OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

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MEMORANDUM FOR JAMES SLOMINSKI
Appeals Officer
Upstate New York Appeals

FROM: Pamela Wilson Fuller
Assistant to the Branch Chief
CC:DOM:IT&A:1

SUBJECT:
WTA-N-116082-99

UIL Number: 6601.08-00

Legend:

Taxpayer Corporation =

Year 1 =

Year 2 =

Year 3 =

Payment 1 =

Payment 2 =

Payment 3 =

$A =

$B =

$C =

$D =

$E =

$F =

$G =

$H =

$I =

This responds to your August 30, 1999, request for advice on the proposed Appeals Case Memorandum ("ACM") that you submitted in accordance with Internal Revenue Manual 8(14)(40), Appeals Conclusion Contrary to Service Position. Your proposed ACM was forwarded to our office in order for us to review the conflict of opinion between Appeals and the Internal Revenue Service ("Service").

ISSUE:

When does interest begin to run on Taxpayer Corporation's Year 1 deficiency?

CONCLUSION:

When a taxpayer applies its Year 1 overpayment to the succeeding year's taxes, and the Service later determines a deficiency for Year 1, interest should be assessed on that portion of the deficiency that is less than or equal to the overpayment from the date on which the overpayment is applied to the succeeding year's estimated taxes. Interest should be assessed on any remaining portion of the deficiency from the original due date of the Year 1 return.

FACTS:

Taxpayer Corporation reported an overpayment on its Year 1 tax return and requested that the overpayment be applied to its Year 2 estimated tax liability. Taxpayer Corporation timely filed its Year 2 tax return, under an extension of time to file its Form 1120, U.S. Corporation Income Tax Return, on September 15, Year 3.

The Service examined the Year 1 tax return and determined that Taxpayer Corporation had a deficiency. The deficiency was assessed on November 7, Year 3. Prior to this assessment, Taxpayer Corporation fully paid the deficiency and accrued interest on September 27, Year 3. The Service determined that interest was due on the Year 1 tax deficiency from April 15, Year 2, to September 27, Year 3, the date of payment.

Taxpayer Corporation disagreed with the Service's calculation, contending that interest on $A of the tax deficiency should not have been charged until September 15, Year 2, the date on which $A of the overpayment was used to partially pay the third quarter estimated tax payment due for the Year 2 tax year.

ANALYSIS:

Section 6601(a) of the Internal Revenue Code ("Code") provides that if any amount of tax is not paid on or before the last date prescribed for payment, interest shall be paid on the amount from such last date to the date paid. Section 6151(a) provides, in general, that the date prescribed for payment is the time fixed for filing the return, determined without regard to any extension of time for filing. Section 6601(b) provides that for determining interest on underpayments, the "last date prescribed for payment" is determined without regard to any extension of time for payment or filing.

Section 6402(b) provides that the Secretary is authorized to prescribe regulations providing for the crediting against the estimated tax for any taxable year of the amount determined by the taxpayer or the Secretary to be an overpayment of the income tax for the preceding taxable year.

Section 301.6402-3(a)(5) of the Regulations on Procedure and Administration provides that a taxpayer may elect to apply all or part of the overpayment shown by its return to its estimated tax for the succeeding tax year by so indicating on its return. No interest is allowed on the portion of the overpayment credited and the amount of the credit is applied as a payment on account of the estimated income tax for the year or the installments thereof. *See also* section 301.6611-1(h)(2)(vii).

Rev. Rul. 99-40[1], 1999-40 I.R.B. 441, holds that 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

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[1] In light of the *May Department Stores* decision, the Service reconsidered the manner in which interest on a subsequently determined deficiency is computed under section 6601(a) when the taxpayer makes an election to apply an overpayment to the succeeding year's estimated taxes. 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 tax return to the succeeding year's estimated tax liability but did not attach a statement to its return indicating the installment to which the Service should credit the overpayment. Pursuant to Rev. Rul. 84-58, the Service applied the overpayment to the first installment. A deficiency was determined for the taxpayer's 1983 tax year and interest was assessed by the Service on the deficiency from the due date of the first installment in accordance with Rev. Rul. 88-98. However, the taxpayer had 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 court concluded that the Service's application of the taxpayer's 1983 overpayment to the first installment did not change the fact that 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) because the overpayment was not needed to satisfy any installment of estimated tax due during that period.

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.

Since the overpayment will be applied in the order necessary to avoid the addition to tax for underpayment of estimated tax, designation of all or part of the overpayment to a specific estimated tax installment is not necessary. Accordingly, when a taxpayer reports an overpayment on its income tax return, and the Service later determines a deficiency for that year, interest will be assessed on the portion of the deficiency that is less than or equal to the overpayment from the date on which the overpayment was applied to the succeeding year's estimated taxes. Interest will be assessed on any remaining portion of the deficiency from the original due date of the tax for the overpayment return year.

Taxpayer Corporation's situation is similar to Situation 2 in Rev. Rul. 99-40. In Situation 2, X Corporation made timely estimated tax payments of $100x for 1995. On March 15, 1996, X filed Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, and received a 6-month extension of time to file its 1995 income tax return. X paid $120x with the request for extension. On September 15, 1996, X filed its U.S. Corporation Income Tax Return for 1995 showing a tax liability of $210x and total payments of $220x. Corporation elected to have the overpayment of $10x credited against its 1996 estimated tax. The $10x overpayment was deemed to arise on March 15, 1996. X's required estimated tax for 1996 was $100x. In order to avoid the addition to tax for underpayment of estimated tax for 1996, X was required to make payments of $25x each on April 15, 1996, June 15, 1996, September 15, 1996, and December 15, 1996. X timely paid $23x on April 15, 1996, and $14x on June 15, 1996, instead of the required payments of $25x on each of these dates. On September 15, X made a payment of $15x. In 1998, the Service examined X's 1995 return and determined that X's correct 1995 tax was $215x, resulting in a tax deficiency of $5x.

Rev. Rul. 99-40 holds that interest on the $5x deficiency for 1995 runs from June 15, 1996, the date on which the overpayment was applied to X's 1996 second quarterly installment of estimated taxes. A portion ($2x) of the overpayment was applied to the April 15$^{th}$ installment of 1996 estimated tax. The remaining $8x of the overpayment was applied to X's June 15$^{th}$ installment of 1996 estimated tax. Because the $8x portion of the return overpayment exceeded the subsequently determined deficiency of $5x, interest did not begin to run for 1995 before the date that portion was applied to X's 1996 estimated taxes.

Applying the analysis in Rev. Rul. 99-40 to this case, Taxpayer Corporation was not underpaid until September 15, Year 2, the date the overpayment was used to partially pay its third quarter Year 2 estimated tax installment. Taxpayer Corporation had made timely estimated tax payments of $B for Year 1. On September 15, Year 2, Taxpayer Corporation timely filed its Year 1 tax return, showing a tax liability of $C and an overpayment of $D. Taxpayer Corporation elected to have this overpayment credited against its Year 2 estimated tax. This overpayment was deemed to arise on March 15, Year 2.

In order to avoid the addition to tax for underpayment of estimated tax for Year 2, X was required to make payments of $E each on April 15, Year 2, June 15, Year 2, September 15, Year 2, and December 15, Year 2. Taxpayer Corporation timely paid Payment 1 on April 15, Year 2, Payment 2 on June 15, Year 2, and Payment 3 on September 15, Year 2, instead of the required payments of $E on each of these dates.

The amount due on Taxpayer Corporation's Year 2 estimated tax installment for the quarter ending March 15, Year 2, was $F. The Service allocated $F of the Year 1 credit elect amount to this first installment. The second quarter of estimated tax installment was overpaid in the amount of $G. Accordingly, the balance of the Year 1 credit elect amount, which was $A, was applied to Taxpayer Corporation's third quarter Year 2 estimated tax installment.

In Year 3, the Service examined Taxpayer Corporation's Year 1 return, and determined a deficiency of $H. Because $A of the Year 1 overpayment was not applied until September 15, Year 2, and the Service had the use of the $A until that time, interest on this amount of the deficiency should only be charged from September 15, Year 2. The interest on the remaining portion of the deficiency, $I, should be assessed from the original due date of the Year 1 return.

If you have any questions regarding this matter, please contact Pamela Wilson Fuller at (202) 622-4910.