

Milbank TAARS® Managing Director Critiques IRS Chief Counsel Pronouncement on “Hot Interest”



Michael J. Grace, JD, Managing Director-TAARS®, on May 26, 2011 critiqued in a major tax publication a recent pronouncement by the Internal Revenue Service Office of Chief Counsel addressing interest on large corporate tax underpayments, colloquially known as “hot interest.” Michael explained that the pronouncement conflicts with both a decision of the United States Tax Court and the IRS’ directives to its revenue agents.

Pertinent Rules

The Internal Revenue Code authorizes the IRS to charge corporations interest on tax underpayments at a rate at least one percentage point higher than the rate at which the IRS pays corporations interest on tax overpayments. Additionally, if a corporation has a “large corporate underpayment,” then the differential in the IRS’ favor widens even more, to three percentage points higher on underpayments compared to the generally applicable rate on overpayments. A “large corporate underpayment” means any underpayment of tax by a C corporation for any taxable period exceeding \$100,000. Tax advisers and the IRS label this increased underpayment rate “hot interest.” See Internal Revenue Code Section 6621(a)-(c).

Example. Assume that the IRS generally pays corporations interest on tax overpayments at the rate of 4%. Accordingly, the IRS generally would charge corporations 5% interest on underpayments. If, however, a corporation underpays tax by more than \$100,000, then the IRS may charge the corporation interest on that underpayment at 7% (three percentage points higher than the 4% interest rate on corporate overpayments).

Interest rates on tax overpayments and underpayments are subject to quarterly adjustments based on changes in interest rates payable on Federal short-term obligations (“Treasuries”). See Internal Revenue Code Sections 6621(b) and 1274(d).

Issue

What if a corporation initially underpays tax by more than \$100,000, but then carries back a tax loss or other item, reducing the underpayment below \$100,000? May the IRS charge the corporation hot interest even though the carryback reduced the underpayment below the threshold of \$100,000?

In *Med James, Inc. v. Commissioner*, 121 TC 147 (2003), the United States Tax Court addressed this issue. Upon examining a corporation’s federal income tax return, the IRS initially determined that the corporation had underpaid tax by more than \$100,000. The corporation then carried back to the same tax year a net operating loss (“NOL”). This carryback reduced the underpayment below \$100,000. The IRS, however, insisted that the NOL carryback did not relieve the corporation from having to pay hot interest on the originally determined underpayment. The parties took their disagreement to the Tax Court. It held that for purposes of determining hot interest the IRS could not ignore the carryback.

Chief Counsel Advice 201120026

In CCA 201120026, released May 20, 2011, the IRS Office of Chief Counsel basically took the position the Tax Court had rejected in *Med James*. Chief Counsel stated it continues to believe that once the \$100,000 threshold has been met, hot interest applies to all underpayments of tax regardless of any “payments” (including NOL carrybacks) subsequently made. According to the CCA, whether a corporation has made a threshold underpayment exceeding \$100,000 should be determined as of the due date of the relevant tax return. “Thus, we would argue that an NOL carryback that arises after the due date of the return does not affect the existence of a threshold underpayment.” The CCA concluded, “We do not agree with the decision in *Med James, Inc., v. Commissioner,...*”

The Office of Chief Counsel essentially operates as the IRS’ law firm. Curiously, CCA 201120026 diverges not only from *Med James* but also from language in the IRS’ Internal Revenue Manual (“IRM”) directing its revenue agents examining tax returns. The IRM states that once hot interest becomes applicable, it generally remains in effect even after a balance is reduced below the \$100,000 threshold. However, the IRM citing *Med James* further states that if a net operating loss carryback reduces tax to \$100,000 or less at the time of assessment, then the hot interest rate will not apply to that assessment. See IRM Section 20.2.5.8.1.

Managing Director’s Critique

In Federal Tax Weekly for May 26, 2011, published by CCH, a Wolters Kluwer business, Michael Grace commented:

“Because of an NOL carryback, a large corporate underpayment on which hot interest might have been owed arguably was not, under the rationale of *Avon Products* (78-2 USTC ¶ 9821), “due and unpaid.” The CCA, which seems to diverge from language in Internal Revenue Bulletin Section 20.2.5.8.1 (4), suggests that IRS Chief Counsel intends to continue litigating the issue in *Med James*.”

Ironically, CCA 201120026 cites *Avon Products* as supporting Chief Counsel’s position that carrying back an NOL after the due date of a tax return should not affect the imposition of hot interest.

About Milbank TAARS®

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