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Reasonable Basis: All in the Taxpayer's Head?

By Donald P. Board • Wood LLP

Judges, as commentators have observed more than once, are not above stretching things a bit to avoid inflicting harsh results on sympathetic defendants. These are the "hard" cases that make bad law. But cases in which judges feel that the law is *not hard enough* on an *un*sympathetic defendant are another rich source of questionable precedents.

This dynamic is currently being played out in litigation about penalties imposed on taxpayers that participated in the notorious Structured Trust Advantaged Repackaged Securities (STARS) transaction. The IRS has been arguing that a taxpayer cannot escape the 20-percent negligence penalty under Code Sec. 6662(b)(1) merely by showing that its reporting position had a "reasonable basis" in the received authorities. The taxpayer must also show that it *relied* on the authorities supporting its position.

This will strike many tax advisors as counterintuitive. Reg. §1.6662-3(b)(1) states that a "return position" is not attributable to negligence if it has a reasonable basis in the Code, judicial decisions, tax regulations, revenue rulings and so forth. The focus appears to be on the merits of the position *per se*, without regard to events that may or may not have occurred inside the taxpayer's head.

That may have shifted in the wake of a recent STARS case, *Wells Fargo & Co.* [260 F. Supp. 3d 1140 (D.C. Minn. 2017)]. There, the district court agreed with the IRS that Wells Fargo could not avoid a $70-million negligence penalty by simply demonstrating that the authorities provided a reasonable basis for the position taken on its tax return. Instead, the bank was required to show that it had "actually consulted" and relied on the authorities when deciding how to report the STARS transaction.

This was a tough break for Wells Fargo. As a sophisticated taxpayer, the bank would certainly have reviewed—and presumably relied on—two circuit-court decisions holding that foreign taxes should not be taken into account when evaluating a transaction's "pre-tax" profit potential. [*See IES Indus. Inc.*, CA-8, 2001-2 USTC ¶50,471, 253 F3d 350; *Compaq Computer Corp.*, CA-5, 2002-1 USTC ¶50,144, 277 F3d 778.]

Congress "overruled" these decisions in 2010, when it codified the economic substance doctrine. [*See* Code Sec. 7701(o)(2)(B).] But this had no effect on the tax year at issue in *Wells Fargo* (2003). The door would still have been open for the bank to rely on these pro-taxpayer precedents.

Wells Fargo, however, had painted itself into a procedural corner. To limit the scope of discovery, the bank had stipulated that it would limit its defense to the negligence penalty to asserting that there was an *objectively* reasonable basis for its return position. The bank specifically agreed that it would *not* advance:

> [a]ny contention that relies upon Wells Fargo's efforts to exercise ordinary and reasonable care in the preparation of its tax return, or Wells Fargo's efforts to determine its proper tax liability under the internal revenue laws arising out of the STARS Transaction, to establish reasonable basis. [260 F. Supp. 3d at 1147.]

This stipulation would have seemed like a good idea during the *liability* phase of the case. By limiting discovery, Wells Fargo avoided what could have been an embarrassing inquiry into what its managers were thinking and saying when they decided to put the bank into the STARS transaction. The stipulation was probably also intended to prevent waiver of the attorney-client privilege, which could have given the IRS access to the tax advice on which the bank had purportedly relied.

However, the stipulation left the bank unable to defend against the negligence penalty to the extent that it requires *subjective reliance* on: (1) favorable legal authorities; or (2) advice received from professional tax advisors. Requiring a defendant to pay a substantial penalty based on the twists and turns of civil procedure sounds like something out of the Court of Common Pleas *circa* 1319. Why, in our more enlightened day and age, did the IRS and the district court decide to go medieval on poor Wells Fargo?

To answer that question, we should (briefly) review the STARS transaction. Once we have a sense of what the IRS and the district court found when they looked under that rock, we can return to the question of whether "reasonable basis" is a subjective or an objective standard. Requiring taxpayer reliance seems dubious as a technical matter, but the district court's determination to penalize Wells Fargo becomes more intelligible when we consider the source of the massive tax deficiency.

Diverting U.S. Tax Revenue for Fun and Profit

In the late 1990s, Barclays Bank PLC and KPMG developed the STARS transaction to exploit differences between U.S. and U.K. tax law. The transaction was formidably complicated, but it began with a simple step. A large U.S. bank (Bank) would contribute, say, $5 billion of income-producing assets to a newly created grantor trust managed by a resident of the United Kingdom.

From a U.S. perspective, transferring assets to the grantor trust had no immediate tax

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consequences. Not so in the U.K., however. The fact that the trust was managed by a resident of the United Kingdom was enough to subject the trust's entire income to U.K. tax at 22 percent. If, over the course of five or six years, the assets generated $1 billion in income, the trust would have to pay $220 million to Her Majesty's Revenue and Customs.

We can skip the details, but Barclays and KPMG had devised a way for Barclays to acquire an interest in the trust that would allow it to claim a *U.K.* tax credit for the $220-million payment. [*See* Donald P. Board, *Transacting with the STARS: Gargantuan Foreign Tax Credits Stumble over Economic Substance*, The M&A Tax Report 1, 2–4 (Jan. 2018).] That was obviously a bonanza for Barclays, but it only worked because Bank had created a trust that triggered a $220-million U.K. tax bill. Why would Bank have agreed to incur this liability?

The short answer is that Barclays was *paying* Bank to do it. The economics of the STARS transaction were set so that Bank would end up with an amount equal to *50 percent* of Barclays' U.K. tax credits. In our hypothetical case, Bank's would have come away with $110 million.

That's a lot of money, but it would not have made up for the $220 million that Bank had to pay to HMRC. The beauty of the STARS transaction, however, was that Bank wasn't really out of pocket for the $220 million. If everything went as planned, Bank would get its U.K. tax payment back in the form of a $220-million credit against its *U.S.* taxes pursuant to Code Sec. 901(a).

Stripped of its legal camouflage, a STARS transaction was pretty simple. Bank would sign a piece of paper transferring a large chunk of U.S. tax revenue to the United Kingdom. This would permit Barclays to claim a U.K. tax benefit equal to the U.S. Treasury's tax loss. Barclays would then reward Bank for its cooperation by kicking back 50 percent of the take.

If not for a tip from the U.K. tax authorities, the IRS might have slept through the whole thing. The Service investigated and then started to challenge STARS transactions using the economic substance doctrine. The IRS's efforts have met with considerable success, resulting in the denial of billions of dollars of bogus U.S. tax credits. [*See Santander Holdings USA, Inc.*, CA-1, 2017-1 USTC ¶50,101, 844 F3d 15, *cert. denied*, 137 SCt 2295 (2017); *Bank of New York Mellon Corp.*, CA-2, 2015-2 USTC ¶50,473, 801 F3d 104, *cert. denied*, 136 SCt 1377 (2016); *Salem Financial, Inc.*, CA-FC, 2015-1 USTC ¶50,304, 786 F3d 932, *cert. denied*, 136 SCt 1366 (2016); *Wells Fargo & Co.*, 116 AFTR 2d 2015-6738 (D. Minn. 2015).].

Penalty Box

Reading the opinions in the STARS cases, it is clear that the judges thought that Wells Fargo and other participating banks had crossed a line. Yet, there is no indication that the government even considered bringing criminal charges. Despite the mind-boggling scale of this assault on the Treasury, the IRS went no further than to assert the 20-percent negligence penalty under Code Sec. 6662(b)(1).

If the STARS transactions had been entered into after March 30, 2010, the IRS would have had more punitive options. Under Code Sec. 6662(b)(6), an underpayment attributable to a tax benefit disallowed under the economic substance doctrine now attracts its own accuracy-related penalty. Armed with this provision, the IRS could have penalized the U.S. banks that participated in STARS without having to show that their conduct was negligent or resulted in a substantial understatement of tax.

Under Code Sec. 6664(c)(1), taxpayers can generally escape penalties if they show that they acted with reasonable cause and in good faith. Now, however, reasonable cause is not a defense to penalties imposed under Code Sec. 6662(b)(6). [*See* Code Sec. 6664(c)(2).] Taxpayers who engage in transactions without economic substance face a strict-liability penalty for the resulting deficiency.

That's not all. If the taxpayer fails to disclose its substance-free transaction, the accuracy-related penalty is *doubled*. [*See* Code Sec. 6662(i) (40-percent penalty on deficiencies attributable to "nondisclosed noneconomic substance transactions").] Congress was not kidding around.

Negligence and Reasonable Basis

Wells Fargo focused on a STARS transaction that had generated $350 million in foreign tax credits in a *single* year. The 2010 legislation did not apply, so the IRS had to assert the traditional negligence penalty under Code Sec. 6662(b)(1). Although the Code does not fully define "negligence," it states that negligence includes a taxpayer's failure to make a reasonable attempt to comply with the provisions of Title 26. [*See* Code Sec. 6662(c).]

Reg. §1.6662-3(b)(1) fleshes this out with several examples of conduct in which negligence is "strongly indicated." It also states that negligence includes the taxpayer's failure to keep adequate books and records or to substantiate items properly. The taxpayer must "exercise ordinary and reasonable care" in the preparation of a tax return.

This is subject to a familiar but critical exception: A return position is *not* attributable to negligence if it "has a reasonable basis as defined in [Reg. § 1.6662-3(b)(3)]." The cited provision does not define "reasonable basis," but it manages to situate it in relation to other common standards.

The regulations state that the reasonable basis standard is significantly higher than "not frivolous" or "not patently improper." A return position that is "merely arguable" or "merely a colorable claim" does not pass the test. However, a return position *will* meet the standard if it is "reasonably based" on one or more relevant authorities. Under Reg. §1.6662-3(b)(3), a position can be reasonably based on the authorities even if it *fails* to satisfy the "substantial authority" standard set out in Reg. §1.6662-4(d)(2).

Wells Fargo contended that it was off the hook because there was a reasonable basis *in the authorities* to support the foreign tax credits claimed on its 2003 return. The circuit-court decisions in *IES* and *Compaq*, *supra*, provided the bank with more than a "merely arguable" justification for its position. What Wells Fargo may have *thought* about the decisions—or whether it thought about them at all—was irrelevant.

The IRS, on the other hand, insisted that Code Sec. 6662(b)(1) is a *negligence* penalty. As such, what matters is how *carefully* the taxpayer conducted itself in formulating and adopting its return position. In the IRS's view, the existence of authorities that objectively supported Wells Fargo's position did not matter unless the bank actually consulted them.

As noted above, Wells Fargo almost certainly *had* considered the application of *IES* and *Compaq* to the STARS transaction. But the bank had stipulated that its only defense to the negligence penalty would be that its return position was *objectively* reasonable under the authorities. It could not assert a defense that would have required it to demonstrate that it had *subjectively* relied on the favorable decisions.

Objectivity and Substantial Understatements

Tax lawyers and accountants spend a lot of time advising clients regarding potential return positions. Given the context, tax professionals are unlikely to even consider the possibility that reliance might be required to establish a reasonable-basis defense. They will be evaluating what the authorities say, not what is going on between their clients' ears.

An "objective" view of reasonable basis also seems natural because of its close association with the substantial-authority standard. When a client is considering how to report a major tax item, an advisor must ask whether the position could result in a "substantial understatement of income tax" within the meaning of Code Sec. 6662(d). If the understatement is big enough, it will trigger an automatic 20-percent penalty pursuant to Code Sec. 6662(b)(2).

The advisor's next mental step will be to review two "defenses" built into the penalty provision itself. Under Code Sec. 6662(d)(2)(B), an erroneous item is disregarded (for penalty purposes) if: (1) there was substantial authority for the taxpayer's treatment of the item; or (2) there was a reasonable basis for that treatment and the taxpayer adequately disclosed the relevant facts when it filed its return.

Reg. §1.6662-4(d)(2) states that substantial authority is an "objective standard" that involves "an analysis of the law and application of the law to relevant facts." Does this imply that the reasonable-basis defense is "subjective"? Practitioners understand that the facts relating to the more doubtful position must be *disclosed*—the regulation says so. But it seems like a jump to claim that a taxpayer must *rely* on the relevant in order to defeat the substantial understatement penalty.

Linguistic Hints

Reg. §1.6662-3(b)(3) says that a return position satisfies the reasonable basis standard if it is "reasonably based" on any of the authorities identified in Reg. §1.6662-4(d)(3)(iii). The key question in *Wells Fargo* was whether "return position" refers to: (1) the tax position *as such*; or (2) the taxpayer's *adoption* of the position that appears on the return.

The district court opted for the second interpretation, describing a return position as, "in essence, an *opinion* regarding what obligations the law imposes on the taxpayer." [260 F. Supp. 3d at 1148 (emphasis supplied).] To decide whether a return position has a reasonable basis, we must consider the process by which the taxpayer came to *hold* the "opinion" that was expressed on its tax return. This leads us directly to the question of reliance:

> It is difficult to know how a taxpayer could "base" a return position on a set of authorities without actually consulting those authorities, just as it is difficult to know how someone could "base" an opinion about the best restaurant in town on Zagat ratings without actually consulting any Zagat ratings. [260 F. Supp. 3d. at 1148.]

This makes sense, assuming that "return position" refers to the taxpayer's adoption of an opinion regarding the tax treatment of an item. But if a "return position" is simply the substantive position set forth on the return, the taxpayer's subjective reliance on the authorities supporting the position is irrelevant. The question is whether the position itself was reasonably based on the authorities.

The conceptualization of "return position" in the Code and regulations is not as clear as it should be, but it generally indicates that a tax position is one thing and a taxpayer's adoption of a tax position is another. Code Sec. 6662(d)(3), for example, authorizes the Secretary of the Treasury to prescribe a "list of positions" that do *not* meet the substantial-authority standard. If it is possible to create a generic list of "bad" return positions, positions would appear to exist independently of the mental processes by which taxpayers adopt them.

Does Negligence Imply Subjectivity?

Because *Wells Fargo* involved the negligence penalty, the IRS argued that the focus should be on how *carefully* the taxpayer conducted itself. After all, Code Sec. 6662(c) requires the taxpayer to make a "reasonable attempt" to report in accordance with the requirements of Title 26. If negligence turns on the adequacy of what the taxpayer "attempted" to do, the inquiry must have a subjective component.

The law of torts, many readers will fondly recall, adjudicates negligence based on a delicate combination of subjective and objective considerations. The basic standard of care—ordinary prudence—is objective. But what ordinary prudence demands can vary depending on features specific to the defendant. These may include dispositions and mental states that are highly subjective, *e.g.*, what the defendant knows (or thinks it knows) at a particular time.

But determinations of negligence can also deal in stereotypes. Suppose that Smith had an accident while driving over the speed limit. Under the doctrine of negligence *per se*, that is enough to establish that Smith failed to exercise ordinary prudence under the circumstances. If a statute requires that headlights be used when driving a buggy at night, driving without them is negligent as a matter of law. [*See Martin v. Herzog*, 228 NY 164, 126 NE 814 (Ct. App. 1920) (Cardozo, J.).]

This is effectively a form of strict liability, yet it resides comfortably in the law of negligence. We should be careful not to infer too much about a legal rule based on doctrinal rubrics. Even doctrines with a fundamentally subjective orientation can incorporate objective elements.

This provides us with a perspective on Code Sec. 6662(b)(1). We can acknowledge that the negligence penalty is essentially subjective. But this does not rule out an objective version of the reasonable-basis defense.

One might think of this as the mirror image of negligence *per se*—something like "prudence *per se*." If the authorities reasonably *support* the position set forth on the return, the taxpayer will be deemed to have exercised reasonable care as a matter of law. The taxpayer's actual mental state when he *adopted* the position does not matter.

Distinguished Cases

The IRS argued for its subjective interpretation by citing cases that had imposed the negligence penalty based on a detailed review of the taxpayer's conduct. The district court agreed that these cases supported a narrow application of the reasonable-basis defense. However, the cases are less than compelling on this point.

Consider, for example, *H. Chakales* [CA-8, 96-1 USTC ¶50,175, 79 F3d 726]. Mr. Chakales had participated in a tax shelter involving a series of straddles. The IRS challenged the shelter and asserted the negligence penalty—a whopping five percent—under former Code Sec. 6653(a)(1).

Mr. Chakales defended on the ground that he had exercised reasonable care under the circumstances. However, his defense was undercut by his admission: (1) that he had never really understood the shelter; and (2) that he had not independently investigated its tax consequences. Mr. Chakales' attorney had given the scheme a cursory review, but ultimately the taxpayer relied on representations made by the shelter promoters.

The Eighth Circuit upheld the Tax Court's finding that the taxpayer's reliance on the promoters had been negligent. That sounds like the right result. However, it doesn't tell us anything about the issue in *Wells Fargo*.

Mr. Chakales contended that he had not been negligent, because he had reasonably *adopted* his tax position when he relied on the shelter promoters. The Tax Court found that Mr. Chakales had behaved carelessly, so the penalty was properly applied. We don't know what the result would have been if he had argued that the promoters' position was reasonably based on the authorities.

Auer Deference?

The IRS did not actually convince the district court in *Wells Fargo* that a taxpayer must consult the authorities. But the court said the regulations were at least *ambiguous* on this point, so it was able to pass the buck. Citing *Auer v. Robbins* [SCt, 519 US 452 (1997)], the court deferred to the IRS's interpretation of its ambiguous regulation.

Under the more familiar *Chevron* doctrine, courts defer to an agency's reasonable interpretation of an ambiguous *statute* that Congress has delegated to the agency to administer. [*See Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc.*, SCt, 467 US 837 (1984).] *Auer* is *Chevron*'s less ambitious little brother: It holds that courts should defer to an agency's reasonable interpretation of an ambiguous *regulation* written by the agency itself.

Auer deference sounds relatively inoffensive, but it may not be long for this world. The Supreme Court is now hearing arguments in *Kisor v. Wilkie* [*cert. granted*, 139 SCt 657 (2018)], a dispute between an ex-Marine and the Department of Veterans Affairs regarding the meaning of the term "relevant" in one of the VA's regulations. The petitioner has raised a number of constitutional concerns that seem likely to resonate with the current majority on the Court.

Even if *Auer* survives *Kisor*, one may ask what the district court was deferring to in *Wells Fargo*. There was no indication that the IRS had a history of requiring actual reliance in reasonable-basis cases. The IRS had taken no steps to amend the regulations, issue a revenue ruling, or even put out at notice informing taxpayers that reasonable basis is a subjective standard.

Instead, IRS may have developed the reliance requirement for reasons that do not extend much further than the STARS litigation. Wells Fargo's conduct was outrageous, so it is understandable that the IRS and the district court would have wanted the bank to pay a price. Wells Fargo's stipulation that it would limit itself to arguing that its return position was *objectively* reasonable put a target on its back.

Although it is difficult to muster much sympathy for Wells Fargo, this application of *Auer* deference seems questionable. Deferring to the IRS's technical and policy expertise in order to fill gaps and resolve ambiguities in a regulation is one thing. But simply acceding in what appears to be the IRS's *ad hoc* litigating position is another.

The challenge here is to distinguish between deferring to the IRS's *expertise* and simply deferring to the IRS. If the Service has addressed the controversial point in a statement that other taxpayers can rely on, that should carry some weight. Conversely, a court might be less deferential to the IRS if it has failed to put its money where its litigating mouth is.

From time to time, the IRS will put out a revenue ruling addressing an issue it is litigating before some tribunal. Such rulings are often dismissed as attempts to concoct additional "authority" for the government's position. That perception may be accurate, but a revenue ruling indicates that the IRS is at least sincere about the position it is espousing in litigation.

That could make *Auer* deference more plausible, but *Wells Fargo* suggests that sincerity has its limits. The IRS was no doubt quite sincere in its belief that the bank should not be allowed to plunder the U.S. Treasury and then walk away scot-free. But that is not the same thing as a principled conviction that "reasonable basis" includes a reliance requirement.

Reliance, Reasonable Cause, and Good Faith

Most practitioners will be surprised to hear the IRS contend that a taxpayer must demonstrate reliance in order to assert the reasonable-basis defense to the negligence penalty. On the other hand, they will be quite familiar with the role of reliance under Code Sec. 6664(c)(1). No penalty will be imposed under Code Sec. 6662—which includes the negligence penalty—if the taxpayer had reasonable cause for the understatement and acted in good faith.

Whether a taxpayer had reasonable cause and acted in good faith is determined based on all the facts and circumstances. This is a frankly subjective test, which focuses on "the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." The most popular way for a taxpayer to make the necessary effort is to obtain *and rely on* the advice of a competent tax professional with knowledge of the relevant facts. [*See* Reg. §1.6664-4(b)(1).]

The tax professional's advice does not have to be correct. It doesn't even have to have a reasonable basis in the authorities. What matters is whether the taxpayer was acting with reasonable cause and in good faith when it decided to *follow* the professional's advice.

When a taxpayer's defense under Code Sec. 6664(c) is that it reasonably relied on professional advice, subjective reliance is obviously required. "Substantial authority" and "reasonable basis," on the other hand, are plausibly understood as objective features of the tax position itself. Whether the taxpayer relied on the authorities is irrelevant.

Wells Fargo surely consulted with sophisticated tax advisers before buying into the STARS transaction. Yet, it did not raise reliance on professional advice as a defense against the negligence penalty. One possible explanation is that the bank's tax advisors actually warned *against* the transaction, which would have scuttled a reliance defense.

More likely, however, Wells Fargo did not want to open the door to discovery of the advice on which it had in fact relied. The IRS has successfully maintained in another STARS case that a taxpayer who asserts reliance on advice of counsel as a defense to penalties pursuant to Code Sec. 6664(c) *waives attorney-client privilege*. So, that 75-page opinion laying out all the strengths and weaknesses of the taxpayer's position might have to be turned over to the IRS. [*See Salem Financial, Inc.*, 102 Fed Cl 793, 109 AFTR 2d 2012-604 (Ct Fed Cl 2012).]

The favored rationale is that the taxpayer cannot have it both ways. By raising the reasonable-cause defense, the taxpayer is putting the professional's advice at issue. The taxpayer cannot selective disclose some parts of the tax advice in order to contest the penalties, while using the attorney-client privilege to shield the rest.

However, this seems like little more than a timing problem. If the liability and the penalty proceeding were temporally distinct, would we hesitate to allow the taxpayer to "defer" the waiver of privilege until after its tax liability had been established? The waiver would kick in only when there was a penalty for the taxpayer to contest.

When tax liability and penalty are considered in a single proceeding, however, it is easy to charge the taxpayer with wanting to have it both ways. The taxpayer can request to bifurcate the proceeding, but this will often fall on deaf ears. For example, in *G-I Holdings Inc.* [92 AFTR 2d 2003-6451, 2004-1 USTC ¶50154 (D.N.J. 2003)], the district court *denied* a bifurcation request intended to protect the attorney-client privilege. The court found that the taxpayer had already "permanently waived" the attorney-client privilege, because it had acknowledged (in response to an IRS interrogatory) that it planned to assert a reasonable-basis defense to penalties.

Conclusion

The STARS transaction cries out for sanctions. The IRS seems happy to oblige, even if this means it must argue for a reliance requirement that has hitherto escaped the notice of courts and commentators. The district court in *Wells Fargo* deferred to the IRS's novel interpretation of Reg. §1.6662-3(b)(1).

Wells Fargo seems to be one of those cases in which logic has yielded to what Justice Holmes called "experience":

> The felt necessities of the time, the prevalent moral and political theories, intuitions of public policy, avowed or unconscious, even the prejudices which judges share with their fellow-men, have had a good deal more to do than the syllogism in determining the rules by which men should be governed.

[O.W. Holmes, THE COMMON LAW 1 (1881).] Given the scale of the tax abuse in the STARS transactions, we should not be surprised that the IRS and the district court found a way to impose a penalty. Nor, for that matter, should Wells Fargo.

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