Interest reviews offer low risk/high reward opportunities for companies*

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Many companies either have paid the Internal Revenue Service (IRS) considerably more interest than they actually owed or have received less allowable interest than they were entitled to, due primarily to incorrect IRS calculations. The good news is that significant refund opportunities may exist for companies that find themselves in this situation. The bad news is that most companies do not have the internal resources needed to review complex interest computations, identify and correct errors, and obtain refunds.

Significant Refund Opportunities

There are three principal reasons why significant refund opportunities may exist.

First, IRS interest computations have been shown to have high error rates. A 1993 General Accounting Office study of IRS interest computations in complex cases found an error rate of 63 percent. More recently, over 40 percent of the tax accounts reviewed in 2001 by the Treasury Inspector General for Tax Administration either contained errors or were unnecessarily restricted (i.e., manual interest computations were unnecessary and the IRS's computer system should instead have been allowed to compute interest).

Second, the rules that govern computation of interest change, as new statutory provisions are enacted, courts decide disputes regarding interest issues, and the IRS issues guidance in the form of revenue rulings, revenue procedures, etc. As a result, computations performed in the past, using the old rules no longer may be correct. The IRS cannot be expected to identify and self-correct these “errors.” Instead, it is up to the taxpayer to bring such situations to the attention of the IRS by filing refund claims.

Finally, with respect to issues such as “use of money” and interest netting, the IRS requires taxpayers to be proactive in order to obtain the full benefits to which they are entitled. That is, the taxpayer must provide the IRS with much of the information needed to quantify the benefit by filing a claim for refund with supporting interest computations.

Let's take a closer look at several situations causing companies to pay more interest, or receive less interest, then they should.

Types of possible IRS errors

The amount of interest that a taxpayer owes on a tax underpayment, or is entitled to receive on a tax overpayment, can be determined by using the following formula:

> Interest = Principal (the amount of the tax underpayment or overpayment at issue) x Rate (the applicable rate(s) of interest under section 6621) x Time (the period of time during which interest is payable or allowable).

All three factors — principal, rate, and time are susceptible to error.

Principal

Current year adjustments may be confused with carryback recaptures, resulting in a significant impact on interest. That is because interest on an underpayment attributable to a carryback recapture would begin to run as of the unextended due date of the source year return,[1] while interest on a current year tax increase would run from the unextended due date of that year's return.

Interest rate

For corporations, the normal overpayment interest rate is the Federal short term rate plus two percent. However, under section 6621(a)(1)(B), the rate of interest paid by the IRS to corporate taxpayers on overpayments of tax is reduced to the Federal short-term rate plus one-half percent for any portion of overpaid tax that exceeds $10,000. This is commonly referred to as the "GATT rate" because it was enacted as part of the statute that gave effect to the agreements reached at the Uruguay Round of Multilateral Trade Negotiations conducted under the auspices of the General Agreement on Tariffs and Trade ("GATT").

For all taxpayers, the normal underpayment interest rate is the Federal short term rate plus three percent. However, pursuant to section 6621(c), the underpayment rate increases to the federal short-term rate plus five percent for "large corporate underpayments." This increased underpayment rate is commonly referred to as "hot interest" because interest is running at a two percent higher or "hotter" rate. If the IRS uses the "hot interest" rate when it is not applicable, the taxpayer will be charged too much underpayment interest.

The global interest netting provisions of section 6621(d) serve to eliminate the interest differential (the difference between the rate the IRS charges corporations on tax underpayments and pays them on tax overpayments) during "periods of mutual indebtedness." Said another way, netting equalizes the rates of interest during overlapping overpayment and underpayment periods.

The benefit derived from interest netting can be substantial, since the interest rate differential can be as much as four and one half percent where underpayment interest is running at the two percent higher hot interest rate and overpayment interest is running at the lower (by one and one half percent) GATT rate.

> *Example* -- For the tax year 1998, Corporation X received a refund of $1,284,343 on June 15, 2005, comprised of $1 million of tax and $284,343 of overpayment interest. For the tax year 1999, Corporation X pays $1,555,798 ($1 million tax plus $555,798 of deficiency interest) to the IRS on October 15, 2005. Two percent "hot" interest began on January 1, 2001. During the overlapping period – March 15, 2000, to June 15, 2005 – the interest-netting provisions decrease the rate of interest charged by the IRS on the 1999 deficiency from the normal (and later "hot" rate) to the lower overpayment rate. As a result, the taxpayer saves $307,558 (i.e., deficiency interest is reduced from $555,798 to $248,240).

Global netting is applicable across different types of tax. For instance, income taxes can be netted against employment taxes or excise taxes. [2]

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[1] If no interest was paid on the carryback refund, then underpayment interest on the recapture would only begin to run as of the date of the refund.

[2] When a taxpayer receives a refund *with interest* and the IRS later determines an underpayment of tax for the same year, Rev. Proc. 94-60 provides for "within module" or "annual" netting. Pursuant to Rev. Proc. 94-60, interest is calculated as follows: For the period for which the taxpayer was paid interest on the prior refund, interest is charged at the same rate on the portion of the underpayment that does not exceed the tax refund. (For any period for which interest is not paid on the prior refund, the IRS will not charge interest on the portion of the underpayment that does not exceed the refund.) Interest at the underpayment rate is charged on the portion of the underpayment that exceeds the prior refund from the original due date of the return and on the entire underpayment from the date of the refund check.

Time -- In General

There are certain “interest-free” periods during which the IRS should not charge a taxpayer underpayment interest. For example, pursuant to section 6601(c), if the taxpayer signs a waiver of the restrictions on assessment (Forms 870, 870-AD, or 4549) and the IRS fails to make notice and demand for the additional tax within 30 days, interest is suspended beginning on the 31st day following the filing of the waiver until notice and demand is issued. Rev. Rul. 88-98[3] provides that if the taxpayer received a refund without interest and an underpayment of tax is later determined for the same tax year, interest on the underpayment (up to the amount of the earlier refund) will not begin to run until the date the refund was issued.

When money is moved from one tax account of a taxpayer to an earlier account of the same taxpayer, it is applied to the earlier tax account as of the credit’s “availability” (or “effective”) date. In general, the availability date of a credit is the unextended due date of the return for the tax period that the credit is coming out of, or, if later, the date on which the money was paid into that account. When money is credited to a later tax account, it should be applied as of the unextended return due date of the account receiving the credit, or, if later, the date on which the money was paid. In both cases, it is not uncommon for the IRS to lose track of the correct effective date(s) when it moves money between tax periods/accounts, and to apply the credit incorrectly as of the date of the transfer.

Time -- "Use of money" principles

Finally, application of the “use of money” principles can delay the start date for interest on a tax underpayment.

In *May Department Stores v. United States,*[4] the U.S. Court of Federal Claims explored and further developed the “use of money” principles. Presented in somewhat simplified fashion, the relevant facts in *May Department Stores* are as follows:

The taxpayer obtained an extension of time to file its return for Year One and, when the return was filed, elected to have the overpayment of tax shown on the return credited against estimated tax for Year Two. The taxpayer did not designate to which installment of estimated tax the credit elect from Year One was to be applied, but had fully paid its first and second installments of Year Two estimated tax at the time the return for Year One was filed. The IRS later determined a deficiency (underpayment) for Year One.

The issue in *May Department Stores* was whether “use of money” principles prohibited the IRS from charging interest on the underpayment for Year One until October 15th of Year Two, when the taxpayer filed its Year One tax return and elected to apply the overpayment shown on that return to its liability for Year Two estimated tax. The U.S. Court of Federal Claims held that the taxpayer was not liable for interest until the date it filed its Year One return, since before October 15th of Year Two the taxpayer had paid in full the first two installments of its Year Two estimated tax liability. The Service’s application of the overpayment to the first installment of estimated tax for Year Two, which installment had already been paid, could not change the fact that the government had the use of the funds at issue from April 15 to October 15 and, therefore, suffered no underpayment.

The IRS issued an Action on Decision[5] in which it acquiesced in the decision of the U.S. Court of Federal Claims in *May Department Stores*.

In another case, *Sequa Corporation v. United States,*[6] the U.S. District Court for the Southern District of New York applied the “use of money” principles to a situation wherein the taxpayer elected to credit its Year One tax overpayment to its estimated tax for Year Two, but ultimately never needed any part of that overpayment to satisfy its Year Two tax liability. In a logical extension of the holding in *May Department Stores*, the District Court held that the IRS was not entitled to interest on

[3] 1988-2 CB 356.
[4] 96-2 USTC ¶ 50,596, 36 Fed. Cl. 680 (1996).
[5] AOD/CC-1997-008 (Aug. 4, 1997).
[6] 99 USTC ¶ 50,379 (DC S.D.N.Y.) (June 10, 1998).

additional tax later determined to be due for Year One until March 15, Year Three, the unextended due date of Sequa's Year Two tax return.

The reasoning and holdings in *May Department Stores* and *Sequa* were adopted by the Service in Rev. Rul. 99-40.[7] Accordingly, in a situation where (1) a calendar-year corporate taxpayer elects to have the overpayment reported on its income tax return for Year One applied to its estimated tax liability for Year Two, (2) the Year One credit elect is not needed for Year Two estimated tax purposes, and (3) a deficiency in tax is later determined for Year One, current IRS procedures provide that interest on the Year One deficiency will not begin to run until March 15, Year Three, the unextended due date of the taxpayer's Year Two tax return.

Observations

Although the concept of interest on tax underpayments and overpayments is fundamentally simple - i.e., the government or taxpayer should be compensated for the time the other party has use of its money -- it is not surprising that putting the concept into practice is anything but simple when dealing with a particular taxpayer's complex fact situation and the 5000-plus page tax code.

Applying the correct rate of interest to the correct principal amount for the correct period of time requires the government or taxpayer to --

1. choose correctly from no fewer than five possible rates of interest, all of which can fluctuate quarterly;
2. properly distinguish between current year and carryback adjustments;
3. identify any relevant interest-free periods;
4. consider the applicability of "use of money" principles and the interest-netting provisions; and
5. take into account the entire series of tax increases and decreases, advance payments, deposits, and other transactions that affect the running balance of the tax account in question.

Therefore, although they are critically important, interest and account reviews can be quite time-consuming, which has created demand in the marketplace for process efficiencies.

Contingent Fees

The final "Circular 230" regulations that the Treasury Department issued in September 2007 allow contingent fees for services rendered in connection with:

- The IRS's examination of, or challenge to, an original tax return.
- An amended return or claim for refund or credit filed within 120 days of the date the taxpayer receives written notice regarding an examination of, or a written challenge to, the original return.

In addition, in a change to the proposed regulations, contingent fees are permitted for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS (subject to applicable SEC and state board of accountancy rules).[8]

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[7] 1999-2 CB 441.

[8] The provision in the final regulations regarding contingent fees is effective for fee arrangements entered into after March 26, 2008.

Conclusion

Because large dollar amounts of interest often are at stake, it is critical for companies to take prompt action. Specifically, companies should either:

- Have their federal tax accounts and any related interest computations reviewed by an interest specialist; or
- Work cooperatively with the IRS as interest computations are performed to ensure they are correct.

A few companies with especially robust tax departments may have the highly specialized expertise necessary to perform or review complex interest computations in-house. However, many companies choose to work with outside interest specialists because their tax departments do not have that specialized expertise. Moreover, since interest reviews can still be performed on a contingent fee basis, companies often take advantage of the "no risk" nature of that type of fee arrangement. Although each company's situation is unique, many companies have been pleasantly surprised by the amount of interest they recover after conducting an interest review.

For more information

Tune in to PwC's podcast, "Solving the Mystery of IRS Interest Computations," by logging on to www.pwc.com/audiodigest.

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