

DON'T LEAVE MONEY ON THE TABLE! IRS [MIS]COMPUTATION OF INTEREST

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ISSUES

- **Errors (law is clear)**
- **Disputes (law is unclear)**
- **Procedural issues**

ANNUAL INTEREST NETTING

- Many of the interest provisions in the Code are written from the perspective of a single event – original return, deficiency on audit, refund claim, etc. – and how interest should be computed for that event.
- But interest is actually computed on the net balance of all such events in the tax year.
- This “annual netting” concept effectively modifies the literal language of the Code.

EXAMPLE

- **The taxpayer files its original return for the 2011 tax year on March 15, 2012, showing tax liability of \$200,000, payments of \$300,000, and a refund due of \$100,000. The IRS pays the refund on April 28, 2012, without interest.**
- **The IRS later conducts an audit and determines that the proper tax liability was \$290,000, resulting in a deficiency of \$90,000. The taxpayer concedes and pays the deficiency on July 5, 2014.**

EXAMPLE, cont'd

- **Balance from 3/15/12 – 4/28/12**
 - Tax liability of \$290,000
 - Net amount paid of \$300,000
 - Overpayment balance of \$10,000, which doesn't earn overpayment interest
- **Balance from 4/29/12 – 7/5/14**
 - Tax liability of \$290,000
 - Net amount paid of \$200,000 (after the refund)
 - Underpayment balance of \$90,000 on which the taxpayer owes underpayment interest

OVERLAPPING EVENTS

- **Overpayment of \$100,000 from 3/15/12 – 4/28/12**
- **Underpayment of \$90,000 from 3/15/12 – 7/5/94**
- **The overpayment doesn't earn overpayment interest – but it does prevent underpayment interest during that period on an underpayment up to the amount of the overpayment.**

ERRORS

CREDIT ELECT TRANSFERS

- On their original returns, taxpayers can choose to have all or a portion of any overpayment credited to their estimated taxes for the following year.
- Problem arises if a subsequent audit results in a deficiency. Under the annual netting concept, underpayment interest on a subsequently determined deficiency accrues from the date of a refund – but what is the date of a credit elect transfer??

CREDIT ELECT TRANSFERS, cont'd

- Courts have concluded, and the IRS concedes, that the effective date of the credit elect transfer – when underpayment interest on the subsequently determined deficiency begins to accrue – is the date of the first estimated tax installment for the following year for which the credit elect transfer was needed to avoid a penalty. Compare the cumulative payments to the cumulative minimum estimated tax obligations.

CREDIT ELECT TRANSFERS, cont'd

- The IRS will apply this principle – it's no longer a disputed legal issue.
- The IRS knows the dates and amounts of the actual payments of estimated taxes, as well as the tax liability reported on that next year's return.
- But estimated tax installment obligations are not necessarily just 1/4 of the total tax liability on that return. If an exception applies, the IRS won't have that information.

CARRYBACKS

- **All changes to tax liability resulting from or directly attributable to a carryback are effective as of the return due date for the year in which the loss/credit arose, rather than the year to which it was carried back.**
- **The direct effects of a carryback are easy. But the IRS often misses indirect effects, or may attribute a change to the wrong source year if there are multiple carrybacks.**

HOT INTEREST

- **“Hot interest” is a 2% increase to the underpayment interest rate that applies after a “large corporate underpayment” (LCU), \$100,000 or more, is not paid within 30 days.**
- **The higher interest rate is applied starting 30 days after the earlier of**
 - **30-day letter**
 - **Notice of deficiency**
 - **If deficiency procedures don’t apply, the first notice of assessment or proposed assessment**

HOT INTEREST

- But letters/notices that are withdrawn, are for less than \$100,000, or are paid in full within 30 days are disregarded in determining the applicable date.
- The “threshold underpayment” is the excess of the total tax liability, excluding penalties and interest, for the tax year over amounts paid on or before the return due date.
- Based on the assessment or court decision, not the proposed deficiency.

HOT INTEREST

- **The rules for hot interest (Treas. Reg. § 301.6621-3) are complex and depend on information that may not be reflected (properly or at all) in the account transcript. Hot interest is often applied when it should not be or begins before it should.**
- **If the IRS applies the higher interest rate, the taxpayer should always confirm whether it applies at all as well as check the applicable date on which hot interest starts accruing.**

CREDITS

- **When the taxpayer has an overpayment in one year, instead of refunding it the IRS can instead apply it against an underpayment in another year. The IRS should reflect that credit transfer effective as of the same date in both years, but doesn't always.**
- **Differences can mean the taxpayer gets no benefit for a gap period – neither earning overpayment interest in one year nor avoiding underpayment interest in the other.**

REFUND DATES

- **The IRS interest computations normally use the correct date for computer-generated refunds, and don't allow overpayment interest for the appropriate back-off period before that date.**
- **But the dates for manual refunds require manual intervention and often are wrong.**

SUSPENSIONS OF OVERPAYMENT INTEREST

- **Overpayment interest is suspended for**
 - Timely refunds, and
 - Refund back-off periods.
- **The IRS normally properly suspends overpayment interest in these situations.**
- **But if the IRS later determines a deficiency for that tax year, underpayment interest should – but may not – be suspended for the same period as overpayment interest was suspended.**

SUSPENSION OF UNDERPAYMENT INTEREST

- **Underpayment interest should be suspended**
 - If the underpayment is paid within 21 calendar days (or ten business days if at least \$100,000) from the date of notice and demand, or
 - If no notice and demand is made within 30 days of filing Form 870, consenting to immediate assessment.
- **But suspension of interest in these situations requires manual intervention, and often is missed by the IRS.**

PENALTIES

- Interest on accuracy-related penalties, fraud penalties, and penalties for failure to file or failure to pay is computed from the return due date, including extensions, until the date paid.
- Interest on other penalties is computed only from the date of notice and demand – and no interest is due at all if the taxpayer pays within 21 calendar days (or ten business days if more than \$100,000).

PENALTIES, cont'd

- **Increases to the underlying tax (other than resulting from or attributable to a carryback) accrue interest starting from the return due date without extensions.**
- **The IRS sometimes incorrectly uses the same effective date for penalties as for the underlying tax.**

DISPUTES

HOT INTEREST

- Does hot interest apply if the underpayment is reduced below \$100,000 by a carryback?
- Tax Court – Yes, if the carryback is pre-assessment, *Med James, Inc. v. Comm’r.* “Threshold underpayment” is determined based on the assessment or court decision.
- IRS disagrees, CCA 201120026, because a carryback is a “payment” made after the return due date.

GLOBAL INTEREST NETTING

- **“To the extent that, for any period, interest is payable [on an underpayment] and allowable [on an overpayment] on equivalent underpayments and overpayments by the same taxpayer . . . , the net rate of interest . . . on such amounts shall be zero”**
- **Either compute overpayment interest (in one period) at the underpayment rate or compute underpayment interest (in the other period) at the overpayment rate.**

GLOBAL INTEREST NETTING

- **Several different legal issues related to netting**
 - “Same taxpayer”
 - Direction of netting
 - Transitional rules
 - Interest-free periods

SAME TAXPAYER

- IRS initially interpreted “same taxpayer” broadly
 - Pre-merger balances of merging entities can be netted; surviving company is liable for underpayments, and entitled to overpayments, of the non-surviving entity.
 - Overpayment by subsidiary can be netted against underpayment of parent; joint & several liability.
 - Underpayment by subsidiary possibly can be netted against subsidiary’s share of overpayment of parent.

SAME TAXPAYER, cont'd

- **More recently, the IRS has retreated to a very narrow interpretation.**
 - **The overpayment and underpayment must both relate to returns filed under the same TIN.**
 - **And a consolidated group may not even be able to net its own overpayments and underpayments. The consolidated group, even under the identical TIN, is not the “same taxpayer” in year A and year B if the composition of the group – the affiliates included – is not exactly identical.**

RECENT CASES

- ***Energy East Corp.*** – affiliates cannot net balances from tax years before joining the group.
- ***Magma Power Co.*** – underpayment by subsidiary can be netted against group's overpayment "to the extent the consolidated group's overpayment can be traced to" it.
- ***Wells Fargo*** – predecessors to surviving corporation in statutory merger can net their balances.

DIRECTION OF NETTING

- **IRS practice is to equalize by adjusting interest rate in the year with the underpayment, if still open.**
- **But this is not required by Code or Regs.**
- **There is no reason equalization of interest rates shouldn't be permitted in either year, if both are open. It may be more beneficial to adjust the interest rate in the year with the overpayment.**

TRANSITIONAL RULE

- **IRC § 6621(d) applies to interest periods after 10/1/98, and permits netting if the statute of limitations is open for either year.**
- **A special uncodified transitional rule applies to earlier period but has a strangely-worded statute of limitations provision.**
- **The IRS interprets the provision to mean that, at the time the netting claim is filed, the statute of limitations must be open for both years to be netted.**

AND THE COURTS SAY . . .

- In *Fannie Mae* (2004), the Federal Circuit agreed with the IRS – both years must be open.
- In *Exxon Mobil* (2012), the Second Circuit agreed with the taxpayer – netting is permitted as long as either year is still open.

INTEREST-FREE PERIODS

- Can a taxpayer net an underpayment balance on which interest is payable against an overpayment balance on which interest was not allowable? That would reduce the interest rate on the underpayment to 0%.
- In *Computervision*, the Court of Federal Claims decided that interest-free overpayments cannot be used to “equalize” the interest rate on an underpayment balance.

CREDIT APPLICATION ORDERING

- This involves an extension of the annual netting concept, but for which there is no clear rule.
- The situation arises when there is a net overpayment balance including:
 - An overpayment on which interest is allowed.
 - An overpayment on which interest is not allowed.
 - An underpayment.

CAO - EXAMPLE

- Taxpayer timely files 2008 tax return on 9/15/09, showing tax liability of \$320,000, payments of \$370,000, and an overpayment of \$50,000. The IRS refunds the \$50,000 on 10/15/09 without interest.
- The taxpayer files a refund claim on 5/15/11, and the IRS abated tax of, and refunded, \$60,000 on 6/5/11 with interest (for the period before 5/15/11).
- On 8/20/12, a tax assessment of \$75,000.

CAO - BALANCE

- **Balance for the period 3/15/09 – 10/15/09**
 - Tax liability (after all adjustments) of \$335,000
 - Net payments (before the refund) of \$370,000
 - Net overpayment balance of \$35,000
- **Net overpayment balance is composed of:**
 - Overpayment of \$50,000, not entitled to interest
 - Overpayment of \$60,000, entitled to interest
 - Underpayment of \$75,000
- **Is the taxpayer entitled to interest on that interim overpayment balance of \$35,000???**

ANSWER IS UNCLEAR

- **The Code and Regs don't tell taxpayers which overpayment event the net balance comes from, and therefore whether interest is allowable. No neutral ordering rule.**
- **The IRS position is that interest is allowable only to the extent that the net balance is greater than the overpayment event for which no interest is allowable. That is, the net balance always includes the event on which no interest is allowable.**

AND THE CASES REACH DIFFERENT RESULTS

- In *Soo Line R.R.*, (1999), the CFC agreed with the IRS – the net overpayment balance came from the transaction on which interest was not allowable.
- In *Coca-Cola Co.* (2012), the CFC agreed with the taxpayer – the net overpayment balance came from the transaction on which interest was allowable.
- The difference in facts doesn't persuasively explain the different results.

DEPOSITS

- A “deposit” stops underpayment interest but does not earn overpayment interest.
 - But the taxpayer can get it back any time by request.
 - IRC § 6603 now provides for a lower rate of interest on a returned “section 6603 deposit.”
- A “payment” stops underpayment interest and also earns overpayment interest.
 - But the taxpayer can only get it back by a refund claim/refund suit.

DEPOSITS, cont'd

- **Revenue Procedures concerning deposits address what happens when the deposit is**
 - Returned at the taxpayer's request, or
 - Applied as a payment automatically when the IRS assesses tax.
- **The Revenue Procedures do not contemplate a remittance that is**
 - Initially treated as a deposit, and
 - Then later converted into a payment, before any assessment, on designation by the taxpayer.

DEPOSITS, cont'd

- In *Ford Motor Co.*, the taxpayer initially remitted deposits and later designated the deposits as payments. When the IRS ultimately determined that there was no deficiency, it refunded the overpayments with interest from the date of designation.
- The taxpayer argued it was entitled to interest from the original date of remittance.
- On remand from the Supreme Court, the Sixth Circuit again ruled for the government.

GATT INTEREST

- **Corporations earn overpayment interest at a lower rate on their overpayments in excess of \$10,000, starting 1/1/95.**
- **What about pre-1995 accrued interest? Does it compound at the lower GATT rate?**
- **The IRS separates pre-1995 overpayments and associated accrued interest into two buckets – the first \$10,000 and the remainder. Interest in the second bucket compounds at the lower GATT rate.**

GATT INTEREST

- The Federal Circuit (*General Electric*) and Fifth Circuit (*Exxon Mobil*) agree with the IRS methodology.
- But the IRS allowed compounding of accrued interest at the normal interest rate prior to 1999, and made a policy decision not to recapture interest when it changed methodologies.
- The taxpayer may be able to argue for the normal interest rate under other theories.

PROCEDURAL ISSUES

OVERPAYMENT INTEREST

- **For taxpayer seeking additional interest**
 - A refund claim is not necessary, because overpayment interest is not tax.
 - But a refund claim may be helpful, to try to resolve the issue administratively.
 - Taxpayer cannot wait indefinitely for the IRS to evaluate the claim. The statute of limitations for refund suits does not apply. Instead, the general six-year statute of limitations for suit, from the date the overpayment is scheduled, applies.

OVERPAYMENT INTEREST

- For government seeking recovery of excessive overpayment interest paid
 - The IRS cannot simply assess the amount to be recovered.
 - The only options are an offset to reduce a refund (for the same type of tax and the same tax period) or an erroneous refund suit.
 - In *Pacific Gas & Electric*, the Federal Circuit concluded that offsets were also subject to the two year statute of limitations for erroneous refund suit. The IRS disagrees and won't follow.

RULE 155 COMPUTATIONS

- **An overpayment determined by the Tax Court is reduced by any underpayment interest. And the taxpayer cannot challenge that determination after it becomes final.**
- **Don't wait to resolve interest issues until after entry of the decision! Make sure the IRS's proposed Rule 155 computations are correct, and resolve any disputes concerning interest, before submitting the computations to the court for entry of decision.**