Imputed Interest in Legal Settlements

By Robert W. Wood

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Wood argues that even in corporate acquisitions and dispositions, consideration should be given to why a payment is made, because as a recent case from the Court of Federal Claims demonstrates, there may be an interest element that is not immediately obvious.

Companies of every size routinely face litigation and resolve it. Litigation arises in diverse areas, including labor and employment, contracts, intellectual property, government investigations, environmental disputes, and shareholder conflicts. The list is almost endless.

For companies that engage in mergers and acquisitions activity, litigation can be pursued by a party, shareholders, competitors, or the government. Litigation on fairness, terms, or competing offers can occur before a transaction. Litigation can also arise in the aftermath of a transaction, particularly when it appears that the deal, once consummated, did not prove to be as fruitful as had been hoped.

In the latter setting, tax advisers may focus solely on whether the settlement payment (along with counsel fees) can be deducted or must be capitalized. It might seem like an immediate deduction is what counts most. However, other tax issues could be present for the payer and payee.

For example, *Colorcon Inc. v. United States*,[1] a recent case from the Court of Federal Claims involving a short-form merger, reminds us that characterization issues abound in litigation and many go beyond the deduction or capitalization question. Colorcon Inc. started corporate life as Berwind Pharmaceutical Services Inc. The company had made a payment to the David Berwind Trust, a minority shareholder, to settle two lawsuits stemming from the parent company's 1999 short-form merger.

Under the applicable Pennsylvania short-form merger statute, a parent company can eliminate minority shareholder interests. Any disaffected minority shareholders generally do not have the right to obtain an injunction preventing the merger unless they can show fraud or fundamental unfairness. Nevertheless, valuation disputes do occur.

In this case, the Berwind Trust sued for a statutory appraisal of its Berwind Pharmaceutical shares. It also sought damages for breaches of fiduciary duty. The trust even requested an injunction against the merger and a declaration that it was void, although it seemed clear that its claims were unlikely to bear fruit.

The parties eventually settled, and the settlement agreement required Colorcon to pay the Berwind Trust $191 million in 2002. Colorcon paid the amount and capitalized most of the payment as an acquisition cost. However, it deducted 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. In the Service's view, the payment was for the settlement of a lawsuit and there was no note or other obligation on which interest could run. Thus, the IRS found that no interest deduction was allowed.

Imputed Interest

Tax advisers and business people alike can comprehend the broad theory of imputed interest. It 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.

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[1] No. 09-594 (Fed. Cl. Apr. 30, 2013).

In general, when property is sold via a deferred payment arrangement that provides for no or inadequate interest, the principal is worth less. Also, the tax law says interest is attributed — that is, part 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.[2]

In *Colorcon*, the IRS argued that the company did not have an unconditional and legally enforceable obligation to pay the former shareholder the principal sum of any indebtedness under section 163. The IRS also asserted that because Colorcon did not have a contract to purchase Berwind Pharmaceutical stock from the Berwind Trust, section 483 did not apply. Colorcon paid the tax and penalties assessed by the IRS and sued for a refund.

The first question before the court was whether a short-form merger (which had been the subject of an earlier suit for rescission) should be treated as consummated as of the date of the merger for purposes of section 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 its shares held by the Berwind Trust. Moreover, there was a genuine dispute as to how the $191 million settlement payment should be allocated.

Origin of the Claim

Colorcon argued that it was *required* to impute interest on the settlement payment. After all, the short-form merger was contracted for a sale or exchange, it contended. Colorcon found support in *Jeffers v. United States*.[3] There, the Court of Claims treated a short-form merger as a contract for the sale of property, which over time meant imputed interest.

Moreover, Colorcon asserted the relevance of an applicable Pennsylvania law. That law made it clear that the merger was effective when the articles of merger were filed. The articles even stated that they would be effective when filed on December 16, 1999. Colorcon claimed that at that point, the Berwind Trust had an unconditional right to be paid.

The amount may not have been set. It would be either the consideration offered by Berwind Pharmaceutical or the amount determined by a court under state dissenters' rights. Given the obligation to satisfy the dissenters' rights, Colorcon reasoned 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 section 483 was triggered, Colorcon argued.

Unconvinced, the IRS contended that the 2002 settlement agreement obviated section 483 and that the agreement *itself* superseded any payment obligation Colorcon may have had for the Berwind Pharmaceutical shares held by the Berwind Trust. The IRS noted that the 1999 merger was challenged in court.

Because the case settled, however, the IRS insisted that the court was required to treat the Berwind Trust's claim for rescission as if it had been granted.[4] In short, the Service maintained that there should be no question about characterization.

According to the IRS, the $191 million payment was consideration for the 2002 settlement agreement, not for the 1999 merger. It is not unreasonable to come to differing conclusions in cases focusing on the origin of a claim, but the court did not believe this was a close one.

Section 483 Applied

Despite the arguments of the IRS, the court agreed with Colorcon that the imputed interest provisions of section 483 applied. The court held 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 rejected the notion that because the merger was challenged, the transaction was rescinded. The payment was made by Berwind Pharmaceutical solely to replace the value of the stock that the Berwind Trust owned before the merger. In short, Colorcon's arguments were vindicated.

From Interest Deductions to Boot

The *Colorcon* decision is one of a long line of cases suggesting that the resolution of legal disputes depends on the origin of the claim. That analysis can seem particularly difficult in a corporate transaction. Consider the Ninth Circuit's decision in *Tribune Publishing Co. v. United States*.[5] The disputed items arose long after a corporate reorganization was completed. After protracted litigation involving alleged securities fraud concerning the transaction, settlement proceeds were eventually received to conclude the lawsuit.

It may seem counterintuitive to have a party to a reorganization arguing *for* boot treatment. Boot, after all, is usually undesirable. However, in *Tribune*

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[2]Section 483(a); reg. section 1.483-2(a)(1).

[3]556 F.2d 986 (Ct. Cl. 1977).

[4]The IRS relied on *Lyeth v. Hoey*, 305 U.S. 188 (1938), for this proposition.

[5]836 F.2d 1176 (9th Cir. 1988).

Publishing, the taxpayer contended that boot treatment was appropriate. The taxpayer argued this point so it could claim the dividends received deduction. The government, on the other hand, asserted that the settlement proceeds were not triggered by the reorganization. The IRS instead argued that it 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. After settling the securities fraud litigation eight years after the merger, the plaintiff received $451,000 in cash from Boise Cascade, as well as Boise Cascade's promise of discounts on newsprint to be purchased in the future. The plaintiff received the newsprint discounts over the next several years. It reported a portion of the cash settlement as a dividend, treating the bulk of the proceeds as a nontaxable return of basis.

The Fine Print

However, the plaintiff also reduced its basis in subsequent years by the amount of newsprint discounts. The government disagreed and assessed a deficiency. Both the IRS and taxpayer agreed that the underlying claim in the securities fraud litigation was for the market value of the Boise Cascade stock the taxpayer received in the reorganization. That value had been inflated because of Boise Cascade's failure to disclose material facts.

The IRS and 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. Nevertheless, the IRS and 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 own stock, but also the $451,000 in cash and the newsprint discounts as part of the same exchange. Because the underlying transaction was a reorganization under section 368(a)(1)(A), 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 under the plan of reorganization. The IRS maintained that these amounts were received under the settlement agreement, not the merger agreement. The question was, ultimately, in lieu of what were the damages awarded?

Reasons for Payments

Numerous cases can be cited regarding the pivotal nature of the origin of the claim doctrine.[6] In *Tribune Publishing*, the Ninth Circuit said the taxpayer received the settlement proceeds and discounts in lieu of additional consideration it *would have received* in the reorganization 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.

Is Interest Special?

Is interest a particularly immutable category of payments? In litigation, an award of interest is usually a matter less of discretion than of compliance with a pertinent statute. Statutes can award prejudgment or post-judgment interest, and sometimes both can be involved. Tax issues raised by the allocation of interest are commonly discussed when cases are resolved during or after an appeal.

The leading case dealing with prejudgment interest is *Kovacs v. Commissioner*,[7] which involved a wrongful death claim. The interest portion of the award did not constitute excludable damages under section 104. Other cases have resulted in similar findings.[8] In *Brabson v. United States*,[9] the Tenth Circuit held that prejudgment interest was awarded for the time value of money and therefore could not be tax free.

In *Rozpad v. Commissioner*,[10] the IRS argued that a portion of unallocated tort settlements reached on appeal constituted taxable prejudgment interest. The Tax Court did not require much convincing to agree, even though the settlement agreements said none of the settlements represented interest. The First Circuit was also not persuaded that a no interest stipulation was effective.

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[6]One of the leading cases is *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944).

[7]100 T.C. 124 (1993), *aff'd*, 25 F.3d 1048 (6th Cir. 1994).

[8]*See Aames v. Commissioner*, 94 T.C. 189 (1990) (involving a stated interest element that was held to be taxable on a personal injury award); *see also Pagliarulo v. Commissioner*, T.C. Memo. 1994-506 (interest was held to be taxable on a workers' compensation award); and *Crews v. Commissioner*, T.C. Memo. 1994-64, *aff'd in part, rev'd in part, remanded*, 94 F.3d 523 (9th Cir. 1996) (involving the question whether attorney fees allocable to prejudgment interest were deductible by the payer).

[9]73 F.3d 1040 (10th Cir. 1996).

[10]154 F.3d 1 (1st Cir. 1998).

Can an express award of interest be ameliorated by a settlement agreement?[11] The *Rozpad* decision suggests that merely stipulating that there is no interest will be insufficient. Rather, it would seem to invite the IRS to invoke the full amount of the interest awarded or, at least, prorate the interest initially awarded in proportion to the other elements of the recovery. There can be a big difference between a disclaimer of any interest and a compromise of some of it.

The IRS and courts could be persuaded to respect a stipulation of a much smaller portion of the award being designated as interest. After all, many elements of a case are frequently compromised on appeal. If the parties agreed on a more moderate amount of interest, such as prejudgment interest, from a specified date forward, it would be much more difficult for the IRS to second-guess the stipulation.

Many cases involving settlements on appeal show that failing to say anything about interest likely will result in a pro rata allocation. In *Woods v. Commissioner*,[12] the Tax Court held that the IRS correctly divided the recovery into its disparate damages and prejudgment interest components. Similarly, in *Forest v. Commissioner*,[13] the court sustained the Service's determination that the plaintiff was taxable on interest as part of the settlement. It reasoned that the verdict awarded prejudgment interest to the plaintiff, so a share of the recovery had to be interest.

Likewise, in *Delaney v. Commissioner*,[14] the Tax Court upheld the proration by the IRS to determine what portion of the settlement represented interest. In *McCann v. Commissioner*,[15] the Fifth Circuit affirmed the Tax Court and held that part of a settlement from a medical malpractice suit was taxable interest. Although the settlement agreement ignored the question of interest, the check noted that $400,000 was for damages and $439,000 was for interest.

[11]*See* Robert W. Wood, "Should Prejudgment Interest Be Taxable?" *Tax Notes*, Feb. 1, 1999, p. 719; and William L. Raby, "When Interest Is Not Interest," *Tax Notes*, Oct. 10, 1994, p. 229.

[12]T.C. Memo. 1998-435.

[13]T.C. Memo. 1995-377, *aff'd without published op.*, 104 F.3d 348 (1st Cir. 1996).

[14]T.C. Memo. 1995-378, *aff'd*, 99 F.3d 20 (1st Cir. 1996); *see also Woods*, *supra* note 12; and Wood, "Interest Characterization in Settlement Agreements," *Tax Notes*, Mar. 10, 1997, p. 1337.

[15]87 Fed. Appx. 359 (5th Cir. 2004), *aff'g* T.C. Memo. 2003-36; *see also High v. Commissioner*, T.C. Summ. Op. 2011-36.

Despite these authorities, taxpayers can sometimes beat the numbers, even with interest. In *McShane v. Commissioner*,[16] the IRS argued that a portion of the settlement of an action for injuries received in a gas explosion constituted interest. The Tax Court concluded that the payments did not include interest. The court was persuaded that: (1) the agreement provided that the settlement was to be paid without costs and interest; (2) the intentions of all parties as stated by their attorneys were consistent with the payment of no costs or interest; and (3) the taxpayers and attorneys uniformly testified that the tax consequences of the settlements were never considered in the negotiations and that instead, the settlement was based on the risks each party faced in continuing the appeal.

It appears that the Tax Court is particularly inflexible when it comes to the interest allocation issues of settlements, usually ruling in favor of the IRS. Nonetheless, if the settlement agreement contains an express and reasoned allocation of interest, and not simply a no interest clause, the IRS or Tax Court may accept it.

Conclusion

It is important to consider why a payment is made in corporate transactions. Often, there can be multiple reasons for a payment, on which the payer and payee may not agree. The reasons for payments that terminate litigation may seem more straightforward. Even so, perceptions and reasons can vary materially.

In some cases, one could conclude that the payment is made so business can continue. It could be made so a major supplier will go back to filling orders. The payment could be a pure public relations move, because a CEO is retiring, or a merger is about to be announced. That there are many such catalysts for payment does not necessarily mean each one alters the character of the payment.

Tax cases are consistent in requiring a historical analysis of the payment by reference to the origin and nature of the claim. That inquiry can hurt or help the IRS. Likewise, it can hurt or help the taxpayer. However, even in corporate acquisitions and dispositions one should not fail to consider it. Moreover, as *Colorcon* demonstrates, there may be an interest element present — whether interest income or an interest deduction — in ways that are not obvious.

[16]T.C. Memo. 1987-151.