

Report to the Congress on

**NETTING OF INTEREST ON
TAX OVERPAYMENTS AND UNDERPAYMENTS**



Department of the Treasury
Office of Tax Policy

April 1997

APR 18, 1997

The Honorable Bill Archer
Chairman
Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Section 1208 of Public Law 104-168, the Taxpayer Bill of Rights 2, provides that the Secretary of the Treasury shall submit a report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate, a study of: (1) the legal and policy issues related to the netting of interest on federal tax overpayments and underpayments; and (2) the Internal Revenue Service's administrative practices in that regard.

Pursuant to that section, I hereby submit "Netting of Interest on Tax Overpayments and Underpayments."

Our study concludes that while "global" interest netting would be consistent with the intent expressed by Congress in the past, additional legislation would be necessary to achieve this policy goal. The Administration has proposed, as part of its recently-released simplification package, to allow "global" interest netting for income taxes with respect to tax periods not barred by the statute of limitations. The Treasury Department's Office of Tax Policy looks forward to working with your Committee and your staff in developing such legislation.

I am sending a similar letter to Representative Rangel.

Sincerely,

/signed/

Donald C. Lubick
Acting Assistant Secretary
(Tax Policy)

Enclosure

APR 18, 1997

The Honorable William V. Roth, Jr.
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Section 1208 of Public Law 104-168, the Taxpayer Bill of Rights 2, provides that the Secretary of the Treasury shall submit a report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate, a study of: (1) the legal and policy issues related to the netting of interest on federal tax overpayments and underpayments; and (2) the Internal Revenue Service's administrative practices in that regard.

Pursuant to that section, I hereby submit "Netting of Interest on Tax Overpayments and Underpayments."

Our study concludes that while "global" interest netting would be consistent with the intent expressed by Congress in the past, additional legislation would be necessary to achieve this policy goal. The Administration has proposed, as part of its recently-released simplification package, to allow "global" interest netting for income taxes with respect to tax periods not barred by the statute of limitations. The Treasury Department's Office of Tax Policy looks forward to working with your Committee and your staff in developing such legislation.

I am sending a similar letter to Senator Moynihan.

Sincerely,

/signed/

Donald C. Lubick
Acting Assistant Secretary
(Tax Policy)

Enclosure

TABLE OF CONTENTS

EXECUTIVE SUMMARY	1
INTRODUCTION	3
BACKGROUND	5
Basic concepts	5
Pre-1986 interest rules	7
IRS administration of these rules before 1986	8
1986 and subsequent changes in interest rules	11
Changes in the IRS administration of interest	12
Other developments	14
TAX POLICY ISSUES INVOLVED IN INTEREST NETTING	16
Policies underlying interest on taxes	16
Policies underlying differential interest rates	18
Policies underlying interest netting	20
LEGAL ISSUES INVOLVED IN INTEREST NETTING	25
Congressional guidelines	25
Approaches to global netting	28
A. Credit/offset approach	28
B. Interest equalization approach	31
Limitations period considerations	33

ADMINISTRATIVE ISSUES INVOLVED IN INTEREST NETTING	36
Annual netting	36
Offsetting	37
Global netting	39
Making global netting feasible	40
CONCLUSION AND RECOMMENDATIONS	44
APPENDICES	Following page 44
APPENDIX ONE -- Notice 96-18, 1996-14 I.R.B. 27 (April 1, 1996).	
APPENDIX TWO -- Persons submitting comments in response to Notice 96-18.	
APPENDIX THREE -- Witnesses at hearing September 4, 1996.	
APPENDIX FOUR -- Excerpt from IRM 31(59)(31).	

EXECUTIVE SUMMARY

Since 1986, the Internal Revenue Code has required taxpayers to pay a higher rate of interest on tax underpayments (deficiencies) than the Treasury pays on tax overpayments (credits or refunds). The difference between the two rates (the interest rate differential) ranges from one percent to as much as 4½ percent for large corporate taxpayers.

Taxpayers can be in both an underpayment and an overpayment situation simultaneously with respect to their federal tax liabilities, for instance if a taxpayer both owes tax for one year and is owed a refund for another year. In various statutory provisions, and in the legislative history of the interest rate differential provisions enacted since 1986, Congress has urged the Internal Revenue Service (“IRS”) to “net” a taxpayer’s underpayments and overpayments so that the interest rate differential is not charged in these situations of mutual indebtedness.

Since 1986, the IRS has followed Congress’s instructions to implement the most comprehensive interest netting procedures that are consistent with sound administrative practice. First, the IRS has implemented netting in cases where taxpayers temporarily have underpayments and overpayments with respect to a single tax year -- a procedure referred to for purposes of this study as “annual” netting. See Rev. Proc. 94-60, 1994-2 C.B. 774. The IRS also nets in all cases where taxpayers simultaneously have outstanding tax overpayments and underpayments for different years -- a procedure referred to as “offsetting.” However, the IRS does not net interest if an overpayment or underpayment was previously in existence but has been satisfied as of the time the netting computation is performed (i.e., the deficiency has already been fully paid by the taxpayer and/or the overpayment has already been fully refunded by the Government, so that one of the taxpayer’s tax accounts has a balance of zero). This third, broader form of netting is referred to as “global” netting.

This report discusses the tax policy, legal, and administrative issues that are involved in interest netting practices, and in particular global netting. It concludes that, in both mandating an interest rate differential and requiring comprehensive netting to the extent feasible, Congress has expressed inconsistent policy preferences with respect to issues such as the time value of money, incentives for promptly settling tax accounts, and the annual accounting concept. The statutory scheme that Congress has provided reflects to some extent this policy uncertainty, because it permits netting in some situations but not others. In particular, while statutory authority for offsetting is set forth in the Internal Revenue Code, see §§ 6402(a) and 6601(f), annual netting is possible based only on a broad administrative interpretation of existing provisions (particularly § 6621), and global netting is probably not authorized at all under current law.

Administratively, interest computations are often extremely difficult and complex to perform even in the comparatively straightforward annual netting and offsetting situations. Collecting and inputting data can be very time-consuming and costly, and taxpayers and the IRS often disagree over the appropriate analysis indicated by the data. This report describes some of the complexities of netting computations, and it discusses the additional legal and administrative difficulties that global interest netting could be expected to introduce if implemented.

To date, the IRS has not implemented global netting, due primarily to uncertainty about its authority to do so, but also because of the administrative difficulties of the necessary procedures. Treasury and the IRS have concluded, based on this study, that the IRS cannot implement global netting until Congress provides clear statutory authority for it. In so doing, Congress should also clarify its preferences between the competing policy concerns that are involved. Congress has previously concluded that comprehensive interest netting is desirable to the maximum extent feasible. Assuming that Congress continues in this policy preference, it makes little sense for interest netting to be available in some cases (like the annual netting or offsetting situations) but not in the global netting situation. Accordingly, legislation authorizing global netting would be appropriate.

As for the administrative difficulties, implementing global netting may have a significant adverse effect on IRS resources. Providing some limitations on the scope and extent of global netting may minimize this adverse effect and make it possible for the IRS to accomplish global netting at little additional cost.

Treasury and the IRS therefore recommend a statutory change that will achieve the broadest global netting that is consistent with sound administration. In particular, we recommend legislation providing for interest equalization when taxpayers and the IRS have overlapping periods and amounts of mutual indebtedness (taxes and refunds due). Such legislation should also authorize Treasury to promulgate regulations incorporating our suggested limitations on this procedure. We look forward to working with the tax-writing committees to implement these recommendations as promptly as possible.

INTRODUCTION

Section 1208 of the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1453, 1473 (July 30, 1996) (TBOR 2), requires the Secretary of the Treasury to perform a study of the netting of interest on federal tax overpayments and underpayments. Specifically, it provides as follows:

SEC. 1208. STUDY OF NETTING OF INTEREST ON OVERPAYMENTS AND LIABILITIES.

(a) IN GENERAL. -- The Secretary of the Treasury or his delegate shall --

(1) conduct a study of the manner in which the Internal Revenue Service has implemented the netting of interest on overpayments and underpayments and of the policy and administrative implications of global netting, and

(2) before submitting the report of such study, hold a public hearing to receive comments on the matters included in such study.

(b) REPORT. -- The report of such study shall be submitted not later than 6 months after the date of the enactment of this Act to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

The House Committee on Ways and Means Report sets forth the following reasons why this study was requested:

The Committee believes that it is important for the Committee to understand in detail how the IRS has implemented netting procedures to date. Congress has never adopted differential interest rates, or increased the amount of such differential, without at the same time also encouraging the IRS to implement comprehensive interest netting procedures. The Committee is concerned that the IRS has failed to implement comprehensive interest netting procedures and is interested in learning whether the delay stems from technical difficulties or substantive questions about the scope of such interest netting procedures.

H.R. Rep. No. 506, 103d Cong., 2d Sess. 50 (1996).

The Department of the Treasury initiated this study of interest netting before TBOR 2 was finally enacted. In Announcement 96-5, 1996-4 I.R.B. 99 (Jan. 22, 1996), Treasury and the IRS stated:

Treasury and the IRS are beginning a formal study of issues relating to the IRS's current and future interest netting procedures. Treasury and the IRS will soon issue a Notice that will ask for public comment on specific legal and administrative issues.

1996-4 I.R.B. at 101.

The particular issues on which Treasury and the IRS requested public comments in connection with this study were identified in Notice 96-18, 1996-14 I.R.B. 27 (April 1, 1996), a copy of which is included as Appendix One to this report. The IRS received twelve written comments from interested parties in response to Notice 96-18. A list of the persons who provided comments is set forth in Appendix Two to this report, and the comments they submitted are available for public inspection at the IRS in Washington, D.C. Further, in accordance with the statutory requirements of TBOR 2, a public hearing was announced on August 19, 1996, see Announcement 96-75, 1996-34 I.R.B. 29, and was held on September 4, 1996, in Washington D.C. A list of the five persons who testified at that hearing is set forth in Appendix Three.

The study of these issues was performed primarily by the Department of the Treasury's Office of Tax Policy and the IRS. The comments and testimony of the interested parties noted above have been carefully taken into account in this study and in the preparation of this report. Treasury and the IRS wish to thank all those who submitted comments or testified in connection with this study. We appreciate the public's willingness to assist us in examining the policy, legal, and administrative issues related to the IRS's interest netting practices.

BACKGROUND

Determining the amount of interest owed to or by taxpayers in connection with their federal tax liabilities may involve relatively complicated and time-consuming computations for both taxpayers and the IRS. The complexity of such calculations is primarily due to the interaction of the Internal Revenue Code^{1/} provisions governing interest on tax liabilities with other, more general, procedural provisions of the Code. Accordingly, any study of current interest netting procedures must commence with a review of these basic concepts and Code provisions.

This section first examines the authorities in the Internal Revenue Code that govern the manner in which the IRS handles each taxpayer's account. These provisions reflect an historical concept that each kind of tax due, for each period, from each taxpayer is a separate and distinct liability.

This section then reviews the relevant statutory rules governing the calculation of interest with respect to federal tax liabilities. These rules are found in sections 6601 and 6611 of the Internal Revenue Code. It then focuses on section 6621 and the changes that have been made to that provision since 1986. The "interest netting issue" can be traced largely to the interest rates set by this provision. Specifically, the interest netting issue derives from the fact that taxpayers are both charged interest on their unpaid tax liabilities and paid interest on their overpayments of taxes. If the interest rates on underpayments and overpayments are the same, then the net interest due or payable will be zero whenever underpayments and overpayments overlap in time and dollar amounts. If the underpayment and overpayment interest rates are not equal, however, then the method by which imbalances are applied against each other can be critical in determining whether there is any net interest due or payable.

This report focuses on federal income taxes. The same concepts and statutory provisions generally apply, however, to federal employment, excise, gift, and estate taxes, although those taxes may be subject to different technical rules.

Basic concepts

One of the most fundamental principles of federal income taxation, which Congress and the courts have repeatedly endorsed, is that each taxpayer's income tax liability for a single tax year is a separate and distinct liability. Although this is not a necessary feature of an income tax -- some tax theorists have argued that the most appropriate tax base may be income over the course of the taxpayer's lifetime rather than just in a single year -- it is a basic convenience that makes our current system manageable. The Code is structured to reflect this central concept, and a substantial amount of federal tax practice and procedure turns on it.

^{1/} Except where otherwise noted, all references to the "Code" or "IRC" are to the Internal Revenue Code of 1986.

For instance, the Code generally requires that taxable income of every taxpayer must be computed on the basis of that taxpayer's taxable year, see IRC § 441(a), and that each taxpayer must prepare and file returns on an annual basis, see IRC §§ 6012, 6072. Courts have also routinely held that the liability for each year's tax from each taxpayer constitutes a separate cause of action or claim for relief. Commissioner v. Sunnen, 333 U.S. 591 (1948). This rule prevents taxpayers from litigating a single year's tax in multiple court proceedings (*i.e.*, "splitting" a cause of action), and it has significant consequences for res judicata and collateral estoppel purposes.

In implementing its responsibility to assess and collect all federal income taxes, see generally IRC §§ 6201, 6301, the IRS has generally adhered to the concept that every tax liability for a single tax year is separate and distinct. For example, the IRS's main computer system for tracking taxpayer accounts (the "Master File") is organized by "modules," each of which represents a taxpayer's liability for a specific kind of tax (*e.g.*, income or employment taxes) for a single tax period (tax year or quarter). Income tax examinations are typically devoted to a selected cycle of years (modules) for the taxpayer under examination.

While the Code and the Treasury Regulations contain literally hundreds of provisions that implement the fundamental legal and accounting concept that each liability is separate and distinct, they also provide a number of exceptions to this general principle. For example, the installment sale provisions, see IRC § 453 et seq., the inventory accounting rules, see IRC § 471 et seq., the original issue discount provisions, see IRC § 1271 et seq., and even the elementary distinction between expenditures that must be capitalized and those that can be deducted as "ordinary and necessary" business expenses are all intended to reflect economic reality better than the annual income accounting concept would otherwise permit. Similarly, the rules permitting carryovers and carrybacks of net operating loss deductions or certain credits between tax years, see IRC §§ 172, 39, illustrate Congress's recognition that, without some provision for relief, the annual income tax concept could potentially lead to arbitrary or distorted results. See, e.g., Libson Shops, Inc. v. Koehler, 353 U.S. 382, 386 (1957) (carrybacks "ameliorate the unduly drastic consequences of taxing income strictly on an annual basis").

The Code also grants the IRS some discretion concerning how to apply overpayments made by a taxpayer to the taxpayer's outstanding liabilities for different periods. Section 6402(a) authorizes the Secretary to credit or refund certain overpayments by taxpayers:

In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to subsections (c) and (d), refund any balance to such person.

IRC § 6402(a). This provision uses the permissive term "may" when referring to the Secretary's offset authority; by contrast, refund of overpayments is made mandatory by use of the term "shall." Similarly,

In the case of a tax payable in installments, if the taxpayer has paid as an installment of the tax more than the amount determined to be the correct amount of such installment, the overpayment shall be credited against the unpaid installments, if any.

IRC § 6403.

As further evidence that each tax liability is considered separate and distinct, the Code provides for the payment of interest on every tax liability -- interest to the taxpayer in the case of an overpayment of tax and interest to the Government in the case of an underpayment of tax. See generally IRC §§ 6601, 6611.

Pre-1986 interest rules

While interest has been charged on underpayments of federal taxes since shortly after the Civil War, it was not until 1921 that interest was provided for overpayments of federal taxes. In 1921, Congress set the rate for overpayment interest at one-half of one percent per month (6% per annum), the same as the existing underpayment interest rate. Internal Revenue Act of 1921, Pub. L. No. 67-98, § 1324, 42 Stat. 227, 316. At times between 1921 and 1935, the underpayment interest rates for estate taxes and excise taxes were raised to encourage taxpayers to pay those taxes promptly. E.g., Internal Revenue Act of 1924, Pub. L. No. 68-176, § 274(f), 43 Stat. 253, 297; H.R. Rep. No. 179, 68th Cong., 1st Sess. 30 (1924). Conversely, on at least one occasion, Congress eliminated interest on overpayments of excise taxes “to discourage delay in claiming credit or refund and to discourage litigation.” H.R. Rep. No. 708, 72d Cong., 1st Sess. 39 (1932); Revenue Bill of 1932, Pub. L. No. 72-154, § 621(c), 47 Stat. 169, 268. Generally, however, from 1939 until 1986 the overpayment and underpayment rates were the same for all taxes. Special treatment -- and special interest rates -- have persisted for certain taxes; for instance, a special 4% rate still applies to certain estate taxes for which the payment date is extended. See IRC §§ 6601(j), 6166.

Since 1954, the Code has provided that taxpayers who underpay their taxes generally must pay interest to the Government on the amount of the underpayment for the period running from the date payment was due until the date payment is made. Section 6601(a) of the Code provides:

GENERAL RULE.--If any amount of tax imposed by this title (whether required to be shown on a return, or to be paid by stamp or by some other method) is not paid on or before the last date prescribed for payment, interest on such amount at the underpayment rate established under section 6621 shall be paid for the period from such last date to the date paid.

Likewise, if a taxpayer has overpaid taxes, the Code provides that the Government shall pay interest on the overpaid amount for the period beginning with the date of the overpayment and ending when the overpayment is credited or refunded to the taxpayer. Section 6611(a) provides that “[i]nterest shall be allowed and paid upon any overpayment in respect of any internal revenue tax at the overpayment rate established under section 6621.” Section 6611(b) states that:

PERIOD.--Such interest shall be allowed and paid as follows:

(1) CREDITS.--In the case of a credit, from the date of the overpayment to the due date of the amount against which the credit is taken.

(2) REFUNDS.--In the case of a refund, from the date of the overpayment to a date (to be determined by the Secretary) preceding the date of the refund check by not more than 30 days.

Interest running in either direction has, since 1982, been compounded daily. IRC § 6622(a).

The running of interest in either direction can be suspended for various reasons. For example, if the Commissioner makes notice and demand for the payment of taxes, and the tax is paid within 21 calendar days after the date of the notice and demand (10 business days if the amount due exceeds \$100,000), then interest is not imposed for the period after the date of the notice and demand. IRC § 6601(e)(3) (as amended by TBOR 2). Similarly, the Government is not liable to the taxpayer for interest on an overpayment if the overpayment is refunded or credited within 45 days after the due date for filing the return of such tax, or if the Government otherwise pays a taxpayer's claim for refund within 45 days after it is filed. IRC §§ 6611(e)(1), (e)(2).

Interest computations can be substantially complicated by the presence of carryover tax attributes from another tax year. For example, if a net operating loss deduction is carried back to a tax year pursuant to section 172, or a credit is carried back pursuant to section 39, interest on a resulting overpayment in the carryback year will generally not begin to run until the due date of the return for the credit or loss year. IRC § 6611(f). Likewise, if an underpayment for one tax year is reduced due to such a carryback from another year, interest is still due on the full underpayment amount up through the due date of the return for the credit or loss year and on the reduced underpayment amount only after that date. IRC § 6601(d).

Certain interest is statutorily prohibited or is limited to specific time periods as a matter of law. These "restricted interest" computations can be particularly complex for large corporate taxpayers, which commonly have multiple carrybacks and carryovers of different credits and deductions over any given period of years and are subject to multi-year audits. As will be discussed in more detail below, the IRS does not have the capability to perform all restricted interest computations automatically on its Master File system. Instead, many of these complex calculations must be performed manually (*i.e.*, using stand-alone computer or calculator systems with data manually inputted).

IRS administration of these rules before 1986

As noted above, section 6402(a) of the Code permits the IRS to credit a taxpayer's overpayment of one tax liability against a liability for another tax. The Treasury Regulations have long provided for the crediting of overpayments against underpayments in accordance with this provision. The pertinent regulation, Treas. Reg. § 301.6402-1, provides:

The Commissioner, within the applicable period of limitations, may credit any overpayment of tax, including interest thereon, against any outstanding liability for any tax (or for any interest, additional amount, addition to the tax, or assessable penalty) owed by the person making the overpayment and the balance, if any, shall be refunded, subject to subsection 6402(c) and (d) and the regulations thereunder, to that person by the Commissioner.

In accordance with the regulation, the IRS has generally implemented section 6402(a) by applying overpayments only against a taxpayer's other outstanding (unpaid) liabilities. See generally IRM (22)000. If an outstanding underpayment for one kind of tax or tax period exists at the same time that the taxpayer has an overpayment for a different tax or period, the IRS will usually apply the balance of the overpayment against the underpayment before refunding any amount to the taxpayer. If more than one such underpayment exists, the overpayment will generally be applied to the "oldest" underpayment (the one that arose earliest in time) in order to reduce the accrual of further underpayment interest due from the taxpayer. If there are no currently outstanding liabilities at the time the overpayment arises, the IRS will refund the overpayment to the taxpayer. The IRS refers to the procedure described in this paragraph as "offsetting," and henceforth in this study that term will be reserved for this practice.

Offsetting -- crediting an overpayment against an outstanding liability pursuant to section 6402(a) -- has been performed by the IRS for many years. Indeed, offsetting is performed automatically at the Master File when an overpayment and an outstanding underpayment register on the system simultaneously. Courts have confirmed, however, that offsetting under section 6402(a) is discretionary; the IRS is permitted to offset overpayments against deficiencies but is not required to do so. Northern States Power v. United States, 73 F.3d 764 (8th Cir.), cert. denied, 117 S.Ct. 168 (1996); Kalb v. United States, 505 F.2d 506, 509 (2d Cir. 1974), cert. denied, 421 U.S. 979 (1975); Acker v. United States, 519 F.Supp. 178, 182 (N.D. Ohio 1981); Mounts v. United States, 95-2 U.S.T.C. (CCH) ¶ 50,399 (S.D.W.Va. 1995).

A special interest rule applies in the offsetting situation. Section 6601(f) provides:

If any portion of a tax is satisfied by credit of an overpayment, then no interest shall be imposed under this section on the portion of the tax so satisfied for any period during which, if the credit had not been made, interest would have been allowable with respect to such overpayment.

Ordinarily, interest on an underpayment would be charged to a taxpayer under section 6601 irrespective of the existence of other overpayments by the same taxpayer; likewise, interest on an overpayment would ordinarily accrue to the benefit of the taxpayer pursuant to section 6611 regardless of the existence of the taxpayer's other underpayments. If the underpayment interest rate and the overpayment interest rate are equal, then, to the extent that the underpayment and the overpayment overlap temporally (i.e., exist at the same time) and in amount, the interest calculations are duplicative. When an underpayment is satisfied by the application of an overpayment by the same

taxpayer, pursuant to section 6402(a), then section 6601(f) permits the IRS to avoid computing interest on the underpayment for the amount and period of mutual indebtedness.

An example is perhaps the best way to illustrate the interaction of the interest rules with sections 6402(a) and 6601(f). Assume that a taxpayer had an underpayment (i.e., owed tax) in the amount of \$1,000 for tax year 1983, starting with the return filing date of April 15, 1984. Assume further that the taxpayer had an overpayment (i.e., was entitled to a refund) of \$600 for 1984, starting with the return filing date of April 15, 1985. Finally, assume that the computations are being made as of April 15, 1986, and that the interest rate for both overpayment and underpayment interest is 6%.^{2/}

Ordinarily, the taxpayer would owe underpayment interest on the 1983 deficiency of \$1,000 for the two-year period from April 15, 1984 through April 15, 1986, computed as follows:

Tax due 4/15/84	=	\$1,000.00
Interest 4/15/84 - 4/15/85: \$1,000 x 6%	=	\$60.00
Interest 4/15/85 - 4/15/86: \$1,060 x 6%	=	<u>\$63.60</u>
Total interest	=	<u>\$123.60</u>
Total tax plus interest due as of 4/15/86	=	\$1,123.60

The Government would also owe the taxpayer interest on the 1984 overpayment of \$600 for the one-year period from April 15, 1985, through April 15, 1986, as follows:

Overpayment arises 4/15/85	=	\$600.00
Interest 4/15/85 - 4/15/86: \$600 x 6%	=	<u>\$36.00</u>
Total refund plus interest as of 4/15/86	=	\$636.00

When the amount owed by the taxpayer is netted against the money owed to the taxpayer, the net underpayment as of April 15, 1986 equals \$1,123.60 minus \$636.00, or \$487.60.

^{2/} This example makes certain simplifying assumptions. For instance, in the example interest is compounded only on an annual basis, whereas the Code requires that it be compounded daily, see IRC § 6622(a). Likewise, interest rates may actually vary on a quarterly basis as the Federal short-term rate fluctuates, see IRC § 6621(b), although this rule did not apply to the years in the example. A constant 6% rate is used here simply for hypothetical purposes.

From an overall perspective, as of April 15, 1985, the taxpayer really owed the Government only \$460, consisting of \$400 in tax (i.e., the \$1,000 deficiency for 1983, less the \$600 refund due for 1984) plus \$60 in interest (6% interest on the \$1,000 deficiency for the period April 15, 1984 through April 15, 1985). While the Code treats the two tax amounts as separate, section 6402(a) permits the IRS to offset the \$600 overpayment against the \$1,000 outstanding deficiency as soon as it becomes available (i.e., on April 15, 1985). Pursuant to section 6601(f), the taxpayer is not charged underpayment interest to the extent of the offset amount during the period of mutual indebtedness, or between April 15, 1985 and April 15, 1986. Instead, during that period the taxpayer owes interest only on the net balance due. Interest will accordingly be calculated as follows:

Tax due 4/15/84	= \$1,000.00
Interest 4/15/84 - 4/15/85: \$1,000 x 6%	= <u>\$60.00</u>
Total tax plus interest due as of 4/15/85	= \$1,060.00
Credit for overpayment as of 4/15/85	= <u>(\$600.00)</u>
Adjusted tax plus interest due as of 4/15/85	= \$460.00
Interest 4/15/85 - 4/15/86: \$460 x 6%	= <u>\$27.60</u>
Net underpayment as of 4/15/86	= \$487.60

As this example illustrates, both methods ultimately arrive at the same net underpayment figure for the taxpayer. This is because calculating interest on two amounts and then netting the results will always mathematically yield the same figure as first netting the amounts and then doing the interest computation, assuming the rates used are the same in both instances.^{3/} The calculations of interest become slightly more complex, however, and the application of netting principles becomes more important, because of the new interest rate rules that Congress enacted in 1986 and subsequent years.

1986 and subsequent changes in interest rules

In 1986, Congress for the first time enacted different rates of interest for underpayments and overpayments, providing that the interest rate on tax underpayments was to equal the Federal short-

^{3/} Mathematically, for interest rate “Y” and tax amounts “A” and “B,” then for any period of time:

$$Y \times (A + B) = (Y \times A) + (Y \times B).$$

This will continue to hold true if “A” is a positive value (tax owed to the Government) and “B” a negative one (refund owed to the taxpayer), or vice versa.

term rate plus 3 percentage points, while the interest rate on tax overpayments was to equal the Federal short-term rate plus 2 percentage points. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1511(a), 100 Stat. 2085, 2744 (1986). The 1986 amendment to section 6621 applies for purposes of determining interest for periods after December 31, 1986. *Id.*, § 1511(b). This means, in effect, that the different rates apply to the balances due and balances payable (*i.e.*, both underpayments and overpayments) for all pre-1986 tax years that were still outstanding as of the end of 1986, as well as to new tax liabilities that arose after 1986.

Congress increased the section 6621 underpayment rate for large corporate underpayments in 1990. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11341(a), 104 Stat. 1388, 1388-470. Under this provision, if a C corporation has an underpayment for any tax period that exceeds \$100,000, the applicable underpayment rate of interest is the Federal short-term rate plus 5 percentage points, rather than the Federal short-term rate plus 3 points that applies to other underpayments. IRC § 6621(c)(1), (3).

In 1994, Congress again amended the interest provisions, reducing the interest payable to large corporate taxpayers on certain overpayments under section 6621(a) by 1.5 percentage points. Uruguay Round Agreements Act, Pub. L. No. 103-465, §713, 108 Stat. 4809, 5001 (1994). Under the revised provision, the interest payable on corporate overpayments of more than \$10,000 is reduced from the Federal short-term rate plus 2 percentage points to the Federal short-term rate plus 0.5 percentage points. IRC § 6621(a)(1)(last sentence).

As a consequence of these amendments, the differential between the interest rate paid by the Government on large corporate overpayments (under section 6621(a)) and the maximum interest rate paid by C corporations on large corporate underpayments (under section 6621(c)) is now 4.5 percentage points.

Changes in the IRS administration of interest

The IRS has improved its administration of the new interest rate structure since 1986. First, offsetting has become more critical since the interest rate differential of section 6621 was enacted. To the extent an underpayment and an overpayment overlap in time and amount, section 6601(f) operates to nullify the interest rate differential. In accordance with that provision, no interest is imposed on the portion of an underpayment that is satisfied by the offsetting application of an overpayment from another tax period. Likewise, no overpayment interest is paid to the taxpayer with respect to the offset amount and period. Section 6601(f) thus has the effect of completely eliminating the interest rate differential with respect to the amount that is offset for the period of the overlap in time. However, the interest rate differential continues to be an issue to the extent an underpayment is not fully satisfied by the crediting of an overpayment.

The IRS has also implemented enhanced interest netting procedures in Rev. Proc. 94-60, 1994-2 C.B. 774. Under this procedure, which is referred to as “annual” interest netting, the IRS will consider all increases and decreases in a taxpayer’s liabilities within a single tax year before applying

the statutory interest rate to the resulting net underpayment or overpayment for that year.^{4/} As a consequence, the taxpayer ultimately gets charged only one interest rate, depending on the net balance at the time of the adjustment. Support for this approach lies in the concept that a taxpayer does not really have an “underpayment” or “overpayment” of a particular kind of tax for a given tax period until the correct amount of tax for that period is finally determined. See generally IRC § 6211 (definition of “deficiency”).

The IRS’s position, however, is that it still does not perform “global” interest netting. The global netting situation is somewhat similar to the offsetting situation in theory, for it involves utilizing (at least for interest purposes) a taxpayer’s overpayment of one tax liability to affect the taxpayer’s underpayment of another tax liability. Unlike offsetting, however, the balance (underpayment or overpayment) for one of the taxes that is going to be utilized in the computation has already been paid, and there is neither any further tax or interest due from the taxpayer, nor any tax or interest payable by the Government, with respect to that tax. In a global netting computation, in other words, the balance in one of the tax accounts equals zero. The IRS’s position is that it will perform offsetting only, not global netting. Overpayments will be applied against underpayments *only* if the overpayment and the underpayment are both *outstanding*, *i.e.*, not in a zero balance, at the time of the computation. See Treas. Reg. § 301.6402-1.

Several commentators have alleged that offsetting is applied inconsistently by IRS Field Offices and Service Centers, that offsetting is sometimes used as a negotiating chip against taxpayers in settling cases at Appeals, or that some local offices will perform global netting while others will not. Although Treasury and the IRS National Office are aware of these complaints, we believe offsetting is generally performed properly and are unaware of actual instances where true global netting has been performed. It bears repeating that the Master File is programmed to perform offsetting automatically, and we are unaware of circumstances where it has not done so. By contrast, no Master File mechanism exists for global netting (quite apart from the uncertain legal authority or the capability of IRS employees to perform it). It is also possible that the complaints are caused by some confusion over terminology. Situations in which comprehensive offsetting has occurred may have been erroneously characterized as “global” netting, leaving other taxpayers to complain that their requests for actual global netting have been unfairly denied.

At any rate, in response to the request of many commentators, Treasury and the IRS wish to make very clear the current IRS policy with respect to offsetting. It is the IRS’s policy to maximize offsetting, and the resulting interest savings to taxpayers, whenever there is a true offsetting situation, *i.e.*, whenever overpayments and underpayments are simultaneously outstanding.

Because the IRS has already implemented interest netting in many situations in accordance with Congress’s directions, global netting presently remains the only significant form of netting that

^{4/} The IRS has long had procedures for applying and computing restricted interest within a single tax year. See Rev. Proc. 60-17, § 3, 1960-2 C.B. 942.

the IRS has not yet adopted. Thus, global netting, and in particular the policy, legal, and administrative issues related to it, is the principal focus of the remainder of this report.

Other developments

Several civil tax cases have recently considered interest netting issues, although two involved offsetting and only one clearly addressed the global netting situation. In Pettibone Corp. v. United States, 34 F.3d 536 (7th Cir. 1994), the IRS examined the corporate taxpayer's income taxes for the 13-year period preceding its bankruptcy. The taxpayer and the IRS agreed to the amounts of underpayments and overpayments for each year, many of which resulted from net operating loss carrybacks. 34 F.3d at 539. The IRS "netted these overpayments and underpayments to establish the total tax liability" by "*following its established procedures*" under section 6402(a). 34 F.3d at 538 (emphasis added). The court ultimately held that such netting did not amount to a prohibited setoff under the Bankruptcy Code.

Focusing on the court's shorthand summary of the Government's argument ("the IRS argued for continuous netting of overpayments, underpayments, and interest on the balance"), several commentators have assumed that Pettibone involved global netting and have concluded that the IRS does indeed perform global netting on a selective basis. A similar argument was made by the taxpayer in Northern States Power Co. v. United States, 73 F.3d 764 (8th Cir.), *cert. denied*, 117 S.Ct. 168 (1996). As the court in Northern States Power realized, however, that contention is erroneous. Close reading of the Pettibone case clearly demonstrates that offsetting, not global netting, was at issue: the netting involved the crediting of outstanding overpayments against outstanding underpayments pursuant to section 6402(a). As a consequence, "nothing in that decision [Pettibone] suggests netting is required when past underpayments have already been fully paid." 73 F.3d at 769.

Some commentators have similarly suggested that another case demonstrates that the IRS occasionally performs global netting. See United States v. Midway Industrial Contractors, Inc. (In re Midway Industrial Contractors, Inc.), 178 Bankr. 734 (N.D. Ill. 1995). Again, however, Midway involved offsetting with respect to unpaid (outstanding) liabilities pursuant to sections 6402(a) and 6411(b) (relating to tentative refund adjustments). See 178 Bankr. at 735-36. Thus Midway is not a global netting case.

The only case to have addressed true global netting is Northern States Power. In that case, five years (1980 through 1984, inclusive) were at issue, and the taxpayer had initially overpaid for two of them (1981 and 1982). In 1990, the IRS proposed deficiencies for four of the years (1980, 1981, 1983, and 1984), and although the taxpayer disagreed with the deficiencies, it promptly paid them. The parties ultimately agreed that the deficiencies totaled less than the amounts paid, and they stipulated to the amount of the overpayments for all five years. 73 F.3d at 765. Global netting was involved because the taxpayer argued that the IRS should credit its 1981 and 1982 overpayments to the agreed deficiencies for 1980, 1983, and 1984 as of the time those deficiencies arose (the return due dates for the deficiency years), even though at those times the 1980, 1983 and 1984 tax years did not have any underpayments due and bore zero balances.

The Government argued that overpayments can only be credited against “outstanding” liabilities pursuant to section 6402(a) and Treas. Reg. § 301.6402-1, and moreover that such crediting was at the IRS’s discretion. The Eighth Circuit agreed on both counts. With respect to the authority for crediting in such situations, the Court stated:

We agree with the United States that the word “liability” in Section 6402 means “*outstanding* liability,” one that is unpaid when the credit is made. The Treasury regulations support this reading, *see* 26 C.F.R. § 301.6402-1 (referring to an “outstanding liability”), and we properly defer to these regulations. *See Cottage Savings Ass’n v. Commissioner*, 499 U.S. 554, 560-61 (1991) (courts “must defer to [the Commissioner’s] regulatory interpretations of the Code so long as they are reasonable”); *Miller v. United States*, 65 F.3d 687, 689 (8th Cir. 1995) (same). This is also the reading that makes the most sense, because only an outstanding liability can be “satisfied” by a credit. *See* IRC § 6601(f). NSP provides no support, other than a strained reading of miscellaneous bits of legislative history, for its assertion that section 6402(a) is somehow “time-neutral,” that a “liability” may be one that no longer exists, but once did. We think this argument withers before the statute’s plain meaning. We are likewise not convinced by NSP’s attempt to read the word “outstanding” out of the relevant Treasury regulation, 26 C.F.R. § 301.6401-2. In our view, the regulation means what it says.

So there must be an outstanding tax liability, against which an overpayment may be credited, before section 6402’s netting exception comes into play.

73 F.3d at 767 (emphasis in original). The court also agreed with the Government’s claim that crediting under section 6402(a) was discretionary:

even assuming [an outstanding] liability, the IRS has discretion whether to credit an overpayment to that liability or not. Section 6402 is clear: the IRS “*may* credit the amount of such overpayment . . . against any liability.”

Id. (emphasis in original). The court summarized its holding as follows:

Thus, the IRS may credit an overpayment against an outstanding liability, and, if it does, section 6601(f)’s netting provision comes into play. In this case, however, not only has the IRS apparently chosen not to credit the overpayments, there were no outstanding liabilities against which the overpayments might be credited. . . . Under section 6402, then, the IRS could not credit the overpayments, and so section 6601(f)’s netting rule does not apply.

73 F.3d at 768.

The holding of *Northern States Power* set forth above reflects the IRS’s view of the law with respect to global netting. This report now turns to the policy, legal, and administrative issues that would be raised if the IRS’s interest netting practices were expanded to cover global netting.

TAX POLICY ISSUES INVOLVED IN INTEREST NETTING

The practice of interest netting, and in particular global netting, involves several different, and sometimes competing, tax policies. The basic requirement that interest be paid on imbalances in federal tax accounts is premised on fundamental economic concepts regarding the use of money. Related considerations underlie the post-1986 differential in the interest rates for overpayment and underpayment interest. The use of netting to minimize that differential during periods of mutual indebtedness invokes another set of policy concerns. At one time or another in the legislative history of the interest rate provisions, Congress has mentioned all of these policy goals as justifications for its actions. Some of these underlying policies are, however, at least arguably incompatible.

This section discusses the various policy goals that are involved in the interest provisions of the Code, the interest differential, and Congress's countervailing desire for broader interest netting. It concludes by suggesting possible methods to reconcile these competing goals.

Policies underlying interest on taxes

“Interest” is fundamentally a charge or compensation for the use or forbearance of another’s money. See, e.g., Deputy v. DuPont, 308 U.S. 488, 498 (1940); Old Colony R. Co. v. Commissioner, 284 U.S. 552, 560 (1932). Courts have similarly stated that compensation for the use of money is the principal, or even the only, rationale for charging interest with respect to tax deficiencies or overpayments. See Manning v. Seeley Tube & Box Co., 338 U.S. 561 (1950); Avon Products, Inc. v. United States, 588 F.2d 342 (2d Cir. 1978); Alexander Proudfoot Co. v. United States, 454 F.2d 1379, 1384 (Ct. Cl. 1972); May Department Stores Co. v. United States, 36 Fed. Cl. 680 (1996). However, these broad statements subsume a number of related theories that individually may justify charging interest: that interest reflects the fungibility and time value of money; that it provides incentives for prompt satisfaction of debts; or that it is compensation for the risk of lending money and collecting unpaid debt.

First, the fungibility and time value of money provide a basic justification for interest on tax debts. A fundamental premise underlying financial markets is that a dollar payable in the future is worth less than a dollar paid today. The discount may be attributable to alternative investments (e.g., prevailing rates of return, including interest rates) as well as inflation and the parties’ expectations (concerning risk and the credit-worthiness of the debtor, etc.). Interest accordingly must be charged on any debt in order to leave the creditor whole. The failure to charge interest on a tax debt (underpayment or overpayment) for which payment is long-delayed would leave the creditor (either the Government or the taxpayer) worse off for having the right to be paid than if that party had been paid immediately and sought alternative investments.

Some courts have considered the time value of money, particularly the parties’ expectations concerning inflation, to be a primary purpose of the interest rules in the Code. For example, in Mounts v. United States, 95-2 U.S.T.C. (CCH) ¶ 50,399 (S.D.W.Va. 1995), the court, citing Latterman v. United States, 872 F.2d 564, 467 (3d Cir. 1989), stated:

the purpose of § 6601 is to allow the government to recover amounts due in ‘real’ (inflation-adjusted) dollars. . . . When a taxpayer owes the government money and delays payment after the date on which payment was due, the government should not have to suffer a depletion in real dollars because of that delay and, conversely, the taxpayer should not reap the benefit of delaying payments, thereby in effect diminishing the amount owed.

Interest also provides some incentive for the prompt satisfaction of debts. If taxpayers were not charged interest on their tax underpayments, they would not only lack incentives to pay their taxes promptly, they would in fact have a positive incentive *not* to pay promptly. Because money is fungible, it would be economically rational for them to use their funds for other investment purposes, for which they presumably could obtain a competitive market rate of return, and to delay satisfaction of their tax debts. The Government would have an incentive to do the same thing if interest were not charged to it and payable to taxpayers on tax overpayments.

Congress has long recognized the relationship between interest rates and the promptness with which tax debts are paid. E.g., H.R. Rep. No. 179, 68th Cong., 1st Sess. 30 (1924) (explaining that the Internal Revenue Act of 1924 raised underpayment rates to encourage payment). More recently, Congress implicitly recognized this when it permitted the interest rate on both underpayments and overpayments to “float” with market rates in 1979. See Act of December 29, 1979, Pub. L. No. 96-167, § 4(b), 93 Stat. 1275. It also expressly relied on this rationale in enacting the interest rate differential in 1986, stating that the lack of a differential “may cause taxpayers either to delay paying taxes as long as possible to take advantage of an excessively low rate” in comparison with the rest of the economy “or to overpay to take advantage of an excessively high rate.” H.R. Rep. No. 426, 99th Cong., 1st Sess. 849 (1985), reprinted in 1986-3 C.B. (Vol. 2) 849; S. Rep. No. 313, 99th Cong., 2d Sess. 184 (1986), reprinted in 1986-3 C.B. (Vol. 3) 184. Providing that a tax-related debt in either direction bears a market-related interest charge neutralizes (or at least reduces) the advantages that could otherwise be obtained by avoiding payment and investing elsewhere. Consequently, interest charges in both directions are necessary to prevent giving either taxpayers or the Government perverse incentives to fail to settle their tax accounts.

In the commercial world, interest also provides compensation for the risk of non-payment and the costs of collection. Thus, trustworthy borrowers with established credit histories can generally obtain loans at a lower interest rate than borrowers who may not be so reliable. Unlike interest on commercial debts, however, tax interest is not clearly related to risk or the creditworthiness of the “borrowing” party. This may be due in part to the fact that neither the Government nor the taxpayer has any choice but to deal with each other. There is no competitive market for taxes or tax debts. In particular, the Government typically has little choice whether it will “extend credit” to taxpayers who fail or refuse to pay their taxes. It must take on as its “customer” anyone who neglects or refuses to pay taxes in a timely fashion. Likewise, taxpayers cannot choose to pay taxes to another agency in order to obtain a better interest rate on their temporary overpayments. Nor does the Federal Government engage in the sale of tax debts in order to make such a market or shift the risk of non-collection, as some localities do for property tax debts. Finally, individualized negotiations

over the terms and conditions governing a tax debt, in particular the applicable interest rate, would plunge the system into administrative chaos. Flat statutory rates are a practical convenience needed to administer the tax system fairly.

In other ways, however, Congress has to some extent treated tax liabilities as if they were similar to ordinary commercial debts, and the Code reflects this treatment. For instance, in 1982 Congress repealed a provision that had prevented interest from compounding, as interest ordinarily does on commercial indebtedness, and revised the Code to provide specifically that interest must be compounded daily. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 344, 96 Stat. 324, 635; IRC § 6622(a). This treatment is also reflected in the requirement that interest be charged and paid on imbalances running in both directions. See H.R. Rep. No. 426, 99th Cong., 1st Sess. 849 (1985), reprinted in 1986-3 C.B. (Vol. 2) 849; S. Rep. No. 313, 99th Cong., 2d Sess. 184 (1986), reprinted in 1986-3 C.B. (Vol. 3) 184. If temporary imbalances in tax liabilities are treated just like other commercial transactions in the economy between parties that are independent, unrelated, and operating at arm's length, then it follows that an interest charge is appropriate. The interest requirement thus demonstrates Congress's belief that tax debts are simply a species of "loan" from the taxpayer to the Government (overpayments), or vice versa (underpayments).

Policies underlying differential interest rates

Section 6621 of the Code, the provision setting the interest rates, most clearly reflects Congress's determination to treat tax indebtedness in accordance with commercial concepts. Since 1986, section 6621(a) has set two different interest rates -- one for overpayments and another for underpayments.^{5/} Both rates are tied to the "Federal short-term rate," a rate defined in sections 6621(b) and 1274(d) that generally reflects short-term market interest rate conditions. The "basic" overpayment and underpayment rates differ by one percent: the overpayment rate equals the Federal short-term rate plus 2 percentage points, while the underpayment rate equals the Federal short-term rate plus 3 percentage points.

The rationale for enacting the one percent differential was set forth, in identical language, in the House Committee on Ways and Means report and the Senate Committee on Finance report that accompanied the 1986 amendment to section 6621:

The committee is concerned that [the Code's] interest provisions are not modeled sufficiently closely on other interest rates in the economy; this may have distortive effects. First, the committee is concerned that both the interest rate taxpayers pay the Treasury and the rate the Treasury pays to taxpayers are the same rate. Few financial institutions, commercial operations, or other entities borrow and lend money at the same rate. Thus, either the rate taxpayers pay the Treasury or the

^{5/} Post-1986 amendments to section 6621 have expanded on this basic structure, setting special rates for corporate overpayments to the extent they exceed \$10,000, see IRC § 6621(a)(1) (second sentence), and for "large corporate underpayments," see § 6621(c).

rate the Treasury pays taxpayers is necessarily out of line with general interest rates in the economy. This distortion may cause taxpayers either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate. Consequently, the committee has approved a one-percent differential between these two interest rates.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 849 (1985), reprinted in 1986-3 C.B. (Vol. 2) 849; S. Rep. No. 313, 99th Cong., 2d Sess. 184 (1986), reprinted in 1986-3 C.B. (Vol. 3) 184.

First, the committee reports highlight Congress's perception that a single interest rate for both underpayments and overpayments "is *necessarily* out of line with general interest rates in the economy" (emphasis added). If capital markets were perfect one might be able to borrow and lend at the same rate, but financial institutions and other commercial operations in fact employ different rates depending on whether they are borrowing or lending. (The differences may be due to market imperfection and the assumption by lenders of the risk of non-payment.) Thus prevailing market rates for borrowing and lending differ. Using a single rate for both borrowing and lending, as the United States had been doing prior to 1986 for tax underpayments and overpayments, inevitably means that the rate used will differ from at least one, or perhaps both, of the prevailing rates for those activities in the rest of the economy. According to the Congressional reports, using different rates for overpayments and underpayments is necessary to avoid, or at least reduce, the inevitable distortion that would come from using a single rate.

Further, this discussion indicates Congress's concern that the potential for distortion between tax interest rates and other interest rates in the economy could lead sophisticated taxpayers to manipulate their tax liabilities into an overpayment or underpayment posture in order to maximize the differential with available returns in the rest of the economy. Congress thus recognized that, while some such arbitrage opportunities were unavoidable, they should be minimized to the extent possible. Otherwise, taxpayers might delay paying taxes, if the underpayment rate were too low relative to prevailing rates in the economy, or overpay their taxes, if the overpayment rate were excessively high. Imposing differential interest rates more in keeping with the prevailing economic rates reduces the incentive to indulge in such manipulations.

Finally, this excerpt indicates that Congress felt the IRS should act more like "financial institutions, commercial operations, or other entities" that "borrow and lend money" at differing rates. This reinforces the view that Congress thought of tax debts in commercial terms, treating an underpayment as if it were a loan from the Government to the taxpayer and an overpayment as a borrowing by the Government from the taxpayer. It follows from the analogy to financial or commercial institutions that the Government, like any other commercial entity in the marketplace, should charge a higher interest rate on the money it lends (underpayments) than on the money it borrows (overpayments), which is precisely what Congress enacted.

It is interesting to note that in enacting an interest differential for tax debts Congress never mentioned one of the principal factors that drives interest charges in the marketplace, the relative risk

of a loan and the creditworthiness of a potential debtor. As noted above, this is probably in part because there is no market for taxes or individualized negotiation of tax interest rates. Further, the underpayment and overpayment interest rates do not reflect the real risk of non-payment to either the Government or taxpayers. For example, Congress has imposed on the United States an overpayment interest rate that exceeds the “risk-free” rate that the Government pays when it borrows on the open market. See IRC §§ 6621(a), 1274(d) (defining applicable Federal rates by reference to marketable obligations of the United States, which are essentially risk-free). If risk or creditworthiness were considered, however, the underpayment rates would vary with the borrower, as commercial loans do, and the overpayment rate would reflect only the applicable Federal rates, since the risk of non-payment by the Government is essentially zero. Risk and creditworthiness thus do not appear to be reflected in the interest rates Congress has chosen with respect to tax debts.

Policies underlying interest netting

In the economy as a whole, most participants are simultaneously both borrowers and lenders to some extent. It is commonplace for commercial entities to owe each other overlapping or offsetting debts, particularly in longstanding or established business relationships, such as that between a bank and its customer, a wholesaler and a retail merchant, or two firms that provide services to each other. Most individuals likewise have some savings or investment accounts that pay them interest at the same time they are paying interest on automobile loans or home mortgages.

It may be questioned whether the fungibility and time value of money rationales for charging interest that are discussed above make sense when two economic entities simultaneously owe each other offsetting liabilities. To the extent of the overlapping indebtedness, neither party really has the use of the other’s funds, since the amounts negate each other for a period of time. Interest clearly continues to provide some insurance against the risk of non-collection and some incentives for timely payment (or penalties for untimely payment). But at least to the extent of the overlapping indebtedness, these risks and incentives also offset each other. Further, the same goals can be accomplished through self-help, *i.e.*, non-payment or direct offset of the common amounts (although such self-help may have collateral costs or may not be permitted by law). Thus the fungibility and time value of money rationales for a net interest charge may not be persuasive.

In most situations in our economy, however, the fact that two parties have overlapping or offsetting liabilities to each other does not prevent the separate accrual of interest on each debt. Ordinarily, the two liabilities are accounted for separately; the debts are not set off against each other before principal and interest are paid, nor typically are the interest payments themselves netted.

In part, the general failure to net offsetting liabilities is due to the wide diversity of the kinds of accounts that parties in a complex economy may have with each other and the difficulty of relating those accounts for bookkeeping purposes. Consider, for example, an individual investor who holds a bond of the same major corporation from which the investor buys and finances an automobile. The bond (which is essentially a loan from the investor to the corporation) and the automobile financing indebtedness (a loan from the corporation to the individual) will likely have dramatically different

terms, accruing and paying interest at different times and using different rates, amortization schedules, methods of payment, etc. Further, the two debts may be entered with different corporate subsidiaries and, because both obligations may be freely traded in secondary markets, their owners may change more or less frequently. The practical difficulties of offsetting such simultaneous debts before computing and paying a “net” principal or interest amount would in cases like this be nearly insurmountable. Multiply this complexity millions of times throughout the economy and the general failure to net principal or interest payments is easily understandable.

Even in an ongoing relationship between just two parties, however, netting of offsetting liabilities is not the ordinary commercial practice. Banks or other financial institutions typically do not net the principal amounts of deposits and loans involving the same customer before computing the net interest due, nor do they directly net the two interest payments themselves, even though the bookkeeping for such netting would be comparatively simple and could in many cases be performed by a single accounting function within the bank. Indeed, netting is the exception rather than the rule, for the most part limited to the relatively rare situations in which the parties are making a final settlement of their debts against each other and discontinuing further business -- for example, upon the bankruptcy or other debt restructuring of one of the parties.

The Code similarly anticipates that in general each federal tax will be treated as a separate liability and will be accounted for separately. Courts have thus frequently held that different kinds of taxes (such as excise, income, or employment taxes) are different liabilities that are not accounted for together. E.g., United States v. Hecla Mining Co., 302 F.2d 204, 213 (9th Cir. 1961); Babcock & Wilcox C. v. Pedrick, 212 F.2d 645, 649 (2d Cir. 1954); W.G. Duncan Coal Co. v. Glenn, 120 F.Supp. 948, 949-50 (D. Ky. 1952).^{6/} Even in the income tax context, the Code is structured around the annual accounting concept and the notion that each tax year’s tax liability is separate. As noted previously, there are many exceptions to this basic structure -- net operating loss and business credit carrybacks and carryforwards, offsets under § 6402(a), etc. -- but they are the exceptions, not the general rule.

Congress recognized that, because of the separate accounting for separate tax liabilities, taxpayers can simultaneously be underpaid with respect to some taxes and overpaid with respect to others. It provided early on for some degree of netting if the Government found itself in a situation of mutual indebtedness with a taxpayer. For example, in the predecessor to section 6402(a) of the Code, the Internal Revenue Code of 1939 provided that overpayments of income tax “shall be credited against any income, war-profits, or excess-profits tax or installment thereof then due from the taxpayer, and any balance shall be refunded.” Internal Revenue Code of 1939, § 322(a), 53 Stat.

^{6/} These cases involved the issue whether offsetting and the resulting interest netting was required where the taxpayers had offsetting liabilities for different taxes, such as income taxes and excess profits tax. The courts found that offsetting was not required in these situations. As discussed below, however, the cases involved tax years prior to the inclusion of sections 6402(a) and 6601(f) of the Code. Under current law, the separate liabilities discussed in the cases could at the IRS’s discretion be offset against each other pursuant to those provisions.

1, 91. In 1949, Congress added a discretionary element to this crediting procedure, providing that “the Commissioner may, in his discretion, in lieu of refunding an overpayment of tax . . . credit such overpayment against any tax due from the taxpayer.” Act of August 27, 1949, § 9, 63 Stat. 666, 669 (adding § 3770(a)(4) to the Internal Revenue Code of 1939). These provisions were merged into section 6402(a) of the Code in 1954, and, as discussed previously, the offsetting procedure described by that provision has remained in place since then.

Congress likewise has recognized that such mutual liabilities were tantamount to overlapping loans between the parties. Unlike the typical commercial situation where parties have offsetting debts with each other, taxpayers who are both borrowers and lenders with respect to the Government -- who have both underpaid taxes and overpaid taxes -- are accorded the benefits of netting in some situations pursuant to section 6601(f). Congress discussed this precise scenario in the legislative history of the 1986 amendment to section 6621:

Section 6601(f) provides that, to the extent a portion of tax due is satisfied by a credit of an overpayment, no interest is imposed on that portion of the tax. Consequently, if an underpayment of \$1,000 occurs in year 1 and an overpayment of \$1,000 occurs in year 2, no interest is imposed in year 2 because of the rule in section 6601(f).

H.R. Conf. Rep. 841, 99th Cong., 2d Sess. II-785 (1986), reprinted in 1986-3 C.B. (Vol. 4) 785. Further, both times Congress has revisited the interest rate provisions since 1986, it has repeated that interest is netted in offsetting situations under sections 6402 and 6601, and it has urged the Secretary to implement “the most comprehensive netting procedures under section 6402 that are consistent with sound administrative practice.” See H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1101 (1990), reprinted in 1991-2 C.B. 591; S. Rep. No. 412, 103d Cong., 2d Sess. 144 (1994); H.R. Rep. No. 826, Part I, 103d Cong., 2d Sess. 178 (1994), reprinted in 1995-1 C.B. 254.

However, Congress has never articulated a clear policy reason why interest should be netted in the offsetting situation, or for that matter in any other situation. The legislative history quoted above -- in which Congress encourages interest netting at the same time that it is enacting significant interest differentials between underpayments and overpayments -- instead gives contradictory policy signals. On the one hand, three times in the last eleven years Congress has increased the differential between interest paid on refunds and interest charged on deficiencies, in each case reiterating one or more of the traditional rationales for interest -- time value of money, incentives for prompt payment, running taxation more like other financial functions in the economy, etc. At the same time, however, Congress has simultaneously urged netting to ameliorate the impact of the very interest differentials it has repeatedly adopted.

In urging “the most comprehensive netting procedures . . . consistent with sound administrative practice,” Congress has implicitly endorsed several long-term policy shifts without explicitly examining the fundamental premises underlying them. For example, expanded use of netting represents a further erosion of the concept of separate tax liabilities -- a shift that Congress

has undertaken elsewhere (in such provisions such as the carryback and carryforward of net operating losses or business credits) only after serious policy consideration is given to the consequences. While it may be intuitively appealing for taxpayers to keep a single "running balance" with the IRS and constantly be "netting out" the interest on temporary underpayments and overpayments, the shift to such a system should be deliberate and recognized for what it is.

Global interest netting, which by definition takes into account tax years that have a zero balance, also has profound implications for the concept of finality. Under the current system, statutes of limitation generally bar the reconsideration of a taxpayer's liability, by either the taxpayer or the IRS, after a certain period of time has passed. See generally IRC §§ 6501, 6503, 6511. The principal rationale for finality is that it permits "repose" to the parties; after a certain time taxpayers know that they cannot be audited and that the amount of their tax liability is permanently fixed. Limitations periods also prevent the litigation of stale conflicts in which evidence becomes increasingly difficult to collect, as memories are blurred, documents discarded, etc.

Several commentators have suggested, however, that global netting should be available whenever zero balance years overlap temporally with outstanding liabilities -- a fairly common situation -- even if adjustments to the tax liability for the zero balance year are barred by the applicable statute of limitations. The principal argument that has been made for extending global netting even to statute-barred years is to analogize it to net operating loss or credit carrybacks (or, less frequently, carryforwards) under sections 172 or 39, which can affect the tax liability in otherwise barred years. Such carryback provisions, however, are statutory exceptions to the general model of separate tax liabilities for separate years which have their own independent policy justifications. No other independent policy justification is given for netting interest in statute-barred years.

Likewise, the argument that taking statute-barred years into account for global netting purposes is somehow "fairer" than leaving such years alone also directly conflicts with the primary policy rationale for statutes of limitations. Statutes of limitation are by definition "unfair": they cut off claims that might otherwise be legitimate, based upon a considered decision that other policy goals like finality and repose outweigh the claims. Alone, therefore, an amorphous claim of "unfairness" is not a sufficient reason for an exception to a limitations period.

Some commentators also have argued that limiting global netting to open (non-statute barred) tax years will lead taxpayers to continue extending their statutes of limitations on zero balance tax years in order to retain the prospect of global netting for interest computation purposes. This argument ignores several factual realities, however. First, extensions of the limitations period expose the taxpayer to additional examination and assessments by the IRS. Most taxpayers seek to foreclose that possibility, and it will be the rare taxpayer for whom the prospect of global interest netting overrides the goal of closing a taxable year. Further, extensions generally require agreement by the IRS as well as the taxpayer, so unilateral action by a taxpayer to retain the chance of global netting is unlikely.

Perhaps the most policy persuasive argument for implementing more comprehensive interest netting is that Congress has already indicated its preference for “the most comprehensive netting procedures . . . consistent with sound administrative practice.” As discussed below in the legal section of this report, it is not clear that Congress ever envisioned the global netting situation, and the statutory authority for implementing netting probably does not extend so far. Nevertheless netting has been clearly authorized by Congress in at least some situations (the annual netting and offsetting cases). It makes little sense from a policy standpoint to permit interest netting in some factual circumstances but not in others, particularly when the difference between the permissible and impermissible netting situations turns on the comparatively trivial question of whether there is a zero balance or an outstanding balance due one way or the other.

Other factual uncertainties as to how global netting would work prevent much specificity as to its effects on taxpayers. Some restrictions to make global netting administratively feasible are suggested below -- such as limiting it to non-statute-barred years, requiring taxpayers to provide necessary documentation, etc. The taxpayers who meet these conditions and thus could take advantage of global netting are probably only larger corporate taxpayers and a few very wealthy individuals. As a practical matter only those who have multiple-year open examinations are likely even to consider whether the potential savings from global netting are worth the cost of compiling the data and performing the calculations.

A final policy consideration that must be taken into account in enacting global netting is its potential revenue impact. Interest netting will always lose revenue in comparison to a non-netting baseline, because it eliminates some or all of the interest rate differential in section 6621, which always runs in the Government’s favor. Global netting simply eliminates the differential for more years and more taxpayers than offsetting or annual netting. The ultimate revenue impact of global netting will depend on the limitations imposed on it.

LEGAL ISSUES INVOLVED IN INTEREST NETTING

This portion of the report discusses the authorities for netting and in particular whether global netting is currently permitted under the Code. The “Background” section above set forth the provisions of current law that permit the IRS to net overpayments and underpayments of tax. This section reviews the Congressional guidance for the interpretation of these provisions that is found in the legislative history of the amendments to section 6621. It then provides examples of the two general approaches to global interest netting that have been recommended by taxpayers and analyzes whether those approaches are permitted under current law. Finally, certain period of limitations aspects of global netting are discussed.

Congressional guidelines

As discussed above, in 1986 Congress for the first time enacted a differential between the interest rate that taxpayers paid the Government on underpayments and the interest rate that the Government paid taxpayers on overpayments. In enacting the interest differential, Congress recognized that a taxpayer might have both an overpayment and an underpayment of tax outstanding at the same time and potentially accruing interest at different rates. The Senate report states:

Taxpayers subject to differential interest rates may have an underpayment for a type of tax in one taxable year and an overpayment for the same type of tax in another taxable year.

S. Rep. No. 313, 99th Cong., 2d Sess. 185 (1986), reprinted in 1986-3 C.B. (Vol. 3) 185. The Conference Report provides an example illustrating when interest netting under section 6601(f) would be applicable:

Section 6601(f) provides that, to the extent a portion of tax due is satisfied by a credit of an overpayment, no interest is imposed on that portion of the tax. Consequently, if an underpayment of \$1,000 occurs in year 1 and an overpayment of \$1,000 occurs in year 2, no interest is imposed in year 2 because of the rule in section 6601(f).

H.R. Conf. Rep. 841, 99th Cong., 2d Sess. II-785 (1986), reprinted in 1986-3 C.B. (Vol. 4) 785.

Both the Senate Report and the Conference Report then go on to discuss the potential for administrative problems if an interest rate differential were enacted. The Senate Report states:

The IRS requires substantial lead time to develop the data processing capability to net such underpayments and overpayments in applying differential interest rates. The bill, therefore, provides that the Secretary of the Treasury may prescribe regulations providing for netting of tax underpayments and overpayments through the period

ending three years after the date of enactment of the bill. By that date, the committee expects that the IRS will have implemented computerized netting procedures.

S. Rep. No. 313, 99th Cong., 2d Sess. 185 (1986), reprinted in 1986-3 C.B. (Vol. 3) 185. Similarly, the Conference Report provides:

The IRS can at present net many of these offsetting overpayments and underpayments. Nevertheless, the IRS will require a transition period during which to coordinate differential interest rates with the requirements of section 6601(f). The Senate amendment, therefore, provides that the Secretary of the Treasury may prescribe regulations providing for netting of tax underpayments and overpayments through the period ending three years after the date of enactment of the bill. By that date, the IRS should have implemented the most comprehensive netting procedures that are consistent with sound administrative practice.

H.R. Conf. Rep. 841, 99th Cong., 2d Sess. II-785 (1986), reprinted in 1986-3 C.B. (Vol. 4) 785.

In accordance with this legislative history, section 1511(b) of the Tax Reform Act of 1986 authorized regulations providing for the netting of underpayments and overpayments:

COORDINATION BY REGULATIONS.--The Secretary of the Treasury or his delegate may issue regulations to coordinate section 6621 of the Internal Revenue Code of 1954 (as amended by this section) with section 6601(f) of such Code. Such regulations shall not apply to any period after the date 3 years after the date of enactment of this Act.

Treasury and the IRS did not, however, issue any regulations pursuant to the authority granted under this provision. As the excerpts from the legislative history illustrate, interest computations became substantially more complex once differential interest rates were added to the credit/offset regime of sections 6402(a) and 6601(f). But the basic principles of that regime were unchanged by the addition of differential interest rates, and the existing regulations under those sections already provided sufficient authority to implement “the most comprehensive netting procedures that are consistent with sound administrative practice.” Thus no additional regulations were necessary to implement the new interest rates.

Some commentators have argued that section 1511(b) of the 1986 Act and its accompanying legislative history demonstrate that Congress envisioned not just offsetting but global netting when it enacted the interest rate differential. They contend that section 1511(b) constitutes a shorthand authorization for Treasury to implement global netting. According to these commentators, the provision does not make sense unless Congress intended global netting to be in place at the end of the three-year period stated in section 1511(b).

This argument, however, is not supported by the actual language Congress used in the reports and authorizing provision. The reports excerpted above refer only to “offsetting,” “underpayments,” and “overpayments;” the prospect of applying credits and liabilities against zero-balance tax years for interest netting purposes is never mentioned. Further, in accordance with the existing credit/offsetting scheme, Congress cited only section 6601(f) in both the reports and section 1511(b). But section 6601(f) applies only “if any portion of a tax is satisfied by credit of an overpayment,” and as the court held in Northern States Power, citing section 6601(f), “only an outstanding liability can be ‘satisfied’ by a credit.” 73 F.3d at 767. Finally, section 1511(b) merely authorizes regulations that “coordinate” section 6621 with section 6601(f). It does not provide any statutory basis for interest netting beyond that which is otherwise contained in section 6601(f). Likewise, section 6621, which is limited to imposing different rates on underpayments and overpayments, provides no basis for interest netting.

Certainly section 1511(b) is an indication of Congressional intent regarding interest netting. Just as clearly, however, Congress only envisioned reconciling differential interest rates with the existing credit/offset scheme, not the creation of an additional netting practice.

This conclusion is confirmed by Congress’s subsequent deliberations. When Congress increased the interest rate for large corporate underpayments under certain circumstances in 1990, see Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, § 11341(a), 104 Stat. 1388, 1388-470, the Conference Report commented on interest netting as follows:

Under present law, the Secretary has the authority to credit the amount of any overpayment against any liability under the Code (sec. 6402). To the extent a portion of tax due is satisfied by a credit of an overpayment, no interest is imposed on that portion of the tax (sec. 6601(f)). The Secretary should implement the most comprehensive crediting procedures under section 6402 that are consistent with sound administrative practice.

H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1101 (1990), reprinted in 1991-2 C.B. 591. Here, Congress expressly referred not only to section 6601(f) but also to the credit rules of section 6402(a) in connection with its discussion of interest netting procedures.

Again, when Congress amended the interest provisions in 1994, see Uruguay Round Agreements Act, Pub. L. No. 103-465, § 713, 108 Stat. 4809, 5001 (1994), the legislative history discussed netting practices as follows:

Under present law, the Secretary of the Treasury has the authority to credit the amount of any overpayment against any liability under the Code (section 6402). To the extent a portion of tax due is satisfied by a credit of an overpayment, no interest is imposed on that portion of the tax (section 6601(f)). The Secretary should implement the most comprehensive crediting procedures under section 6402 that are consistent with sound administrative practice, and should do so as rapidly as is practicable.

S. Rep. No. 412, 103d Cong., 2d Sess. 144 (1994); see also H.R. Rep. No. 826, Part I, 103d Cong., 2d Sess. 178 (1994), reprinted in 1995-1 C.B. 254. As in 1990, Congress referred to sections 6402 and 6601(f) as the source for the mechanical rules by which it contemplated interest netting would be accomplished.

Some taxpayers have argued that the 1990 and 1994 committee report language again provides a Congressional mandate directing Treasury to implement global netting. This legislative history does indicate that Congress was concerned about ameliorating the effect that larger interest rate differentials would have when an underpayment is satisfied by a credit of an overpayment. But the legislative history provides no basis for interest netting other than as authorized under existing law. Congress instead referred repeatedly to the existing statutes that permit the IRS to net interest under the credit/offset regime (i.e., sections 6402 and 6601(f)). Moreover, the legislative history's consistent use of the phrase "is satisfied by a credit" supports the view (discussed in more detail below) that interest netting can only occur if there are actual credits of overpayments against outstanding liabilities.

Approaches to global netting

There are generally two conceptual ways to implement global netting, which will be referred to as the "credit/offset approach" and the "interest equalization approach." Although some variations may exist in specific proposals, the two approaches are generally representative of the views of taxpayers who submitted comments in connection with this study.

The IRS already uses both the credit/offset and interest equalization models, in different contexts. The credit/offset approach is very similar to the method for offsetting under section 6402(a). Congress has provided clear statutory authority for it (in limited situations) and, as discussed previously, has referred to it in enacting the interest differential provisions. The credit/offset approach does not, however, apply well in the global netting situation, particularly in certain fact scenarios.

The interest equalization approach is the conceptual premise for annual netting, as adopted by the IRS in Rev. Proc. 94-60, and the Commissioner's Advisory Group advocated extending it to global netting situations in 1993. However, interest equalization is not provided for by the Code in any factual context that involves tax liabilities for more than one year.

A. Credit/offset approach

The "credit/offset approach" is basically an extension of the IRS's current offsetting methodology under section 6402(a). The principal difference is that in the global netting situation an overpayment could be credited to an underpayment of tax irrespective of whether the overpayment or underpayment exists as of the time of the adjustment. Under this approach, credits would be allowed "as if" the overpayment had not previously been refunded or the underpayment had not previously been paid.

Some taxpayers maintain that section 6402(a) already provides the IRS with the authority to allow such treatment. If so, section 6601(f) would automatically allow interest netting, since that section is a self-executing provision that effectively nets interest during periods of mutual indebtedness, once a liability is satisfied by a credit. The credit/offset approach cannot be implemented, however, because current law does not provide the authority to apply a previously refunded overpayment as a credit against a deficiency, or an overpayment as a credit against a previously paid deficiency.

Section 6402(a) presently applies only where credit is made against “outstanding” liabilities. The regulation under section 6402 clearly states that overpayments can be credited only against *outstanding* tax liabilities:

The Commissioner, within the applicable period of limitations, may credit any overpayment of tax, including interest thereon, against any outstanding liability for any tax (or for any interest, additional amount, addition to the tax, or assessable penalty) owed by the person making the overpayment and the balance, if any, shall be refunded, subject to subsection 6402(c) and (d) and the regulations thereunder, to that person by the Commissioner.

Treas. Reg. § 301.6402-1. Since a liability that has been paid is not “outstanding,” and since global netting relies on crediting overpayments against previously paid liabilities for interest netting purposes, it follows that global netting is not authorized by the regulations. The court in Northern States Power Co. v. United States, 73 F.3d 764 (8th Cir.), cert. denied, 117 S.Ct. 168 (1996), agreed with this analysis.

Some commentators nevertheless suggest that the regulation under section 6402(a) can be changed. They point out that the actual statutory language in the Code states that overpayments can be credited against “any liability.” The word “outstanding” is not used in the statute, and, these taxpayers argue, it can be deleted from the regulation as well.

The legislative history of section 6402(a) indicates that the regulation provides the correct reading of the statute, however. The predecessor of section 6402(a), section 322(a) of the Internal Revenue Code of 1939, provided:

Where there has been an overpayment of any tax imposed by this chapter, the amount of such overpayment shall be credited against any income, war-profits, or excess-profits tax or installment thereof *then due* from the taxpayer, and any balance shall be refunded. (Emphasis added.)

Authority under this provision was clearly limited to credits against *unpaid* tax liabilities. Similarly, section 3770(a)(4) of the 1939 Code, as amended by the Act of August 27, 1949, § 9, 63 Stat. 666, 669, provided that the Commissioner “in his discretion” could, in lieu of refunding an overpayment, credit such overpayment against any tax due from the taxpayer. Congress did not change these rules

when section 6402(a) was enacted in 1954. It merely added interest on the overpayment to the amount that could be credited to any outstanding liability.

Moreover, implementing global netting through the credit/offset approach under existing law would require a strained reading of section 6402(d), particularly in light of its purpose. That provision permits an overpayment to be *credited* against another *liability* in lieu of refunding the overpayment. In this context, it seems unreasonable to interpret “liability” to mean -- solely for purposes of computing interest on a prior underpayment under section 6601 -- a tax liability that has already been satisfied.

This view is supported by Northern States Power Co. v. United States, 73 F.3d 764 (8th Cir.), cert. denied, 117 S.Ct. 168 (1996), the only case to address this issue directly. The court there concluded that the term "liability" as used in section 6402(a) meant "outstanding" liability, relying not only on the existing regulation but also on its reading of the entire statutory scheme, including section 6601(f), the interest netting rule that applies if a credit or offset is made under section 6402(a):

We agree with the United States that the word "liability" in Section 6402 means "outstanding liability," one that is unpaid when the credit is made. The Treasury regulations support this reading, see C.F.R. § 301.6402-1 (referring to an "outstanding liability"), and we properly defer to these regulations.... *This is also the reading that makes the most sense*, because only an outstanding liability can be "satisfied" by a credit. See I.R.C. § 6601(f). NSP provides no support, other than *a strained reading of miscellaneous bits of legislative history*, for its assertion that Section 6402(a) is somehow "time-neutral," that a "liability" may be one that no longer exists, but once did. We think *this argument withers before the statute's plain meaning*. We are likewise not convinced by NSP's attempt to read the word "outstanding" out of the relevant Treasury regulation, 26 C.F.R. § 301.6402-1. In our view, the regulation means what it says. (Emphasis added.)

Like section 6402(a), section 6601(f) is apparently intended to apply only when an *outstanding* liability is satisfied by the application of an overpayment. As the court in Northern States Power noted, the phrase “if any portion of a tax is *satisfied* by credit of an overpayment” contemplates that the tax against which the overpayment is credited has *not* been satisfied until the credit is made -- or in other words that it is an unpaid, outstanding liability at the time of the credit. Congress would not have referred to the “satisfaction” of a liability that was already fully paid.

On the other hand, the overall intent of section 6601(f) is to eliminate interest to the extent there is mutuality of indebtedness between the taxpayer and the Government. For example, the legislative history of that provision states:

Under present law situations can arise where, even though underpayments and overpayments offset each other, the Internal Revenue Service collects more interest than it pays or the taxpayer is entitled to more interest than he owes the Government.

*

*

*

The House bill eliminates these erratic differences of present law by terminating the interest both as to the overpayment and underpayment during any period of time to the extent they offset each other, except that interest on a deficiency will be charged for any period during which interest on the overpayment would not have been allowed if the overpayment had not been credited against the deficiency.

S. Rep. No. 1983, 85th Cong., 2d Sess. 97-100 (1958), reprinted in 1958-3 C.B. 1020-21. Although Congress was not referring to the interest rate differential (which was not enacted for nearly 30 years), this language indicates that Congress was concerned with the ability of the government to collect more interest than it pays during periods of mutual indebtedness -- generally an analogous situation. As the U.S. Court of Claims stated in Fruehauf Corp. v. United States, 477 F.2d 568, 572 (1973):

The evil at which the statute was aimed was the disparate running of interest on overpayments and underpayments, and the remedy provided by the Act was termination of the interest on both during any period of time to the extent that they offset each other.

But the Technical Explanation in the Senate Report makes clear that the operation of section 6601(f) depends on actual crediting of overpayments:

Interest on a *credited overpayment* would in either case now run only from the date of the overpayment to the original due date of the amount *against which it is credited*. Thus, if it is credited against an underpayment antedating the overpayment, no interest would run on the overpayment at all. Since interest would otherwise run on the overpayment from the date of the overpayment to the date of the refund, interest on the underpayment will stop running as of the date of the overpayment; that is, when the mutuality of indebtedness arises. Similarly, in the case of an overpayment that antedates the due date of the underpayment, interest will run on the overpayment only until such due date, that is, when the mutuality of indebtedness arises.

S. Rep. No. 1983, 85th Cong., 2d Sess. 234-35 (1958), reprinted in 1958-3 C.B. 1156 (emphasis added). Fruehauf likewise does not support global netting because that case did not involve the application of an overpayment to a previously paid underpayment.

B. Interest Equalization Approach

The interest equalization approach does not rely on actual or deemed credits or offsets. Rather, the concept is that interest rates are equalized, i.e., no net interest is charged in either direction, to the extent that there are periods and amounts of overlapping mutual indebtedness

between the Government (owing a taxpayer a refund) and a taxpayer (owing the Government a deficiency). This approach forms the basis for annual netting, as set forth in Rev. Proc. 94-60, 1994-2 C.B. 774, and is similar to a proposed revenue procedure submitted to the IRS by the Commissioner's Advisory Group as part of the IRS's earlier efforts at addressing the interest rate differential problem. Several commentators in this study suggested that the proposed revenue procedure could form an appropriate way to extend interest equalization to the global netting situation.

The proposed revenue procedure, which was not adopted by the IRS, describes how interest on an underpayment or overpayment should be calculated by the IRS during periods of mutual indebtedness. Mutual indebtedness is generally any period of time during which the taxpayer owes money to the Government and the Government owes money to the taxpayer. In order to adjust for the interest rate differential, the tax accounts are netted by paying or crediting to the taxpayer a "rate equalization amount" for the period of mutual indebtedness. The "rate equalization amount" is equivalent to the interest rate differential for the period and amount of mutual indebtedness.

The interest equalization approach thus does not rely on the IRS's authority to make credits pursuant to section 6402(a) or on the "satisfaction" of a tax liability under section 6601(f).^{2/} Rather, utilizing the rate equalization computation, a taxpayer would simply be charged less underpayment interest (or paid more overpayment interest) to effectively equalize the interest during any period of mutual indebtedness. Therein lies the problem, however, for interest equalization cannot be implemented in a multi-year (global netting) situation under current law. Under the current Code provisions, sections 6601 and 6611 set forth the periods for which interest is computed and refer to section 6621 for the interest rates to be used. Section 6601 clearly requires that interest on an underpayment *shall* be paid "at the underpayment rate established under section 6621." Likewise, section 6611(a) clearly provides that interest on an overpayment "*shall* be allowed and paid upon any overpayment . . . at the overpayment rate established under section 6621" (emphasis added). Section 6621(a) is similarly mandatory: it states that the overpayment and underpayment interest rates "shall" be those shown in that provision. In short, no interest rates, other than those set forth in section 6621, are authorized for interest computation purposes.

While the general purpose of an interest equalization method is to net interest during a period of mutual indebtedness, the netting is ultimately accomplished by reducing the amount of underpayment interest below the rate set by section 6621, or by paying more overpayment interest than is allowed under section 6621. This is tantamount to charging or paying interest at an incorrect rate under the statute. There simply is no authority in sections 6601, 6611, or 6621 permitting this approach. It is well settled that the government may pay interest only if authorized to do so by a specific statutory provision. U.S. ex. rel. Angarica v. Bayard, 127 U.S. 251 (1888).

^{2/} Of course, in the credit/offset situation section 6601(f) ultimately works to equalize the interest rates as well. But under the interest equalization model there is no actual crediting of funds against each other in order to achieve the section 6601(f) result.

Under current law, the interest equalization approach would violate this established principle. Thus, in order for global netting to be implemented using an interest equalization model, Congress would have to enact authorization to pay or charge interest at a different rate than that set forth in section 6621 to the extent there are periods of overlapping mutual indebtedness.

Taxpayers have suggested that the interest equalization approach is merely an extension of Rev. Proc. 94-60, 1994-2 C.B. 774, to multiple year situations. However, the approach taken in Rev. Proc. 94-60 is legally permissible only because it applies interest equalization in a limited manner for purposes of computing interest with respect to a single tax year. For any given tax year there ultimately can be either an underpayment or an overpayment, but not both (although one or the other may appear to exist at any particular point in time). The method of the revenue procedure is first to net all adjustments to a single year's account, determine whether the ultimate balance is an underpayment or an overpayment, and then apply the appropriate interest rate only to the net underpayment or overpayment. In the single-year situation it is not necessary to apply another, non-authorized interest rate to one or more of the accounts in question. Rather, section 6621 is simply interpreted to apply only to the ultimate, net underpayment or overpayment for the year under consideration.

The approach of Rev. Proc. 94-60 cannot be extended under existing law to multiple year situations, however, because for separate tax years there can really be an actual underpayment for one year and an actual overpayment for the other year. If an (outstanding) underpayment and an (outstanding) overpayment exist for two different tax years, then interest netting can take place under current law only if the underpayment is satisfied by crediting of the overpayment, pursuant to sections 6402(a) and 6601(f). By contrast, the single-year situation does not involve the application of those provisions.

The only way to allow interest equalization over multiple years and taxes would be to interpret "underpayment" or "overpayment" as broadly in the multi-year context as it is in the single-year context covered by Rev. Proc. 94-60. Some commentators have suggested this, arguing that global netting could be accomplished by taking several years of tax liabilities, netting them all together, determining whether the taxpayer is in a net under- or overpayment position for all those years, and then applying the appropriate interest rate under section 6621 to the multi-year balance. This, however, violates the clear statutory concept that each tax year is a separate and distinct liability, with only limited exceptions expressly provided in the Code. The commentators who have suggested this methodology fail to cite any legal authority for treating multiple years as a single underpayment or overpayment with a net balance.

Limitations period considerations

As noted earlier, some commentators suggested that global netting should be allowed for interest accruing after December 31, 1986 for all years, whether open or closed, to the extent necessary to compute interest accurately for a refund or an assessment in an open year. The periods

of limitation applicable to claims for refund create a substantial legal restriction on the Government's ability to achieve global netting, however.

In general, the amount of any tax must be assessed within 3 years after a return is filed (whether or not the return is filed on the date prescribed). IRC § 6501. The Secretary and the taxpayer may agree to extend the period of limitation on assessment by written agreement entered into prior to the expiration of the period of limitation. IRC § 6501(c). Interest on underpayments prescribed under section 6601 may be assessed and collected at any time during the period within which the tax to which such interest relates may be collected. IRC § 6601(g).

Claims for credit or refund of an overpayment, on the other hand, generally must be filed within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever period expires later. IRC § 6511(a). If the parties agree to extend the period of limitations on assessment, see IRC § 6501(c)(4), then the period of time for filing a claim for credit or refund generally will not expire prior to 6 months after the expiration of the extended period. IRC § 6511(c).

No credit or refund can be allowed or made after the expiration of the applicable period of limitations unless a claim for credit or refund is filed by the taxpayer within such period. IRC § 6511(b)(1). In particular, section 6511(b)(2)(A) provides that if the claim is filed within the 3-year period, the amount of the credit or refund shall not exceed the portion of the tax paid within the immediately preceding 3-year period plus any extension of time to file, and section 6511(b)(2)(B) provides that if the claim is not filed within the 3-year period, the amount of the credit or refund shall not exceed the amount of tax paid within the 2-year period immediately preceding the filing of the claim. If a taxpayer pays interest on a deficiency and it is later determined that the taxpayer is not liable for the deficiency, the amount of the underpayment interest previously paid by the taxpayer is considered part of the overpayment subject to the period of limitations set forth in section 6511. See Treas. Reg. § 301.6611-1(c). Again, these rules are mandatory. Refunds made in violation of them are considered erroneous, and credits made in violation of them are considered void. IRC § 6514(a).

These periods of limitation on refunds create a legal impediment to the adoption of global netting. This is easily demonstrated by the following example. Assume that a taxpayer files an income tax return for 1990 on April 15, 1991, and an underpayment is ultimately determined and paid on April 15, 1993. Interest at the underpayment rate is charged and paid on the underpayment for the period from April 15, 1991 to April 15, 1993. Assume further that the same taxpayer files an income tax return for 1991 on April 15, 1992. A claim for refund is then filed on April 15, 1994, requesting a refund for 1991. The claim is allowed and a refund with interest is paid on October 15, 1995. The taxpayer realizes in retrospect that the interest rate differential on the 1990 underpayment could have been partly avoided if the 1991 overpayment had been taken as a credit against the 1990 underpayment instead of having been refunded. Therefore, on April 15, 1996, the taxpayer asks the IRS to apply the 1991 overpayment as a credit to the 1990 tax liability solely for interest computation purposes.

In this example, the period of limitation on claims for refund prohibits the IRS from refunding any portion of the interest paid on the 1990 underpayment, since any claim for refund with respect to interest paid for that year should have been filed on or before April 15, 1995 (two years from the date of payment). See IRC § 6511; Treas. Reg. § 301.6611-1(c); Alexander Proudfoot Co. v. United States, 354 F. 2d 1379 (Ct. Cl. 1972) (claims for refund of deficiency interest must be filed within the period specified in section 6511). Further, if the IRS did refund the portion of the interest equal to the differential rate, such amount would be a statutory erroneous refund. See IRC § 6514(a).

A similar problem also exists under the interest rate equalization approach. Although the interest rate equalization approach does not employ actual or deemed tax credits, the period of limitation for filing a claim for overpaid deficiency interest must still be open at the time the overpayment is determined. In the example above, a claim for refund of the interest differential paid for the period from April 15, 1992, to April 15, 1993 must be filed by April 15, 1995. However, in this case the existence of the 1991 overpayment, which is a necessary element of the period of mutual indebtedness, is not determined by the IRS until October 15, 1995, which is after the period of limitation has expired with respect to the 1990 tax year.

In short, existing limitations provisions present obstacles to netting, irrespective of whether a credit/offset approach or an interest equalization approach is used.

ADMINISTRATIVE ISSUES INVOLVED IN INTEREST NETTING

This section will first describe the IRS's current administrative procedures relating to interest computations for annual interest netting and offsetting. It will then describe what new procedures and additional resources would be required to expand these procedures to perform global interest netting computations.

Annual netting

The simplest case in which interest netting becomes an issue involves a single tax year for a taxpayer, in which a refund with overpayment interest has been issued and a subsequent deficiency is assessed with respect to the same year, so that underpayment interest is due. See Rev. Proc. 94-60, § 1, 1994-2 C.B. 774. The question is whether interest at the higher, underpayment rate should be imposed on the deficiency for the period for which overpayment interest (at the lower, overpayment interest rate) was previously paid. Ordinarily, section 6601(a) would require that the higher, underpayment interest rate under section 6621 be applied to the full amount of the deficiency for the full amount of time since the tax became due, and the taxpayer would not get any benefit of netting. Pursuant to Rev. Proc. 94-60, however, for the period for which the taxpayer was already paid overpayment interest on the excessive tax refund, the IRS will collect interest at the same (lower, overpayment) rate, not the underpayment rate, on the portion of the tax underpayment that does not exceed the excessive tax refund. Rev. Proc. 94-60, § 3, 1994-2 C.B. at 775.

The IRS performs annual interest netting two ways. In simple cases, the IRS's Master File system will calculate netted interest automatically when the Rev. Proc. 94-60 criteria apply to a taxpayer's module. The interest computations in such cases do not require any manual calculation, and therefore no additional resources are needed to implement Rev. Proc. 94-60. This automatic computation is also highly accurate and reliable.

Even for annual interest netting, however, many cases require manual computations of interest that cannot be performed systemically. There are two related reasons for this: the legal requirements of the computations and the computer capabilities necessary to take all such legal requirements into account.

The legal requirements relate principally to the starting and ending dates that are part of the interest computation. The Code contains several special provisions that require starting an interest computation from a date other than the normal due date of the return. E.g., IRC §§ 6601(b), (e)(2)(A); 6611(d),(f), (g). Likewise, the ending date for interest computations in many situations is not the same as the date of the final adjustment to a tax account. E.g., IRC §§ 6601(d)(1), (d)(2)(A). Most of these provisions relate to penalties and carrybacks from other tax years. Quite apart from the effects of offsetting in multi-year situations, these special rules can require annual netting with respect to a specific tax year whenever multiple years of the taxpayer are open.

The IRS's Master File system, which was designed to track and store taxpayer account activity, cannot accommodate and manipulate all the possible combinations of these special starting and stopping dates for complex interest computations. The simpler computations with "regular" starting and stopping dates can be performed on the Master File, but the more complex cases require review and calculations by a trained specialist.

To the extent manual computations of annual interest netting are required, the calculations may be performed by various IRS employees depending on the nature and complexity of the adjustments. The computations are generally made by processing technicians in connection with entering the adjustment to the taxpayer's account. Since adjustments can arise due to amended returns, audits, Appeals decisions, collection actions, court decisions, etc., the interest computations may be performed at IRS Service Centers, District Offices, or Appeals Offices.

The procedures for annual interest netting are set forth in IRM 31(59)0, an excerpt from which is enclosed as Appendix Four.^{8/} Briefly, the general interest computation procedure requires the technician to analyze the transactions on the taxpayer's account, identify which transactions affect the interest computation, and then determine the appropriate interest starting and stopping dates and interest rates to be applied. In particular, annual interest netting requires determining the period(s) of time for which overpayment interest was previously paid, and then calculating underpayment interest at the overpayment rate on the refunded amount for such period(s).

The technician performs the analysis using a transcript of the taxpayer's account and the report of any adjustments that are being, or have been, made. Data from those sources that are needed for the interest computation are input into a separate computer program that is not part of the IRS's Master File system for tracking taxpayer accounts. Technicians must be familiar not only with the interest rules in the Code, regulations, and Internal Revenue Manual, but also with the nuances of the Master File, the IRS's Non-Master File system, and the stand-alone interest computation computer programs. After the calculations are performed off-line, the net interest amount is entered as a separate adjustment on the taxpayer's Master File account. Because of the special conditions that required manual interest computations in the first place, a special code is entered with the net interest adjustment to prevent the computer from erroneously making automatic adjustments to that account in the future. Thereafter, any future interest computations that involve that tax year must also be performed manually.

Offsetting

Offsetting arises whenever an overpayment is determined with respect to one tax year (or liability) and may be applied to an outstanding liability for another year pursuant to section 6402(a). As discussed above, there is a special interest computation rule for such situations, section 6601(f) of the Code. As this rule operates, if an overpayment is actually applied against an underpayment, interest is calculated only on the net outstanding balance for the period (and amount) of the overlap.

^{8/} This section will be renumbered as IRM (22)000, entitled "Interest," in 1997.

In effect, therefore, both the underpayment and overpayment interest rates for the overlapping period and offsetting amount are zero. Interest is charged (or paid) only on the net balance.

By law, an offsetting situation involves at least two unsettled tax accounts, one an overpayment and one an underpayment. As with annual interest netting, offsetting is performed both systemically by the IRS computers and manually by technicians. The Master File is programmed to search for outstanding liabilities (tax-due accounts) for the same taxpayer whenever it shows a credit (overpayment) available for that taxpayer. This search is performed every time an overpayment arises, whether for individual or business taxpayers, literally millions of times each year.

Whenever an offset can be systemically performed, the Master File system also computes the appropriate interest on all the affected accounts, in accordance with the special rule of section 6601(f). The taxpayer in such a situation will receive a statement explaining the adjustments, including the interest computation. Again, in such situations, the interest computations do not require any manual calculation or additional resources, and the computations are routinely accurate and reliable based on the information on record.

However, there are frequently conditions under which an offset cannot be systemically performed. Many of these conditions relate to the same kinds of legal issues that prevent automatic annual netting, such as the applicability of restricted interest rules with special interest starting and ending dates. Other situations include the bankruptcy of the taxpayer or statutes of limitations that are about to expire.

Offsetting frequently arises in extremely complex cases involving multi-year audits for large corporations. In such cases there may be numerous adjustments to each account, some issues that are agreed and others that are unagreed, partial tax payments or refunds, and many resulting periods of overlapping indebtedness. These cases, which present the greatest challenges in calculating interest, almost always involve one or more of the conditions that require the calculations to be done manually rather than by the computer system.

Although offsetting interest computations use essentially the same procedures that were described above for annual interest netting, there are additional layers of complexity at each step due to the fact that more tax periods and transactions are at issue. Simply performing the analysis requires a sophisticated understanding of all the adjustments that may be made to the taxpayer's account under the Code, such as the carryforward and carryback rules and the restricted interest rules, as well as familiarity with the IRS's various computer systems. The analysis and computations in offsetting cases are thus usually performed by GS-8 and GS-9 technicians who are assigned the most complex interest calculations.

Performing offsetting interest calculations can take a significant amount of time for even the best-trained IRS personnel. Gathering the data, performing the necessary legal and computational analysis, and actually running the computations can frequently take a technician 40 to 80 hours for a single case. The time is even greater in certain situations, where for example necessary back-up

documentation for previous manual adjustments to the accounts is not available. If such back-up data are missing, it can be virtually impossible to reconstruct earlier manual interest computations.

Global netting

From a conceptual point of view, global netting would largely be the same as offsetting, with one significant difference. Offsetting can only occur when all tax periods at issue still have an imbalance (underpayments or overpayment) outstanding, but global netting would additionally involve tax years that have no outstanding underpayments or overpayments, *i.e.* balances of zero.

Although the methodology applied for global netting would be basically the same as for offsetting, the addition of zero-balance years would substantially increase the amount of data that must be gathered and analyzed. Further, data on zero-balance years is much more difficult to obtain due to the IRS's document retention practices. For example, because of the limited data storage capacity of the IRS's Master File, the IRS must routinely archive data for inactive accounts. It takes an account "off-line" shortly after it is fully paid (*i.e.*, in a zero balance), moves the account to a lower level of storage after a couple years of inactivity, and eventually moves it to archives. Further, only certain key data elements are sent to the archives, and those elements are insufficient to perform global interest netting calculations.

In addition to the information on the Master File for a particular taxpayer, the tax returns and back-up documentation for previous computations must be obtained before a new netting computation can be performed. For example, to perform a global interest netting computation for a large corporate taxpayer, a technician would need the return and supporting schedules, current transcripts, the Revenue Agent's Report and related workpapers, previous interest computation worksheets and Forms 2285 ("Restricted interest on concurrent determinations of deficiencies and overpayments"), any pertinent court decisions, settlement memoranda, Appeals audit statements, and similar documents. For older, zero-balance years, this information is frequently unavailable or incomplete.

If all of this documentation were available, the time required for the analysis in a multiple year global netting computation would still be extensive. By comparison, a multiple year manual offsetting case, which is substantially simpler than a global netting case, takes an IRS technician one to two weeks to perform. Even when a taxpayer provides the documentation for prior tax years, the effort can be enormous, as one commentator candidly stated:

The time involved in reviewing the source documents so as to glean all of the necessary underlying facts can range from 40 to 600 hours. In the usual case of a large corporate taxpayer, 300 to 400 man-hours typically would be required to complete the review and computations.

Comments of KPMG Peat Marwick LLP (June 30, 1996) at 37. Moreover, as with any computation of this complexity, the possibilities for error expand dramatically. Mistakes are more likely, and consequently more double-checking and review is needed to eliminate mistakes.

Taxpayers have argued that the time required to do global netting computations would be considerably less because the taxpayers themselves would do most of the work and the IRS would only have to verify the calculations. Indeed, the same commentator quoted above stated:

The IRS would only incur a fraction of this cost, because it only would have to review the accuracy of the taxpayer's calculations.

Id. While taxpayers can undoubtedly assist in accumulating data, especially for zero-balance years, it would be irresponsible for the IRS to accept a taxpayer's computations and pay the taxpayer's claim without verifying both the data and the calculations that form the basis for the claim. In particular, such items as the effects of carrybacks and carryforwards and the appropriate starting and stopping dates for interest under various circumstances require significant independent analysis and are often subject to varying legal interpretations.

The IRS currently does not perform global interest netting because of its position that it lacks the legal authority to do so. In addition, the calculations are considerably more complex than multiple-year offsetting cases because the addition of the zero-balance years vastly increases the universe of possible legal issues that must be analyzed and the interest rules that must be considered for their effect on open tax years that require adjustment. As discussed above, the IRS has limited data storage capacity on its Master File and documentation in case files for zero-balance years is often incomplete or unavailable. The lack of data for zero-balance years on the Master File and the limited ability of the Master File to manipulate data for the complex calculations required for global interest netting prevents the IRS from performing such calculations on its Master File. Therefore, the IRS would have to spend significant resources to gather and analyze the data necessary to make global interest netting calculations and input the data into a stand-alone interest computation program. For these reasons, the IRS has determined that, apart from the legal restrictions on global interest netting discussed above, such computations would be highly problematic administratively.

Making global netting feasible

The IRS recognizes that Congress has repeatedly instructed it to implement the most extensive interest netting procedures possible, consistent with sound administrative practice and the various provisions of the Code. E.g., H.R. Conf. Rep. 841, 99th Cong., 2d Sess. II-785 (1986), reprinted in 1986-3 C.B. (Vol. 4) 785; H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1101 (1990), reprinted in 1991-2 C.B. 591; H.R. Rep. No. 826, Part I, 103d Cong., 2d Sess. 178 (1994), reprinted in 1995-1 C.B. 254. If the legal issues presented by global interest netting are resolved by Congress through enactment of express statutory authority, the IRS believes that it can implement global interest netting fairly and equitably only if certain limitations are provided.

Even with these limitations, however, global interest netting calculations will involve significant administrative complexity. This potential complexity is illustrated by an example that one commentator submitted at the public hearing on global interest netting held by IRS and Treasury on September 4, 1996. The commentator submitted the example to illustrate how simple global interest netting would be to administer, and yet it is approximately 25 pages long, most of which would require extensive manual data inputting. The example contains no tax years barred by statute, and no partial payments or credits on any of the years, which are frequent for corporate taxpayers and which complicate interest calculations significantly. The commentator's initial presentation of this example contained a minor presentation error,^{2/} which illustrates the need for IRS to check the computations. Most importantly, the assumptions of the example implicitly ignore the most problematic issue with global interest netting -- the collection of the data necessary for an accurate calculation. As noted previously, global interest netting requires extensive documentation for all tax years that will be a part of the calculation, but such information is not always available or complete.

In light of the administrative difficulties associated with global netting, Treasury and the IRS believe that such netting should be authorized by Congress only if the following limitations are adopted. First, global interest netting should be implemented legislatively through an interest equalization approach, rather than through a credit/offsetting approach. The legislation would provide for interest equalization (or a net interest rate of zero percent) to the extent taxpayers and the IRS have overlapping periods and amounts of mutual indebtedness (i.e., taxes or refunds due). Under this approach, global interest netting would require at least one non-zero-balance tax year to be taken into account in the computation.

An interest equalization model should be substantially easier for the IRS to administer and should allow the IRS to adjust taxpayer accounts in a manner consistent with existing procedures. Many commentators and IRS personnel believe that using a credit/offset model, by contrast, could improperly create new liabilities in zero-balance accounts, with corresponding difficulties that could result in incorrect notices being sent to taxpayers and erroneous collection activity.

Second, global interest netting should be limited to income taxes only. Congress apparently contemplated a restriction of this sort when interest netting was first discussed in 1986. See S. Rep. No. 313, 99th Cong., 2d Sess. 185 (1986), reprinted in 1986-3 C.B. (Vol. 3) 185 (IRS should net underpayments and overpayments "for the same type of tax" in different years). Allowing global netting across different kinds of taxes would be extremely difficult to administer and would substantially increase the amount of IRS resources that would need to be devoted to make such calculations. For example, the largest companies make employment tax deposits on a daily basis, and only a part of such deposits constitute the employer's portion of the taxes to which netting could apply (the other parts include employee withholding and the employees' portion of employment

^{2/} The total on the 23rd page of calculations did not tie with the first line of page 24 (a one-day difference accounted for the discrepancy), although the rest of the example reflected the correct number. To its credit, the commentator brought this minor discrepancy to the IRS's attention after the hearing and promptly provided a corrected example.

taxes). Similarly, excise taxes frequently present difficult questions concerning who has paid them or whether they have been passed on to other taxpayers.

Global interest netting for different kinds of taxes would vastly increase the amount of data that would need to be located, gathered, analyzed, and entered into a calculation. The data would have to be manually input, and because interest is compounded daily the computations could become very complex, with a corresponding increase in the probabilities of errors or disagreements with the taxpayer over the calculations. As a result, global netting across different types of taxes should not be required.

Third, global netting should apply only to tax years that are not barred by statute. There are compelling reasons for both taxpayers and the IRS to favor finality, and large amounts of money and time are expended to reach finality for past tax years. Since the principal amounts of underpaid or overpaid taxes in barred years are not considered in adjusting taxpayers' other tax year accounts, it makes little sense to consider the interest that was charged or paid on those underpayments or overpayments. Taxpayers who are concerned about the interest rate differential may extend the statutes of limitations for assessments, even with respect to tax years that have a zero balance, in order to preserve the chance of global interest netting. Conversely, it makes little sense to reopen statutorily-barred years because of an interest netting computation unless they are also opened for reconsideration of other, substantive tax issues -- a result that many taxpayers would not want.

The administrative difficulties of including barred years in the computations are also substantial. Limitations on computer and other storage capacity means that the IRS retains little data on barred years, and in particular may not be able to reconstruct previous interest adjustments that were made in such years.

Fourth, the IRS should only perform global interest netting calculations at a taxpayer's request, and the taxpayer should bear the burden of demonstrating entitlement to any netted interest amount claimed. The taxpayer's request should supply the IRS with all relevant documentation and a copy of the taxpayer's calculations. Providing such documentation and calculations will assist the IRS in verifying the accuracy of the calculations, thus significantly shortening the time needed to process the request.

In particular, global netting should ordinarily be performed only once with respect to the account for any tax year, because once an account has been considered in a global netting calculation, the actual netted interest amount due is entered as a single adjustment to the taxpayer's account. That final adjustment would not be further adjusted unless the taxpayer provided explicit documentation to back up any changes (including every underlying document for the prior interest calculation).

Most of these suggested restrictions (other than the first one) could be implemented by regulations if Congress enacts a global netting provision using an interest equalization approach. As a further condition for global netting, therefore, authority to prescribe regulations in these areas

should be granted to Treasury. The regulations would be expected to reflect the restrictions suggested above.

Finally, to the extent global interest netting requires additional personnel and resources, Congress should make adequate appropriations to fund the additional costs that the IRS will bear. Because of the administrative difficulty of global netting and the additional resources needed to implement it (including training and new personnel), a phase-in period of approximately two years should be provided.

CONCLUSION AND RECOMMENDATIONS

There is a tension between the imposition of interest rate differentials for overpayments and underpayments and the desire to allow interest netting in situations of mutual indebtedness. Congress has not clearly expressed its preference between these goals, particularly in the global netting situation. Although Congress has increased the interest differential several times in the past decade, it has simultaneously urged expanded interest netting each time it has done so.

This contradiction is reflected in the fact that Congress has never provided the clear statutory authority that is necessary to implement true global interest netting nor clarified the policy justifications for it. It makes little sense, however, for interest netting to be available in some situations (i.e., offsetting or annual netting) but not in others (the global netting situation). Resolving the policy issues and providing unambiguous legal authority for global interest netting would complete Congress's efforts in this area.

So long as Congress adheres to the policy goal of the most comprehensive interest netting that is administratively feasible to implement, it makes sense to provide specific statutory authority for netting in all cases, including the true global netting situation. Accordingly, the Department of the Treasury recommends that Congress enact clear statutory authority for global interest netting, using an interest equalization approach and subject to the other limitations discussed in the previous section, which are necessary to make global netting administratively feasible. Treasury and the IRS are prepared to work with the tax-writing committees of Congress to enact this legislation.

APPENDIX ONE

Notice 96-18, 1996-14 I.R.B. 27 (April 1, 1996).

Part III. Administrative, Procedural, and Miscellaneous

Interest Netting Study

Notice 96-18

This Notice invites public comment in connection with the Internal Revenue Service's and Treasury's study of "interest netting." This study was initially described in Announcement 96-5, "Administrative Initiatives to Enhance Taxpayer Rights," 1996-4 I.R.B. 99 at 101 (January 22, 1996).

BACKGROUND

The Internal Revenue Code provides that taxpayers who underpay their taxes generally must pay interest to the government for the period of the underpayment. Section 6601. The IRS has limited authority to abate the interest that is required by statute. Section 6404.

The Code likewise generally requires the government to pay interest to taxpayers with respect to any overpayment of taxes. Section 6611. There are, however, a number of limitations on the government's liability for interest, including the rule that no interest is payable with respect to a tax refund claimed for a current year if the refund is issued within 45 days of the last day prescribed for filing a return claiming the refund. Section 6611(e).

Prior to enactment of the Tax Reform Act of 1986, the same interest rate applied to underpayments and overpayments. The Tax Reform Act of 1986, however, provided for the interest rate charged on underpayments to be one percentage point higher than the interest rate paid on overpayments. See §§ 6621(a)(1) and (2). The Omnibus Budget Reconciliation Act of 1990 added that, under certain conditions, the interest rate on large corporate underpayments would be 3 percentage points higher than the interest rate on overpayments. The Uruguay Round Agreements Act, enacted in 1994, increased the differential between large corporate underpayments and certain corporate overpayments to 4.5 percentage points. See §§ 6621(a)(1) and (c).

If an overpayment is credited against an underpayment, the effect of these interest rate differences is reduced. Section 6601(f) provides:

If any portion of a tax is satisfied by credit of an overpayment, then no

interest shall be imposed ... on the portion of the tax so satisfied for any period during which, if the credit had not been made, interest would have been allowable with respect to such overpayment.

Section 6402(a) provides general authority for the IRS to credit an overpayment against an underpayment. This section states:

In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall ... refund any balance to such person.

Section 301.6402-1 of the Regulations on Procedure and Administration provides that the Commissioner may credit any overpayment of tax against any "outstanding liability" for any tax.

Congress has recognized the potential burden that the interest rate differential places on taxpayers who have both overpayments and underpayments. Thus, each time Congress has increased the interest rate differential, Congress has stated in legislative history that the Service should implement the most comprehensive procedures "consistent with sound administrative practice" to allow overpayments to be credited against underpayments. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., 1986-3 C.B. (Vol. 4) 785 (accompanying the Tax Reform Act of 1986); H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess., 1991-2 C.B. 591 (accompanying the Omnibus Budget Reconciliation Act of 1990); H.R. Rep. No. 826, 103d Cong., 2d Sess., 1995-1 C.B. 254 (accompanying the Uruguay Round Agreements Act).

The Service has developed substantial crediting procedures to implement interest netting. For example:

(a) The Service will consider all increases and decreases in a taxpayer's liabilities within a single tax year before applying the statutory interest rules to that year. Rev. Proc. 94-60, 1994-2 C.B. 774, provides that a taxpayer will not be charged the differential interest rate under § 6621(a) on an underpayment that is satisfied by credit of an overpayment arising in the same taxable year. This interest netting procedure is referred to as "annual interest netting."

(b) The Service permits crediting of overpayments against underpayments for the period of time when the underpayments and overpayments are both unpaid and outstanding, even if they are from different tax years or for different types of tax. This procedure for interest netting is referred to as "offsetting."

The Service, however, generally does not net interest where a taxpayer realizes an overpayment in one tax year that overlaps with a deficiency that a taxpayer has already paid for a different tax year. Likewise, the Service generally does not net interest where an unpaid deficiency in one tax year overlaps with an overpayment that the Service has already paid for a different tax year. This kind of interest netting is referred to as "global interest netting."

The Eighth Circuit recently addressed whether the Service is required to perform global interest netting calculations. *Northern States Power Co. v. United States*, 73 F.3d 764 (8th Cir. 1996). Interpreting §§ 6402(a) and 301.6402-1, the Eighth Circuit held that where the taxpayer's liability was fully paid, there was no "outstanding liability" against which to net the taxpayer's subsequent overpayment. The court further held that the Service, in any event, has the discretion whether to credit overpayments against underpayments.

REQUEST FOR PUBLIC COMMENT

Many taxpayers and practitioners have suggested that the Service adopt global interest netting procedures. Global interest netting, however, raises a number of legal, policy and administrative issues. Thus, Announcement 96-5 states that the Service will conduct a study of these issues and solicit public comments for the study.

Legal and Policy Issues of Global Interest Netting

As described above, global interest netting would allow the taxpayer or the Service to recalculate interest for a certain period of time whenever a taxpayer has either a new overpayment that overlaps with an underpayment that the taxpayer has already paid to the Service, or a new underpayment that overlaps with an overpayment that

the Service has already paid to the taxpayer. The Service requests comments on the following issues:

1. In view of the policy generally favoring the finality of tax determinations, should a rule concerning the finality of global interest netting computations be adopted, and, if so, what should that rule be? What effect, if any, should the statute of limitations have on global interest netting, particularly considering the language in § 6402(a) regarding the applicable period of limitations? Should the statute of limitations be kept open longer in light of global interest netting?

2. When would it be appropriate for the Service to net interest globally for a particular tax year or period? For example, would it be appropriate to net interest globally before the final decision of an appeal or court decision for a tax period overlapping with the period at issue that might affect the interest calculation for such period? Would it be appropriate to net interest globally before the final decision of an appeal or court decision for a tax period that does not overlap with the period at issue, if such decision could produce an adjustment, such as a net operating loss or credit, that might affect the interest calculation for such period?

3. What would be the effect of carrybacks and carryforwards (e.g., net operating losses, various credits, etc.) on the global interest netting calculation for a certain period? Would carrybacks and carryforwards always require a recalculation of interest for such period? Or should global interest netting calculations only be made after carryforwards and carrybacks that might affect the period at issue are finally determined? How would the analysis be affected by the restricted interest provisions of §§ 6601(d) and 6611(f)?

4. Does global interest netting present any unique implications for taxpayers filing consolidated returns?

5. How would global interest netting affect § 861 allocations or interact with other U.S. international tax provisions?

Administrative Issues

The Service's computer system does not have the data storage capacity to keep information concerning paid deficiencies and paid refunds on line. The Service thus cannot make global interest netting calculations on its computer

system but must instead retrieve the data on paid deficiencies and paid refunds from its computer storage files and then manually make the interest calculations. This procedure could entail a significant additional commitment of IRS resources, primarily because of the need to verify the accuracy and completeness of the data necessary to make a global interest netting calculation and ensure an accurate calculation. Accordingly, the Service requests the following comments:

1. To the extent that taxpayers or practitioners currently make global interest netting calculations for themselves or their clients, the Service would like to receive a detailed description of how those calculations are performed, the cost of performing those calculations, and the reasons why the method used by particular taxpayers or practitioners would be appropriate for the Service to apply to large numbers of taxpayers without requiring significant additional Service resources.

2. How should the Service fulfill its obligation to verify the accuracy and completeness of all taxpayer data relevant to make a global interest netting calculation for a particular period, given the Service's computer data storage limitations?

Time and Address for Comments

The Service and Treasury would appreciate written comments on the above issues. Comments should be submitted by June 30, 1996, to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:DOM:CORP:T:R:IT&A
(Branch 1) Room 5228
Washington, DC 20044

The comments you submit will be available for public inspection and copying.

DRAFTING INFORMATION

For further information regarding this notice, contact Joel Rutstein on (202) 622-4530 (not a toll-free call).

Study of Certain Joint Return and Community Property Issues For Divorced and Separated Taxpayers

Notice 96-19

This Notice invites public comments

for a study being conducted by the Service and Treasury on certain joint return and community property issues, particularly as they affect divorced and separated taxpayers. This study was initially described in Announcement 96-5, "Administrative Initiatives to Enhance Taxpayer Rights," 1996-4 I.R.B. 99 at 101 (Jan. 22, 1996).

BACKGROUND

Section 6013(a) of the Internal Revenue Code generally provides that spouses may file a joint return even though one of the spouses has neither gross income nor deductions. Section 6013(d)(3) states that spouses are jointly and severally liable for the taxes on a joint return.

For married taxpayers who filed jointly but then divorce or separate, joint and several liability means that a former spouse remains liable for all taxes, additions to tax, penalties and interest due with respect to the joint return even if all the income was earned by the other spouse. This liability remains regardless of the terms of any divorce decree or separation agreement.

Congress was concerned that the joint and several liability standard could unfairly attribute tax liability on a joint return to a spouse who should not be held liable for such taxes under certain circumstances. Congress thus enacted the innocent spouse provisions of § 6013(e). Section 6013(e), however, establishes a detailed set of requirements that must be met to obtain innocent spouse relief. As a result, the innocent spouse provisions do not apply in many situations.

"Community property" laws also present unique issues for divorced or separated taxpayers. Community property laws generally consider each spouse to own one-half of the community income of the spouses. Consistent with these general principles of community property laws, the Supreme Court in 1930 held that spouses who live in community property jurisdictions but file separate returns must each include half of the community income in his or her return, even if all the income was earned by one spouse. *Poe v. Seaborn*, 282 U.S. 101 (1930). Under this rule, each spouse would be liable for taxes, additions to tax, penalties and interest due with respect

APPENDIX TWO

Persons submitting comments in response to Notice 96-18.

The following persons or entities submitted comments to the IRS in response to Notice 96-18, 1996-14 I.R.B. 27 (April 1, 1996).

American Bar Association

American Gas Association

American Institute of Certified Public Accountants

Dresser Industries, Inc.

Edison Electric Institute

Ernst & Young LLP

Financial Executives Institute

KPMG Peat Marwick, LLP

New York Clearing House

Price Waterhouse LLP

Tax Executives Institute, Inc.

Marshall W. Taylor, Esq., Taylor, Simonson & Winter

APPENDIX THREE

Witnesses at hearing September 4, 1996.

A hearing was held on September 4, 1996, in Washington, D.C., pursuant to section 1208(a)(2) of TBOR 2 and Announcement 96-75, 1996-34 I.R.B. 29. The following persons testified at that hearing:

Mark H. Ely, representing KPMG Peat Marwick, LLP

Jim Crook, representing Caterpillar Inc., and Eileen Reiger, representing Price Waterhouse
LLP

Kathy Everidge, representing Ernst & Young LLP

Robert L. Ashby, representing Tax Executives Institute, Inc.

APPENDIX FOUR

Excerpt from IRM 31(59)(31).

2 The Service now assesses the deficiency of \$125,000.00 plus interest. The "threshold" underpayment amount is the \$126,000.00 now being assessed. The "trigger" date is March 31, 1992 (the date the 90 day letter was issued). The additional 2% rate will be effective April 30, 1992 (the 30th day after the 90 day letter was issued). Because the taxpayer paid the \$1,000.00 tax assessed May 1, 1990, plus accruals, before January 31, 1991, this notice of assessment does not qualify as an applicable "trigger" date.

3 The interest must be manually computed and assessed using TC 340. The interest is computed at the prevailing interest rates for the period March 16, 1990 through April 30, 1992, and at the prevailing interest rate plus 2% for the period May 1, 1992 to the waiver date plus 30 days, payment date or the 23C date of the assessment, whichever is earlier. Reference Number 200 will be entered in Item 15 of Form 5344/5403 with the date entered in the amount field as April 30, 1992.

31(59)(31) (1-1-95) Netting of Credit and Debit Interest

31(59)(31).1 (1-1-96) Background

(1) After the advent of dual interest rates (debit interest one percent higher than credit interest) in 1986, Congress mandated that the Service implement the most comprehensive "netting" procedures possible.

(2) Netting was necessary in order to eliminate the one percent rate difference during "overlapping" interest periods within a single module. "Overlapping" interest periods occur when a taxpayer owes debit interest on a deficiency, and at the same time, credit interest was allowed on an overpayment. In order to "net" debit and credit interest, the interest rates must be equalized by charging debit interest using "allowable" interest rates during the overlapping interest period.

(3) The Avon Products, Inc., court case of 1978, established the "Use of Money" concept. The concept held that taxpayers should not be charged interest during the period of time that the Service had use of their money. Thus, during overlapping interest periods within a single module, credit and debit interest should net.

(4) To accomplish netting, changes to existing regulations and updates to systemic and manual processing procedures were needed. Two major revisions necessary to accomplish netting were as follows:

(a) The "due date" of interest has been changed. The regulations under Code Section 6611 which govern the due date of interest and additions to tax for purposes of offsetting, were revised. Interest is now due as it accrues instead of when it is assessed (see section below concerning "Netting—Due Date of Interest—Code Section 6611").

(b) Revenue Ruling 88-98 (formerly "Avon Ruling-83-112") needed to be amplified to address adjusting modules where refunds were given WITH interest and a subsequent assessment occurred (see section below concerning "Netting of Credit and Debit Interest Within a Single Module").

(5) Effective January 1993, Master File programming was updated to accomplish netting within a single module where refunds were issued WITH interest.

(6) Effective January 1993, netting procedures must be applied to all cases requiring account restriction with TC 340 which contain refunds (with interest) with effective dates January 1, 1987, and subsequent.
NOTE: If a module is not already or does not otherwise require restriction, DO NOT input TC 340 solely to effect netting. The Master File program will perform netting on unrestricted modules.

31(59)(31).2
Netting of Credit and Debit Interest Within a Single Module

(1) Current processing reflects Revenue Ruling 88-98 which provides that debit interest is charged on a liability only when it is both due and unpaid. Therefore, interest on a subsequent assessment of tax determined after a refund is issued WITHOUT interest, (up to the amount of refund), is computed from the refund date (see IRM section concerning Revenue Ruling 88-98). As a result of netting, a revenue ruling has been proposed to address the computation of interest on subsequent assessments where refunds are issued WITH interest.

(2) Master File processing will perform netting on unrestricted modules. Master File will post the "netted interest amount" with TC 777 which will carry a "999" in the Julian Date field of the DLN. The use of "999" will provide an audit trail which reflects a netting adjustment. (See the following figure: COMPUTER GENERATED NETTING)

COMPUTER GENERATED NETTING

T/C	POSTED	TRANS-AMOUNT	CYC	T	DLN
150	061791	470.00	9121	F	32221-119-09234-1
-----POSTED TRANSACTIONS SECTION-----					
T/C	POSTED	TRANS-AMOUNT	CYC	T	DLN
660	063090	749.00-	9028		32220-183-00471-0
660	091890	749.00-	9040		32220-262-04652-0
660	011391	749.00-	9104		32220-014-21417-1
660	040590	749.00-	9123		32220-096-04327-0
XREF-TIN>000-00-3333					
540	061791	0.00-	9123		32221-119-09234-1
846	061791	2,557.33	9123		32221-119-09234-1
REFND-INT>					
776	061791	31.33-	9123		32221-119-09234-1
670	082593	1,009.00-	9336		32217-238-82312-3
570	092093	0.00	9336		32217-238-82312-3
971	082593	0.00	9337		32277-645-01089-3
977	082593	0.00	9337		32277-645-01089-3
290	100493	1,009.00	9338		32254-658-15349-3
ADJ-RSN-CD>18-76-					
777	061791	12.51	9338		32221-999-09234-1
196	100493	202.33	9388		32221-119-09234-1

JULIAN DATE
999

Figure 66

(3) Master File WILL NOT perform systemic netting on any tax module that contains a restricted interest transaction TC 340, 341, 772, or TC 770 (with a significant amount) input via Document Code 47/54.

(4) When computing interest on subsequent assessments where refunds were given WITH interest, the following procedures apply:

NOTE: If the subsequent assessment is equal to or greater than the refund given, the TC 776 for the refund will be the "netted interest amount" that will be input with TC 772. If this is the situation, follow procedures under (4) (e) below.

(a) Recompute the correct refund amount, if any (i.e., the amount the taxpayer should have received as a result of the subsequent assessment).

(b) Recompute the correct credit interest amount (i.e., the amount of credit interest the taxpayer should have received on the corrected refund as a result of the subsequent assessment). Use the same computation method for the allowable interest as originally calculated (compute to the 23C Date minus 9 days for BMF modules or 13 days for IMF).

(c) Compare the allowable interest issued on the refund (before the subsequent assessment was determined) against the corrected allowable interest determined in (4) (b) above.

(d) The difference determined in (4)(c) above is the "netted interest amount". The "netted interest amount" represents the amount of debit interest on the deficiency that is being charged at the credit interest rate from the due date of the return to the refund date. This is how we effect elimination of the 1 percent differential during the overlapping periods. The taxpayer should not be CHARGED debit interest at a higher rate than the credit interest previously received.

(e) To compute debit interest, perform the following steps:

1 Compute debit interest on the "netted interest amount" "FROM" the refund date to the appropriate interest computation "TO" date.

2 Compute debit interest on the subsequent assessment (up to the amount of refund ORIGINALLY ISSUED minus the corresponding allowable interest) "FROM" the refund date to the appropriate interest computation "TO" date.

3 Compute debit interest on the remaining balance of the subsequent assessment "FROM" the applicable due date of the tax liability to the appropriate interest computation "TO" date. **NOTE:** Debit interest on the netted interest amount is computed to the waiver plus 30 days, payment date or 23C Date, whichever is earlier.

(f) Input the adjustments in (2)(e) above as follows:

1 Input the tax adjustment with the appropriate tax transaction code.

2 Input TC 340 for the amount of debit interest determined in (2)(e) 1, 2, and 3, above.

3 Input TC 772 for the "netted interest amount".

EXCEPTION: When processing erroneous refunds with TC 844, do not input TC 772. Master File programming will generate a TC 777 for the "netted interest amount". (See the following figure: MANUALLY COMPUTED NETTING)

MANUALLY COMPUTED NETTING

T/C	POSTED	TRANS-AMOUNT	CYC	T	DLN
150	062193	7,323.00	9323	D	32206-102-50142-3
806	041593	6,236.00-	9323		WTHLDNG TAX CREDIT POSTED WITH RETURN
-----POSTED TRANSACTIONS SECTION-----					
T/C	POSTED	TRANS-AMOUNT	CYC	T	DLN
610	040993	1,087.00-	9316		32206-502-50142-3
670	051493	1,036.00-	9322		32217-139-81209-3
570	061493	0.00	9322		32217-139-81209-3
846	062193	1,040.27	9323		32206-102-50142-3
					RFND-INT> . 4.27-
776	062193	4.27-	9323		32206-102-50142-3
420	051493	0.00	9325		32277-150-00000-5
300	081693	1,036.00	9331		32247-607-15355-3
					ADJ-RSN-CD>29- - -
772	062193	4.27	9331		32247-607-15355-3
340	081693	17.11	9331		32247-607-15355-3
-----PENDING TRANSACTIONS SECTION-----					
PN 670	092293	1,076.50-	9340		32217-267-78808-3
					DESG-PYMT-CD>

Figure 67

(5) When processing subsequent assessments with multiple prior refunds, begin the netting adjustment calculation with the earliest refund and continue through the latest dated refund.

(6) Master File processing will perform netting on unrestricted modules. Master File will post the "netted interest amount" with TC 777 which will carry a "999" in the Julian Date field of the DLN. The use of "999" will provide an audit trail which reflects that a netting adjustment was made.

(7) Master File WILL NOT systemically net on any tax module that contains a restricted interest transaction TC 340, 341, 772, or any TC 770 (with a significant amount) input via Document Code 47.54.

(8) When processing "quick and prompt" assessments for which interest is restricted, TC 772 will be input on Form 2859 along with TC 340 and any other applicable assessment transaction codes.

(a) When processing a quick assessment for which the interest is NOT restricted, special processing is warranted to eliminate unnecessary restriction of the module.

1 Calculate the netted interest amount and deficiency interest that is due on the module. On a Form 2859, combine the netted interest and deficiency interest amounts and enter the total with TC 190. When the TC 190 posts, Master File will generate the TC 777 (which should match the netted interest that was computed) and adjust the TC 190 for the amount of netted interest that was included.

2 In the remarks section of the Form 2859, separately reflect the two amounts to show what the TC 190 consists of (for purpose of an audit trail).

31(59)(31).3
Netting—Due Date of Interest—Code Section 6611

(1) To implement netting, a revision to the regulations under Code Section 6611 was made. The change allows for paying off a liability with a credit at the earliest possible credit availability date. For the purpose of offsetting against a liability, the revision changes the deemed due dates of liabilities as follows:

(a) **INTEREST**—Interest is now always due as it accrues. The change in due date is explained below:

1 Formerly, interest was considered to be due only when it was assessed. Therefore, when an overpayment was credited against an interest liability, interest on the overpayment ran from the date of overpayment to "THE DATE OF ASSESSMENT OF THE INTEREST LIABILITY". This rule still applies for credits made prior to August 25, 1992.

2 Based on the Section 6611 regulation changes, debit interest will stop as of the date it is paid by the credit **INSTEAD OF WHEN IT IS ASSESSED**. **NOTE:** Effective for credits made on or after August 25, 1992, if a credit is applied against interest that accrued prior to January 1, 1983, the due date for that interest is the earlier of the date of assessment or December 31, 1982. If a credit is applied against interest that accrued after December 31, 1982, interest is due as it accrues, not when assessed.

(b) **PENALTIES, ADDITIONS TO TAX AND ADDITIONAL AMOUNTS**—When offsetting a credit against an addition to tax, penalty or additional amount liability, the liability due date is as follows:

1 **ADDITIONS TO TAX—THE DATE THE AMOUNT WOULD BEAR INTEREST IF NOT SATISFIED BY A PAYMENT OR CREDIT.** Thus, for additions to tax for which interest begins on the due date/extended due date of the return, interest on the overpayment would stop as of the due date/extended due date of the addition to tax that is being paid by the credit.

2 **PENALTIES—THE DATE OF ASSESSMENT.** Thus, for penalties that accrue interest from the 23C Assessment Date, interest on the overpayment would stop as of the date the penalty is assessed or paid, whichever is earlier.

3 **ADDITIONAL AMOUNT (e.g., Accumulated Earnings Tax/ Personal Holding Company Tax)**—The due date of this type of liability is governed by the applicable statute.

(2) Based on the change to Section 6611, when **MANUALLY** offsetting credits against liabilities, the following rules apply:

(a) **WHEN OFFSETTING CREDITS THAT ARE AVAILABLE EARLIER THAN THE DUE DATE OF A LIABILITY OTHER THAN DEBIT INTEREST**—The TC 820 (in the losing module) will carry the availability date of the credit and the corresponding TC 700 (in the gaining module) will be dated with the due date of the liability being paid. This ensures that credit interest on the offset amount (TC 820) will be computed to the due date of the liability and because the credit is earlier than the liability there will be no debit interest due on the deficiency up to the amount of the credit.

NOTE: If allowable interest is due the taxpayer, as a result of the manual offset, allowable interest must be manually computed and posted with a TC 770. Masterfile **WILL NOT** be able to accurately calculate allowable interest in this situation.

(b) WHEN OFFSETTING CREDITS THAT ARE AVAILABLE LATER THAN THE DUE DATE OF A LIABILITY OTHER THAN DEBIT INTEREST—The TC 820 and TC 700 will carry the same date. This will result in the computation of no allowable credit interest and stop debit interest on the earlier liability as of the availability date of the credit.

(c) WHEN OFFSETTING "ALLOWABLE" INTEREST CREDITS TO PAY "DEBIT" INTEREST—Input TC 850 with the 23C Date of the TC 770 transaction and input TC 730 with the availability date of the credit (the availability date of the credit will be the date credit interest was computed to). This will stop accruals on the interest liability as of the credit availability date.

NOTE: Formerly, both TC 850/730 were input with the 23C Date of the interest assessment. This prevented paying off an interest liability until it was assessed. Using the credit availability date for the TC 730 instead of the 23C Date eliminates the overlapping interest period and allows for paying the interest liability as soon as a credit is available.

(d) WHEN OFFSETTING CREDITS (THAT ARE NOT INTEREST CREDITS) TO PAY DEBIT INTEREST—The TC 820 (in the losing module) will carry the availability date of the credit and the corresponding TC 700 (in the gaining module) will be dated with the due date of the liability being paid. Since the liability is interest, the "due date" is the date debit interest was computed to.

(e) WHEN OFFSETTING OVERPAYMENTS TO PAY LIABILITIES OF TAX OR ADDITIONAL AMOUNTS—Credit interest continues to accrue to the due date of the liability.

(3) Master File systemically offsets in accordance with (2)(a), (2)(b), and (2)(d) above.

31(59)(31).4 (1-1-96)

Netting—Special Computations

(1) Subsequent Assessments Involving Tax Motivated Transactions—The following netting procedures apply when the subsequent assessment involves tax motivated transactions:

(a) If the entire assessment is due to tax motivated transactions, debit interest is charged on the TMT tax as usual. Do not net the tax (or any interest due on the tax) attributable to the tax motivated transactions. During any overlapping period, the credit rate plus 20 percent would be the applicable rate to use to calculate the interest. Currently the Service has no program that calculates interest on an underpayment at the credit interest rate plus 20 percent. NOTE: Although netting does not apply to TMT tax or interest, netting applies to interest on any penalties that may also be assessed.

(b) If only part of the assessment is due to tax motivated transactions, net only the part of the underpayment that **WILL NOT** accrue interest at the 120 percent rate. Netting would also apply to any interest on the tax or penalties that is not due to TMT. The percentage determined is multiplied by the TOTAL credit interest amount.

(2) Erroneously Computed Credit Interest—When refiguring a taxpayer's refund based on a subsequent assessment and it is determined that credit interest was originally overpaid or underpaid, the following procedures apply.

(a) **OVERPAID CREDIT INTEREST**—If the taxpayer received excess credit interest on the previous refund and the statute for recovering the erroneous amount is still open, implement erroneous refund procedures. If the statute for recovery is not open, DO NOT implement erroneous refund procedures. After taking the applicable action, continue to follow netting procedures.

(b) **UNDERPAID CREDIT INTEREST**—If the taxpayer was underpaid credit interest on the previous refund, and the statute for refunding is open, reduce the deficiency interest on the subsequent assessment by the amount of credit interest that was underpaid to the taxpayer. If the statute for refunding is not open, DO NOT reduce the deficiency interest by the underpaid amount.

31(59)(32) 1-1-96
General Agreement on Tariffs and Trade (GATT)

31(59)(32).1 1-1-96
Background

Effective January 1, 1995, The General Agreement on Tariffs and Trade (GATT) established a new differential credit interest rate. The GATT rate is one and a half points below the normal credit interest rate for refund amounts exceeding \$10,000, for ALL business returns for taxpayers with a corporate filing requirement. (Forms 1120, 990C, 990T filing requirements).

31(59)(32).2 1-1-96
Credit Interest Computations on Refunds

- (1) Credit interest accrued through December 31, 1994:
 - (a) is NOT subject to the GATT rate.
 - (b) is calculated at the normal interest rate, and
 - (c) WILL NOT be considered for purposes of determining if the \$10,000 threshold has been reached.
- (2) Any amount (excluding interest) refunded after January 1, 1995, is used to determine if the \$10,000 threshold is met and the lower GATT rate applies. The threshold amount DOES NOT include credits offset against a liability.
- (3) The 45 day interest-free period established by OBRA 93 (relating to amended returns, claims, and IRS initiated adjustments) must be considered when computing credit interest FROM and TO dates.
- (4) The GATT rate was programmed for Master File, effective January 1, 1995, and for IDRS Command Code COMPA, and PICRD effective January 1995.
- (5) GATT rates will affect future computations where netting is involved.
- (6) GATT INTEREST COMPUTATIONS (Exhibit 31(59)0-2), illustrate how the GATT interest provision applies.
- (7) GATT interest rate and factor charts are provided in Exhibit 31(59)0-2.

