INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

September 20, 2002

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Index (UIL) No.: 6601.00-00; 6601.01-00
CASE MIS No.: TAM-128502-02/CC:PA:APJP:B1

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
$a =
$b =
$c =
$d =
$e =
$f =
$g =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

ISSUE

On what date does interest begin to accrue on a deficiency for Year 1 when Taxpayer credits an overpayment shown on its Year 1 return to its Year 2 estimated tax liability and also makes estimated tax payments sufficient to satisfy its estimated tax liability for Year 2, 3, and 4.

CONCLUSION

Interest on Taxpayer's Year 1 deficiency accrues from the due date of Taxpayer's Year 2 income tax return (March 15, Year 3).

FACTS

Year 1-2

Taxpayer originally reported an overpayment of $a for Year 1. Taxpayer elected to apply all of its Year 1 overpayment to its Year 2 estimated taxes. Taxpayer made estimated tax payments for Year 2 that were sufficient to satisfy each of its required four installments and which exceeded its Year 2 tax liability by $b. Therefore, the credit was not necessary to satisfy Taxpayer's estimated taxes for Year 2.

Year 2-3

Taxpayer reported an overpayment of $c for Year 2, which it elected to apply to its Year 3 estimated taxes. Taxpayer made estimated tax payments that were sufficient to satisfy its first, second, and fourth required installments for Year 3; however, Taxpayer underpaid its third required installment. In Taxpayer's calculations, Taxpayer applied the overpayments from its first and second installments to satisfy its third installment instead of applying the credit elect from Year 2. Taxpayer's Year 3 tax liability was underpaid by $d. Taxpayer's interest calculation treats the Year 3 tax due as satisfied by the cumulative credit carryforward of $c leaving an overpayment for Year 3 of $e.

Year 4-5

Taxpayer reported an overpayment of $e for Year 3, which it elected to apply to its Year 4 estimated taxes. Taxpayer made an estimated tax payment that was sufficient to satisfy its first required installment; however, Taxpayer underpaid its second, third and fourth required installments. Again, Taxpayer applied the overpayment from its first installment to satisfy the underpayments for its second, third and fourth installment instead of applying the credit elect from Year 3. The estimated tax payments made in Year 4 exceeded Taxpayer's Year 4 income tax liability by $f which created an overpayment for Year 4 of $g.

Year 5

Taxpayer reported an overpayment of $g for Year 4, which it elected to apply to its Year 5 estimated taxes. Taxpayer made estimated tax payments that were sufficient to satisfy its first and second required installments; however, Taxpayer underpaid its third and fourth required installments. Taxpayer applied the overpayments from its first and second installments and the Year 4 credit elect to satisfy the underpayments.

Taxpayer calculated interest on its Year 1 deficiency beginning September 15, Year 5. Taxpayer relies on "use of money" principle as set forth in Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978), May Department Stores Co. v. United States, 36 Fed. Cl. 680 (1996), acq. AOD CC-1997-008 (Aug. 4, 1997) and Sequa Corp. v. United States, 99-1 U.S.T.C. (CCH) P50,379 (S.D.N.Y. June 10, 1998), to argue that prior to September 15, Year 5, its Year 1 overpayment was not applied against its tax liability or estimated tax installment, and, therefore, the government did not lose the use of Taxpayer's money until that date. Taxpayer also cites In re Vendell Healthcare, Inc., 222 B.R. 564 (Bankr. M.D. Tenn. 1998) in support of its argument.

The Service calculated interest on Taxpayer's Year 1 deficiency beginning on March 15, Year 3. The Service argues that when a taxpayer credits an overpayment to its succeeding year's estimated tax liability and the credit is not needed to satisfy the taxpayer's estimated taxes, the credit is applied as a payment against the succeeding year's income tax as of the due date of the succeeding year's return. As such, the Service loses the use of the taxpayer's money in the prior year's account and that prior year's account becomes unpaid on the due date of the succeeding year's return. Therefore, interest would begin to accrue on Taxpayer's Year 1 deficiency from March 15, Year 3, because March 15, Year 3 is the due date for Taxpayer's Year 2 income tax return and the date $a was applied to the Year 2 account.

LAW

Section 6601(a) provides that if any amount of tax is not paid on or before the last date prescribed for payment, interest will be paid on the amount from such last date to the date paid.

Section 6513(b)(2) provides that any amount paid as estimated income tax for any taxable year shall be deemed to have been paid on the last day prescribed for filing the return under section 6012 for such taxable year (determined without regard to any extension of time for filing such return), which in the case of a calendar year corporation is March 15th.

Section 6513(d) provides that if any overpayment of income tax is claimed as a credit against estimated tax for the succeeding taxable year, such amount shall be considered as a payment of the 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. This deemed payment rule applies for purposes of determining when overpayment interest begins to accrue. See section 6611(d).

In Avon Products, the taxpayer filed its 1967 tax return on September 15, 1968. The taxpayer reported an overpayment and elected to credit the overpayment to its 1968 estimated tax liability. Subsequent to the transfer of the overpayment a deficiency was determined for 1967. The Service assessed interest on the 1967 deficiency from March 15, 1968. The court held that pursuant to section 6601(a) deficiency interest can only be charged when the tax is both due and unpaid. The court based its holding on the "clearly established principle that interest is not a penalty but is intended only to compensate the Government for delay in payment of a tax." The government was not entitled to compensation for its use of money until September 15, 1968, because on that date the overpayment was shifted from the taxpayer's 1967 account to its 1968 account and the 1967 tax account became both due and unpaid.

In May Department Stores, the taxpayer elected to credit its 1983 overpayment to its 1984 estimated tax liability but did not indicate to which installment the Service should credit the overpayment. The Service applied the overpayment to the first installment according to Rev. Rul. 88-98, 1988-2 C.B. 356. However, the taxpayer had already made estimated tax payments sufficient to avoid the addition to tax imposed by section 6655 for 1984 for the first and second installments of estimated tax due for 1984. The Service later determined a deficiency for the taxpayer's 1983 tax year and assessed interest on the deficiency from the due date of the first installment. The court concluded that the Service's application of the taxpayer's 1983 overpayment to the first installment did not change the fact that the government had the use of the taxpayer's overpayment from the due date of the first installment (May 15) to the date the overpayment was applied to the third installment (October 15). Therefore, the court held that interest on the taxpayer's deficiency did not begin to accrue until October 15th.

In Rev. Rul. 99-40, 1990-40 I.R.B. 441, which modified and superseded Rev. Rul. 88-98, the Service reconsidered the manner in which interest on a subsequently determined deficiency is computed in light of May Department Stores decision. When a taxpayer elects to apply an overpayment to the succeeding year's estimated taxes, the overpayment is applied to 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 sections 6654 or 6655 with respect to such year. The Service will assess interest on a subsequently determined deficiency for the overpayment year from the date(s) that the overpayment is applied to the succeeding year's estimated taxes.

In Sequa, the taxpayer filed its 1990 tax return on September 15, 1991. The taxpayer elected to credit its 1990 overpayment to its 1991 estimated tax liability. Subsequent to the transfer of the overpayment the taxpayer filed an amended return showing an additional tax due. The taxpayer asked the Service to reduce the amount of the 1990 overpayment credited to its 1991 estimated taxes by the amount of the later determined tax liability. The Service credited the taxpayer's 1990 account by $1,676,263 as of March 15, 1992; however the Service assessed interest on the taxpayer's 1990 liability from September 15, 1991, to March 15, 1992.[1] The court held that interest on the deficiency begins to run on the date that the overpayment is actually applied to the taxpayer's income tax liability, not on the date the taxpayer elects to credit the overpayment to its succeeding year's estimated taxes. The court concluded that since the taxpayer's 1990 credit elect was not used to satisfy its 1991 taxes until the credit was effective on March 15, 1992, the Service had use of the credit elect funds to offset the 1990 deficiency until March 15, 1992.

In Vendell Healthcare, the taxpayer's 1991 return reported a zero tax liability. The taxpayer did not make any estimated or other income tax payments for its 1991 tax year. Accordingly, the taxpayer did have an overpayment for 1991. For 1992, the taxpayer reported an overpayment which it elected to apply to its 1993 estimated taxes. The taxpayer also made estimated tax payments for 1993. The taxpayer did not have a tax liability for 1993; thus, the credit was not necessary to satisfy the taxpayer's 1993 estimated taxes. The credit resulted in an overpayment for 1993. The taxpayer elected to apply the 1993 overpayment to its 1994 estimated taxes. The taxpayer did not have a tax liability for 1994; thus, the credit was not necessary to satisfy the taxpayer's 1994 estimated taxes. The credit resulted in an overpayment for 1994 which the Service refunded on April 6, 1995. After the credit of the 1992 overpayment to 1993 and the credit of the 1993 overpayment to 1994, deficiencies were determined for the taxpayer's 1991 and 1992 tax years. The court held that because the overpayments were credited to tax years for which the taxpayer had no tax liability, the overpayments were never effective as payments toward those years; therefore, interest on the subsequently determined deficiencies should only accrue on the 1991 and 1992 underpayments for all periods of time and to the extent that the Service was holding sufficient funds to satisfy the tax liabilities.

ANALYSIS

An Unused Credit Elect is a Payment Against the Succeeding Year's Income Tax

In Avon and May Department Stores, the courts relied on the "use of money" principle to hold that deficiency interest can only be charged when a tax is both due and unpaid.

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[1]Once a taxpayer elects to credit an overpayment to its estimated taxes, the election is irrevocable and binding on both the taxpayer and the Service. See IRC § 6513(d); Martin Marietta Corp. v. United States, 216 Ct. Cl. 47; Rev. Rul. 55-448, 1955-2 C.B. 595, amplified by Rev. Rul. 77-339, 1977-2 C.B. 475. Thus, the Service did not have the authority to reduce the credit elect by the amount of the additional tax liability. The Service credited the $1,676,263 to the taxpayer's 1990 liability after the taxpayer filed its 1991 tax return and was determined to have an overpayment for 1991. Only then did the Service have the authority, pursuant to section 6402(a), to make the credit.

The Service adopted this principle in Rev. Rul. 99-40, and, consequently, will only compute interest on a subsequently determined deficiency that is equal to or less then the overpayment from the date or dates that the overpayment is applied to the succeeding year's estimated taxes, because on that date the deficiency becomes both due and unpaid. Rev. Rul. 99-40 did not address the issue of when interest begins to accrue when a credit elect is made under section 6402(b) but the taxpayer makes sufficient payments to satisfy the estimated tax liability in its succeeding year. However, pursuant to section 6513(d), an overpayment that is credited to the succeeding year's estimated taxes is considered a payment of the *income tax* for the succeeding taxable year whether or not claimed as a credit. Thus, the issue becomes on what date is an unused credit elect applied as a payment of income tax for the succeeding year.

Section 6513(b)(2) provides that any amount paid as estimated income tax for any taxable year shall be deemed to have been paid on the last day prescribed for filing the return under section 6012 for such taxable year (determined without regard to any extension of time for filing such return). Therefore, in accordance with sections 6513(b)(2) and 6513(d), a credit elect is treated as a payment against the succeeding year's income tax as of the due date of that year's return. In addition, the credit elect amount will constitute an overpayment for the succeeding year regardless of whether taxpayer had a tax liability. See section 6401(c). Furthermore, pursuant to section 6611(d), the credit is applied to the succeeding year's liability as of the due date for purposes of determining interest. Whether the taxpayer chooses to obtain a refund or again applies the overpayment as an interest-free credit to the succeeding year's tax is discretionary. In either case, the credit is no longer in the account for the year the payments were actually made, and, therefore, cannot be used to determine whether that account's taxes are due and unpaid. Accordingly, the Service loses the use of the taxpayer's money in the account for which the payments were made on the due date of the succeeding year's income tax return. To the extent the credit results in an overpayment of the succeeding year's tax liability that overpayment is only relevant if an underpayment determined for the succeeding year. Thus, pursuant to Rev. Rul. 99-40, the Service will compute interest on a subsequently determined deficiency starting on the due date of the succeeding year's return.

Deficiency Interest on Taxpayer's Year 1 Deficiency

As stated above, Taxpayer reported an overpayment for Year 1 and elected to have it credited to its Year 2 estimated tax liability. Taxpayer made estimated tax payments for Year 2 that were sufficient to satisfy its estimated tax liability; thus, the credit was not necessary to satisfy Taxpayer's Year 2 estimated taxes. The Service subsequently determined a deficiency for Taxpayer's Year 1 tax year. Pursuant to Rev. Rul. 99-40 and in light of Sequa, interest on Taxpayer's Year 1 deficiency accrues from the date the overpayment was applied to Taxpayer's Year 2 taxes. Because the credit was not needed to satisfy Taxpayer's Year 2 estimated taxes, the credit is treated as a payment against Taxpayer's Year 2 income tax as of the unextended due date of the Year 2 return. The due date for Taxpayer's Year 2 income tax return was March 15, Year 3. Therefore, interest begins to accrue on Taxpayer's Year 1 deficiency from March 15, Year 3, which is the due date the $a was applied to the Year 2 account.

Taxpayer's Arguments

Taxpayer calculated interest on its Year 1 deficiency beginning September 15, Year 5. Taxpayer relies on "use of money" principle to argue that prior to September 15, Year 5, its Year 1 overpayment was not applied against its tax liabilities or estimated tax installments, and, therefore, the government did not lose the use of Taxpayer's money until that date. In support of its argument, Taxpayer cites to Avon Products, May Department Stores, and Sequa. In addition, Taxpayer cites to In re Vendell Healthcare.

First, Taxpayer's argument that its Year 1 overpayment was never applied to its tax liabilities of estimated tax installments is clearly erroneous. As we discussed above an overpayment that is credited to the succeeding year's estimated taxes is treated as a payment for the succeeding year even if the overpayment is not needed to satisfy the estimated taxes. In addition, according to Taxpayer's own calculations, the Year 1 overpayment was applied to Year 2. Taxpayer's calculations show an overpayment for Year 2 of $c. The overpayment of $c includes $b (the amount by which Taxpayer overpaid its Year 2 estimated taxes) and $a (the Year 1 overpayment). If according to Taxpayer's theory, Taxpayer's Year 1 overpayment was never applied to Taxpayer's Year 2 liability, Taxpayer's calculations should show an overpayment for Year 2 of $b, not $c. Thus, Taxpayer's own calculations apply the Year 1 overpayment to Year 2.

Second, the cited cases are factually distinguishable. In Avon Products and May Department Stores, the deficiencies and the overpayments were for the same tax year. In addition, the overpayments were applied to the succeeding years' estimated taxes. Thus, the courts in Avon Products and May Department Stores were not required to consider the issue raised in this case. In Sequa, the deficiency and the overpayment were for different years. Nevertheless, the overpayment was applied to the deficiency as a credit as of the due date of the succeeding year's return. Therefore, deficiency interest stopped accruing on the due date of the succeeding year's return and the court was not required to consider the issue raised in this case. In Vendell Healthcare, the deficiencies and overpayments were not for the same tax year. However, the court did not consider the precise issue in this case because additional facts were distinguishable. In Vendell Healthcare, the overpayments were credited to tax years for which the taxpayer had no tax liability. Based on that fact, the court held that the overpayments were never effective as payments toward those years, and, therefore, interest on the subsequently determined deficiency should only accrue to the extent that the underpayment was not satisfied by the overpayments. In Taxpayer's case, the overpayment was credited to a year for which Taxpayer had a tax liability; thus, the Service is not persuaded by the bankruptcy court's decision in Vendell Healthcare.

Taxpayer obtained the use of the money on the due date of the Year 2 return. The taxpayer had the option of either obtaining a refund for Year 2 in which interest would accrue from the due date of the Year 2 return or making an interest-free credit elect to the Year 3 estimated tax. The fact that Taxpayer chose to make a credit elect does not mean that the Year 1 liability continues to be due and unpaid. The Supreme Court has “observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, ... and may not enjoy the benefit of some other route he might have chosen to follow but did not.” Mellon Bank, N.A. v. United States, 265 F.3d 1275, 1281-82 (Fed. Cir. 2001).

In addition, Taxpayer’ approach to carrying forward the Year 1 credit for interest computation purposes to Year 5 is not supported by any provision of the Code. There is nothing in the Code that suggests that the first installment for Year 3 should be deemed to be satisfied out of the Year 3 payment rather than the pre-existing Year 1 credit, the dollar amount of which was known at the time the estimated tax payment was due.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.