Department of the Treasury
Internal Revenue Service
Office of Chief Counsel

Notice

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October 27, 1999

Subject: CHANGE IN LITIGATING POSITION **Cancel Date:** Upon Incorporation Into the CCDM

The purpose of this notice is to announce a change in the Service's litigating position with respect to when interest begins to accrue on a deficiency in tax if, pursuant to the taxpayer's election, the Service credited the reported overpayment against the taxpayer's estimated tax liability for the succeeding taxable year.

This issue was litigated in *The May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996). On August 4, 1997, the Service acquiesced in the decision in *The May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996), *acq.*, AOD CC-1997-008 (Aug. 4, 1997).

In light of *the May Department Stores* decision, the Service has reconsidered the manner in which overpayments are applied to the succeeding year's estimated tax when the taxpayer makes an election to credit the overpayment against its estimated tax for the succeeding year. Rev. Rul. 99-40, 1999-40 I.R.B. 441 (Oct. 4, 1999). When the taxpayer files its return on or before the due date or the due date as extended and elects to credit its reported overpayment against its estimated tax for the succeeding year, the overpayment is considered as applied to the unpaid installments of estimated tax due on or after the date(s) 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 I.R.C. §§ 6654 and 6655 with respect to such year. Id.

Interest on a deficiency in tax is assessed only for the period for which the tax is due and unpaid. The Service, therefore, will no longer litigate cases where the taxpayer elected to credit its reported overpayment to its estimated tax for the succeeding year and interest was assessed on a deficiency, or portion thereof, that is equal to or less than the claimed overpayment before the claimed overpayment, or a portion thereof, was needed to avoid an addition to tax for failure to pay estimated tax, or to the extent that a portion of the overpayment was not needed to satisfy the specific installments of estimated tax, from the original due date of the succeeding year's income tax return. *See The May Department Stores Co. v. United States*, 36 Fed. Cl. at 680.

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How to determine whether the overpayment was needed to avoid an addition to tax for failure to pay estimated tax

Once it is determined that there is a deficiency in tax in a year for which the taxpayer reported an overpayment of tax and elected to have the overpayment applied to the succeeding year's estimated tax, the Service will need to determine whether the overpayment was needed to avoid an addition to tax for failure to pay estimated tax for the succeeding taxable year. The following information is needed to make this determination:

1. when the tax became overpaid,
2. what, if any, payments of estimated tax the taxpayer made for the succeeding taxable year,
3. the date any such payments were made,
4. the taxpayer's reported total tax for the succeeding year, and
5. the method by which the amount of the taxpayer's required installments of estimated tax were determined for purposes of section 6654 or section 6655.[1]

This information can be found on the taxpayer's transcripts of account for the deficiency and succeeding year, and the taxpayer's return for the succeeding year, including Form 2220, Underpayment of Estimated Tax by Corporations; Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts; or Form 2210-F, Underpayment of Estimated Tax by Farmers and Fisherman.

Using the information described in 4 and 5 above, determine the amount of each of the taxpayer's required installments of estimated tax for the succeeding year. *See* sections 6654(d) and 6655(d) or (e). If the amount of the taxpayer's required first installment is equal to or less than the amount of any payments of estimated tax made on or before the due date for the first installment, not including the credited overpayment, the taxpayer did not need the overpayment to avoid an addition to tax for failure to pay the first installment of estimated tax. For the second required installment, all payments made on or before the due date for that installment, not including the credited overpayment, are added together and, if the total payments exceeds the sum of the first two installments, the taxpayer did not need the overpayment to avoid the addition to tax. Similar calculations are made with respect to third and fourth installments.

If, however, the amount of any of the taxpayer's required installments exceeds the amount of all payments of estimated tax made on or before the due date for that installment, not including the credited overpayment, the taxpayer needed the overpayment (or a portion thereof) to avoid an addition to tax for failure to pay an installment of estimated tax. The overpayment, therefore, is reduced by the amount

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[1] If the taxpayer's installments of estimated tax were determined based on a method other than those described in sections 6654(d) or 6655(d), the taxpayer has the burden of establishing that the method used was proper.

that the required installment exceeds the amount of all other payments made on or before the installment due date. If the remaining overpayment is less than the determined deficiency, underpayment interest will accrue on the difference from the due date of the installment until the date that the deficiency is paid. The following example demonstrates the proper methodology to be used in these cases:

> Pursuant to a six month extension, corporation X, a calendar year taxpayer, timely files its 1995 return on September 15, 1996. On its 1995 return, corporation X reported a tax liability of $80x and total payments of $100x, all of which were made on or before March 15, 1996. Corporation X has elected to have its entire overpayment of $20x applied to its estimated tax for 1996. In April 1998, it is determined that corporation X's correct tax liability for 1995 is $100x, and corporation X pays the deficiency of $20x. For its 1996 tax year, corporation X reported total tax of $90x, and that, by annualizing its income, as it was permitted to do, its required installments of estimated tax were $10x, $25x, $25x, and $30x, respectively. Corporation X also made a timely payment of each of its installments of estimated tax for 1996, not including the overpayment credited from 1995, in the amounts of $15x, $15x, $15x, and $25x, respectively.
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> Corporation X's required first installment of estimated tax for 1996 ($10x) was less than the payments of estimated tax it made prior to the installment due date ($15x), not including the overpayment credited from 1995. Corporation X, therefore, did not need to use the overpayment to avoid an addition to tax with respect to that installment. For interest purposes, the 1995 overpayment of $20x is considered a payment of 1995 tax through the first installment of estimated tax for 1996, and corporation X's payment of tax for 1995 through the first installment of estimated tax for 1996 is equal to its correct tax liability for 1995. Interest, therefore, does not begin to accrue on the 1995 deficiency before the due date of the second installment of estimated tax for 1996.
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> With respect to the second installment of estimated tax for 1996, corporation X did not make sufficient cash payments ($15x + $15x = $30x) to satisfy the amount required to be paid ($10x + $25x = $35x). To avoid an addition to tax for failure to pay estimated tax, corporation X, therefore, is required to use $5x of the 1995 overpayment as a payment of estimated tax for 1996 as of the due date for the second installment. For interest purposes, only $15x of the 1995 overpayment is still considered a payment of tax for 1995, and corporation X's correct tax liability for 1995 now exceeds its payment of tax for 1995 by $5x. Interest on the $5x therefore begins to accrue on $5x of the deficiency as of the due date of the second installment of estimated tax for 1996.
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> By the due date for the third installment, corporation X's estimated tax liability for 1996 ($10x + $25x + 25x = $60x) exceeded its payments ($45x (cash) + $5x (overpayment previously credited) = $50x) by an additional

$10x. Corporation X avoids an addition to tax for failure to pay estimated tax because it uses an additional $10x of the 1995 overpayment as of the due date for the third installment or estimated tax for 1996. Corporation X's correct tax liability for 1995 now exceeds its payment of tax for 1995 by $15x, and interest accrues on $15x of the 1995 deficiency as of the due date for the third installment of estimated tax for 1996.

Corporation X's estimated tax liability for the fourth installment ($10x + $25x + $25x + $30x = $90x) exceeded its payments ($70x (cash) + $15x (overpayment previously credited) = $85x) by $5x. Corporation X avoids an addition to tax for failure to pay estimated tax because it has $5x of additional 1995 overpayment, which is credited against the 1996 estimated tax liability as of the due date for the fourth installment. Corporation X's correct tax liability for 1995 now exceeds its payment for that year by the full amount of the deficiency ($20x), and interest accrues on the $20x as of the due date for the fourth installment of estimated tax for 1996.

The above analysis should be applied in all cases involving *May Department Store* issues.

Please contact the Procedural Branch if you have any questions regarding this Notice.

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