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SETTLEMENT OF MINORITY SHAREHOLDER'S CLAIM RESULTED IN UNSTATED INTEREST UNDER CODE SEC. 483

Colorcon, Inc., (Ct Fed Cl 4/30/2013) 111 AFTR 2d ¶ 2013-700

In a summary judgment, the U.S. Court of Federal Claims has concluded that a corporation correctly treated part of its settlement payment to a minority shareholder in a dispute arising from a merger under State law as imputed interest under Code Sec. 483. The corporation was entitled to an interest deduction and a refund of interest and penalties assessed by IRS.

Background. If property is sold under certain deferred payment arrangements that provide for either no interest, or interest at a rate less than the prescribed rate in effect at the time of sale, interest is imputed in the contract price. A portion of each payment received under the contract is considered to consist of a portion of the total unstated interest so imputed. The seller must include the unstated interest amount in income as interest. (Code Sec. 483(a), Reg. § 1.483-2(a)(1))

Specifically, Code Sec. 483 requires taxpayers to impute interest according to a statutory formula for payments on account of the sale or exchange of property which constitutes part of or all of the sales price and which is due more than six months after the date of such sale or exchange under a contract (A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and (B) under which there is total unstated interest.

Facts. Colorcon, Inc. (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 consolidated lawsuits related to its '99 short-form merger under Pennsylvania law. Under the short-form merger statute, a parent corporation can eliminate the minority shareholders' interests, and disaffected minority shareholders generally have no right to obtain an injunction against the merger without showing fraud or fundamental unfairness. (15 Pa. C.S. §1105)

Under the settlement agreement, Colorcon paid the DB Trust $191 million in 2002. In the settled lawsuits, the DB Trust had sought, among other things, a statutory appraisal for the fair value of the BPSI shares, as well as damages stemming from alleged breaches of fiduciary duties by various BPSI directors. The DB Trust had also sought an injunction against the short-form merger and a declaration that the short-form merger was void.

On its return, Colorcon claimed an interest deduction for the amount of imputed interest that resulted from the settlement payment.

IRS challenged the deduction, issuing a notice of proposed adjustment to Colorcon contending that it wasn't entitled to deduct interest on the 2002 payment because the dispute between Colorcon and its former shareholders arose out of a redemption transaction. It argued that Colorcon didn't have an unconditional and legally enforceable obligation to pay the former shareholders a principal sum that could be considered "indebtedness," under Code Sec. 163. Further, it claimed that since Colorcon didn't have a contract to purchase BPSI stock from the DB Trust, Code Sec. 483 wasn't applicable.

Colorcon paid and sought a refund of the federal income taxes and related penalty.

The issues. The Court determined that there were two issues to be decided: (1) whether a short-form merger that was subject to a suit for rescission was, for Code Sec. 483 purposes, to be treated as having been consummated as of the date of the merger—rather than as of the date when the suit for rescission was settled or a final judgment was entered; and (2) if the settlement payment was treated as resolving BPSI's obligation to pay the fair value of the DB Trust's BPSI shares following the short-form merger, whether there was a genuine dispute as to how the $191 million settlement payment was to be allocated in the consolidated suits.

The parties' positions. Colorcon asserted that it was required to impute interest on the settlement payment because the '99 short-form merger constituted a sale or exchange under a contract for purposes of Code Sec. 483. It relied on Jeffers v. U.S., (Ct. Cl. 1977) 40 AFTR 2d 77-5026, in which the Court of Claims treated a short-form merger as a contract for the sale of property. Colorcon further argued that under Pennsylvania law, the merger was effective upon the filing of the articles of merger (which expressly stated that they would be effective upon filing on Dec. 16, '99). Thus, the DB Trust, as of Dec. 16, '99, had an unconditional right to be paid either the consideration offered by BPSI or the amount determined by a court under the State's dissenters' rights provisions. Colorcon claimed that it was required to impute interest on the settlement payment because the $191 million was paid by Colorcon to satisfy the DB Trust's dissenters rights, and the payment was made more than one year after the redemption of the DB Trust's shares.

On the other hand, IRS argued that Code Sec. 483 wasn't applicable in this case because the 2002 settlement agreement superseded any payment obligation of Colorcon for the DB Trust shares in BPSI under the '99 merger. Relying on Lyeth v. Hoey, (Sup Ct 1938) 21 AFTR 986, IRS contended that because the '99 merger was challenged, and the parties settled the litigation prior to a final judgment, the Court must treat the DB Trust's claim for rescission in the consolidated litigation as if it had been granted. Accordingly, it argued that the $191 million payment couldn't have been made to satisfy a payment obligation stemming from the merger in '99, but rather was consideration as part of a settlement agreement that was consummated in 2002.

Court's conclusion. The Court found that Colorcon had showed that it correctly imputed interest on the deferred $191 million payment.

The Court found, as a matter of law, that at least part of the $191 million settlement was paid in lieu of DB Trust's shares redeemed by BPSI through the '99 short-form merger. The Court found that IRS's reliance on **Lyeth** was misplaced and rejected IRS's contention that the '99 short-form merger had to be deemed rescinded, for Code Sec. 483 purposes, because the validity of the merger was challenged.

The Court couldn't ignore the uncontroverted facts that: (1) the DB Trust sought to receive the fair value of its shares by invoking its dissenters' rights under Pennsylvania corporate law provisions; (2)

the DB Trust obtained an appraisal of the '99 value of its interest in BPSI; and (3) BPSI subsequently filed a statutory appraisal action that was removed and consolidated with the other litigation.

Further, the Court rejected IRS's unsupported assertion that there was a genuine dispute as to how the $191 million payment should be apportioned among the DB Trust's various claims in the consolidated litigation. The uncontroverted facts established that the payment was made by BPSI solely in lieu of the value of the BPSI stock held by the DB Trust prior to the '99 short-form merger's effectuation.

References: For imputed interest under Code Sec. 483, see FTC 2d/FIN ¶ J-3951 ; United States Tax Reporter ¶ 4834.0 ; TaxDesk ¶ 152,010 ; TG ¶ 12526 .