

# Taxpayers Receive Tax-Exempt Interest on Settlement

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In *DeNaples v. Commissioner*, 109 AFTR 2d 2012-1419 (March 19, 2012), the U.S. Court of Appeals for the Third Circuit, in partially reversing the U.S. Tax Court, held that taxpayers were in receipt of tax-exempt interest income under Section 103 of the Internal Revenue Code with respect to installment payments made pursuant to a settlement agreement with the commonwealth of Pennsylvania that arose out of an eminent domain proceeding. The Third Circuit affirmed the holding of the Tax Court that the stated interest component of the settlement was not excludable under Section 103 because of the taxpayers' failure to meet its required burden of proof.

Members of the DeNaples family, through their control of various entities, owned several parcels of real property in Pennsylvania that were condemned by the Pennsylvania Department of Transportation (PennDOT) to facilitate the construction of the Lackawanna Valley Industrial Highway. In 1998, PennDOT initiated condemnation proceedings against the properties by filing a declaration of taking. The DeNapleses objected to the taking and litigation ensued, according to the opinion.

On Nov. 7, 2001, the parties signed a memorandum of intent to settle the condemnation litigation. The DeNapleses agreed that, in exchange for their ownership interests in the condemned properties, they would receive compensation of \$40.9 million, of which \$24.6 million was allocated to principal and \$16.3 million was allocated to interest, according to the opinion. The record of the condemnation proceedings did not indicate how the allocation between principal and interest was determined.

To assist the commonwealth in its ability to pay the full settlement amount, including the settlement interest, the DeNapleses agreed that payment could be made in five annual installments, with the first payment of \$8.1 million plus accrued interest due by March 1, 2002, and the remaining four payments of \$8.2 million plus interest due on March 1 in 2003, 2004, 2005 and 2006. The commonwealth prepaid its last installment obligation in 2005. By agreement, interest accrued annually on the unpaid settlement amount at the rate set by (former) Rule 238 of the Pennsylvania Rules of Civil Procedure (Pa. R. Civ. P. 238). Rule 238 established a variable interest rate and was used in the calculation of delay damages in certain types of litigation.

On their 2003 through 2005 federal income tax returns, the DeNapleses excluded that portion of the settlement interest they received that exceeded 6 percent. The

DeNapleses also excluded all of the installment interest they received, according to the opinion. The IRS, upon audit and review of the DeNapleses' returns for these years, disagreed with the tax-exempt interest positions taken on the returns and claimed that none of the interest received by the DeNapleses should have been excluded from income. In excluding a portion of the settlement interest and all of the installment interest, the DeNapleses relied upon the interest exclusion contained in Section 103(a) of the code.

Section 103(a) of the code holds, in relevant part: "Gross income does not include interest on any state or local bond." A "state or local bond" is defined in Section 103(c)(1) as "an obligation of a state or political subdivision thereof." Since the inception of the code in 1913, interest on obligations of states and their political subdivisions has been excluded from the interest recipient's gross income. The rationale for the exclusion is to avoid a perceived unconstitutional burden on the borrowing power of state and local governments. As with other tax exclusions, the application of Section 103 has consistently been narrowly construed by the courts.

In *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84 (1934), the Supreme Court held that for the exclusion contained in Section 103 to apply, the obligation to pay interest must arise from the state or local governmental authority's discretionary use of its borrowing power. Conversely, where a state's obligation to pay interest arises by operation of law, such as by a statutory or judicial command, the state's borrowing power is not implicated and Section 103 is unavailable.

In its review of the IRS disallowance of the DeNapleses' interest exclusions, the Tax Court sided with the government and held that no portion of either the settlement interest or installment interest was excludable from gross income under Section 103. (See *DeNaples*, T.C. Memo. 2010-171.) As to the settlement interest, the Tax Court concluded that the DeNapleses had failed to demonstrate that the interest they received as part of the \$40.9 million settlement was above and beyond what the commonwealth was legally required to pay under Pennsylvania's eminent domain statute as "just compensation" for the condemnation taking. Therefore, the Tax Court concluded that the settlement interest was part of what was required to be paid by operation of law and was not an obligation of the state as described within Section 103 because it did not invoke the state's discretionary borrowing authority. The Tax Court also found that the allocation to interest by the parties was arbitrary and was not the product of a mathematical computation of interest.

As to the installment interest, the Tax Court also held that no amount of that interest was excludable under Section 103, again finding that the DeNapleses were entitled, as

a matter of law, to be compensated for agreeing to receive the settlement payments on a deferred basis as part of their right to "just compensation."

In reviewing the case de novo, the Third Circuit affirmed the holding of the Tax Court that the settlement interest was part of what the DeNapleses were entitled to receive as "just compensation" by operation of law. The court noted that under Pennsylvania law, a condemnee is entitled to the fair market value of the condemned property, plus interest from the date of the taking. Accordingly, the Third Circuit affirmed the holding of the Tax Court that the payment of the settlement interest did not implicate Pennsylvania's discretionary borrowing authority and the exclusion of Section 103 was not available for such interest. The Third Circuit agreed with the Tax Court that the DeNapleses had failed to meet their burden of proof that any portion of the interest component of the settlement was above the prevailing commercial rate that would have been the interest rate required to constitute "just compensation" (i.e., the DeNapleses asserted that interest in excess of 6 percent was more than what was required under the "just compensation" standard).

However, with respect to the installment interest received by the DeNapleses on the deferred payments, the Third Circuit reversed the Tax Court and held that the DeNapleses had no obligation to accept payment of the condemnation settlement on a deferred basis and by agreeing to such deferred payments, the DeNapleses were, in fact, "extending credit" to the commonwealth. In his opinion, Judge Julio M. Fuentes noted that the commonwealth's obligation to pay interest arose from a voluntary arm's-length negotiation, not by operation of law, and Section 103 was therefore applicable. Accordingly, all of the installment interest received by the DeNapleses was properly excluded from their income in the years 2003-05.

Fuentes specifically addressed the IRS argument that because the settlement agreement between the parties required the commonwealth to pay the installment interest at the rate set forth in Rule 238, such interest became payable by operation of law. In rejecting this argument, the court held that the Rule 238 interest rate was voluntarily selected by the parties as a convenient benchmark and was not imposed by any statute or court decree. In fact, the court noted that by its terms, Rule 238 was inapplicable to eminent domain proceedings.

In *DeNaples*, the Third Circuit acknowledged the distinction, for purposes of Section 103, between interest paid by a state or local government by operation of law (i.e., pursuant to statute or court order) and interest paid pursuant to a voluntary agreement of the parties (which is deemed to implicate the state or local governmental entity's borrowing authority). The only issue that remains open as a result of the *DeNaples*

decision is whether at least a partial exclusion of the interest component of an eminent domain settlement can be sustained under Section 103 if the parties are able to negotiate and substantiate a reasonable rate of interest in excess of the prevailing commercial rate. In such circumstance, it is possible that the interest component of the settlement above the prevailing commercial rate could be held to be "discretionary," thereby implicating the governmental entity's borrowing authority.

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