Smith v. Commissioner, 93 T. C. 378 (1989)

Refunded withholding taxes do not reduce the underpayment subject to the addition to tax under section 6661(a) for substantial understatements.

Summary

In Smith v. Commissioner, the U. S. Tax Court clarified that when taxpayers claim and receive refunds for withheld taxes on their returns, those refunds do not offset the underpayment subject to penalties under section 6661(a). The petitioners had claimed deductions that were disallowed, resulting in understatements of their tax liability. They argued that their withheld taxes should reduce the underpayment for penalty calculation. The court, however, ruled that because the petitioners had received refunds of the withheld amounts, these could not be considered as payments reducing the underpayment. This decision impacts how tax professionals should advise clients on the implications of requesting refunds of withheld taxes on potential tax penalties.

Facts

The petitioners, Dean B. Smith and Irma Smith, and James Karr and Nancy L. Karr, claimed deductions on their tax returns that were later disallowed by the court, resulting in substantial understatements of their income tax. They had also claimed credits for withholding tax and requested refunds of these amounts, which were granted. The issue arose when calculating the addition to tax under section 6661(a), where the petitioners argued that the withheld taxes should reduce the underpayment subject to the penalty.

Procedural History

The case originated in the U. S. Tax Court, where the initial disallowance of certain partnership deductions was upheld in 1988. The court then directed the parties to compute the additions to tax under section 6661. Disagreement on the calculation led to the supplemental opinion in 1989, where the court addressed whether the refunded withholding taxes should be considered in calculating the underpayment.

Issue(s)

1. Whether the amount of tax withheld from the petitioners' wages, which was refunded to them, should be subtracted from the underpayment subject to the addition to tax under section 6661(a).

Holding

1. No, because the refunded withholding taxes cannot be considered as a payment of tax for the year in issue, and thus do not reduce the underpayment subject to the section 6661(a) penalty.

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Court’s Reasoning

The court distinguished this case from Woods v. Commissioner, where unrefunded withholding was allowed to reduce the underpayment. In Smith, the petitioners had claimed and received refunds of the withheld taxes, which the court reasoned could not be considered as payments under section 6151(a). The court emphasized that “pay” means to satisfy an obligation by transfer of money, and since the withheld taxes were refunded, they did not satisfy the tax liability for the year in question. The court also noted that this interpretation aligns with the legislative intent of section 6661(a), which aims to penalize underpayment due to understatements, not merely reporting errors. No dissenting or concurring opinions were noted in this case.

Practical Implications

This decision has significant implications for tax practitioners and taxpayers. It underscores the importance of considering the impact of requesting refunds of withheld taxes on potential penalties for underpayment due to understatements. Tax professionals should advise clients that claiming and receiving refunds of withheld taxes will not offset underpayments for penalty purposes under section 6661(a). This ruling may influence how taxpayers approach their tax filings, particularly in situations where they anticipate potential understatements. Subsequent cases, such as Abel v. Commissioner, have cited Smith to clarify the treatment of refunded withholding in similar contexts.

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