



Interest Netting: A Taxpayer Win on Underpayment and Overpayment of Federal Tax - and for Possible Challenges to Broad Assertion of Sovereign Immunity

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2012 – Issue 47 – The Internal Revenue Code is notorious for complicated rules, confusing provisions and differing interpretations of its most simple provisions. For example, the global interest netting provision in Section 6621(d) enacted in 1998 was recently subject to the same confusion that plagues so many other sections. Enacted to benefit corporate taxpayers by eliminating the interest rate differential on underpayment and overpayment of federal taxes (including income, employment, etc.) by the same taxpayer, the confusion over the special rule that accompanies the provision has created a burden for some taxpayers. Simply stated, Congress recognized that it was inequitable for a taxpayer to owe interest to the U.S. Government when no net tax liability is due. (See H.R. Rep. No. 99–841, pt. 2 at 785 (1986).) Thankfully, a recent case has cleared up much confusion about the global interest rate netting rules, thereby opening the door to challenge the government's defenses to global netting.

Interest Netting Background: IRC Section 6621(d)

Prior to the Tax Reform Act of 1986, interest netting was a non–issue for corporations because the same rate of interest applied to overpayments and underpayments of tax. However, beginning in May 1986, Congress increased the interest rate applicable to corporate tax underpayments compared to the rate payable to the same corporate taxpayer for interest on tax overpayments. The IRS pays interest on corporate overpayments at a rate equal to the federal short–term rate plus 2 percent, unless the refund for any year equals or exceeds \$10,000, in which case the rate drops to the federal short–term rate plus 0.5 percent. However, if a corporation had made an underpayment on tax, the underpayment rate is equal to the federal short–term rate plus 3 percent or, for large corporations, federal short–term rate plus 5 percent. (See IRC Sec. 6621(a) and IRC Sec. 6621(c).)

Congress recognized that the interest rate differential between overpayments and underpayments can be as great as 4.5 percentage points, causing a significant underpayment liability for corporations. To remedy the situation, Congress called on the IRS to put into practice interest netting rules that would eliminate the inequity caused by the interest rate gap. The conference report that accompanied the Tax Reform Act of 1986 asked the IRS to put in place rules to eliminate the interest owed by a corporation when it had no net tax liability because of overpayments and underpayments that existed during the same time, but in different tax years. After 10 years of inaction by the IRS, Congress stepped in and enacted IRC Sec. 6621(d) on July 22, 1998, to solve the interest netting problem the new rates created.

IRC Section 6621(d) states "to the extent that, for any period, interest is payable [...] on equivalent underpayments and overpayments by the same taxpayer of tax imposed by this title, the net rate of interest under this section on such amounts shall be zero for such period." To come up with a net rate of interest of zero, the IRS will force the same rates for both years by either increasing the interest rate on an overpayment or decreasing the interest rate on an underpayment.

The simple addition to IRC Section 6621 was also accompanied by an un–codified special rule put in place by the IRS to extend the interest rate netting to corporations for periods before July 22, 1998, when Section 6621(d) was enacted. The special rule was the IRS's way to make up for dropping the ball on eliminating the problem when the tax rates changed in 1986. The special rule states "subject to any applicable statute of limitation not having expired with regard to either a tax underpayment or a tax overpayment, the amendments made by this section shall apply to interest for all periods before the date of the enactment of this Act" as long as the taxpayer identifies the periods of overpayments and underpayments and requests to apply Section 6621(d) no later than December 31, 1999.

However, this seemingly simple special rule created controversy and confusion regarding whether the overpayment and

underpayment must both be within the statute of limitations for taxpayers seeking retrospective relief versus prospective relief. In addition, the IRS often asserted either that it had no authority to offset interest for periods that had been time barred (the retrospective relief from 1999 back to 1987) or that the sovereign immunity doctrine barred suits against the government for interest relating to time barred periods.

The Federal National Mortgage Association ("Fannie Mae") first brought the issue of retrospective relief to the Federal Circuit court in 2004, and the issue resurfaced recently in August 2012 with the Exxon Mobil Corporation case in the Second Circuit Court. The two cases had different outcomes, but the later Exxon Mobil case provides significant insight into the interest netting rules (especially for retrospective relief) and a resolution to the issue of sovereign immunity on retrospective interest netting claims.

Federal National Mortgage Association v. U.S.

Fannie Mae sued the U.S. Treasury in the Court of Federal Claims for relief from interest due to the IRS under the Section 6621(d) special claim for retrospective application of zero net interest rate to pre-1998 periods of overlapping underpayments and overpayments. (See *Federal National Mortgage Association v. U.S.*, 56 Fed. Cl. 228 (2003).) The Court of Federal Claims held that "the special rule applies as long as at least one of the applicable statutes of limitations remains open." The case addressed statutory construction arguments, IRS authority and deference to IRS Revenue Procedures in deciding that only one leg of the underpayment or overpayment needs to be open for statute of limitations purposes for the zero net interest rate to apply.

However, the case was reversed on grounds that the U.S. had not consented to be sued and, in this case, the underpayment period was a period for which the applicable statute of limitations had expired. The court did not in any way criticize or differ with the Court of Federal Claims approach or result regarding interest rate netting. The court merely ruled that the U.S. Government had not expressly waived its sovereign immunity to be sued for netting for periods that are time barred. (See *Federal National Mortgage Association v. U.S.*, 379 F.3d 1303 (2004).)

Exxon Mobil Corp v. Commissioner

Exxon Mobil found itself in similar position as Fannie Mae regarding the interest netting issue. Exxon Mobil tried to apply the interest rate netting rule of IRC Section 6621(d) and the special un-codified rule allowing retrospective relief to result in no interest due even if an overlapping period had expired from a statute of limitations perspective.

Exxon Mobil first took its case to the Tax Court in 2011, where the Tax Court disagreed with the Commissioner and the Court of Appeals decision in *Federal National Mortgage Association v. U.S.* on both issues: (1) requiring both periods to be open for the netting rule to apply and (2) the applicability of sovereign immunity as a defense to the Government.

The Government appealed to the Second Circuit Court of Appeals. The Second Circuit similarly disagreed with the Commissioner and the Fannie Mae decision and upheld the Tax Court's decision in this case allowing Exxon Mobil the relief under the special interest rate netting rule without regard to the fact that one leg of the overlapping period was time barred under the statute of limitations. (See *Exxon Mobil Corp. & Affiliates v. Commissioner*, 689 F.3d 1 (Ct. App. 2nd Cir. 2012).) The court also dealt a blow to the Commissioner's reliance on sovereign immunity as a defense to a request for zero interest rate for no net tax due situations. The court referred to IRC Section 6611 as the express waiver of sovereign immunity (including cases that examined the issue and agreed) for taxpayers to claim interest on overpayments from the U.S. Government.

Having rejected the sovereign immunity argument, the Second Circuit went back to the provision's structure, historical context and purpose to interpret whether the special rule was meant to apply to one or both legs of the overlapping interest periods without regard to whether one of the periods was time barred. The Second Circuit Court ruled that "IRC Sec. 6621(d) and the special rule ----- both parts of the Internal Revenue Service Restructuring and Reform Act of 1998 ----- are best understood as remedial provisions, and should therefore be interpreted broadly to effectuate Congress's remedial goals." In all three court cases, it was agreed that the special rule did not clearly state whether all or one year of the overpayments and underpayments must be open to receive the remedial treatment. The relief was allowed prospectively as long as at least one of the affected periods is open under the applicable statute of limitations. The issue before the Second Circuit was whether the IRS's denial of retrospective relief where one of the affected periods was time barred was proper. The Second Circuit was not impressed by any argument attempting to distinguish the prospective relief from retrospective relief. Exxon Mobil was a clear win for taxpayers with similarly situated facts.

Alvarez & Marsal Taxand Says:

The recent decision in the Exxon Mobil case is a clear victory for the taxpayers who have filed requests for retrospective interest

netting under the special rule in IRC Section 6621(d) extending the interest rate netting to corporations for periods before July 22, 1998, when Section 6621(d) was enacted. Corporations may also have an opportunity to file an interest refund claim as long as statute of limitations is open for either the overpayment or underpayment years. It is unlikely that the Supreme Court will hear the case to resolve the split between courts as the dispute over the special tax rule today affects only very few taxpayers. To benefit directly from this decision, the taxpayer should have filed a retrospective interest netting request by 1999 and still have time to file a suit or have one pending.

However, all taxpayers will benefit from Exxon Mobil case as it provides precedent for challenging the broad assertion of sovereign immunity in tax cases. The Second Circuit found the express waiver in another code section and found the waiver to be satisfactory for claims under the different code section.

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