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

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Impact of Erroneous Refund on Deficiency Interest Computation

This Field Service Advice responds to your memorandum dated October 26, 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 =

$a =
$b =
$c =
$d =
$e =
$f =

Year 1 =
Year 2 =
Year 3 =

ISSUE

When the Service has failed to credit a taxpayer's overpayment of estimated income tax against the same taxpayer's outstanding income tax liability for an

earlier year, is the Service required, as a matter of law, to effectively credit taxpayer's subsequent remittance as of the date of the estimated tax refund?

CONCLUSION

Because the Service has discretion whether to apply overpayments to any outstanding liability or to refund them to the taxpayer, it is under no legal obligation to credit taxpayer's subsequent remittance as of the date the estimated tax overpayment would have been credited against the outstanding income tax liability had the Service performed an offset; nor is the Service required to calculate deficiency interest on the outstanding liability as though it had been satisfied through a credit/offset.

FACTS

X files its federal income tax returns on a calendar year basis. For Year 1, X's return showed an overpayment of $a, and on that return, X elected to apply $b of the overpayment as a credit against its estimated tax liabilities for Year 2. The Service refunded the balance of the overpayment without interest on September 28, Year 2, because the return had been filed under extension less than 45 days earlier, on September 14, Year 2.[1]

During Year 2, X made estimated federal income tax payments totalling $c. Based on an expected income tax liability of zero for that year, X timely filed a Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax, on March 14, Year 3, indicating an overpayment of estimated tax in the amount of $c. The application for refund consisted of estimated tax payments made in Year 2 and the amount of tax overpaid on X's Year 1 return, which had been credited to X's estimated tax for Year 2. In a letter, dated March 10, Year 3, which accompanied the Form 4466, X directed that "$[d] of the overpayment be applied to the [Year 1] Form 1120X (photocopy attached)." On that same date, X had filed an Amended U.S. Corporation Income Tax Return (Form 1120X) for Year 1, showing a balance due of $d. [2]

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[1] See I.R.C. section 6611(e); Treas. Reg. section 301.6611-1(j)(2).

[2] X filed its amended Year 1 income tax return (Form 1120X) on March 14, Year 3. On the Form 1120X, X reported that its corporate income tax liability was $e rather than $f, thus, $d more than it had originally reported. X requested in the letter accompanying its amended return that the Service apply $d of the overpayment from its Year 2 Form 4466, Application for Quick Refund of Overpayment of Estimated Tax, to the additional income tax liabilities for Year 1, shown on its amended return.

No credit was effected for the Year 1 income liability; rather, on March 22, Year 3, the Service refunded the entire amount of the overpaid estimated taxes for Year 2. In a letter accompanying X's later payment of April 14, Year 3, for its Year 1 liability, X states that it received a wire transfer for the full amount of the Year 2 estimated tax overpayment on March 23, Year 3, and that, upon contacting the Service was instructed to remit a check in the amount of $d, which the Service would then apply to the Form 1120X liabilities as of March 23, Year 3, "so we would not be erroneously assessed any interest or penalties." (Letter, dated April 13, Year 3, to IRS Technical Unit.)

The Service's current transcript of account for X's Year 1 income tax shows an additional tax assessment of $d made on May 3, Year 3. During the first week of June in Year 3, Service personnel reversed a payment transaction of $d, which had been posted a month earlier, showing an effective date of April 26, Year 3, and re-entered the payment, changing the effective payment date to December 7, Year 2.[3]

Deficiency interest on X's Year 1 underpayment of $d was computed using a start date of September 28, Year 2. This is the date the Service had refunded that portion of X's Year 1 tax that was claimed as an overpayment on its original return, and which was not used as a credit toward Year 2 estimated tax liabilities. Deficiency interest stopped running on March 15, Year 3, when all accrued interest on the underpayment had been fully satisfied using a credit offset from an earlier overpayment occurring before Year 1.

LAW AND ANALYSIS

1. The Start Date for Deficiency Interest

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 date deficiency interest starts running under section 6601 with respect to a later determined underpayment, 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

[3] The documentation supporting this transaction, Form 5147, provides no explanation as to why December 7, Year 2, was used as an effective date.

precedes the credit election. Rev. Rul. 88-98, 1988-2 C.B. 356, modified and superseded by Rev. Rul. 99-40, 1999-40 I.R.B. 441; Rev. Rul. 77-475, 1977-2 C.B. 476, revoked by Rev. Rul. 83-111, 1983-2 C.B. 245, reinstated and modified by Rev. Rul. 84-58, 1984-1 C.B. 254. Moreover, the use-of-money principles enunciated in May Department Stores Co. v. United States, 36 Fed. Cl. 680 (1996), acq. AOD CC-1997-008 (Aug. 4, 1997), and Sequa Corporation v. United States, 99-1 U.S.T.C. (CCH) ¶ 50,379 (S.D.N.Y. June 10, 1998), require that the credit cannot be effective as a payment of the next year's estimated tax, when other funds are available to fully pay the estimated tax.[4] In the case of a refund made without interest under Code section 6611(e), the date on which the Government loses the use of the money in question as a payment of the original year's tax is when the amount in question is refunded, even when that date is subsequent to the date of the claim for refund.

Here, the entire credit elect was not needed to pay estimated taxes. Yet, prior to the date the credit was effective as a payment of the succeeding year's income taxes, X filed a Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax, on which X indicated an overpayment of estimated tax of $c, consisting of estimated tax payments made in Year 2, and the credit elect from X's Year 1 return. On March 22,
Year 3, the Service refunded the entire amount. With the allowance of X's application for refund, there were no estimated tax payments or credit elect that could be considered a payment of income tax as of the date prescribed for filing the

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[4] Thus, in Revenue Ruling 99-40, 1999-40 I.R.B. 441, the Service now takes the position that the credit will be 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. Where the credit is not needed to satisfy any installment of estimated tax in the succeeding year, "such amount shall be considered as a payment of ... income tax for the succeeding taxable year," pursuant to Code section 6513(d), and for purposes of the statute of limitations on credits or refunds, "shall be deemed to have been paid on the last day prescribed for filing the return ... for such taxable year ... determined without regard to any extension of time for filing ... ," under Code section 6513(b)(2). The same date–the last day prescribed for filing the return for the succeeding taxable year–is also used to determine when the credit is effective as payment for the succeeding year's income taxes and when Government has lost the use of the money as a payment of the original year's tax. Accordingly, where no part of the credit is used to satisfy estimated taxes, the original year's tax would become due and unpaid as of the unextended due date of the succeeding year's return. And on that date, deficiency interest would start under section 6601.

Year 2 return. Thus, the amount at issue (that part of the credit elect equal to the subsequently determined Year 1 underpayment) remained available to offset the underpayment up until the refund date of estimated taxes. Accordingly, deficiency interest under Code section 6601 starts running on X's Year 1 underpayment as of the date of the refund, because the Year 1 income taxes were not underpaid until the $c was refunded without interest on March 22, Year 3.

2. The Stop Date for Deficiency Interest

X claims that its remittance of $d on April 14, Year 3, in payment of its Year 1 income tax liability, should be credited for interest purposes as of March 23, Year 3. This is the date X received a full refund of its overpayment of Year 2 estimated taxes. Pursuant to X's instructions, however, $d of the overpaid estimated tax for Year 2 was to have been credited against its Year 1 income tax liability. X claims that a credit/offset should have been performed before any balance was refunded, and thus, the refund date should be deemed the effective date of its later payment of the Year 1 liability.

Code section 6425(a) allows a corporation that has overpaid its estimated income tax to file an application for an adjustment ("quick refund") of the overpayment. The Secretary, if he allows the adjustment, " ... may credit the amount of the adjustment against any liability in respect of an internal revenue tax on the part of the corporation and shall refund the remainder to the corporation." I.R.C. § 6425(b)(2)(emphasis supplied). Code section 6402(a), under which any credit would have been effected, provides that "in the case of any overpayment, the Secretary ... within the applicable period of limitations, may credit the amount of such 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 supplied.) Thus, allowing a credit, rather than making a refund, remains discretionary with the Service. See, Northern States Power v. United States, 73 F.3d 764, 767 (8th Cir.), cert. denied, 519 U.S. 862 (1996)(and cases cited therein). Since the Service was not required to credit X's estimated tax overpayments against its Year 1 income tax liabilities, there is absolutely no legal authority requiring the Service to calculate X's deficiency interest as though it did.

3. The Discretion Accorded the Service Under Section 6402 has not been Restricted by the Voluntary Payment Rule

Under the voluntary payment rule, when a taxpayer with outstanding tax liabilities voluntarily makes a payment, the Service generally, as a policy matter, will honor

the taxpayer's request about how to apply the payment. See Rev. Rul. 73-305, 1973-2 C.B. 43, modified by Rev. Rul. 79-284, 1979-2 C.B. 83. Thus, a taxpayer may designate the application of tax payments that are voluntarily made, but may not designate the application of involuntary payments. Muntwyler v. United States, 703 F.2d 1030, 1032 (7th Cir. 1983). An involuntary payment is defined as "'any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.'" United States v. Pepperman, 976 F.2d 123, 127 (7th Cir. 1992)(quoting Amos v. Commissioner, 47 T.C. 65, 69 (1966). Here, X did not make an initial payment with directions to the Service as to which liabilities it should apply; rather X attempted to control the allocation of a refund. X requested that the Service apply overpaid estimated taxes to its unpaid income tax liability for Year 1. Instead, the Service refunded the entire overpayment.

United States v. Ryan (In re Ryan), 64 F.3d 1516 (11th Cir. 1995), upholds the Service's discretion under Code section 6402 in allocating a tax overpayment among various tax liabilities, and concludes that the Service has not extended its voluntary payment rule to tax overpayments. See also, Kalb v United States, 505 F.2d 506 (2d Cir. 1974), cert. denied, 421 U.S. 979 (1975); but cf. Jung v. United States, 701 F.Supp. 175 (E.D. Wis. 1988)(suggesting a taxpayer might be able to direct the application of an unrefunded overpayment if instructions are given before the Service makes an offset under Code section 6402), aff'd, without published opinion, 787 F.2d 596 (7th Cir. 1986). Ryan notes, however, that to the extent the Service has given taxpayers any ability to designate the application of overpayments, it has limited the taxpayer to requesting a credit for the succeeding tax year, and even that request can be refused by the Service. See Treas. Reg. § 301.6402-3(a)(5) & (6)(i). Here, of course, X has requested allocation of the overpayment not to a succeeding year but to a prior year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Nevertheless, it appears that the Service's failure to make the requested offset was a mistake. X had self-assessed the Year 1 income tax liability pursuant its amended return, and brought the liability to the Service's attention by attaching a copy of the amended return to its Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax. In a letter attached to the Form 4466, X directed that "$[d] of the overpayment be applied to the [Year 1] Form 1120X (photocopy attached)."

Procedures in the Internal Revenue Manual instruct that "[w]hen initiating a manual refund request," as was the case here, personnel are to "ensure that prepaid credits claimed by the taxpayer are available for refund and that the taxpayer does not

have any outstanding balances for which the credits could be offset." I.R.M. 21.4.4.4(6), at page 4. Because "[t]ax offset capability is lost when a manual refund is issued," Service personnel "must ensure that the taxpayer does not have any outstanding tax liabilities that must be satisfied ... ," id., at 21.4.4.4.1(1) at page 4, and "[w]hen an outstanding tax debt is identified, a manual refund may only be issued for the amount of overpayment in excess of the balance due." Id., at 21.4.4.4.2(2) at page 6. Thus, notwithstanding evidence of X's liability, and I.R.M. instructions to the contrary, the Service personnel manually refunded the entire amount of X's overpaid estimated taxes.

While violation of the Internal Revenue Manual does not invalidate the Service's action or confer any rights to X, see Matter of Carlson, 126 F. 3d 915, 922 (7th Cir. 1997), cert. denied, 523 U.S. 1060 (1998), in this instance, we believe the Service should correct its error by allowing X's subsequent remittance of April 14, Year 3, to be effectively credited for interest purposes, as of March 22, Year 3, the date the offset should have been performed. See, e.g., American Trucking Ass'ns v. Frisco Transportation Co., 358 U.S. 133, 144-146 (1958); Bugge v. United States, 99 F.3d 740, 745 (5th Cir. 1996). Had the offset been performed, the Year 1 underpayment would have been satisfied on the same the date that it arose. Thus, in this instance, no interest should be charged for X's Year 1 underpayment.

By: _____

GEORGE E. BOWDEN
Technical Assistant to the
Assistant Chief Counsel
(Field Service) CC:DOM:FS