

## 8th Circuit Affirms that the Reasonable-Basis Defense to Negligence Tax Penalty Requires Actual Reliance on the Relevant Authority



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The Internal Revenue Regulations provide for a defense from the 20% negligence penalty imposed under Section 6662(a) of the Internal Revenue Code only where the taxpayer's "return position is reasonably based on one or more [relevant] authorities." 26 C.F.R. § 1.6662-3(b)(3) (emphasis added). In [Wells Fargo & Company v. United States](#), 2020 WL 1966847 (April 24, 2020), a recent tax shelter decision authored by Judge Shepherd of the Eighth Circuit Court of Appeals, the Court considered the weight of that regulation's word *based*, and found that the negligence defense requires that a taxpayer must have *actually* relied on the relevant cited authority at the time the return position was taken. In short, the Court found that a taxpayer's negligence defense of reliance on relevant authority must be both objectively reasonable and subjectively real.

In *Wells Fargo*, the underlying matter was a complicated bi-national tax shelter whose machinations are irrelevant to this discussion. What is relevant is that the taxpayer, Wells Fargo, argued that its return position was objectively reasonable under the relevant legal authorities, and also that it was irrelevant whether Wells Fargo actually relied upon those same authorities when forming its return position. What Wells Fargo was saying was that it was not subject to the 20% negligence penalty because support existed in favor of its position, although it never consulted such support prior to entering into the transaction. Under Wells Fargo's theory, so long as the taxpayer got to a reasonable position on the return, it was "irrelevant as to how it actually arrived there—whether by 'much deliberation' or simply by 'sheer luck.'" The Eighth Circuit found that base proposition troubling, and cited to the lower federal district court's view of it, stating that "[i]t is difficult to know how a taxpayer could 'base' a return position on a set of authorities without actually consulting those authorities."

The Eighth Circuit discussed that the regulation at issue does not require the taxpayer's position to be simply "consistent with" or "supported by" the relevant legal authority, noting that if the regulation did support such a position, then it might be sufficient that the relevant authorities supported the taxpayer's position regardless of whether the taxpayer relied upon them. But the Court found such a position troubling, finding that in order for a taxpayer to "base" its position on relevant authority, as required by the regulation, the taxpayer must have had actual knowledge of those authorities and actually relied upon them when forming its return position. The Court found that this subjective, actual reliance requirement has sound policy reasons, incentivizing taxpayers to actually conform to the requisite standard of care rather than simply taking the chance that there might be a reasonable basis for their underpayment of

tax. This policy argument appears to undermine a hope that a similar argument made with regard to less complicated tax matters might have a different legal result.

The Court also noted that the negligence penalty includes consideration of whether a taxpayer made a reasonable attempt to comply with the provisions of the Tax Code at the time the taxpayer took that return position. Judge Shepherd noted that the negligence penalty is based upon whether the taxpayer's actual conduct met the standard of care necessary when preparing its return. Of import, since negligence is tied to actual conduct and Wells Fargo's actual conduct here reflected that it did not in fact consider that authority when taking its return position, Wells Fargo's lack of action was not a reasonable attempt to comply with the tax laws and thus the negligence penalty was proper.

In a dissent, Judge Grasz disagreed with Judge Shepherd's finding that reliance must be actual, arguing instead that the regulation's failure to use the word reliance meant that the defense did not require same. Instead, Judge Grasz argued that the regulation required that the IRS or the courts determine whether there was a reasonable basis for the taxpayer's position. This argument may frame later challenges to the Court's holding.

So what does this mean for the Tax Bar? Judge Shepherd's opinion is the most current statement of that law in our circuit. Clearly, this is a shot across the bow for those of us sitting in the shadow of the Eighth Circuit, which includes my peers here in Arkansas. Our clients will have greater need for us in the future. But there's a whole swath of folks out there taking return positions without seeking counsel advice prior to filing same. *Wells Fargo* provides due caution in that circumstance, at least where the negligence penalty is involved, teaching us that relevant law supporting that return position should be contemporaneously review and relied upon by the time the return is finalized, lest later support-gathering be unavailing. It seems that in the end Justice Potter Stewart was right, at least when it comes to the reasonable cause defense against the negligence penalty in the Eighth Circuit: you [only] know it when you [actually] see it.