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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: GEORGE E. BOWDEN
 TECHNICAL ASSISTANT CC:DOM:FS

SUBJECT: DEFICIENCY INTEREST COMPUTATION REFUND CLAIM

This Field Service Advice responds to your memorandum dated September 3, 1998, requesting assistance in the computation of deficiency interest in light of the Action on Decision, A.O.D. CC-1997-008 (August 4, 1997), in May Department Stores v. United States, 36 Fed. Cl. 680 (1996). 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:

- | | | |
|--------------------|---|----------|
| X = | . | Year 3 = |
| | | Year 5 = |
| | | Year 6 = |
| | | Year 7 = |
| X's Representative | | \$a = |
| | | \$b = |
| | | \$c = |
| | | \$d = |
| | | \$e = |
| | | \$f = |
| Year 1 = | | \$g = |
| Year 2 = | | \$h = |

ISSUE:

At what date does interest start running on an underpayment of tax for Year 1 where X has reported an overpayment of tax on its return, and elected to have the overpayment applied to estimated taxes for the succeeding year, but the Service has subsequently determined a deficiency that is greater than the overpayment reported on the return.

CONCLUSION:

Where X has reported an overpayment on its Year 1 return, and has elected to have the overpayment applied to its estimated taxes, interest will be assessed on that portion of the subsequently determined deficiency less than or equal to the overpayment, as of the dates the overpayment is applied to succeeding year's estimated taxes, or 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. Interest will be assessed on any remaining portion of the deficiency that is in excess of the return overpayment from the original due date of the tax for Year 1.

FACTS:

X timely filed its Year 1 tax return under extension, on 15, Year 1. The return showed a tax liability of \$a, and an overpayment of \$b which X elected to apply to its Year 2 estimated taxes. Because X did not specify the installment to which the overpayment was to be applied, the Service applied the overpayment to the first installment of Year 2, pursuant to Rev. Ruling 88-98, 1988-2 C.B. 356. See also, Rev. Rul. 77-475, 1977-2 C.B. 476, as modified by Rev. Rul. 84-58, 1984-1 C.B. 254. This first installment would have been underpaid without the application of the overpayment.

The Service later assessed a deficiency of \$c against X for Year 1. This amount was greater than the overpayment reflected on X's return, and in computing the amount of interest due on the Year 1 deficiency, the Service used 15, Year 2, the date the Year 1 tax was due, as the date interest began to run. After X informed the Service it had a credit elect from Year 1, the Service used 15, Year 2, the due date of the first installment of Year 2 estimated taxes, as the date interest began to run on that part of the deficiency equal to the return overpayment. The remaining deficiency amount had interest correctly computed as of the due date of the Year 1 tax.

Thereafter, in an attempt to comply with May Department Stores v. United States, 36 Fed. Cl. 680 (1996), Appeals authorized the Examination Division's Support and Processing (ESP) Unit to apply that part of X's return overpayment, not used in satisfying the first installment of estimated taxes for Year 2, to the third installment. The ESP Unit calculated the amount required for the first installment to be 25 percent of the tax shown on the Year 2 return, and applied X's overpayment to the shortfall. The remaining balance of the overpayment was then applied to the third installment. Appeals agreed with X. The later determined deficiency corresponding to the purported overpayment did not arise, and deficiency interest did not begin to run, until the effective use of the overpayment in Year 2. Your memorandum questions the adequacy of May Department Stores as authority for splitting the overpayment between two installments of estimated tax, although ultimately you conclude that newly enacted Code § 6621(d) allows the Service to "apply overpayments in a manner to net out a taxpayer's interest obligation on an underpayment with its interest entitlement on an overpayment."

¹ For its part, X raises an additional issue; it argues that the overpayment should be allocated to the first and the third installments of estimated tax in amounts necessary to satisfy only 22.5 percent of the tax shown on its Year 2 return, not 25 percent.

With respect to its estimated taxes, X made the following payments for Year 2:

<u>Payment Due Dates</u>	<u>Deposits</u>
15, Year 2 ²	\$d
15, Year 2	\$e
15, Year 2	\$f
15, Year 3	\$g.

¹ Code § 6621(d) provides that "[t]o the extent that, for any period, interest is payable ... and allowable ... on equivalent underpayments and overpayments by the same taxpayer ..., the net rate of interest under this section on such amounts shall be zero for such period."

²

X's total income tax liability for Year 2 was \$h.

For Years 5 and 6, X reported overpayments on its timely filed returns and elected to have the overpayments applied to the following years' estimated taxes. X made estimated tax payments sufficient to cover the following years' first and second installments, without applying any portion of the overpayment reflected on the return. However, X did not make sufficient estimated tax payments for the third and fourth installments.

Similarly, for Year 7, X timely filed its return and elected to credit the return overpayment toward its estimated tax liability for Year 8. The overpayment was used as an estimated tax payment for the first and fourth installments of Year 8. X claims deficiency interest should be charged from the due dates of those installments and against the overpayment amounts needed to satisfy estimated tax liabilities for those installments.

LAW AND ANALYSIS

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), 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.³ 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 § 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 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 shown on its 1983 tax return to the succeeding year's estimated tax liability but did not attach a statement to its return indicating the installment to which the Service should credit the overpayment. A deficiency

³ Code § 6601(a) provides "[i]f any amount of tax ... is not paid on or before the last date prescribed for payment, interest on such amount ... shall be paid for the period from such last date to the date paid."

was determined for the taxpayer's 1983 tax year, and interest was assessed by the Service on the deficiency from the due date of the first installment in accordance with Rev. Rul. 88-98. However, the taxpayer had made estimated tax payments sufficient to avoid the addition to tax imposed by § 6655 for 1984 for the first and second installments of estimated tax due for 1984. The court concluded the Service's application of taxpayer's 1983 overpayment to the first installment did not change the fact that the government had the use of taxpayer's overpayment from the due date of the first installment (May 15) to the date taxpayer filed its 1983 tax return (October 15), since the overpayment was not needed to satisfy any installment of estimated tax due during that period.

In light of the May Department Stores decision, the Service has reconsidered the manner in which interest on a subsequently determined deficiency is computed under § 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 §§ 6654 and 6655. The Service will assess interest on a subsequently determined deficiency for the overpayment year from the date(s) 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.⁴

The May Department Stores AOD did not address splitting the overpayment between installments of estimated tax. However, under the estimated tax rules the overpayment is applied as needed to satisfy all or part of the amount payable on the installment due date. When an overpayment is split,

⁴ Code § 6655, as in effect for Year 2, imposed an underpayment penalty on the difference between payments made by the due date of the installment and the required installment amount, based on the lesser of (1) 90 percent of the tax shown on the return; or (2) 100 percent of the tax shown on the preceding year's return. I.R.C. § 6655(d)(B)(i) & (ii). The second method of calculating the required installment amount generally does not apply to a large corporation, except that a large corporation may use 100 percent of the tax shown on the preceding year's return for purposes of calculating its first installment of estimated taxes for any taxable year. In determining whether a corporation is a large corporation because its taxable income is greater than \$1 million, net operating losses and capital loss carryforwards are disregarded. § 6655(g)(2)(A) & (B)(iii). In this case the minimum amount of estimated taxes due per installment is 25 percent of 90 percent of the tax shown on the Year 2 return, or 22.5 percent of the tax shown.

the taxpayer will receive the use of its money at different times depending on the installments to which the overpayment is applied. Accordingly, it is consistent with both Avon Products and May Department Stores to conclude that the deficiency interest computations take into account the manner in which the overpayment was split.

These same estimated tax rules also allow any excess payments X has made to the second installment of Year 2, to be applied against later installments. See § 6655(b)(3). To the extent X's deposit of \$e for the second installment was greater than the required amount, it may be rolled forward and credited to the third installment. This excess amount, when added to X's deposit of \$f for the third installment, more than satisfied the minimum amount due, without requiring the application of X's return overpayment. To the extent the remaining balance of the return overpayment is not needed to satisfy any of the remaining installments of estimated tax for Year 2, the return overpayment should be applied to Year 2's income tax liability as of the unextended due date of the Year 2 return. X's credit election for the remaining portion of the return overpayment should be deemed effective as of the unextended due date of the Year 2 return. The tax deficiency equivalent to the balance of the return overpayment is unpaid as of this date, and deficiency interest begins to run from this date.

Finally, we do not agree that § 6621(d) supports the taxpayer's position. The net interest rate of zero authorized by § 6621(d) applies to the extent that, for any period, interest is payable under § 6601 and allowable under § 6611 on equivalent underpayments and overpayments by the same taxpayer. The mechanics of the computation require that the interest on the overpayment and the interest on the underpayment be netted to arrive at net interest of zero for any period during which the overpayment and the underpayment overlap. However, when a taxpayer makes an election to apply an overpayment shown on the return to the succeeding year's estimated tax, no interest is payable on the overpayment that is the subject of the taxpayer's election. See § 301.6402-3(a)(5) and § 301.6611-1(h)(2)(vii). Accordingly, § 6621(d) does not apply in any case in which the overpayment is applied to the succeeding year's estimated taxes since no interest is allowable on the overpayment in that situation.

In sum, the deficiency amount for Year 1 that is in excess of the overpayment reflected on the Year 1 return, should accrue deficiency interest from the original due date of the tax for Year 1. That part of the deficiency that is equal to the return overpayment starts to accrue deficiency interest when the overpayment is applied to unpaid installments of estimated tax for the succeeding year. In determining whether an installment of estimated tax is unpaid, the taxpayer must pay the minimum amount required to avoid additions to tax under § 6655. The taxpayer may roll forward its excess payments of estimated tax from one installment to another. After application

of X's estimated tax payments, X's return overpayment may be split between the installments and applied as needed to satisfy all or part of the amount payable on the installment due date so as to avoid additions to tax under § 6655. To the extent the return overpayment is not needed to satisfy any installments of estimated tax for the succeeding year, it should be applied to that year's income tax liabilities as of the unextended due date of that return. The same reasoning is applicable in computing deficiency interest on the deficiencies for Years 5, 6 and 7. For deficiencies in Years 5 and 6, interest begins to run on that portion of the deficiency that is less than or equal to the overpayment, as of date on which the overpayment is applied to succeeding year's estimated taxes, the due dates of the third and fourth installments. For the Year 7 deficiency, interest begins to run from the due dates of the first and fourth installments of estimated tax for Year 8.