WNTS Insight

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Second Circuit affirms taxpayer win in interest-netting case

In *Exxon Mobil v. Commissioner of Internal Revenue*, the U.S. Court of Appeals for the Second Circuit recently affirmed a taxpayer-favorable 2011 decision of the U.S. Tax Court in a case regarding interest netting on tax overpayments and underpayments. Because the Federal Circuit in 2004 reached a contrary result in *FNMA v. United States*, the Second Circuit's decision creates a split in the circuits regarding the proper interpretation of the uncodified "special rule" that makes the interest-netting provisions of section 6621(d) applicable to periods of overlapping indebtedness that occurred prior to the July 22, 1998, effective date of the statute.

For prior coverage of the Tax Court decision, see WNTS Insight, "Tax Court addresses interest-netting issues," February 15, 2011.

Background

Section 3301 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 1998) added to the Internal Revenue Code section 6621(d), which provides for what is commonly referred to as a "net interest rate of zero" to the extent of overlapping tax underpayments and overpayments.

The term "net interest rate of zero" is something of a misnomer, however, 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 pays them on tax overpayments -- for so-called periods of mutual indebtedness, i.e., overlapping overpayment and underpayment periods. Said another way, netting equalizes the rates of interest during overlapping periods.

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The benefit derived from interest netting can be substantial, because 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.

Section 6621(d) applies to interest accrued after the July 22, 1998, effective date of RRA 1998. A special rule that also was enacted as part of section 3301 -- but never codified as part of the Internal Revenue Code -- allows taxpayers to request that the IRS apply a zero net interest rate to pre-enactment periods of mutual indebtedness "subject to any applicable statute of limitation not having expired with regard to either a tax underpayment or a tax overpayment." The IRS issued Rev. Proc. 99-43 (and then Rev. Proc. 2000-26) to implement the rules enacted in section 3301.

Facts

Exxon Mobil Corporation and Affiliated Companies (Exxon) timely filed consolidated tax returns for the tax years 1975 to 1980. The IRS examined those returns over a period ending in 1990. The result of the examination — as affected by numerous administrative and judicial challenges by Exxon — was that Exxon had tax underpayments for 1975 to 1978 that overlapped tax overpayments for 1979 and 1980.

In December 1999, Exxon filed an administrative interest-netting claim with the IRS. At that time, the period of limitations for the underpayment leg of the overlapping period (i.e., tax years 1975 to 1978) may have expired, but the period of limitations for the overpayment leg (i.e., tax years 1979 and 1980) was still open.

Apparently, the IRS never acted on that netting claim, and on February 28, 2005, Exxon timely filed a motion with the Tax Court to redetermine post-decision interest for 1979 and 1980 pursuant to section 7481(c) and Tax Court Rule 261. The parties stipulated that if Exxon's motion was granted, it would be entitled to almost $9 million of additional interest.

Issue

Before the Tax Court, Exxon and the IRS disputed the meaning of the prefatory phrase of the special rule: "Subject to any applicable statute of limitations not having expired with regard to either a tax underpayment or a tax overpayment..."

Exxon argued that the special rule extending interest-netting relief to pre-enactment interest is available if the statute of limitations for either the underpayment or overpayment period had not expired as of July 22, 1998. The IRS took the position that the special rule applies only when both the overpayment and underpayment periods were open on that date.

Discussion

The Tax Court held that interest netting should be available even if only one applicable limitations period -- i.e., the period within which Exxon could have filed a refund claim for overpaid underpayment interest or the period during which it could have requested additional overpayment interest -- was open as of the July 22, 1998, effective date of RRA 1998.

On appeal, the Second Circuit, like the Tax Court, rejected the IRS's argument that the special rule is a waiver of sovereign immunity and therefore must be construed narrowly in favor of the government. Instead, the court of appeals held that in Exxon's case the relevant waiver of sovereign immunity is found in section 6611(a), which provides that interest shall be allowed and paid on tax overpayments. The court found that the special rule, in contrast, "merely allows for the interest-netting provision of section 6621(d) to be applied retroactively to claims raised under section 6611(a)," and while it might constitute a waiver of the general rule that congressional enactments and administrative rules will not be given retroactive effect, the special rule cannot properly be understood as a waiver of sovereign immunity.

The court of appeals further held, as had the Tax Court, that the structure, context, and evident purpose of the special rule (which it deemed it necessary to consult due to the special rule's ambiguity) indicate that it is to be read broadly, such that interest netting is applicable when at least one leg of the underpayment/overpayment overlapping period was not barred by the applicable period of limitations as of July 22, 1998.

Observation

Although the decision in *Exxon Mobil* creates a split in the circuits, it appears questionable whether the Supreme Court would grant certiorari to resolve the issue because, as noted in footnote 6 of the decision, there appear to be few, if any, remaining tax disputes whose disposition depends on the meaning of the special rule. It seems likely, therefore, that the IRS will follow the *Exxon Mobil* decision only in cases appealable to the Second Circuit (which is comprised of New York, Connecticut, and Vermont).

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