Payment Strategies to Reduce Individual Taxpayers' Interest Costs in IRS Settlements

By W. Scott Rogers

W. Scott Rogers sets forth a little-known strategy to assist individual taxpayers in applying complex interest rules to their advantage to decrease the overall cost of examination related interest charges in situations in which certain fact patterns are present.

Introduction

The IRS often examines several income tax years simultaneously in the course of an individual's income tax examination (the examination "cycle"). 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. When this fact pattern arises, the IRS routinely applies the overpayments to the deficiency year(s) 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 Code Sec. 6402(a), 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 a net balance due remains after the overpayments have been offset to the deficiencies, the taxpayer will remit the remaining amount due to the IRS. The converse applies should the overpayments exceed the deficiencies, in which case the IRS will issue a net refund to eliminate the remaining overpayment balance(s).

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 the taxpayer simultaneously remits payments with respect to any deficiency years included in the cycle. However, given the present status of the various authorities that determine how interest is computed on tax adjustments, taxpayers often overlook a significant savings opportunity by agreeing to the offset method.

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Understanding the Authorities Applicable To Interest Computations

The payment strategy set forth herein takes advantage of the present state of case law, statutes and recognized IRS procedures that are commonly utilized in preparing interest computations for both deficiencies and overpayments. The taxpayer needs to have a basic understanding of the somewhat contradictory court decisions that give rise to payment optimization if he or she is to minimize the overall costs of an examination or appeals settlement. We could dedicate many pages to explaining the evolution of the prevailing interest rules, but such discussion would not be fruitful to the taxpayer whose only concern is minimization of his prospective costs. Thus, we opt

to limit our discussion to presently applicable rulings to the extent practical.

We begin by explaining certain rulings applicable to deficiency interest computations. The decision in *May Department Stores Co.*[1] led the IRS to issue Rev. Rul. 99-40,[2] in 1999. Pursuant to the ruling, interest on a tax deficiency assessed for a period shall not begin to run until the deficiency is both due and unpaid.

The deficiency interest fact patterns that are compatible with our payment strategy include scenarios in which 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. The impact of such transactions on the start date of subsequently assessed tax deficiencies is explained in the examples below.

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Example 1. John Taxpayer (hereinafter "Taxpayer") filed Form 1040 for tax year 2000 under a timely extension on August 15, 2001, reporting an overpayment of $50 that Taxpayer requested the IRS to refund. The IRS refunded the $50, without allowable interest on September 25, 2001, within 45 days of the return's filing. See Code Sec. 6611(e)(1), which sets forth the 45-day interest-free period for issuing refunds. Subsequently, the IRS examined Taxpayer's 2000 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 September 25, 2001, 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 Taxpayer's $50 overpayment from April 15, 2001, the original due date of the return, to September 25, 2001, 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 Taxpayer wasn't compensated for the period of time during which the government held his money before issuing the refund, the government is precluded from subsequently charging Taxpayer interest on a deficiency up to the refund amount for the same period. Thus, the tax deficiency was not both due and unpaid before September 25, 2001, on which date deficiency interest shall begin running.

Example 2. Taxpayer filed Form 1040 for tax year 2000 under a timely extension on August 15, 2001, reporting an overpayment of $50 that Taxpayer elected to have applied to the subsequent year's estimated tax payments (the "credit elect"). Pursuant to Code Sec. 6513(d), the IRS did not allow interest on the credit elect transferred to tax year 2001. Taxpayer timely deposited all estimated tax payments due for tax year 2001, so the credit elect from 2000 was not needed to satisfy any of Taxpayer's estimated payment liabilities for the year. Subsequently, the IRS examined Taxpayer's 2000 return and determined that additional tax of $25 was due. Since the credit elect was not needed to satisfy any of Taxpayer's tax year 2001 estimated payment liabilities, the government had interest free use of the credit elect amount until at least April 15, 2002, the due date of the 2001 return. Thus, the tax year 2000 deficiency is not both due and unpaid until at least April 15, 2002, on which date deficiency interest shall begin to accrue.

We now turn our attention to refund interest, commonly referred to as allowable interest. Code Sec. 6611(b)(1) states 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 our payment strategy is the presently recognized definition of the due date of a deficiency, as determined by the IRS to identify the ending date of allowable interest on overpayment amounts that are offset to pay deficiencies.

The IRS determined in Technical Advice Memorandum 9443007[3] that the due date of a deficiency is 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. Note that, although the facts set forth in the ruling varied somewhat from our fact pattern, the interest theory applied by the IRS in its analysis is not distinguishable from our facts. 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.** We return to Taxpayer's 2000 tax year, with respect to which a $50 overpayment was refunded on September 25, 2001. Once again, the IRS subsequently examines Taxpayer's 2000 return and determines that additional tax of $25 is due. The IRS recognizes that deficiency interest on the tax increase shall begin running on September 25, 2001. However, pursuant to the examination of tax year 1999 in the same cycle, IRS determines that there is a tax overpayment of $100 in that tax year. The IRS decides to offset a portion of the 1999 overpayment to the 2000 deficiency and refund the balance of the overpayment to Taxpayer. Applying TAM 9443007, the IRS computes allowable interest with respect to $25 of the 1999 overpayment from the overpayment date to September 25, 2001, the date on which the 2000 deficiency becomes due and unpaid for purposes of deficiency interest. The IRS then offsets $25 from 1999 to 2000, effective September 25, 2001. The balance of the 1999 overpayment is refunded with allowable interest.

The IRS reversed its position several years after TAM 9443007 was released, developing a stricter interpretation of Code Sec. 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 above; under the new policy, the IRS pays allowable interest on the $25 overpayment that it offsets from 1999 to 2000 only to April 15, 2001, the due date of the 2000 return. Consequently, Taxpayer loses the benefit of the deferred deficiency interest start date that was previously preserved by TAM 9443007, under which the allowable interest on the 1999 overpayment offset of $25 would have accrued to September 25, 2001, not April 15, 2001.

Several corporations later filed suit, requesting the courts to apply the use of money theory established in the prior deficiency interest cases equally to allowable interest transactions. Unfortunately, the courts in *AT&T Corporation & Subsidiaries*[4] and *Marsh & McLennan Companies, Inc.*[5] disregarded TAM 9443007, choosing rather to agree with the government's interpretation of Code Sec. 6611(b)(2). In distinguishing their decisions from the more equitable "use of money" decisions handed down in the deficiency interest cases, the courts pointed out that the language set forth in Code Sec. 6611(b)(2), with respect to the stop date for allowable interest on offsets, lacked the ambiguity of language in Code Sec. 6601(a), applicable to the start date of deficiency interest.

The Payment Strategy

We now turn to an example that will aid Taxpayer in both grasping the importance of understanding the above interest rules and appreciating the magnitude of savings that can be obtained by using the rules to Taxpayer's advantage. For purposes of this exercise, we will assume that the IRS has completed the examination cycle for Taxpayer's 1999 and 2000 income tax years. The agreed-to tax changes consist of an overpayment of $200,000 for tax year 1999 and a deficiency of $100,000 for tax year 2000.

First, we will address the method by which the IRS will pay off the deficiency and refund the remaining overpayment, unless Taxpayer intervenes. Table 1 utilizes actual IRS interest rates computed to hypothetical dates to arrive at a net refund amount. As set forth in the table, Taxpayer has an overpayment of $200,000, effective April 15, 2000, the due date of the 1999 tax year. The IRS will offset $100,000 of the overpayment to tax year 2000, effective April 15, 2001, the due date for the tax year. The remaining overpayment is refunded with allowable interest computed on the full $200,000 from April 15, 2000, to April 15, 2001, plus additional interest that accrues on the remaining overpayment to a hypothetical refund date of April 30, 2006. The total amount refunded on that date is $158,239.

Table 1: John Taxpayer–Customary IRS Offset Method

1999 overpayment at April 15, 2000	$ 200,000
Offset to pay 2000 deficiency at April 15, 2001	(100,000)
Principal balance at April 15, 2001	100,000
Allowable interest on $200,000 to April 15, 2001	18,704
Total overpayment at April 15, 2001	118,704
Allowable interest to April 30, 2006	39,535
Refund issued on April 30, 2006	$158,239

Table 2: John Taxpayer–Alternate Payment Strategy

2000 deficiency as of April 15, 2002	($100,000)
Deficiency interest to February 28, 2006	(22,946)
Payment remitted on February 28, 2006	($122,946)
1999 overpayment at March 15, 2000	$200,000
Allowable interest to April 30, 2006	91,544
Refund issued on April 30, 2006	$291,544

Table 2A

1999 refund on April 30, 2006	$ 291,544
Less 2000 Payment on February 28, 2006	(122,946)
Net refund	$ 168,598

Table 3: John Taxpayer–Payment Strategy Opportunity Costs

Net refunds attributable to Payment Strategy	$168,598
Less net refund attributable to IRS offset method	(158,239)
Benefit of Payment Strategy before consideration of opportunity costs	$ 10,359
Less 7% opportunity cost related to February 28, 2006 payment remitted for 2000 that was not recovered until April 30, 2006 when the 1999 refund was issued	(1,438)
Net savings attributable to applying the Payment Strategy	$ 8,921

Next, we determine whether our net refund may be enhanced by making a payment to the IRS to pay off the tax year 2000 deficiency, plus interest thereon, and having the IRS refund the full 1999 overpayment, instead of offsetting $100,000 to tax year 2000. We assume that Taxpayer reported an overpayment in excess of $100,000 on its tax year 2000 return and had the overpayment credited to tax year 2001, in which year, the overpayment was not needed to satisfy any estimated payment liabilities. As we recall from Example 2, in this scenario, the tax year 2000 deficiency is not considered both due and unpaid for interest purposes before April 15, 2002, the due date of the tax year 2001 return.

In Table 2, we assume that Taxpayer makes a payment of $122,946 on February 28, 2006, paying off the tax year 2000 deficiency, plus interest accrued thereon from April 15, 2002 to the payment date. Since the 2000 deficiency is now paid off, the IRS will refund the full 1999 overpayment of $200,000, plus interest thereon. The IRS will not schedule an overpayment refund under most circumstances until outstanding deficiencies have been paid off. Thus, we assume a two-month delay occurs between the date on which the deficiency was paid and the date on which IRS issues the refund check. We project that a refund of $291,544 will be issued on April 30, 2006.

Note that interest netting is not applicable to Form 1040 tax years with overlapping overpayments and deficiencies accruing interest after December 31, 1998. The interest rates applicable to individual income tax filers, with respect to both deficiency interest and overpayment (allowable) interest accruing on or after January 1, 1999, were equalized by Congress. Had both tax years in our example been subject to accrual of interest prior to the effective rate equalization date, we would need to consider the impact of interest netting in this exercise. However, interest netting, as set forth in Code Sec. 6621(d), need not be considered for purposes of our analysis of tax years 1999 and 2000, neither of which was accruing interest as of December 31, 1998.

At this point in our analysis, we have determined that Taxpayer will receive a 1999 refund of $158,239 on April 30, 2006 if the company allows the IRS to use the offset method to eliminate the tax year 2000 deficiency. Conversely, by remitting a payment for the 2000 deficiency to preserve the one-year deficiency interest deferral available for the year, Taxpayer will receive a net refund totaling $168,598 as shown in Table 2A.

The amount above is $10,359 greater than the refund Taxpayer will receive if he fails to intervene to prevent the IRS from paying off the tax year 2000 deficiency by offset. However, our analysis is not complete without considering the opportunity cost to Taxpayer of being deprived of the use of the funds remitted to pay the 2000 deficiency, from February 28, 2006, the payment date, to April 30, 2006, the date on which the IRS issues the 1999 refund. The opportunity cost may be a significant factor when

analyzing the feasibility of applying this strategy for Taxpayer. Specifically, Taxpayer must decide whether the cost of losing the use of $122,946 for two months exceeds the $10,359 savings attributable to implementing the payment strategy.

In Table 3, we estimate Taxpayer's opportunity cost to be $1,438. The variables we applied in our present value analysis will differ among various taxpayers. Note that allowable interest accruing on the refunds mitigates the opportunity costs to some degree, and may even eliminate the cost, depending on Taxpayer's expected rate of return on funds he normally invests. For example, during the period in which Taxpayer was deprived of the use of $122,946, the 1999 overpayment, which included the $100,000 no longer being offset to pay the tax year 2000, was accruing refund interest at a rate of 7 percent compounded daily. That rate of return should convince Taxpayer that he was earning a respectable return on his 2000 payment while awaiting the 1999 refund.

Conclusion

The strategy set forth herein is applicable only to taxpayers who 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, taxpayers need to 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. Taxpayers attempting to make such a determination must have expertise with respect to interest computation matters, must be able to project the opportunity costs specific to their situation and must act proactively 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.*[6]

Endnotes

1 *May Department Stores Co.*, FedCl, 96-2 USTC ¶50,596, 36 FedCl 680.
2 Rev. Rul. 99-40 , 1999-2 CB 441.
3 TAM 9443007, May 19, 1994.
4 *AT&T Corporation & Subsidiaries*, FedCl, 2004-2 USTC ¶50,397, 62 FedCl 490.
5 *Marsh & McLennan Companies, Inc.*, CA-FC, 2002-2 USTC ¶50,625, 302 F3d 1369; *aff'g*, FedCl, 2001-2 USTC ¶50,575, 50 FedCl 140.
6 *Northern States Power Co.*, CA-8, 96-1 USTC ¶50,022; 73 F3d 764; *cert. denied*, 117 SCt 168.