



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Filed Service) CC:DOM:FS

SUBJECT: State and state school as same taxpayer

This Field Service Advice responds to your memorandum dated September 22, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

School 1 Representative(s):

School 2

State

Finance office

YEAR 1, YEAR 2, YEAR 3

Calendar years

ISSUES

1. Whether tax overpayments by a state or by a state school that files separate returns may be credited against outstanding tax liabilities of the state or another state school under section 6402(a), particularly ----
 - a state's employment tax overpayments against a state school's Unrelated Business Income Tax (UBIT) underpayments; or
 - a state school's UBIT overpayment against another state school's unpaid UBIT liability.
2. Whether, for purposes of computing interest on equivalent overpayments and underpayments of tax under section 6621(d), the above-referenced overpayments and underpayments are "of the same taxpayer."

CONCLUSIONS

Because, on the facts as presented, State is ultimately liable for the tax obligations of School 1 and School 2, tax overpayments made by State may be credited, upon a request by State, against outstanding tax liabilities of the state or of either school under section 6402(a). If such credits are made, interest on the overpayments and on the underpayments of tax satisfied by the credits may be computed under section 6611(b)(1) and section 6601(f), respectively. Since a request for interest netting is not appropriate on the facts presented, we are not opining whether corresponding and equivalent overpayments and underpayments by the state and by state entities, such as School 1 and School 2, are liabilities of "the same taxpayer" for purposes of interest netting under section 6621(d).

Whether there is a "person" for purposes of section 6402(a) or the "same taxpayer" for purposes of section 6621(d) is not relevant for determining who is the taxpayer for purposes of other Code provisions such as those regarding UBIT under section 511 and tax exemption under section 501. Moreover, each school must determine its UBIT liability independently before applying section 6402(a) or section 6621(d).

FACTS

State, one of fifty, is registered with the Service as a state governmental agency. It is exempt from income tax under an implied constitutional and statutory immunity. Helvering v. Therrell, 303 U.S. 218 223 (1938); Texas v. White, 74 U.S. (7 Wall.) 700, 725 (1868); see Aprill, The Integral, The Essential, and The Instrumental: Federal Income Tax Treatment of Governmental Affiliates, 23-2 The Exempt Organization Tax Review 263 (1999) and Tucker and Rombro, State Immunity from Federal Taxation: The Need for Re-examination, 43 Geo. Wash. L. Rev. 501 (1975).

With respect to other federal taxes either collected by or due from State, the State Finance Office is the primary contact between State and the Service. The Finance Office files employment tax forms (such as Form 941), excise tax returns (such as Form 720), foreign withholding tax forms (such as Form 1042), and information reporting forms (such as Form 1099 and Form W-2) for itself and all state agencies. State uses its own taxpayer identification number (TIN) for these forms and returns.

School 1 and School 2 are agencies of State and are treated as subdivisions of State. Boards appointed by State officials run the operations of School 1 and School 2 and administer their budgets. School 1 and School 2 deposit monetary receipts into the State treasury. Expenses of School 1 and School 2, such as employee salaries and taxes, are paid from the State treasury based upon warrants drawn on the State treasury by School 1 and School 2. Operational and capital expenses of School 1 and School 2 are funded by State legislative appropriations, the proceeds of bonds issued by State, donations and grants, tax exempt income, and unrelated business income.

Apart from their status as agencies of State, School 1 and School 2 might also qualify as section 501(c)(3) organizations. Neither, however, has been listed in Publication 78 as a qualified exempt organization under section 501(c)(3). As state agencies, School 1 and School 2 are nevertheless subject to UBIT under section 511(a)(2)(B). Both entities file their own Forms 990-T each year to report unrelated business income tax (UBIT) using TINs issued in the name of each school; these TINs differ from the TIN used by State. School 1 and School 2 routinely draw warrants on the State treasury to pay the tax shown on the Forms 990-T. Provision for payment of the taxes is included in their operating budgets, as approved by the State legislature.

The Service is currently auditing School 1 and School 2. The audits cover each school's UBIT liability and the portion of State's overall liability for other taxes that pertain to each school. The audit of School 1 covers YEAR 2 and YEAR 3 while the School 2 audit covers YEAR 1 and YEAR 2.

For YEAR 3, the Service has made a preliminary determination that State has overpaid its employment tax liability with respect to employees of School 1, while State has underpaid its Form 1042 liability with respect to School 1, and School 1 has underpaid the UBIT liability reportable on its Form 990-T. The net overpayments by State that are attributable to School 1 exceed the net underpayments, so that a refund for YEAR 3 would be due if the employment tax, Form 1042 liability, and UBIT liability were netted for YEAR 3. State has asked that any overpayments of its tax liability be netted against the unpaid liability of School 1 for interest computation purposes.

The audits for YEAR 1 and YEAR 2 are ongoing. The Service proposes to issue a single report netting School 1's and School 2's liability for YEAR 2, and a separate report for School 2's YEAR 1. For YEAR 2, the auditors anticipate that one School will have underpaid its UBIT liability while the other has overpaid its UBIT liability.

LAW AND ANALYSIS

1. Credits under section 6402

Although your request was directed toward anticipated interest netting under section 6621(d), it appears from your presentation of facts that all of the overpayments and underpayments of tax remain outstanding. In enacting section 6621(d), Congress has indicated that in situations in which interest is both payable and allowable by the same taxpayer for the same period, the Secretary will take all reasonable steps to offset the liabilities, rather than process them separately using the net interest rate of zero under section 6621(d). See H.R. Conf. Rep. No. 599, 105th Cong. 2d Sess. 257 (1998). Accordingly, the authorization for crediting overpayments under section 6402(a), rather than section 6621(d), is the relevant statutory authorization with respect to these facts.

Section 6402(a) authorizes the Service, in lieu of refunding an overpayment of tax to a taxpayer, to credit an overpayment against any existing liabilities "on the part of the person who made the overpayment." Thus, whenever an overpayment of tax is determined and another tax liability of the person who made the overpayment remains unpaid, the Service has the option of refunding the overpayment or of crediting the outstanding overpayment against the outstanding underpayment pursuant to section 6402(a). Northern States Power Co. v. United States, 73 F.3d 764, 767 (8th Cir. 1996); Pettibone Corp. v. United States, 34 F.3d 536, 538 (7th Cir. 1994).

When overpayments are credited against outstanding liabilities, interest is accrued on either the overpayment or the underpayment satisfied by the credit only until the date on which the two amounts simultaneously exist. When an overpayment is credited against another tax liability of the same taxpayer, section 6611(b)(1) provides that interest is to be allowed and paid on the overpayment “from the date of the overpayment to the due date of the amount against which the credit is taken.” For underpayments satisfied by a credited overpayment, section 6601(f) parallels section 6611(b)(1) by providing that “no interest shall be imposed under this section on the portion of the tax so satisfied for any period during which, if the credit had not been made, interest would have been allowable with respect to such overpayment.”

In contrast, interest continues to accrue independently during an overlapping period on both the overpayments and underpayments if a section 6402(a) credit is not made. Section 6611(b)(2) allows interest on refunds from the date the overpayment arises until a date preceding the date of a refund check by no more than 30 days. With respect to underpayment of tax, section 6601(a) provides that interest on an underpayment of tax that is not paid on or before the last date prescribed for payment accrues from the prescribed payment date until the date on which the tax is paid.

If a taxpayer has an underpayment of tax from one year and an overpayment of tax from a different year that are outstanding at the same time, the taxpayer usually benefits by having the interest on simultaneously existing underpayments and overpayments computed, whenever possible, using the section 6402(a) credit process. Because the overpayment interest rates imposed under section 6621(a)(1) between January 1, 1987 and December 31, 1998 were lower than the underpayment interest rates imposed under section 6621(a)(2) during that period,¹ taxpayers benefit by having interest computed on simultaneously existing overpayments and underpayments for the shortest period possible.

The relevant criteria for using the credit in this case is that section 6402(a) only authorizes the Service to credit an overpayment against any existing liabilities “on the part of the person who made the overpayment.” In applying section 6402(a) to the facts of this case, we believe that State is both the person who made the overpayment and the person against whom the existing liabilities exist.

¹ Section 3302(a) of the IRS Restructuring and Reform Act of 1998 (RRA), Pub.L. No. 105-206, 112 Stat. 741, increased the overpayment interest rate under section 6621(a) to equal the underpayment rate for non-corporate taxpayers for the second and succeeding calendar quarters beginning after the July 22, 1998 effective date of the Act.

Under section 7701(a)(1), a person is to “be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.” While section 7701(a)(1) does not specifically list a state as a “person,” the Supreme Court has held that a state will be included as a “person” whenever the inclusion is appropriate under a specific Code section’s legislative environment. Sims v. United States, 359 U.S. 108, 112 (1959) (States are persons under section 6332 and wages of state employees are subject to levy); Ohio v. Helvering, 292 U.S. 360, 370 (1934)(states that sell liquor are persons subject to federal excise tax on liquor sales).

The legal precedents are not as clear in determining whether various state entities are to be treated as part of the state “person” or as separate “persons” in their right. For purposes such as determining the application of a state’s sovereign immunity, Federal diversity jurisdiction, and the existence of Federal income tax liability, the issue has been widely litigated without a clear or consistent result. See, e.g., University of Rhode island v. A.W. Chesterton Company, 2 F.3d 1200 (1st Cir. 1993) and cases cited therein; see also Aprill, The Integral, The Essential, and The Instrumental: Federal Income Tax Treatment of Governmental Affiliates, 23-2 The Exempt Organization Tax Review 263 (1999) and Tucker and Rombro, State Immunity from Federal Taxation: The Need for Re-examination, 43 Geo. Wash. L. Rev. 501 (1975). Each case turns upon the statute to be applied and the extent of the authority and independence delegated to each School.

In the context of section 6402 as applicable to the facts of this case, State appears to be the person ultimately responsible for the payment of taxes incurred both directly and through state instrumentalities such as School 1 and School 2. The budgets for state agencies, such as School 1 and School 2, are included within the State budget approved by the State legislature. Based upon the budget, the State legislature makes annual appropriations to cover anticipated expenses of State, including those of School 1 and School 2, that are not covered by other sources of income. Employees of School 1 and School 2 are employees of State for all purposes. State files a single employment tax form (Form 941) for its employees, including those of School 1 and School 2. Income received by School 1 and School 2 is deposited into the State treasury and the entities’ expenses are paid by warrants drawn on the State treasury.

Despite their capacity as entities of State, both School 1 and School 2 engage in activities that produce unrelated business income that is taxable under section 511(a)(2)(B). Each school separately computes and reports its UBIT liability pursuant to the Code ². Whether submitted with a return or based upon an audit

² Nothing within this advice should be construed as having any effect upon the determination of who is the taxpayer subject to UBIT or the computation of UBIT

adjustment, however, the UBIT liability is paid by warrants drawn on the State treasury.

Thus, overpayments of taxes previously paid by State from the State treasury and otherwise refundable to State may be credited in satisfaction of obligations, such as those of School 1, that are also payable from the State treasury. Likewise, since State pays both, an overpayment of one State school's UBIT liability may be credited in payment of another State school's unpaid UBIT liability. Once the credits are made, interest may be computed under section 6611(b)(1) and section 6601(f).

Since, on the facts presented, State has paid the tax liabilities that will constitute the anticipated overpayments of tax as a result of the current audit and since State is ultimately liable for the tax obligations of School 1 and School 2, we recommend that the Service honor a request from State to have any overpayments credited against underpayments of tax. Any request for having an overpayment credited should be in writing and signed by an individual authorized to file a refund claim or to execute the tax return on which the overpayment is based. Because the state laws establishing state colleges and universities vary from state to state and within a single state, the Service should not presume that a state is the person responsible for paying UBIT liability incurred by a school without representations to that effect by the state. Such representations should be documented.

We are not opining on the State law provisions governing who may act on behalf of State or either school in making a request for credits.

2. Determination of "same taxpayer" under section 6621(d)

As effective for periods beginning after July 22, 1998, section 6621(d) provides for a net interest rate of zero to the extent of overlapping tax underpayments and overpayments by the "same taxpayer." The statute, as enacted by section 3301 of the RRA, and amended by section 4402(d) of the Tax and Trade Relief Extension Act of 1998 (TTREA), Pub. L. No. 105-277, 112 Stat. 2681, provides:

To the extent that, for any period, interest is payable under subchapter A and allowable under subchapter B on equivalent underpayments and overpayments by the same taxpayer of tax imposed by this title, the net rate of interest under this section on such amounts shall be zero for such period.

In limited circumstances, the statute will also apply to periods beginning before the

liability for such taxpayer.

effective date if the applicable statute of limitations has not expired with regard to either the tax underpayment or overpayment, and the taxpayer reasonably identifies and establishes the overlapping period for which the zero rate applies and files a timely request. See Rev. Proc. 99-43 (issued November 22, 1999), 1999-47 I.R.B. 579, for guidance on making a timely request.

As noted above, to the extent that the Service can credit overpayments against outstanding underpayments of the person who made the overpayment, section 6621(d) is inapplicable. The Service may credit the overpayments against outstanding liabilities under section 6402.

You have not advised us of any previously made refunds and payments that might bring section 6621(d) into play. Without specific facts to address, we have not determined whether underpayments and overpayments by various entities within a state government are by the "same taxpayer." We do note, however, that the legislative history of section 6621(d) indicates that the zero interest rate applies in those circumstances where the Service would normally offset if the underpayments and overpayments were currently outstanding. H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. 257 (1998).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

It is not necessary for the Service to make a "final determination" with respect to all of State's employment tax or other tax liabilities for the years at issue before making assessments and/or abatements of tax with respect to School 1 or School 2 and before making the credits under section 6402(a). If the Service is interested in pursuing a further audit of State's tax liabilities upon completion of the School 1 and School 2 audits, it can do so without regard to the interest computations. The Service should, however, follow established procedures for properly notifying State of the continuing audit to avoid charges that it has, in fact, begun a second examination in contravention of section 7605(b).

Please call if you have any further questions.

Deborah A. Butler
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By: _____

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