

WNTS Insight



Tax Court addresses interest-netting issues

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The U.S. Tax Court recently ruled in favor of Exxon Mobil Corporation in a case regarding interest netting on tax overpayments and underpayments. While a key holding in the case regarding retroactivity is of limited applicability because it involved interest prior to July 22, 1998, the decision addresses a variety of interesting issues regarding the Tax Court's jurisdiction over interest-netting cases.

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.

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.

Section 7481(c) gives the U.S. Tax Court nonexclusive jurisdiction to determine disputes over underpayment and overpayment interest, if the taxpayer files a motion for such a redetermination of interest within one year after the date the decision of the Tax Court becomes final.

The Tax Court decision

Facts

Exxon Mobil Corporation and Affiliated Companies (Exxon) timely filed consolidated tax returns for tax years 1975 to 1982. The IRS examined those returns over a period ending in 1990 and sent Exxon notices of deficiency for tax years 1977 to 1982. Exxon paid assessments and underpayment interest based on adjustments to which it agreed and petitioned the Tax Court regarding the proposed deficiencies for 1979 to 1982. During the audits and litigation, Exxon made advance payments of taxes and interest for the 1979 and 1980 deficiencies.

The Tax Court issued a number of opinions addressing the issues raised in the 1979 and 1980 to 1982 cases. After the parties resolved the remaining issues, the court entered stipulated decisions in accordance with the parties' agreed computations. (A revised stipulated decision later was entered in the 1979 case.)

Exxon also litigated issues regarding its 1975 tax liability in the U.S. Court of Federal Claims and its 1976 to 1978 tax liabilities in the U.S. District Court for the Northern District of Texas.

At the end of the day, Exxon had tax underpayments for 1975 to 1978 that overlapped tax overpayments for 1979 and 1980. All along, Exxon had sought to preserve its right to interest netting. 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 for

the overlapping periods of indebtedness under section 6621(d), which would earn additional interest until paid.

Issues

The Tax Court first addressed the IRS's contention that an interest-netting claim is a general claim for money against the government.

Although the IRS conceded that Exxon had complied with the procedural requirements set forth in section 7481(c) and Rule 261, it contended that section 7481(c) does not grant the Tax Court jurisdiction to determine interest netting under section 6621(d).

Specifically, the IRS argued that section 6621(d) is not an interest rate provision but a computation of a separate interest-netting amount for the IRS to apply. Therefore, the determination of a net rate of interest of zero will result in the IRS paying money to the taxpayer (unless there are balances due against which the interest could be offset pursuant to section 6402). Therefore, it was the IRS's position that an interest-netting claim constitutes a general claim for money against the government (i.e., a Tucker Act claim) that must be brought in a separate proceeding.

The Tax Court disagreed, holding that at its core section 6621(d) is an interest rate provision, because both section 6601, which imposes interest on tax underpayments, and section 6611, which provides for interest on tax overpayments, refer to section 6621 to determine the rate of interest. While section 6621(a) initially sets the general overpayment and underpayment rates (subject to adjustments required by sections 6621(b) and (c)), section 6621(d) reduces the rate to a net rate of zero during periods that equivalent tax underpayments and tax overpayments overlap. The court therefore held that the fact that interest netting may result in the government owing money to a taxpayer does not transform a claim filed under section 6621(d) into a general claim for money.

The Tax Court then addressed the IRS's contention that the court's jurisdiction under section 7481(c) is limited to the determination of interest rates.

The court rejected the IRS's argument, noting that the language of section 7481(c) specifically refers to "the amount" by which a taxpayer has (1) overpaid interest or (2) been underpaid interest by the IRS. Because determining the amount of interest under section 7481(c) requires the court to analyze the applicable rate of interest, the principal amount, and the length of time the underpayment or overpayment is outstanding, the court held that its jurisdiction necessarily encompasses all those factors.

The third IRS argument the Tax Court addressed was that it was not proper for the court to consider tax years 1975-1978, over which it did not have original jurisdiction.

The IRS argued that the Tax Court's interest determinations under section 7481(c) must be limited to 1979 and 1980, years over which it has original jurisdiction, and did not extend to prior years over which it has no jurisdiction. The Tax Court rejected this argument on the basis that (1) it was not making any determination with respect to 1975-1978, years for which underpayments had been determined through litigation, or settlements reached during litigation, in other courts, and (2) section 6214(b) expressly allows the court to consider facts related to the 1975-1978 underpayment years -- which the parties had stipulated to -- in order to determine interest netting for the 1979 and 1980 overpayment years over which the court had original jurisdiction.

Finally, the Tax Court addressed netting for pre-enactment interest under the special rule in RRA 1998.

The 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.

Exxon had argued that the special rule extending interest-netting relief to pre-enactment interest is available if 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 over- and

underpayment periods were open on that date. Noting that the same arguments were made in *FNMA v. United States* (Fed. Cir. 2004), the Tax Court said the statutory language is open to either interpretation and does not show an obvious congressional intent as to its meaning.

The Tax Court declined to afford deference under the Supreme Court's 1944 decision in *Skidmore v. Swift Co.* to Rev. Proc. 99-43, which required both periods of limitation be open for retroactive application of the special rule, because the revenue procedure did not include any supporting rationale for that interpretation. The court characterized the pronouncement in Rev. Proc. 99-43 as a litigation position rather than an interpretation of the special rule.

The court also considered *FNMA*, but disagreed with the Federal Circuit's conclusion in that case that language in the special rule limited a court's jurisdiction and required strict construction. The Tax Court said that "[t]he special rule is not a waiver of sovereign immunity but an interest rate provision" and is not necessarily governed by the strict construction principle. Instead, as modified by the special rule, section 6621(d) is a remedial statute that must be interpreted in that light regardless of whether the rule is a waiver of immunity. Further, the language relied on by the Federal Circuit was meant to act as a technical correction to expand, not restrict, interest netting.

Based on its analysis, the Tax Court held that interest netting should be available even if only one applicable limitations period was open as of the effective date of RRA 1998, and that Exxon was entitled to additional interest under section 6621(d) and the special rule.

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