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Payment Strategy to Reduce Interest Costs On IRS Settlements

By W. Scott Rogers

Introduction

The Internal Revenue Service normally examines several income tax years simultaneously in the course of a corporation's periodic federal income tax examination. It is not uncommon for the IRS to propose overpayments in the earlier years and deficiencies in one or more of the later years included in the cycle (or vice versa). When the deficiencies occur in the later years included in the examination cycle, the IRS routinely applies the overpayments to the deficiency years as of the due date of the deficiency years' returns.

The movement of funds between different tax periods is referred to as offsetting. Such transactions are authorized by section 6402(a) of Internal Revenue Code, which states that "[i]n 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." If the deficiency amount exceeds the overpayments, the taxpayer will remit the remaining amount due to the IRS.

Most taxpayers are content to allow the IRS to use the offset method to eliminate deficiencies agreed to in an examination. After all, it makes more sense at first glance to allow the IRS to net out the accounts to the extent possible as opposed to issuing refunds for overpayment years while simultaneously remitting payments with respect to any deficiency years included in the cycle. Given the intricate rules for determining how interest is computed on tax adjustments, however, taxpayers may overlook a significant savings opportunity by agreeing to the offset method. This article sets forth an alternative.

Understanding the Authorities

To optimize a company's position in respect to the computation of interest on refunds and deficiencies, a tax executive must understand the somewhat contradictory court decisions and IRS rulings. In Rev. Rul. 99-40, 1999-2 C.B. 441, the IRS ruled that interest on a tax deficiency assessed for a period shall not begin to run until the deficiency is both due and unpaid. This ruling creates an opportunity where either a refund requested on an original tax return was issued without allowable interest after the return was filed or an overpayment reported on the return was credited to the subsequent year's tax.

Example 1: XYZ Corp. filed Form 1120 for tax year 1999 under a timely extension on September 15, 2000, reporting an overpayment of \$50 that XYZ requested the IRS to refund. The IRS refunded the \$50 without allowable interest

on October 27, 2000, within 45 days of the return's filing. (Section 6611(e)(1) of the Code sets forth the 45-day interest free period for issuing refunds.) Subsequently, the IRS examined XYZ's 1999 return and determined that additional tax of \$25 was due. Pursuant to Rev. Rul. 99-40, the start date for deficiency interest on the \$25 assessment will be October 27, 2000, the date on which the overpayment reported on the return was refunded without allowable interest. Since the government had benefited from interest free use of XYZ's \$50 overpayment from March 15, 2000 (the original due date of the return) to October 27, 2000 (the date on which the \$50 refund was issued without interest), it would be inequitable

to allow the government to later charge interest for that same period on any deficiency up to the amount of the refund. In short, since XYZ was not compensated for the period of time during which the government held its money before issuing the refund, the government is precluded from subsequently charging XYZ interest on a deficiency up to that amount for the same period. Thus, the tax deficiency was not both due and unpaid before October 27, 2000, on which date deficiency interest shall begin running.

Example 2: ABC Corp. filed Form 1120 for tax year 1999 under a timely extension on September 15, 2000, reporting an overpayment of \$50 that ABC elected to have applied to the subsequent year's estimated tax payments (the "credit elect"). Pursuant to section 6513(d), the IRS did not allow interest on the credit elect transferred to tax year 2000. ABC timely deposited all estimated tax payments due for tax year 2000, so the credit elect from 1999 was not needed to satisfy any of ABC's estimated payment liabilities for the year. Subsequently, the IRS examined ABC's 1999 return and determined that additional tax of \$25 was due. Since the credit elect was not needed to satisfy any of ABC's tax year 2000 estimated payment liabilities, the government had interest-free use of the credit elect amount until at least March 15, 2001 (the due date of the 2000 return). Thus, the 1999 deficiency is not both due and unpaid until at least March 15, 2001, on which date deficiency interest shall begin to accrue.

Another aspect of this topic is "refund interest," which is commonly referred to as "allowable interest." Section 6611(b)(1) provides that allowable interest on an overpayment that is offset to pay an amount due in another tax account will be paid "from the date of the overpayment to the due date of the amount against which the credit is taken." The issue that gives rise to a helpful payment strategy is the current definition of the "due date of a deficiency" as determined by the IRS, which sets the ending date of allowable interest on overpayment amounts that are offset to pay deficiencies.

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The IRS determined in Technical Advice Memorandum 9443007 that the due date of a deficiency was the date on which the deficiency was both due and unpaid. Consequently, the IRS concluded that allowable interest on an overpayment offset to pay an outstanding deficiency would accrue, not to the due date of the deficiency year's return but to the date on which the deficiency was also considered to be unpaid. The following example sets forth the method by which the IRS would compute allowable interest on an overpayment offset to pay a deficiency during the period in which TAM 9443007 was the prevailing authority.

Example 3: Consider again XYZ Corp.'s 1999 tax year, with respect to which a \$50 overpayment was refunded on October 27, 2000. Assume the IRS subsequently examines XYZ's 1999 return and determines that additional tax of \$25 is due. The IRS recognizes that deficiency interest on the tax increase shall begin running on October 27, 2000. Pursuant to the examination of tax year 1998 in the same cycle, however, the IRS determines that there is a tax overpayment of \$100 in that tax year. The IRS decides to offset a portion of the 1998 overpayment to the 1999 deficiency and refund the balance of the overpayment to XYZ. Applying TAM 9443007, the IRS computes allowable interest on \$25 of the 1998 overpayment from the overpayment date to October 27, 2000, the date on which the 1999 deficiency becomes due and unpaid for purposes of deficiency interest. The IRS then offsets \$25 from 1998 to 1999 effective October 27, 2000. The balance of the 1998 overpayment is refunded with allowable interest.

Several years after TAM 9443007 was released, the IRS reversed its position, developing a stricter interpretation of section 6611(b)(2). Reasoning that "the due date of the amount against which the credit is taken" should be interpreted narrowly as the due date of the deficiency year's tax return without regard to extensions, the IRS began disregarding situations in which the deficiencies were not due and unpaid until some later date, instead computing allowable interest on offset overpayments only to the original return due date of the liability years' returns.

Consider the application of this computational method to Example 3. Under the new policy, the IRS would pay allowable interest on the \$25 that it offset from 1998 to 1999 only to March 15, 2000, the due date of the 1999 return. Consequently, XYZ would lose the benefit of the deferred deficiency interest start date that was previously preserved by TAM 9443007, under which the allowable interest would have accrued to October 27, 2000, not March 15, 2000.

The IRS change of position prompted several taxpayers to file suit requesting the courts to apply the use-of-money theory established in the prior deficiency interest cases to allowable interest transactions. Unfortunately, the courts in *AT&T Corp. & Subsidiaries v. United States*, 62 Fed. Cl. 490 (2004), and *Marsh & McLennan Co. v. United States*, 302 F.3d 1369 (Fed. Cir. 2002), *affg* 50 Fed. Cl. 140 (2001), disregarded TAM 9443007 and accepted the government's subsequent interpretation of section 6611(b)(2). In distinguishing the more equitable use-of-money decisions in the deficiency interest cases, the courts explained the language of section 6611(b)(2) with respect to the stop date for allowable interest on offsets lacked the ambiguity of language in section 6601(a) applicable to the start date of deficiency interest.

The Payment Strategy

Despite the IRS's victories in the aforementioned cases, opportunities remain for taxpayers to use the interest rules to their own advantage. The potential benefit can be illustrated by the following example: Assume that the IRS has completed the examination cycle for DEF Corporation's 1999 and 2000 income tax years. The agreed-to tax changes consist of an overpayment of \$20,000,000 for tax year 1999 and a deficiency of \$10,000,000 for tax year 2000.

First, consider the results set forth in Table 1, which illustrates how (absent DEF's intervention) the IRS will pay off the deficiency and refund the remaining overpayment. As set forth in Table 1, DEF has an overpayment of \$20,000,000 effective March 15, 2000 (the due date of the 1999 tax year). The IRS will offset \$10,000,000 of the overpayment to tax year 2000 effective March 15, 2001 (the due date for the tax year). The remaining overpayment will be refunded with allowable interest computed on the full \$20,000,000 from March 15, 2000 to March 15, 2001, plus additional interest that accrues on the remaining overpayment after the \$10,000,000 offset to a hypothetical refund date of June 15, 2005. The total amount refunded on that date is \$12,906,198.

**TABLE 1: DEF Corporation —
Customary IRS Offset Method**

1999 overpayment at March 15, 2000	\$20,000,000
Offset to pay 2000 deficiency at March 15, 2001	(10,000,000)
Principal balance at March 15, 2001	10,000,000
Allowable interest on \$20,000,000 to March 15, 2001	1,330,871
Total overpayment at March 15, 2001	11,330,871
Allowable interest to June 15, 2005	1,575,327
Refund issued on June 15, 2005	\$12,906,198

Next, consider whether the net refund may be enhanced by paying off the tax year 2000 deficiency (plus interest) and having the IRS refund the full 1999 overpayment instead of offsetting \$10,000,000 to 2000. To this end, Table 2 assumes that DEF reported an overpayment in excess of \$10,000,000 on its tax year 2000 return and had the overpayment credited to tax year 2001, in which year the overpayment was not

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needed to satisfy any estimated payment liabilities. In this scenario (as illustrated in Example 2), the tax year 2000 deficiency is not considered both due and unpaid for interest purposes before March 15, 2002 (the due date of the tax year 2001 return).

Thus, DEF makes a payment of \$11,677,732 on April 15, 2005, paying off the tax year 2000 deficiency plus interest from March 15, 2002, to the payment date. Since the 2000 deficiency is paid off, the IRS will refund the full 1999 overpayment of \$20,000,000 plus interest. The IRS will not schedule an overpayment refund under most circumstances until outstanding deficiencies have been paid off. Thus, it is reasonable to assume a two-month delay occurs between the date on which the deficiency is paid and the date on which IRS issues the refund check. Using this assumption, the projected refund of \$24,297,189 will be issued on June 15, 2005.

**TABLE 2: DEF Corporation —
Alternate Payment Strategy**

2000 deficiency as of March 15, 2002	(\$10,000,000)
Deficiency interest to April 15, 2005	(1,677,732)
Payment remitted on April 15, 2005	(\$11,677,732)
1999 overpayment at March 15, 2000	\$20,000,000
Allowable interest to June 15, 2005	4,297,189
Refund issued on June 15, 2005	24,297,189

DEF must recognize that the 1999 and 2000 years are available for interest netting as set forth in section 6621(d). In simple terms, interest netting is used to eliminate the interest rate differential that arises when interest accrues on deficiencies at a higher rate than that accruing on overpayments during overlapping periods of time. Since the 1999 overpayment overlapped the 2000 deficiency during the period of time on which deficiency interest was accruing in tax year 2000, DEF needs to file an interest netting claim to recoup the difference, which is assumed to be filed on June 15, 2005, the date on which the 1999 refund was issued. Based on the average time the IRS takes to process such claims, it is reasonable to assume that the interest netting refund will be received a year later, on June 15, 2006.

Thus, in the example, if the company allows the IRS to use the offset method to eliminate the tax year 2000 deficiency, DEF will receive a refund of \$12,906,198 on June 15, 2005. Conversely, by remitting a payment for the 2000 deficiency to preserve the one-year deficiency interest deferral available for the year, DEF will receive net refunds totaling \$13,528,865, as follows:

1999 refund on June 15, 2005	\$24,297,189
Less 2000 Payment on April 15, 2005	(11,677,732)
Plus interest netting refund on June 15, 2006	909,409
Net refunds	\$13,528,865

Using the alternative method, the refund in the example is \$622,668 more than if DEF fails to intervene to prevent the IRS from paying off the tax year 2000 deficiency by offset. The analysis is not complete, however, without consideration of the opportunity cost to DEF of being deprived of the use of the funds remitted to pay the 2000 deficiency from April 15, 2005 (the payment date) to June 15, 2005 (the date on which the IRS issues the 1999 refund). The taxpayer must also take into account the opportunity cost of DEF's waiting a full year (from June 15, 2005, to June 15, 2006) to receive its interest netting refund. Table 3 estimates those opportunity costs to be \$136,613 and \$63,659, respectively, though concededly the parameters applied in the present value analysis will differ among taxpayers. Significantly, allowable interest accruing on the refunds mitigates the opportunity costs to some degree.

**TABLE 3: DEF Corporation —
Payment Strategy Opportunity Costs**

Net refunds attributable to Payment Strategy	\$13,528,865
Less net refund attributable to IRS offset method	(12,906,198)
Benefit of Payment Strategy before consideration of opportunity costs	\$622,668
Less 7% opportunity cost related to April 15, 2005 payment remitted for 2000 that was not recovered until June 15, 2005, when the 1999 refund was issued	(136,613)
Less 7% opportunity cost related to the interest netting refund not being issued until one year after the initial 1999 refund was issued on June 15, 2005	(63,659)
Net savings attributable to applying the Payment Strategy	\$422,396

Conclusion

The strategy illustrated in this article is available only to taxpayers that are positioned to have certain tax deficiencies paid by offsets of overpayments that are available as of the due dates of the deficiency years. In such cases, tax executives should determine whether the potential for savings exists with respect to applying the payment strategy and, if so, whether the amount justifies the efforts required to implement the strategy. Tax executives attempting to make such a determination must be able to project the opportunity costs specific to their organization and must act to remit payments before the IRS pays deficiencies via offsets. Once the IRS eliminates a deficiency by an offset, a taxpayer will rarely be successful in attempts to have IRS reverse the offset and accept a payment for a deficiency year. See *Northern States Power Company*, 3 F.3d 764 (8th Cir. 1996), cert. denied, 117 S. Ct. 168 (1996).

