

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **201046009**

Release Date: 11/19/2010

CC:ITA:B05:SJKim

POSTS-106979-10

UILC: 460.02-01

date: September 08, 2010

to: Senior Tax Analyst, Servicewide Interest
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Office of Associate Chief Counsel
(Income Tax & Accounting)

subject: Look-back Interest Issues

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

You have asked our office for advice on various issues relating to look-back interest payable to a taxpayer.¹ Specifically, you have posed the following issues:

1. Whether the Internal Revenue Service may offset look-back interest due to a taxpayer against the taxpayer's tax liability;
2. When is look-back interest considered available to offset a tax liability;
3. Whether look-back interest due to a taxpayer itself accrues "add-on interest" and the period over which any add-on interest accrues;
4. Whether a bifurcated interest rate similar to the "GATT" interest rate under section 6621 of the Internal Revenue Code² applies to look-back interest;

¹ In this memorandum, we assume that any look-back interest due or payable to a taxpayer is not attributable to an amount previously paid by or collected from the taxpayer.

5. When Form 8697, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts, is due for filing, what is the effect of an extension of time to file a taxpayer's federal income tax return, and what are the adverse consequences, if any, to a taxpayer from the overdue filing of Form 8697 when look-back interest is due to the taxpayer.

LAW AND ANALYSIS

Overview of the look-back interest rules under section 460

Section 460(a) requires that the taxable income from any long-term contract be determined under the percentage-of-completion method as modified in section 460(b) ("PCM"). Under section 460(b), a taxpayer using PCM to account for income from long-term contracts is required to pay or is entitled to receive interest on the amount of tax liability deferred or accelerated under that method of accounting. This interest is referred to as "look-back interest."

Under section 460(b)(2) and section 1.460-6(c) of the Income Tax Regulations, a taxpayer determines its look-back interest for a taxable year in three steps. First, the taxpayer reapplies the PCM to all long-term contracts completed or adjusted in the current taxable year (the "filing year") using actual total contract price and actual total contract costs, and determines the taxable income that it would have reported for each prior taxable year ("redetermination year"). See § 460(b)(2)(A); § 1.460-6(c)(2), Income Tax Regs.

Second, the taxpayer compares the redetermined tax liability for each redetermination year with the reported tax liability for that year and determines the hypothetical underpayment or overpayment of tax for each redetermination year. See § 460(b)(2)(B); § 1.460-6(c)(3), Income Tax Regs.³

Finally, the taxpayer applies the adjusted overpayment rate (*i.e.*, overpayment rate in effect under section 6621 for the calendar quarter in which interest begins to accrue), compounded daily, to the hypothetical underpayment or overpayment of tax for each redetermination year. See § 460(b)(2)(C); § 1.460-6(c)(4). Under section 1.460-6(c)(4)(i), the interest accrual period begins on the return due date (not including extensions) for the redetermination year and ends on the earlier of (1) the return due date for the filing year and (2) the date when the taxpayer both files its return for the filing year and has paid the tax for that year. A net amount of interest payable by (or to) the taxpayer is computed for each filing year.

² All section references herein are to the Internal Revenue Code, unless noted otherwise.

³ The redetermined tax liability can vary from the reported tax liability of a redetermination year because PCM relies on estimates of total contract price and total contract costs to determine the year's income from a long-term contract. As noted, redetermined income is based on actual contract price and costs.

Section 1.460-6(f)(1) of the Income Tax Regulations provides that "[t]he amount of any interest due from, or payable to, a taxpayer as a result of applying the look-back method is computed on Form 8697 for any filing year."

The flush language of section 460(b)(1) provides that, for purposes of subtitle F (other than provisions governing estimated tax penalties), any look-back interest required to be paid by the taxpayer must be treated as an increase in income tax for the filing year. Section 460, however, is silent as to how look-back interest due from the government must be treated.

Section 1.460-6(f)(2)(i) of the Income Tax Regulations reiterates the statutory treatment of look-back interest due from the taxpayer under subtitle F and provides that, for purposes of computing taxable income under subtitle A, it constitutes interest expense. The regulation further provides that any look-back interest received from the government "is treated as taxable interest income for all purposes, and is not treated as a reduction in tax liability or a tax refund." § 1.460-6(f)(2)(i), Income Tax Regs. (fourth sentence).

Section 1.460-6(f)(3) of the Income Tax Regulations provides that for purposes of the period of limitation a "taxpayer's claim for look-back interest . . . that is not attributable to an amount previously paid by or collected from a taxpayer is a general, non-tax claim against the federal government." Thus, the claim is subject to the period of limitation set forth in sections 2401 and 2501 of Title 28 of the United States Code. In contrast, look-back interest owed by a taxpayer is subject to the limitations on assessment and collection provided in sections 6501 and 6502, and a taxpayer's claim for look-back interest previously paid is a claim for credit or refund of an overpayment of tax subject to the limitations provided in section 6511.

Section 1.460-6(f)(3) of the Income Tax Regulations also refers the reader to sections 6601 through 6622 "for guidance applicable to the compounding of interest when the look-back interest is not paid." Presumably, this sentence refers to both look-back interest owed by the taxpayer and look-back interest owed by the government.

Issue 1. Offsetting look-back interest due to a taxpayer against the taxpayer's tax liability

A. Credit under section 6402

Section 6402 provides that the Service, within the applicable period of limitation, may credit or refund an overpayment to the taxpayer who made the overpayment. Under this provision, the Service may offset the amount of an overpayment against any tax liability of the taxpayer.

For an overpayment of tax to arise there must be an amount paid by or collected from the taxpayer (which exceeds the tax owed). Look-back interest due to a taxpayer that

does not consist of an amount that was previously paid by or collected from the taxpayer is not an overpayment. Because section 6402 applies only to overpayments, this provision does not provide the Service with the authority to credit look-back interest owed to the taxpayer against a tax liability of the taxpayer.

B. Common law offset authority

Courts have allowed the United States government to retain all or some of a claim against it to offset an amount due to the government. United States v. Munsey Trust Co., 332 U.S. 234, 239 (1947) (recognizing that “[t]he government has the same right which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him”). Thus, common law offset “merely involves the government’s application of money owed to a taxpayer to reduce the taxpayer’s outstanding liability.” United States v. Warren Corp., 805 F.2d 449, 451 (1st Cir. 1986); see also Malman v. United States, 202 F.2d 483, 485 (2d Cir. 1953) (offsetting amount due from U.S. army against taxpayer’s overdue tax liability); Algonac Mfg. Co. v. U.S., 428 F.2d 1241, 1250 (Ct. Cl. 1970) (same).

Pursuant to section 1.460-6(f)(3) of the Income Tax Regulations, look-back interest due to a taxpayer is treated as “a general, non-tax claim against the federal government.” Under the principle upheld in Munsey Trust and subsequent cases, the United States government has a right to apply that claim against the taxpayer’s tax liability. In a situation where the Department of the Treasury both owes look-back interest to a taxpayer and is owed income tax by that taxpayer, it is only logical for the Department of the Treasury (and the Service as its agent) to have the right to offset. Accordingly, the Service may offset look-back interest against a taxpayer’s tax liability under common law principles.

Issue 2. Date on which look-back interest is available for offset

A taxpayer’s claim for look-back interest accrues, or becomes an enforceable right, at the end of the interest accrual period. Under section 1.460-6(c)(4)(i) of the Income Tax Regulations, the period for which look-back interest is computed ends on the earlier of the return due date for the filing year, and the date when the taxpayer files the return and pays the tax for that year. Accordingly, as of that date, the taxpayer has an enforceable claim against the federal government that is available for offset against the taxpayer’s tax liability.

Issue 3. “Add-on interest”

Neither section 460 nor the regulations thereunder explicitly addresses whether look-back interest itself accrues interest. Nevertheless, section 1.460-6(f)(3) of the Income Tax Regulations strongly suggests that the taxpayer is entitled to “add-on” interest. The third sentence begins as follows: “A taxpayer’s claim for look-back interest (or interest payable on look-back interest) that is not attributable to an amount previously paid by or

collected from a taxpayer is a general, non-tax claim" (emphasis added). Further, the last sentence of the same paragraph refers the reader to sections 6601 to 6622 (i.e., "Chapter 67—Interest") for "guidance applicable to the compounding of interest when the look-back interest is not paid," without specifying the party whose nonpayment triggers the application of those interest provisions. Those two sentences strongly suggest that the regulations under section 460 contemplate add-on interest when a taxpayer's claim for look-back interest is unpaid, and, moreover, that rules comparable to the overpayment interest rules set forth in section 6611 should apply to add-on interest.

Section 6611 allows interest on any "overpayment in respect of an internal revenue tax." It is true that look-back interest due to a taxpayer does not constitute an overpayment of tax and, therefore, falls outside the purview of section 6611. Nevertheless, the intent of section 1.460-6(f)(3) of the Income Tax Regulations is that add-on interest be computed under rules similar to those found in section 6611. Thus, although the section 6611 rules themselves do not apply to look-back interest because such interest does not constitute section 6611 interest, the regulations under section 460 are interpreted to apply rules similar to the section 6611 rules.

Section 6611(a) allows interest on any overpayment at "the overpayment rate established under section 6621." Under section 6611(b)(1), the period over which overpayment interest accrues begins on the date of the overpayment. Under section 6611(b)(2), the period ends, in the case of a credit, on the due date of the amount against which the credit is taken or, in the case of a refund, on a date (to be determined by the Secretary) preceding the refund date by not more than 30 days. See also § 301.6611-1(g), *Proced. & Admin. Regs.* (delegating authority to determine a date preceding the refund date to the district director or the director of the regional service center). Section 6611(b)(3) provides that if the taxpayer files a return after the due date, no interest is allowed for any day before the date when the return is filed. Under section 6611(e)(2), if an amount is refunded within 45 days of a claim filing, no interest is allowed from the date the claim is filed until the date the refund is made. Section 6611(g) provides that no interest will be allowed unless the return in issue is filed in processible form.

Accordingly, in interpreting the section 460 regulations, we apply rules comparable to those of section 6611 to add-on interest and conclude:

- (a) Applying a rule similar to that of section 6611(b)(1), add-on interest generally begins to accrue on the earlier of the due date of the federal income tax return for the filing year and the date the return is filed with any tax paid. That is the date taxpayer acquires a claim for look-back interest.
- (b) Applying a rule similar to that of section 6611(b)(2), the accrual period for add-on interest ends on a prescribed date preceding the date the look-back interest is

either paid or offset against taxpayer's tax liability, as determined by the district or service center director.

- (c) Applying a rule similar to that of section 6611(b)(3), if a taxpayer files a claim for look-back interest late, the accrual period should not begin prior to the date when the claim is actually filed.
- (d) Applying a rule similar to that of section 6611(e), the Service should allow no add-on interest from the date a claim is filed until a refund is made if it pays look-back interest (or makes an offset) within 45 days after the claim is filed.
- (e) Applying a rule similar to that of section 6611(g), the Service should not allow add-on interest for any period prior to the time the taxpayer has filed a processible Form 8697.

Issue 4. Look-back interest due a taxpayer and the bifurcated interest rate

Whether the bifurcated interest rate under section 6621(a)(1)(B)(flush language) applies to look-back interest itself is a separate question. Both section 460(b)(7)(A) and section 1.460-6(c)(4)(i) state that the overpayment rate in effect under section 6621 applies to determine look-back interest. For purposes of interpreting the section 460 regulations, this includes a rate similar to the reduced rate provided in the flush language of section 6621(a)(1) for overpayments of tax by a corporation in excess of \$10,000.⁴

As discussed, the look-back regulations contemplate the payment of add-on interest under rules comparable to those governing the payment of overpayment interest. Accordingly, the bifurcated interest rate applies as well to the computation of add-on interest on look-back interest due to a taxpayer.⁵

Issue 5. Due date of Form 8697 and consequences of its late filing when taxpayer is owed look-back interest

Neither section 460 nor the regulations thereunder provide the due date for filing Form 8697. Instructions for Form 8697 as revised in September 2005 provide that taxpayers that owe look-back interest or are not entitled to receive look-back interest must attach the Form to their income tax returns for the filing year. For those taxpayers, the due date of the Form 8697 is presumably the due date (including extensions) of their

⁴ In the context of section 6621, this interest rate is labeled the "GATT" interest rate. See Exxon Mobil Corp. v. Commissioner, 484 F.3d 731, 732 (5th Cir. 2007).

⁵ Because look-back interest owed the taxpayer is generally not an overpayment (and more specifically, not an overpayment under the facts presented), it is not taken into account in determining whether the "GATT" interest rate applies to any overpayment by a taxpayer. For example, if taxpayer was owed look-back interest of \$17,000, that amount would never be taken into account when determining if the threshold is met for applicability of GATT rate to any overpayment for the same tax year.

respective income tax return. The Instructions further provide that taxpayers that are owed look-back interest must file Forms 8697 separately with the Service Center in Philadelphia or in Cincinnati on or before their income tax return due dates (including extensions). In short, the due date of Form 8697 is the same as the taxpayer's return due date (including any extension) for the filing year.

Although the Code and the regulations do not provide any express sanction for the late filing of a Form 8697 against a taxpayer who is owed look-back interest, there are some adverse consequences. For example, under rules comparable to those provided in section 6611, the taxpayer will receive no add-on interest for any period prior to the date when it actually files a processible Form 8697.

Further, and as noted earlier, a taxpayer's claim for look-back interest is subject to limitations set forth in sections 2401 and 2501 of Title 28 of the United States Code. Section 2401(a) of Title 28 limits the period to bring a civil action against the United States to "six years after the right of action first accrued." Section 2501 of the same title provides that the petition on every claim of which the United States Court of Federal Claims has jurisdiction must be filed within "six years after such claim first accrues." The late filing of Form 8697 does not affect the six-year periods of limitations under sections 2401 and 2501 of Title 28 of the United States Code. The limitations periods begin to run on the day when the taxpayer's claim for look-back interest accrues, i.e., on the earlier of the due date of taxpayer's return for the filing year or the date the return is filed with tax paid.

CONCLUSIONS

For the foregoing reasons, we conclude as follows:

1. The Service may offset look-back interest due to a taxpayer against the taxpayer's tax liability under federal common law principles.
2. Look-back interest is available to offset a tax liability on the earlier of the return due date for the filing year and the date when the taxpayer files the return and pays the tax for that year.
3. Add-on interest accrues on look-back interest due to a taxpayer, and the accrual period is determined, as discussed herein, under rules comparable to those provided in section 6611.
4. A bifurcated interest rate applies to the computation of both look-back interest due to a taxpayer and the computation of add-on interest.
5. A Form 8697 showing interest due to the taxpayer is due on or before the due date (including any extension) of the taxpayer's income tax return for the filing

year; and while there is no express penalty for a late filing, there are adverse consequences for the taxpayer.

Please call (202) 622-4960 if you have any additional questions or wish to discuss this matter.