

ACKNOWLEDGED SIGNIFICANT ADVICE, MAY BE DISSEMINATED

**Office of Chief Counsel
Internal Revenue Service**

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memorandum

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to: Associate District Counsel, Salt Lake City
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from: Chief, Branch 1
Assistant Chief Counsel (Income Tax & Accounting)

subject: Application of Overpayments to Outstanding Tax Liabilities under
General Agreement on Tariffs and Trade (GATT)

This responds to your request for Significant Service Center Advice dated September 26, 1997, concerning the computation of interest on overpayments and the crediting of overpayments to underpayments for other taxable years. This memorandum provides "Significant Advice" subject to the coordination procedures of Notice N(35)000-143, dated February 10, 1997.

The rate of interest on overpayments was affected by the amendment made to section 6621(a)(1) of the Code made by section 713 of the Uruguay Round Agreements Act (GATT), Pub. L. No. 103-465 (1994). The GATT legislation changed the interest rate on corporate overpayments in excess of \$10,000, effective for periods beginning after December 31, 1994.

ISSUES

1. Does the Internal Revenue Service (IRS) have the authority to credit accrued interest on an overpayment, as well as the overpayment itself, against an underpayment for a subsequent taxable year?

2. Does the GATT legislation's reduction in the rate of interest applicable to the "excess portion" of a corporate overpayment (the portion in excess of \$10,000) apply only to the excess portion of an overpayment outstanding on GATT's effective date (January 1, 1995) or does it also apply to the interest that accrued on such excess portion prior to January 1, 1995?

3. Does the GATT legislation's reduction in the rate of interest applicable to the excess portion of a corporate overpayment apply if the overpayment is credited against an underpayment for another taxable year, rather than refunded to the taxpayer?

CONCLUSIONS

1. The IRS has the authority to credit accrued interest on an overpayment, as well as the overpayment itself, against an underpayment for a subsequent taxable year.

2. As of January 1, 1995, the reduced rate of interest under GATT (the "GATT rate") applies not only to the excess portion of an overpayment, but also to the interest that accrued on such excess portion under pre-GATT law.

3. The GATT rate of interest applies in calculating interest on an overpayment in excess of \$10,000 regardless of whether the overpayment is refunded to the taxpayer or credited against an underpayment for another taxable year.

STATUTORY PROVISIONS

Under section 6402(a), the IRS may credit the amount of an overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment. (emphasis added)

Section 6611(a) provides that interest shall be allowed and paid upon any overpayment in respect of any internal revenue tax at the overpayment rate established under section 6621.

Section 6611(b) distinguishes between overpayments that are refunded and those that are credited against liabilities for other taxable years. However, this distinction only affects the period during which interest is allowed on an overpayment, not the rate of interest applicable to the overpayment.

Under section 6621(a)(1), as amended by section 713 of GATT, to the extent a corporate overpayment exceeds \$10,000, interest accrues, for periods after December 31, 1994, on the first \$10,000 of the overpayment at the federal short-term rate plus 2 percentage points (the "normal rate"). Interest accrues on the excess of the overpayment over \$10,000 at the federal short-term rate plus one-half a percentage point (the "GATT rate").

Section 6622(a) provides, in part, that in computing the amount of any interest required to be paid, interest shall be compounded daily. Thus, overpayment interest is computed on overpayment interest as well as on the overpayment itself. Section 6622 was added by section 344(a) of Pub. L. No. 97-248 (1982), the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

DISCUSSION

I. Issue 1

The IRS has discretion under section 6402(a) to refund an overpayment or to credit the overpayment and accrued interest thereon against an underpayment for another taxable year. See Northern States Power Co. v. United States, 73 F.3d 764 (8th Cir. 1996), cert. denied, 117 S.Ct. 168 (1996), and the court cases cited therein. There is no basis for a contention that the IRS has the authority to credit an overpayment against an underpayment for another taxable year, but lacks the authority to credit the accrued interest on the overpayment against the underpayment. This contention is contrary to the plain language of section 6402(a)

II. Issue 2

The GATT legislation's reduction in the rate of interest applies not only to the portion of an overpayment outstanding on January 1, 1995, in excess of \$10,000 (the "excess portion" of the overpayment), but also to the accrued interest on the excess portion. As explained below, this result follows from interpreting the GATT legislation consistently with the interest compounding provisions of section 6622.

Because section 6622 requires interest on overpayments to be compounded daily, there is no distinction between the overpayment of tax (i.e., the original principal amount) and the prior accrued interest. The full debt (overpayment and accrued interest) is used to calculate the additional interest accrual. As noted frequently by the federal courts, the tax and the interest thereon are generally treated as one. See, for example, Alexander Proudfoot Company v. United States, 454 F.2d 1379 (Ct. Cls. 1972) ("[t]he Code's design for...interest is to assimilate it to the tax itself..."), 454 F.2d at 1382. See also section 6601(e)(1) ("any reference in this title...to any tax imposed by this title shall be deemed also to refer to interest imposed by this section on such tax").

For example, consider a situation in which an overpayment of \$12,000 arises after the effective date of GATT. Interest is computed on the \$10,000 threshold at the normal rate and on the \$2,000 excess at the GATT rate. Moreover, because section 6622 requires daily compounding of interest, the GATT rate applies to interest on the \$2,000 as well as the \$2,000 itself. To apply the GATT rate only to the \$2,000 excess, and not also to interest on the \$2,000 excess, would be contrary to the requirements of section 6622.

We believe that the same analysis also would apply to an overpayment of \$12,000 arising before the effective date of GATT. Beginning on January 1, 1995, interest would be computed at the GATT rate on both the \$2,000 and the interest that accrued on the \$2,000 prior to January 1, 1995. This result is required because for periods after December 31, 1994, the GATT rate applies in the same manner to overpayments arising before January 1, 1995, and those arising after that date. This is made clear from a consideration of the effective date provision for the GATT legislation and its legislative history. The effective date provision for the GATT legislation states that the GATT rate applies "for determining interest for periods after December 31, 1994." Pub. L. No. 103-465, §713(a). Also, the legislative history states:

"The provision is effective for purposes of determining interest for periods after December 31, 1994, regardless of the taxable period (if any) to which the underlying tax may relate."

H.R. Rep. No 103-826, p.178. [emphasis added]

At the current time, there are no court cases that address the GATT interest issue. However, four courts of appeals have considered a similar issue: whether the requirement of section 6622 that interest be compounded applies only to an underpayment outstanding on the effective date of TEFRA (January 1, 1983) or, rather, also applies to the simple interest that had accrued on such underpayment prior to that effective date. See RJR Nabisco, Inc. v. U.S., 955 F.2d 1457 (11th Cir. 1992); Purer v. U.S., 872 F.2d 277 (9th Cir. 1989); Cohn v. U.S., 872 F.2d 533 (2d Cir. 1989); and Gannet v. U.S., 877 F.2d 965, 968 (Fed. Cir. 1989).

In all four cases, the courts concluded that compounding applies not only to the underlying underpayment, but also to the simple interest that had accrued on the underpayment prior to TEFRA's effective date, January 1, 1983. The courts concluded that nothing in the statutory language indicated that simple interest accruing prior to the effective date was excepted from the requirement of compounding for the period beginning on the effective date. Similarly, nothing in the statutory language of GATT indicates that interest on an overpayment that accrued prior to GATT's effective date is excepted from the new lower rate of interest for the period beginning on the effective date.

Although there was legislative history directly on point for the section 6622 question in RJR Nabisco and the other cases, the RJR Nabisco court indicated that it might have reached the same conclusion even without the aid of the legislative history. The court reasoned that, based on the logic of the compound interest requirement, the distinction between principal and interest

disappears and "[a] debt is a debt, whether the corpus consists of principal or interest or a combination thereof." 955 F.2d at 1462.

We conclude, therefore, that in the present context, no distinction should be made between the portion of an overpayment in excess of \$10,000 and the accrued interest on such portion for purposes of applying the GATT rate. The result is that the normal interest rate applies to the first \$10,000 of the overpayment plus the accrued interest on that portion, and the GATT rate applies to the excess portion of the overpayment and the accrued interest on the excess portion. This may be illustrated by the following example:

Example. On September 15, 1991, a corporation overpaid its 1990 income tax by \$25,000. The accrued interest as of January 1, 1995, is assumed to be \$5,000. Thus, the total amount owed to the corporation as of January 1, 1995, was \$30,000. On March 31, 1995, the Service refunded the overpayment and paid all interest thereon to the corporation.

As of January 1, 1995, there was \$5,000 of accrued interest, \$2,000 of which is allocable to the \$10,000 threshold amount and \$3,000 of which is allocable to the \$15,000 excess portion of the overpayment. Therefore, the normal rate of interest applies to the \$10,000 threshold and the \$2,000 of interest that accrued thereon, and the GATT rate applies to the \$15,000 excess portion of the overpayment and \$3,000 of interest that accrued thereon.

III. Issue 3

The third issue presented is whether the GATT legislation's reduction in the rate of interest applicable to corporate overpayments applies only to overpayments that are refunded to taxpayers. It has been suggested that the reduction in the rate of interest does not apply to an overpayment that is credited against a tax liability, rather than refunded.

The rate of interest applicable to an overpayment is the same whether the overpayment is refunded or credited. Although section 6611 draws a distinction between overpayments that are credited and those that are refunded, the distinction relates only to the period during which interest is allowed, not the applicable rate of interest. Nothing in sections 6611 and 6621 indicates that the interest rate applicable to an overpayment depends on whether the overpayment is refunded or credited against a tax liability for another taxable year. Thus, we

