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Shareholder Settlements: Deductions, Character and Imputed Interest

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Many companies of all sizes routinely face litigation and eventually resolve it. Although this occurs in many contexts, M&A TAX REPORT readers may focus on litigation surrounding sale and acquisition activity. In that factual setting, tax advisors for the defendant entity may focus solely on whether the settlement payment (along with counsel fees) can be deducted or must be capitalized. But that can be shortsighted.

The deduct-versus-capitalize dichotomy can lull one into thinking that the precise character of the payment is unimportant as long as it can be deducted. However, there are other issues for both payor and payee worth considering. For example, a recent case from the U.S. Court of Federal Claims makes clear that characterization issues abound in litigation, and that these issues include interest. The case arose out of a short-form merger.

In *Colorcon, Inc.*, 2013 U.S. Claims Lexis 347 (Ct. Cl. 2013), Colorcon (formerly known as Berwind Pharmaceutical Services Incorporated (BPSI)) made a payment to its minority shareholder, the David Berwind Trust (DB Trust), to settle two lawsuits related to a short-form merger in 1999. Under the applicable Pennsylvania short-form merger statute, a parent can eliminate minority shareholder interests. Disaffected minority shareholders generally have no right to obtain an injunction against the merger unless they can show fraud or fundamental unfairness.

In the lawsuits, the DB Trust sought a statutory appraisal of its BPSI shares and damages for alleged breaches of fiduciary duty. The DB Trust also sought an injunction against the merger and a declaration that it was void. The Settlement Agreement called for Colorcon to pay the DB Trust $191 million in 2002, which it did.

On its 2002 tax return, Colorcon deducted the imputed interest from

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the settlement payment. The IRS challenged the deduction, contending that it was not deductible. The IRS claimed that the dispute between Colorcon and its former shareholders arose out of a redemption so there was simply no imputed interest element.

Code Sec. 483 Basics

If property is sold under certain deferred payment arrangements that provide for inadequate or no interest, interest is attributed. The impact is spread over time. 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).]

The IRS position was that Colorcon did not have an unconditional and legally enforceable obligation to pay the former shareholders a principal sum that could be considered "indebtedness," under Code Sec. 163. The IRS also argued that since Colorcon did not have a contract to purchase BPSI stock from the DB Trust, Code Sec. 483 simply did not apply. Colorcon paid the tax and penalty and sued for a refund.

The questions were two-fold. First, should a short-form merger subject to a suit for rescission be treated as consummated as of the date of the merger for Code Sec. 483 purposes? The alternative was to treat it as consummated on the date the suit for rescission was settled.

Second, it seemed clear that the settlement payment resolved BPSI's obligation to pay the fair market value of the DB Trust's BPSI shares following the merger. However, was there 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 because the short-form merger constituted a sale or exchange under contract. [*See Jeffers*, CtCls, 536 F2d 986 (1977), in which the Court of Claims treated a short-form merger as a contract for the sale of property.] Furthermore, under Pennsylvania law, the merger was effective upon the filing of the articles of merger.

Those articles expressly stated that they would be effective upon filing on December 16, 1999. That gave the DB Trust an unconditional right to be paid *either* the consideration offered by BPSI *or* the amount determined by a court under state dissenters' rights. Colorcon was required to impute interest on the settlement payment, it claimed, because the $191 million was paid by Colorcon to satisfy the DB Trust's dissenters' rights.

Of course, the payment was made more than one year after the redemption of the DB Trust's shares. Colorcon said that meant Code Sec. 483 was triggered. Nevertheless, the IRS argued that the 2002 settlement agreement obviated Code Sec. 483 by *superseding* any payment obligation of Colorcon for the DB Trust's shares in BPSI under the 1999 merger.

After all, asserted the IRS, the 1999 merger was challenged. The parties settled, so the IRS

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claimed the court had to treat the DB Trust's claim for rescission as if it had been granted. [*See M.L. Lyeth v. Hoey, SCt*, 38-2 USTC ¶9602, 305 US 188 (1938)] That made the $191 million payment consideration for the 2002 settlement agreement, not for the 1999 merger.

Code Sec. 483 Applied

Despite the IRS's arguments, the court agreed that Colorcon correctly deducted the imputed interest on its deferred $191 million payment. Part of the $191 million settlement was paid in lieu of the DB Trust's shares redeemed by BPSI through the 1999 merger. The mere fact that the validity of the merger was challenged did not mean the deal was rescinded, said the court. The payment was made by BPSI solely in lieu of the value of the BPSI stock held by the DB Trust prior to the 1999 short-form merger.

Securities Fraud

If this imputed interest case sounds like an outlier, it isn't. Consider the extent to which the underlying transaction, even if litigated, remains controlling. A good example is the Ninth Circuit's decision in *Tribune Publishing Co.*, CA-9, 88-1 USTC ¶9125, 836 F2d 1176 (1988), which illustrates the pervasiveness of the origin of the claim test,

In that case, the disputed items arose long after the reorganization was completed. For settlement proceeds received as a result of securities fraud litigation, the taxpayer contended that boot treatment was appropriate. The taxpayer argued this point so that it could claim the dividends-received deduction.

The government contended that the settlement proceeds were not triggered by the reorganization. Rather, the IRS argued, this was just a payment to settle a lawsuit, and 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 at a later date. 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 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 fair 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. Because the underlying transaction was a reorganization under Code Sec. 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 pursuant to the plan of reorganization. The IRS asserted they were received pursuant to the settlement agreement, not the merger agreement. Ultimately, the question was: In lieu of what were the damages awarded?

Last Word

Numerous cases can be cited for the importance of this question, including *Raytheon Production Corp.*, CA-1, 44-2 USTC ¶9424, 144 F2d 110 (1944). Here, the court said, the settlement proceeds and discounts were clearly received by the taxpayer in lieu of additional consideration that it would have received in the reorganization. It would have received this consideration had the fraud not taken place.

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