



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL

FROM: Sara M. Coe
Chief, Field Service Procedural Branch
CC:DOM:FS:PROC

SUBJECT: Deficiency interest computation

This Field Service Advice responds to your memorandum dated November 30, 1998 . Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Authorized representative:

X =

E.I.N.:

Year 01 Tax year ending
Year 02 Tax year ending

3/15/02 -- filing due date for tax year
9/15/02 -- filing date for tax year
3/15/03 -- filing due date for tax year

4/15/02, 6/15/92, 9/15/02, 12/15/02 Due dates (7/15/92, 9/15/92, 12/15/92. And 3/15/93) for making estimated tax payments for tax year

ISSUE(S):

As of what date (or dates) does underpayment interest begin to accrue on an underpayment of tax for X's Year 01 where the underpayment is attributable to X's election on 9/15/02 to have an overpayment of tax from Year 01 credited to its estimated tax liability for Year 02 without designating the estimated tax payments to which the overpayment was to be credited.

CONCLUSION:

Where X has reported an overpayment on its Year 01 return, and has elected to have the overpayment credited to its estimated taxes for the succeeding tax year, interest will be assessed on the portion of any subsequently determined deficiency less than or equal to the overpayment as of the date or dates the overpayment is applied to the succeeding year's estimated tax liabilities, or to the original due date of the succeeding year's income tax return to the extent the overpayment is not needed to satisfy specific installments of estimated tax. If the deficiency is less than the amount of the overpayment that was credited to the next tax year, interest on the deficiency should be computed by matching the amount of the deficiency against each application of the overpayment starting with the portion of the overpayment that was paid on the most recent date.

FACTS:

X timely filed its Year 01 tax return under extension on 9/15/02. The return reported a tax liability of \$10M, previous tax payments of \$40M, and an overpayment of \$30M. All of the tax payments were made before the 3/15/02 original due date for the Year 01 return. On the return, X elected to have the entire \$30M overpayment credited to its estimated tax liabilities for Year 02 under I.R.C. 6402(b), but did not designate the installment to which the overpayment was to be applied. Pursuant to Rev. Rul. 88-98, 1988-2 C.B. 356, and Rev. Rul. 77-475, 1977-2 C.B. 476, as modified by Rev. Rul. 84-58, 1984-1 C.B. 254, the Service applied the entire overpayment to the first installment payment for Year 02, which was due on 4/15/02. X made no other estimated tax payments for Year 02.

For Year 02, X reported \$10M of tax liability, \$30M of previous tax payments (credited from 01), and an overpayment of \$20M, which it elected to have credited to the next tax year.

In Year 05, the Service assessed an audit deficiency of \$3M against X for Year 01. X has paid the tax deficiency, together with underpayment interest computed from 9/15/02 through the date the tax was paid. The Service computed the underpayment interest starting as of 4/15/02, and has attempted to collect the difference from X. Collection efforts have been stopped pending this request for advice.

LAW and ANALYSIS

Section 6601(a) of the Internal Revenue Code provides “[i]f any amount of tax . . . is not paid on or before the last date prescribed for payment, interest on such amounts . . . shall be paid for the period from such last date to the date paid.” The date prescribed for payment of income tax is the due date for the tax return, without regard to extensions. I.R.C. §§ 6151; 6601(b).

In situations where the Service determines a deficiency in tax after a taxpayer has elected to have an overpayment that is claimed on a timely filed return (including one filed under extension) for the deficiency year credited against an installment of the succeeding year’s estimated tax liability, Rev. Rul. 88-98, 1988-2 C.B. 356, concludes that interest on the subsequently determined deficiency runs from the due date of the installment payment against which the overpayment was credited on the part of the deficiency that is equal to or less than the claimed overpayment, and from the original due date of the first year’s return on the remainder of the deficiency.

Rev. Rul. 88-98 follows Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978), in which the court interpreted § 6601(a) to mean that interest on a deficiency can only be charged when the tax is both due and unpaid. No one disputes that an income tax liability is due as of the original return filing due date. Under the Avon Products analysis, however, it is also paid as of that due date to the extent that there are sufficient payments in the account to cover the liability. The tax liability does not become unpaid until the date on which amounts that were in the account on the due date have been refunded to the taxpayer or credited to another tax liability.

In Rev. Rul. 88-98, the Service took the position that the critical date as of which the tax became unpaid was the due date for the estimated tax installment payment that the taxpayer designated for payment with the overpayment credit. If the taxpayer designated no specific installment payment, Rev. Rul. 88-98 provided that the Service would use the earliest installment date for the succeeding year.

In May Department Stores Co. v. United States, 36 Fed. Cl. 680 (1996), acq. AOD CC:1997-008 (Aug. 4, 1997), the taxpayer elected to credit an overpayment from its 1983 tax year to its 1984 estimated tax liability, but did not attach a statement

indicating the installment to which the Service should credit the overpayment. When a tax deficiency was later determined for the 1983 tax year, the Service relied upon Rev. Rul. 88-98 to compute interest on the underpayment from the due date of the first 1984 estimated tax installment. However, before the credit election was made on October 15, 1984, with the filing of the 1983 return, the taxpayer had already made sufficient estimated tax payments for the first two quarters of 1984 to avoid any addition to tax that might have been imposed under I.R.C. 6655 for failure to pay estimated tax. The Court of Federal Claims concluded that the Service's application of the overpayment credit to the first installment period was not material; because the overpayment was not needed to satisfy any installment obligation prior to the date when the return was filed, the Service had the use of the taxpayer's money from the due date of the first installment (May 15) to the date the return was filed (October 15).

In light of May Department Stores, the Service has reconsidered the manner in which interest on a subsequently determined deficiency is to be computed under § 6601(a) when the taxpayer has made an election to apply an overpayment to the succeeding year's estimated taxes. When such an election is made, the overpayment will be 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 the tax for failure to pay estimated income tax under §§ 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 tax obligations. In all situations, the estimated tax rules in effect for the tax year to which the overpayment is credited will be used to determine the amount of estimated taxes due, and thus, the amount of the overpayment needed to satisfy the obligation for each installment of estimated tax. Any remaining balance of the overpayment credit will be applied as of the due date, without extensions, for filing the successive year's income tax return.

Except for the credit overpayment from Year 01, X made no estimated tax payments for Year 02. Your request for advice does not include information about X's potential estimated tax liability. X's liability for each installment payment for the Year 02, can be readily ascertained, however, by having a computation done of the amount of payment necessary each quarter to avoid an addition to tax for failure to pay estimated tax. For purposes of computing interest on the Year 01 deficiency, the overpayment credit from Year 01 of \$30M can then be allocated to each estimated tax payment due in Year 02, with the balance being applied as of the 3/15/03 due date for the Year 02 income tax return.

In this case, the \$30M overpayment credit greatly exceeds the total \$10M tax liability for Year 02 and the \$3M deficiency subsequently determined for Year 01. Assuming that an estimated tax liability equal to the total Year 02 liability of \$10M

was to be paid in four equal payments of \$2.5M, \$20M of the Year 01 overpayment would not have become unpaid until 3/15/03.¹ The \$3M deficiency determined for Year 01 in Year 05 is easily payable out of that amount, which was “paid” until 3/15/03. Because the full amount of the tax deficiency would not have become unpaid until 3/15/03, deficiency interest on that underpayment would not start to accrue until 3/15/03.

The Service is not entitled to assess interest on the deficiency starting as of 4/15/02. Further, provided that a timely refund claim is filed, X would be entitled to a refund of deficiency interest paid for the period from 9/15/02 through 3/15/03.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The Service should recompute the underpayment interest due from X on the Year 01 deficiency, and make the appropriate adjustments to X's account for Year 01. If the computation is consistent with that provided by X and the interest has, in fact, been overpaid, no further collection action should be taken and X should be notified of the overpayment. It appears that X may file a timely claim for refund inasmuch as a significant portion of the total payment of the deficiency plus interest was paid within the last two years.

¹ For the Year 01, the total amount of tax paid would have decreased over the Year 02, as follows:

<u>Date</u>	<u>\$ applied to Year 02</u>	<u>Tax paid balance - Year 01</u>
3/15/02		\$40 M
4/15/02	-\$2.5 M	37.5 M
6/15/02	- 2.5 M	35 M
9/15/02	- 2.5 M	32.5 M
12/15/02	- 2.5 M	30 M
3/15/03	- 20 M	10 M