



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

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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT: Interest Start Dates and Offsets

This Field Service Advice responds to your memorandum dated January 10, 2000. 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=	Year 1 = 1979
	Year 2 = 1980
	Year 3 = 1981
	Year 4 = 1982
T.I.N.s	Year 5 = 1983
	Year 17= 1995
X's Representative =	Year 18= 1996

ISSUES:

1. What is the appropriate start date for the accrual of interest on income tax deficiencies for taxable Years 1, 3, and 4?
2. Are the deficiencies subject to interest at the tax-motivated interest rate under section 6621 of the Internal Revenue Code?

3. Is it appropriate for the Service to offset against any interest abatements determined by the Tax Court, which would result in a refund of interest to X, additional amounts resulting from a corrected interest computation?

CONCLUSIONS

1. The start dates for deficiency interest for each of the respective years are January 1, Year 4, June 7, Year 4, and April 15, Year 5.
2. Yes, the deficiencies are subject to interest at the tax-motivated interest rate.
3. The Service has the right to retain X's prior payments of interest to the extent they do not exceed the amount of X's actual interest liability.

FACTS

The above interest computation and offset issues arise in the context of a Tax Court proceeding to determine whether the Internal Revenue Service's failure to abate interest under I.R.C. section 6404(e), was an abuse of discretion. Section 6404(e)(1) provides that the Service may abate the assessment of interest on any payment of tax to the extent that the error or delay in payment is attributable to an officer or employee of the Service being erroneous or dilatory in performing a ministerial act.¹ On November 13, Year 18, the Service issued a notice of disallowance to X stating that his requests for abatement of interest were only partially allowed. The Service agreed to abate interest accruing during a period which, for the most part, coincided with the period X's requests for abatement were under consideration by the Service. X filed a petition for review of the Service's partial denial of the request for abatement, and thereafter, fully paid the remaining amount of interest due. X has fully paid all deficiency and interest assessments for the years at issue.²

¹ In 1996, section 6404(e) was amended to permit the Service to abate interest with respect any unreasonable error or delay resulting from managerial or ministerial acts. See Taxpayer Bill of Rights 2, Pub. L. 104-168, 110 Stat. 1452, 1457 (1996).

² While the Tax Court has jurisdiction to review the Service's denial of a taxpayer's request for abatement of interest, see Code section 6404(g)(redesignated as

Taxable Year 1³

On June 28, Year 4, X received a refund for an overpayment of income tax for Year 1, resulting from a carryback of a net operating loss arising in Year 3. The Service paid the refund with interest. Although additional taxes and interest were later assessed against X for Year 1, the deficiency assessment which appears to have spawned the present interest controversy stems from the Service's subsequent disallowance of the Year 3 net operating loss.

Taxable Year 3

For Year 3, X timely filed his return, showing an overpayment and requesting a refund of that amount. The Service paid the refund without interest, on June 7, Year 4. In Year 17, the Service examined X's return and assessed an additional amount of tax, which was less than the amount originally refunded.

subsection (i) by the Internal Revenue Service Reform and Restructuring Act of 1998 (RRA), Pub. L. No. 105-206, sec. 3305(a), 112 Stat. 741), it is the Service's position that the court's authority does not extend to the computation of interest, because Code section 6404(b) prohibits taxpayers from filing an abatement claim pursuant to Code section 6404(a) on grounds that the interest is excessive in amount. See also, Melin v Commissioner, 54 F.3d 432 (7th Cir. 1995). Nevertheless, X's full payment of the interest after having filed his petition for review, arguably allows the Tax Court to determine the amount of abatement to which he is entitled as an overpayment, and thus compute the correct amount.

³ In light of the Tax Court's prior holding that it does not have jurisdiction to abate interest accruing on deficiencies for tax years beginning before January 1, 1979, this memorandum discusses the interest computations for only three of the four tax years described in your request for field service advice.

Taxable Year 4

X timely filed his return, claiming a refund, which the Service paid on June 13, Year 5, with interest. In Year 17, the Service examined the return, and assessed additional tax in an amount less than the original refund.

LAW AND ANALYSIS

Section 6601 (a) requires a taxpayer to pay interest on any deficiency from the time the deficiency arises until it is paid or otherwise abated.⁴ With respect to interest accruing before October 3, 1982, section 6601(d) provides that interest is not affected by a carryback before the last day of the taxable year in which the loss or credit arises. Thus, the party who has the use of the money pays interest up until the event which causes him to no longer have use of the money. The other pertinent statutory provision is section 6611(f)(1), which provides that the Government shall not be liable for interest when a net operating loss creates an overpayment by the taxpayer in the carryback year. "[I]f any overpayment of tax ... results from a carryback of a net operating loss such overpayment shall be deemed not to have been made prior to the close of the taxable year in which such net operating loss ... arises." *Ibid.*⁵ Accordingly, the Government has use of the taxpayer's money as of the close of the taxable year in which the net operating loss arises.

Start date and Rate of Deficiency Interest

⁴ Under Code section 6601 (a), "[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 courts have construed this statutory language under use-of-money principles, initiating interest only "when a tax becomes both due and unpaid." Avon Products, Inc. v. United States, 588 F.2d 342, 344 (2d Cir. 1978). See also, May Department Stores v. United States, 36 Fed. Cl. 680, 689 (1996).

⁵ In the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, sec. 346(c), 96 Stat. 637, Congress changed the effective dates of carryback losses in all of the carryback interest provisions for both overpayments and deficiencies from the last day of the taxable year in which the net operating loss arose to the due date for filing the return for that year. This change was effective for interest accruing after October 3, 1982.

Here, X received a refund for an overpayment of Year 1 income taxes, resulting from a carryback of a net operating loss arising in Year 3. The refund was paid with interest. Although the facts in your request for field service advice do not make clear when overpayment interest started, we assume that the start date was the first day after the close of the taxable year in which the carryback became available, January 1, Year 4. In determining the start date for interest on the subsequently determined deficiency, assessed as a result of the Service's disallowance of the carryback of the net operating loss from Year 3, the underlying objective is to determine how long X has had the use of the Government's money. Clearly, X had the use of the Government's money since January 1, Year 4, the date the Government started compensating X for the use of that money, mistakenly believing the money was due X as a refund, as X had claimed.

For the period in which X received interest on what was ultimately an excessive tax refund, the Service should charge interest at the same rate on the portion of the deficiency that does not exceed the excessive tax refund. See Rev. Proc. 94-60, 1994-2 C.B. 774, 775 at sec.3. Interest at the underpayment rate on the entire deficiency amount should run from date of the refund check until paid. Ibid. For any period in which interest was not paid on an excessive refund, the Service should not charge interest on the portion of the later determined deficiency that does not exceed the excessive tax refund. Ibid. The deficiency determined for Year 3 was less than the original refund which was paid without interest. Thus, the start date for interest on this Year 3 deficiency is the date of the refund check, June 7, Year 4.

For the Year 4 deficiency, the start date for deficiency interest should be April 15, Year 5. The Service paid interest on the excessive tax refund for Year 4, starting April 15, Year 5. Since the later determined deficiency for Year 4 was less than the refund, the Service should charge interest at the same rate on the portion of the deficiency that does not exceed the excessive tax refund, for the same period in which X was paid interest. Rev. Proc. 94-60, 1994-2 C.B. 774, 775 at sec. 3. Interest should then run at the underpayment rate (as increased by the differential for tax-motivated transactions) from the date of the refund check until paid. Ibid.

Taxpayers' argument that the interest payable under Code section 6601 with respect to any substantial underpayment of tax attributable to tax motivated transactions should not be imposed with respect to these deficiencies, because taxpayers received refunds at the regular overpayment rate, appears meritless. For the period in which the taxpayer was paid interest on the excessive tax refund, the

Service should charge interest at the same rate on the portion of the tax deficiency that does not exceed the excessive tax refund. Rev. Proc. 94-60, 1994-2 C.B. 774, 775 at sec. 3. Thereafter, interest at the underpayment rate (as increased by the rate differential for underpayments attributable to tax-motivated transactions) should run on the deficiency amount from the date of the refund check until paid, if in fact the statutory criteria for the imposition of interest at the elevated rate have been met. We are assuming they have.

Offsets against Refunds

It is appropriate for the Service to offset against any interest abatement determined by the Tax Court for a particular year, underassessments of interest for that same year. First, if the Service has timely assessed the underlying tax, it can assess additional interest relating to that tax for as long as the 10-year statute of limitations on collection remains open. See Code sections 6502 & 6601 (g). Moreover, under the principles established in Lewis v. Reynolds, 284 U.S. 281 (1932), a taxpayer's claim for refund must be reduced by the amount of the correct tax liability for the taxable year, regardless of the fact that the Service can no longer assess any deficiency for that year. See also, Fisher v. United States, 80 F.3d 1576, 1580-1581 (Fed. Cir. 1996)(holding interest barred from assessment by expiration of the statute of limitations may be offset against overpayment). This doctrine has been applied in the Tax Court in the determination of an overpayment, Bachner v. Commissioner, 109 T.C. 125 (1997), and in so far as the Tax Court has jurisdiction over the main claim,⁶ it must apply the Service's defenses under Lewis v. Reynolds.

Please call if you have any further questions.

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⁶ See footnote 2, supra.