Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:MWD:MIL:TL-N-LO-2117-99
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date: August 2, 1999

to: Chief, Examination Division, Midwest District
Attn: Manager, E:PSP:T Mail Stop 4012 MIL

from: District Counsel, Midwest District, Milwaukee

subject: **[redacted]'s Request for Application of May Department Store Case to Interest Computation for [redacted], [redacted], and [redacted]**

This memorandum responds to your request for our advice regarding the application of the May Department Stores case (May Department Stores Co. v. United States, 36 Fed. Cl. 680, 96-2 U.S.T.C. 50,596 (1996) to the interest calculations for [redacted] [redacted]'s [redacted] taxable years [redacted], [redacted], and [redacted].

ISSUE

Whether the Internal Revenue Service (the Service) properly calculated deficiency interest for [redacted]'s taxable years [redacted], [redacted], and [redacted] given the interpretation of the "use of money" principle in the Federal Claims Court opinion in the May Department Stores case.

CONCLUSION

Though not entirely clear, it appears the Service has overstated the amount of deficiency interest and [redacted] has understated it. We believe the table below presents the appropriate calculation of deficiency interest.

Year	Total Deficiency	Portion of Deficiency on Which Interest Calculated	Date Interest Begins
[redacted]	$[redacted]	$[redacted][1]	[redacted]

[1] This amount does not take into account any netting of an overpayment plus interest determined on audit of [redacted]. See footnote 2.

[redacted] $[redacted] $[redacted] [redacted]

[redacted] $[redacted] $[redacted] [redacted]

FACTS

[redacted]'s [redacted] income tax return was originally due on [redacted]. [redacted] requested and received an extension for filing the return from [redacted], to [redacted]. [redacted] filed its [redacted] income tax return on [redacted]. The return showed an overpayment of $[redacted] that [redacted] elected to credit to its tax liability for [redacted]. The tax return did not specify to which installment for [redacted] the overpayment should be credited. The Service credited the overpayment as of [redacted], [redacted], the due date of [redacted]'s first installment of estimated tax.

The Service audited [redacted]'s [redacted] income tax return and determined a deficiency of $[redacted]. Accordingly, [redacted] had no overpayment for [redacted]. It had in fact had underpaid its liability by $[redacted] ($[redacted] - $[redacted]).

[redacted]'s [redacted] income tax return was originally due on [redacted]. [redacted] requested and received an extension for filing the return from [redacted], to [redacted]. The table below shows the required 1995 installment payments, the amount of the payment, and the amount over- or underpaid.

Date	Installment Due	Amount Paid	(Over)/Underpaid
[redacted]	$[redacted]	$[redacted]	$[redacted] ([redacted]) ([redacted])

[redacted] uses an annualized income installment method in calculating the amount of its required installment payments. [redacted] incurred no addition to tax for failure to pay estimated income tax under I.R.C. § 6655 for [redacted]. (No Form 2220, Underpayment of Estimated Tax by Corporation, was included when [redacted] filed its [redacted] income tax return.)

[redacted] filed its [redacted] income tax return on [redacted]. The return showed an overpayment of $[redacted] that [redacted]

elected to credit to its tax liability for [redacted]. The tax return did not specify to which installment for [redacted] the overpayment should be credited. The Service credited the overpayment as of [redacted], the due date of [redacted]'s first installment of estimated tax.

The Service audited [redacted]'s [redacted] income tax return and determined a deficiency of $[redacted]. Accordingly, [redacted] had no overpayment for [redacted]. It had in fact had underpaid its liability by $[redacted] ($[redacted] - $[redacted]).

[redacted]'s [redacted] income tax return was originally due on [redacted]. [redacted] requested and received an extension for filing the return from [redacted], to [redacted]. The table below shows the required [redacted] installment payments, the amount of the payment, and the amount over- or underpaid.

Date	Installment Due	Amount Paid	(Over)/Underpaid
[redacted]	$[redacted]	$[redacted]	$[redacted] ([redacted]) ([redacted])

As stated above, [redacted] uses an annualized income installment method in calculating the amount of its required installment payments. [redacted] incurred no addition to tax for failure to pay estimated income tax under I.R.C. § 6655 for [redacted]. (No Form 2220, Underpayment of Estimated Tax by Corporation, was included when [redacted] filed its [redacted] income tax return.)

[redacted] filed its [redacted] income tax return on [redacted]. The return showed an overpayment of $[redacted] that [redacted] elected to credit to its tax liability for [redacted]. The tax return did not specify to which installment for [redacted] the overpayment should be credited. The Service credited the overpayment as of [redacted], the due date of [redacted]'s first installment of estimated tax.

The Service audited [redacted]'s [redacted] income tax return and determined a deficiency of $[redacted]. Accordingly, [redacted] had no overpayment for [redacted]. It had in fact had underpaid its liability by $[redacted] ($[redacted] - $[redacted]).

The table below shows the required [redacted] installment payments, the amount of the payment, and the amount over- or underpaid.

Date	Installment Due	Amount Paid	(Over)/Underpaid
[redacted]	$ [redacted]	$ [redacted]	$ [redacted]

[redacted], [redacted], [redacted] [redacted]

Again, [redacted] uses an annualized income installment method in calculating the amount of its required installment payments. [redacted] incurred no addition to tax for failure to pay estimated income tax under I.R.C. § 6655 for [redacted]. (No Form 2220, Underpayment of Estimated Tax by Corporation, was included when [redacted] filed its [redacted] income tax return.)

Though not entirely clear from your request, it appears the Service calculated interest on the entire deficiency for each of [redacted], [redacted], and [redacted] from the due date for the first installment of estimated tax for the succeeding year, i.e., April 15, [redacted], [redacted], and [redacted]. Though also not entirely clear, it appears [redacted] calculates interest on the deficiencies as summarized in the table below.

Year	Total Deficiency	Portion of Deficiency on Which Interest Calculated	Date Interest Begins
[redacted]	$[redacted]	$[redacted][2]	[redacted]
[redacted]	$[redacted]	$[redacted]	[redacted]
[redacted]	$[redacted]	$[redacted]	[redacted]

For each year, the first amount in the third column represents the difference between the total deficiency for the year and the credit elect from that year to the succeeding year.

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[2] Bandag's actual calculation incorporates the netting of an overpayment plus interest determined on audit of [redacted]. The overpayment plus interest through [redacted], totals $[redacted] ($[redacted] overpayment + $[redacted] interest). [redacted] calculates interest on the amount of the deficiency less the [redacted] amounts and the credit elect from [redacted] to [redacted], i.e., $[redacted] [$[redacted] deficiency - ($[redacted] + $[redacted])]. We do not address this netting issue in this memorandum and ignore it for purposes of the table above.

ANALYSIS

Under I.R.C. § 6601(a) interest on a tax begins when it is both due and unpaid. Avon Products, Inc. v. United States, 588 F.2d 342, 344 (2d Cir. 1978). The "use of money" principle provides that the Service can assess interest only when a taxpayer has use of funds rightfully belonging to the government. May Department Stores, citing among others, Manning v. Seeley Tube & Box Co., 338 U.S. 561 (1950).

Rev. Rul. 88-98, 1988-2 C.B. 356, holds that when a taxpayer claims an overpayment on a return filed either on the original due date or on extension, and the claimed overpayment is applied in full against an installment of the succeeding year's estimated tax, interest on a subsequently determined deficiency for the earlier year runs from the due date of that installment on the part of the deficiency that is equal to or less than the claimed overpayment, and from the original due date of the return on the remainder. Rev. Rul. 88-98 follows Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978). The date the overpayment becomes a payment on account of the succeeding year's estimated tax determines when the prior year's tax became unpaid for purposes of I.R.C. § 6601(a), and thus when deficiency interest begins to run. Prior to that date the government has had the use of the funds with respect to the prior year's tax.

In the May Department Stores case, May's 1983 tax return was due April 15, 1984. May filed for an automatic extension for filing from April 15 to October 15, 1984. May had estimated its 1983 tax liability at $111,000,000.00 and had timely paid that amount by April 15 through installment payments of estimated tax, an election to credit the overpayment from 1982 to 1983, and a payment with the extension request.

When May filed its 1983 income tax return on October 15, 1984, it showed a tax liability of $103,090,774.00 and an overpayment of $7,909,226.00, which it elected to apply to its 1984 income tax liability. May did not designate which installment the overpayment applied to, though its Form 2220 for 1984 indicated May applied it to its first installment of estimated tax for 1984 due on May 15, 1984. The Service applied the overpayment to May's first installment of estimated tax due on May 15, 1984. May incurred no addition to tax for failure to pay estimated income tax under I.R.C. § 6655 for its 1984 taxable year.

On audit the Service determined May's tax liability to be $108,018,931.00. Thus May's overpayment was $2,981,069.00 not $7,909,226.00. The Service assessed interest on the deficiency from May 15, 1984, the date of the first installment of estimated

tax for 1984 in accordance with Rev. Rul. 88-98. May contended that interest did not begin until October 15, 1984, when it made its election to apply the overpayment to its 1984 tax liability and moved the funds out of the 1983 tax year. The Federal Claims Court agreed with May. It concluded that the tax (deficiency) was not unpaid because the government had use of the funds for the 1983 year until May elected to apply the overpayment to its 1984 tax liability and took the funds out of the 1983 tax year.

May's 1984 tax return was due April 15, 1985. May filed for an automatic extension for filing from April 15 to October 15, 1985. May had estimated its 1984 tax liability at $142,000,000.00 and had timely paid that amount by April 15 through installment payments of estimated tax, an election to credit the overpayment from 1983 to 1984, and a payment with the extension request.

When May filed its 1984 income tax return on October 15, 1985, it showed a tax liability of $136,161,486.00 and an overpayment of $5,838,514.00, which it elected to apply to its 1985 income tax liability. May did not designate which installment the overpayment applied to, though its Form 2220 for 1985 indicated May applied it to its first installment of estimated tax for 1985 due on May 15, 1985. The Service applied the overpayment to May's first installment of estimated tax due on May 15, 1984. May incurred no addition to tax for failure to pay estimated income tax under I.R.C. § 6655 for its 1985 taxable year.

On audit the Service determined May's tax liability to be $142,740,592.00. Thus May had no overpayment and had in fact underpaid its 1984 tax by $740,592.00. Following Rev. Rul. 88-98, the Service assessed interest on the entire deficiency from May 15, 1985, the date of the first installment of estimated tax for 1985. May contended that interest did not begin on the $5,838,514.00 portion until October 15, 1985, when it made its election to apply the overpayment to its 1985 tax liability and moved the funds out of the 1984 tax year. Interest on the $740,592.00 was not at issue because both May and the Service agreed that interest on that portion of the deficiency ran from the due date of the return. Again, the court agreed with May. It concluded that the tax (deficiency) was not unpaid because the government had use of the funds for the 1984 year until May elected to apply the overpayment to its 1985 tax liability and took the funds out of the 1985 tax year. ([redacted]'s [redacted] [redacted]'s [redacted] tax year.)

In light of the <u>May Department Stores</u> decision, the Service has reconsidered the manner in which interest on a subsequently determined deficiency is computed under I.R.C. § 6601(a), when the taxpayer makes an election to apply an overpayment to the

succeeding year's estimated taxes. When such election is made, the overpayment is applied to unpaid installments of estimated tax due on or after the date the overpayment arose, in the order in which they are required to be paid to avoid an addition to tax for failure to pay estimated income tax under I.R.C. §§ 6654 and 6655. The Service will assess interest on a subsequently determined deficiency for the overpayment year from the date or dates that the overpayment is applied to the succeeding year's estimated taxes. In all situations, the estimated tax rules in effect for the tax year in which the credit elect is used determine the amount of estimated taxes due, and thus, the amount of the overpayment needed to satisfy the installments of estimated tax. The unused balance of the overpayment is deemed effective as a payment of the succeeding year's income tax liabilities as of the unextended due date of the return.

The date the overpayment becomes a payment on account of the succeeding year's estimated tax determines the date the prior year's tax became unpaid for purposes of I.R.C. § 6601(a). Prior to that date the government has had the use of the funds with respect to the prior year's tax, and no interest is payable on the overpayment that is the subject of the taxpayer's election. See I.R.C. § 6402(b); Treasury Reg. §§ 301.6402-3(a)(5) and 301.6611-1(h)(2)(vii). Interest should be charged from the point the prior year's tax is both due and unpaid. May Department Stores Co. v. United States, 36 Fed. Cl. 680 (1996), acq. AOD CC-1997-008 (Aug. 4, 1997); Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978); Rev. Rul. 88-98, 1988-2 C.B. 356. See also Kimberly-Clark Tissue Company v. United States, 97-1 USTC 50,308 (E.D. Pa. 1997).

Where the overpayment is not needed to satisfy any installment of estimated tax in the succeeding year, the overpayment would be treated as a payment of the succeeding year's income tax. I.R.C. § 6513(d) provides that if any overpayment of income tax is, in accordance with I.R.C. § 6402(b), claimed as a credit against estimated tax for the succeeding tax year, such amount shall be considered as a payment of income tax for the succeeding taxable year (whether or not claimed as a credit in the return of estimated tax for such succeeding taxable year) and no claim for credit or refund of such overpayment shall be allowed for the taxable year in which the overpayment arises. In addition, I.R.C. § 6513(a) provides that a payment of income tax made before the date prescribed for payment of the tax is considered paid on that date. The date prescribed for payment of tax is the time fixed for filing the return (determined without regard to any extension of time for filing the return). I.R.C. § 6151. Further, it is on this date that the overpayment is treated as a payment for purposes of computing interest on any overpayment of income taxes with respect

to the succeeding year under I.R.C. §§ 6611(a) and (d). Thus, we conclude that the statute requires that an overpayment which the taxpayer elects to credit against estimated tax for the succeeding year must be treated as a payment against the next year's tax with an effective date no later than the due date of the next year's return.

As stated above, when the taxpayer makes an election to apply an overpayment to the succeeding year's estimated taxes, the overpayment is applied and treated as a payment of estimated taxes in the order in which the estimated taxes are required to be paid to avoid an addition to tax for failure to pay estimated income tax under I.R.C. §§ 6654 and 6655. The critical factor is whether some or all of the amount of a credit elect is necessary to avoid (or reduce) the addition to tax for failure to pay estimated tax as determined under the estimated tax rules for the year to which the credit is carried.

> If an amount that was originally paid with respect to the tax is subsequently credited against a different obligation, the date on which the first tax is both due and unpaid is not necessarily the filing date of the request for the credit but rather the date as of which the credit is effective as a payment of the other obligation, even when that date precedes the date of the credit election.

Rev. Ruling 88-98, 1988-2 C.B. 356. The above language and use of money principles requires that the effective date of a credit as payment of estimated taxes occurs when the overpayment is applied to the unpaid installments. This includes unpaid installments that are due both before and after the election.

Moreover, to the extent the return overpayment is not needed to satisfy any installment of estimated tax for the succeeding year, the overpayment should be applied to that succeeding year's income tax liability as of the unextended due date of that year's return. I.R.C. §§ 6513(a) & (d).

Accordingly, we believe the table below presents the appropriate calculation of deficiency interest for [redacted], [redacted],

and [redacted].

Year	Total Deficiency	Portion of Deficiency on Which Interest Calculated	Date Interest Begins
[redacted]	$[redacted]	$[redacted]	[redacted]
[redacted]	$[redacted]	$[redacted]	[redacted]
[redacted]	$[redacted]	$[redacted]	[redacted]

We should note that we are aware of the opinions in the cases of Sequa Corporation v. United States, No. 95 Civ. 2086, 1998 U.S. Dist. LEXIS 8556 (S.D. N.Y. June 10, 1998) and In re Vendell Healthcare, Inc., 222 B.R. 564 (1998). Both cases effectively hold that the government does not lose use of the funds comprising a credit elect from one year to the next, and therefore cannot assess interest, if the specific funds making up the credit elect are not used to satisfy the next year's liability, i.e., the credit elect does not constitute payment of the succeeding year's tax. The effect of this could mean interest would not be allowable on a deficiency so long as an unused credit elect was carried from one year to the next, i.e., an indefinite deferral.

We believe both Sequa and Vendell were wrongly decided. The reasoning in the opinions violate the annual accounting period, namely that each taxpayer's income tax liability for a single tax year is a separate and distinct liability, and that taxable income and payments of tax must be computed on the basis of that annual taxable year. See I.R.C. § 441. If there are no shortfalls in estimated tax in the subsequent year, then the overpayment from the prior year is to be treated as a payment of the subsequent year's income taxes as of the unextended due date of the subsequent year's return.

DISCLOSURE STATEMENT

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(Signed) George W. Bezold

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