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Internal Revenue Service  
**memorandum**

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from: Assistant Chief Counsel, CC:DOM:IT&A

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subject: Significant Service Center Advice

This responds to your request for Significant Advice in connection with a question posed by the Memphis Service Center.

Disclosure Statement

**Unless specifically marked "Acknowledged Significant Advice, May Be Disseminated" above, this memorandum is not to be circulated or disseminated except as provided in Paragraphs III.D.4. and IV.A.5 of CCDM (35)2(13)4. This document may contain confidential information subject to the attorney-client and deliberative process privileges. Therefore, this document shall not be disclosed beyond the office or individual(s) who originated the question discussed herein and are working the matter with the requisite "need to know." In no event shall it be disclosed to taxpayers or their representatives.**

**Issues**

1. Should a Service Center treat a Form 8697, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts, reporting look-back interest owed to the government as a tax return?
2. Should a Service Center treat a Form 8697 claiming look-back interest owed to the taxpayer as a claim for refund?

3. Should a Service Center issue a statutory notice of deficiency (or notice of claim disallowance) if a Form 8697 contains a mathematical or clerical error otherwise subject to §6213(b)(1) of the Internal Revenue Code?
4. When does look-back interest compound?

## **Conclusions**

1. A Form 8697 reporting look-back interest owed to the government is an attachment to a tax return.
2. A Form 8697 claiming look-back interest owed to the taxpayer is a general claim against the government to which §6511 does not apply.
3. If a Form 8697 is attached to a taxpayer's return and contains a mathematical or clerical error, the Service Center may follow the assessment procedures in §6213(b)(1), which do not require the sending of a deficiency notice. If the error is not a mathematical or clerical error as defined in §6213(g), or if the taxpayer timely requests abatement of the math error assessment, the Service must send a deficiency notice.
4. Look-back interest owed to the government compounds under §6622 from the due date (not including extensions) of the return ("original due date") for a "filing year" through the date both the return is filed and the look-back interest is paid. Look-back interest owed to the taxpayer generally compounds under §6622 from the original due date for a filing year through the date the look-back interest is refunded.

## **Overview**

A taxpayer must report the income from a long-term contract subject to §460(a) using the percentage-of-completion method of accounting ("PCM") and the look-back method. In somewhat simplified terms, a taxpayer using the PCM includes revenues in gross income over the life of a contract based upon the percentage of the estimated total contract costs that have been incurred during the year and takes the related contract costs into account in the year incurred. In the year that a taxpayer completes a long-term contract ("completion year"), the taxpayer applies the look-back method. A taxpayer reapplies the look-back method in a post-completion year if a contract's revenues or costs are "adjusted" in a post-completion year. Any year for which a taxpayer must apply or reapply the look-back method is a "filing year."

Section 1.460-6(c) of the Income Tax Regulations describes the operation of the look-back method. Under the look-back method, a taxpayer computes the amount of look-back interest payable (receivable) on the hypothetical underpayment (overpayment) of federal income tax for each year of the contract's existence that precedes the filing year. Each of these years is a "redetermination year." The underpayments and overpayments are called "hypothetical" because the taxpayer does not actually file amended returns for the redetermination years. Instead, the taxpayer

recomputes its taxable income for each redetermination year using *actual* contract revenues and costs instead of *estimated* contract revenues and costs. Then, the taxpayer computes its hypothetical underpayment (overpayment) of tax for each redetermination year. Finally, the taxpayer computes the amount of look-back interest payable (receivable) for each redetermination year by applying the overpayment rate designated under §6621, compounded daily, to the hypothetical underpayment (overpayment) of tax for each redetermination year. Look-back interest generally is charged (credited) on hypothetical underpayments (overpayments) from the original due date of the return for the redetermination year to the earlier of (1) the original due date of the return for the filing year, or (2) the date both the income tax return for the filing year is filed and the tax for that year has been paid in full.

Section 1.460-6(f) provides guidelines concerning look-back reporting. A taxpayer reports all the data required by the look-back method on Form 8697, often with subsidiary schedules. The instructions to Form 8697 provide that a taxpayer who owes look-back interest must file Form 8697 with its federal income tax return but a taxpayer who is owed look-back interest must file Form 8697 separately. Whether a taxpayer owes, or is owed, look-back interest for a filing year is determined on a net basis.

Look-back interest is treated as interest expense (income) for most federal income tax purposes. A taxpayer must account for the look-back interest using its method of accounting for interest expense (income). In most cases, a taxpayer's method of accounting for interest expense (income) will be its overall method of accounting, and in most cases, the overall method of accounting of a taxpayer with long-term contracts will be the accrual method. An accrual method taxpayer will accrue most of the look-back interest expense (income) in the filing year and will accrue the remaining portion in the following tax year.

In addition, §460(b)(1) provides that look-back interest owed by a taxpayer is treated as income tax for the purposes of subtitle F of the Code (other than §§6654 and 6655), which concerns tax procedures and administration. Thus, a taxpayer that owes look-back interest but fails to file a Form 8697 or pay the look-back interest is subject to any applicable penalties under subtitle F. As previously stated, whether a taxpayer owes, or is owed, look-back interest for a filing year is determined on a net basis.

Service Center personnel processing Forms 8697 review the forms (and any subsidiary schedules) for mathematical accuracy, proper calculation of look-back interest, and adherence to the form's instructions. Sometimes, Service Center personnel discover an error that increases or decreases the amount of look-back interest due from, or owed to, a taxpayer. Occasionally, what is reported as look-back interest owed by the taxpayer becomes look-back interest owed to the taxpayer, and vice versa.

## **Discussion**

### Issue 1

Whether a Form 8697 reporting look-back interest owed to the government is a

tax return depends on whether look-back interest payable under §460 and the §1 income tax are separate and distinct items for purposes of §6011<sup>1</sup> or whether they are “closely connected” under the rationale of Rev. Rul. 82-185, 1982-2 C.B. 395. Rev. Rul. 82-185 holds that the filing of a Form 1040 that fully reports all income, but contains no entry with respect to self-employment tax, will be treated as the filing of a valid self-employment tax (“SECA”) return. The rationale is that the SECA tax imposed by chapter 2 of the Code and the individual income tax imposed by chapter 1 are not separate and distinct taxes for reporting purposes. The revenue ruling concludes, based on legislative history, that the two taxes are so “closely connected” that the filing of a return with respect to one of these taxes must be accepted as the filing of a return with respect to both of these taxes. Thus, SECA tax may not be assessed more than 3 years after the filing of a Form 1040 that fully reports all income, but which makes no entry for self-employment tax or self-employment income.

By contrast, Rev. Rul. 79-39, 1979-1 C.B. 435, provides that an employee has not made a valid return for purposes of the social security tax imposed on tips by §3101 if he or she files a Form 1040 and reports all salary income, but fails to file Form 4137, Social Security and Medicare Tax on Unreported Tip Income, to report tip income not reported to the employer.

The 1989 amendment to §460(b)(1)(B), which provides that interest required to be paid by the taxpayer shall be treated as an increase in tax, indicates that look-back interest and the §1 income tax are not separate and distinct items but, rather, are components of the overall income tax liability of the taxpayer. Although the matter is not free from doubt, we conclude that the regular income tax and look-back interest payable under §460 are not separate and distinct items for purposes of §6011. Thus, Form 8697 is not a tax return but, rather, an attachment to the income tax return. We further conclude that if a taxpayer files an income tax return without attaching Form 8697, the statute of limitations on assessing look-back interest starts to run upon the filing of the tax return.<sup>2</sup>

Our conclusion is consistent with the Interest Handbook under Restricted Interest, which controls the processing of Form 8697, and provides that “[f]ull paid and balance due original Forms 8697 are filed as an attachment to the related income tax return.”

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<sup>1</sup> Section 6011(a) provides that when required by regulations prescribed by the Secretary of the Treasury or his delegate any person made liable for any tax imposed by the Code, or for the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary or his delegate. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

<sup>2</sup> In general, §6501(a) provides that the amount of any tax must be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed). The term “return” means the return required to be filed by the taxpayer. If the taxpayer has not filed the return, the statute of limitations on assessment does not begin to run.

IRM 121.1.9.17, Look Back Method (NMF), (07/01/98).

If you have any questions concerning Issue 1, please contact John Moran at (202) 622-4940.

## Issue 2

For subtitle F purposes, look-back interest owed *to* the taxpayer is treated differently from look-back interest owed *by* the taxpayer. Look-back interest owed by the taxpayer is treated as additional tax. By contrast, look-back interest owed to the taxpayer is not treated as an overpayment because it is not interest that has been paid.<sup>3</sup> Thus, we conclude that a Form 8697 claiming look-back interest is not a tax return or claim for refund but instead a non-tax claim against the government to which §6511 is inapplicable. A similar issue was presented in Rev. Rul. 56-506, 1956-2 C.B. 959, concerning overpayment interest payable under §6611. Rev. Rul. 56-506 explains that §6511<sup>4</sup> only applies to a claim for credit or refund of tax, penalty, or interest *collected from* a taxpayer. This rationale applies to look-back interest payable to a taxpayer under §460 as well as overpayment interest payable under §6611. In both situations, it appears the claimant is subject to a non-tax statute of limitations found in Title 28 applicable to general claims against the government. *See also* Rev. Rul. 57-242, 1957-1 C.B. 452, holding that the filing of a claim for credit or refund will not protect the taxpayer's right to overpayment interest under the non-tax statute of limitations.

We have one caveat to add to the preceding discussion. If a taxpayer has paid a liability for look-back interest and subsequently seeks a refund for all or part of that payment (e.g., a reapplication of the look-back method in a post-completion tax year), we believe that this *is* a claim for a refund of an overpayment under §6402 and that §6511 will apply.

If you have any questions concerning Issue 2, please contact John Moran at (202) 622-4940.

## Issue 3

Look-back interest due from a taxpayer generally is treated as income tax for the procedural purposes of subtitle F of the Internal Revenue Code. Subtitle F includes §§6211, 6212, and 6213, which concern tax deficiencies.

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<sup>3</sup> However, as in the case of outstanding look-back interest owed to the government, under §6622, interest compounds daily on outstanding look-back interest owed to the taxpayer until the date the look-back interest is refunded.

<sup>4</sup> Section 6511(a) provides that a claim for refund or credit of an overpayment of tax must be filed within 3 years from the filing of the tax return or 2 years from the payment of the tax, whichever period expires later.

Section 6211(a) defines “deficiency” generally as the amount by which the tax imposed exceeds the excess of (1) the sum of (A) the amount shown as the tax on the return, plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over (2) the amount of rebates made. Whenever the Service determines that a deficiency exists, the Service may send the taxpayer a notice of deficiency. Section 6212.

Section 6213(a) bars the assessment and collection of a deficiency until 90 days (or 150 days if the notice is addressed to a person outside of the United States) after the notice of deficiency has been mailed. The purpose of the 90-day period is to allow a taxpayer time to petition the Tax Court for a redetermination of a proposed deficiency.<sup>5</sup> If a taxpayer files a petition with the Tax Court, the Service may not assess or collect the proposed deficiency until the decision of the Tax Court has become final.

The general rules of §6213(a) do not apply if a deficiency results from a “mathematical or clerical error” appearing on a taxpayer’s return. Section 6213(g)(1) defines a “return” to include “any return, statement, schedule, or list, and any amendment or supplement thereto.” Because Form 8697 is required to be filed with the taxpayer’s return, it is part of the return for purposes of §6213.<sup>6</sup> The Service may assess an error-related deficiency immediately and must furnish a notice of assessment, which sets forth the taxpayer’s error and provides an explanation. Under §6213(b)(2), the collection of the deficiency is stayed for 60 days. If the taxpayer requests an abatement during this 60-day period, the assessment must be abated, and any reassessment is subject to the deficiency procedures.

A mathematical or clerical error is defined in §6213(g)(2) as being one of several specific types of errors. The most likely errors related to a Form 8697 filed with a return include:

(A) an error in addition, subtraction, multiplication, or division shown on any return;

(B) an incorrect use of any table provided by the Service with respect to any return if the incorrect use is apparent from the existence of other information on the return; and

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<sup>5</sup> Though the Tax Court generally lacks jurisdiction to redetermine the amount of “regular” underpayment interest owed by a taxpayer, see §6601(e)(1) (parenthetical); *Commissioner v. Kilpatrick Estate*, 140 F.2d 887 (6th Cir. 1944); *LTV Corp. v. Commissioner*, 64 T.C. 589 (1975), the Court has jurisdiction to redetermine the amount of look-back interest owed by a taxpayer because look-back interest is treated as a tax for the procedural purposes of subtitle F.

<sup>6</sup> Note that this treatment under the special definition in §6213(g)(1) applies solely for the purposes of §6213. It does not mean that Form 8697 is a return, or part of a return, for other purposes.

(C) an entry on a return of an item which is inconsistent with another entry of the same or another item on the return.

As indicated in the legislative history behind the current math-error procedures, the Service should use its summary procedures only when “not only is the error apparent from the face of the return, but the correct amount is determinable with a high degree of probability from information that appears on the return”; the “summary assessment procedure is not to be used where the Service is merely resolving an uncertainty against the taxpayer.” S. REP. NO. 938, 94th Cong., 2d Sess. (1976) at 375, 377, reprinted at 1976-3 C.B. 413, 415. The exception does not apply to substantive errors. *See, e.g., Adler v. Commissioner*, 85 T.C. 535, 542 (1985).

Form 8697 requires a taxpayer to compute the interest due by using the overpayment interest rate determined under §460(b)(7) compounded on a daily basis for the interest accrual period. The overpayment interest rate in §460(b)(7) comes from §6621(a)(1) and is updated quarterly in the Internal Revenue Bulletin. Which interest rate is used also depends on whether the tax increase exceeds \$10,000 for the interest accrual period. That portion of the increase that exceeds \$10,000 is required to use a different interest rate than the portion of increase that is \$10,000 or below.

Given the difficulty of computing look-back interest, a taxpayer might owe more look-back interest than shown on the return because of mathematical errors, misread tables, or transcription or transposition errors. However, these errors must be apparent on the face of Form 8697, (for example:  $1 + 2 = 4$ , or  $\$100 \times 10\% = \$1,000$ ), not the result of a substantive error on the taxpayer’s part.

If the amount of look-back interest due from a taxpayer is greater than that reported on a return to which Form 8697 is attached, the result is a deficiency under §6211. Accordingly, if a Service Center determines that a taxpayer has underreported the amount of look-back interest due to the government, a notice of deficiency should be issued if the taxpayer does not agree with the Service Center’s determination. However, if it is obvious from the face of the return that the underreported amount is a result of a taxpayer’s mathematical or clerical error, the Service Center may assess the deficiency immediately by following the procedures in §6213(b), subject to abatement at the taxpayer’s request.

When a deficiency exists, including a deficiency resulting from an abated math-error assessment, the case must be processed using deficiency procedures, rather than claim-disallowance procedures, even if the taxpayer claimed a refund on the return and the deficiency would only reduce or eliminate the overpayment. This preserves the taxpayer’s right to choose to contest the deficiency in either the Tax Court or a refund forum.

If a taxpayer has mistakenly *overstated* the amount of look-back interest, the Service has the authority to correct the error and adjust the account accordingly. Although this type of favorable correction is sometimes called a “math error” adjustment, the statutory basis is the Service’s refund and abatement authority in §§6402 and 6404, and the restrictions and rules in §6213 do not apply.

If you have any questions concerning Issue 3, please call John Dryden at (202) 622-4930.

#### Issue 4

Section 1.460-6(c)(4) provides rules governing the calculation of look-back interest, but these rules are not exclusive. Look-back interest is computed on hypothetical underpayments (overpayments) of tax until the original due date of the return for the filing year. If that return is not filed on the original due date and the look-back interest is not paid (refunded) on that date, §1.460-6(c)(4)(iv) provides that interest is charged (credited) on the look-back interest through the date the return is filed. If the look-back interest is not paid by the date the return is filed, the rules under §6601 apply from the date the return is filed to the date the look-back interest is paid. Thus, if a taxpayer owes look-back interest, but has not paid it by the original due date, interest on the look-back interest runs from the original due date through the date the return is filed and the look-back interest is paid, except to the extent that the taxpayer has a tax refund that offsets the amount of unpaid look-back interest. If there is a hypothetical overpayment of tax and the Service owes look-back interest, interest compounds on look-back interest owed to the taxpayer from the original due date through the date the look-back interest is refunded or credited.

Different rules apply when a taxpayer paid look-back interest as of a contract's completion year but later claims a refund of the overpaid look-back interest after reapplying the look-back method in a post-completion tax year. In this case, interest compounds from the overpayment date to the date the look-back interest is refunded unless the government refunds the look-back interest within 45 days. Section 6611(e)(2). The following two examples clarify the application of these rules.

**Example (1).** On March 15, 2000, the taxpayer timely files its 1999 federal income tax return for the filing year and separately files its Form 8697, which claims \$1,000 of look-back interest. The Service paid the look-back interest on April 15, 2000 (31 days later). Interest begins to run on the look-back interest owed to the taxpayer on March 15, 2000. Under §6622, this interest will be compounded daily. Furthermore, the Service owes the taxpayer interest until April 15, 2000, the date of payment. The 45-day rule of §6611(e) does not apply in this case because the money owed to the taxpayer is not an "overpayment" for the purposes of §6611.

**Example (2).** On March 15, 2000, the taxpayer timely filed its 1999 federal income tax return (and Form 8697) for the filing year and paid \$3,000 of look-back interest. On March 15, 2001, the taxpayer timely filed its 2000 federal income tax return for the filing year and separately filed its Form 8697, which claims \$1,000 of look-back interest. The amount claimed in the second Form 8697 is attributable solely to the reapplication of the look-back method for contracts completed and reported on the taxpayer's 1999 return. The Service refunded the overpaid look-back interest on May 15, 2001 (61 days later). Interest begins to run on the overpayment on March 15, 2001. Note that in this case, the taxpayer actually has overpaid the look-back interest. Thus, this is an "overpayment" for the purposes of §6611(e), and the 45-day rule will apply. However,



because the Service did not pay the taxpayer within 45 days, the Service owes the taxpayer interest on the \$1,000 from the filing date to the date paid. If the Service had paid the taxpayer within 45 days of the filing date, the Service would not have been required to pay interest on the overpayment. In this case, the Service will be required to pay the taxpayer overpayment interest at the overpayment rate found in §6611.

If you have any questions concerning Issue 4, please call Laura C. Nash at (202) 622-4910.