Revenge of the Tax Nerds

By Christopher A. Karachale • Wood LLP • San Francisco

The average tax lawyer is an egghead. He or she enjoys lucubrating over the latest temporary repair regulations, excited about the rules governing the capitalization of tangible assets. A tax lawyer will often adopt sesquipedalian prose, when simple, straightforward English would suffice.

However, for all the tax lawyers out there, counting their beans during the day and reading Ancient Greek in their spare time, not all are the same. No tax lawyer is more conservative, risk adverse and likely to wear a pocket protector than the tax lawyer who practices in the tax-exempt bond field.

These lawyers laboriously pore over the minutiae of tax-exempt deal documents. They fret about the private business use test or the weighted average life of a bond with persnickety attention. The bond tax lawyer will fight tooth and nail to stop a $100 million bond issuance because the class life of an HVAC system has not been double-checked.

In short, the tax lawyers whose practice areas include Internal Revenue Code Sections ("Code Secs.") 103 and 141 through 150 are generally the nerdiest of the tax lawyer nerds.

The Fool on the Hill

These tax lawyers generally prefer to remain in their windowless offices calculating bond yields with their HP 12C calculators. However, a recent Third Circuit tax case may change the role of the Code Sec. 103 experts. Indeed, *D. DeNaples*, CA-3, 2012-1 USTC ¶50,249 (2012), may make arguments about tax-exempt interest significantly more important for taxpayers who are subject to condemnation proceedings or other eminent domain litigation. If the interest paid by a state or local entity in such condemnations is an "obligation" for purposes of Code Sec. 103, *DeNaples* may allow normally taxable interest payments to be magically transmuted into tax-free money.

In *DeNaples*, the taxpayers owned several parcels of real estate in Pennsylvania that the state condemned to construct a highway. The taxpayers filed objections to the taking.

However, some years later they entered into a settlement agreement with the state of Pennsylvania for a $40.9 million payment.

The settlement agreement allocated the settlement payment $24.6 million as principal for the land and $16.3 million as interest ("Settlement Interest"). At the time, Pennsylvania law required that interest be paid at the prevailing commercial loan rate from the date of the condemnation award until actual payment of such award. In addition, since the state lacked funds to make the entire $40.9 million payment in one lump sum, the taxpayers agreed to accept the settlement monies in five installment payments.

Each installment payment was also subject to interest that accrued at a variable rate as determined by Pennsylvania law ("Installment Interest"). This variable rate was different (and lower) than the commercial loan rate required by statute for the Settlement Interest.

On their tax returns for the years involving the settlement payment, the DeNaples excluded a portion of the Settlement Interest. With considerable gusto, the DeNaples went on to also exclude *all* of the Installment Interest as amounts paid as an obligation of Pennsylvania under Code Sec. 103. The IRS balked and issued a notice of deficiency, believing that neither the Settlement Interest nor the Installment Interest was tax exempt.

At issue was whether Pennsylvania incurred the obligation to pay the Settlement Interest and the Installment Interest *in the exercise of its borrowing authority*. If so, the DeNaples could exclude the interest from their gross income by virtue of the exemption contained at Code Sec. 103.

The Long and Winding Road

Almost uniformly, interest income is taxable. It is explicitly listed as one of the items of gross income enumerated in Code Sec. 61. However, Code Sec. 103 provides one of the few exclusions from taxable income generated by interest. In part, the code section provides that "gross income does not include interest on any State or local bond." [Code Sec. 103(a).]

Code Sec. 103 has been with us since the enactment of the Sixteenth Amendment. Congress established the exemptions to aid in the flotation of government bonds and securities by making them tax-free, and therefore more attractive to investors. [*See American Viscose Corp.*, CA-3, 3 USTC ¶881, 56 F2d 1033, 1034 (1932).] In the typical Code Sec. 103 situation, a state or local entity issues bonds for purchase by the general public.

Knowing that the interest will be tax-free, investors are often willing to pay more for the bonds or otherwise accept lower yields than might be available with a taxable bond. Significantly, certain state and local bonds are not subject to the alternative minimum tax, making them particularly attractive to high-income investors. But where interest is being paid in connection with a condemnation proceeding, the issue is whether it arises from the exercise of the state or local entity's borrowing authority.

Generally, the answer is no. In fact, Judge Learned Hand's cousin, Augustus Hand, writing for the Second Circuit, opined:

> An award in condemnation, bearing interest, cannot be regarded as 'issued' by a municipality, nor can taxation of the interest received upon such an award in any way affect the borrowing power of the state. There is no bargaining by the municipality in connection with the matter. The owner of the property condemned is obliged to sell it because of the exercise of the right of eminent domain. ... It disregards the whole purpose of the exemption to apply it to interest upon obligations of a state which it can compel a citizen to take in exchange for the fair value of his property. *U.S. Trust Co. v. Anderson*, 65 F.2d 575, 578 (2d Cir. N.Y. 1933).

This reasoning appears perfectly sound. If a state or local entity exercises its eminent domain power and, by statute, the governmental entity is required to pay the taxpayer interest where there is a delay in payment of the award, such interest payment could hardly implicate the state or local entity's borrowing power. In short, taxing the recipient on the interest paid in connection with the condemnation does not adversely affect the government's ability to borrow money. [*See S.D. Stewart*, CA-9, 83-2 USTC ¶9573, 714 F2d 977, 981 (1983).]

Twist and Shout

So what did the DeNaples argue in the face of this relatively clear interpretation of the scope of Code Sec. 103? They conceded that the interest

paid at a fixed rate or pursuant to a state or local statute in condemnation proceedings was not excludible under Code Sec. 103. However, that was a kind of clever feint.

The DeNaples then argued that where the government's obligation to pay interest arose *out of voluntary bargaining*, the interest exclusion may play a role in allowing the state to reduce its borrowing cost. Surely, arm's-length bargaining over the amount of interest implicates the state's borrowing authority. As such, these interest payments are arguably within the purview of Code Sec. 103.

The DeNaples' argument was certainly not without precedent. Many courts have previously acknowledged the distinction between interest that is the product of a state or municipal entity's voluntary bargaining and interest arising by statute in condemnation proceedings. [*See, e.g., Kings County Development Co.*, CA-9, 37-2 USTC ¶9585, 93 F2d 33 (1937), *cert. denied*, 304 US 559, 82 LEd 1527, 58 SCt 941 (1938); *H.V.L. Meyer*, CA-2, 39-1 USTC ¶9518, 104 F2d 155 (1939); *T.M. Drew*, CA-5, 77-1 USTC ¶9374, 551 F2d 85 (1977).]

Of course, there is theory and there is practice. It turns out that showing an interest payment is the product of arm's-length voluntary borrowing on the part of the government entity is very difficult. For example, in *G.M. Holley*, CA-6, 42-1 USTC ¶9205, 124 F2d 909 (1942), *cert. denied*, 316 US 685 (1942), a taxpayer claimed tax-exempt status for interest paid to him by the city of Detroit.

The taxpayer in *Holley* and the city of Detroit had entered into an agreement under which the city was to pay two condemnation awards in annual installments. Interest would be paid on the unpaid balance. The Court of Appeals for the Sixth Circuit held that the interest was not exempt from tax. Why? Although the contract to defer payment was *voluntary*, the taking was not. Since the taxpayer and the city had not bargained for anything and the compensation being paid was necessarily compulsory upon the taxpayer, the interest was considered to be part of the award itself. That meant it was taxable.

The Tax Man

In the Tax Court (TC Memo. 2010-171), the DeNaples argued that the Settlement Interest (in excess of the statutorily required amount) and the Installment Interest were excludible as the products of voluntary bargaining. However, Judge Arthur L. Nims III, was hardly moved by these arguments. With respect to the Settlement Interest, the Tax Court ruled that the DeNaples had failed to demonstrate which portion of the $16.3 million Settlement Interest was allocable to the commercial loan rate and which potion was in excess of this amount.

In fact, the Tax Court characterized the allocation between the principal and Settlement Interest as arbitrary and excessive. As a consequence, the court did not even reach the question of whether the payment of Settlement Interest in excess of the statutory rate was voluntary. With respect to the Installment Interest, the Tax Court found the U.S. and Pennsylvania Constitutions required the payment of "just compensation," including interest from the settlement date until the DeNaples actually received their money.

The result, said the Tax Court, was that there was no voluntary bargaining for the Settlement Interest. After all, *by operation of law*, Pennsylvania was required to pay interest on the installment payments. Although the DeNaples sought reconsideration of the original Tax Court Memorandum (TC Memo. 2011-46), Judge Nims remained unconvinced.

The Tax Court characterized the DeNaples' arguments as hoping to "perform alchemy by using the [s]ettlement [a]greement to transmute legally required interest into tax-exempt interest."

Get Back

Presumably given the financial stakes involved, the DeNaples appealed to the Third Circuit. There they met with surprising success. On account of the procedural history of the case, the Third Circuit was unwilling to revisit the taxability of the Settlement Interest.

However, the court reviewed the Installment Interest and found that Pennsylvania had indeed bargained with the taxpayers regarding the payment of this interest. In fact, the state had invoked its borrowing authority. The Third Circuit stated that Pennsylvania and the DeNaples negotiated a complete and independent arm's-length settlement of Pennsylvania's claims to the appropriated land.

This was significant for the court. Because the DeNaples agreed to a lower, variable interest rate

for the purpose of extending credit to Pennsylvania, "the State's obligation arose by voluntary bargaining, not by operation of law." Given the long judicial history of cases ruling that interest in condemnation proceedings normally arises through operation of law, this decision is remarkable.

The court did point out that in most condemnation proceedings, the state's obligation to pay interest arises by operation of law. However, the key to the court's reasoning appears to be that Pennsylvania and the DeNaples engaged in two distinct negotiations. Artificial perhaps, but here's how the Third Circuit saw it.

First, the parties sat down at the table and negotiated a total and complete settlement regarding the eminent domain proceedings. This agreement was separate from the judicial process and the constitutional requirement of just compensation. But it was enough to extinguish the condemnation proceedings. Then, in an analytically distinct transaction, the DeNaples agreed to take installment payments because the state needed credit.

In fact, the Third Circuit was convinced that the DeNaples accepted a lower, variable interest rate than the rate to which they were otherwise entitled. Presumably the DeNaples had the right to interest at the prevailing commercial rate (like the Settlement Interest). Even so, they agreed to accept a lower, variable interest rate for installment interest. According to the court, the statutory right to interest became nothing more than a negotiating chip in the DeNaples' pocket. It could be, and was, bargained away.

Importantly, the Third Circuit makes sure to point out that its ruling is consistent with the underlying purpose of Code Sec. 103. In a Pennsylvania condemnation proceeding, a court could have imposed interest at the prevailing commercial rate. That can be as much as the prime rate plus three percent.

Instead, through its negotiations with the DeNaples and in part because of the Code Sec. 103 exclusion, Pennsylvania was able to borrow money from the DeNaples at a lower rate of interest. Ultimately, that bit of negotiating aided the state's borrowing authority and saved it money.

The End

DeNaples is an important case. It shows that in appropriate situations, taxpayers may indeed engage in alchemy to transform normally taxable interest into tax-free interest under Code Sec. 103. This may represent a seismic shift in the role of the Code Sec. 103 tax nerds.

No longer will these tax lawyers be confined to their roles as the gate-keepers of average asset lives. *DeNaples* may be the harbinger of the strutting-greased-back-hair-cigar-smoking Code Sec. 103 litigator. Look out Subchapter C tax megastars—a new hot tax lawyer is arriving on the scene.