

ISSUES:

1. Whether X must pay interest on a tax deficiency for Year 1, from March 15, Year 2 (the last date prescribed for payment of the Year 1 tax) through September 15, Year 2 (the extended due date for the Year 1 return), where X's Year 1 return reflected an overpayment, which X elected to credit against its Year 2 estimated tax, but the Service subsequently determined a deficiency in an amount less than the credit elect, and no amount of the excessive credit was required to satisfy X's estimated tax liabilities for Year 2.

2. Whether X must pay interest from September 15, Year 2, through March 15, Year 3, where the facts are the same as Issue 1. above.

3. Whether X must pay interest on the Year 1 deficiency from March 15, Year 3, through October 17, Year 3, where the facts are the same as in Issue 1. above, but X filed a return for Year 2 on October 17, Year 3, which reflected a refund of \$e.

CONCLUSION:

1. X is not required to pay interest on its Year 1 deficiency from March 15, Year 2, through September 15, Year 2. Interest on that part of the deficiency that is greater than the credit elect will run from the last date prescribed for payment of the Year 1 tax--the original due date of the Year 1 return, March 15, Year 2. Where the deficiency is less than or equal to the credit elect, as is the case here, deficiency interest will run from the date the credit is applied to the succeeding year's estimated taxes, in the order in which they are required to be paid to avoid an addition to tax for failure to pay estimated tax under section 6655. Further, where the credit elect was not required to satisfy any of X's estimated tax installments for Year 2, interest on the Year 1 deficiency would not begin to run until March 15, Year 3, the original due date of the succeeding Year's (Year 2) income tax return.

2. See Conclusion 1. above.

3. To the extent X's credit elect is not needed to satisfy any estimated tax installments, the overpayment should be applied to that succeeding year's income tax liability as of the unextended due date of that year's return. Any position which treats the credit elect as a payment on the date X filed its Year 2 return claiming a refund, ignores section 6513(a) which provides that a payment of income tax made before the date prescribed for payment of the tax is considered paid on that date. Here, the date prescribed for payment of Year 2 tax is the time fixed for filing the return, March 15, Year 3, (determined without regard to any extension of time for filing the return). See § 6151.

FACTS:

It is assumed X timely filed its tax return for Year 1, on September 11, Year 2, prior to what is assumed to have been the extended due date of September 15, Year 2. The Year 1 return reflected a tax liability of \$a, and an overpayment of \$b, which X elected to have applied to its Year 2 estimated tax liability.

It is also assumed that in calculating the amount of Year 2 estimated tax due each quarter, X was entitled to use the annualized income method (Code section 6655(e)(1)) for its first quarter, due April 15, Year 2, and could switch to the preceding-year safe harbor (Code section 6655(d)(1)(B)(ii)) for its second, third, and fourth quarters.¹

Code section 6655 imposes a penalty on corporations that fail to pay their estimated taxes on a quarterly basis. The penalty equals the amount of interest, at the underpayment rate established under section 6621, accrued on the amount of underpayment, for the period of underpayment. Id., § 6655(a). The amount of underpayment is the amount of the required quarterly installment, over the amount actually paid on or before the due date of the installment. Code § 6655(b). The required quarterly installments are 25 percent of the required annual payment. The required annual payment is, either (1) 100 percent of the tax shown on the current year's return or 100 percent of the current year's tax if no return is filed; or (2) 100 percent of the tax shown on the return for the preceding year with certain exceptions for large corporations; or (3) the tax due for the current year, calculated by placing the corporation's income for the months preceding the installment due date on an annualized basis, or (4) if the corporation has seasonal income, estimated taxes may be paid according to the seasonal pattern in which the income is earned. Corporations may use whichever required annual payment will yield lower quarterly installments. See Code § 6655(d) & (e). Moreover, when a corporation using the annualized income method switches to a different method in calculating subsequent quarterly installments, the reduction of estimated tax payments under the annualized method must be recaptured in full. Code § 6655(e)(1)(B).

Accepting as correct, the figures and analysis provided in your incoming memorandum, X made the following estimated tax payments against the following required quarterly installments:

¹ Large corporations, those with taxable income of more than \$1,000,000 in any of the three preceding years (Code section 6655(g)(2)(A) & (B)) are prohibited from using the preceding-year safe harbor. See Code § 6655(d)(2).

<u>Installment Due Dates</u>	<u>Amount Due</u>	<u>Amount Paid</u>
April 15	\$0	\$0
June 15	\$2c	\$5c
Sept. 15	\$c	\$5c
Dec. 15	\$c	\$0

Please note that in order for X to have a required quarterly installment of \$0 for the first quarter of Year 2, using the annualized income method, X would have had zero taxable income, alternative minimum taxable income, and modified alternative taxable income for either the first two or three months of Year 2, depending on the cut-off date chosen under section 6655(e)(2)(A) or (C). See also Code § 6655(e)(2)(B).

On audit, the Service determined that X had a deficiency of \$d for Year 1. This amount was less than the credit elect. X claims that in computing interest on this deficiency, the Service should run interest from the dates the excessive credit was used to satisfy shortfalls in estimated taxes. Assuming the facts are as stated in your incoming memorandum, that X did not have any shortfalls in estimated tax payments for

Year 2 and needed only a small portion of the credit elect from Year 1 to satisfy its Year 2 income tax liabilities, you ask at what date does interest begin to run on the deficiency determined for Year 1. As relevant here, \$e of the Year 1 credit elect was claimed as a refund for Year 2, on October 17, Year 3, when X filed its Year 2 return.

LAW AND ANALYSIS

Rev. Rul. 88-98, 1988-2 C.B. 356, holds that when a taxpayer claims a credit elect on a return filed either on the original due date or on extension, and the credit 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 equal to or less than the credit elect. Rev. Rul. 88-98 follows Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978), in which the court interpreted Code section 6601(a) to mean that interest on

a deficiency can only be charged when the tax is both due and unpaid.² 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 apply the credit. A deficiency was determined for the taxpayer's 1983 tax year, and interest was assessed 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 section 6655 for 1984 for the first and second installments. The court concluded that 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 deficiency interest is computed under section 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 credit 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 sections 6654 and 6655. The Service will assess interest on a subsequently determined deficiency from the date the credit 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 is used will determine the amount of estimated taxes due, and thus, the amount of the credit needed to satisfy the quarterly installments of estimated tax. The unused balance of the credit is deemed effective as a payment of the succeeding year's income tax liabilities as of the unextended due date of the return.

Where the overpayment is not needed to satisfy any installment of estimated tax, the overpayment should be treated as a payment of the succeeding year's income tax. Section 6513(d) provides that if any overpayment of income tax is claimed as

² 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."

a credit against estimated tax for the succeeding tax year, such amount shall be considered as a payment of income tax for the succeeding taxable year (whether or not claimed as a credit in the return of estimated tax for such succeeding taxable year) and no claim for credit or refund shall be allowed for the taxable year in which the overpayment arises. See also

§ 6513(a)(income tax paid before the date prescribed for payment considered paid on the due date). The date prescribed for payment of tax is the time fixed for filing the return (determined without regard to any extension of time for filing the return). § 6151. Further, it is on this date that the credit is treated as a payment for purposes of computing interest on any overpayment of income taxes with respect to the succeeding year under section 6611(a) and (d). Thus, we conclude that the statute requires that an overpayment which the taxpayer elects to credit against estimated tax for the succeeding year, which is not needed to satisfy estimated taxes, should be treated as a payment against the subsequent year's income tax as of the due date of the return.

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