

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

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

## Significant Refund Opportunities

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

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

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

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

## Types of possible IRS errors

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

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

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

Although the concept of interest on tax underpayments and overpayments is fundamentally simple - i.e., the government or taxpayer should be compensated for the time the other party has use of its money -- it is not surprising that putting the

concept into practice is anything but simple when dealing with a particular taxpayer's complex fact situation and the 5000-plus page tax code.

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

1. choose correctly from no fewer than five possible rates of interest, all of which can fluctuate quarterly;
2. properly distinguish between current year and carryback adjustments;
3. identify any relevant interest-free periods;
4. consider the applicability of "use of money" principles, which in certain circumstances can significantly delay the start date for interest on underpayments of tax;
5. consider the applicability of the Code's interest-netting provisions, which can be used to eliminate the difference between the higher rates of interest the IRS charges corporate taxpayers on tax underpayments and the lower rates it pays them on tax overpayments during "periods of mutual indebtedness"; and
6. take into account the entire series of tax increases and decreases, advance payments, deposits, and other transactions that affect the running balance of the tax account in question.

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

## Contingent Fees

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

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

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

## Conclusion

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

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

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

## For more information

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

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