



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

September 13, 1999

Number: **199952008**
Release Date: 12/30/1999
CC:DOM:FS:PROC
TL-N-2549-99
UILC: 6601.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL

FROM: Deborah Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Claim for Refund of Deficiency Interest

This Field Service Advice responds to your memorandum dated June 9, 1999. 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 1 =
Year 2 =

\$a =
\$b =
\$c =

X's Representative =

\$d =
\$e =
\$f =

ISSUE:

At what date does interest start running on a deficiency in tax for a particular year, where the taxpayer has reported an overpayment on its return and elected to credit the overpayment to its estimated taxes for the next succeeding year, but the Service has subsequently determined a deficiency that is not only less than the credit elect, but less than the unused portion of the credit elect remaining after the shortfalls in taxpayer's estimated tax payments have been satisfied.

CONCLUSION:

Where the deficiency in tax is less than the amount of the unused credit elect, interest starts running on the entire deficiency amount as of the unextended due date of the next succeeding year's income tax return.

FACTS:

X, a calendar year taxpayer, timely filed its federal income tax return for Year 1 on the extended due date, September 15, Year 2. The return reflected an overpayment of \$a, which X elected to have applied to its Year 2 estimated tax liability. The Service offset \$b of the overpayment against a liability of a related taxpayer, which X does not dispute; the remaining overpayment (hereinafter referred to as the credit elect) was applied to X's first and third installments of estimated tax for Year 2, although it is unclear why the third installment was credited.

Upon audit, the Service determined that X had a deficiency of \$c for Year 1, which was less than the credit elect. X claims that interest should run on the deficiency from the unextended due date of the succeeding year's return, because at no time during the succeeding year—Year 2—did the amount of the credit elect used in satisfying X's estimated tax liabilities exceed the overpayment amount to which X was ultimately entitled. Per X's analysis, only \$d of the credit elect was needed to avoid an addition to tax, under Code section 6655, for failure to pay the first installment of estimated taxes, due on April 15, Year 2.¹ Similarly, only \$e of the credit elect was needed to avoid the addition to tax for the second estimated tax installment, due on June 15, Year 2. Having fully paid the third and fourth installments without using any part of the remaining credit elect, X claims the remaining unused credit elect, \$f, exceeded the subsequently determined deficiency, and thus, the deficiency arose and started accruing interest when the

¹ These facts are based on X's transcript of account and its Form 2220 (Underpayment of Estimated Tax by Corporations) showing estimated tax payments X has made in Year 2, and the required amount of each installment.

unused credit elect was applied as a payment to succeeding year's income taxes. This occurred on the unextended due date of the Year 2 return. We agree with X's conclusion.

LAW AND ANALYSIS

In general, deficiency interest under Code section 6601(a) can be charged only when the tax is both due and unpaid. Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978). When an amount originally paid with respect to one tax (here, X's income taxes for Year 1) is subsequently credited against a different obligation (X's estimated tax liabilities for Year 2), the significant date for interest to start running under section 6601 is the point at which the Government loses the use of the money in question as a payment of the original year's tax. In a credit situation, this occurs when the credit is effective as payment of the next year's estimated tax, even when that point precedes the credit election. Rev. Rul. 88-98, 1988-2 C.B. 356; Rev. Rul. 77-475, 1977-2 C.B. 476. Here, on the original due date of the return X remitted more than enough money to satisfy the correct tax as ultimately determined (compare overpayment amount to subsequently determined deficiency), and the issue is when X gained the use of those funds as a payment of the succeeding year's estimated taxes. In answering this question, May Department Stores Co. v. United States, 36 Fed. Cl. 680 (1996), acq. AOD CC-1997-008 (Aug. 4, 1997), holds the credit elect may not be used as a payment of estimated tax installments due prior to the date of the election, where those taxes have already been fully paid, without the application of the credit.

In May Department Stores, the taxpayer reported overpayments on its timely filed 1983 and 1984 returns and elected to have the overpayments applied to the following years' estimated tax liabilities, but did not designate which quarterly installments against which the credit elect should be applied. In accordance with Rev. Rul. 84-58, 1984-1 C.B. 254, the Service applied the credit elect to the following years' first quarterly installment, even though the taxpayer had made sufficient estimated tax payments for its first and second installments without application of the credit elect.² On audit, the Service determined deficiencies in tax

² In Revenue Ruling 84-58, the Service held that, for returns filed after December 31, 1983, when a taxpayer elects to have an overpayment of income tax credited against its estimated tax for the next succeeding year, such overpayment arising on or before the due date of the return will be applied against the first installment of estimated tax for the next succeeding year unless the taxpayer requests that it be applied to a later installment.

for the 1983 and 1984 years in amounts less than the credit elects, and computed deficiency interest from the due dates of the first installments of estimated tax for each year. The Court of Federal Claims agreed with the taxpayer: No interest was owed on the deficiency until the due dates of the third estimated tax installments because the credit elects were not needed to cover estimated tax payments until those third installments.

In light of May Department Stores, the Service has reconsidered the manner in which deficiency interest is computed under section 6601(a), when taxpayer makes an election to credit the 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 Code sections 6654 and 6655. Thus, the Service will accrue interest on a subsequently determined deficiency from the date the credit elect is applied to the succeeding year's estimated taxes to the extent the credit elect is equal to or less than the deficiency amount. 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.³ 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. See Code §§ 6513(a) & (d); 6151. Thus, a credit elect that is not needed to satisfy estimated taxes will be treated as a payment against the subsequent year's income tax as of the due date of that year's return. Interest on that amount of the deficiency corresponding to the unused credit, accordingly, runs from that same date.

Here, the deficiency for Year 1 is less than the amount of the unused credit elect remaining after having been applied to satisfy shortfalls in X's first and second

³ While the Action on Decision with respect to May Department Stores did not address the situation where a taxpayer splits the credit elect between installments of estimated tax, the estimated tax rules allow the credit elect to be applied as needed to satisfy all or part of the amount payable on the quarterly installment due date. When a credit elect is split among various installments the taxpayer will use money ultimately belonging to the Government at differing times to satisfy estimated tax liabilities. Accordingly, we conclude that deficiency interest computations that take into account the manner in which the credit elect was split among installments of estimated tax are consistent with both May Department Stores and Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978).

installments of estimated tax. Thus, the entire deficiency started accruing interest as of the unextended due date of the Year 2 income tax return.

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By: _____
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