

The Third Circuit Examines Tax-Exempt Interest.

Section 103(a) of the Code excludes interest on “any State or local bond” from gross income. While there are exceptions, this exemption is potentially applicable to a range of state and municipal obligations, since the Code defines a “bond” as “an obligation of a State or political subdivision thereof.” I.R.C. § 103(c)(1). The exemption is not as broad as these provisions might suggest: tax exemptions are generally construed narrowly, and a number of courts have held that the exemption under Section 103(a) of the Code applies to state or municipal obligations that involve the application of the state’s borrowing power. In contrast, where interest is imposed on a state or municipality by operation of law, the exemption does not apply. *See, e.g., Stewart v. Comm’r*, 727 F.2d 977, 981 (9th Cir. 1983). This is because taxing interest that is imposed by law does not impair a state’s ability to borrow. *Id.*; *see also American Viscose Corp. v. Comm’r*, 56 F.2d 1033, 1033-34 (3d Cir. 1932) (addressing statutory interest paid by Treasury on tax refunds).

Given this background, it is no surprise that interest that is payable as part of a condemnation award is treated as tax-exempt. *See Stewart*, 727 F.2d at 981-82. What happens when the parties to a condemnation proceeding settle? The Third Circuit addressed this question in [*DeNaples v. Commissioner*](#), No. 11-2205, slip op. (3d Cir. Mar. 19, 2012).

The parties in *DeNaples* settled a condemnation proceeding for \$40.9 million, allocating \$24.6 million to principal and \$16.3 to interest. *Id.*, slip op. at 5. By the time the parties finalized their settlement agreement, the state lacked sufficient funds to pay the full amount due; as a consequence, the parties agreed to an arrangement that provided for five installment payments with interest on those installment payments at the rate provided under the Pennsylvania Rules of Civil Procedure for delay damages in tort cases, which is basically the prime rate plus one percent. *Id.*, slip op. at 5-6.

The taxpayers treated this interest as partially exempt on their tax returns: they treated the settlement interest as exempt to the extent that it exceeded six percent, and they treated all of the installment interest as exempt. *Id.*, slip op. at 7. The IRS issued deficiency notices, which were sustained by the Tax Court.

The Third Circuit commenced its analysis of the status of this interest by reviewing the basic principle that the exemption under Section 103(a) of the Code only applied in situations where state or municipal borrowing power was at stake. The Court then turned to the appropriate treatment of the installment interest. Noting that the Supreme Court of Pennsylvania had ruled that a participant in a condemnation proceeding is entitled to interest at the greater of six percent or the prevailing commercial rate as a matter of law, *DeNaples*, slip op. at 11-12, the court characterized that legal right as a bargaining chip. The Third Circuit then concluded that if the legal entitlement to interest was bargained away for a lower rate, the state’s borrowing power was implicated, because the obligation shifted from a mandatory obligation to a voluntary one. *Id.*, slip op. at 12. Because the installment interest under the parties agreement was the result of voluntary bargaining, the Third Circuit concluded that it was exempt. *Id.*, at 13.

Turning to the settlement interest, the court of appeals sustained the Tax Court’s ruling that the interest was not exempt. Essentially, the problem here was a lack of sufficient evidence. The Tax Court had ruled that the parties’ allocation of the \$40.9 million in settlement consideration was arbitrary, and there was no evidence in the record concerning the prevailing commercial rate to

contradict this conclusion. *Id.*, slip op. at 16-17. The taxpayers sought to fix this problem in the Tax Court by filing for reconsideration and asking the Tax Court to recalculate the deficiency. Because Tax Court Rule 155(c) barred the introduction of new evidence at that stage of the proceeding, the Third Circuit affirmed its disposition of the settlement interest. *DeNaples*, slip op. at 17-18.

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