



Tax Talk

by Andrew Strelka

Choose, but Choose Wisely: Designating a Partial Federal Tax Payment

Paying your taxes is like being seated in a

restaurant. Most customers simply tell the host the number in their party and are then directed to a table. The discerning customer, however, may request a window seat, a booth, or maybe even a table outside. So too a taxpayer submitting a partial payment of their total federal tax liabilities may designate to which tax period the payment should be applied and—to a certain extent—even how it should be applied. Just as a passive diner is directed to any table the host desires, a silent taxpayer's partial payment will be applied by the Internal Revenue Service (IRS) as it sees fit.

The procedures for designating a partial payment are found in Revenue Procedure 2002-26.¹ These procedures must be precisely followed in order to effectuate a proper designation. Taxpayers attempting to broaden the scope of what constitutes a proper designation will soon find themselves on the losing end of an issue that has been well established by the courts.

Take for example the noble and patriotic Tina Taxpayer who timely pays all of her federal tax liabilities. This hero may not be aware that tax liabilities come in three general flavors: (1) taxes; (2) penalties; and (3) interest. Tina's twin brother Timmy, however, knows this fact all too well. Timmy just can't seem to get his affairs in order. Year after year Timmy has failed to pay all required taxes and has also filed late returns—when he remembered to file at all. Accordingly, the IRS has assessed taxes, penalties, and interest against Timmy for multiple years. Unlike his upstanding sister, Timmy now owes the IRS \$100,000! An amount subject to statutory additions and further accruals.

For his birthday, Timmy receives \$100 from his grandmother. Wanting to show the world that he has changed his ways, Timmy decides to send the money to Uncle Sam.

First, Timmy writes a \$100 check to the U.S. Treasury, puts it in an envelope, and mails it to the IRS. Assuming the IRS accepts the payment, the service will apply the undesignated payment to



the tax periods in the order of priority that they determine will serve its best interest.² The payment will be applied to satisfy the liability for successive periods in descending order of priority until the payment is absorbed. This generally means that partial payments are usually first applied to the tax period with the earliest collection statute expiration date. Other factors such as lien priority and the type of tax (such as income versus employment) may also be taken into consideration. If the amount applied to a period is less than the liability for the period, the amount will

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be applied to tax, penalty, and interest, in that order, until the amount is absorbed.

But with no designation whatsoever, the IRS determines that in Timmy's case, it is in the government's best interest for Timmy's \$100 check to be applied to his oldest tax year, with the amount applied solely to tax—leaving penalties and interest unchanged.

A week later, Timmy thinks that he might be better situated if the \$100 check is applied only to the penalties relating to his most recent tax year. Timmy calls the IRS and instructs the agent to "please apply my most recent payment to the assessed penalties in my most recent tax year that has a balance." Unfortunately for Timmy, a proper designation cannot be made orally, but must be made in writing.³ Angry at himself, Timmy pens a letter to the IRS, referencing the payment and demanding that it be applied to the penalties in his most recent tax year. Regrettably, Timmy is still out of luck. The written designation must be made at the time of payment.⁴

Several years later, Timmy starts a business and enrolls in the IRS' Electronic Federal Tax Payment System (EFTPS) in order to make online quarterly tax deposits. The same day that he makes an online tax deposit through EFTPS, Timmy mails a letter to the IRS stating that he would like the deposit applied only to his employees' share of the tax liabilities. To Timmy's complete dismay, he learns that EFTPS provides no mechanism for designating between employer and employee shares. Additionally, Timmy learns that only voluntary *payments* may be

designated, not tax *deposits*.⁵

Fortunately for Timmy, his twin sister Tina went to law school, joined the Federal Bar Association's Section on Taxation, read Revenue Procedure 2002-26, and effectively advises her clients on how to properly designate partial tax payments. She has even agreed to help Timmy on a pro bono basis. ☺

Endnotes

¹Rev. Proc. 2002-26; 2002-1 C.B. 746.

²See, e.g., *Southeast Waffles, LLC v. United States*, 460 B.R. 132 (B.A.P. 6th Cir. 2011), *aff'd*, 702 F.3d 850 (6th Cir. 2012).

³See, e.g., *Kinnie v. United States*, 994 F.2d 279 (6th Cir. 1993).

⁴See, e.g., *United States v. Lavi*, No. 02-CV-6299, 2004 WL 2482323, at *3, 2006-1 U.S. T.C. P50,208 (E.D.N.Y. Sept. 23, 2004).

⁵See, e.g., *Romano-Murphy v. Commissioner of Internal Revenue*, No. 27236-09L, T.C.M. 2012-330 (T.C. Nov. 29, 2012).

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