

# Thinking Beyond Uncertain Tax Positions: Understanding the Potential Impact of Interest Computations and Penalties

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In recent months, corporate tax departments have been devoting a good deal of attention to the implementation of the Financial Accounting Standards Board's Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48" or "the Interpretation"). While it is understandable that such efforts have primarily been focused on identifying and evaluating the companies' uncertain tax positions, some may find that the penalty and interest computations related to those positions may be equally challenging.

## Introduction and background

In the normal course of business, companies often seek to reduce their overall tax burden and minimize or delay cash outflows for income taxes. For example, they may enter into tax planning transactions, structure their business in a tax-efficient manner, or seek tax-optimized methods of transacting with affiliates and others. Yet even in the absence of such tax planning activities, the average corporate tax return may include numerous positions that are "uncertain" within the meaning of FIN 48, insofar as the application of the law is unclear. Thus, it is uncertain whether the company's application of the law will be agreed to or accepted by the relevant taxing authority, even though the positions relate to transactions entered into in the ordinary course of business (e.g., routine compensation, leasing, and financing arrangements).

FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on its tax return. Under the Interpretation, the financial statements will reflect expected future tax consequences of such positions, presuming the tax authorities' full knowledge of the position and all relevant facts, but without considering time values. Tax positions also include conclusions that a company is not subject to a jurisdiction's tax and therefore need not file a return.

## Interest on underpayments

Generally, taxing authorities assess interest on tax underpayments, and if a disallowed position does not meet certain minimum thresholds of support penalties may also be imposed. With respect to interest, FIN 48 Paragraph 15 specifically provides the following guidance:

When the tax law requires interest to be paid on an underpayment of income taxes, an enterprise shall begin recognizing interest expense in the first period the interest would

begin accruing according to the provisions of the relevant tax law. The amount of interest expense to be recognized shall be computed by applying the applicable statutory rate of interest to the difference between the tax position recognized in accordance with this Interpretation and the amount previously taken or expected to be taken in a tax return.

While interest is required to be recognized on tax benefits that, as a result of FIN 48, are unrecognized, a company's US interest computations in this context can be complex.

FIN 48 operates on the premise that to the extent a tax benefit does not qualify for financial reporting recognition, the benefit constitutes a loan from the government, resulting in an interest charge. Consequently, the basis for interest accrual for each tax position is the difference between the tax position recognized in the financial statements and the amount claimed (or expected to be claimed) in the tax return. Interest expense should begin to be recognized in the first period that interest would begin to accrue in accordance with the relevant tax law (e.g., in the case of U.S. federal taxes, the Internal Revenue Code, Treasury Regulations, and related authorities).

In the U.S., because of the existence of net operating loss or tax credit carryforwards, there may be cases where no interest would be due even if recognized tax benefits taken by the company are not ultimately sustained. In other cases the outcome of a specific issue may impact the appropriate interest rate that would be expected to apply to other issues (e.g., the aggregation of several smaller positions that in aggregate would subject a company to "hot interest"). An aggregated by jurisdiction by tax year calculation, based upon the relevant tax laws within a jurisdiction, would allow for the consideration of these and other tax law intricacies of computing the FIN 48 interest accrual. Use of this approach would result in an aggregated interest calculation that would be computed as if all of the unrecognized tax benefits within a particular jurisdiction and tax year were to be lost in ultimate settlement.

When a company books a provision for interest, the amount should be that which would actually be due on the corresponding unrecognized tax benefit. Therefore, a high-level interest computation that disregards such issues as interest netting, "hot interest," interest-free periods, and "use of money" principles, and instead simply starts interest from the unextended due date of the return and applies only normal rates of interest might not provide a reasonable estimate of the interest that would be due if the amount representing the unrecognized tax benefit were not ultimately sustained.

#### What factors affect how much interest a taxpayer owes?

Determining how much interest to recognize for purposes of FIN 48 involves three variables: (1) the amount of principal (i.e., tax) on which interest may be owed, (2) the rate of interest, and (3) the period of time during which interest will be running. The tax amount, of course, will be computed by the taxpayer as part of the process by which it evaluates its various tax positions under FIN 48. However, determining the correct rate(s) of interest and the period of time during which interest accrues requires the taxpayer to identify, and apply correctly to its own specific facts and circumstances, the complicated and interrelated rules and procedures that govern the computation of interest.

#### Determining the period during which interest runs

Pursuant to IRC § 6601(a), interest is payable where the amount of any tax is not paid on or before the last day prescribed for its payment (determined without regard to any extension of time to pay or any written installment agreement entered into under IRC § 6159). IRC § 6151(a) provides that the

last day prescribed for payment is the unextended due date of the return. Therefore, as a general rule, interest runs from the original return due date to the date on which payment is received.<sup>1</sup>

The Internal Revenue Code and IRS procedures, however, provide for certain periods during which interest on a tax underpayment does not run. For example, pursuant to IRC §6601(c), if the taxpayer signs a waiver of the restrictions on assessment (e.g., Form 870, 870-AD, or 4549) and the IRS fails to make notice and demand for the additional tax within 30 days, interest is suspended beginning on the 31st day following the filing of the waiver until notice and demand is issued.

In addition, Rev. Proc. 94-60<sup>2</sup> provides that if the taxpayer received a refund without interest and an underpayment of tax is later determined for the same tax year, interest on the underpayment (up to the amount of the earlier refund) will not begin to run until the date the refund was issued.

Finally, the application of “use of money” principles may delay – in some cases significantly – the start date for interest on a tax underpayment. These principles have evolved in a series of court decisions, starting with *Avon Products Inc. v. United States*.<sup>3</sup> The more recent cases of note are *May Department Stores v. United States*<sup>4</sup> and *Sequa Corporation v. United States*.<sup>5</sup>

*Avon Products* established that interest is a charge for the use of money and should not be asserted as a penalty. The U.S. Court of Appeals for the Second Circuit stated that it “is a clearly established principle that interest is . . . intended only to compensate the Government for delay in payment of tax.” Further, the court found that interest begins only when a tax is “both due and unpaid.”

In *May Department Stores* the U.S. Court of Federal Claims further explored and developed the “use of money” principles first enunciated in *Avon Products*. Presented in somewhat simplified fashion, the relevant facts in *May Department Stores* are as follows:

The taxpayer obtained an extension of time to file its return for Year 1 and when the return was filed elected to have the overpayment in tax shown on the return credited against estimated tax for Year 2. The taxpayer did not designate to which installment of estimated tax the credit elect from Year 1 was to be applied, but had fully paid its first and second installments of Year 2 estimated tax at the time the return for Year 1 was filed. The IRS later determined a deficiency (underpayment) for Year 1.

The issue in *May Department Stores* was whether “use of money” principles prohibited the IRS from charging interest on the underpayment for Year 1 until October 15<sup>th</sup> of Year 2, when the taxpayer filed its Year 1 tax return and elected to apply the overpayment shown on that return to its liability for Year 2 estimated tax. The U.S. Court of Federal Claims held that the taxpayer was not liable for interest until the date it filed its Year 1 return, since before October 15<sup>th</sup> of Year 2 the taxpayer had paid in full the first two installments of its Year 2 estimated tax liability. The Service’s application of the overpayment to the first installment of estimated tax for Year 2, which installment had already been paid, could not change the fact that the Government had the use of the funds at issue from April 15 to October 15 and, therefore, suffered no underpayment.

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<sup>1</sup> If a tax liability for one tax year is satisfied by the credit of an overpayment of tax for a subsequent year, interest runs on the underpayment from the due date of the return for the earlier year to the unextended due date of the return for the subsequent year if that return is filed timely (including extensions), and to the actual date of filing if that return is delinquent. See Rev. Rul. 88-97.

<sup>2</sup> 1994-2 C.B. 774.

<sup>3</sup> 588 F.2d 342 (2d Cir. 1978).

<sup>4</sup> 36 Fed. Cl. 680 (1996), *acq.* AOD CC-1997-008 (Aug. 4, 1997).

<sup>5</sup> 99-1 USTC ¶ 50,379 (DC S.D.N.Y.) (June 10, 1998) (not reported in F.Supp.).

The IRS issued an Action on Decision<sup>6</sup> in which it acquiesced in the decision of the U.S. Court of Federal Claims in *May Department Stores*.

In *Sequa*, the U.S. District Court for the Southern District of New York applied the “use of money” principles to a situation wherein the taxpayer elected to credit its Year 1 tax overpayment to its estimated tax for Year 2, but ultimately never needed any part of that overpayment to satisfy its Year 2 tax liability. In a logical extension of the holding in *May Department Stores*, the district court held that the IRS was not entitled to interest on additional tax later determined to be due for Year 1 until March 15, Year 3, the unextended due date of *Sequa*'s Year 2 tax return.

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

### Determining the applicable rate(s) of interest

Pursuant to IRC § 6621(a), the normal rate of interest charged by the IRS on tax underpayments is the federal short term rate plus 3 percent. Under IRC § 6621(c), the underpayment rate increases to the federal short-term rate plus 5 percentage points for “large corporate underpayments.” This increased underpayment rate is sometimes abbreviated “LCU (large corporate underpayment) interest,” but is more commonly referred to as “hot interest,” because interest is running at a 2 percent higher or “hotter” rate.

In order for hot interest to apply, there must first be a “threshold underpayment of tax” of more than \$100,000. The threshold underpayment of tax is the excess of the tax imposed (excluding interest, penalties, additional amounts and additions to tax) for the tax period over the amount of such tax paid on or before the last date prescribed for payment. Different types of taxes (for example, income taxes and employment taxes) and amounts that relate to different tax periods are not added together in determining the \$100,000 threshold.

Once the threshold underpayment requirement has been met, the hot interest rate applies to all underpayments (including interest, penalties, additional amounts and additions to tax) for periods after the “applicable date” or “trigger date.”

When the deficiency procedures set forth in IRC §§ 6211 to 6216 apply, the applicable period is the 30th day after the earlier of (1) the date on which the IRS sends the taxpayer the first notice of deficiency (30-day letter) that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals, or (2) the date on which the IRS issues a deficiency notice under IRC § 6212 (90-day letter).

For underpayments to which deficiency procedures do not apply, the applicable date is the 30th day after the date on which the IRS sends the first letter or notice that notifies the taxpayer of the assessment or proposed assessment of tax.

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<sup>6</sup> AOD CC-1997-008 (Aug. 4, 1997).

<sup>7</sup> 1999-2 C.B. 441.

A letter or notice is disregarded for purposes of establishing or "triggering" an applicable date if: (1) the taxpayer pays the full amount shown as due within 30 days of the mailing date of the letter or notice, (2) the amount of the deficiency or proposed deficiency (or assessment or proposed assessment) is not greater than \$100,000 (without regard to interest or penalties), or (3) the letter or notice is later withdrawn.

### Global interest netting

Rev. Procs. 99-43 and 2000-26 and IRC §6621(d)<sup>8</sup> implement a provision of the IRS Restructuring and Reform Act of 1998 that provides for a "net interest rate of zero" to the extent of overlapping tax underpayments and overpayments.

The term "net rate of zero" is something of a misnomer, because under the netting procedures interest is neither paid nor allowed at a zero rate. Instead, netting serves to eliminate the interest differential (the difference between the rate the IRS charges corporations on tax underpayments and pays them on tax overpayments) for "periods of mutual indebtedness," *i.e.*, overlapping overpayment and underpayment periods. Said another way, netting equalizes the rates of interest during overlapping periods.

The benefit derived from interest netting can be substantial, since the interest rate differential can be as much as 4½ percent where underpayment interest is running at the 2 percent higher hot interest rate and overpayment interest is running at the lower (by 1½ percent) large corporate overpayment (a/k/a GATT) rate under IRC § 6621(a)(1)(B).

Global netting is applicable across different tax periods and different types of tax, *e.g.*, income taxes can be netted against employment taxes and/or excise taxes, etc.<sup>9</sup> The various overpayments and underpayments must, however, be those of the "same taxpayer." In addition, each overpayment and underpayment may be considered only once in determining whether equivalent amounts of overpayment and underpayment interest exist.

### Example

For the tax year 2000, Corporation X filed a claim for refund for \$3 million, which is pending with the IRS. If the claim is allowed, Corporation X would receive \$670,850 of overpayment interest, computed from March 15, 2001, to December 31, 2006.

For the tax year 2001, the IRS issued a 30-day letter on December 2, 2004. Corporation X filed a protest and the case is pending in Appeals. Two percent "hot" interest is applicable as of January 1, 2005. Corporation X's FIN 48 liability is \$3 million, on which underpayment interest from March 15, 2002, to December 31, 2006, would be \$1,112,114.

<sup>8</sup> Although the interest netting rules generally apply to interest for periods beginning after July 22, 1998 (interest accruing on or after October 1, 1998), Rev. Proc. 99-43 provides guidance for submitting claims with respect to interest accruing before October 1, 1998. Rev. Proc. 2000-26 provides guidance for applying the interest-netting provisions to interest accruing on or after October 1, 1998.

<sup>9</sup> When a taxpayer receives a refund *with interest* and the IRS later determines an underpayment of tax for the same year, the within module netting rules of Rev. Proc. 94-60 apply. Pursuant to that revenue procedure, interest is calculated as follows:

For the period for which the taxpayer was paid interest on the prior refund, interest is charged at the same rate on the portion of the underpayment that does not exceed the tax refund. (For any period for which interest is not paid on the prior refund, the IRS will not charge interest on the portion of the underpayment that does not exceed the refund.) Interest at the underpayment rate is charged on the portion of the underpayment that exceeds the prior refund from the original due date of the return and on the entire underpayment from the date of the refund check.

During the overlapping period – March 15, 2002, to December 31, 2006 – the interest-netting provisions would decrease the rate of interest charged by the IRS on the 2001 deficiency from the normal (and later “hot” rate) to the lower overpayment rates.

As a result, Corporation X’s interest savings would be \$607,488 (*i.e.*, deficiency interest would be reduced from \$1,112,114 to \$504,626).

## Penalties

FIN 48, paragraph 16 states that, “if a tax position does not meet the minimum statutory threshold to avoid payment of penalties (considering the factors in paragraph 7 of this Interpretation), an enterprise shall recognize an expense for the amount of the statutory penalty in the period in which the enterprise claims or expects to claim the position in the tax return.” Applicable penalties should be accrued (or reversed) when the company’s assessment about an uncertain tax position changes to the degree that the sustainability of the position(s) in question decreases below (or increases above) such thresholds.

## Classification

FIN 48 gives companies the option, upon its adoption, of classifying interest as components of either income tax expense or interest expense as an accounting policy. The Interpretation requires that companies disclose that policy and the amount of interest and penalties charged to expense each period, and that they disclose the amounts accrued as of the balance sheet date.

## Implementation

In appropriate circumstances, compliance with the more defined and rigorous accounting model introduced by FIN 48 will require the exercise of significant judgment by a company’s management in order to develop a reasonable estimate of interest. In developing an estimate of US interest due on uncertain tax positions, the company should, consider that:

1. Underpayment interest should generally begin to run as of the due date for payment;
2. Overpayment interest should begin to run as of the date the client’s account is first overpaid;
3. The correct quarterly interest rates must be used (including “GATT” and “hot” rates) and interest must be compounded daily;
4. Any payments and/or deposits made by the company need to be taken into account; and
5. Tax increases/decreases attributable to general (*i.e.*, current year) adjustments must be distinguished from those attributable to carryback adjustments and dealt with separately for interest purposes

In addition, tax department officials may want to determine whether the start date for underpayment interest can be delayed through application of “use of money” principles and whether the effect could be material. The following inquiries are relevant to that analysis:

1. Have there been material tax or interest payments made to the revenue authorities?
2. Were tax overpayments reported on a return applied to the next year’s estimated tax?
3. If so, what were the amounts of the overpayments?
4. Were Forms 2220, “Underpayment of Estimated Tax by Corporations,” prepared?
5. Did the company receive any refunds (including tentative refunds) without interest?

Finally, if during the past 6 years the company has paid any significant underpayment interest to the IRS, or has been paid any overpayment interest by the IRS, the company should consider whether it is entitled to the benefits of interest netting as described above and whether these benefits would be material.

## Conclusion

Where interest and penalties are a significant factor in a company's uncertain tax position, the new FASB Interpretation will require a good deal of real world mathematical and intellectual rigor, as well as the exercise of good judgment. Not only must the company identify, evaluate, and measure its uncertain tax positions, it then must also compute the interest attributable to those positions in a manner that reflects the relevant statutory, regulatory, and procedural provisions.

We have described and discussed above the computational steps that companies with US tax exposures who also report on a US GAAP basis should consider. Given the significant impact that complex principles such as "use of money" and interest netting can have, a Company may determine that additional steps may need to be performed or that advice from outside tax advisors on interest issues is warranted.