William A. Woods II, Petitioner v. Commissioner of Internal Revenue, Respondent, 91 T. C. 88 (1988)

The term 'underpayment' for the substantial understatement penalty under section 6661 includes withholding credits, unlike other penalty sections.

Summary

William A. Woods II challenged the IRS's imposition of a 25% penalty under section 6661 for a substantial understatement of his 1983 income tax, which he did not file. The IRS calculated the penalty on the total tax deficiency of $7,152, ignoring Woods's withholding credits of $3,813. 77. The Tax Court ruled that 'underpayment' in section 6661 should account for withholding credits, reducing the penalty base. The court rejected Woods's other 'tax protester' arguments and upheld other penalties, but invalidated the regulation that equated 'underpayment' with 'understatement' for section 6661 purposes.

Facts

In 1983, William A. Woods II earned $32,844 in wages and $53 in interest income but did not file a federal income tax return. The IRS determined a deficiency of $7,152 and imposed various penalties. Woods contested the penalties, arguing that his wages were not taxable income, that filing was voluntary, and that withholding credits should reduce the section 6661 penalty. The IRS had not disputed the $3,813. 77 in withholding credits claimed by Woods.

Procedural History

The IRS issued a notice of deficiency on September 13, 1985, assessing a 25% penalty under section 6661 based on the full deficiency. Woods timely filed a petition with the Tax Court. The court considered the IRS's motion for judgment on the pleadings and supplemental motion to increase the section 6661 penalty to 25% under the Omnibus Budget Reconciliation Act of 1986. The court ultimately issued its decision on July 25, 1988, as amended on August 2, 1988.

Issue(s)

1. Whether the term 'underpayment' in section 6661(a) includes withholding credits in calculating the penalty for a substantial understatement of income tax.
2. Whether the regulation at section 1. 6661-2(a), Income Tax Regs. , equating 'underpayment' with 'understatement' for section 6661 purposes is valid.

Holding

1. Yes, because the plain meaning of 'underpayment' suggests it accounts for payments made, including withholding credits, thus reducing the penalty base to the actual unpaid amount.

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2. No, because the regulation conflicts with the statutory language of section 6661 and the ordinary meaning of ‘underpayment’, rendering it invalid.

Court’s Reasoning

The court analyzed the statutory language of section 6661, focusing on the terms ‘understatement’ and ‘underpayment’. It determined that ‘understatement’ is defined as the difference between the tax required and the tax shown on the return, which in Woods’s case was the full deficiency since he filed no return. However, ‘underpayment’ was not defined in section 6661, and the court interpreted it according to its ordinary meaning as the amount by which the payment was insufficient, which includes withholding credits. The court rejected the IRS’s argument to use the definition from sections 6653 and 6659, which exclude withholding credits, noting that those sections specifically modify the term ‘underpayment’, whereas section 6661 does not. The court also found that the regulation at section 1. 6661-2(a) was invalid because it ignored the statutory language and rendered parts of it superfluous. The court emphasized the need to give effect to every part of the statute and noted that Congress’s omission of a specific definition for ‘underpayment’ in section 6661 was significant.

Practical Implications

This decision clarifies that withholding credits must be considered when calculating the ‘underpayment’ for the section 6661 penalty, potentially reducing the penalty amount for taxpayers who have had taxes withheld. It invalidates the regulation that treated ‘underpayment’ and ‘understatement’ as equivalent, requiring the IRS to revise its approach to this penalty. Practitioners should ensure that clients’ withholding credits are properly accounted for in penalty calculations. The ruling also underscores the importance of statutory interpretation and the need to consider the plain meaning of terms, which may affect how other tax provisions are analyzed. Subsequent cases, such as Pallottini v. Commissioner, have applied this ruling, confirming the 25% rate for section 6661 penalties post-1986.

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