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

MEMORANDUM FOR
DISTRICT COUNSEL CC:SER:VWV:RCH

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

SUBJECT: Computation of Interest on Deficiencies with respect to Credit Elects

This Field Service Advice responds to your memorandum dated May 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 =

X's Representative =

Year 1 =
Year 2 =
Year 3 =
Year 6 =

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

ISSUE:

At what date does interest start running on an underpayment of tax for a particular year, where the taxpayer has reported an overpayment on its return and elected to apply that overpayment to estimated taxes for the succeeding year, but the Service has subsequently determined a deficiency in tax.

CONCLUSION:

A subsequently determined deficiency, equal to or less than the credit elect, runs interest from the due date of the installments of estimated tax against which the credit elect is required to be applied, in order to avoid additions to tax under Code sections 6654 and 6655. That amount of the credit elect not needed to pay the estimated tax liabilities is deemed a payment of income taxes for the next succeeding year, and thus, the corresponding deficiency amount runs interest from the original due date of the succeeding year's income tax return. For that part of the deficiency greater than the credit elect, interest runs from the original due date of the return for the year in which the taxpayer originally claimed the overpayment.

FACTS:

For calendar Year 1, X timely filed its Form 1120 (U.S. Corporation Income Tax Return), under extension, on September 14, Year 2. The return reflected an overpayment of $a, which X elected to apply to its estimated tax liabilities for Year 2. Since X did not designate which quarterly installment of estimated taxes was to be credited with the overpayment, the Service applied the "credit elect" to the first quarter, pursuant to Rev. Ruling 84-58, 1984-1 C.B. 254. The Service later assessed an income tax deficiency against X for Year 1 in the amount of $b, and ran deficiency interest on that portion of the deficiency exceeding the credit elect from March 15, Year 2, the unextended due date of the Year 1 return.[1] Interest on the deficiency, equal to the amount of the credit elect, accrued as of the due date of the first quarter of Year 2's estimated taxes, April 15, Year 2. This was the quarter against which the Service had applied the credit elect.

X paid the assessed tax and interest on March 31, Year 6, and having filed an administrative claim for the abatement and credit of the deficiency interest, provided a breakdown of the amount of estimated taxes due and paid per quarter.

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[1] Code section 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. 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. I.R.C. section 6151.

X’s calculations show that only $c of the credit elect from Year 1 was used to satisfy estimated tax liabilities for the second quarter of Year 2.

The facts are relatively the same for Year 2, except that the overpayment of $d reflected on X's return, and elected as a credit against estimated taxes for Year 3, was greater than the subsequently determined Year 2 deficiency of $e. Moreover, X used only $f and $g of the credit elect to satisfy its estimated tax liabilities for Year 3 in the first and second quarters, respectively. These amounts were less than the credit elect to which X was ultimately entitled.[2]

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 on either the original due date or 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 the installment, for that part of the deficiency equal to or less than the credit elect, and from the original due date of the return on the remaining deficiency amount exceeding the credit elect. Rev. Rul. 88-98 follows Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978), which holds that interest under Code section 6601(a), can be charged only when the tax is both due and unpaid. Thus, once the credit elect is used to pay the succeeding year's estimated tax, the prior year's tax becomes unpaid for purposes of section 6601(a), and deficiency interest begins to run. Prior to that date, the government has had the use of the taxpayer's funds with respect to the prior year's tax, and interest may not be charged.

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 return to the succeeding year's estimated tax liability, but did not attach a statement to the return, indicating the installment to which the Service should apply the credit. A deficiency was determined for the 1983 year, and interest was assessed from the due date of the first installment in accordance with Rev. Rul. 88-98. The taxpayer, however, had made sufficient payments of estimated tax for the first and second quarterly installments of 1984, to avoid the addition to tax imposed

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[2] X actually overpaid its Year 2 income taxes by $h, the difference between the credit elect of $d, and the subsequently determined, but lesser, deficiency amount of $e. In using only a fraction of the credit elect ($e + $f) to satisfy its estimated tax liabilities for Year 3, X never passed the threshold amount of $h, to which it was ultimately entitled. At issue here is when X created the Year 2 income tax deficiency by having claimed an excessive credit on its Year 2 income tax return.

by Code section 6655 for these quarters.[3] 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 money from the due date of the first installment (May 15) to the date taxpayer filed its 1983 tax return (October 15), since the credit elect 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 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.[4] Thus, 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.[5] 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 income taxes for the next succeeding year. Section 6513(d) provides that if any overpayment of income tax

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[3] 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 rate established under section 6621, that has accrued on the amount of underpayment for the period the estimated tax was underpaid. Id., § 6655(a) & (b).

[4] Code section 6654 imposes a penalty on individuals failing to pay estimated tax.

[5] 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 its money 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.

is claimed as 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 on 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. Income tax paid before the date prescribed for payment is considered paid on the due date, I.R.C. § 6513(a), and Code section § 6151 provides that the date prescribed for payment of income tax is the time fixed for filing the return (determined without regard to any extension of time for filing the return). Accordingly, it is on the unextended due date of the next suceeding year's return that the unused credit is treated as a payment for purposes of computing interest on the subsequently determined deficiency amount corresponding to the unused credit elect. Further, any overpayment of income taxes with respect to the succeeding year that would result from this application of the credit elect would also run interest from the due date of the succeeding year's return, under Code section 6611(a) and (d). Thus, 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 that year's return.

Here, where the subsequently determined deficiency for Year 1 is greater than the credit elect taken on X's Year 1 return, deficiency interest runs from the original due date of the Year 1 return (March 15, Year 2) for that amount of the deficiency exceeding the credit elect. With respect to $c of the credit elect used to satisfy X's estimated tax liabilities for the second quarterly installment of Year 2, deficiency interest on $c of the Year 1 deficiency would start running as the due date of the second quarterly installment, June 15, Year 2. Finally, with respect to that amount of the deficiency representing the credit elect not needed to satisfy estimated tax liabilities for Year 2, that amount (here, $a- $c) should be treated as a payment of Year 2 income taxes, as of the unextended due date of the Year 2 return, March 15, Year 3, and thus would run deficiency interest from that date.

For the Year 2 deficiency, which was less than the credit elect, the amount of the credit elect used by X to satisfy estimated tax liabilities for its first and second quarterly installments of the next succeeding year, was less than the amount of the amount of credit elect to which X ultimately was entitled. Thus, the entire deficiency amount of $e for Year 2 arose, and deficiency interest commenced to run as of the unextended due date of the Year 3 income tax return.

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By: ______________________________

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