taxnotes federal

Volume 169, Number 7 ■ November 16, 2020

Conservation Easement Settlement: More Guidance, More Questions

by Hale E. Sheppard

Reprinted from *Tax Notes Federal*, November 16, 2020, p. 1085

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Conservation Easement Settlement: More Guidance, More Questions

by Hale E. Sheppard

Hale E. Sheppard is a shareholder in the tax controversy section and chair of the international tax section of Chamberlain, Hrdlicka, White, Williams & Aughtry in Atlanta.

In this updated article, Sheppard explains what the IRS has and has not addressed in its guidance thus far on the conservation easement settlement initiative.

Copyright 2020 Hale E. Sheppard. All rights reserved.

I. Introduction

Uplifted by some recent Tax Court victories on "technical" issues in conservation easement disputes, and cognizant of the enormous amount of additional cases headed its way in the coming years, the IRS announced a settlement initiative in June. The agency first described the terms of the settlement initiative through two means: a public release[1] and private offer letters to eligible partnerships. Not surprisingly, that initial guidance had several holes. The IRS tried to plug them in October by publishing a chief counsel notice, along with a second release.[2] This article analyzes all the information provided thus far about the settlement initiative, identifying key issues that remain unaddressed by the IRS, whether strategically or inadvertently.[3]

II. Conservation Easement Donations

Some background on conservation easement donations and disputes is important in understanding the problems with the recent settlement initiative. Below is an overview.

Taxpayers that own undeveloped real property have several choices. For instance, they might (1) hold the property for investment purposes, selling it when it appreciates sufficiently; (2) determine how to maximize profitability from the property and do that, regardless of the negative effects on the local environment, community, and economy; or (3) donate an easement on the property to a charitable organization so it is protected forever for the benefit of society. The third option not only achieves the goal of environmental protection but also triggers another benefit: tax deductions for donors.

To qualify for a tax deduction, taxpayers generally must donate their entire legal interest in a particular piece of property, not just a portion of that interest.[4] This is a critical concept, because taxpayers who own all attributes of a piece of property (that is, they own it in fee simple) do not donate the property outright to a charitable organization in the easement context. Instead, they retain ownership of the property but convey an easement on that property to an independent, nonprofit organization with the ability, capacity, willingness, and resources to safeguard the property forever. This is usually a land trust. If the easement, which is just a partial interest in property, constitutes a qualified conservation

[1] IR-2020-130.

[2] CC-2021-001 and IR-2020-228.

[3] This article is a follow-up to Hale E. Sheppard, "Questions Remain About the Conservation Easement Settlement Initiative," *Tax Notes Federal*, Sept. 21, 2020, p. 2219.

[4] Section 170(a)(1); reg. section 1.170A-1(a); section 170(f)(3)(A); and reg. section 1.170A-7(a)(1).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

contribution, the taxpayer is entitled to the tax deduction.[5]

As one would expect, taxpayers cannot donate an easement on any old property and claim a tax deduction; they must demonstrate that the property is worth protecting. A donation has an acceptable conservation purpose if it meets at least one of the following requirements: (1) It preserves land for outdoor recreation by, or the education of, the general public; (2) it preserves a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem; (3) it preserves open space (including farmland and forestland) for the scenic enjoyment of the general public and will yield a significant public benefit; (4) it preserves open space (including farmland and forestland) in accordance with a federal, state, or local governmental conservation policy and will yield a significant public benefit; or (5) it preserves a historically important land area or a certified historic structure.[6]

Taxpayers memorialize the donation to charity by filing a deed of conservation easement or the like. In preparing the deed, taxpayers often coordinate with the land trust to identify limited activities that can continue on the property after the donation without interfering with the deed, prejudicing the conservation purposes, or jeopardizing the tax deduction.[7] These activities are called reserved rights. The IRS, in its Conservation Easement Audit Techniques Guide (ATG) and elsewhere, openly recognizes that reserved rights are ubiquitous in deeds.[8]

The IRS will not allow the tax deduction stemming from a conservation easement unless the taxpayer, before making the donation, provides the land trust with "documentation sufficient to establish the condition of the property at the time of the gift."[9] This is called the baseline report. It may feature several things, including (1) survey maps from the U.S. Geological Survey showing the property line and other contiguous or nearby protected areas; (2) a map of the area drawn to scale showing all existing man-made improvements or incursions, vegetation, flora and fauna (for example, locations of rare species, animal breeding, roosting areas, and migration routes), land use history, and distinct natural features; (3) an aerial photograph of the property at an appropriate scale taken as close as possible to the date of the donation; and (4) on-site photographs taken at various locations on the property.[10]

The value of the conservation easement is the fair market value of the property at the time of the donation.[11] FMV ordinarily means the price on which a willing buyer and willing seller would agree, with neither party being obligated to participate in the transaction, and with both parties having reasonable knowledge of the relevant facts.[12] The IRS explains in its ATG that the best evidence of the FMV of an easement would be the sale price of other easements that are comparable in size, location, usage, etc. The ATG recognizes, though, that it may be difficult, if not impossible, to find comparable sales.[13] Consequently, appraisers often must use the before-and-after method instead. This means that an appraiser must determine the highest and best use (HBU) of the property *and* the corresponding FMV twice. First, the appraiser calculates the FMV as if the property were put to its HBU, which generates the "before" value. Second, the appraiser identifies the FMV taking into account the restrictions on the property imposed by the easement, which creates the "after" value.[14] The difference between the before value and the after value, with some other adjustments, produces the value of the easement donation.

As indicated earlier, in calculating the FMV of property, appraisers and courts must take into account not only the current use of the property but also its HBU.[15] A property's HBU is the most

[5]Section 170(f)(3)(B)(iii); reg. section 1.170A-7(a)(5); section 170(h)(1) and (2); and reg. section 1.170A-14(a) and (b)(2).

[6]Section 170(h)(4)(A); reg. section 170A-14(d)(1); and S. Rep. No. 96-1007, at 10 (1980).

[7]Reg. section 1.170A-14(b)(2).

[8]IRS, "Conservation Easement Audit Techniques Guide," at 23 (rev. Jan. 24, 2018) (ATG); *see also* reg. section 1.170A-14(e)(2) and (3).

[9]Reg. section 1.170A-14(g)(5)(i).

[10]*Id.*

[11]Section 170(a)(1) and reg. section 1.170A-1(c)(1).

[12]Reg. section 1.170A-1(c)(2).

[13]ATG, *supra* note 8, at 43.

[14]*Id.*

[15]*The Stanley Works v. Commissioner*, 87 T.C. 389, 400 (1986); and reg. section 1.170A-14(h)(3).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

profitable use for which it is adaptable and needed in the reasonably near future.[16] HBU has also been defined as the use of property that is physically possible, legally permissible, financially feasible, and maximally productive.[17] Importantly, valuation in the easement context does not depend on whether the owner has actually put the property to its HBU in the past;[18] the HBU can be *any* realistic potential use of the property.[19] Common HBUs are construction of a residential community, creation of a mixed-use development, or mining.

Properly claiming the tax deduction stemming from an easement donation is surprisingly complicated. It involves a significant amount of actions and documents. The main ones are as follows: The taxpayer must (1) obtain a qualified appraisal from a qualified appraiser; (2) demonstrate that the land trust is a qualified organization; (3) obtain a baseline report adequately describing the condition of the property at the time of the donation and the reasons why it is worthy of protection; (4) receive from the land trust a contemporaneous written acknowledgement both for the easement itself and for any endowment/stewardship fee donated to finance the perpetual protection of the property; (5) complete a Form 8283, "Noncash Charitable Contributions," and have it executed by all relevant parties; (6) (assuming that the taxpayer is a partnership) file a timely Form 1065 enclosing Form 8283 and the qualified appraisal; and (7) send all the partners their Schedules K-1 and a copy of Form 8283.[20]

III. Technical Victories by the IRS

The ATG concerning conservation easements, which revenue agents and others use when conducting audits, contains a "Conservation Easement Issue Identification Worksheet."[21] This worksheet identifies a large number of technical challenges that the IRS can (and does) raise in cases.[22] The ATG seems to encourage creativity, explaining to IRS personnel that the checklist should *not* serve as a limitation. Indeed, it states: "This worksheet is not an all-inclusive list of potential issues for donations of conservation easements. Users should review IRC Section 170, [Deficit Reduction Act of 1984] Section 155, the corresponding Treasury Regulations, Notice 2006-96 and case law."

The IRS has taken the ATG to heart the past few years, identifying numerous "technical" problems in conservation easement disputes, some legitimate but many specious. These IRS attacks generally focus on unintentional flaws with the deed, the appraisal, the baseline report, or Form 8283. Many in the tax and legal communities believed that justice ultimately would prevail (to borrow a cliché) when the courts finally had a chance to evaluate the long-standing legislative support for conservation easements under section 170(h), the extreme enforcement actions by the IRS, the significant due diligence conducted by taxpayers before donating easements and claiming the corresponding tax deductions, the applicability of the substantial compliance doctrine, the abundance of reasonable cause, and more. To the surprise and disappointment of donors and their representatives, the Tax Court has ruled in favor of the IRS on several technical issues, triggering charitable deductions of $0 and, sometimes, large penalties.[23]

IV. Initial Settlement Guidance

The IRS knew that it had some momentum, thanks to the early victories in cases centered solely on technical glitches. The IRS also must have realized that its advantage likely would be

---

[16] *Olson v. United States*, 292 U.S. 246, 255 (1934).

[17] *Esgar Corp. v. Commissioner*, 744 F.3d 648, 659 n.10 (10th Cir. 2014).

[18] *Id.* at 657.

[19] *Symington v. Commissioner*, 87 T.C. 892, 896 (1986).

[20] *See* ATG, *supra* note 8, at 24-31; IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements"; IRS Publication 526, "Charitable Contributions"; section 170(f)(8) and (11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; and T.D. 9836.

[21] ATG, *supra* note 8, at 83-86, Exhibit 12-1.

[22] *Id.*; *see also* C. Timothy Lindstrom, "A Tax Guide to Conservation Easement Syndications," 47 *Real Est. Rev.* 3 (Winter 2018).

[23] *See, e.g.*, *Lumpkin One Five Six LLC v. Commissioner*, T.C. Memo. 2020-94; *Lumpkin HC LLC v. Commissioner*, T.C. Memo. 2020-95; *Plateau Holdings LLC v. Commissioner*, T.C. Memo. 2020-93; *Village at Effingham LLC v. Commissioner*, T.C. Memo. 2020-102; *Riverside Place LLC v. Commissioner*, T.C. Memo. 2020-103; *Maple Landing LLC v. Commissioner*, T.C. Memo. 2020-104; *Englewood Place LLC v. Commissioner*, T.C. Memo. 2020-105; *Smith Lake LLC v. Commissioner*, T.C. Memo. 2020-107; *Belair Woods LLC v. Commissioner*, T.C. Memo. 2020-112; *Cottonwood Place LLC v. Commissioner*, T.C. Memo. 2020-115; and *Red Oak Estates LLC v. Commissioner*, T.C. Memo. 2020-116.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

short-lived. This is because many involved with land conservation are sophisticated, informed, and receptive to improvement. They have evolved, studying the early challenges by the IRS and the decisions by the Tax Court, and then modifying all relevant documentation and processes to minimize, or ideally eliminate, further technical impediments. They want to do everything possible to avoid IRS scrutiny or, if that is not feasible, get to the real issue in charitable donation cases: valuation.

Whatever its motivations, the IRS announced the settlement initiative in June. The remainder of this section summarizes, in question-and-answer format, the information in the June release (which is public) and the IRS offer letters (which are not).

1. To which transactions does this apply?

The settlement initiative applies to syndicated conservation easement transactions (SCETs) and substantially similar transactions (SSTs), including some fee simple donations of property.

2. Are all partnerships eligible?

The settlement initiative applies only to cases that are currently docketed with the Tax Court — that is, cases for which petitions have already been filed with the Tax Court. Stated another way, the settlement initiative does not apply to partnerships that donated an easement but are not yet under audit, partnerships that are under audit, or partnerships that are seeking review by the Office of Appeals directly after an IRS audit.

3. What is the deadline for making the election?

The partnership and its partners must elect to participate in the settlement initiative within 60 days of the date on the offer letter.

4. How is the election made?

The partnership and its partners must elect to participate in the settlement initiative through the tax matters partner, who must initial each page of the offer letter, execute it, and return it to the IRS attorneys.

5. Must the IRS accept an election?

No, the election appears to be more of an acknowledgement of interest, or an application. The offer letters expressly state that they are not binding on the IRS, the partnership, or the partners; that they do not constitute acceptance by the IRS of an offer to settle; and that they do not ultimately obligate the IRS or the partnership to execute a Form 906, "Closing Agreement on Final Determination Covering Specific Matters."

6. Must all partners agree to settle?

The settlement initiative generally is open only to partnerships in which *all* partners agree to the settlement terms. However, the offer letters ambiguously state: "The IRS may consider offers to resolve cases on terms similar to those contained herein where fewer than all partners in the partnership agree to enter into the settlement. In such cases, the IRS may revise certain terms, including, for example, by requiring a greater penalty than the penalty required under the settlement initiative."

7. What if a criminal investigation is underway?

The settlement initiative ordinarily is not available to any partnership in which one or more partners are under criminal investigation, yet the offer letters also ambiguously state that "the IRS may consider offers from the partners in such a partnership who are not under criminal investigation to resolve the case on terms similar to those contained herein."

8. Who determines who owes what?

The partnership must do all this work. The offer letters indicate that the partnership must provide the IRS attorneys with computations of the settlement amount (as defined later) within 90 days of the day on which the partnership elects to participate in the settlement initiative. The IRS indicates that it might grant extensions of this 90-day limit on a case-by-case basis, but it "encourages" partnerships and their partners to start crunching numbers immediately.

The offer letters state that partners can submit documentation to support the calculation of their share of the settlement amount, but that this does not relieve the partnership of its duty to provide the IRS with an "aggregated proposed settlement amount and interest."

All computations provided, either by the partnership or its partners, are subject to review and approval by the IRS. Moreover, the IRS warns that if the partnership or any partner submits a

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

computation containing a "material error," the election to participate in the settlement initiative will be void, and the partnership and all partners will be ineligible to participate.

9. Who must pay the IRS, and by when?

The partnership must pay the entire settlement amount before or when the partnership and its partners submit their executed Forms 906 to the IRS.

10. Does the IRS treat all partners the same?

No. The offer letters describe two types of partners. Category 1 partners are those who engaged in any of the following activities or who meet any of the following criteria:

- organized or participated, directly or indirectly, in the sale or promotion of *any* SCET or SST;
- received fees for organizing, selling, or promoting *any* SCET or SST;
- received fees for providing an appraisal in *any* SCET or SST;
- received fees for providing legal advice or tax advice for *any* SCET or SST;
- received fees for tax return preparation services (including both signing and non-signing preparers) for *any* SCET or SST;
- was a donee/recipient of a conservation easement or a fee simple property interest in *any* SCET or SST;
- was a material adviser for *any* SCET or SST;
- was a partner in a partnership, or an employee of an entity, that engaged in any of the activities listed above when he participated in the SCET or SST; or
- was related to any of the persons that engaged in any of the activities listed above, as defined in section 267(b).

By default, category 2 partners are those who are not category 1 partners.

11. What is the cost, generally?

The partnership must pay the settlement amount, which consists of three parts: (1) federal income taxes, which vary depending on which category a partner is in; (2) penalties, which vary depending on which category a partner is in and on whether the partnership and all partners filed timely and proper Forms 8886, "Reportable Transaction Disclosure Statement," with the IRS; and (3) interest charges.

12. What is the cost, in terms of taxes?

The partnership cannot deduct, under section 170 or any other tax provision, any portion of the charitable deduction that it originally claimed on its Form 1065 for the SCET or SST. Likewise, the partners cannot deduct, under section 170 or any other tax provision, any portion of the charitable deduction originally claimed by the partnership that flowed through to the partners.

Under the settlement initiative, the partnership must pay the federal income tax liability for each partner for each year affected by the SCET or SST, calculated as follows: Category 1 partners cannot claim any deduction for contributions of cash or other property to participate in an SCET or SST. In other words, category 1 partners get a charitable deduction of $0 and essentially lose their investment in the partnership.

By contrast, category 2 partners can claim an ordinary tax deduction equal to the out-of-pocket costs paid to participate in the SCET or SST, which includes both cash and other property contributed in exchange for partnership interests. However, there is a caveat: The IRS explains that these deductions are reduced by any previous distributions from the partnership, as well as by any deductions previously claimed by category 2 partners and not disallowed by the agency.

13. What is the cost, in terms of penalties?

The partnership must aggregate all penalties for all partners for all affected years in calculating the settlement amount. The penalties fall into two categories: (1) accuracy-related penalties under section 6662, and (2) penalties under section 6707A for failure to file Form 8886.

The settlement initiative contemplates accuracy-related penalties. For category 1 partners, the highest penalty asserted by the IRS in the notice of final partnership administrative adjustment or the highest penalty asserted by the IRS attorney later during Tax Court litigation will apply. Generally, this is the 40 percent penalty for a gross valuation misstatement.

For category 2 partners, the accuracy-related penalty is based on one of three percentages, depending on the return-on-investment ratio. If

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the partner claimed a charitable deduction in an amount that was less than or equal to five times his investment in the partnership that engaged, directly or indirectly, in the SCET or SST, the penalty is 10 percent of the tax underpayment. If the partner claimed a charitable deduction that was more than five times but less than or equal to eight times his investment in the partnership, the penalty is 15 percent of the tax underpayment. And if the partner claimed a charitable deduction that exceeded eight times his investment in the partnership, the penalty is 20 percent of the tax underpayment.

The settlement initiative includes further penalties for situations in which the partnership or particular partners failed to file Form 8886. The IRS provides the following guidelines in this regard: (1) The partnership must provide evidence, documents, or affidavits that the partnership and all its partners filed timely and proper Forms 8886; and (2) if any party failed to do so, the settlement amount will include a penalty under section 6707A. For listed transactions, like an SCET or SST, the maximum penalty for individual partners is $100,000, while the maximum for entities is $200,000. The minimum penalty is $5,000 for individuals and $10,000 for entities.

14. What is the cost, in terms of interest?

The partnership must aggregate all interest required by law for all partners for all affected years (on both the tax liabilities and penalties), and interest suspension under section 6404(g) will not apply.

15. Will participation affect tax attributes?

Yes. The offer letters state that all partners, including both category 1 partners and category 2 partners, must adjust any tax attributes (for example, carryovers and basis) to conform to the terms of the settlement initiative.

16. Will participation end problems with the IRS?

No. The offer letters emphasize that participation in the settlement initiative will not affect, limit, or prohibit the IRS in later asserting criminal penalties, promoter penalties, appraiser penalties, return preparer penalties, discipline under Circular 230, or any other penalty. If that is not clear enough, the letters go on to state that nothing in the settlement initiative "precludes the [IRS] from investigating any associated criminal conduct or recommending prosecution of any individual or entity that participated in, or assisted or advised others in participating in, [an SCET or SST] for violation of any criminal statute."

17. Can cases before the Office of Appeals participate?

This depends on the method by which a case landed in Appeals. The offer letters explain that in situations in which a petition involving an SCET or SST was filed with the Tax Court and the case was then automatically routed to Appeals for reconsideration, if the partnership and its partners elect to participate in the settlement initiative, Appeals will return the case to the IRS attorneys for implementation. Applying deductive reasoning, this means that partnership cases developing in a traditional manner (for example, the IRS issues an examination report, the partnership submits a protest letter, and the matter goes directly to the Appeals officer for reconsideration) will not receive offer letters.

18. What must be done besides signing and paying?

The partnership and all its partners must agree to "fully cooperate" with the IRS attorneys during the settlement process, which includes providing all additional information requested.

19. Must partners disclose personal data?

Yes. The offer letters explain that all partners must execute Form 8821, "Tax Information Authorization," to permit the partnership and the partners to calculate the settlement amount by aggregating the tax liabilities, penalties, and interest charges for each partner for each affected year.

20. Who must sign Forms 906 with the IRS?

The offer letters state that the partnership, as well as "all direct and indirect partners," must execute a Form 906 consistent with the terms of the settlement initiative. It is common in SCETs and SSTs for individual partners to purchase interests in one partnership (InvesCo), which, in turn, makes a capital contribution to the partnership (PropCo) that owns the land and donates the conservation easement and/or fee

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

simple interest to a charitable organization. The offer letters seem to indicate that PropCo, all direct partners in PropCo, and all indirect partners in PropCo through InvesCo will need to execute Forms 906.

21. Can partners later seek refunds?

No. The offer letters confirm that the Forms 906 will provide that the settlement amount payment will not be refundable.

22. Are amounts paid to the IRS deductible?

No. Forms 906 will provide that the settlement amount will not be deductible for federal income tax purposes under any circumstances.

V. Additional IRS Guidance

In October, four months after issuing the June release — and likely after reviewing comments, questions, and complaints from interested parties — the IRS issued additional guidance about the settlement initiative. This time the guidance came in the form of a chief counsel notice accompanied by a second release.

The stated purpose of the notice is to disseminate "additional information to help address questions" concerning the settlement initiative. However, one might argue that the real goal of the notice is to further intimidate individual taxpayers. This perspective is derived from several comments by the IRS in the October release, such as:

- partners should obtain guidance from independent advisers not related to, or recommended by, the alleged promoter;
- SCETs and SSTs are "abusive transactions";
- the IRS has "many grounds" for disallowing tax benefits;
- the IRS plans to soon update its ATG to feature "new arguments that taxpayers can expect the IRS to make" in future cases; and
- the IRS is considering civil fraud penalties and criminal referrals.[24]

In addition to alarming partners, the notice provides the following information, which supplements and/or clarifies aspects of the June release and the offer letters.

A. Threats of Civil Fraud

The notice warns that if partners decide not to accept the settlement initiative, they risk getting a charitable deduction of $0, along with potential civil fraud penalties equal to 75 percent of their tax underpayments "in appropriate cases."[25] The IRS had previously highlighted less severe civil penalties, such as the 40 percent penalty for a gross valuation misstatement, the 20 percent penalty for a reportable transaction understatement, and the 20 percent penalty for negligence.

B. Settling Without Unanimity

The notice starts resolutely, stating that individual partners cannot make a side deal with the IRS, because generally all the partners in a partnership, including category 1 partners and category 2 partners, must agree to the terms of the settlement initiative. However, as it did before, the IRS then created some wiggle room: The notice explains that the IRS might consider settling with a group of partners, as long as (1) the group represents a "significant percentage" of all the ownership interests in the partnership; (2) absolutely all partners in the partnership, even those refusing the settlement initiative, waive their right to a consistent agreement with the IRS; and (3) the group cooperates with the IRS in supplying information and documentation.[26]

C. Effects of Disagreement

Resolution with holdouts triggers a less favorable result for partners participating in the settlement initiative. The notice explains that those participating "must agree to the applicable increased penalty rate," which is 5 percent above the normal rate.[27] For instance, if a partner acquired an interest in a partnership that engaged in an SCET with a return-on-investment ratio of 4.5 to 1, the penalty under the settlement initiative would increase from 10 percent to 15 percent.[28] This jump could lead to serious financial

[24] IR-2020-228.

[25] CC-2021-001, Q&A A(2).

[26] *Id.* at Q&A B(2).

[27] *Id.* at Q&A B(3).

[28] *Id.* at Q&A B(3) and C(7)(b).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

differences for partners whose tax liability is significant, after reducing their charitable donation to the amount invested in the partnership. Exhibiting capriciousness, the IRS then explains in the notice that in cases with "extraordinary circumstances" it might not insist on the increased penalty.[29] Of course, the notice provides no examples of what the IRS might deem extraordinary.

D. Need for Quick Action

The notice states that a less-than-unanimous group of partners that intends to participate in the settlement initiative must make an offer to the IRS within 30 days of the issuance of the notice, which presumably is October 31. In doing so, the group must identify all the participating partners, how much of the partnership each owned, and the amount of tax deductions claimed.[30]

E. Giveth and Taketh Away

As noted earlier, the June release and offer letters explained that the settlement initiative ordinarily is unavailable to any partnership in which one or more partners are under criminal investigation, but they indicated that the IRS "may consider" offers from partners who are not being scrutinized criminally. The notice adds some negativity in this area, announcing that the IRS is not above sending and later retracting an offer letter. In particular, the notice states that "the presence of a partner in the partnership who is under criminal investigation may render the partnership ineligible for the settlement, even if it had received an Offer Letter."[31]

F. Potential Expansion of Eligibility

The IRS clarified in the June release and offer letters that the settlement initiative applies only to cases that were already filed with the Tax Court ("docketed") at the time. The IRS seems to have softened on this point, indicating in the notice that it "may extend the settlement terms to certain newly petitioned cases."[32] However, the IRS cautions that it will consider "a number of factors" in determining whether a particular partnership merits this preferential treatment, including whether the partnership, its partners, and representatives cooperated during the audit. The IRS also warns in the notice that the settlement terms for any such partnership will not necessarily be the same. Indeed, the notice ominously states that the IRS "may at any time modify the standard terms" and that "partnerships with newly petitioned cases should carefully review the specific terms of any settlement offer."[33]

G. Settle Some, Litigate Others

The IRS recognizes that some individuals have been partners in separate SCETs in separate years, all of which might now be under attack by the IRS. The notice makes two clarifications in this regard. First, it explains that if a partner is involved in both a docketed case (because the partnership has already filed a petition with the Tax Court) and a non-docketed case, he is eligible to participate in the settlement initiative only for the docketed case.[34] Second, the notice indicates that if a partner invested in two partnerships, both of which engaged in SCETs and both of which were docketed cases when the IRS issued the June release, that partner has the freedom to participate in the settlement initiative for none, one, or both partnerships.[35]

H. More Time for Hand-Wringing

The June release and the offer letters stated that the partnership and its partners had to elect to participate in the settlement initiative within 60 days of the date on the offer letter. The notice introduces some temporal flexibility, indicating that a partnership, through its tax matters partner, can request an extension of up to 30 days, and the

[29] *Id.* at Q&A B(3).

[30] *Id.* at Q&A B(3) and (10).

[31] *Id.* at Q&A B(1).

[32] *Id.* at Q&A B(5).

[33] *Id.*

[34] *Id.* at Q&A B(6).

[35] *Id.* at Q&A B(7).

For more Tax Notes® Federal content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

IRS will then determine whether to grant additional time on a case-by-case basis.[36] The notice provides no specifics about acceptable reasons for extensions, duties of consistency by the IRS, potential avenues of appeal if the IRS denies an extension, etc.

The notice warns partnerships not to push their luck, though. The June release and offer letters previously explained that the partnership must provide the IRS with computations of the settlement amount within 90 days of electing to participate in the settlement initiative. They also indicated that the IRS might grant extensions of this 90-day limit on a case-by-case basis. More recently, in the notice, the IRS admonished procrastinators, explaining that partnerships that receive an extension of the 60-day period to make an election to participate in the settlement initiative "should not expect any further extensions of time to carry out the settlement."[37]

I. Stuck With the Tab

The notice clarifies that it is the partnership (in the case of unanimous settlement) or the group of participating partners (in the case of partial settlement) that must pay the settlement amount to the IRS, including all taxes, penalties, and interest.[38] On a related note, the notice explains that the IRS will not assess a tax liability against individual partners if they participate in the settlement initiative and full payment occurs: "The Settlement Amount to be paid by the partnership (or the group in the case of a settlement with fewer than all of the partners) will be in lieu of any deficiency in tax or penalties that would have been assessable or collectable against individual partners for the disallowance of the deduction under section 170."[39]

J. No Defenses by Individual Partners

The notice, like the June release and the offer letters, indicates that category 2 partners participating in the settlement initiative face an accuracy-related penalty based on the return-on-investment ratio. If the partner claimed a charitable deduction that was equal to or less than five times his investment in the partnership that engaged (directly or indirectly) in the SCET or SST, the penalty is 10 percent of the tax underpayment. If the partner claimed a charitable deduction that exceeded five times his investment in the partnership but was less than or equal to eight times his investment amount, the penalty is 15 percent of the tax underpayment. And if the partner claimed a charitable deduction that exceeded eight times his investment in the partnership, the penalty is 20 percent of the tax underpayment.[40]

The notice then adds two notable points. First, it emphasizes that there is no wiggle room for individual partners, because all partner-level defenses and partnership-level defenses must be waived as part of the settlement initiative.[41] On a brighter note, the notice acknowledges that if the IRS concedes, or would concede, that accuracy-related penalties could not apply to a particular partnership because the agency did not obtain the necessary preapprovals required by section 6751(b)(1), participating partners will escape those penalties under the settlement initiative.[42] This sounds uplifting in theory, but the IRS has aggressively disputed in court the relinquishment of penalties as the result of noncompliance with section 6751(b)(1).[43]

K. Take It or Leave It

The notice indicates that the partnership and all participating partners must ultimately memorialize their participation in the settlement initiative by executing a Form 906 with the IRS and executing a decision document for the Tax Court.[44] The notice quells any thoughts about partnerships and partners personalizing terms with the IRS based on their supposedly unique circumstances. Indeed, the notice explains that

[36] *Id.* at Q&A B(9).

[37] *Id.* at Q&A C(17).

[38] *Id.* at Q&A C(2), (12), and (13).

[39] *Id.* at Q&A C(2).

[40] *Id.* at Q&A C(7).

[41] *Id.* at Q&A C(9).

[42] *Id.* at Q&A C(11).

[43] *See, e.g.*, *Graev v. Commissioner*, 149 T.C. 485 (2017); *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017); *Belair Woods LLC v. Commissioner*, 154 T.C. No. 1 (2020); *Oropeza v. Commissioner*, T.C. Memo. 2020-111; and *Carter v. Commissioner*, T.C. Memo. 2020-21.

[44] CC-2021-001, Q&A E(1)(a).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

normally "no provision of either document is subject to negotiation."[45]

L. Signing Parties

When the partnership and all partners agree to the settlement initiative, they all must execute the Form 906. In cases in which unanimity does not exist, only the participating partners are obligated to sign.[46]

M. No Need for Amended Returns

Partnerships participating in the settlement initiative are not burdened with filing Forms 1065X, "Amended Return or Administrative Adjustment Request," or corrected Schedules K-1, and participating partners likewise have no duty to file Forms 1040X.[47]

N. Full Payment, Period

The notice is remarkably clear in its show-me-the-money statements. It explains, for instance, that the partnership or group of participating partners must fully pay the settlement amount (consisting of taxes, penalties, and interest) when it executes the Form 906 for the IRS and the decision document for the Tax Court.[48] The notice also specifies the only acceptable mode of payment, stating that the IRS requires a check payable to "United States Treasury," and that electronic payments are unwelcome.[49] The notice goes on to clarify that the "Settlement Amount will be paid by the partnerships (or the group in the case of a settlement with fewer than all of the partners."[50]

O. No Finality for Category 1 Partners

The earlier offer letters stated that participation in the settlement initiative will not affect, limit, or prohibit the IRS from later asserting criminal penalties, promoter penalties, appraiser penalties, return preparer penalties, discipline under Circular 230, or any other penalty. The recent notice takes matters further. First, it contains a broad description of all the activities (primarily related to organizing, selling, soliciting, appraising, pre-donation advising, and return preparing) that might get one characterized as a category 1 partner.[51] It then says that the partnership or group of participating partners "must identify all Category One Partners" for the IRS.[52] Echoing the offer letters, the notice goes on to state that participation in the settlement initiative will not halt the IRS from pursuing other types of penalties and punishments, civil and criminal.[53] Finally, even though section 7121 generally provides that an executed Form 906 is "final and conclusive," the notice admonishes that executing a Form 906 as part of the settlement initiative "does not preclude the IRS from investigating any associated criminal conduct or recommending prosecution for violation of any criminal statute."[54]

P. Extent of Cooperation

Participation in the settlement initiative requires convincing all or nearly all the partners to concede; calculating applicable tax, penalty, and interest amounts for each partner (which is challenging given years of carryforward deductions, lots of correlative adjustments on each Form 1040, etc.); executing a Form 906 and a decision document, reflecting an increased penalty if unanimity is absent; and coming up with all the necessary cash at once. The notice mandates other things unpleasant to partnerships and partners, too.

For instance, imagine that a partnership files a petition with the Tax Court, the case is routed back to the Office of Appeals for reconsideration as a matter of course, and the partnership receives an offer letter. At that point, *all* the partners in the partnership (including those not electing to participate in the settlement initiative) must

[45] *Id.* at Q&A E(1)(a).

[46] *Id.* at Q&A E(2) and (3).

[47] *Id.* at Q&A E(4).

[48] *Id.* at Q&A F(1).

[49] *Id.*

[50] *Id.* at Q&A C(12).

[51] *Id.* at Q&A C(4).

[52] *Id.*

[53] *Id.* at Q&A C(10) and D(2).

[54] *Id.* at Q&A D(2); section 7121(b); and reg. section 301.7121-1(c).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

consent to having the case transferred from Appeals back to the IRS attorneys.[55] In other words, it appears that the nonparticipating partners would be obligated to waive their general right to pretrial review by the Office of Appeals.

The partnership and the partners also must "fully cooperate" with the IRS. Cooperation in this scenario includes supplying the IRS with the following items designed to facilitate its examination and investigation of many others affiliated with SCETs and SSTs: correspondence, emails, communications, and other documentation exchanged between the participating partner and (1) the partnership; (2) other partners; (3) agents or representatives of the partnership; (4) any organizer, promoter, or proponent; (5) appraisers, mining engineers, or others involved with valuing the relevant property; (6) tax return preparers; and (7) tax advisers.[56]

VI. Open Issues

The June release, the initial offer letter, the October release, and the chief counsel notice provide considerable information about the settlement initiative. However, as explained earlier, various issues remain unaddressed by the IRS.

A. Effect on State Income Tax Issues

The settlement initiative addresses only federal income tax and related issues (that is, issues with the IRS); it does not cover state income tax issues. In other words, although participation in the settlement initiative might allow the partnership and its partners to rectify federal income tax issues related to an SCET or SST, it would not rectify past issues with any state tax authority. The IRS generally shares information that it gathers about taxpayers with the relevant state tax authorities, including Forms 906. Moreover, many states, like Georgia, have laws requiring taxpayers to file amended state income tax returns within a limited time when changes occur at the federal level.[57] Accordingly, when calculating the true cost of participating in the settlement initiative with the IRS, the partners likely must add the costs (in terms of tax liabilities, penalties, and interest charges for each affected year) of rectifying matters with the relevant state tax authorities.

B. Improbability of Full Payment

Concluding matters under the settlement initiative is not cheap under any scenario. Indeed, a partnership or group of participating partners must pay the settlement amount, which consists of federal income taxes, penalties, and interest charges. The IRS demands that the partnership pay the *entire* settlement amount before or when the partnership and all direct and indirect partners submit their Forms 906 to the IRS and their decision documents to the Tax Court. Thus, allowing some partners to resolve payment matters through an installment agreement or offer in compromise is impossible. Full payment by all partners seems unrealistic amid a massive economic slowdown caused by the coronavirus, with no definitive end in sight.

C. Undefined Key Terms

Category 1 partners face unfavorable settlement terms, consisting of charitable deductions of $0, penalties of 40 percent, and interest charges accruing over many years on both the taxes and penalties. Logically, taxpayers would like to avoid classification as category 1 partners. One problem is that in describing the relevant activities and criteria, the IRS did not define, limit, or clarify the pivotal terms for purposes of the settlement initiative. For instance, "organize," "sell," "promote," "participate," "material adviser," "tax return preparation," "signing preparer," "non-signing preparer" and other terms used in the IRS guidance are technical terms of art, defined differently in different contexts, in various parts of the IRC, the tax

[55] CC-2021-001, Q&A D(1)(a).

[56] *Id.* at Q&A D(1)(b).

[57] *See* Ga. Code Ann. section 48-7-82(e)(1). This provision requires Georgia taxpayers to file amended state income tax returns within 180 days of any change in net income at the federal level made by the IRS or any other competent U.S. tax authority.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

regulations, IRS pronouncements, and court decisions.

D. Eligibility of Non-TEFRA Partnerships

Most partnerships that donate conservation easements or fee simple interests in property are subject to the special audit rules introduced in the 1982 Tax Equity and Fiscal Responsibility Act. This is because they have more than 10 partners, or at least one of their partners is a passthrough entity.[58] Under the TEFRA rules, instead of auditing each of the partners separately, the IRS audits a partnership, and any adjustments resulting from the audit (such as a reduction of the charitable contribution deduction) filter to the partners based on their ownership percentage in the partnership.

Some partnerships that make charitable donations are called "syndicated" because they were promoted to a handful of partners, but they do not qualify as TEFRA partnerships. In these situations, the IRS audits each of the partners individually, not the partnership. The result is that partners in a syndicated non-TEFRA partnership might be ineligible for the settlement initiative because the IRS would not be addressing matters at the partnership level, would not be in a position to send an offer letter to the partnership, and might have little incentive to grant the partners a chance to participate since the agency must spend its resources to challenge them individually anyway. In all events, none of the guidance issued by the IRS about the settlement initiative has addressed the eligibility of syndicated non-TEFRA partnerships.

E. Lack of Finality

Participation in the settlement initiative does not limit or prohibit the IRS from later asserting criminal penalties, promoter penalties, appraiser penalties, return preparer penalties, discipline under Circular 230 with the Office of Professional Responsibility, or any other penalty. This is noteworthy because, as explained earlier, when taxpayers normally execute a Form 906 with the IRS, all matters covered thereby are considered "final and conclusive" unless there is a later showing of fraud, malfeasance, or material misrepresentation by the taxpayer.[59] Similarly, a decision document filed with the Tax Court in a particular case generally cannot be appealed by either party.[60]

Ponder the following possibility: An accountant becomes a partner in an SCET, encourages some of his clients to do the same in exchange for a commission or similar fee, writes a tax opinion on which the partnership relies, and prepares the Form 1065 for the partnership. Although he believes in the validity of the transaction and the corresponding easement valuation, the accountant, classified as a category 2 partner, agrees to participate in the settlement initiative for the benefit of the other partners, who are less bullish on the outcome if the partnership were forced into Tax Court litigation. The accountant signs his Form 906 and pays all amounts due, after accepting a charitable deduction of $0 and a penalty of 40 percent. He hopes that conceding the issues with the IRS and voluntarily paying the highest amount will conclude matters, but he is wrong. Under the settlement initiative, the IRS reserves the right to later start a criminal investigation, promoter penalty audit, return preparer penalty audit, etc., against the accountant and/or his firm.

F. Liability in Other Contexts

Participation in the settlement initiative requires each partner to indicate and sign a Form 906 with the IRS confirming in writing that he is either a category 1 partner or a category 2 partner. If a partner concedes that he falls into the former category, it might be construed as an admission that he did one or more of the following in connection with an SCET or SST: (1) organized, sold, or promoted; (2) prepared an appraisal; (3) provided legal or tax advice; (4) supplied return preparation services; or (5) took actions making him a material adviser. These types of admissions might cause serious problems for a partner with the IRS, particularly if he made prior filings with the IRS that were inconsistent or later he becomes

[58] Sections 6221 and 6231(a).

[59] Section 7121(b).

[60] *See, e.g.*, *White v. Commissioner*, 776 F.2d 976 (11th Cir. 1985); *Pesko v. United States*, 918 F.2d 1581 (Fed. Cir. 1990); *Sherry Frontenac Inc. v. United States*, 868 F.2d 420 (11th Cir. 1989); and section 7481(a).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the target of a criminal investigation, promoter penalty audit, return preparer penalty audit, etc. Moreover, such admissions by a partner might be exploited by plaintiffs' attorneys, who are busy filing lawsuits nowadays against individuals and firms involved in any manner with the planning, structuring, or implementation of a partnership that donated a conservation easement.[61] Finally, the Justice Department — which has already filed one lawsuit seeking an injunction of easement-related activities and disgorgement of proceeds from those activities — would surely find some use for admissions of organizing, selling, promoting, or advising on easement transactions.[62]

G. Time Frame and Morphing Terms

Ambiguity regarding the duration of the settlement initiative is also a problem. The IRS stated in its June release that this is a "time-limited settlement" and that the IRS, in its sole discretion, will decide which partnerships receive an offer to participate. This creates a conundrum for some partnerships.

Take, for instance, a partnership that agreed to extend the assessment period before the IRS announced the settlement initiative, received an examination report or the like, filed a protest letter to elevate the dispute to the office of Appeals, and knows that the relevant deed has a potentially fatal technical flaw. If the partnership were to contact Appeals, retract the protest letter, request the immediate issuance of an FPAA, and then file a petition with the Tax Court to convert the matter into a docketed case, would this somehow ensure receipt of an offer letter from the IRS? What about a partnership that is under audit, decides to waive its right to reconsideration by Appeals in order to draw a quick FPAA, and then files a petition to become a docketed case? Would this definitely trigger an offer letter?

The IRS has offered no such assurances. On the contrary, high-ranking IRS officials have publicly stated that the IRS is being "strategic" in deciding which partnerships receive offer letters, excluding some partnerships because their cases contain "unique issues that could further develop the law" and "for other reasons."[63] Moreover, the recent chief counsel notice indicates that the IRS might change "at any time" the current terms of the settlement initiative, so all partnerships that filed a petition with the Tax Court after the IRS issued the June release "should carefully review the specific terms" of any offer letter.[64]

H. Unclear Incentives for Some Partners

The hallmark of any settlement is that both sides leave something on the table, and thus nobody walks away fully satisfied. This is certainly true with most voluntary disclosure programs offered by the IRS, such as the offshore voluntary disclosure program, the streamlined foreign offshore procedure, and the streamlined domestic offshore procedure.[65] These programs generally are characterized by limiting matters to specific years, reducing civil penalties, waiving potential criminal sanctions, etc. However, the settlement initiative, at least for some partners, seemingly has no upside.

The IRS's standard approach in easement donation cases is to fully disallow the charitable deduction based on one or more technical arguments.[66] In other words, the IRS initially claims that the partnership is entitled to a deduction of $0 because of supposed flaws in the hundreds (if not thousands) of pages prepared in connection with a typical conservation easement. Then, as a backup plan, the IRS claims that the charitable deduction should be $0 because of supposed valuation problems. Further, the IRS typically proposes several alternative penalties against the partnership, ranging in severity. These invariably start with the 40 percent penalty for a gross valuation misstatement. This is consistent

[61] *See, e.g.*, Complaint, *Lechter v. Aprio LLC*, No. 1:20-cv-01325 (N.D. Ga. Mar. 26, 2020); and Complaint, *Turk v. Morris, Manning & Martin LLP*, No. 1:20-cv-02815 (N.D. Ga. July 3, 2020).

[62] *See* Complaint, *United States v. Zak*, No. 1:18-cv-05774 (N.D. Ga. Dec. 18, 2018).

[63] Kristen A. Parillo, "Criticism of Easement Settlement Deal Doesn't Worry IRS," *Tax Notes Federal*, July 20, 2020, p. 534.

[64] CC-2021-001, at Q&A B(5).

[65] Sheppard, "IRS Amnesty Covers More Than Foreign Accounts: Analyzing the Updated Voluntary Disclosure Practice, New International Tax Withholding Procedure, and Guidelines for Late Returns by Foreign Corporations," 97 *Taxes* 19 (2019).

[66] For a discussion of the many technical arguments the IRS can and does raise, see Sheppard, *supra* note 3, at Section III; *see also* ATG, *supra* note 8, at 83-86, Exhibit 12-1.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

with the ATG, which explains that an FPAA "will generally include a tiering of proposed penalties with multiple alternative positions."[67]

Under the settlement initiative, category 1 partners get hit with a charitable deduction of $0 and a 40 percent penalty, plus they must pay the entire amount right away. Thus, if category 1 partners participate in the settlement initiative, they are guaranteeing themselves the worst possible outcome, consistent with most FPAAs.[68] However, if they decline the settlement initiative, and the partnership proceeds to Tax Court litigation (and, if necessary, the appropriate court of appeals), the possibility remains of getting some amount of charitable deduction and lower (or no) penalties.

Reticence by category 1 partners to concede might put them at odds with category 2 partners, who might be eager to participate in the settlement initiative, accept a charitable deduction equal to the amount they invested, pay the reduced penalty, avoid a capital call for litigation fees, and conclude matters. A cynic might surmise that this is exactly what the IRS wanted from the outset: placing category 1 partners and category 2 partners in conflict — the classic divide-and-conquer strategy.

I. Fate of Nonparticipating Partners

The IRS has clarified that not all partners must participate in the settlement initiative, as long as the partnership and a "group of partners representing a significant percentage of the partnership interests" elect to proceed.[69] The IRS has also set forth the terms of resolution in cases of both full and partial partner participation. What the IRS has not clarified, however, is what will occur with nonparticipating partners. In the notice it simply warns that nonparticipating partners "run the risk of full disallowance of all deductions" claimed for the SCET or SST, plus the imposition of penalties, including the 40 percent gross valuation misstatement penalty, the 20 percent reportable transaction understatement penalty, or the 75 percent civil fraud penalty.[70]

Important procedural questions remain. For instance, will the IRS continue the Tax Court litigation against the partnership, applying the results only to the nonparticipating partners in the traditional way, by sending them notice of computational adjustments? If that were to occur, who would be responsible (financially, procedurally, legally, and otherwise) for defending the partnership in Tax Court and possibly in the appropriate court of appeals? Alternatively, will participation in the settlement initiative by a significant group of partners convert the dispute into a non-TEFRA matter, with the IRS later challenging the nonparticipating partners individually?

VII. Conclusion

As this article demonstrates, the IRS has supplied some guidance about the settlement initiative through the June release, offer letters, the October release, and the chief counsel notice. However, the IRS still has not clarified several important issues, which has triggered confusion and caution among partnerships and partners alike. All matters involved with SCETs and SSTs are complex, and the settlement initiative is no exception. ■

[67] ATG, *supra* note 8, at 82.

[68] The IRS might argue that the worst scenario for category 1 partners would not be a gross valuation misstatement penalty equal to 40 percent of the tax underpayment, but rather a civil fraud penalty of 75 percent. *See* CC-2021-001, at Q&A A(2).

[69] *Id.* at Q&A B(3).

[70] *Id.* at Q&A A(2).

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.