



Interest Netting Between Merging Corporations

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In general, taxpayers pay interest on tax underpayments and receive interest on overpayments, but for corporations the interest rate on underpayments is higher than the rate on overpayments. Thus, if a corporation has an underpayment from one year and an overpayment in the same amount from another year, it will owe interest even though it owes no net tax. For corporations with significant tax deficiencies and overpayments, the rate differential may be as much as 4 percentage points.

To alleviate this problem, Congress enacted section 6621(d) of the Code, an "interest netting" rule. Under section 6621(d), if "*the same taxpayer*" has "equivalent" amounts of underpayment and overpayment, "the net rate of interest on such amounts" is zero.

There have been several court decisions and IRS chief counsel advice memoranda addressing the issue of what is "the same taxpayer" in the context of corporate acquisitions.

WELLS FARGO DECISION

On June 27, the Court of Federal Claims announced a decision construing "the same taxpayer" in the context of corporate mergers. *Wells Fargo & Co. v. United States*, No. 11-808T, ___ Fed. Cl. ___, 114 AFTR 2d 2014-___ (Ct. Fed. Cl. 2014). The decision deals with several acquisitive mergers by Wells Fargo and its corporate predecessors. In each of the mergers, the parent of a consolidated group merged into the parent or a subsidiary member of another group. Ultimately all the target corporations, or their successors by merger, were merged into Wells Fargo, which was the parent of a consolidated group.



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The parties filed cross motions for partial summary judgment on the issue of whether interest netting was permitted. Wells Fargo argued that the target and the acquiror in a merger were "the same taxpayer," and that, therefore, underpayments and overpayments by the targets and the acquirors could be netted against each other for periods both before and after the mergers. The Government argued that netting was permitted only if the corporation making the overpayment and the underpayment had the same TIN at the time of both events.

The court described mergers as presenting three potential interest-netting scenarios:

- Netting of pre-merger underpayments (or overpayments) by the acquiror against pre-merger overpayments (or underpayments) by the target.
- Netting of pre-merger underpayments (or overpayments) by the acquiror against post-merger overpayments (or underpayments) by the acquiror.
- Netting of pre-merger underpayments (or overpayments) by the target against post-merger overpayments (or underpayments) by the acquiror.

The court granted Wells Fargo's motion and denied the Government's motion, holding that interest netting was permitted in all three scenarios. This holding was based on the rationale that, as a matter of state law, in a statutory merger, "the acquired and acquiring corporations have no post-merger existence beyond the surviving corporation; instead, they become one and the same by operation of law, and thereafter the surviving corporation is liable for the pre-merger tax payments of both the acquired and acquiring corporations.[F]ollowing a merger, the law treats the acquired corporation as though it had always been part of the surviving entity." *Wells Fargo*, slip op. at 16-17.

Unresolved Issues

The scope of the *Wells Fargo* holding is not clear, and a number of issues remain unresolved:

- **Taxable Mergers.** The mergers in *Wells Fargo* were tax-free reorganizations, but the court's opinion concentrates on the corporate law consequences of a merger combining the identities of the target and the acquiror. Thus, the *Wells Fargo* holding may also apply to mergers that do not qualify for tax-free treatment. Rev. Rul. 69-6, 1969-1 C.B. 104 (forward merger for nonstock consideration treated as taxable sale of target assets and liquidation of target); Rev. Rul. 73-427, 1973-2 C.B.301 (reverse merger for cash consideration treated as sale of target stock).

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- **Mergers of Target Corporation into Disregarded Entity.** It is common for a target corporation to be merged into a disregarded entity, such as an LLC, that is owned by a corporation. Such a merger can qualify as a tax-free "statutory merger or consolidation" of the two corporations. IRC 368(a)(1)(A); Reg. 1.368-2(b)(1)(ii). As a corporate law matter, however, the merger combines the target corporation and the disregarded entity, not its owner. Thus, it is not clear whether the *Wells Fargo* holding would support interest netting between the target and the corporate owner of the disregarded entity.
- **Consolidated Returns.** The mergers in *Wells Fargo* involved common parents of consolidated groups, but the court's opinion does not address netting within a single consolidated group or between groups. The background to this issue can be described as follows:
 - Netting within a consolidated group where there is no change in the composition of the group does not appear to be a subject of controversy.
 - In *Energy East Corp. v. United States*, 645 F.3d 1358, 107 AFTR 2d 2011-2606 (Fed. Cir. 2011), the Federal Circuit held that, if a target corporation joins a group (not in a merger), netting is not permitted between interest on the target's pre-acquisition overpayments (or underpayments) and interest on the group's pre-acquisition underpayments (or overpayments).
 - In *Magma Power Co. v. United States*, 101 Fed. Cl. 562, 108 AFTR 2d 2011-6943 (Ct. Fed. Cl. 2011), the Court of Federal Claims held that, if a target corporation joins a group (again, not in a merger), interest on the target's pre-acquisition underpayments (or overpayments) may be netted against interest on the group's post-acquisition overpayments (or underpayments), to the extent the group's overpayment (or underpayment) can be traced to the target.
 - See also FSA 200212028 (Jan. 16, 2002) (interest netting requires liability for the underpayment by the entity with the overpayment).

What happens if, as in *Wells Fargo*, the common parent of one consolidated group merges into the common parent of another group? Does netting apply to interest on underpayments and overpayments generated by both groups on a consolidated basis, or just to interest on underpayments and overpayments generated by the target and the acquiror as separate entities? The parties' motions for partial summary judgment in *Wells Fargo* did not require the court to address this issue, and the court's opinion does not do so.

Take-Away

Under the *Wells Fargo* holding, it is clear that interest netting applies between the target and the acquiror in a two-party corporate merger that qualifies as a tax-free reorganization.



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Netting may also apply even if the merger does not qualify for tax-free treatment, and/or a corporate target merges into a disregarded entity, but the *Wells Fargo* opinion does not address these points. Also, the *Wells Fargo* opinion does not clarify the application of netting where the target or the acquiror (or both) is a consolidated group parent.

In many instances, an acquisition (tax-free or taxable) can be structured in a number of ways, including a two-party merger. Often such a merger is rejected, e.g., to prevent the acquiror from assuming the target's contingent liabilities. Such concerns are important, but the availability of interest netting may be a tangible factor in favor of a two-party merger acquisition structure.

If you have questions or comments, please contact Bob Wellen or Pat Smith.