BNA, INC.

DAILY TAX REPORT

BNA Employee-Owned Since 1947

VOL. 8, NO. 91 MAY 12, 2008

Mixed Signals—The Current State of Authorities With Respect to Netting Interest Between Affiliated Companies

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Interest netting, created pursuant to legislation effective July 22, 1998, eliminates the interest rate differential suffered by taxpayers in instances in which the same taxpayer has overlapping deficiencies and overpayments.

It appears that the service is allowing cross-entity interest netting only in situations of merger in which only one of the two companies survives and the surviving company assumes all liabilities of the liquidated company.

The enacted statute, Internal Revenue Code Section 6621(d), reads as follows:

> (d) Elimination of Interest on Overlapping Periods of Tax Overpayments and Underpayments.—To the extent that, for any period, interest is payable under subchapter A and allowable under subchapter B 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.

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Many questions remain unanswered with respect to the definition of the ''same taxpayer'' for interest netting purposes. These questions will most likely not be resolved until litigation is undertaken.

Early authorities issued by the Internal Revenue Service indicated that ''cross-entity'' interest netting would be allowed if both the overpayment and underpayment could be sourced back to the same company.

Field Service Advice 200212028, which set forth nine fact patterns with respect to which netting might be considered, never specifically stated that interest netting would be allowed between two entities that had become part of the same consolidated group if the pre-consolidated tax item of one was sought to be netted with a post-consolidation tax item of the group. However, in discussing criteria that must be addressed in determining whether to allow such a netting claim, the service stated in the FSA that ''[based on the facts as presented] it is unclear whether the [overpayment] is attributable to either A, B or both A and B.''

An example may help clarify the fact pattern. Assume in Year 1 Company A files Form 1120. In Year 2, Company A joins Group B as a new subsidiary of the consolidated group. Subsequently, the service determines that Company A has an underpayment for Year 1, while Group B has an overpayment for Year 2. Group B seeks to net the overpayment in Year 2 with Company A's Year 1 underpayment. In language present in several examples in FSA 200212028, IRS implies that netting may be allowed if the Year 2 overpayment can be sourced back to Company A's pre-consolidation Year 2 income. In short, both the overpayment and underpayment must be sourced back to the same taxpayer.

Change of Direction With CCA

Later, in IRS Chief Counsel Advice Memorandum 200707002, the service concluded that netting would not be allowed in the above fact pattern. Deciding that ''the same taxpayer'' is defined as a taxpayer both entitled to any overpayment and liable for any underpayment with respect to which a company or group seeks to net interest, IRS concluded that, since the overpayment was payable to the consolidated group and not

 ISSN 0092-6884

any single member of the group, Company A could not be both liable for the underpayment and entitled to the overpayment.

The service appears to have thus abandoned the positions implied in previous FSA 200212028.

The above litmus test has also been applied with respect to netting interest with respect to different tax types reported within a consolidated group.

Suppose, for example, that Company B is a subsidiary filing as part of consolidated Group C. For Tax Year 1, Company B, which files its own excise tax returns, incurs excise tax underpayments. In Year 2, Group C is found to have an overpayment of federal income tax. Pursuant to the implications in FSA 200212028, the excise tax underpayment may be netted with the income tax overpayment to the extent that the overpayment may be sourced back to the pre-consolidation income of Company B.

This fact pattern is addressed again in subsequent CCA 200707002, in which the service concluded that the ''same taxpayer'' test is not met, so we are able to confidently speculate that IRS has changed the position taken in older FSA 200212028.

Where does IRS's evolving position leave the taxpayer who seeks to net interest across entity lines and possibly across tax types as well? It appears that the service is allowing cross-entity interest netting only in situations of merger in which:

- only one of the two companies survives, and
- the surviving company assumes all liabilities of the liquidated company.

Path for Taxpayers

As this brief discussion indicates, the service continues to change its course with respect to interest netting and appears to be steering away from issuing clear guidelines, perhaps in a maneuver to gird itself for inevitable litigation. Meanwhile, how does a taxpayer determine what types of interest netting claims to file?

We recommend that taxpayers aggressively pursue cross-entity interest netting until litigation precedent is established. However, taxpayers who benefited from the more liberal interpretations held by the service prior to CCA 200707002 may not want to risk filing additional interest netting claims that include years previously netted between entities, as the risk exists that the service may attempt to recapture the prior interest refunds under the new, stricter guidelines.

  DTR ISSN 0092-6884