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Wells Fargo & Co. v. U.S.: A Potential Beginning of The End of The Objective Reasonable Basis Tax Penalty Defense

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Wells Fargo & Co. v. U.S.: A Potential Beginning of The End of The Objective Reasonable Basis Tax Penalty Defense

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I. OVERVIEW

The Internal Revenue Code ("IRC") § 6662(a) permits the IRS to impose a twenty-percent (20%) accuracy-related penalty to an underpayment of tax, and there are several different defenses to this

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penalty depending on the facts of the case and the reason for the penalty.[3] One of the most common accuracy-related penalties is the negligence penalty.[4] Although there are multiple different reasons for the application of an accuracy-related penalty, only one penalty may be applied for each understatement.[5] If a taxpayer faces the negligence penalty, one common defense is that the taxpayer's return position has a reasonable basis under the relevant authorities.[6] Until recently, most courts simply proceeded through a discussion on whether the authorities supported the taxpayer's return position, and did not even reach whether the taxpayer actually relied on relevant authorities when forming a return position.[7] However, over the past few years, several courts have begun to require a subjective actual reliance component to the reasonable basis standard, in addition to the other requirements described under the regulations.[8]

This article explores these concepts more in detail in six parts. Part II introduces the statutory reasonable basis defense, reviewing the applicable regulations[9] and the circumstances when the negligence penalty is applied.[10] Next, Part III introduces prior case law analyzing the reasonable basis defense, ranging from cases applying a more objective reasonable basis defense, and several courts applying a subjective[11] component to the

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[3] 26 U.S.C. § 6662(a): *See* MARTIN L. FRIED, 2 TAXATION OF SECURITIES TRANSACTIONS § 34.02 (No. 82, 2020)(Provides a table showing the penalty percentages for the other accuracy-related penalties).

[4] 26 U.S.C. § 6662(c). 26 U.S.C. § 6662(b) lists the reasons under which the IRS can apply an accuracy related penalty under 26 U.S.C. § 6662. The reasons include negligence or disregard of rules or regulations, any substantial understatement of income tax, any substantial valuation misstatement under chapter 1, any substantial overstatement of pension liabilities, any substantial estate or gift tax valuation understatement, and any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701 (o)) or failing to meet the requirements of any similar rule of law. 26 U.S.C. § 6662(b).

[5] Smoker v. Comm'r, T.C. Memo 2013-56, at *18 (2013)(citing 26 C.F.R. § 1.6662-2(c).

[6] 26 U.S.C. § 6662(d)(B)(ii)(II); 26 C.F.R. § 1.6662-3(b)(3).

[7] *See e.g.* Pederson v. Comm'r, T.C. Memo. 2013-54, at *58–59 (2013); TIFD III-E Inc. v. United States, 8 F. Supp.3d 142, 148-52 (D. Conn. 2014); Taibo v. Comm'r, T.C. Memo. 2004-196, at *7 (2004); Oakbrook Land Holdings, LLC, v. Comm'r, T.C. Memo. 2020-54, at *43 (2020).

[8] *See* Wells Fargo & Co. v. United States., No. 17-3578, 2020 U.S. App. LEXIS 13279 (8th Cir. Apr. 24, 2020); Blue Mt. Energy, Inc. v. United States., No. 2:14-cv-418-DN, 2016 U.S. Dist. LEXIS 103625, at *29 (D. Utah Aug. 5, 2016); Blue Mt. Energy v. United.States., 418 F. Supp.3d 901, 908 (D. Utah Sept. 27, 2019).

[9] *See* 26 C.F.R. § 1.6662-3(b); 26 C.F.R. § 1.6662-3(b)(3); 26 C.F.R. § 1.6662-4(d)(3)(iii).

[10] 26 U.S.C. § 6662(c).

[11] *Wells Fargo & Co.*, No. 17-3578, 2020 U.S. App. LEXIS 13279, at *23–33; *Blue Mt. Energy, Inc.*, No. 2:14-cv-418-DN, 2016 U.S. Dist. LEXIS 103625, at *29; *Blue Mt. Energy*, 418 F. Supp.3d at 908.

reasonable basis defense. Until recently, many courts did not examine whether a taxpayer actually relied on the authorities listed to support its position, but instead looked to if the taxpayer's return position was objectively supported by the relevant authorities. Part IV examines *Wells Fargo & Co. v. United States* in detail including the facts of the case, the holding on the tax in which the court struck down Wells Fargo's STARS transaction[12], and the court's reasoning that actual reliance is required as part of the reasonable basis defense.[13] The court looked at the broader statutory and case law framework, as well as the definition of "base," and determined the reasonable basis standard also required a subjective actual reliance component.[14] Further, the court determined that a part of the STARS transaction did not have any purpose other than tax savings.[15] Part V examines how other courts may view this holding going forward and discusses how the majority incorrectly concluded that under the reasonable basis defense a taxpayer's return position must not only be supported by one or more relevevant authorities, but the taxpayer must also rely on those authorities when contemplating tax decisions.[16] In circuits requiring an actual reliance on one or more relevant authorities, taxpayers must document or be able to show that they actually relied on the authorities cited in support of their case, and the return position cannot be a position taken after the return is filed to support the return position. Lastly, Part VI provides an overview of the conclusions reached in this article.

II. THE STATUTORY REASONABLE BASIS DEFENSE

Under IRC § 6662(a), the IRS may impose an accuracy-related penalty on "an amount equal to twenty percent (20%) of the portion of the underpayment on which this section applies."[17] The negligence penalty is one of the more common accuracy-related penalties a taxpayer faces and, by statute, may assert reasonable basis as a defense.[18] Under IRC § 6662(c), negligence is defined as "any failure to make a reasonable attempt to comply with the provisions of this title."[19] Regulations describe negligence as "any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and

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[12] *Wells Fargo & Co.,* No. 17-3578, 2020 U.S. App. LEXIS 13279, at *15–25.
[13] *Id.* at *25–33.
[14] *See id.*
[15] *Id.* at *17–23.
[16] *Id.*
[17] 26 U.S.C. § 6662(a).
[18] 26 U.S.C. § 6662(d)(B)(ii)(II).
[19] 26 U.S.C. § 6662(c).

reasonable care."[20] The regulations continue to define the boundaries of taxpayer negligence to include "any failure by the taxpayer to keep adequate books and records or to substantiate properly."[21] While codified, case law demonstrates that courts are unlikely to apply the negligence penalty where the "issue to be resolved by the Court is one of first impression involving unclear statutory language."[22]

In *Mortensen v. Comm'r*, the Sixth Circuit noted that the burden is on the taxpayer to prove that they did not act negligently in preparing their tax return and that the Commissioner's choice to apply the penalty is "presumptively correct."[23] The Sixth Circuit then curtailed this broad statement by stating that "[a] taxpayer is not required to be perfect for this would be an unrealistic expectation."[24] The court continued, "[r]easonable minds can differ over tax reporting and sometimes the IRS disallows certain transactions."[25] Thus, the Sixth Circuit recognized navigating tax issues can be complicated, and simply because the taxpayer and the IRS do not interpret the IRC in the same manner does not mean that the taxpayer is always negligent.[26] However, in this case, the Sixth Circuit reasoned that the taxpayer did not "do what a reasonable and ordinarily prudent person would do under the circumstances"[27] because the taxpayer should have noticed, among other issues, that large tax losses were "too good to be true."[28]

Juxtaposed with the court's willingness to view the Commissioner's imposition of penalties as "presumptively correct," is the language of Treasury Regulations stating, "[a] return position that has a reasonable basis as defined in paragraph (b)(3) of this section is not attributable to negligence."[29] As such, a taxpayer that can support their return position with one or more relevant authorities will not be liable for negligence as an accuracy-related penalty.[30] The reasonable basis standard is defined as being "a relatively high standard of tax reporting," and the reasonable

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20 26 C.F.R. § 1.6662-3(b).

21 *Id.*

22 Lemishow v. Comm'r, 110 T.C. 110, 114 (1998) (citing Hitchins v. Comm'r, 103 T.C. 711, 720 (1994).

23 Mortensen v. Comm'r, 440 F.3d 375, 385 (6th Cir. 2006).

24 *Id.*

25 *Id.*

26 *See id.*

27 *Id.* (quoting Leuhsler v. Comm'r., 963 F.2d 907, 910 (6th Cir. 1992)).

28 *Id.* at 386; *see* Treas. Reg. § 1.6662-3(b)(ii) (2019) ("Negligence is strongly indicated where . . . [a] taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances . . . ").

29 Treas. Reg. § 1.6662-3(b); 26 U.S.C. § 6662(c)(2)(B)(ii)(II).

30 *See* Treas. Reg. § 1.6662-3(b); 26 U.S.C. § 6662(c); Treas. Reg. § 1.6662-3(b)(3); Treas. Reg. § 1.6662-4(d)(3)(iii).

basis standard will not be met by "a return position that is merely arguable or that is merely a colorable claim."[31] There are five legal standards that might apply that the taxpayer must overcome to escape the penalty.[32] In order from most to least stringent, the standards are: more likely than not; substantial authority; realistic possibility of being sustained on the merits; reasonable basis; and not frivolous.[33] To gain a better understanding of reasonable basis, "though the Regulations do not assign a numerical probability of success that a reasonable basis position must equal or exceed, the standard is generally regarded as satisfied if the taxpayer has at least a one in five (or 20%) chance of prevailing . . . on the merits."[34] Although this percentage is not a codified rule, it provides the taxpayer with a comparative view to how the courts view the different legal standards.[35] Accordingly, reasonable basis, as it requires a much lower threshold, should be the more easily met standard for the courts view of the taxpayer's return position.[36]

As additional support for a lower threshold for the reasonable basis standard in court, the regulation offers up that "[i]f a return position is reasonable based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii)(taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard . . . ."[37] The different authorities listed under 26 C.F.R. § 1.6662-4(d)(3)(iii) open up a cornucopia of authorities that include case law, the Internal Revenue Code, and the regulations.[38] The regulation limits relevant authority under this section and excludes "[c]onclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals."[39] Although these

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31 Treas. Reg. § 1.6662-3(b)(3).

32 *See* Stuart E. Seigel & Joy Taylor, *It's a New Ballgame - Rules to Practice by*, 51 MAJOR TAX PLAN. 14-1, 14-35–40 (1999).

33 *Id.*

34 FRIED, *supra* note 3.

35 Seigel & Taylor, *supra* note 32 ("The most stringent 'more likely than not' standard is similar to the preponderance of the evidence standard, requiring a finding that there is more than a 50-percent likelihood that the position taken for an item is proper.").

36 *See id.*

37 *Id.* Treas. Reg. § 1.6662-4(d)(2) (2019) describes the substantial standard as "an objective standard involving an analysis of the law and application of the law to relevant facts." Further, "Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment." Treas. Reg. § 1.6662-4(d)(3)(i). The substantial authority standard is more stringent than the reasonable basis standard. *See* Treas. Reg. § 1.6662-4(d)(2).

38 Treas. Reg. § 1.6662-4(d)(3)(iii).

39 *Id.*

authorities may not constitute relevant authority, "[t]he authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item."[40] Thus, a taxpayer may rely on the advice of a tax professional if the tax professional's opinion is derived from relevant authorities.[41] As a final bone thrown to the taxpayer facing penalties, if a return position is not reasonably based in the relevant authorities, the reasonable cause and good faith defense may be available to the taxpayer.[42]

III. CASE LAW APPLYING AN OBJECTIVE STANDARD

A. *Cases Applying Objective Standard Upholding Negligence*

In *Fidelity Intern. Currency Advisor A Fund, LLC, v. United States.*, the court imposed the negligence penalty, but specifically noted the "negligence standard is an objective one, requiring a "lack of due care or the failure to do what a reasonable and prudent person would do under similar circumstances."[43] The court recognized when examining whether the accuracy-related penalty for negligence was correctly applied, the court would view the actions of the taxpayer objectively.[44] Although not discussing reasonable basis, the court viewed the underlying reason for the penalty (negligence) objectively, which arguably shows that reasonable basis should also be viewed objectively considering that reasonable basis serves as a defense to the negligence penalty.[45]

In *Bunney v. Comm'r.*, the Tax Court found the taxpayer liable in part for the negligence penalty but determined there was a reasonable basis for a position on an issue which had not been addressed previously by the court.[46] Here, the court noted "[a] return position that is 'arguable, but fairly unlikely to prevail in court' satisfies the reasonable basis standard."'[47] This statement further supports the notion that to be

[40] *Id.*
[41] *See id.*
[42] *See* Treas. Reg. §1.6662-3(b)(3); Treas. Reg. § 1.6664-4(a) ("No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was a reasonable cause for, and the taxpayer acted in good faith with respect to, such portion.").
[43] Fidelity Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49 (D. Mass. 2010).
[44] *See id.*
[45] *See id.*
[46] Bunney v. Comm'r, 114 T.C. 259, 267 (2000).
[47] *Id.* at 266.

successful under the reasonable basis standard, a taxpayer's return position need to be only around twenty percent (20%) likely to be successful on its merits.[48] In items the taxpayer conceded, the court found the taxpayer was liable for the negligence penalty and did not accept the defense that the return was complicated and the taxpayer had used a tax program in completing the return.[49] However, even though the court found the text of the disputed Code section to be "clear and unambiguous," the Commissioner had interpreted the Code section "in a manner that is inconsistent with our holding herein."[50] Thus, the taxpayer was not liable for the negligence penalty when the IRS interpreted an IRC provision differently than the court.[51] The court, however, does not go into any analysis of whether the taxpayer relied on the disputed Code section when preparing the return and did not require the taxpayer to show evidence of reliance when preparing the return.[52]

More recently, in *Pederson v. Comm'r*, the court said "[I]n order to determine whether petitioners had substantial authority or a reasonable basis for the tax treatment of items related to their horse breeding activities, we reviewed a multitude of relevant authorities citied in this opinion and in the parties' briefs."[53] The court further recognized the "substantial authority standard is an objective standard less stringent than the more-likely-than-not standard."[54] From this analysis, the court considered both the substantial authority and reasonable basis standards, with the substantial authority standard being a more stringent objective standard than the reasonable basis standard.[55] Additionally, the court does not look to whether the taxpayer actually relied on the authorities in arguing a return position, but instead analyzed whether the return position could be supported by the authorities cited in the opinion and in the briefs.[56] This suggests taxpayers may support their return position once the return is already filed without having actual reliance on the authorities when preparing the return.[57] The court's description of the reasonable basis standard directly correlates with the reasonable basis standard being objective.[58] The court does not directly mention whether the taxpayer needed to rely on the authorities when contemplating tax decisions or

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48 *See id.*; *see also* FRIED, *supra* note 3.
49 *See Bunney*, 114 T.C. at 267.
50 *Id.*
51 *See id.*
52 *See id.*
53 Pederson v. Comm'r, T.C. Memo. 2013-54, at *58–59 (2013).
54 *Id.* at *58 (citing Treas. Reg. § 1.6662-4(d)(2) (2019)).
55 *See id.* at *58-59.
56 *See id.*
57 *See id.*
58 *See id.*

before filing the return, but goes directly into the analysis as to whether the taxpayer's return position was supported by the relevant authorities.[59]

In *TIFD III-E Inc. v United States*, the district court found the negligence penalty did not apply because the taxpayer had a reasonable basis; however, the Second Circuit reversed and said the authorities did not support the reasonable basis standard, but did not specifically address the district court's analysis of the reasonable basis standard.[60] The district court noted "both the negligence penalty and the substantial understatement penalty involve an objective analysis of relevant authorities."[61] Although this does not specifically address the reasonable basis standard, this further shows that the courts view other related standards through an objective lens.[62] Further, the court noted the Joint Committee on Taxation has said '"the 'reasonable basis' standard will be satisfied, and a taxpayer cannot be found negligent, if its tax position has a 20% chance of success on the merits."[63] The court recognized that even if a taxpayer reaches the wrong conclusion, they can still act reasonably.[64] This must be true or else "there would be no such thing as a 'reasonable but mistaken' position, and every situation in which litigation leads to tax liability would support imposition of a tax penalty."[65] The court then continued that the "government essentially asks me to draw an adverse inference from the fact that TIFD did not waive the attorney-client privilege with respect to the tax advice it received, but instead attempted to win based on the state of the law alone."[66] Thus, the court recognized that a taxpayer should not have to waive attorney-client privileged information in order to raise the reasonable basis defense.[67]

However, if courts view the reasonable basis defense objectively, there is no need for the court to examine priviledged information, because the court will simply evaluate the return position based on the authorities cited by the taxpayer.[68] In many instances, for a taxpayer to show reliance on relevant authorities before the return is filed, the taxpayer will have to show conversations between the taxpayer and the attorney.[69] The court

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59 *See id.*

60 TIFD III-E Inc. v. United States, 8 F. Supp. 3d 142, 148-52 (D. Conn. 2014); TFID III-E Inc. v. United States, 604 F. App'x 69, 70–71 (2d Cir. 2015).

61 *TIFD III-E Inc*., 8 F. Supp.3d at 147.

62 *See id.*

63 *Id.* at 148.

64 *Id.*

65 *Id.*

66 *Id.* at 150-51.

67 *See id.*

68 *See id.* at 151.

69 *See id.*

continued by saying the IRS's "interpretation defies both common sense and the larger structure of the regulations governing penalties."[70] The court observed, "[i]n general, a review for reasonableness is an objective assessment, one that does not consider an individual's actual state of mind."[71] The court continued by explaining that reading an actual reliance component into the reasonable basis standard would create overlap with the reasonable cause and good faith defense, which is meant to examine the taxpayer's conduct.[72]

B. *Cases Applying Reasonable Basis Finding No Negligence*

In *Taibo v. Comm'r*, the court found "the question of whether petitioner had a reasonable basis for the nontaxability of his Johnston Island wages is to be evaluated as of . . . the day petitioner filed his 2000 individual Federal income tax return."[73] Thus, the court did not look to whether the taxpayer consulted relevant authorities before filing the return, but instead looked at the relevant authorities in effect at the filing of the return.[74] In this case, the Tax Court noted the IRS had not applied accuracy-related penalties to any other taxpayer litigating the same issue, and the taxpayer was relying on letters from the IRS saying that the regulations regarding the subject were current.[75] The court observed the taxpayer could have a reasonable basis even though all the other cases litigating the issue had all gone against the taxpayer's position.[76] The court concluded by holding the taxpayer had a reasonable basis for his return position.[77]

In *Matthies v. Comm'r*, the court found the taxpayer was not liable for the penalty of negligence because this was a case of first impression for the Tax Court. The court noted "the negligence penalty may not be appropriate where an issue to be resolved by the Court is one of first impression involving unclear statutory language."[78] Further, in a newer case decided after *Wells Fargo & Co* v. *U.S.*, the Tax Court in *Oakbrook Land Holdings, LLC v. Comm'r* allowed that where "[t]here is a

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[70] *Id.*
[71] *Id.*
[72] *Id.*; Treas. Reg. § 1.6664-4(b)(1) (2020) ("The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.").
[73] Taibo v. Comm'r, 88 T.C.M. (CCH) 181, at *7 (2004).
[74] *See id.*
[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] Matthies v. Comm'r, 134 T.C. 141, 154 (2010) (citing Bunney v. Comm'r, 114 T.C. 259, 266 (2000); Lemishow v. Comm'r, 110 T.C. 110, 114 (1998); Hitchins v. Comm'r, 103 T.C. 711, 719-20 (1994)).

disagreement among us on whether the contested regulation is valid, and that might also be some indication of the objective reasonableness of Oakbrook's position."[79] In this case, the taxpayer was not liable for the negligence penalty because the taxpayer had a reasonable basis for relying on a private letter ruling in regards to setting up a conservation easement.[80] In *Campbell v. Comm'r*, the court found that a taxpayer had a reasonable basis for only part of the return position.[81] The taxpayer based their argument on a footnote from a case that held adversely to the taxpayer's position, and the court found that this argument did not rise to the level of reasonable basis.[82] However, the court found that the taxpayer had a reasonable basis for excluding contingency fee payments as income because the case relied upon, which was overturned after the filing of the return, provided a reasonable basis for the taxpayer's position.[83] Again, even though the court did not directly address whether the taxpayer actually relied on the source when arriving at a return position, the court agreed with the taxpayer that a taxpayer's return position should be evaluated by the authorities that existed at the time the return was filed.[84] The court did not require that the authorities be valid when determining a return position, which occurs prior to filing the return, but instead evaluated whether the case was good law on the date the return was actually filed.[85]

C. Cases Applying Reasonable Basis with Reliance Component

In *Blue Mt. Energy, Inc. v. United States*, the Government argued the taxpayer submitted "no evidence that anyone at BME was aware of the existence of that revenue ruling at the time the decision was made to ignore the clear language of the regulations and to use an artificial price rather than the actual retail price when computing BLET."[86] Further, the Government asserted "'[t]his failure leads to the obvious conclusion that BME did not rely on that ruling, but rather consciously chose to ignore applicable guidance."[87] In denying summary judgment for the taxpayer,

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[79] Oakbrook Land Holdings, LLC v. Comm'r, 119 T.C.M. (CCH) 1352, at *43-45 (2020).
[80] *Id.* at *43-44.
[81] Campbell v. Comm'r, 134 T.C. 20, 31 (2010).
[82] *Id.*
[83] *Id.* at 32.
[84] *See id.*
[85] *See id.*
[86] Blue Mt. Energy, Inc. v. United States, No. 2:14-cv-418-DN, 2016 U.S. Dist. LEXIS 103625, at *29 (D. Utah Aug. 5, 2016) ("BLET" stands for black lung excise tax).
[87] *Id.*

the court noted the taxpayer might be able to prevail on reasonable basis, but also mentions "an issue of fact whether BME was aware and relied on Revenue Ruling 81-188 when it filed its tax returns during the relevant times at issue."[88] In later proceedings, the court concluded the taxpayer did not have a reasonable basis for their return position.[89] The court began by saying the taxpayer "cannot assert that its own interpretation of 26 U.S.C. § 4216(b) and related federal regulations can serve as a rational basis for its filings and return position for the years in question."[90] The court then analyzed whether the relevant authorities could support the taxpayer's return position, and decided the stated authority did not provide a reasonable basis for the taxpayer's position.[91] The court, however, did not directly address the actual reliance portion mentioned in the earlier hearing, but instead looked at the relevant authorities and determined the taxpayer could not have formed a reasonable basis from those authorities.[92]

In *Candyce Martin 1999 Irrevocable Trust v. United States*, the court said "[r]easonable basis requires reliance on legal authorities and not on opinions rendered by tax professionals."[93] However, when the court was describing the negligence penalty, the court noted that "[d]ue care is an objective standard by which the taxpayer must show that he acted as a reasonable and prudent person would act under similar circumstances."[94] This creates some disconnect between the negligence penalty and the reasonable basis standard used as a defense to the negligence penalty. In *Wells Fargo & Co. v. United States*, the court said that while the overall statutory framework supports actual reliance, this may not be the case when looking at the negligence penalty with due care language.[95] To determine whether the negligence penalty is applicable, courts examine the taxpayer's actions objectively.[96] Thus, if the courts apply the

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88 *Id.*

89 Blue Mt. Energy, Inc. v. United States, 418 F. Supp. 3d 901, 908 (D. Utah Sept. 27, 2019).

90 *Id.* at 907.

91 *See id.* at 908.

92 *Id.* at 906–08.

93 Candyce Martin 1999 Irrevocable Trust v. United States, 822 F. Supp. 2d 968, 1013 (N.D. Cal. 2011).

94 *Id.*

95 *See id.;* Wells Fargo & Co. v. United States, 957 F.3d 840, 853 (8th Cir. 2020). *See generally* Treas. Reg. § 1.6662-4(g)(1)(i) (2020); Treas. Reg. § 6404(f)(2)(A) (2020); Treas. Reg. § 6662(c) (2020).

96 *See* Fidelity Int'l. Currency Advisor A Fund, LLC, v. United States, 747 F. Supp. 2d 49, 242 (D. Mass. 2010); TIFD III-E, Inc. v. United States, 8 F. Supp. 3d 142, 147 (D. Conn. 2014); Hansen v. Comm'r, 471 F.3d 1021, 1028 (9th Cir. 2006); *Candyce Martin 1999 Irrevocable Trust*, 822 F. Supp. 2d at 1013.

negligence penalty objectively, the courts should also apply the reasonable basis defense objectively.[97]

D. *The Wells Fargo & Co. v. United States Case*

1. Facts

In 2002, Wells Fargo and Barclays Bank entered into a structured advantaged repackaged securities transaction ("STARS"), and as a result, Wells Fargo claimed foreign-tax credits on its 2003 tax return.[98] The purpose of claiming foreign-tax credits is to avoid paying taxes on the same income twice.[99] The foreign-tax credit operates by allowing "a taxpayer to claim a dollar-for-dollar tax credit against its federal tax liability for taxes paid in another country."[100] Further, in order to claim the credit, the underlying transaction must not be a "sham transaction" and must have "economic substance outside of its tax consequences."[101]

First, it should be noted that the STARS transaction was described in the district court as "extraordinarily complicated—so complicated, in fact, that it almost defies comprehension by anyone (including a federal judge) who is not an expert in structured finance."[102] In this transaction, Wells Fargo placed $6.7 billion of income-producing assets into a Delaware trust and named another Wells Fargo entity (a U.K. resident for tax purposes) as trustee. Barclays then loaned Wells Fargo $1.25 billion for a five-year interest in the trust.[103] Additionally, Wells Fargo would pay interest on the loan every month, and Barclays would send a fixed payment to Wells Fargo called "Bx."[104] It is well-established that STARS transactions have both a loan component and a trust component.[105] Further, Barclays did not really receive funds from the trust because the trust distributions were placed in a "blocked account."[106] The funds were then reinvested into the trust and Barclays was able to claim a loss as a result of this transaction. From this transaction, Wells Fargo claimed foreign-tax credits because of U.K. taxes paid as well as received Bx payments from Barclays, and

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97 *See id.*
98 *Wells Fargo & Co.*, 957 F.3d at 842.
99 *Id.* at 842-43.
100 *Id.*
101 *Id.* at 843.
102 *Id.*
103 *Id.*
104 *Id.*
105 *Id.* at 844.
106 *Id.*

Barclays received a gain in the transaction from receiving the interest payments, while the IRS received nothing in taxes.[107]

In the district court, the jury found the trust component of the transaction was a sham, but the loan component was not.[108] Further, the court found the Bx payment constituted a tax benefit and Wells Fargo was subject to the negligence penalty under IRC § 6662(b)(1).[109] The government asserted that "[b]ecause Wells Fargo did not submit any evidence that it subjectively based its return position on legal authority, the government submits that the district court correctly applied the negligence penalty."[110] However, Wells Fargo claims its return position just needed to be "objectively reasonable under the relevant legal authorities."[111]

2. The Holding on the Tax

The Eighth Circuit held the "STARS's trust component had no reasonable possibility of pre-tax profit, even assuming that Bx was pre-tax income to Wells Fargo."[112] In arriving at this holding, the Eighth Circuit analyzed whether the Bx payments and Wells Fargo's payments of UK taxes were pre-tax income or a post-tax benefit.[113] Looking at other similar cases regarding STARS transactions, the court noted that it does not matter how the Bx payment is classified because the taxpayer loses either way.[114] The court provided the example that "every $1 Wells Fargo makes via the Bx payments comes at the cost of $2 in U.K. taxes, to which Wells Fargo intentionally subjected itself."[115] The court concluded, "because Wells Fargo's pre-tax expenses dwarf any income it receives from the trust in the form of Bx, STARS's trust component simply has no reasonable possibility of profit outside of its tax features."[116]

In considering whether the payment of U.K. taxes was a pre-tax or post-tax expense, Wells Fargo cited several cases which the court rejected as applicable because the facts were distinguishable and those particular cases did not discuss STARS transactions.[117] Further, the court noted that the "STARS's trust component was essentially comprised of economically

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107 *Id*. at 844-45.
108 *Id*. at 846.
109 *Id*.
110 *Id*. at 852.
111 *Id*.
112 *Id*. at 851.
113 *Id*. at 848.
114 *Id*.
115 *Id.*
116 *Id.*
117 *Id.* at 849.

meaningless and circular cash flows."[118] The court recognized "this trust created no value for Wells Fargo outside of generating the foregoing transaction costs and expected tax benefits."[119] The court concluded that the jury did not err in finding that Wells Fargo did not have a valid business purpose in the STARS transaction.[120]

3. The Holding on the Penalty

The Eighth Circuit upheld the imposition of the negligence penalty in this case because Wells Fargo failed to actually rely on the relevant authority under the rational basis defense.[121] The court began by looking at the plain language of the statute and the definition of the word "base."[122] Under the majority's analysis, "a taxpayer must show that it actually relied upon those authorities in forming its position."[123] Further, the court reasoned that "in order for a taxpayer to 'base' its position on relevant authority, it must have actually known about those authorities and actually relied upon them when forming its return position."[124] The court noted that when looking at whether the negligence penalty applied, at least part of the inquiry must be the taxpayer's actual conduct and not just if the taxpayer's position is supported by the relevant authorities.[125] Additionally, the court said, "[R]eading the phrase 'reasonably based' to require evidence of actual reliance is more consistent with the broader statutory and regulatory framework."[126]

Next, the court turned to addressing the three arguments set forth by Wells Fargo. First, Wells Fargo argued a plain reading of the text did not require evidence of actual reliance on the relevant authorities. In support of this argument, Wells Fargo points to other provisions where "actual reliance" is expressly required, and since "actual reliance" language is not present in the reasonable basis definition, the court should just objectively analyze whether Wells Fargo's return position is reasonable under the relevant authorities.[127] The court dismissed this argument as "contrary to

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118 *Id.* at 850.
119 *Id.*
120 *Id.*
121 *Id.* at 852.
122 *Id.* (citing Treas. Reg. § 1.6662-3(b)(3) (2020))). In this context, the court examined Treas. Reg. § 1.6662-3(b)(3) (2020) and determined that under the reasonable basis defense, a taxpayer has to reasonably base their return position on one or more relevant authorities. Thus, this is why the court examines the definition of base instead of basis, because the word base appears in the explanation of the defense.
123 *Id.*
124 *Id.* at 852.
125 *Id.* at 852-53.
126 *Id.* at 853.
127 *Id.*

a plain reading of the term 'base' and inconsistent with the broader statutory context."[128] Further, the court noted that just because other provisions create actual reliance through different language does not mean that actual reliance cannot be created through looking at the broader statutory context[129]

Secondly, Wells Fargo argued the actual reliance standard would require the taxpayer to waive attorney client privilege in order to present evidence the taxpayer actually relied on the relevant authorities.[130] In order for Wells Fargo to show actual reliance on the relevant authorities during the contemplation process for the tax decisions at issue, Wells Fargo would have to disclose confidential discussions with their attorneys to show relevant authorities were actually consulted during the decision-making process.[131] The court found that other defenses also required the taxpayer to waive attorney-client privilege, and this alone would not be enough for Wells Fargo to prevail on the negligence penalty.[132] The Court said that this argument has some appeal, but by itself "is not a convincing reason to adopt Wells Fargo's reading of the regulation."[133]

Thirdly, Wells Fargo argued that, as a policy matter, as long as a taxpayer gets to a reasonable position it does not matter if it is through "much deliberation" or "by sheer luck."[134] However, the court reasoned there "is a sound policy reason underlying a subjective or actual reliance requirement—it incentivizes taxpayers to actually conform to the requisite standard of care rather than simply taking the chance that there may be a reasonable basis for their underpayment of tax."[135] Further, the court concluded by saying that requiring evidence of actual reliance shows a taxpayer who contemplates the relevant authorities when forming a return position "is perhaps less blameworthy or culpable than a taxpayer which simply ignored the existing authorities in forming its tax position and attempts to generate a reasonable basis as a post-hoc justification for its underpayment."[136]

4. The Dissent

Justice Grasz dissented, specifically opposing the majority opinion on the application of the negligence penalty and the requirement for actual

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[128] *Id.*
[129] *Id.*
[130] *Id.*
[131] *See id.*
[132] *Id.* (citing Treas. Reg. § 1.6662-4(g)(1)(i) (2020)).
[133] *Id.*
[134] *Id.*
[135] *Id.* at 853-54.
[136] *Id.* at 854.

reliance.[137] Justice Grasz began by arguing that the district court incorrectly applied *Auer* deference to the IRS's interpretation of its own regulation.[138] However, the majority does not use the same analysis as the district court in applying the negligence penalty.[139] Justice Grasz also analyzed the plain language of the regulation, noting that "nowhere in this language, which is cast in objective terms, does the term 'reliance' appear."[140] Justice Grasz further noted a reliance element is specifically listed in other defenses, such as the reasonable cause and good faith defense.[141] He argued if the "IRS wanted to require actual reliance on the specified authorities to satisfy the reasonable-basis defense, it could have expressly said so, as it did in setting forth eligibility for the reasonable-belief defense."[142] Additionally, Justice Grasz emphasized that there is no language in 26 C.F.R. § 1.6662-3(b)(3) which "assumes the taxpayer must base its position on the specified authorities before the return in filed."[143] Justice Grasz further stated it is the job of the agency or courts to determine whether a taxpayer has reasonable basis for the return, not for the taxpayer to show actual reliance.[144] He recognized the district court failed to even consider if Wells Fargo's return position had an objectively reasonable basis under the relevant authorities, leaving the possibility that Wells Fargo still might be unable to recover even if the defense were analyzed solely objectively.[145] Although the court did not analyze whether the authorities cited would constitute a reasonable basis, *Santander Holdings USA, Inc. v. United States* addressed a different STARS transaction and determined that the taxpayer's did not have a reasonable basis under the relevant authorities.[146]

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137 *Id.* at 855-56.
138 *Id.* at 855.
139 *See id.* at 856.
140 *Id.* (looking mainly at Treas. Reg. § 1.666-3(b)(3), although he considers several other regulations as well).
141 *Id.* (the reasonable cause and good faith defense is described in Treas. Reg. § 1.6664-4).
142 *Id.*
143 *Id.*
144 *Id.*
145 *Id.*
146 *See* Santander Holdings USA v. United States, No. 09-11043-GAO, 2018 U.S. Dist. LEXIS 118681, at *7 (D. Mass. July 17, 2018).

V. ANALYSIS

A. Post-Decision Application

In looking at cases going forward, taxpayers may need to keep better records or documents showing they actually relied on relevant authorities when arriving at a return position. However, the Eighth Circuit is one of the only circuits requiring a taxpayer to prove actual reliance to have a reasonable basis. Other courts either do not discuss reliance or assume the reasonable basis standard is objective by going straight into analysis as to whether a taxpayer's return position has a reasonable basis under the relevant authorities.[147] Further, in many cases, the reasonable basis defense and the substantial authority standard are discussed together and are described as being very similar.[148] Courts outside the Eighth Circuit imply the only difference between the two is that the substantial authority standard is more stringent than the reasonable basis standard.[149] However, because of the *Wells Fargo* decision, the reasonable basis standard and the substantial authority standard are now very different. The reasonable basis standard now requires that the taxpayer show they actually relied on the relevant authorities when contemplating a transaction.[150] This increases the burden on the taxpayer who must now clear another hurdle under the reasonable basis standard when contemplating tax decisions. The substantial authority standard is described as being an "objective standard," and thus it would not require evidence the taxpayer actually relied on the relevant authorities.[151] However, because of the Eighth Circuit's opinion, the reasonable standard seems to shift toward more stringent, requiring the return position be supported by one or more relevant authorities and that the taxpayer consulted these authorities before filing the return.[152] Further, this result would allow taxpayers with clear support, albeit not clear enough, to prevail on the merits, under relevant

[147] *See, e.g.*, Pederson v. Comm'r, 105 T.C.M. (CCH) 54, *58-59 (2013); TIFD III-E Inc. v. United States, 8 F. Supp. 3d 142, 148-52 (D. Conn. 2014); Taibo v. Comm'r, 88 T.C.M. (CCH) 181, at *17-18 (2004); Oakbrook Land Holdings v. Comm'r, 54 T.C.M. (CCH) *43 (2020).

[148] *See, e.g.*, Southgate Master Fund v. United States, 651 F. Supp. 2d 596, 665 (N.D. Texas 2009); Burditt v. Comm'r, 77 T.C.M. (CCH) 1767, *38–41 (1999); *Pederson*, 54 T.C.M. (CCH) at *58–59; Berger v. Comm'r, 76 T.C.M. (CCH), at *34 (1996).

[149] *See Southgate Master Fund*, LLC, 651 F. Supp. 2d at 665; *Burditt*, 117 T.C.M. (CCH) at *38–41; *Pederson*, 54 T.C.M. (CCH) at *58–59.

[150] *Wells Fargo & Co.*, 957 F.3d at 853-54.

[151] *See Southgate Master Fund*, LLC, 651 F. Supp.2d at 665; *Burditt*, 117 T.C.M. (CCH) at *38–41; *Pederson*, 54 T.C.M. (CCH) at *58–59; *Berger*, T.C. Memo. 1996-76, at *34.

[152] *Wells Fargo & Co.*, 957 F.3d at 853-54.

authorities for their position and to still be liable for the negligence penalty if the authority was not relied upon prior to the filing.[153]

B. Is the Holding Correct?

Even though the holding in ____ is persuasive, the overall statutory framework and prior case law do not explicitly support a subjective actual reliance component within the reasonable basis standard. Several courts do not directly discuss the reasonable basis standard but do describe the negligence standard as being objective.[154] This shows that the courts determine whether the negligence penalty is applicable through an objective analysis, and thus one of the main defenses to the negligence penalty should also be viewed objectively.[155] This conclusion is consistent with an objective reasonable basis standard since it provides a defense for the negligence penalty.[156] Additionally, a review of the statutory framework supports the conclusion that courts should apply the reasonable basis standard objectively as many other similar standards are objectively applied as well.[157]

The Eighth Circuit's penalty holding revolves around the definition of the word "base," in which the court chose one definition above all others to support the position that a taxpayer must have actual reliance on relevant authorities when contemplating tax decisions.[158] For instance, the definition of base, as listed in Black's Law Dictionary includes: "[t]o establish (an agreement, conclusion, etc.); to place on a foundation; to ground <the claim is based in tort.>."[159] From this definition, the court could have reached the completely opposite result. For instance, a return position can be grounded in authority, even though the taxpayer may not have consulted with the relevant authorities while completing the return or contemplating a tax decision. Further, in *Oakbrook Land Holdings, LLC*,

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153 *See id.*

154 Fidelity Int'l Currency Advisor A Fund, LLC v. United States., 747 F. Supp. 2d 49, 242 (D. Mass. 2010); TIFD III-E, Inc. v. United States, 8 F. Supp. 3d 142, 147 (D. Conn. 2014); Hansen v. Comm'r, 471 F.3d 1021, 1028 (9th Cir. 2006); Candyce Martin 1999 Irrevocable Trust v. United States, 822 F. Supp. 2d 968, 1013 (N.D. Cal. 2011).

155 *See id.*

156 *See Fidelity Int'l Currency Advisor A Fund, LLC*, 747 F. Supp. 2d at 242; Mario J. Verdolini & Christopher A. Baratta, *The Objectivity of the Reasonable Basis Defense to Tax Penalties*, TAX NOTES (Jan. 20 2020), https://www.taxnotes.com/taxpractice/penalties/objectivity-reasonable-basis-defense-tax-penalties/2020/02/10/2bqz0?highlight=verdolini (The authors present an alternative argument that the negligence standard and the reasonable basis standard can be distinguished even accepting the reasoning of the court.).

157 *See* Verdolini & Baratta, *supra* note 156.

158 *Wells Fargo & Co.*, 957 F.3d at 853-54.

159 Base, Black's Law Dictionary (11th ed. 2019).

which was decided after *Wells Fargo*, the court found that a taxpayer had a reasonable basis for a return position regarding conservation easements when the court itself had a disagreement about the meaning of a contested regulation.[160] The court said, "Section 1.6662-3(b)(3), Income Tax Regs., tells us that a return position generally satisfies the reasonable-basis standard if it is based on, among other types of authorities, private letter rulings."[161] Here, the court also used the phrase "based on," yet does not go into any detail about whether the taxpayer relied upon the language when forming a return position.[162] This seems to suggest that the Tax Court may not impose the subjective requirement that has been added by a few courts.[163]

Additionally, the court determined that "in light of the broader context of the statute," actual reliance is a component of the reasonable basis defense.[164] However, since courts often consider or describe the reasonable basis and the substantial authority standard together, the court should have taken into account that the substantial authority standard is plainly described as an "objective" standard.[165] The courts in another line of cases concluded that, as a result of the substantial authority standard being met, the reasonable basis standard was also met.[166] Under the reasoning in *Wells Fargo & Co.*, a situation may arise where a return position meets the objective substantial authority standard, but fails the less strict reasonable basis standard because the actual reliance component is not met by the taxpayer.

On one hand, the policy reasons set forth by the Eighth Circuit seem persuasive and will lead to taxpayers actually consulting authorities before making tax decisions.[167] For example, the court said actual reliance "incentivizes taxpayers to actually conform to the requisite standard of care rather than simply taking the chance that there may be a reasonable basis for their underpayment of tax."[168] This requires that the taxpayer

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160 Oakbrook Land Holdings, LLC v. Comm'r, 119 T.C.M. (CCH) 1352, at *43 (2020).

161 *Id.* (citing Treas. Reg. § 1.6662-3(b)(3); Treas. Reg. § 1.6662-4(d)(3)(iii)).

162 *See id.*

163 *See id.*; *Wells Fargo & Co.*, 957 F.3d at 853-54; Blue Mt. Energy, Inc. v. United States, No. 2:14-cv-418-DN, 2016 U.S. Dist. LEXIS 103625, at *26 (D. Utah Aug. 5, 2016); Blue Mt. Energy v. United States, 418 F. Supp. 3d 901, 906–08 (D. Utah Sept. 27, 2019).

164 *Wells Fargo & Co.*, 957 F.3d at 852.

165 *See* Southgate Master Fund, LLC v. United States, 651 F. Supp. 2d 596, 665 (N.D. Texas 2009); Burditt v. Comm'r, 77 T.C.M. (CCH) 1767, *38–41 (1999); Pederson v. Comm'r, 105 T.C.M. (CCH) 54, *58-59 (2013); Berger v. Comm'r, 76 T.C.M. (CCH), at *34 (1996).

166 *See Southgate Master Fund, LLC*, 651 F. Supp. 2d at 667; *Burditt*, 117 T.C.M. (CCH) at *40–41.

167 *Wells Fargo & Co.*, 957 F.3d at 853.

168 *Id.* at 853-54.

actually consult authorities when performing transactions, and not just support its decision-making after the return has already been filed.[169] On the other hand, this seems to suggest on some level that just showing the taxpayer read the authorities presents a good chance the taxpayer and the IRS will be in agreement on the interpretation of the relevant authorities.[170] This is clearly not the case since in *Mortensen* the court said, "[r]easonable minds can differ over tax reporting and sometimes the IRS disallows certain transactions."[171] The court continued by saying "[e]very time a transaction is challenged or disallowed, the taxpayer is not liable for penalties."[172] Thus, simply because the taxpayer holds to a position contrary to the IRS does not mean that the taxpayer negligently reached its return position or should be held liable because it did not actually rely on the authorities when arriving at a return position.[173]

Further, much of the prior case law does not fully discuss whether the taxpayer actually relied on the relevant authorities. Instead, the cases either mention reasonable basis in passing or describe the definition of reasonable basis and then see if the relevant authorities provide support for the taxpayer's return position. This may suggest that courts assume the taxpayer relied on the relevant authorities when completing their taxes. However, the more likely explanation is that the courts assume the reasonable basis standard is a solely objective standard and it is the position of the court to determine whether the taxpayer had a reasonable basis in the relevant authorities for its return position.

VI. CONCLUSION

The Eighth Circuit incorrectly held that the reasonable basis standard requires the taxpayer actually rely on the relevant authorities when contemplating a transaction and filling out a tax return. Although the public policy arguments in favor of actual reliance are compelling, looking through the history and analysis of other courts application of the reasonable basis standard does not support the Eighth Circuit's holding. A taxpayer should not have to show actual reliance, but instead the court should analyze the taxpayer's return position to see if it is supported by the relevant authorities. Further, the Eighth Circuit's holding could possibly shift the standards and generate considerable overlap with the reasonable cause and good faith defense. For these reasons, courts going

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169 *See id.*
170 *See id.* at 854.
171 Mortensen v. Comm'r, 440 F.3d 375, 385 (6th Cir. 2006).
172 *Id.*
173 *See id.*

forward should continue to apply the reasonable basis standard in an objective manner.