INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-109639-00/CC:FIP:B1

Taxpayers's Name:
Taxpayer's Address:
Taxpayer's EIN:
Tax Years:
Conference Held:

LEGEND

Taxpayer =
Year 1 =

Year 2 =

Founder =

Date 1 =

Sister 1 =
Sister 2 =

Younger Brother =
Older Brother =

Amount A =

x =
y =

Amount B =

Month 1 =
Month 2 =

Amount C =

Date 2 =
Date 3 =

Amount D =
Amount E =
Amount F =

Date 4 =

Amount G =
Amount H =

Date 5 =

Amount I =

Employee =

ISSUE

Whether Taxpayer may deduct any portion of the settlement payments made in Year 1 and Year 2 as interest expense.

CONCLUSION

Taxpayer may not deduct any portion of the settlement payments made in Year 1 and Year 2 as interest expense.

FACTS

Prior to his death, Founder owned, directly and indirectly, all of the outstanding stock of Taxpayer, a corporation. Following Founder's death, the common stock of the Taxpayer was held by a family trust.

On Date 1, the family trust distributed the common stock of Taxpayer equally to the four children of Founder. On the same day, the Taxpayer redeemed the shares of Sister 1, Sister 2 and Younger Brother. Taxpayer also separately redeemed outstanding Class A and Class B shares that were held in trust. The redemption transactions resulted in Older Brother being the sole shareholder of Taxpayer.

Pursuant to the redemption agreements, the three siblings sold their common shares to Taxpayer in return for a promise to pay Amount A in x equal, annual installments. The redemption agreements provided that a $y payment would be made upon execution, and Taxpayer would deliver an installment promissory note (Redemption Note) to each sibling for the remaining payments. The Redemption Notes provided that the annual payments were inclusive of principal and interest and could be prepaid. No stated interest was provided for in the Redemption Notes. Neither the Redemption Notes nor the redemption agreements provided for contingent payments.

Shortly after the Date 1 redemptions, Taxpayer sold one of its four subsidiary corporations to an unrelated party for Amount B, an amount that was approximately three times the present value of the total combined redemption payments that Taxpayer had agreed to pay for the common stock of the redeemed siblings. Because of questions regarding the fairness of the redemption price, Taxpayer offered to prepay the remaining installment payments owed to the siblings in return for the release of Taxpayer from any claims. Sister 2 and Younger Brother accepted this offer, but Sister 1 declined. Sister 2 and Younger Brother each executed a document that acknowledged receipt of prepayment in cancellation of their Redemption Notes and release of Taxpayer and its officers and directors from all claims and obligations, whether executory or not.

Thereafter, in Month 1, Sister 1 filed a lawsuit against Older Brother and Taxpayer in a federal district court alleging violations of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission, common law fraud and breach of fiduciary duty. The complaint generally alleged that Older Brother and Taxpayer had failed to disclose material facts and misstated others, thereby leading her to sell her shares for less than fair market value. Sister 1 sought compensatory damages of Amount C along with punitive damages against Older Brother, prejudgement interest, fees and costs. The breach of fiduciary duty claim was brought solely against Older Brother.

In Month 2, Sister 2 filed a lawsuit against Older Brother and Taxpayer making much the same claims (but not including a common law fraud claim) as Sister 1 and seeking compensatory damages of Amount C together with prejudgement interest, fees and costs. Again, the breach of fiduciary duty claim was made against Older Brother only.

In both suits, the defendants answered the complaints by denying the principal allegations and asserting affirmative defenses and counterclaims. Among other things, the defendants responded that the complaints were barred by the doctrine of accord and satisfaction. The defendants also asserted that Sisters' only remedy was recission because Taxpayer was not obligated to pay more for the redeemed shares than the amount it agreed to in the redemption agreements. In settlement negotiations, Taxpayer's counsel advised Sister 1 that the defendants would aggressively defend themselves at trial; Taxpayer's counsel also asserted that by litigating Sister 1 ran the risk of receiving far less than was offered in settlement or receiving nothing at all.

On Date 2, Sister 2 entered into a settlement agreement with Older Brother and Taxpayer. The agreement required the Taxpayer and Older Brother, individually and as trustee, to pay Amount D to Sister 2. The agreement released Older Brother and Taxpayer from all liability for any and all claims related to the redemption of the common stock of Sister 2 and the redemption of the Class A and Class B shares. On Date 3, Sister 1 entered into a settlement agreement with Older Brother and Taxpayer. Sister 1's agreement required Taxpayer and Older Brother, individually and as trustee, to pay Amount E to Sister 1 for a release similar to that given by Sister 2. Sister 1 was still owed Amount F on her Redemption Note at the time of the settlement. Each settlement agreement also released Older Brother from liability related to his acquisition of the family lakefront summer house.

The settlement agreements signed by Sister 1 and Sister 2 were extensive 14- and 13-page documents, respectively. Each agreement was entitled “General Release and Settlement Agreement.” The settlement agreements provided that the parties would pay their own costs. The agreements did not allocate the settlement payments in any way. Thus, there was no allocation of the payments between the two defendants nor among the claims, and there was no mention of interest. In one written settlement offer on Date 4, Sister 1 had proposed to settle for Amount G, including interest running from the date of the common stock redemption. In a subsequent written offer, Sister 1 stated that her most recent offer was based on a conservative valuation of the stock and relinquished all interest that would have accrued since the date of the redemption. (The settlement payments to Sister 1 and Sister 2 were equal to approximately 64% and 35%, respectively, of the Amount C compensatory damages that each sister sought in their initial pleadings.)

Taxpayer issued Forms 1099 to Sister 1 and Sister 2, reporting to them a portion of their respective settlement payments as interest based on the mid-term applicable federal rate for the three-month period ending in the month of the original redemption. Sister 1's Form 1099 also included interest of Amount H that Taxpayer calculated as remaining on the final payment of the Redemption Note. Shortly thereafter, Taxpayer’s counsel had telephone conversations with Sister 2's attorney regarding the issuance of the Form 1099. (The request for technical advice does not indicate what was said in those conversations.)

Taxpayer also entered settlement negotiations with Younger Brother. Younger Brother had not filed suit against Older Brother or Taxpayer. On Date 5, Taxpayer agreed to pay Younger Brother Amount I to settle potential claims. The request for technical advice states that Younger Brother did not execute a settlement agreement. Younger Brother did sign a five-sentence document entitled “Receipt and Direction.” This document does not mention the existence of a dispute or contain any language releasing Older Brother or Taxpayer from any liability. It was not signed by Older Brother or Taxpayer. The first sentence of the “Receipt and Direction” document states that Younger Brother acknowledges that he will receive Amount I “representing additional consideration” for his sale of common stock to Taxpayer. Three sentences then describe the tax consequences. They state that Amount I consists of a principal component, which would be reported by Younger Brother’s accountant (who represented Taxpayer in this matter) as long-term capital gain, and an interest component, for which Younger Brother would be issued a Form 1099. The final sentence directs that the Amount I “Redemption Proceeds” be sent to a specific account, which was established in the name of Taxpayer’s Employee, as trustee of the Younger Brother Year 2 Trust. Taxpayer calculated the portion of the payment to Younger Brother that the parties characterized as interest based on the lowest mid-term applicable federal rate for the three-month period ending on the date of the original redemption.

LAW AND ANALYSIS

Taxpayer contends that a portion of the settlement payments is deductible as interest expense. Further, Taxpayer asserts that a court would have awarded statutory prejudgement interest if a judgement had been awarded against it. Therefore, Taxpayer principally contends that a portion of the settlement payments that it made in Year 1 and Year 2 was properly treated as prejudgement statutory interest. Taxpayer further contends that such "putative" prejudgement statutory interest is deductible under § 163 of the Internal Revenue Code because it is a time value of money charge awarded for the delay in payment of damages. Taxpayer also contends that the settlement payments were additional sales proceeds that should be treated as part interest pursuant to § 483.

It is well established that the origin of the claim doctrine determines the nature and character of settlement payments and associated legal expenses. In determining whether legal expenses incurred in a divorce proceeding were personal expenses or deductible business expenses, the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963), held that the determination is made by considering the origin or character of the claim with respect to which an expense was incurred. In an often quoted passage, the origin of the claim test was described by the Tax Court in Boagni v. Comm., 59 T.C. 708, 713 (1973), as follows:

> Quite plainly, the "origin-of-the-claim" rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose. Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy. [Citations omitted]

The principal dispute between Taxpayer and its former shareholders arose out of the Date 1 redemption transactions. Because the dispute originated in a capital transaction, the settlement payments were nondeductible capital expenditures. Locke v. Comm., 568 F.2d 663 (1978); Wagner v. Comm., 78 T.C. 910 (1982); Rev. Rul. 80-119, 1980-1 C.B. 40. The issue herein is whether any portion of the settlement payments was properly deducted as interest.

Prejudgement Statutory Interest

Courts have consistently treated prejudgement statutory interest as ordinary income under § 61. Kieselbach v. Comm., 317 U.S. 399 (1942); Spangler v. Comm., 323 F.2d 913 (2nd Cir. 1963); Drayton v. United States, 801 F.2d 117 (3rd Cir. 1986); Wheeler v. Comm., 58 T.C. 459 (1972); Nichol v United States, 48 F.Supp. 662 (Ct. Cl. 1943). Section 1.61-7(a) of the Income Tax Regulations states that interest income includes the interest portion of a condemnation award. In Kieselbach, New York City acquired title to real estate owned by taxpayer by condemnation proceedings. The taxpayer treated the condemnation award together with interest received as capital gain. The Service denied capital gain treatment on the interest award, asserting instead that the interest award should be taxed as ordinary income. Without having to conclude that the award was “interest,” the Court agreed with the Service that the amount in excess of the condemnation award was compensation for failing to put the award in the hands of the taxpayer on the date the property was taken.

Statutory interest awarded for delayed payment of breach of contract and stock fraud damages has been treated as ordinary income. In Spangler, the taxpayer claimed that interest awarded in a stock fraud suit could be first recovered as a return of capital. The court disagreed. It held that the sums labeled “interest” in the judgement awarded were in lieu of ordinary income the taxpayer would have earned on sums wrongfully withheld had they been paid when due. Thus, the court treated the prejudgement interest award as ordinary income. Similarly, in Wheeler, the court held that the prejudgement interest portion of a jury award in a contract claim was compensation for the delay in receipt of damages that was taxable as ordinary income.

In the case of personal injury awards, the Tax Court has consistently held that the prejudgement interest portion of an award is not excludable under § 104 as damages received on account of personal injury. In Kovacs v. Comm., 100 T.C. 124 (1993) and Aames v. Comm., 94 T.C. 189 (1990), the Tax Court concluded that court awarded statutory interest does not constitute § 104 damages. The Aames court said, “The nature of interest is that it is paid because of delay in the receipt of funds, in this case the principal amount awarded to plaintiff and designated ‘damages’ by the Massachusetts Supreme Judicial Court. As interest, it is taxable to petitioner.” Id. at 193.

In Brabson v. U.S., 73 F.3d 1040 (10th Cir. 1996), the Court of Appeals concluded that prejudgement statutory interest was not excludable from taxable income under § 104. The Service had argued that the statutory interest (even if an element of damages) should be distinguished from damages awarded to recompense underlying personal injury. The Service further asserted that the statutory interest compensated the taxpayer for the time value of money, not directly for personal injury. In discussing the evolution of prejudgement interest awards in personal injury cases, the court said that it has only been relatively recently that such interest has been awarded. The court noted that, prior to the enactment of state laws providing for prejudgement interest, such interest was rarely available under common law. The court said, “The requirement of a liquidated sum, ‘fixed and known,’ posed the greatest obstacle towards recovery of such interest.” Id. at 1046. In finding for the Service, the court ruled that the statutory interest was awarded as compensation for the lost time value of money, not for the injury itself. Following the rule of construction that exclusions from income are construed narrowly, the court concluded that prejudgement interest was not directly received on account of personal injury under § 104. Id. at 1047.

Section 163 – Interest on Indebtedness

Section 163 permits as a deduction all interest paid or accrued within a taxable year on indebtedness.

Without indebtedness, amounts that are labeled as interest expense are not deductible interest under § 163. Under the predecessor provision to § 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 world 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 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 judgements.

Several courts have more directly ruled that prejudgement interest or similar amounts do not constitute interest on indebtedness. Noguchi v. United States, 992 F.2d 226 (9th Cir. 1993), aff'g, T.C. Memo 1991-227 and Midkiff v. Comm., 96 T.C. 724 (1991); Jordan v. Comm., 60 T.C. 872 (1973), aff'd, 514 F.2d 1209 (8th Cir. 1975); Appeal of Bettendorf, 3 B.T.A. 378 (1925). In a consolidated appeal from the Tax Court, the Ninth Circuit in Noguchi addressed whether "blight of summons" damages could be deducted as interest expense by taxpayers that had acquired their residences pursuant to condemnation proceedings under Hawaii law . That law permitted the taxpayers to acquire for fair market value the residences which they had leased. Additional "blight of summons" damages were awarded at a 5 percent per annum rate from the valuation date of the property to be acquired. Midkiff, 96 T.C. at 727. However, even after proceedings were initiated, the taxpayers were free at any point to call off their acquisitions. In affirming the Tax Court, the Ninth Circuit found that the blight of summons damages (even though calculated like interest to compensate for the delay in payment) could not be deducted as interest on indebtedness. The court stated that to be deductible under § 163, "the obligation on which interest is based must be an 'existing, unconditional, and legally enforceable obligation for the payment of a principal sum.'" Noguchi, 992 F.2d at 227. The taxpayers were found not to be unconditionally obligated because they could have backed out of the acquisitions up until the point payment was made for the lots. Id.

The Tax Court's opinion in Midkiff followed much the same analysis.[1] To permit a § 163 interest expense, the court said: "the following requirements must be met: (a) There is 'indebtedness'; (b) the indebtedness is that of petitioners; (c) the payment is of 'interest'; and (d) for cash method taxpayers, the interest is paid in the taxable year that the deduction is claimed." Id. at 734. Again, the court focused upon the absence of indebtedness, particularly the absence of an existing, unconditional and legally enforceable obligation for the payment of a principal sum. The court found that the

[1] In a settlement agreement, the parties in Midkiff characterized the blight of summons damages as interest. Id. at 731.

Midkiffs were not unconditionally obligated to pay just compensation to the lessor until they had affirmatively executed the reply to the lessor's offer, indicating intent to purchase the lot, and escrow closed on the purchase. Id. at 737.

Courts have also ruled that the portion of settlement amounts denominated as interest in securities fraud suits does not constitute deductible interest on indebtedness. In Jordan, 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 recission. The taxpayer claimed that the five percent interest was deductible under § 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 § 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 recission 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 Appeal of Bettendorf, 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 judgement against the taxpayer for damages. The award, as modified by the Iowa Supreme Court, included both prejudgement and postjudgement interest. The Service disallowed the taxpayer's deduction of the interest. The taxpayer argued that the prejudgement and postjudgement interest was deductible as "interest" even though the court had awarded the interest in the form of damages. As to the prejudgement interest, the court disagreed. Though it assumed that the prejudgement 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.[2] 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. However, the court did find that the taxpayer could deduct postjudgement interest because the taxpayer became indebted to plaintiff once a judgement had been rendered. Id. at 384-385.

A debt must be existing and unconditional to be indebtedness under § 163. In Gilman v. Comm., 53 F.2d 47 (1931), the Service disallowed the deduction of interest

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[2] In Mercil v. Comm., 24 T.C. 1150, 1153 (1955), the court said that a debtor-creditor relationship is essential to the existence of indebtedness. It further stated that, "there must be an unconditional obligation to pay, or, stated otherwise, the amount claimed as the debt must be certainly and in all events payable." Id. at 1153.

on promissory notes that the taxpayer had executed and given to his wife and children. The notes had 30-year terms and bore interest at five percent. The instruments, however, were not considered promissory notes under Iowa law because they were not unconditional. Id. at 50. In evaluating whether the obligation created indebtedness under the federal income tax law, the court said that the term "indebtedness" in the federal tax law implies an unconditional obligation to pay. The court said:

> "In order to create an indebtedness there must be an actual liability at the time, either to pay then, or at some future time. Every debt must be solvendum in praesenti, or solvendum in futuro – must be certain and in all events payable; whenever it is uncertain whether anything will ever be demandable by virtue of the contract, it cannot be called a 'debt.' While the sum of money may be payable upon a contingency, yet in such case it becomes a debt only when the contingency has happened, the term 'debt' being opposed to 'liability' when used in the sense of an inchoate or contingent debt." [Citations omitted.]

Id. at 50. The court went on to state that the notes in question were not indebtedness because they were conditional upon the payees being alive. Id.

In the present case, Taxpayer's settlement contracts with Sister 1 and Sister 2 did not treat any portion of the payment as interest. The "Receipt and Direction" document signed by Younger Brother (but not executed by Taxpayer or Older Brother) stated that a portion of the payment made by Taxpayer to Younger Brother was interest. Regardless of how the parties characterized the payments, Taxpayer could only deduct a portion of the payments as interest under § 163 if the interest was on indebtedness. Not all obligations are indebtedness, and indebtedness exists under § 163 when there is an existing, unconditional and legally enforceable obligation to pay a principal sum. Taxpayer disputed both the existence of an obligation and the amount of any liability.[3] In settlement negotiations, Taxpayer's counsel advised Sister 1 that the defendants would aggressively defend themselves at trial; Taxpayer's counsel also asserted that by litigating Sister 1 ran the risk of receiving less than was offered in settlement or might receive nothing at all. Thus, with the exception of the Redemption Note held by Sister 1, Taxpayer did not have an existing, unconditional and legally

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[3] Nor was there a fixed principal sum that was due to the siblings; each sibling ultimately settled his or her claims for different amounts. Interestingly, if Taxpayer had been indebted to each of the siblings for a fixed principal sum, then under Taxpayer's theory it could have had cancellation of indebtedness income to the extent that it was able to satisfy the indebtedness for less than the unpaid principal and interest due. In this case, the amount might be measured by the difference between the sum claimed in the siblings' lawsuits and the amount Taxpayer paid to settle the claims.

enforceable obligation to pay a principal sum that could be considered indebtedness on which interest was properly deductible.[4]

Redemption Notes Subject to OID Rules

Section 483 generally provides rules for treating as interest, in a manner consistent with the method for computing interest under § 1272(a), that portion of the payments made on the sale or exchange of property. Section 483(c) provides that the operative rules of § 483 generally apply to any payment on account of the sale or exchange of property which constitutes part 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 under which some or all of the payments are due more than one year after the date of such sale or exchange and under which there is total unstated interest. Section 483(d) provides that these rules do not apply to any debt instrument for which an issue price is determined under § 1273(b) (other than paragraph (4) thereof) or § 1274.

In the case of any debt instrument issued after July 1, 1982, § 163(e) generally permits a deduction to the issuer equal to the aggregate daily portions of the original issue discount for days during the taxable year. A debt instrument for this purpose is defined by § 1275(a)(1) to be a bond, debenture, note or certificate or other evidence of indebtedness. With certain exceptions not relevant here, § 1274(c) provides that the rules of that section apply to debt instruments given in consideration for the sale or exchange of property.

Section 483 does not apply to Taxpayer's settlement payments because they did not originate from a transaction subject to § 483. Section 483(d) excepts from its treatment those debt instruments that are covered by § 1274. The Redemption Notes were covered by § 1274 because they were debt instruments within the meaning of § 1275(a) that were issued in consideration for the sale of property (the redeemed shares).[5] Accordingly, even if it were appropriate to treat the settlement payments as deferred sales proceeds due under the redemption contracts,[6] the settlement

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[4] In Midkiff, 96 T.C. at 734, the court said that the indebtedness must also be that of the taxpayers to permit a § 163 deduction. Sister 1 and Sister 2 filed lawsuits against Taxpayer and Older Brother.

[5] Neither the Redemption Notes nor the redemption contracts provided for contingent payments.

[6] It is not necessary to consider whether § 483 would have applied during these years to the settlement payments had the underlying redemption been covered by § 483. In Tribune Publishing Company v. United States, 836 F.2d 1176 (9th Cir. 1988), the Ninth Circuit held that the Service could not require a portion of a settlement payment received in a securities fraud suit to be treated as interest under § 483. However, with regard to newsprint that was later sold at a discount under the settlement agreement, the court did find that interest could be imputed from the date of settlement

payments did not arise out of a transaction to which § 483 applied. Because the redemption transactions were not covered by § 483, the origin of the claim doctrine would not treat the settlement payments as part interest under the principles of § 483. Although the settlement payments are not part interest, Taxpayer is entitled to deduct under § 163(e) the original issue discount that accrued during the time in Year 1 that Sister 1 held her Redemption Note.

Other Taxpayer Contentions

Taxpayer contends that express allocations in settlement agreements are generally respected where entered into at arm's length and in good faith. For this proposition, Taxpayer cited Robinson v. Comm., 102 T.C. 116 (1994); McKay v. Comm., 102 T.C. 465 (1994); Threlkeld v. Comm., 87 T.C. 1294 (1986). Based on its reading of those cases, Taxpayer contends that the interest deduction it took for a portion of the settlement payment made to Younger Brother was proper because it was made pursuant to a document signed by Younger Brother that said the payment was interest. The request for technical advice states that Younger Brother did not execute a settlement agreement; however, Taxpayer asserts that the "Receipt and Direction" document signed only by Younger Brother was an arm's length settlement agreement.

The cases cited by Taxpayer address whether personal injury settlements are excludable from the income of recipients. None of those cases suggest that, in the absence of underlying indebtedness, a taxpayer may characterize payments as deductible interest. Courts have rejected efforts by taxpayers to characterize settlement and other payments as deductible interest expense where there is not underlying indebtedness. Gilman, 53 F.2d 47; Midkiff, 96 T.C. 724; Jordan, 60 T.C. 872.

Moreover, it is appropriate to look beyond the language of a settlement agreement to the overall realities. This has been stated to be particularly true where extrinsic evidence suggests that a taxpayer's choice of settlement language may have been driven by tax considerations. Delaney v. Comm., 99 F.3d 20 (1st Cir. 1996); Bagley v. Comm., 121 F.3d 393 (8th Cir. 1997); Robinson, 102 T.C. 116. The request for technical advice states that Younger Brother did not execute a settlement agreement and the "Receipt and Direction" document signed by Younger Brother does not, on its face, constitute a settlement agreement. The settlement agreements with Sister 1 and Sister 2 were extensive 14- and 13-page documents, respectively. Each agreement was entitled "General Release and Settlement Agreement." Each agreement released both Taxpayer and Older Brother, individually and as trustee, from further liability in connection with the redemption and the dispute regarding Older Brother's purchase of the family's lake-front summer house. Neither agreement

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to the date of purchase of the newsprint.

focused on tax implications. On the other hand, the document signed by Younger Brother was a five-sentence document entitled “Receipt and Direction.” It does not state that is a settlement agreement and does not refer to any dispute or contain any language releasing Older Brother or Taxpayer. Rather, the first sentence states that Younger Brother will receive additional consideration for his sale of common stock to Taxpayer. Three sentences then describe the tax consequences. Given that the document seems to have been principally written with tax considerations in mind, its terms would not control the tax treatment here (even assuming § 163 did not require underlying indebtedness).

Taxpayer also contends that the meaning of indebtedness under § 163 is controlled by state law.[7] For this proposition, Taxpayer cited Gilman, 53 F.2d 47; French v. Comm., 138 F.2d 254 (8th Cir. 1943); Mercil, 24 T.C. 1150. The authority cited by Taxpayer is inapposite with its contention.

In evaluating whether promissory notes given by a taxpayer to his wife and children constituted indebtedness under federal income tax law, the court in Gilman observed that the instruments were not “promissory notes” under Iowa law because they were not unconditional promises to pay. The court, however, did not stop there. It then discussed the meaning of indebtedness under federal tax law. It said, “The term ‘indebtedness’ as used in the Revenue Act implies an unconditional obligation to pay. Any definition more flexible would only encourage subterfuge and deception.” Id. at 50.

In Mercil, the court looked to Minnesota law to determine that advances received by a taxpayer from his father for college were gifts because there was not an unconditional obligation to repay the advances. At no point did the court suggest that it was looking to a local law definition of indebtedness or that local law would be controlling. In fact, the court premised its opinion by stating that the issue in front of it was whether the payments by the taxpayer to his father constituted interest within the meaning of § 23(b) of the Internal Revenue Code.

The focus on the federal definition of indebtedness, rather than local law, is consistent with Supreme Court precedent. In its analysis of the term indebtedness under § 23(b), the Court in du Pont, stated that its meaning is determined under federal law. The Court said that it would not look to other law cited by the taxpayer to determine the meaning of interest and indebtedness. Rather, it said that the meaning of interest on indebtedness should, in the context of a revenue act, be determined by well-known business world meanings. The Supreme Court has also more generally instructed that the meaning and application of the federal taxing statutes should be interpreted so as to give uniform application to a nationwide scheme of taxation unless

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[7] Though making this contention, Taxpayer did not cite any state law indicating that its potential liability arising from the redemption and Older Brother’s purchase of the summer family house was “indebtedness.” For authority on state law, Taxpayer pointed to an “opinion” prepared at the time of the income tax audit by its litigation counsel; however, the “opinion” does not cite any state or other law.

Congress expressly makes a statute's operation depend on state law. Lyeth v. Hoey, 305 U.S. 188, 194 (1938).

Based on the above, Taxpayer's only outstanding indebtedness in connection with the redemption was its Date 1 Redemption Note held by Sister 1 during Year 1. Except for that Redemption Note, Taxpayer did not have unconditional and legally enforceable obligations to pay the former shareholders a principal sum that could be considered "indebtedness" under §163. Thus, no portion of the settlement payments was deductible by Taxpayer as interest expense under § 163. Additionally, the Redemption Notes were not subject to the imputed interest rules of § 483. Rather, the Redemption Notes were debt instruments subject to the original issue discount rules prescribed by § 1274. The original issue discount accrued daily on Sister 1's Redemption Note until it was retired in Year 1. The original issue discount accrued during Year 1 independent of the settlement or whether payment was made on the Redemption Note. Thus, Taxpayer was only permitted to deduct in Year 1 under § 163(e) the original issue discount that accrued during Year 1 on the Redemption Note held by Sister 1.

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