

# WNTS Insight

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## Court of Federal Claims supports taxpayer on interest-netting issue

In a taxpayer-favorable decision, the U.S. Court of Federal Claims recently held, in *Magma Power Company v. United States*, that the interest-netting provisions of section 6621(d) applied to (1) a separate 1993 underpayment of Magma Power and (2) 1995 to 1998 overpayments of the consolidated group that Magma Power joined in 1995, to the extent that the group's overpayments were attributable to Magma Power.

### Background

As implemented by Rev. Procs. 99-43 and 2000-26, section 6621(d), enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998, provides for a "net rate of interest" of zero to the extent of overlapping tax underpayments and overpayments.

For the statute to say there is a "net rate of interest" of zero is somewhat misleading, because under the netting procedures interest is not paid or allowed at a zero rate. Instead, netting serves to eliminate the interest differential -- the difference between the rate the IRS charges corporations on tax underpayments and the rate the IRS pays them on tax overpayments -- for "periods of mutual indebtedness," i.e., overlapping overpayment and underpayment periods. Said another way, netting equalizes the rates of interest during overlapping periods.

The benefit derived from interest netting can be substantial, since the interest rate differential can be as much as 4.5 percent when underpayment interest is running at the two-percent-higher hot interest rate and overpayment interest is running at the lower (by 1.5 percent) GATT rate. (**Note:** for corporations there is always at least a one-percent differential, which is why the maximum differential is 4.5 percent instead of 3.5 percent in this case.)



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Global netting is applicable across different types of tax; for example, income taxes can be netted against employment taxes or excise taxes. However, the various overpayments and underpayments must be those of the “same taxpayer.”

## *Magma Power*

The issue in *Magma Power* was whether the overpayment on the affiliated group’s consolidated Form 1120 account, which was processed under the parent corporation’s tax identification number, could be used by Magma Power for interest-netting purposes.

This determination is relevant when a member of the group has a separate tax underpayment -- an income tax underpayment for a tax year prior to the time the member joined the affiliated group, or an underpayment of excise or employment tax.

The “flip side” of this issue -- i.e., when the group has an income tax underpayment and a member has a separate overpayment -- generally does not present a “same taxpayer” problem. That is because Reg. sec. 1.1502-6(a) provides that each member of an affiliated group is severally liable for the group’s underpayment. Accordingly, the member that has the separate-year (or excise or employment tax) overpayment also is liable for the group’s underpayment; thus, for interest-netting purposes, the “same taxpayer” requirement is satisfied.

## *The court's decision*

The Court of Federal Claims rejected the IRS position that the term “same taxpayer” contemplates a “complete identity” between the entities on the tax returns in question (what the court referred to as “the same DNA analysis”). Instead, the court focused on the taxpayer’s taxpayer identification number. That number (1) in the case of a consolidated group, remains the same even though the composition of the group may change from year to year, and (2) in the case of a subsidiary, is not “lost in the shuffle” or rendered irrelevant by the fact that it is a member of a consolidated group.

Indeed, the court found that the IRS’s focus on Magma Power’s status as a member of the MidAmerican Energy group obfuscated the interest-netting issue, since a consolidated group is not a taxable unit but instead is simply a tax-computing unit.

Moreover, after noting that remedial provisions such as interest netting should be liberally construed to effect their primary purpose, the court stated that reading into section 6621(d) an exclusion for consolidated return filers “would effectively disqualify almost the entire corporate taxpayer base and would exclude from the interest-netting program its primary beneficiaries.”

The court therefore held that the interest-netting provisions of section 6621(d) applied to Magma Power’s separate 1993 underpayment and the 1995 to 1998 overpayments of the MidAmerican Energy Holdings consolidated group that Magma Power joined in 1995, to the extent that the group’s overpayments were attributable to Magma Power.

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**Note:** In the litigation, Magma Power had sought to recover approximately \$2.2 million of overpaid underpayment interest. However, the extent to which the consolidated group's overpayments were attributable to Magma Power (and the amount to be refunded to Magma Power) will either have to be agreed to by the parties, or resolved through further judicial proceedings.

## *Observations*

The court's decision is consistent with informal advice provided by IRS Chief Counsel (Field Service Advice memorandum 200212028), which appeared to advocate the same sort of "tracing" approach, whereby the taxpayer must establish which member or members were responsible for the group's overpayment.

However, in Chief Counsel Advice memorandum 200707002, Chief Counsel later concluded that a consolidated group's overpayment does not belong to any particular member or members and therefore cannot be used for interest-netting purposes with respect to a separate tax underpayment of a member. That conclusion was rejected by the court in *Magma Power*.

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