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A Remittance to the IRS May Not Always Operate as Intended

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A taxpayer against whom the IRS determines—not "assesses" but "determines"—a tax deficiency must decide whether to make a remittance to the IRS and if so, whether the remittance is to be treated as a "deposit" or as a "payment" of the determined deficiency. Both, when remitted, stop the accrual of daily compounding interest on the deficiency, which is the reason for making a remittance, but each has different consequences.

A taxpayer generally makes a deposit when it submits a written statement with a remittance to the IRS designating the remittance as a deposit.[1] If the IRS issues a notice of deficiency,[2] the taxpayer may petition the Tax Court to adjudicate the deficiency.[3] No deficiency interest accrues for the period of time that the IRS holds the deposit.[4] If the IRS returns a deposit, for example, because the taxpayer prevails in Tax Court, the taxpayer will receive interest at the relatively modest "Federal short-term rate."[5]

A remittance that is not designated as a deposit is treated as a payment against any outstanding liability.[6] If a taxpayer makes a remittance in the amount of a proposed deficiency before the IRS issues a notice of deficiency, and if the taxpayer waives the period of restrictions before which the IRS can assess the deficiency, the IRS will assess the deficiency[7] and apply the remittance as a payment of the assessment.[8] The taxpayer loses the right to file a petition in Tax Court.[9]

If the taxpayer does not pay the deficiency, the IRS will issue a notice of deficiency, and the taxpayer may petition the Tax Court to redetermine the deficiency, which prevents the IRS from assessing and collecting the deficiency until a final decision is issued, if ever, in the IRS favor.[10]

If the taxpayer does not prevail, and there is no deposit, deficiency interest will accrue until the deficiency is paid.

Two recent cases, *Hill v. Commissioner*, 64 F.4th 1240 (11th Cir. Apr. 10, 2023), and *Ahmed v. Commissioner,*64 F.4th 477 (3rd Cir. Apr. 4, 2023), show that the above expectations of how the IRS will characterize a remittance may not be realized.

In *Hill*, the IRS audited the taxpayer and proposed a gift tax deficiency of $10 million. The taxpayer deposited $10 million with the IRS to stop the accrual of deficiency interest.[11] The taxpayer then filed a petition in Tax Court to challenge the deficiency. Thereafter, the parties stipulated that the taxpayer's gift tax liability was $7 million. The IRS returned the $3 million excess with interest, but the IRS calculated interest using the Federal short-term interest rate.[12] The taxpayer objected, arguing that it was entitled to interest at the higher tax overpayment rate. The taxpayer filed a motion in Tax Court to redetermine the interest payment, the taxpayer’s theory being that if (i) the taxpayer disputes a tax deficiency in Tax Court, (ii) the taxpayer pays the deficiency, (iii) the court determines that the deficiency is less than the tax payment, then the Tax Court can order the tax refund plus overpayment interest on the tax refund at the higher tax overpayment rate.

The Tax Court denied the motion because the Tax Court, itself, did not order a refund. The Tax Court determined a tax deficiency. The parties agreed on how the taxpayer’s remittance should be applied. The IRS returned the $3 million based on the parties' stipulation. The Tax Court did not have jurisdiction to recompute overpayment interest,[13] because it did not decide that there was an overpayment. Moreover, the remittance was a deposit because the taxpayer never instructed the IRS to treat it as a tax payment. The taxpayer appealed to the Eleventh Circuit, which affirmed the Tax Court decision.

Practice Pointer: If the taxpayer wanted overpayment interest to accrue on a tax overpayment, the taxpayer should have ensured that after the Tax Court petition was filed, the $10 million tax remittance was classified as a tax payment rather than as a deposit. A stipulation between parties is not a Tax Court order to make a refund.

In the second case, *Ahmed*, the taxpayer withheld payroll taxes from its employees' compensation but did not remit the withheld taxes to the IRS. A taxpayer is deemed to hold the withheld taxes in trust, and the IRS may assess a penalty for the unremitted withheld tax against a person—for example, the taxpayer's employee—who is responsible for withholding and remitting the withheld tax to the IRS. Ahmed was a "responsible person," and the IRS said that it sent a notice to him at his last known address asserting the penalty. The IRS did not receive a response. It consequently assessed the penalty and initiated collection proceedings, at which point Ahmed petitioned the Tax Court to set the proceeding aside. He also made a remittance to the IRS, which he designated as a deposit. The Tax Court dismissed the petition as moot on the theory that no asserted liability was outstanding because the IRS had assessed the penalty and Ahmed's remittance paid it.

Ahmed appealed to the Third Circuit, arguing that the IRS did not legally assess the penalty because the IRS did not send notice of the penalty to him before it initiated collection proceedings. The Third Circuit ruled that the IRS could apply Ahmed's remittance to the penalty only if the IRS had properly assessed the penalty before it applied Ahmed's remittance to the assessment. If, however, the IRS had not properly sent the notice to Ahmed, the assessment against him was defective, and the IRS could not apply the remittance to pay it, resulting in the Tax Court retaining jurisdiction. The Third Circuit remanded the case to the Tax Court to determine if the IRS had sent Ahmed proper notice.[14]

Practice Pointer: A person subjected to an assessable penalty who objects to the penalty and wants to remit a deposit must challenge the penalty in collection proceedings, which prevents the IRS from immediately collecting the penalty. With no valid collection authority outstanding, the taxpayer can make a deposit with the IRS to stop the running of deficiency interest and have the Tax Court retain jurisdiction.

Please contact the authors or your Miller Canfield attorney to discuss these issues further.

[1] Rev. Proc. 2005-18, §4.01(1) (2005-1 Cum. Bul. 798).

[2] The IRS "determines" a deficiency[2] when there is the difference between the tax amount imposed by law and the tax amount shown on the taxpayer's return. IRC §6211(a).

[3] A notice of deficiency is a prerequisite for the filing of a petition in Tax Court. IRC §6213(a). A deposit is not a payment of a deficiency. The deficiency continues to exist, thus permitting the filing of a Tax Court petition.

[4] Rev. Proc. 2005-18, §8 (2005-1 Cum. Bul. 798).

[5] IRC §6603(d)(4).

[6] Rev. Proc. 2005-18, §4.01(2). A remittance to pay a "proposed" deficiency eliminates the need to issue a notice of deficiency.

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[7] The IRS makes an assessment by recording it as a liability in its records. IRC §6203.

[8] Rev. Proc. 2005-18, §4.02(1) (2005-1 Cum. Bul. 798).

[9] The Tax Court lacks original jurisdiction to adjudicate refund claims because to petition the Tax Court there must be a notice of deficiency. IRC §6213(a). However, the taxpayer can pay a deficiency after filing in Tax Court. Rev. Proc. 2005-18, §4.05(1) (2005-1 Cum. Bul. 798).

[10] IRC §6213(a).

[11] A proposed gift tax liability is within IRC §6603(a), which expressly provides for the making of deposits for unassessed income, estate, gift, and certain excise taxes.

[12] IRC §6603(d)(4).

[13] The Tax Court can order a tax refund when a taxpayer petitions the Tax Court to redetermine a notice of deficiency, and the Tax Court determines not only that the taxpayer does not owe the deficiency but also the taxpayer had, in fact, overpaid its tax liability. IRC §6512(b)(1).

[14] Whether the remittance was a tax payment or deposit was determined on a "facts and circumstances" basis because a trust fund recovery penalty is not within the scope of IRC §6603(a). *Ahmed*, 64 F.4th at 485.