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Negligence Penalty Imposed on Taxpayer Unable to Show Actual Consultation of Supporting Authorities

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A recent ruling from a federal court in Minnesota presents the rare case in which the imposition of a penalty has warranted more attention than the holding on the underlying transaction—and for good reason. In *Wells Fargo & Co. v. United States*,[1] the United States District Court for the District of Minnesota held that the taxpayer's failure to prove *actual consultation* of legal authorities providing a basis for its tax return position justified the IRS's assessment of a 20 percent negligence penalty under I.R.C. § 6662(b)(1). The decision highlights the importance of creating and preserving contemporaneous documentation establishing the actuarial and legal foundations for return positions that may be challenged.

The facts of the case involve the taxpayer's participation in a structured trust advantaged repackaged securities (STARS) transaction.[2] In line with recent federal appeals court decisions on materially identical STARS transactions,[3] the district court in Wells Fargo bifurcated the transaction's trust and loan components and held that the loan portion was not a sham and interest payments thereon were deductible. The trust structure had previously been determined to be a sham, and the taxpayer's claim of related foreign tax credits was disallowed.

Perhaps more significant, though, was the court's determination that the taxpayer was subject to I.R.C. § 6662(b)(1)'s negligence penalty on underpayments associated with the disallowed foreign tax credits. The regulations under I.R.C. § 6662 define "negligence" to include "failure[s] to make a reasonable attempt to comply with the provisions of the internal revenue laws." The definition excludes return positions that have a "reasonable basis," which means positions "reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) . . .."[4] In an effort to limit discovery with respect to the negligence penalty issue, the taxpayer stipulated, among other things, that it would not argue actual reliance on the authorities that form the basis of the reasonable basis defense. Thus, the question for the court became whether it was sufficient for the taxpayer to demonstrate its return position had a reasonable basis without proving that, in preparing the return, it had actually consulted the authorities establishing that reasonable basis.

The court examined the word "negligence" and explained that the term's ordinary meaning indicates a focus on a taxpayer's conduct and whether the taxpayer exercised due care. It acknowledged the taxpayer's argument that the reasonable basis standard in Treas. Reg. § 1.6662-3(b)(1), which reads "[a] return position that has a reasonable basis as defined in [Treas. Reg. § 1.6662-3(b)(3)] is not attributable to negligence," is, indeed, "cast in objective terms." However, the court concluded that, when the regulation is read as a whole, there is ambiguity as to whether a taxpayer must have actually relied on the authorities referenced in Treas. Reg. § 1.6662-3(b)(3). In particular, the court focused on the regulation's use of the term "return position." A return position, according to the court, is essentially an opinion on the obligations the law imposes on a taxpayer, and the court could not envision how a taxpayer could "base" a return position on authorities without actually having consulted them. The court also noted that the substantial authority standard in Treas. Reg. § 1.6662-4(d)(2) is explicitly described as an objective standard, and the absence

of similar language in the reasonable basis standard indicates that the taxpayer's subjective analysis may be relevant. Having determined the regulation is ambiguous, the court concluded that Treasury's reasonable interpretation of its own regulation is controlling,[5] and the reasonable basis defense includes a subjective element that requires the taxpayer to show actual reliance on the authorities forming the basis of that defense.

The lesson to take from the *Wells Fargo* case is the importance of contemporaneously documenting the basis for return positions. That documentation also should be retained through the end of the applicable limitations period. To be certain, the taxpayer in *Wells Fargo* created a unique handicap by waiving its right to demonstrate actual reliance on legal authorities. But, the holding makes clear that a post hoc determination that a return position had a reasonable basis is not sufficient, on its own, to avoid the imposition of the negligence penalty. A taxpayer also must be able to show that, at the time of taking the return position, it actually consulted the authorities that provide the reasonable basis for the position. This limits the universe of supporting authorities to those existing at the time of filing the return. Any rulings or guidance issued after the return position is taken, even those that support the taxpayer's position, would appear to be irrelevant to the reasonable basis analysis as applied in *Wells Fargo*. However, because the pertinent point in time is the taking of the return position rather than the execution of the transaction, authority issued after a transaction, but before that transaction is reduced to a position on a return, would appear to be germane to establishing a reasonable basis for the position.[6]

Treas. Reg. § 1.6662-4(d)(3)(iii) outlines the types of authority on which a return position may be based for purposes of the reasonable basis defense to the negligence penalty.[7] While the regulation specifically excludes conclusions reached in treatises, legal opinions, or opinions by tax professionals, "[t]he authorities underlying such expressions of opinion" may provide a reasonable basis for a return position.[8] Offering the contents of a legal or professional tax opinion as proof that those underlying authorities were actually consulted likely will jeopardize attorney-client or tax practitioner privilege.[9] In many cases, a taxpayer might obtain an opinion for use as a shield in exactly this type of situation. However, as a practical matter, if waiving privilege is undesirable, maintaining an independent, contemporaneous file of the authorities that were consulted in forming the basis for a return position, even if they are the same authorities cited in an opinion, may offer a similar benefit without threatening privilege.

While *Wells Fargo* may be unusual for the fact that the taxpayer had waived the right to show actual reliance on the authorities underlying its return position, it is, nevertheless, a useful look into one court's interpretation of the negligence penalty. The narrow reading of the reasonable basis defense in the case is striking, and this author is unaware of any other cases that explicitly interpret the defense in a similar manner. It is important to note, though, that this is a district court decision, and therefore, it is merely persuasive authority in most of the country. Regardless, *Wells Fargo* demonstrates the value of diligence in maintaining contemporaneous actuarial and legal records supporting return positions that could be challenged. As the axiom goes: an ounce of prevention is worth a pound of cure—or, rather, in the case of the negligence penalty, potentially worth a 20 percent penalty on the underpayment amount. ■

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ENDNOTES

1 No. 09-cv-2764 (D. Minn. May 24, 2017).

2 A STARS transaction is complex, and a discussion of the structure is beyond the scope of this article.

3 *See Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016); B*ank of N.Y. Mellon Corp. v. Commissioner*, 801 F.3d 104 (2d Cir. 2015); *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015).

4 Treas. Reg. § 1.6662-3(b)(1), (3). The reasonable basis standard is a significantly higher standard than not frivolous or not patently improper, and it is not satisfied by a claim that is merely colorable. However, the standard is less demanding than the substantial authority standard. Treas. Reg. § 1.6662-3(b)(3).

5 The court determined Treasury was entitled to Auer deference, which applies to an agency's reasonable interpretation of its own ambiguous regulation unless that interpretation is plainly erroneous or inconsistent with the regulation. *Auer v. Robbins*, 519 U.S. 452 (1997).

6 *Cf.* Treas. Reg. § 1.6662-4(d)(3)(iv)(C) ("There is substantial authority for the tax treatment of an item if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.").

7 *See* Treas. Reg. § 1.6662-3(b)(3).

8 Treas. Reg. § 1.6662-4(d)(3)(iii). Treas. Reg. § 1.6662-4(d) deals with the substantial authority defense to the I.R.C. § 6662(b)(2) substantial understatement penalty, and subparagraph (d)(3)(iii) explains that the authorities underlying a legal or tax professional opinion "may give rise to substantial authority for the tax treatment of an item." *Id*. As mentioned in a previous footnote, the reasonable basis standard is lower than the substantial authority standard, which requires a greater than 50 percent likelihood of a position being upheld. *See* Treas. Reg. §§ 1.6662-3(b)(3), -4(d)(2).

9 *See, e.g.*, *Salem Fin., Inc. v. United States*, 102 Fed. Cl. 793 (Jan. 18, 2012) (tax practitioner privilege was waived when the taxpayer relied on its accountant's advice as a defense against penalties). With respect to tax advice, the common law protections of confidentiality afforded to communications between a taxpayer and an attorney also apply to communications between a taxpayer and any federally authorized tax practitioner. I.R.C. § 7525(a)(1). Federally authorized tax practitioners include attorneys, certified public accountants, enrolled agents, and enrolled actuaries. *See* I.R.C. § 7525(a)(3)(A); 31 U.S.C. § 330; S. Rep. No. 105-174, at 70-71 (1998). Note, however, that this "tax practitioner privilege" may only be asserted in noncriminal tax matters before the IRS and in noncriminal proceedings in federal court brought by or against the United States. I.R.C. § 7525(a)(2).