F. Jeffers,* CtCls, 77-1 USTC ¶9421, 556 F2d 986 (1977), in which the Court of Claims treated a short-form merger as a contract for the sale of property.

In addition, Colorcon argued the relevance of applicable Pennsylvania law. That law made it clear that the merger was effective upon the filing of the articles of merger. The articles even stated expressly that they would be effective upon filing on December 16, 1999.

At that point, claimed Colorcon, the Berwind Trust had an unconditional right to be paid either the consideration offered by Berwind Pharmaceutical or the amount determined by a court under state's dissenters' rights. With the obligation to satisfy dissenters' rights at that point, Colorcon claimed that it was required to impute interest on the settlement payment. The payment was plainly made more than one year after the redemption of the Berwind Trust's shares.

Surely, that meant Code Sec. 483 was triggered, Colorcon argued. However, the IRS

remained unconvinced. The IRS argued that the 2002 settlement agreement obviated Code Sec. 483. The IRS claimed that the settlement agreement *itself* superseded any payment obligation Colorcon may have had to pay for the Berwind Pharmaceutical shares held by the Berwind Trust.

Indeed, the IRS pointed to the fact that the 1999 merger was challenged. Of course, that challenge did not proceed to final judgment. It settled. Given the settlement, the IRS claimed that the court was required to treat the Berwind Trust's claim for rescission as if it had been granted. [For this proposition, the IRS relied on *Lyeth v. Hoey*, SCt, 38-2 USTC ¶9602, 305 US 188 (1938).]

In short, the IRS claimed that there should be no question on characterization here. The $191 million payment was consideration for the 2002 settlement agreement, not for the 1999 merger.

Code Sec. 483 Applied

Despite the IRS arguments, the court agreed with Colorcon that Code Sec. 483's imputed interest provisions applied. The court ruled that the company had correctly deducted imputed interest on its deferred $191 million payment. Part of the $191 million settlement was paid in lieu of the Berwind Trust's shares that were redeemed by Berwind Pharmaceutical.

The court specifically rejected the notion that the fact that the merger was challenged did not mean that the deal was rescinded. The payment was made by Berwind Pharmaceutical solely in lieu of the stock value the Berwind Trust had before the merger.

Colorcon concerns an interest deduction, and Colorcon's arguments that interest had to be imputed on the payment were vindicated. The decision is one more in a long line of cases suggesting that where there are legal disputes, one must look to the origin of the claim. That inquiry can seem particularly elusive in the context of corporate transactions.

From Interest Deductions to Boot

Consider the Ninth Circuit's decision in *Tribune Publishing Co.*, CA-9, 88-1 USTC ¶9125, 836 F2d 1176 (1988). There, the disputed items arose long after a corporate reorganization was completed. After protracted litigation involving alleged securities fraud relating to the transaction, there were eventually settlement proceeds received to conclude the securities fraud litigation.

It may sound counter-intuitive to have a party to a reorganization arguing *for* boot treatment. Boot, after all, is usually undesirable. But here, the taxpayer contended that boot treatment was appropriate.

The taxpayer argued this point so that it could claim the dividends-received deduction. The government, on the other hand, argued that the settlement proceeds were not triggered by the reorganization at all. Rather, the IRS argued, this was simply a payment made to settle a lawsuit. That meant boot treatment was inappropriate.

The litigation arose out of a merger between Boise Cascade and West Tacoma Newsprint Co. The parties settled the securities fraud litigation eight years after the merger. Under the settlement, the plaintiff received $451,000 in cash from Boise Cascade, as well as Boise Cascade's promise of discounts on newsprint to be purchased at a later time.

The plaintiff received these newsprint discounts over the next several years. It reported a portion of the cash settlement as a dividend, and it treated the bulk of the cash as a nontaxable return of basis.

Fine Print

However, the plaintiff also reduced its basis in the subsequent years by the amount of newsprint discounts. The government disagreed and assessed a deficiency. Both the IRS and the taxpayer agreed that the underlying claim in the securities fraud litigation was related to the market value of the Boise Cascade stock the taxpayer received in the reorganization.

Indeed, that value had been inflated because of Boise Cascade's failure to disclose material facts. The IRS and the taxpayer also agreed that the purpose of the fraud action was to recoup the difference between the actual value of the stock the taxpayer received and the price it effectively paid for the stock. But then came the disagreement.

The IRS and the taxpayer disagreed about the event that ultimately resulted in the payments. The taxpayer viewed the transaction as if it had received not only Boise Cascade stock in

exchange for its stock, but also the $451,000 in cash and the newsprint discounts as part of the same exchange. Recall that the underlying transaction was a reorganization under Code Sec. 368(a)(1)(A). As such, the taxpayer contended that the cash and discounts were boot.

In contrast, the IRS argued that the amounts received in settlement of the lawsuit could not be boot because they were not received pursuant to the plan of reorganization. The IRS contended they were received pursuant to the settlement agreement, not the merger agreement. Ultimately, the question was: In lieu of what were the damages awarded?

Reasons for Payments

Numerous cases can be cited for the pivotal nature of the origin of the claim doctrine. [One of the leading cases is *Raytheon Prod. Corp.*, CA-1, 44-2 USTC ¶9424, 144 F2d 110 (1944).] In *Tribune,* the Ninth Circuit said that the settlement proceeds and discounts were clearly received by the taxpayer in lieu of additional consideration that it *would have received* in the reorganization. The taxpayer would have received this additional consideration in the original transaction had the fraud not taken place.

This is a kind of but-for causation. In effect, the cash and newsprint discounts were treated as if they had been received as part of the original transaction. Accordingly, they were taxable as boot.

Conclusion

In corporate transactions as in other contexts, one must consider why a payment is being made. In payments that terminate litigation, the reasons for a payment may seem more straightforward than most payments. In some cases, one might conclude that the payment is being made so business can continue, so a major supplier will go back to filling orders, as a pure public relations move, *etc.*

Yet the tax cases are consistent in requiring a historical analysis of the payment by reference to the origin and nature of the claim. That inquiry may hurt or help the IRS, and may hurt or help the taxpayer. But even in corporate acquisitions and dispositions, don't fail to consider it.

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