

## Jobs Act May Change the Economics in Favor of Deposits

By Peter H. Winslow, Samuel A. Mitchell,  
and Joseph A. Sergi

Peter H. Winslow, Samuel A. Mitchell, and Joseph A. Sergi are lawyers in the firm Scribner, Hall & Thompson LLP, in Washington.

The American Jobs Creation Act of 2004 (the Jobs Act), P.L. 108-357, contains sweeping changes that will keep tax controversy lawyers and advisers busy for many years. Companies that formerly provided services will suddenly be in the "manufacturing" business, and the IRS inevitably will challenge the recharacterizations, prompting administrative appeals and litigation. One significant procedural change, however, may make the controversy process a little easier on taxpayers. Tucked into a list of revenue raisers in the Jobs Act is a new code section (section 6603) that codifies the taxpayer's traditional right to make a deposit in lieu of a payment to stop the running of interest on a potential deficiency, and, for the first time, provides for an interest accrual on the withdrawal of the deposited funds.<sup>1</sup> The new interest accrual changes the economics in considering whether to make a deposit during the audit or appeals process to maintain potential Tax Court jurisdiction, or forgo the right to petition that court and make a payment that can be recovered only in a refund action. At least for large corporate taxpayers, although there are competing considerations, it may now be advisable to make deposits during the controversy process.

The deposit right was first recognized by the Supreme Court in *Rosenman v. United States*,<sup>2</sup> a refund action in which an estate made a remittance before it filed a return and before the IRS made an assessment. By the time the IRS finished examining the return and made an assessment, the period of limitations for recovering a payment had run on the prereturn remittance. The government argued that the statute of limitations barred the taxpayer's refund claim for the payment, but the Supreme Court held that the remittance was not a payment triggering a self-assessment. Rather, the Court held that the remittance was a "payment in escrow" made under protest, merely to stop the running of underpayment interest and not to satisfy a defined liability. The remittance had no

more significance than a "deposit made in the nature of a cash bond." The Court commented that the government had successfully argued in earlier lower court cases that interest should not accrue on similar deposits. Justice Felix Frankfurter noted the unfairness of the government's argument, concluding that "It will not do to treat the same transaction as payment and not as payment, whichever favors the Government."<sup>3</sup> Thus, the Court held that the statute of limitations did not bar the refund.

Although taxpayers and the IRS have continued to litigate the deposit/payment issue for the 59 years since *Rosenman*, in a variety of contexts,<sup>4</sup> the IRS clarified some of the uncertainty with a series of revenue procedures recognizing a taxpayer's right to make a deposit in the nature of a cash bond to cover potential liabilities after it filed its return.<sup>5</sup> The last iteration was Rev. Proc. 84-58, under which a taxpayer could deposit funds with the IRS, in lieu of a payment, to stop the running of underpayment interest. That could be significant, as the "hot interest" provision automatically adds 2 percentage points to the rate on large corporate underpayments (exceeding \$100,000), running from a date 30 days after the IRS issues a 30-day letter notifying a taxpayer of a proposed deficiency.<sup>6</sup> In addition to stopping the running of underpayment and hot interest, a taxpayer that followed the requirements of the revenue procedure by designating the remittance as a deposit retained certain rights, the most important of which was the right to file a petition in the Tax Court to challenge a proposed deficiency if the appeals process did not go the taxpayer's way. The taxpayer also retained the right to allocate the deposit between tax, interest, and penalties if assessments ultimately were made, and the right to withdraw

<sup>3</sup>*Id.* at 663.

<sup>4</sup>For example, there was a split in the circuits for many years over whether an assessment was necessary for there to be a payment. The split was finally resolved in the negative by the Supreme Court in *Baral v. United States*, in which the Court held that remittances of estimated tax and withholding tax were paid on the due date of the return rather than on the date the IRS assessed the liabilities. 528 U.S. 431, *Doc 2000-5170*, 2000 TNT 36-10 (2000). Most of the cases in this area involving deposits, like *Rosenman*, dealt with the issue of whether a statute had run on a payment. Other cases have dealt with whether a remittance could be characterized as a payment to draw interest, see, e.g., *United States v. Tate & Lyle North American Sugars*, 162 F. Supp.2d 236, *Doc 2001-24574*, 2001 TNT 186-17 (S.D.N.Y. 2001), or whether a taxpayer could "dump" money on the Treasury for an interest accrual, see, e.g., *Northern Nat. Gas v. United States*, 354 F.2d 310 (Ct. Cl. 1965).

<sup>5</sup>Rev. Proc. 64-13, 1964-1 C.B. 674; Rev. Proc. 82-51, 1982-2 C.B. 839; Rev. Proc. 84-58, 1984-2 C.B. 501.

<sup>6</sup>Section 6621(c).

<sup>1</sup>Jobs Act section 842.

<sup>2</sup>323 U.S. 658 (1945).

the deposit without going through the sometimes lengthy refund claim process and potential Joint Committee on Taxation review for refunds exceeding \$2 million.<sup>7</sup>

There were risks in the deposit procedure. For example, the IRS could apply the deposit to the subject liability if it determined collection was in jeopardy. The main price of that flexibility under Rev. Proc. 84-58, however, was that the deposit did not draw interest when turned over to the government. Therefore, the taxpayer in controversy with the IRS over a potential tax liability was faced with three choices. First, the taxpayer could make a deposit to stop the running of underpayment interest to preserve Tax Court jurisdiction but forego any overpayment interest on the deposited funds. Second, the taxpayer could keep its funds invested at its own rate of return on investments but risk exposure to underpayment interest and hot interest to preserve potential Tax Court jurisdiction. Third, the taxpayer could forego the option of the Tax Court and make a payment that would draw interest if ultimately recovered through the refund process and all that entails — that is, a formal refund claim, Joint Committee review for a refund over \$2 million, and possible litigation in the Court of Federal Claims or a federal district court. In our experience, the economics of that set of choices rarely balanced in favor of the first choice, depositing funds under Rev. Proc. 84-58. In making that decision, a taxpayer had to weigh its own rate of return that it would realize if it continued to hold the funds and its probability of success or favorable appeals settlement against the possible assessment of underpayment and hot interest. Without any consideration of the strength or weakness of the issue, a deposit usually did not make economic sense unless the spread between the underpayment or hot interest rate and its own rate of return on investments exceeded the spread between its own rate of return and the zero rate on a deposit.

The Jobs Act should change that analysis. It adds a new section to the code (section 6603) that allows a taxpayer to deposit money to stop the running of underpayment and hot interest as under Rev. Proc. 84-58, with a provision for interest on the amount of the deposit that is attributable to disputable tax liabilities.<sup>8</sup> The disputable tax liability requirement is intended to keep taxpayers from dumping excess money on the IRS as an investment opportunity. A disputable tax is the amount of tax specified at the time of the deposit that is the taxpayer's reasonable estimate of the maximum amount of tax attributable to disputable items.<sup>9</sup> A disputable item is any item of income, gain or loss, deduction, or credit if the taxpayer has a reasonable basis for its treatment of such item *and* reasonably believes that the IRS also has a reasonable basis for disallowing the taxpayer's treatment of the item.<sup>10</sup> The disputable tax liability test is automatically satisfied if the taxpayer has received a 30-day letter

proposing a deficiency.<sup>11</sup> To the extent (and only to the extent) the deposit is attributable to a disputable tax that either meets the reasonable basis test or is specified in a 30-day letter, interest will accrue at the federal short-term rate calculated under section 6621(b) if the taxpayer ultimately withdraws the deposit. Although it is not clearly stated in the new law, we presume that the term disputable tax is broad enough to cover deposits attributable to potential deficiency interest accruals from the date of the return to the date of the deposit because those accruals are treated as tax under section 6601(e)(1).<sup>12</sup>

The new law provides a way to keep the Tax Court option open as long as possible, without the traditional risk of hot interest running after the 30-day letter date. That, of course, will not foreclose the option to bring a suit in the Court of Federal Claims or a federal district court if desired. A deposit can be applied as a payment, setting up a refund claim and refund action, with a simple written directive to the IRS. However, there are still a few things to consider in deciding whether to make a deposit. First, excess amounts deposited to cover potential penalties that are not considered taxes apparently do not draw interest. Second, the interest rate credited on the deposit will be less than the rate credited on a refund of an overpayment because the add-ons of section 6621(a)(1)(B) to the federal short-term rate will not apply.<sup>13</sup> In the case of a corporate overpayment exceeding \$10,000, the negative spread will be 0.5 percent.<sup>14</sup> Third, the IRS may still, as under current practice, apply the deposit to tax if it determines that collection is in jeopardy. Finally, taxpayers always have to consider how interest netting under section 6621(d) applies to any payment or potential payment. The conference report to the Jobs Act seems to indicate that a deposit cannot be used to establish a period of a net zero interest rate accrual with simultaneous deficiencies on other tax periods.<sup>15</sup> Under section 6621(c), the hot interest rate on a large corporate underpayment is 5 percent higher than the federal short-term rate that a taxpayer would draw on a deposit. Therefore, a taxpayer with large simultaneous deficiencies running on other tax periods may find it more advantageous to make a payment to establish an overlapping period of a zero interest rate accrual.

There is one final thing to consider. The deposit provision has an effective date of October 22, 2004, which was the date of enactment of the Jobs Act. However, the law provides that currently existing deposits under Rev. Proc. 84-58 can be subject to the new provision, including

<sup>11</sup>New section 6603(d)(3)(B).

<sup>12</sup>That section provides that "any reference in this title . . . to any tax imposed by this title shall be deemed also to refer to interest imposed by this section on such tax."

<sup>13</sup>This perhaps is the reason the provision is included among revenue raisers in the bill. The provision is scored as a \$127 million revenue raiser over 5 years and \$93 million over 10 years. H.R. Conf. Rep. No. 108-755, at 812 (2004).

<sup>14</sup>Section 6621(a)(1) sets the overpayment rate at the federal short-term rate plus 3 percent, 2 percent for corporate overpayments up to \$10,000, or 0.5 percent for corporate overpayments exceeding \$10,000.

<sup>15</sup>H.R. Conf. Rep. No. 108-755, at 649 (2004).

<sup>7</sup>Section 6405.

<sup>8</sup>New section 6603(d)(2).

<sup>9</sup>New section 6603(d)(2)(A).

<sup>10</sup>New section 6603(d)(3)(A).

the interest accrual, starting on the date the taxpayer notifies the IRS it intends the deposit to be subject to the

section 6603. There does not appear to be any reason to fail to make that notification on an existing deposit.