



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (COMMUNICATIONS, TECHNOLOGY,
AND MEDIA: OAKLAND)
CC:LM:CTM

FROM: Senior Technical Reviewer
CC:INTL:BR3

SUBJECT: Prejudgment Interest and Temp. Treas. Reg. §1.861-9T(b)

This Chief Counsel Advice responds to your memorandum dated December 14, 2001, and supplements the advice previously issued in this case on May 13, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

- Corporation A =
- Corporation B =
- Corporation C =

- x =

- Date 1 =
- Date 2 =
- Date 3 =

- Year 4 =

- Date 5 =
- Date 6 =

- Taxpayer =
- Taxpayer Subsidiary =
- \$k =
- \$m =

POSTF-102026-02

\$n =

ISSUE

Whether Taxpayer properly characterized and sourced the prejudgment interest portion of a settlement payment as damages rather than as interest or an interest equivalent under Temp. Treas. Reg. §1.861-9T.

CONCLUSION

Taxpayer's characterization and sourcing of the prejudgment interest portion of the settlement payment as damages is correct. The prejudgment interest portion of the payment does not constitute interest or an interest equivalent under Temp. Treas. Reg. §1.861-9T.

FACTS

On Date 1, Corporation A, a large multinational corporation, entered into a merger agreement with Corporation B, another large multinational corporation. In reliance on the merger agreement, Corporation B reacquired x shares of its stock held by another corporation. Subsequently, on Date 2, Corporation A unilaterally cancelled the merger agreement.

On Date 3, Corporation B filed a lawsuit against Corporation A in state court seeking damages for various claims, including breach of contract. Corporation B sought damages equal to the amount it expended to reacquire its shares in anticipation of the merger. In Year 4, Taxpayer Subsidiary (a wholly owned subsidiary of Taxpayer) acquired all of the outstanding stock of Corporation A, after which Corporation A merged with and into Taxpayer Subsidiary. On Date 5, a jury returned a verdict in favor of Corporation B and awarded damages for breach of contract in the amount of \$k. The court also awarded prejudgment interest on the damages totaling \$m (accruing from the date of the breach to the date of the judgment), and postjudgment interest accruing from the date of judgment to the date of payment. On Date 6, Taxpayer Subsidiary and Corporation B's successor¹ entered into a settlement agreement pursuant to which Taxpayer Subsidiary paid Corporation B's successor \$n, which was the amount of the actual damages plus prejudgment and postjudgment interest.

On its consolidated federal tax return for the tax year in which Taxpayer Subsidiary paid the settlement amount, Taxpayer deducted the postjudgment interest component of that payment as interest and apportioned that amount to both foreign and U.S. source income. However, Taxpayer deducted the damages and

¹ After Corporation B filed the lawsuit, it merged with and into Corporation C. Thereafter, Corporation C acted on behalf of the former Corporation B in the litigation.

POSTF-102026-02

prejudgment interest portions of the payment and allocated and apportioned such amounts separately as amounts other than interest.

LAW AND ANALYSIS

Taxpayers determine their taxable income attributable to gross income from domestic and foreign sources by deducting the expenses, losses, and other deductions properly allocated or apportioned to that gross income, and a ratable part of any expenses, losses, and other deductions that cannot definitely be allocated to some item or class of gross income. Code sections 861(b), 862(b), and 863. Treasury regulations provide specific guidance regarding the allocation and apportionment of deductions, based on the factual relationship between those deductions and gross income. Treas. Reg. §§1.861-8 through 1.861-17. In the case of interest expense, the regulations apply the factual relationship principle for both allocation and apportionment purposes in a manner that acknowledges the fungibility of money. Temp. Treas. Reg. §1.861-9T(a). The fungibility approach recognizes that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. (There are several narrow exceptions to this general fungibility rule, none of which apply in this case.)

Section 864(e)(2) of the Code provides that all allocations and apportionments of interest expense must be made on the basis of assets rather than gross income. Temp. Treas. Reg. §1.861-9T applies only to payments that are (1) interest expenditures deductible under section 163, or (2) "interest equivalent" expenditures, to the extent deductible, that are "incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time ... if such [payment] is substantially incurred in consideration of the time value of money." Temp. Treas. Reg. §1.861-9T(a) and (b).

Temp. Treas. Reg. §1.861-9T(a): Interest Expenditures

Section 163 of the Code provides that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness". Accordingly, in order to come under the section 163 definition of deductible interest, the prejudgment interest payment must meet a two-pronged test: First, the payment must consist of "interest paid or accrued," and second, the payment must be made with respect to "indebtedness."

With respect to the predecessor provision to section 163, the Supreme Court concluded that the taxpayer in Deputy v. du Pont, 308 U.S. 488 (1939), could not deduct as interest on indebtedness the cost incurred to borrow stock used to fund an employee compensation program. Rejecting the notion that the Code could be read to authorize deductions of "effective interest," the Court looked to the ordinary business meaning of the words "interest on indebtedness." The Court stated, "In the business world 'interest on indebtedness' means compensation for the use or forbearance of money." Id. at 498. In a footnote, the Court observed that this definition makes irrelevant lines of authority where "interest" in a different context

POSTF-102026-02

has been used to describe damages or compensation for the detention or use of money or of property. *Id.* at 498 n.11. The "different context" that the Court had in mind was interest awarded in the case of court judgments.

Several courts have more directly ruled that prejudgment interest or similar amounts do not constitute interest on indebtedness. *See, e.g., Noguchi v. United States*, 992 F.2d 226 (9th Cir. 1993), *aff'g*, T.C. Memo 1991-227; *Midkiff v. Commissioner*, 96 T.C. 724 (1991); *Jordan v. Commissioner*, 60 T.C. 872 (1973), *aff'd*, 514 F.2d 1209 (8th Cir. 1975); and *Joseph W. Bettendorf*, 3 B.T.A. 378 (1926).

In *Jordan*, *supra*, the taxpayer, together with other promoters, had organized a corporation in which they acquired subscription rights. The taxpayer sold his subscription rights to a related corporation, which exercised the rights and sold the stock to the public. Claiming to have been misled, the public shareholders filed securities lawsuits against the corporation and taxpayer, as one of the incorporators. In response, the taxpayer and other promoters agreed to refund the purchase price paid for certain purchased shares and pay five percent interest from the date the shares had been purchased to the date of rescission. The taxpayer claimed that the five percent interest was deductible under section 163. The court found that the taxpayer could not deduct the additional five percent denominated as interest because there was no preexisting indebtedness on which interest could accrue, as required by section 163. In finding that indebtedness requires an existing, unconditional and legally enforceable obligation for the payment of money, the court concluded that the amount denominated as interest in the offer of rescission was merely a part of the purchase price paid by the taxpayer to acquire the stock and was not deductible interest. *Id.* at 881-882.

In *Bettendorf*, *supra*, the taxpayer was sued for failing as a fiduciary to make full and complete disclosure of facts in purchasing stock of Bettendorf Axle Company, of which taxpayer was president. The plaintiff was awarded a judgment against the taxpayer for damages. The award, as modified by the Iowa Supreme Court, included both prejudgment and postjudgment interest. The Service disallowed the taxpayer's deduction of the interest. The taxpayer argued that the prejudgment and postjudgment interest was deductible as "interest" even though the court had awarded the interest in the form of damages. As to the prejudgment interest, the court disagreed. Though it assumed that the prejudgment interest qualified as "interest" under the Code, the court opined that the interest was not deductible because it was not paid or accrued on indebtedness. The court found that there was no debtor-creditor relationship between the taxpayer and plaintiff. Rather, the court found that taxpayer was sued as a trustee and there was no debt that was due from the taxpayer to the plaintiff.

Accordingly, the prejudgment interest portion of Taxpayer Subsidiary's settlement payment does not constitute deductible interest under section 163.

POSTF-102026-02

Temp. Treas. Reg. §1.861-9T(b): Interest Equivalent Expenditures

As stated above, the interest allocation and apportionment rules apply not only to actual interest payments, but also to deductible “interest equivalent” payments incurred in a transaction in which a taxpayer secures the use of funds for a period of time. Temp. Treas. Reg. §1.861-9T(b). The regulations do not explicitly define what constitutes securing the use of funds in a transaction. However, in all of the regulatory examples illustrating the rule the taxpayer has secured the use of additional funds not already belonging to the taxpayer in a transaction² that involved either the actual borrowing of money from another party through a formally delineated loan or through the effective borrowing of money through use of a financial instrument such as a cash and carry arrangement or a prepaid swap. The examples are consistent with the clear language of Temp. Treas. Reg. §1.861-9T(b)(1), which requires that a taxpayer secure the use of funds in a transaction for a period of time in order for an expense to be considered an interest equivalent.

In this case, Taxpayer Subsidiary did not incur the prejudgment interest expense in a transaction in which it “secured the use of funds.” The prejudgment interest paid to Corporation C was paid to compensate Corporation B for the loss of the use of money due to it as damages from the time its claim accrued until judgment was entered. See West Virginia v. U.S., 479 U.S. 305 (1987). Taxpayer Subsidiary did not incur the prejudgment interest expense in a transaction in which it obtained the use of funds belonging to another as required under Temp. Treas. Reg. §1.861-9T(b)(1)(i). Rather, Taxpayer Subsidiary incurred the expense through the deferral of the payment of its own funds. Such deferral of payment does not constitute the securing of the use of funds within the meaning of Temp. Treas. Reg. §1.861-

² The funds used to pay the prejudgment interest were not acquired in a “transaction” within the meaning of Temp. Treas. Reg. §1.861-9T(b). While Taxpayer Subsidiary (or its predecessor) had use of the funds relating to the prejudgment interest for the period prior to the judgment, there was no obligation to make a payment until judgment was entered.

POSTF-102026-02

9T(b)(1)(i)³. Consequently, the prejudgment interest paid by Taxpayer Subsidiary cannot be allocated and apportioned as an interest equivalent.

The prejudgment interest is not characterized as interest under Temp. Treas. Reg. §1.861-9T since it was neither interest deductible under section 163 nor was it an interest equivalent since it was not incurred in a transaction in which it obtained the use of funds for a period of time. Accordingly, the prejudgment interest is properly characterized and sourced along with the payment for breach of contract damages, and the deduction must be allocated to all gross income and ratably apportioned among the statutory and residual groupings therein under Treas. Reg. §1.861-8(b)(5) and (c)(3).

Please call (202) 622-3850 if you have any further questions.

ANNE O'CONNELL DEVEREAUX
SENIOR TECHNICAL REVIEWER
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³ Because Taxpayer has not incurred the prejudgment interest expense in a transaction in which it secured the use of funds, it is unnecessary to discuss whether the expense was incurred substantially in consideration of the time value of money.