Computing Interest on Overpayments and Underpayments: How Difficult Can It Be? Very!

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COMPUTING INTEREST ON OVERPAYMENTS AND UNDERPAYMENTS: HOW DIFFICULT CAN IT BE? VERY!

BY MARY A. McNULTY, DAVID H. BOUCHER, JOSEPH M. INCORVAIA, AND ROBERT D. PROBASCO

The multiple elements involved in the correct computation of interest, whether owed to the government or to the taxpayer, include different provisions and different rates for underpayment and overpayment interest, special rules (including transitional rules) for netting and offsets, and the potential misapplication of settled law as well as many areas in which the law is not settled. Given the possibilities for delay, which can trigger interest charges well in excess of the underlying liability, taxpayers must pay attention to these computations.

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Taxpayers often assume that the difficult part is over once there is a final determination of tax liability. All that is left is computing interest on the overpayments and underpayments to determine the final amount due to, or owed by, the taxpayer. There are a myriad of technical interest provisions in the Code, but the application of those provisions is fairly straightforward, isn't it? Not really. Our experience is that interest determinations are as subject to controversy, and as prone to error, as tax liability determinations. Some of the issues that taxpayers should review carefully in the process of finalizing interest computations are explored below. These include some of the many areas in which the Service's interest computations frequently misapply settled law, some issues for which the law is not yet settled, a planning opportunity, and some procedural issues relating to interest disputes.

TERMINOLOGY
We use the following terms in the discussion below:
- **Underpayment interest**, sometimes called deficiency interest, is interest paid by the taxpayer to the government on underpayments.
- **Overpayment interest**, sometimes called allowable interest, is interest paid by the government to the taxpayer on overpayments.
- **Interest-effect dates** (not the actual dates of events) are the key dates that determine when underpayment and overpayment interest starts and stops.
- **Module** is a single tax period for a taxpayer for a specific type of tax. The module for a taxpayer's income tax is a year. The module for a taxpayer's excise and employment tax is a quarter.
- **Transcript of account** is a printout of the transaction detail maintained by the Service for a module. A transcript should include all key events, such as assessments, abatements, payments, and refunds.
- **Account balance** is the net amount due either the government or the taxpayer at any particular effective date. Interest typically is recomputed for the module as a single, fluctuating balance, rather than by individual refunds and deficiencies. A module may have both overpayment interest and underpayment interest, however, as the balance can fluctuate between overpayment and underpayment if the key events making up the balance have different interest-effect dates.

FREQUENT ERRORS
The following areas all involve settled law, for which there should be no question concerning the proper application of the Code. In our experience, however, the Service's interest computations frequently in-
clude mistakes concerning these provisions. Taxpayers need to be aware of the provisions, gather the necessary facts to support their legal positions, and review interest computations carefully to make sure the Code is applied properly.

The most common errors in the Service's interest computations involve:

- Credit elect transfers.
- Carryback analysis.
- LCU (hot) interest.
- Credit transfers.
- Payment back-off periods.
- Refund back-off periods.
- Refunds made without interest.
- Refund check dates.
- Form 870 waiver periods.
- Section 905(c) foreign tax refunds.
- Section 6662 penalties.
- Deposits.

**Credit elect transfers.** Credit elect transfer errors relate to deficiency interest. They arise when a taxpayer elects to apply the overpayment shown on its return to its next year's tax liability, and a deficiency for the first year is later determined. Interest on that deficiency, up to the amount of the credit elect transfer errors relate to deficiency interest. Thus, no interest is allowable if the overpayment is refunded within 45 days of the later of (1) the filing date of the claim for refund, (2) the filing date of the return for the loss/credit year, or (3) the filing date of an application for a tentative carryback adjustment (Form 1139).7

Other effects of the carryback that are "directly attributable" to the carryback also have an interest-effect date of the return due date for the source year.8 The most common directly attributable effect is "credit bumping." The allowable amounts of some tax credits depend in part on the amount of higher priority losses and credits for that tax year. Thus, carrying a loss or credit from year 3 back to year 2 may reduce the amount of a lower priority credit previously taken in year 2. The "bumped" credit then might be carried back to year 1. In that event, the additional carryback from year 2 to year 1 has an interest-effect date (in both years 1 and year 2) related to year 3.9

**EXAMPLE:** The calendar-year taxpayer has a $100 foreign tax credit (FTC) carryback from 1999 to 1998. That credit is effective in 1998 for interest purposes on 3/15/2000, the due date of the 1999 return. If year 2000 has an NOL carryback of $1,000 to 1999, that would further reduce the allowable FTC for 1999. As a result, an additional $250 FTC becomes available for carryback to 1998 from 1999. When computing interest for the 1998 module, the interest-effect date of the first $100 FTC carryback from 1999 remains 3/15/2000. The interest-effect date of the additional $250 FTC carryback from 1999, however, is 3/15/2001, the due date of the taxpayer's 2000 return.

The IRS normally reflects both direct and indirect effects of carrybacks in its restricted interest computations and on Form 2285. Timing analysis can be complex, however, particularly in determining the "cause" of the bumped credit when there are multiple carrybacks from multiple years to the module from which it is bumped. Occasionally the Service does not properly determine the timing on Form 2285 or does not apply it properly in interest computations. The Service's timing analysis always should be reviewed carefully, particularly if there have been multiple adjustments and multiple Forms 2285 for the module.

**LCU (hot) interest.** Beginning in 1987, the interest rate on underpayments by a C corporation was increased by one percentage point. Beginning in 1991, the interest rate on underpayments greater than $100,000 by a C corporation was increased by another two percentage points.10 This is referred to as large corporate underpayment (LCU), or "hot," interest.

The higher interest rate is applicable only if the deficiency is not paid by the taxpayer within 30 days of the date of a 30-day letter (proposed deficiency) or 90-day letter (statutory notice of deficiency). Hot interest is triggered once the cumulative amount of deficiencies (excluding those paid within 30 days) exceeds the $100,000 threshold. For purposes of determining interest for periods after 1997, any letter or notice is disregarded if the amount set forth therein is less than $100,000, not including interest, penalties, and additions to tax. Transcripts of account often show a 2% hot interest date in cases when hot interest should not apply.

**Credit transfers.** The IRS has the discretion to transfer funds between modules to satisfy taxpayer obligations. (See the discussion of "Netting," below.) Interest is allowed from the date of the overpayment to the due date of the return for the tax period to which the credit is applied.11 The tax-
payers should confirm that the interest-effect date of the transfer is consistent between the source module and the recipient module to ensure that it receives the full benefit from the Service's use of its money.

Payment back-off periods. If a taxpayer pays an assessment within 21 calendar days (ten business days for an assessment greater than or equal to $100,000) from the date of notice and demand, no underpayment interest is imposed from the date of notice and demand to the date of payment. Underpayment interest on the assessed amount should be, but is not always, suspended during that period.

Refund back-off periods. Overpayment interest, when allowed, is suspended up to 30 days before the date of a refund check, to give the IRS time to process the payment. Under the Service's current administrative practice, the interest-free period preceding the date of a computer-generated refund check is nine days if the refund is payable to a corporation; for manual refunds, interest is computed up to the date of the refund. The transcripts may show the interest cut-off date. If a deficiency is later asserted, underpayment interest should be suspended for the period during which overpayment interest was suspended.

Refunds made without interest. No interest is paid on an overpayment that is refunded within 45 days of the original due date of the return or, if later, within 45 days of the date that the return was filed. Similarly, if a refund is paid within 45 days of the filing of a claim for refund, interest is not allowed from the date the claim was filed until the date paid. The IRS normally is diligent about suspending overpayment interest for these periods. If a deficiency is later asserted for the same period, however, underpayment interest also should be suspended for the period during which overpayment interest was suspended.

Refund check dates. When the Service makes a manual refund, the interest computation uses the date reflected on the transcript with "transaction code 840—Manual Refund." This date, however, is often inaccurate. The taxpayer should ensure that the date on the transcript and interest computation is not prior to the date of the wire transfer or the date on the manual check. If the refund check is dated later than the transcript date, interest on a subsequent assessment can be reduced.

Form 870 waiver periods. In the event of a deficiency, if the taxpayer executes a waiver of restrictions on assessment (Form 870 or 870-AD) and the Service does not issue a notice and demand for payment within 30 days, no underpayment interest will run from 30 days after the date of the Form 870 until the date of notice and demand. Computational errors frequently arise relating to the amount of the underpayment on which interest is suspended.

Section 905(c) foreign tax refunds. A deficiency interest error may arise when a taxpayer receives a foreign tax refund that correspondingly decreases its foreign tax credits. There are two possible interest-effect dates for the resulting deficiency, depending on whether the foreign taxing authority paid overpayment interest on the foreign tax refund.

1. If interest was paid on the foreign tax refund, deficiency interest runs from the due date of the affected return. If the foreign taxing authority pays interest, but at less than the U.S. underpayment interest rate, deficiency interest runs from the due date of the affected return, but only at the lower rate.
2. If interest was not paid on the foreign tax refund, interest runs from the date of the foreign tax refund.

In either situation, for deficiency interest to accrue, a taxpayer must have been required to pay additional U.S. taxes because of the foreign tax refund.

The second situation is a special exception to the general deficiency interest rule, because interest is not imposed all the way back to the return due date for the applicable tax year. The U.S., not the taxpayer, absorbs the loss of the use of money for the period during which the foreign government had the funds and did not compensate the taxpayer for the use of its money.

The taxpayer should review the treatment of all foreign tax refunds received to see if the special exception applies.

Section 6662 penalties. Section 6601(e)(2)(B)(i) provides that interest on a penalty arising under Section 6662 "begins on the date on which the return of the tax with respect to which such addition to tax is imposed is required to be filed (including any extensions)...." The IRS often will begin interest on the penalty assessment as of the return due date and not the extended return due date. In addition, if the penalty relates to the recapture of a carryback, the penalty will be assessed for the carryback year, not the source year of the carryback. In these situations, the IRS will often effect the interest based on the return due date of the carryback year, instead of the extended return due date of the carryback source period.

Deposits. Like a payment, a deposit suspends the accrual of underpayment interest as of the date of remittance. Unlike a payment, a deposit historically would be returned to the taxpayer on request at any time but would not be.
ear interest, unless and until applied as a payment under Rev. Proc. 84-58, 1984-2 CB 501.\(^{22}\) The American Jobs Creation Act of 2004 (P.L. 108-357, 10/22/04; AJCA) and Rev. Proc. 2005-18, 2005-13 IRB 798, have made some changes to the treatment of deposits, however.\(^{23}\)

The primary change under the new law is that deposits made after 10/22/04 earn interest at the lower federal short-term rate to the extent attributable to a "disputable" tax.\(^{24}\) If the taxpayer receives a 30-day letter, the disputable tax is at least the amount of the proposed deficiency.\(^{25}\) A taxpayer who made a deposit under Rev. Proc. 84-58 may elect to have the new law apply to such deposit.\(^{26}\)

To obtain this benefit, the taxpayer must designate the remittance in writing as a deposit under Section 6603 and specify the type of tax and tax year. A taxpayer that has received a 30-day letter may provide a copy as its written statement of the disputable tax.\(^{27}\) For deposits previously remitted under Rev. Proc. 84-58, the taxpayer must submit the same information and identify the date and amount of the original deposit.\(^{28}\)

Interest on returned remittances generally will run from the date of designation as a deposit under Section 6603. If a written designation is provided before 5/27/05, however, the interest effect date will be (1) the date of the remittance, for deposits made after 10/22/04, or (2) 10/23/04 for deposits made before 10/23/04.\(^{29}\) The Service is taking the position that a Section 6603 deposit that is later applied as a payment and returned to a taxpayer as an overpayment does not bear interest for the period between the date of remittance and the date when applied as a payment, regardless of when designated as a Section 6603 deposit. The IRS reasons that the amount is not returned to the taxpayer as a Section 6603 deposit and therefore is not entitled to interest until it becomes a payment.

Whether taxpayers made a deposit under Rev. Proc. 84-58 or make a deposit under new Section 6603, they should verify that any remittances treated by the Service as deposits when computing interest were intended to be deposits. In addition, taxpayers should manage their deposits to ensure the most benefit from the government's use of their money.

### DISPUTED ISSUES

The courts have not yet reached definitive interpretations of the following Code provisions:

- Foreign tax credit carrybacks.
- Form 870 waivers and use of money suspensions.
- GATT interest.
- Credit application ordering.
- Netting.

Although the Service likely will not concede these issues, a taxpayer should consider pursuing these issues, depending on its facts and circumstances.

### Foreign Tax Credit Carrybacks

The Federal Circuit has held that interest on an underpayment eliminated by a foreign tax credit carryback stops running as of the last day of the tax year in which the carryback arose.\(^{30}\) All other courts that have considered this issue have agreed with the Service's position that interest stops running as of the return due date of the tax year in which the carryback arose.\(^{31}\) (See the discussion of "Carryback Analysis," above.) Congress codified this less-favorable position for foreign tax credit carrybacks arising in tax years beginning after 8/5/97.\(^{32}\)

The IRS did not acquiesce to the Federal Circuit's decision but recognizes its precedential effect on cases appealable to that court.\(^{33}\) The Service should follow the Federal Circuit's decision in cases within that circuit for foreign tax credit carrybacks arising in tax years beginning before 8/6/97. For such carrybacks, the Federal Circuit's position results in a reduction of two and one-half months of underpayment interest.

### Form 870 Waivers and Use of Money Suspensions

As noted above, if the Service does not issue a notice and demand for payment within 30 days, no underpayment interest will run from 30 days after the date of the Form 870 until the date of notice and demand. Taxpayers sometimes make an advance payment at the same time as executing the Form 870. If the IRS does not issue notice and demand timely, that advance payment was not necessary to suspend underpayment interest. In effect, the government has the interest-free use of the taxpayer's money during that period. Under general use of money principles,\(^{34}\) arguably the taxpayer should be entitled to suspension of underpayment interest if there is a subsequent, overlapping assessment.

\(^{22}\) Generally, an undesignated remittance was treated as a payment if the taxpayer (1) remitted it in response to a proposed liability or notice of deficiency, or (2) remitted a deposit during the examination but later (a) signed a waiver of assessment, (b) did not petition the Tax Court in response to the notice of deficiency, or (c) petitioned the Tax Court but did not request in writing that the deposit continue to be treated as a deposit.\(^{23}\)

\(^{23}\) The new Procedure generally continues the treatment of deposits and payments set forth in Rev. Proc. 84-58, 1984-2 CB 501, except with respect to the new provision for overpayment interest allowable on deposits that are returned to the taxpayer rather than converted into a payment.

\(^{24}\) A disputable tax is the maximum amount of tax attributable to disputed items for which the taxpayer (1) has a reasonable basis for its treatment and (2) reasonably believes that the service has a reasonable basis for denying the taxpayer's treatment. AJCA section 842, codified at Section 6603(d).

\(^{25}\) Id., sections 5.01 and 10.

\(^{26}\) Fluor Corp., 126 F.3d 1387, 80 AFTR2d 97-6022 (CA-9, 1997), cert. den.

\(^{27}\) Rev. Proc. 2005-18, 2005-13 IRB 798, sections 4.01(1), 5, and 7. Otherwise, the written statement must include (1) the taxpayer's calculation of the amount of disputable tax, (2) a description of the disputed items, and (3) the basis for the taxpayer's belief that it has a reasonable basis for its treatment of the items and the service has a reasonable basis for denying the taxpayer's treatment.

\(^{28}\) Id.

\(^{29}\) Id., sections 5.01 and 10.


\(^{31}\) Sections 6601(d) and 6611(f).


GATT Interest

Beginning in 1995, the interest rate paid by the IRS on a corporation's overpayments of tax in excess of $10,000 decreased by 1.5 percentage points from the standard overpayment rate. This lower interest rate is referred to as "GATT interest." It is to the taxpayer's advantage, of course, to minimize the application of the GATT interest rate. The Service, however—not surprisingly—applies the GATT interest rate to the greatest extent possible.

The IRS separates the overpayment of tax, from the time it arose, into two components: the first $10,000, and the remainder. Interest accrues on each piece before 1995 at the standard rate. Beginning on 1/1/95, interest continues to accrue on the first $10,000 (plus previously accrued interest associated with such $10,000) at the standard overpayment rate. Interest accrues on the remainder at the lower GATT overpayment rate.

The disputed issue concerns the proper interest rate, beginning on 1/1/95, used to compound any interest that had accrued before 1995 on an overpayment of tax in excess of $10,000. Under the Service's current method (referred to as "New GATT"), such interest begins to compound at the lower GATT rate on 1/1/95. Under "Old GATT," which the IRS applied from 1995-1998, all interest that had accrued before 1995 compounded at the higher standard rate. The legal rationale for this position was that interest on overpayments does not become part of the tax to which it relates. When it switched from the more-taxpayer-favorable Old GATT to the less-taxpayer-favorable New GATT in 1999, the Service made a policy decision that it would not recapture Old GATT interest. Thus, if the IRS already had allowed interest using the Old GATT methodology, any subsequent interest computation for that period would use the Old GATT computation methodology.

The Federal Circuit recently rejected a taxpayer's claim for the application of Old GATT. Some taxpayers are making the same Old GATT argument in the Tax Court that the Federal Circuit rejected. Other taxpayers are pursuing alternative arguments supporting this issue. For example, if the IRS previously paid Old GATT interest to the taxpayer during 1995-1998, a taxpayer may argue that the Service must follow its established policy and cannot now recapture the difference between the Old GATT and New GATT interest. Alternatively, a taxpayer may argue that the IRS abused its discretion by arbitrarily applying New GATT retroactively in some cases and prospectively in other cases and that the Service must apply Old GATT to all overpayments outstanding from 1995-1998. These alternative arguments are currently pending before the U.S. Court of Federal Claims.

Depending on a taxpayer's particular circumstances, if it is prepared to file suit in other jurisdictions, pursuing the GATT issue may still be worthwhile. At a minimum, taxpayers should carefully evaluate the issue so that a decision regarding a claim can be made before the statute of limitations for overpayment interest expires.

Credit Application Ordering

This issue arises in periods with three types of overlapping transactions—a refund without interest, a refund with interest, and an assessment—and an overall net overpayment balance. In such situations, should the taxpayer receive overpayment interest on the net balance? Consider the following.

EXAMPLE: A year-end taxpayer timely filed its 1989 return with extensions on 9/15/90, showing an overpayment of $50,000. The Service refunded the amount on 10/15/90 (i.e., within 45 days) without interest. On 5/15/94, there was a general tax abatement of $60,000, paid with interest on 6/05/94. On 8/20/98, there was a general tax assessment of $75,000. When recalculating the module for the new assessment, is overpayment interest allowed from 3/15/90 to 10/15/90? For the period 3/15/90—10/15/90, the $50,000 overpayment did not receive interest and the $60,000 overpayment did receive interest. After the assessment is made, the net overpayment balance during that period is only $35,000, less than either of the overpayments:

<table>
<thead>
<tr>
<th>Overpayment on return, refunded without interest</th>
<th>Abatement, refunded with interest</th>
<th>Assessment</th>
<th>Net balance as of 3/15/90</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000</td>
<td>$60,000</td>
<td>$75,000</td>
<td>$(35,000)</td>
</tr>
</tbody>
</table>

When recomputing interest for the module in circumstances like this, the Service generally takes the position that no overpayment interest is allowable for the period from 3/15/90 to 10/15/90. All the interest previously allowed for the period, when the $60,000 was refunded, would be recaptured.

The Court of Federal Claims has decided this issue in favor of the government. That case, however, involved unfavorable and distinguishable facts. Other taxpayers are currently pursuing the issue in court. There are several alternative legal theories, which have not yet been addressed by a court, that may support allowance of overpayment interest on the $35,000 balance in the above example. The decision whether to pursue the issue, and the choice of the particular legal theory and strategy to use, will depend on a taxpayer's facts and circumstances. At a minimum, taxpayers should carefully evaluate the issue so that a decision regarding a claim can be made before the statute of limitations for overpayment interest expires.
for the taxpayer to eliminate the negative impact of a higher interest rate charged on underpayments in one module while receiving a lower interest rate on overpayments in another tax period. There are two mechanical methods to address this interest rate imbalance. Offsetting is the process of permanently moving an overpayment in one module to reduce the underpayment in another module. It is available only if the deficiency and overpayment are both outstanding. The offsetting mechanism presents a planning opportunity that will be discussed further below.

The other mechanism, which involves the disputed issues, is netting or “net rate.” This involves changing the rate of interest on either the underpayment or overpayment to effect a zero rate of interest for the period of mutual indebtedness. Section 6621(d) provides for a net interest rate of zero on equivalent amounts of underpayments and overpayments, from different modules, that were outstanding during the same period. Unlike offsetting, netting does not require that the underpayment balance or overpayment balance both remain outstanding.


There are two ways to equalize interest rates to achieve a net rate of zero. The interest rate on the underpayment balance can be decreased, equalizing to the overpayment rate. Therefore, the taxpayer owes less underpayment interest. Alternatively, the interest rate on the overpayment balance can be increased, equalizing to the underpayment rate. Therefore, the government owes the taxpayer additional overpayment interest.

If the statute of limitations for both the overpayment and underpayment closed by 12/31/99, a taxpayer must have filed a netting claim by 12/31/99. Otherwise, Rev. Proc. 99-43 requires that the taxpayer must file a netting claim before both periods of limitations close for the overpayment balance and the underpayment balance. Therefore, even though a period may be closed for purposes of challenging interest computations, it may still be used in netting, so long as the balances in that period will be netted against balances in other periods that are still open.

Because interest netting was recently enacted, some issues have not yet been resolved. These issues include the use of closed periods under the transitional rule, the use of interest-free periods, the definition of a taxpayer, and the proper direction of netting.

Use of closed periods (transitional rule). Only one period of limitations needs to be open when netting for periods after 7/22/98. When netting for periods before 7/22/98, however, Rev. Proc. 99-43 requires both applicable periods of limitations to have been open on 7/22/98. Thus, the period of limitations must be open for both the underpayment interest and the overpayment interest.

The language of the statute is ambiguous, however, and arguably requires that only one of these periods of limitations have been open on 7/22/98. Interest rates then could be equalized by changing the interest rate in whichever module remains open. That interpretation would benefit the taxpayer, by allowing netting in more situations.

The Federal Circuit recently rejected a taxpayer's argument that interest-free overpayments may be used in netting. The court reasoned that netting is allowed under Section 6621(d) only for periods when interest is “payable” on an underpayment and “allowable” on an overpayment.

Definition of taxpayer. Section 6621(d) allows netting on equivalent underpayments and overpayments “by the same taxpayer.” It is not clear who the taxpayer is, especially in the context of a consolidated group. Under Section 7701(a)(14), a taxpayer is any person “subject to” any internal revenue tax. The Supreme Court has interpreted the phrase “subject to” as having a broader meaning than the party against whom a tax liability is assessed. The Service has stated that “application of section 6621(d) among the members of a consolidated group will be difficult to resolve.”

There is authority for treating the consolidated group as a single taxpayer because (1) consolidated income tax liability is computed and reported for the entire group, (2) each member is severally liable for the tax of the entire group, (3) the common parent acts as the agent for the group, and (4) the IRS tracks a group’s consolidated tax liability.
ity under a single account that is indexed to the common parent's taxpayer identification number. Thus, a taxpayer may net pre-merger overpayments against post-merger underpayments. Pending cases seek to allow post-merger overpayments to be netted against pre-merger underpayments.

Direction of netting. Section 6621(d) requires that a zero net interest rate be applied during periods of mutual indebtedness but does not specify how interest rates are to be equalized. Logically, the statute of limitations should be the only constraint over whether the underpayment rate is decreased or the overpayment rate is increased.

The equalization of interest rates is applied to either the overpayment or underpayment module. If the periods of limitations are open for both overpayment interest and underpayment interest, a taxpayer should be allowed to equalize to either the overpayment rate or the underpayment rate. If the period of limitations is open only for overpayment interest, the overpayment rate should be increased. If the period of limitations is open only for underpayment interest, the underpayment rate should be decreased.

Under Rev. Procs. 99-43 and 2000-26, the Service will generally decrease the underpayment interest rate. The IRS will increase the overpayment rate instead only if the underpayment period is closed when the netting claim is filed and the overpayment period is open. Although the Service generally equalizes the underpayment rate when both limitations periods are open, there is no statutory authority for this position. It may be to a taxpayer's benefit to equalize the overpayment rate instead.

PLANNING OPPORTUNITY

As discussed above, the IRS will offset outstanding credit balances from one period to cover the liability of another period. This is done in an orderly fashion. The overpayment from the earliest overpaid module is used to pay the liability from the earliest underpaid module. This process is repeated until there is either a net underpayment or a net overpayment balance for all periods being considered.

Based on the dates the credit transfers are made to the underpayment module, the taxpayer can lose the benefit of interest-free refunds or credit. Elect transfers that already were stopping the running of underpayment interest. Without the offset, the taxpayer would receive interest on the overpayment module but would not pay interest on the underpayment module. The offset would eliminate that net interest receivable by the taxpayer. The only sure way to prevent this lost benefit is to make an advance payment of the underpayment, thereby preventing offsetting. (As discussed above, an interest-free underpayment likely cannot be netted against overpayments.) Obviously, before making a large payment in advance of a pending refund for another tax period, it is necessary to quantify the resulting dollar benefit of making such payment.

PROCEDURAL ISSUES

Identifying problems with interest computations is only the first step. The taxpayer also must take appropriate measures to resolve the discrepancies. There are two particular procedural hurdles that taxpayers need to take into consideration:

- The statutes of limitations.
- The interaction of interest computations with Tax Court Rule 155 computations.

Statutes of Limitations

At issue here are the separate limitations rules affecting the taxpayer's recovery of excessive underpayment interest and claims for additional overpayment interest. Other rules control attempts by the IRS to correct or recover its own interest-related errors.

Underpayment interest. A taxpayer can challenge the computation of underpayment interest only if the statute of limitations is open. Because underpayment interest is treated as part of the tax to which it relates, the same rules that apply to tax refund claims apply to refund claims of underpayment interest. A taxpayer must file a refund claim within the later of three years from the date the tax return was filed, two years from the date of payment, or six months from expiration of the period for making assessments, as extended by agreement.

A special rule applies to the extent a refund claim is related to an NOL or net capital loss carryback. In that event, the period of limitations is governed by the source year of the carryback. For overpayments attributable to foreign tax credits, the period is extended from three years to ten years from the due date for filing the return for the year in which such taxes were actually paid or accrued.

A suit for refund may be filed six months after the refund claim is filed and no later than two years from disallowance of the refund claim.

The key point is that a refund claim must be filed by a taxpayer to preserve its right to challenge computations relating to underpayment interest. The refund claim should state with specificity the error made in the interest computations.

Overpayment interest. To challenge the computation of overpayment interest, the statute of limitations must be open. Overpayment interest is treated as a debt owed by the government to the taxpayer, not as a tax refund. Therefore, the refund claim procedures do not apply. A refund claim is not required and does nothing to protect a taxpayer's rights to challenge interest computations relating to overpayment interest. Nevertheless, taxpayers often file a claim for additional interest in an effort to resolve the issue administratively. If the issue is not resolved within

NOTES

51 Regs. 1.1502-2, -6(9), and -77(a).
52 CCA 200411003 (netting allowed as long as corporation entitled to overpayment was also liable for the group's underpayment).
53 Wells Fargo & Co., Court of Federal Claims (Docket No. 02-3867; Tekaelo Inc., supra note 41).
54 FSA 199939003.
55 Section 6511.
56 Section 6511(d)(2).
57 Section 6511(d)(3).
58 Section 6532(a).
59 See Computervision Corp., supra note 48; see also Reg. 301.6402-2.
The IRS normally reflects both direct and indirect effects of carrybacks in its restricted interest computations and on Form 2285. Timing analysis can be complex, however, particularly in determining the "cause" of the bumped credit when there are multiple carrybacks from multiple years to the module from which it is bumped. Occasionally the Service does not properly determine the timing on Form 2285 or does not apply it properly in interest computations. The Service's timing analysis always should be reviewed carefully, particularly if there have been multiple adjustments and multiple Forms 2285 for the module.

- Whether taxpayers made a deposit under Rev. Proc. 84-58 or make a deposit under new Section 6603, they should verify that any remittances treated by the Service as deposits when computing interest were intended to be deposits.

- The statute of limitations for overpayment interest does not parallel the statute of limitations on assessments. Therefore, a taxpayer typically does not monitor the events relating to the statute of limitations for overpayment interest, and consequently there is more risk that the statute of limitations on overpayment interest will expire without the taxpayer's knowledge. In addition, a taxpayer typically does not know the exact date when the Service schedules an overpayment. A taxpayer may have some idea of that date from its transcript of account, but that date is not conclusive. Therefore, a taxpayer should leave itself some cushion of time when computing the deadline for filing suit to challenge interest computations relating to overpayment interest.

Consequently, there is more risk that the statute of limitations on overpayment interest will expire without the taxpayer's knowledge.

- The taxpayer should carefully re-

six years from the date the overpayment was scheduled, the taxpayer must file suit to preserve its rights to the additional interest.60

The statute of limitations for overpayment interest does not parallel the statute of limitations on assessments. Therefore, a taxpayer typically does not monitor the events relating to the statute of limitations for overpayment interest, as it does with the statute of limitations for underpayment interest.

IRS error. The Service is subject to different limitations periods to correct or recover its interest-related errors. It can assess and collect deficiency interest for ten years after the underlying tax has been assessed61 and can sue to recover erroneous refunds within two years of the date of the refund.62 In addition, the government may recover excessive interest paid to a taxpayer by offset if a taxpayer files a claim or suit against the government for the same tax year.63 The Court of Federal Claims recently decided that the government's right of offset extends to overpayment interest.64 That case is currently on appeal.

Rule 155 Computations

A new trap awaits if the taxpayer's tax liability is adjudicated in the Tax Court. Under Tax Court Rule 155, the court may decide the particular issues presented to it but withhold entry of its decision to allow the parties to submit computations of the deficiency, liability, or overpayment to be entered as the decision. Until recently, it was common for the parties to wait to resolve any issues concerning interest computations until after entry of the Tax Court's decision. That approach may no longer be feasible.

The Tax Court recently held that an "overpayment" by the taxpayer is reduced by any underpayment interest. If the court enters a decision reflecting an overpayment by the taxpayer, that is also a final decision with respect to any underpayment interest for the module.65 If the Rule 155 computations either exclude or improperly calculate underpayment interest, both parties will be stuck with them.66 Deficiency decisions, on the other hand, cannot include interest, which must be determined through a supplemental proceeding after the decision is entered.67

The taxpayer should carefully review any underpayment interest included in the Service's Rule 155 computations in a Tax Court case that determines an overpayment and resolve any disputes concerning the interest before submitting the computations to the court.

CONCLUSION

Just as it is rare for a large corporate tax audit to yield no change, it is equally unlikely the first evaluation of interest for a tax period will remain unchanged after scrutiny. It is always in the best interest of the taxpayer to review thoroughly the factual, computational, and legal basis for the interest computations presented. When the tax liability has been finally determined, the hard work of interest resolution has just begun.