

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200836025**

Release Date: 9/5/2008

CC:ITA:5:
POSTN-110181-08

UILC: 172.01-00, 172.01-05, 172.06-00

date: May 20, 2008

to: _____, Attorney
(CC:SB/SE: _____)

from: William A. Jackson, Branch Chief
(CC:ITA:5)

subject: Specified Liability Losses: Product Liability--Interest Payments

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
TYa	=
TYb	=
YEARc	=
YEARd	=
TY(a-10)	=
TY(b-10)	=

ISSUES

1. Whether prejudgment and post-judgment interest that Taxpayer pays on product liability losses is deductible solely under I.R.C. § 163, or whether Taxpayer may

instead deduct these amounts under section 162 and remain within the limiting language of section 172 (f)(1)(A).

2. Whether prejudgment and/or post-judgment interest on product liability claims qualifies as product liability damages within the meaning of section 172 (f)(4) and would be eligible for the 10-year carryback provided for in section 172 (b)(1)(C).

CONCLUSIONS

1. Prejudgment interest is not deductible under section 163 since it is not interest on indebtedness; however, prejudgment interest stemming from product liability is an ordinary and necessary business expense deductible under section 162 and post-judgment interest relating to product liability is deductible under either section 162 or section 163.
2. Prejudgment and/or post-judgment interest on product liability claims does not qualify as product liability damages within the meaning of section 172 (f)(4) and thus is not eligible for the 10-year carryback provided in section 172 (b)(1)(C)

FACTS

In TYa and TYb, Taxpayer paid various judgments in several product liability suits on a product it manufactured and supplied from YEARc to YEARd. Those judgments included both prejudgment and post-judgment interest. Taxpayer deducted the prejudgment and post-judgment interest on its TYa and TYb returns and carried back those amounts 10 years as purported specified liability losses under section 172(f)(1)(A) to its taxable years TY(a-10) and TY(b-10), respectively.

LAW AND ANALYSIS

ISSUE 1

Section 163

Section 163(a) generally provides for a deduction on all interest paid or accrued within the taxable year on indebtedness. The Supreme Court interpreted “interest on indebtedness” in a predecessor statute to section 163 as compensation for the use or forbearance of money, and added that this definition makes irrelevant authority where interest in a different context had been used to describe damages or compensation for the detention or use of money. *Deputy v. du Pont*, 308 U.S. 488, 498 (1939). More recently, the Tax Court has defined indebtedness for purposes of section 163 as an existing, unconditional, and legally enforceable obligation for the payment of money. *Howlett v. Commissioner*, 56 T.C. 951, 960 (1971). See also *Kaempfer v. Commissioner*, T.C. Memo. 1992-19.

Prejudgment and post-judgment interest are generally provided pursuant to state law. The Supreme Court has described prejudgment interest as compensating a plaintiff for the loss of use of money due as damages from the time the claim accrues until judgment is entered. *West Virginia v. United States*, 479 U.S. 305, 311 n.2 (1987). Post-judgment interest is charged to compensate for delays in collecting a judgment after it is entered. See, e.g., *Sharp v. Commissioner*, 75 T.C. 21, 29 (1980), *aff'd*, 689 F.2d 87 (6th Cir. 1982) (regarding Kentucky statute providing that a judgment shall bear legal interest from the date it is rendered).

The issue of whether a payer may deduct prejudgment and post-judgment interest as interest on indebtedness was addressed by the Board of Tax Appeals in *Appeal of Bettendorf v. Commissioner*, 3 B.T.A. 378 (1926), *acq.* 1926-1 C.B. 1. In *Bettendorf*, the taxpayer, a trustee, was sued by the trust's beneficiary for breach of fiduciary duty. A state court entered a judgment for the plaintiff, and ordered the trustee to pay prejudgment and post-judgment interest. The trustee contended that even though referred to as damages in the judgment, the interest paid represented interest on indebtedness deductible under the predecessor provision of section 163. The Service argued that these amounts constituted a portion of the damages awarded and was not interest on indebtedness. The Board held that the interest relating to the period prior to the entry of judgment was not deductible as interest on indebtedness. It reasoned that the parties were not in a debtor-creditor relationship prior to the entry of the judgment; rather, they were in a relationship of trustee and beneficiary. The Board did allow deduction for interest paid on the judgment rendered because the trustee had become indebted to the plaintiff after entry of the judgment. The Board observed that a judgment is an obligation for the payment of money and is evidence of indebtedness of the highest degree known to the law. Although the Board acknowledged that interest on a judgment is not interest in the strict sense---it is in the nature of liquidated damages for delay in payment---it nevertheless held that it constitutes interest on indebtedness. *Bettendorf*, 3 B.T.A. at 385.

More recently, the Tax Court has applied similar reasoning to amounts labeled as interest or damages in settlement agreements or to court-awarded damages. In *Sharp v. Commissioner*, the Tax Court held that *supersedeas* damages awarded by a state court are not deductible as interest under section 163 since the damages were not designed to compensate judgment creditors for collection delays. *Sharp*, 75 T.C. at 29. Citing *Bettendorf*, the Court noted in *dicta* that interest on a judgment would be deductible under section 163 since a judgment constitutes "indebtedness of the highest degree known to law." *Id.* at 25, n. 4.

In *Jordan v. Commissioner*, 60 T.C. 872 (1973), *aff'd*, 514 F.2d 1209 (8th Cir. 1975), the Tax Court held that amounts labeled as interest in a securities fraud settlement agreement were not interest on indebtedness deductible under section 163. The taxpayer, who organized a corporation and sold subscription rights to the shares, was sued by the public shareholders for violations of securities laws. As part of a settlement

of the suit, the taxpayer agreed to refund the entire purchase price paid for certain shares and pay five per cent interest from the date the shares were purchased to the date the purchase was rescinded. The Tax Court denied the taxpayer an interest deduction because there was no indebtedness. The amounts labeled as interest were held to be a part of the purchase price the taxpayer paid to acquire the shares, rather than an existing, unconditional, and legally enforceable obligation for the payment of money. The Tax Court held, however, that amounts designated as interest in a settlement agreement between the taxpayer, who had defrauded the bank by which he was employed, and a bonding company (which indemnified the bank for its losses) were deductible under section 163 as interest on indebtedness. The Tax Court found that a portion of the taxpayer's payments constituted compensation to the bonding company for the use of its money. *Wusich v. Commissioner*, 35 T.C. 279, 288 (1960).

The Ninth Circuit affirmed two Tax Court opinions, on a consolidated appeal, holding that "blight of summons damages" paid to compensate owners of condemned property for the delay between the taking of their property and the receipt of a condemnation award did not constitute interest deductible under section 163. *Noguchi v. United States*, 992 F.2d 226 (1993), *aff'g Midkiff v. Commissioner*, 96 T.C. 724 (1991) and *Noguchi v. United States*, T.C. Memo. 1991-227. A state land reform law gave the taxpayers an option to purchase the land that they leased. The taxpayers who exercised this option were responsible for paying the lessors, as condemnees, the fair market value of the land at the date of condemnation and "blight of summons damages." The taxpayers argued that an indebtedness arose from the date the lots were designated for acquisition. Both cases held there was no indebtedness that would allow the taxpayers to deduct the "blight of summons damages" as interest under section 163. The taxpayers were not unconditionally obligated to pay compensation to the condemnees until they affirmatively executed a reply to the sales offer and escrow closed on the purchases. The taxpayers had an opportunity to choose not to purchase the leased interest in their lots up to the date of closing. Citing *Bettendorf*, the Tax Court noted that prior to the date of closing the taxpayers were not indebted to the condemnees. *Midkiff*, 96 T.C. at 741.

Based on the authorities discussed above, a judgment constitutes a legally enforceable obligation that satisfies the indebtedness requirement of section 163. Interest that accrues after a judgment has been entered would therefore be deductible under this section, provided no specific exception to that deductibility applies. Taxpayer is entitled to deduct post-judgment interest under section 163, as it does not appear that any of the exceptions to the deduction of interest thereunder or the related regulations apply. Conversely, however, prejudgment interest is not paid with respect to an existing, legally enforceable obligation for the payment of a principal sum; therefore, it is not interest on indebtedness for purposes of section 163(a). Taxpayer would thus not be entitled to deduct prejudgment interest under section 163; however, we must also consider whether section 162 is available.

Section 162

Section 162 does not expressly provide for any interest deduction. Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 1.162-1(a) of the regulations provides that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or credit under provisions of the law other than section 162.

Judgments and settlement payments have been held to be currently deductible as long as the acts that gave rise to the litigation originated in a taxpayer's trade or business and otherwise satisfy the requirements of section 162(a). See *Chief Industries, Inc. & Subsidiaries v. Commissioner*, T.C. Memo. 2004-45 (settlement payments held to be deductible under section 162(a) since they were paid during subject years in connection with taxpayer's trade or business, were ordinary and necessary, and were not capital in nature); *Vanderbilt v. Commissioner*, T.C. Memo. 1957-235 (amount taxpayer paid on a libel judgment is deductible as an ordinary and necessary business expense).

In *Illinois Tool Works Inc. v. Commissioner*, 117 T.C. 39, 44-45 (2001), *aff'd*, 355 F.3d 997 (7th Cir. 2004), a taxpayer paid a judgment, as well as prejudgment and post-judgment interest, stemming from a patent infringement lawsuit commenced against a corporation before it was acquired by the taxpayer. The taxpayer had assumed the defense of the lawsuit after it acquired the corporation. The payments were not deductible under section 162(a), but were capital expenses which became part of the cost of the acquired corporation's assets. Neither the Tax Court nor the Seventh Circuit mentioned section 163 in reference to the deductibility of the prejudgment or post-judgment interest.

Interest payments arising from amounts payable under a settlement agreement have also been held to be deductible under section 162(a) if these originate in and are proximately related to a taxpayer's trade or business. See *Keane v. Commissioner*, T.C. Memo. 1998-116; *Holmes v. Commissioner*, T.C. Memo. 1993-387. In *Keane*, the taxpayer sought to deduct interest under either section 162 or 163 on settlement payments arising from his breach of a contract with the Department of Health and Human Services to serve as an employee in exchange for the agency's payment of his medical school tuition. The Tax Court denied a section 162 deduction since the taxpayer failed to prove that the interest portion of settlement payments was paid or incurred in a trade or business. It also held that the taxpayer could not deduct the interest payments under section 163(a) because they constituted nondeductible personal interest. Interest payments on loans have also been held to be deductible as ordinary and necessary business expenses under section 162(a). *Adelson v. United States*, 87-1 U.S. Tax Cas. (CCH) P9282 (interest on loans proximately related to taxpayer's business held deductible under section 162).

The precedent involving the deductibility of interest payments described above does not specifically address whether interest is deductible as an ordinary and necessary business expense under section 162(a) notwithstanding that section 163 specifically allows for interest deductions. The Tax Court has, however, discussed this issue in the context of whether a taxpayer is a personal holding company. *Western States Investment Corp. v. Commissioner*, T.C. Memo. 1963-245; *McNutt-Boyce Company v. Commissioner*, 38 T.C. 462 (1962), *aff'd* 324 F.2d 957 (5th Cir. 1963), *acq. in result only*, 1966-2 C.B. 3.

In both cases, the Tax Court held that interest is deductible under section 162 for purposes of the requirement in section 542(c)(9) that the “deductions allowable under section 162 (relating to trade or business expenses)” constitute fifteen per cent or more of gross income to come within the exception to the definition of a personal holding company. In *McNutt-Boyce*, the Tax Court reasoned that even though section 163 specifically allows for an interest deduction, a taxpayer may also deduct interest under section 162 if it constitutes an ordinary and necessary business expense of the taxpayer. The Court observed that sections 162 and 163 are not inconsistent with each other, are of equal dignity, and to the extent interest paid on indebtedness also meets the test of a business expense, the two sections overlap, and the interest may be deducted under either, but not both, sections. The Revenue Act of 1964 amended the above-referenced language in section 549 to include deductions that are allowable only by reason of section 162 for purposes of applying the fifteen per cent of gross income test. *See also Audrey Realty, Inc. v. Commissioner*, 50 T.C. 583, 585 (1968).

Several decisions have applied the Tax Court’s reasoning in *McNutt-Boyce*. In *Bayou Verret Land Co. v. Commissioner*, 52 T.C. 971, 982-983 (1969), *acq.* 1970-2 C.B. xviii, *aff'd*, 450 F.2d 850 (5th Cir. 1971), the Tax Court held that real estate and franchise taxes are deductible under section 162 for purposes of computing the fifteen per cent of gross income threshold in section 542(c)(9). Citing *McNutt-Boyce*, the Court stated that although the deduction of taxes is specifically authorized by section 164, this does not prevent a taxpayer from deducting the amount under the more general provision of section 162. *Ungerman Revocable Trust v. Commissioner*, 89 T.C. 1131 (1987), addressed whether a trust could deduct interest on a deferred estate tax liability under section 212 even though section 163 specifically provides for an interest deduction. If the interest was deductible under section 212, the expense would qualify as a “cost paid or incurred in connection with the administration of an estate or trust” under section 57(b)(2)(B)(i) and the trust would not be subject to the alternative minimum tax. The Service argued that the trust may not deduct the interest expense under section 212 since interest is specifically deductible under section 163. The Court held that the interest expense was deductible as a trust administration expense under section 212, even though it also may be allowable as a deduction under section 163. The Court stated that since section 212 is *in pari materia* with section 162, and sections 162 and 163 are of equal dignity and transparently not inconsistent with each other, it follows that sections 212 and 163 are of equal dignity and not inconsistent with each other.

In sum, courts have allowed taxpayers to deduct interest payments as ordinary and necessary business expenses under section 162(a) in various factual contexts, notwithstanding the existence of a specific provision for the deduction of interest under section 163(a). The above-referenced cases, therefore, support a deduction under section 162(a) for amounts paid or incurred by Taxpayer for both prejudgment and post-judgment interest.

ISSUE 2

Section 172(f)(4)

Section 172(a) allows a deduction for the taxable year an amount equal to the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year.

Section 172(b)(1)(C) provides that in the case of a taxpayer that has a specified liability loss (as defined in section 172(f)) for a taxable year, such specified liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the year of such loss.

Section 172 (f)(1)(A) defines a specified liability loss to include any amount allowable as a deduction under section 162 or section 165 that is attributable to (i) product liability or (ii) expenses incurred in investigating, settling, and opposing claims against the taxpayer on account of product liability to the extent taken into account in computing the net operating loss for the taxable year.

Section 172(f)(4) provides that the term "product liability" means (A) the liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product that is manufactured, leased, or sold by the taxpayer but only if (B) such injury, harm or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

As your request for advice correctly notes, the language of section 172(f)(4) mirrors that of section 104(a)(2) in defining product liability damages as being "on account of physical injury or emotional harm [emphasis added]." Section 104(a)(2) provides that gross income does not include the amount of damages received "on account of personal physical injuries or physical sickness [emphasis added]." Consequently, drawing the appropriate analogies to the "personal injury" definition, interest paid on product liability obligations does not arise on account of the product liability; rather, it is a function of the forbearance from the use of, or "time value" of, the money involved. This is demonstrated in the cases dealing with the taxability of interest payments.

Under section 61(a)(4), a taxpayer must include interest received in gross income. Similarly, section 1.61-7(a) of the regulations provides that, as a general rule, interest

received by or credited to the taxpayer constitutes gross income and is fully taxable. The regulation further lists examples of such taxable interest, including interest on savings or other bank deposits, interest on a promissory note or mortgage and the interest portion of a condemnation award. See also *Kieselbach v. Commissioner*, 317 U.S. 399, 403 (1943).

Post-judgment interest refers to interest that accrues upon the judgment itself from the date of judgment until the award is paid. In order to receive such interest, the prevailing party must be deprived of the use of the money during the time for which interest has been awarded. Courts have agreed unanimously post-judgment interest does not fall within the section 104(a)(2) exclusion. See *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933); *Ames v. Commissioner*, 94 T.C. 189 (1990); and *Rice v. United States*, 834 F. Supp. 1241 (E.D. Cal. 1993).

The Tax Court, the Sixth, Tenth, and First Circuits have concluded that prejudgment interest fails to meet the requirements for exclusion. *Kovacs v. Commissioner*, 100 T.C. 124 (1993), *aff'd without pub. opinion*, No. 93-1637 (6th Cir. June 9, 1994), *cert. denied*, 513 U.S. 963 (1994); *Brabson v. United States*, 73 F.3d 1040 (10th Cir.), *cert. denied*, 519 U.S. 1039 (1996); *Delaney v. Commissioner*, 99 F.3d 20 (1st Cir. 1996); *Forest v. Commissioner*, T.C. Memo. 1995-377, *aff'd without pub. opinion*, 104 F.3d 348, 97-1 U.S.T.C. & 50,118 (1st Cir. 1996); *Rozpad v. Commissioner*, T.C. Memo. 1997-528, *aff'd*, 154 F.3d 1 (1st Cir. 1998); *Woods v. Commissioner*, T.C. Memo. 1998-435; and *Serpa v. Commissioner*, T.C. Memo. 1998-453.

In *Kovacs*, taxpayers sought to exclude statutory prejudgment interest received on damages that were awarded to them in a wrongful death action. The parties had agreed that the underlying damages recovery was excludable from gross income under section 104(a)(2). The Tax Court distinguished the term "damages" from other terms such as "debt", "interest", "penalty", "salary", and "value." *Id.* at 129. See also *Wilson v. Commissioner*, T.C. Memo. 1996-418 (statutory prejudgment interest not part of underlying condemnation award eligible for section 1033 treatment).

In *Brabson*, the court addressed whether prejudgment interest awarded under state law as an item of damages qualifies for exclusion. Taxpayers brought suit to recover for personal injuries and property damage occasioned by an explosion linked to a gas leak. After a jury verdict, the court entered a judgment awarding taxpayers separate amounts for personal injuries, for property damage and for prejudgment interest allowed by Colorado law.

The district court in *Brabson*, 859 F. Supp. 1360 (D. Colo. 1994), expressly disagreed with the majority views of the Tax Court in *Kovacs* that "interest" is not "damages." The court examined state judicial decisions to determine the nature of prejudgment interest and concluded that it was an item of compensatory damages, awarded to compensate

the plaintiff for the time value of the award eventually obtained against the tortfeasor. *Allstate Ins. Co. v. Starke*, 797 P.2d 14, 19 (Colo. 1990). See also *Houser v. Eckhardt*, 532 P.2d 54, 57 (Colo. App. 1975) (prejudgment interest is in the nature of another item of damages wholly distinct from post-judgment interest). The court then reasoned that even if prejudgment interest were otherwise taxable, that fact becomes irrelevant once it is awarded as damages in a personal injury action. The court also agreed with taxpayers' suggestion that because prejudgment interest is not deductible under section 163, *Midkiff v. Commissioner*, 96 T.C. 724, 734-735 (1991); *Jordan v. Commissioner*, 60 T.C. 872, 881, *aff'd per curiam*, 514 F.2d 1209 (8th Cir. 1975), it does not constitute interest for purposes of section 61.

Agreeing that the "interest is interest" approach constitutes tautology, the Tenth Circuit examined state law to determine the purposes served by an award of prejudgment interest. Noting that prejudgment interest was not available under common law in personal injury actions and that it compensates for the lost time value of money, the court concluded that prejudgment interest did not constitute "damages on account of personal injury" under section 104(a)(2). *Brabson*, 73 F.3d at 1046-1047.

Thus, whether prejudgment interest represents delay damages, the time value of the substantive damages, or opportunity costs, such interest is designed to compensate for the delay in receiving the underlying award, *Library of Congress v. Shaw*, 478 U.S. 310, 322 (1986), and not to compensate for the underlying injury. Further, the personal injury does not affect the amount of prejudgment interest recovered. *Commissioner v. Schleier*, 515 U.S. 323, 330-331 (1995). Accordingly, prejudgment interest does not constitute damages "on account of" personal physical injury or physical sickness and consequently fails to meet the requirements for exclusion from income under section 104(a)(2). See *Forest, Delaney, and Rozpad, supra*.

Analogous to the Service positions taken in the foregoing interest income cases and on the basis of the weight of authority discussed above supporting those positions, it is our view and advice that, similarly, the interest paid on the product liability claims involved here—whether post- or prejudgment—is not designed to compensate for physical injury or emotional harm; nor for the damage to or loss of use of property. Consequently, the pre- and post-judgment interest are not "on account" of product liability and, hence, are not specified liability losses and not eligible for the 10-year carryback provided for such losses under section 172(b)(1)(C).

THIS WRITING MAY CONTAIN PRIVILEGED INFORMATION. ANY UNAUTHORIZED DISCLOSURE OF THIS WRITING MAY UNDERMINE OUR ABILITY TO PROTECT THE PRIVILEGED INFORMATION. IF DISCLOSURE IS DETERMINED TO BE NECESSARY, PLEASE CONTACT THIS OFFICE FOR OUR VIEWS. PLEASE CALL (202) 622-4960 IF YOU HAVE ANY QUESTIONS.