taxnotes federal

Volume 180, Number 4 ■ July 24, 2023

# California's Settlement Initiative For Conservation Easements

by Hale E. Sheppard

Reprinted from *Tax Notes Federal*, July 24, 2023, p. 543

# California's Settlement Initiative for Conservation Easements

by Hale E. Sheppard

Hale E. Sheppard (hale.sheppard@chamberlainlaw.com) is a shareholder in the tax controversy section of Chamberlain Hrdlicka in Atlanta.

In this article, Sheppard examines efforts by the California Franchise Tax Board to stop taxpayers, particularly individual partners, from claiming tax benefits derived from syndicated conservation easement transactions before disputes have been resolved at the federal level.



## I. Introduction

Interesting developments regarding conservation easement donations never seem to end. The latest is the manner in which the California Franchise Tax Board is trying to convince residents to concede state benefits and pay taxes and penalties now — well before the underlying legal, tax, and valuation issues have been resolved at the federal level.

This article explores (1) the historical support for easements by Congress and the IRS, (2) the many enforcement actions taken by the IRS to halt what it calls syndicated conservation easement transactions (SCETs), (3) two previous methods used by the IRS to entice taxpayers to voluntarily settle their disputes, and (4) two current methods employed by the FTB to do the same. This article also poses the bigger question: Will the FTB succeed in persuading partners to make large payments and permanently surrender their rights regarding SCETs before all the evidence has been presented, and before final determinations have been made by the IRS or the Tax Court?[1]

## II. Overview of Conservation Easements

Taxpayers who own undeveloped real property have several choices. They might hold the property as an investment and then sell it when it appreciates. Another option is to figure out how to maximize profit from the property and do that right away, regardless of the negative effects on the environment or community. One more possibility is to voluntarily restrict future uses of the property to benefit society as a whole. This last option, known as donating a conservation easement, might trigger tax deductions for donors.[2]

Congress has offered tax incentives for donating conservation easements for more than five decades, starting in 1969.[3] It codified the practice as section 170(h) in 1980.[4] Four years after enacting that provision, members of Congress introduced legislation to sweeten the pot. They wanted to expand the tax rewards for protecting land, mindful of increasing pressure for development and decreasing federal budgets earmarked for land acquisition. A hearing about the proposed legislation left no doubt that

[1] For earlier coverage of similar issues, see Hale E. Sheppard, "Comparing Federal and State Proposals for Resolving Conservation Easement Disputes," 136(6) *J. Tax'n* 3 (2022).

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

[3] Tax Reform Act of 1969, section 201; H.R. Conf. Rep. No. 91-782 (1969); *see also* Tax Reform Act of 1976, section 2124(e); *see also* Tax Reduction and Simplification Act of 1977, section 309.

[4] Tax Treatment Extension Act, section 6(a) (1980); S. Rep. No. 96-1007 (1980).

Congress was encouraging private land preservation — and that the motivation of donors was linked to tax benefits.[5]

Notably, the IRS recognized tax deductions for charitable donations of partial interests in real property even before Congress did, in 1964.[6] The IRS has proclaimed since then that it does not object to conservation easements in general, but cannot tolerate abuse of the rules, such as claiming large tax deductions based on overvaluations. For this reason, the IRS announced in late 2016 that it intended to aggressively challenge SCETs.[7] These transactions, according to the IRS, are characterized by the following four steps:

> (1) An investor receives promotional materials that offer prospective investors in a pass-through entity [such as a partnership] the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment.
>
> (2) The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds the real property.
>
> (3) The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor.
>
> (4) Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.[8]

## III. IRS Enforcement Activities

Saying that the IRS dislikes SCETs would be an enormous understatement. Indeed, based on the actions and statements of the IRS over the past half-decade, it seems to absolutely despise those who promote or participate in them. Harnessing this strong sentiment, the IRS has tried many "sticks" to halt SCETs. It has: (1) issued Notice 2017-10, 2017-4 IRB 544, making SCETs listed transactions; (2) launched a compliance campaign; (3) placed SCETs on its notorious "Dirty Dozen" list; (4) engaged in a media blitz replete with ominous threats; (5) routinely disallowed charitable deductions based on a creative list of "technical" flaws; (6) sought a permanent injunction of SCET activities by multiple parties; (7) formed an Office of Promoter Investigations; (8) established a Fraud Enforcement Office; and (9) eliminated long-standing procedural protections for appraisers.[9]

Perhaps the biggest stick brandished by the IRS so far is its threat of ubiquitous challenges. The IRS has declared its plan to attack every single SCET, starting with examinations and ending with litigation. The IRS announced that it "will not stop in [its] pursuit of everyone involved," it will employ "every available enforcement option," and it is "committing significant examination and investigative resources to vigorously audit the entities and individuals involved in this scheme."[10] If that was not clear enough, the IRS confirmed that it examines "100 percent of these deals and plans to continue doing so for the foreseeable future."[11] The National Fraud Counsel also admonished that "the IRS is auditing 100 percent of these cases."[12] Chief Counsel for the IRS, piling on, explained that his

[5] Joint Committee on Taxation, "Description of S. 1675 (Public Land Acquisition Alternatives Act of 1983)," JCX-1-84, at 10 (Feb. 4, 1984) (statement by Sen. Malcolm Wallop).

[6] Rev. Rul. 64-205, 1964-2 C.B. 62.

[7] Notice 2017-10, preamble and section 1.

[8] Notice 2017-10, section 2.

[9] For more information about IRS enforcement actions, see Sheppard, "30 Wrongs Do Not Make a Right: Revealing Extraordinary IRS Actions in Conservation Easement Disputes," 135(3) *J. Tax'n* 21 (2021).

[10] IRS, "IRS Increases Enforcement Action on Syndicated Conservation Easements," IR-2019-182 (Nov. 12, 2019).

[11] IRS, "IRS Issues Guidance on the Elimination of the Deduction of Qualified Transportation Fringe Benefit," IR-2020-125 (June 19, 2020).

[12] Nathan J. Richman, "IRS Shifting Tack on Fighting Syndicated Conservation Easements," *Tax Notes Federal*, Feb. 7, 2022, p. 898.

troops are prepared "to take each of these [pending SCET cases] and all other cases being developed by the IRS to trial."[13]

Many have questioned whether these sticks are a worthwhile proposition, particularly keeping in mind the massive resources the IRS is devoting to these efforts, the drag on the Tax Court and other judicial bodies, the related costs to American taxpayers as a whole, and the mixed results that the IRS has achieved thus far. Putting that polarizing debate aside, what remains undisputed is that the IRS realized the need for a complementary approach, the proverbial "carrot" for taxpayers who need a real incentive before yielding to the IRS's will. Specific enticements offered by the IRS are explored below.

## IV. Settlement Suggestion by the IRS

The IRS first encouraged individual partners of partnerships that engaged in SCETs to resolve their issues by filing qualified amended returns (QARs). The IRS published an information release in November 2019 directing taxpayers to file QARs, with insinuations of penalty mitigation in exchange for full, voluntary concessions of all tax benefits. The release contained the following advice:

> If you engaged in any questionable [SCET], you should immediately consult an independent, competent tax advisor to consider your best available options. It is always worthwhile to take advantage of various methods of getting back into compliance by correcting your tax returns before you hear from the IRS. . . . Taxpayers may avoid the imposition of penalties relating to improper contribution deductions if they fully remove the improper contribution and related tax benefits from their returns by timely filing a [QAR] or timely administrative adjustment request.[14]

## V. Settlement Offer by IRS

Around that same period, the IRS prevailed in several Tax Court cases focused on supposed technical flaws in the vast amount of documentation associated with easement donations.[15] The IRS tried to capitalize on its momentum by introducing a settlement initiative in June 2020.[16] The terms of the initiative morphed over time, with the IRS supplying guidance via a news release, offer letters to partnerships, a chief counsel notice, and a second news release.[17] Important aspects of this guidance are summarized below.[18]

### A. Eligibility Standards

The IRS initially explained that the settlement initiative applied only to cases that were docketed with the Tax Court. Stated another way, the initiative did not apply to partnerships that donated easements but were not yet under audit, partnerships already under audit, or partnerships seeking review by the Appeals Office directly after an audit.

The IRS later softened on this point, indicating that it "may extend the settlement terms to certain newly petitioned cases."[19] The IRS cautioned that it would consider a number of factors in determining whether a particular partnership merited an offer letter, including whether the partnership, its partners, and its representatives cooperated during audit. The IRS also warned that just because a partnership that becomes

[13] IRS, "IRS Continues Enforcement Efforts in Conservation Easement Cases Following Latest Tax Court Decision," IR-2019-213 (Dec. 20, 2019).

[14] IRS, *supra* note 10; *see also* IRS, *supra* note 13.

[15] *See, e.g.*, *Dasher's Bay at Effingham LLC v. Commissioner*, No. 4078-18, Order (T.C. 2019); *Ogeechee River Preserve LLC v. Commissioner*, No. 2771-18, Order (T.C. 2019); *Riverpointe at Ogeechee LLC v. Commissioner*, No. 4011-18, Order (T.C. 2019); *River's Edge Landing LLC v. Commissioner*, No. 1111-18, Order (T.C. 2019); *TOT Property Holdings LLC v. Commissioner*, No. 5600-17, Order (T.C. 2019).

[16] For details regarding the evolution of the settlement initiative, see Sheppard, "Questions Remain About the Conservation Easement Settlement Initiative," *Tax Notes Federal*, Sept. 21, 2020, p. 2219; and Sheppard, "Conservation Easement Settlement: More Guidance, More Questions," *Tax Notes Federal*, Nov. 16, 2020, p. 1085.

[17] IRS, "IRS Offers Settlement for Syndicated Conservation Easements; Letters Being Mailed to Certain Taxpayers With Pending Litigation," IR-2020-130 (June 25, 2020); chief counsel notice CC-2021-001 (Oct. 1, 2020); "IRS Provides Details About Settlements in Syndicated Conservation Easement Transaction Initiative," IR-2020-228 (Oct. 1, 2020).

[18] The IRS guidance covered both SCETs and substantially similar transactions. For the sake of simplicity, this article references only SCETs throughout.

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

docketed in the future might get a chance to participate in the settlement initiative does not mean that it will be on the same terms. Indeed, the IRS ominously stated that it "may at any time modify the standard terms" and "partnerships with newly petitioned cases should carefully review the specific terms of any settlement offer."[20]

The IRS was somewhat capricious when it came to criminal matters. The news release and offer letters explained that the settlement initiative ordinarily would not be available to any partnership in which one or more partners were under criminal investigation. Despite these strong words, the IRS indicated in the subsequent chief counsel notice that it might consider offers from those partners who were not personally being scrutinized criminally.[21]

### B. Unanimous Participation

The IRS began by resolutely stating that the settlement initiative was open only to partnerships in which all partners agreed to the terms. However, the offer letters to particular partnerships explained that the IRS might consider offers to resolve cases in situations in which fewer than all the partners agree to settle. The IRS admonished, though, that in those situations greater penalties might be imposed against the partners.

The chief counsel notice later exhibited some flexibility. It revealed that the IRS might consider settling with just a group of partners, as long as:

- the group represented a significant percentage of all the ownership interests in the partnership;
- absolutely all partners in the partnership, even those refusing the settlement initiative, waived their right to a consistent agreement with the IRS; and
- the group cooperated with the IRS by supplying all requested information and documentation.[22]

### C. Disparate Treatment

The offer letters from the IRS described two types of partners. Category 1 partners were those who engaged in any of the following activities or who met any of the following criteria for any SCET, even those in prior years:

- organized or participated, directly or indirectly, in sales or promotion;
- received fees for organizing, selling, or promoting;
- received fees for providing an appraisal;
- received fees for providing legal or tax advice;
- received fees for tax return preparation services;
- received a conservation easement or a fee simple property interest;
- was a material adviser; or
- was related to any of the persons who engaged in any of the activities listed above.

Thus, partners were forced to consider all their past behavior regarding all partnerships to determine whether the IRS would deem them Category 1 partners. By default, Category 2 partners were those who were not Category 1 partners.

### D. Three Costs

Partnerships or partners concluding matters under the settlement initiative had to pay the so-called settlement amount, which was composed of three parts: taxes, penalties, and interest.

#### 1. First cost — taxes.

Under the initiative, the partnership could not deduct, under section 170 or any other federal tax provision, any of the charitable deductions that it originally claimed on its Form 1065, "U.S. Return of Partnership Income," for the SCET. Likewise, the partners were prohibited from deducting on their Forms 1040, "U.S. Individual Income Tax Return," the allocations of the charitable deductions that flowed through to them. Stated differently, the partnership had to completely reverse the charitable tax deduction previously claimed, bringing it to $0. The partners, therefore, were allocated a percentage of $0, which was always $0.

[20] *Id.*

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

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

Moreover, Category 1 partners could not claim any deduction for contributions of cash or other property to participate in an SCET. Category 1 partners got a charitable deduction of $0 and lost their investments in the partnership.

Category 2 partners also got a charitable deduction of $0, but they were allowed to claim an ordinary tax deduction equal to the out-of-pocket costs paid to participate in the SCET, which included both money and other property contributed in exchange for partnership interests.

**2. Second cost — penalties.**

The partnership had to aggregate all penalties, for all partners, for all affected years, to calculate the settlement amount.[23]

For Category 1 partners, the highest penalty asserted by the IRS in the notice of final partnership administrative adjustment or the highest penalty later asserted by the IRS's attorney during Tax Court litigation would apply. This normally was the 40 percent penalty for a gross valuation misstatement.

For Category 2 partners, the size of the accuracy-related penalty depended on the return-on-investment ratio. Three possibilities existed. First, if the partner claimed a charitable deduction that was between one and five times his investment in the partnership that engaged, directly or indirectly, in the SCET, then the penalty was 10 percent of the tax underpayment. Second, if the partner claimed a charitable deduction that was between 5.1 times and eight times his investment in the partnership, then the penalty increased to 15 percent of the tax underpayment. Third, if the partner claimed a charitable deduction that was more than 8.1 times his investment in the partnership, then the penalty jumped to 20 percent of the tax underpayment.

The IRS tried to pressure all partners to the table by creating rules that prejudiced participating partners in situations in which not all their colleagues were willing to settle. The chief counsel notice explained that partners participating in the settlement initiative had to agree to a penalty increase of 5 percent when unanimity was lacking.[24] 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, then the penalty under the settlement initiative would increase from 10 percent to 15 percent.[25] The IRS later hedged somewhat, acknowledging that it might not insist on the increased penalty in cases with "extraordinary circumstances."[26] The IRS did not provide examples of what it might deem extraordinary, of course.

**3. Third cost — interest.**

The partnership had to aggregate and pay all interest for all partners and years, on both the tax liabilities and penalties.

### E. Full Payment

The chief counsel notice was remarkably clear in its show-me-the-money stance. It explained that the partnership, or group of participating partners, must fully pay the settlement amount at the time of executing Form 906, "Closing Agreement."[27]

### F. No Modifications

The chief counsel notice quelled any thoughts of partnerships and partners customizing terms based on their unique circumstances. Indeed, it explained that no provision of Form 906 "was subject to negotiation."[28]

### G. No Hindrance to IRS

The offer letters emphasized that participation in the settlement initiative would not have an effect, limitation, or prohibition against the IRS later asserting criminal penalties, promoter penalties, appraiser penalties, return preparer penalties, or any other penalty. If that were not clear enough, the offer letters went on to state that nothing in the settlement initiative precluded the

[23] The settlement initiative contemplated accuracy-related penalties, as well as those for situations in which the partnership or certain partners failed to file Form 8886. The IRS provided the following guidelines in this regard: The partnership had to provide evidence that the partnership and all its partners filed timely and proper Forms 8886, and if any party failed to do so, then the settlement amount would include a penalty under section 6707A.

[24] CC-2021-001, Q&A B(3).

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

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

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

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

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.

### H. Ongoing Cooperation

The partnership and the partners had to commit to fully cooperate with the IRS. Cooperation in this scenario included, but was not limited to, supplying the IRS with items designed to facilitate audits or investigations of others involved with SCETs. These consisted of correspondence, emails, communications, and other documentation exchanged between a 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.[29]

### I. Limited Participation and Uneventful End

The IRS introduced the settlement initiative with gusto, but later eliminated it discreetly, without announcement or fanfare. It appears that the IRS simply stopped sending offer letters to partnerships at some point in 2021 and never released statistics regarding the level of participation. The IRS tends to broadcast, far and wide, anything that it considers a victory. Therefore, the abrupt termination of the settlement initiative and subsequent silence left many to speculate that participation levels were quite low.

## VI. California Rules

The FTB, like its federal counterpart, has employed both sticks and carrots to stop California taxpayers from claiming tax benefits derived from SCETs. Readers first need some background on California law to understand the issues. A peek at just a few of the relevant state rules follows.[30]

### A. Shared Definition

Any item that the IRS identifies as a listed transaction, such as an SCET, will be one for California purposes, too.[31]

### B. Forms 8886 for Participants

Generally, a participant in a reportable transaction, including listed transactions, must attach a Form 8886, "Reportable Transaction Disclosure Statement," to his original California income tax return for each tax year in which he participates in a reportable transaction. Also, a participant must mail a copy of Form 8886 to the Abusive Tax Shelter Unit of the FTB for the initial year of participation.[32] Failure to file a timely, complete Form 8886 triggers a penalty of $15,000 per violation, which increases to $30,000 in situations involving listed transactions.[33]

### C. Tax-Related Penalties

The FTB might assert multiple penalties against individual partners under California law. The FTB can impose an accuracy-related penalty of 20 percent of a tax understatement.[34] It can also assess a sanction of equal size for tax understatements attributable to reportable transactions.[35] The FTB is empowered to punish taxpayers even more severely in cases involving "non-economic substance transactions." The financial toll in those instances is 40 percent of the tax understatement, as opposed to just 20 percent.[36] Finally, the FTB has an interest-based penalty in its arsenal. It is equal to 100 percent of

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

[30] I am not licensed to practice law in California, do not practice law in California, and do not opine or advise on California law by publishing this article. Readers should engage California legal counsel if they need to confirm or update any information in this article, obtain a legal opinion about issues raised in this article, get any guidance on which they can rely regarding California law, or deal with the FTB.

[31] Cal. chief counsel announcement 2003-1 (Dec. 31, 2003).

[32] Cal. Rev. & Tax. Code section 18407.

[33] *Id.* at section 19772.

[34] *Id.* at section 19164.

[35] *Id.* at section 19164.5.

[36] *Id.* at section 19774.

the interest attributable to the relevant tax understatement, which effectively doubles the interest owed. This penalty applies to tax understatements deriving from nondisclosed reportable transactions, tax shelters, listed transactions, or non-economic substance transactions.[37]

### D. Amended Returns

A taxpayer must rectify matters with the FTB if there is a change in the situation at the federal level resulting from a dispute with the IRS or the voluntary filing of Form 1040X, "Amended U.S. Individual Income Tax Return." Specifically, the law requires a taxpayer to file an amended California income tax return within six months of the federal event.[38] If a taxpayer ignores this obligation, then the FTB can send a notice of proposed assessment resulting from a federal adjustment at any time.[39]

### E. Extended Assessment Periods

There is an extended assessment period in cases involving abusive tax avoidance transactions, which classification encompasses nondisclosed reportable transactions, tax shelters, listed transactions, or non-economic-substance transactions.[40] SCETs are listed transactions for IRS purposes, so they are considered abusive tax avoidance transactions by the FTB. The result is that the FTB has 12 years from the time taxpayers file their California Forms 540, "California Resident Income Tax Return," not the normal three years, to audit and propose additional taxes, penalties, and interest.[41]

## VII. Settlement Suggestion by the FTB

The settlement initiative announced by the IRS in June 2020 only addressed federal income taxes and corresponding matters; it did not cover state income tax issues. Therefore, participation in the settlement initiative allowed a partnership and its partners to rectify federal income taxes for an SCET, it did not resolve past issues with any state tax authority, including the FTB.

The IRS generally shares information that it gathers about taxpayers with state tax authorities, including Forms 906. Moreover, as noted, many states, including California, have laws requiring taxpayers to file amended state income tax returns within a particular time when changes occur at the federal level.[42]

Most states are content to allow the IRS to do the heavy lifting. This consists of identifying taxpayers who take questionable tax positions, conducting audits and issuing reports, supplying taxpayers an outlet for administrative appeals, and litigating disputes in the Tax Court and courts of appeals, as necessary. States stand to benefit from this, expending little effort and simply waiting for taxpayers to file amended state income tax returns to reflect outcomes from their dealings with the IRS.

Some states audit individual partners immediately, not waiting for the partnership-level dispute with the IRS to conclude, and not waiting for partners or the IRS to inform them of changes at the federal level. One example is California.

The FTB started sending letters to individual partners who are California residents and who claimed federal income tax deductions stemming from SCETs.[43] The letters reveal that the FTB identified the partners because they filed, in compliance with the law, Forms 8886 reporting their participation in an SCET. The letters then stated that (1) SCETs might be "abusive tax avoidance transactions lacking economic substance," (2) the Senate Finance Committee found that SCETs were "retail tax shelters that allow the taxpayer to buy deductions without any economic risk," (3) about two dozen Tax Court cases have held that partnerships are not entitled to tax deductions derived from SCETs, and (4) partners have filed five lawsuits against supposed promoters alleging misconduct and fraud.[44]

The FTB warned in the letters that it was increasing enforcement activity regarding SCETs,

[37] *Id.* at section 19777.

[38] *Id.* at section 18622.

[39] *Id.* at section 19060(a).

[40] *Id.* at section 19753.

[41] *Id.* at section 19755(a)(2).

[42] *Id.* at section 18622; Ga. Code Ann. section 48-7-82(e)(1).

[43] FTB, Letter AUD 1521 PASS (Rev. 09-2016).

[44] *Id.*

which included deploying several teams to start additional examinations. The FTB further admonished that those examinations might result in tax deductions of $0, plus a long list of penalties, including accuracy-related penalties, reportable transaction penalties, non-economic-substance transaction penalties, and interest-based penalties.[45] Finally, it ominously reminded partners that the FTB has 12 years after a taxpayer files Form 540 to audit and propose additional taxes, penalties, and interest for SCETs.[46]

The FTB then offered a suggestion to partners: "Before you file your future [California] income tax returns, we recommend you consult an independent, competent tax advisor on the proper treatment for past and future tax years and consider your best options for any improperly claimed deductions or other tax benefit, including filing amended [California] returns."[47]

The letters also underscored two potential solutions. First, if a partner decided not to claim tax benefits for SCETs on California Form 540 in the future, then he had to send a letter to the FTB identifying the prior years in which he had, including a sworn declaration. The FTB stated that it would take into account if a partner sends that letter when deciding potential compliance actions.[48]

Second, in situations in which a partner was interested in not only avoiding future issues but also rectifying past matters on preferable terms, he could file amended California Forms 540, erasing any previous tax benefits for SCETs. The letters clarified that these returns would be considered QARs, so the partner would mitigate penalty exposure. Avoiding any chance for confusion on this point, the letters dangled the following carrot: "If you plan to file [QARs] we will not assess the penalties discussed in this letter."[49]

The timing was short. The letters demanded a response within 30 days and reminded the partners that if the FTB were to start an examination in the meantime, they would no longer be eligible to file QARs.[50]

## VIII. Resolution Process by the FTB

The FTB, mimicking the IRS's playbook, began with a suggestion for taxpayers and later announced a formal settlement program. In late May, the FTB disseminated Notice 2023-02, "Resolution of Micro-Captive Insurance Transactions and Syndicated Conservation Easement Transactions," with details about the so-called resolution process for SCETs.[51]

### A. Who Can Participate?

The notice describes the types of California taxpayers who can apply for the resolution process. Among them are:

- taxpayers under audit by the FTB or IRS, or those seeking review by IRS Appeals after an audit;
- taxpayers who have received a notice of proposed assessment from the FTB and are disputing it with the FTB or the California Office of Tax Appeals;
- taxpayers in litigation with the IRS;
- taxpayers who are direct or indirect partners in a partnership that is under audit by the FTB or IRS, or that is in litigation with the IRS; and
- certain California partnerships.[52]

The notice underscores that taxpayers who directly or indirectly entered into an SCET before the notice was issued and have not yet used the corresponding tax benefits cannot participate in the resolution process. The notice warns those taxpayers not to claim benefits in the future because "they will be subject to all applicable penalties" and the 12-year assessment period will govern.[53]

[45] *Id.* (citing Cal. Rev. & Tax. Code sections 19774, 19164.5, 19164, and 19777).

[46] *Id.* (citing Cal. Rev. & Tax. Code section 19755).

[47] FTB, Letter AUD 1521 PASS.

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] The notice also applied to micro-captive insurance transactions.

[52] *Id.*

[53] *Id.*

### B. What Is the Deadline?

The notice indicates that taxpayers must submit all required documents and payments to the FTB between July 10 and November 17, 2023.

### C. What Are the Settlement Terms?

The notice features six different settlement terms, depending on the existence or status of a tax dispute with the FTB or IRS. The categories consist of the following[54]:

- *Taxpayers who have received a notice of proposed assessment from the FTB*. These taxpayers must pay all income taxes shown on the notice of proposed assessment, meaning that they get no tax benefits whatsoever from the SCET. Moreover, they must pay any interest-based penalty imposed by the FTB, as well as all interest charges accruing until the date of full payment.
- *Taxpayers who have received a notice of proposed assessment from the FTB and who have already resolved their issues with the IRS by participating in the settlement initiative*. These taxpayers must reverse the tax benefits for the SCETs that they claimed on their California Forms 540 to the same extent that they reversed them at the federal level under the settlement initiative. This results in a state income tax liability, which these taxpayers must pay, along with interest-based penalties and interest charges.
- *Taxpayers who have been contacted by the FTB or the IRS regarding an audit of a tax return on which they claimed tax benefits from an SCET, but who have not received a notice of proposed assessment from the FTB*. These taxpayers must fully reverse the tax benefits from the SCETs that they claimed on their California Forms 540, pay the resulting state income tax liability, pay an accuracy-related penalty of 20 percent, and pay interest charges. As part of the resolution process, the FTB will not assess reportable transaction penalties, non-economic-substance transaction penalties, or interest-based penalties.
- *Taxpayers who have not been contacted by the FTB or IRS regarding a tax return on which they claimed tax benefits from an SCET*. These taxpayers must fully reverse the tax benefits from the SCETs that they claimed on their California Forms 540, pay the resulting state income tax liability, and pay interest charges. The FTB, for its part, will not assess accuracy-related penalties, reportable transaction penalties, non-economic-substance transaction penalties, or interest-based penalties.
- *Taxpayers who participated in the settlement initiative with the IRS and who have not received a notice of proposed assessment from the FTB*. These taxpayers must reverse the tax benefits from the SCETs that they claimed on their California Forms 540 to the same extent that they were reversed at the federal level under the settlement initiative. In addition to paying the resulting state income tax liability, taxpayers must pay an accuracy-related penalty at the same percentage they were obligated to pay under the settlement initiative (for example, 10, 15, or 20 percent), plus interest.[55]
- *Taxpayers who have conclusively resolved their issues with the IRS through some method other than the settlement initiative, such as a settlement with the IRS Appeals Office, pretrial decision document filed with the Tax Court, or federal court decision whose period for judicial appeal has expired*.[56] These taxpayers must reverse the tax benefits from the SCETs that they claimed on their California Forms 540 to the same extent that they had to be backed out at the federal level. This creates a state income tax liability. The penalties for these taxpayers vary, depending on whether they have received a notice of proposed assessment from the FTB. If they have, they must pay interest-based penalties and interest charges. If they have not, the penalty is an accuracy-related one of 20 percent, plus interest.

[54] *Id.*

[55] *Id.* The notice discusses both individual and partnership taxpayers in this category, but only individuals are mentioned in the article for the sake of clarity and simplicity.

[56] *Id.* For these purposes, "contact" by the FTB or IRS has the same meaning as in the QAR rules in reg. section 1.6664-2(c)(3)(i). *Id.* reg. section 1.6664-2(c)(3)(i).

### D. Are Form 8886 Penalties Eliminated?

The notice expressly states that participating in the resolution process does not relieve taxpayers of any penalties previously imposed by the FTB for unfiled or late Forms 8886.[57]

### E. Can Taxpayers Favorably Treat Expenses?

Generally, taxpayers concluding California issues through the resolution process cannot treat as an ordinary loss, capital loss, deduction, expense, capitalized cost, or increase in basis any amounts paid to promoters, material advisers, attorneys, accountants, appraisers, or others for planning or carrying out an SCET. Those amounts include, but are not limited to, promotional fees, legal or accounting bills, commissions, or any other transactional costs.[58]

### F. Must Taxpayers Pay It All?

The normal rule is that taxpayers "must submit payment in full of all taxes, interest, and penalties" under the resolution process at the time they execute the closing agreement and submit all required materials to the FTB. In limited cases in which a taxpayer can demonstrate that making the large payment would trigger a financial hardship, the FTB might permit an installment agreement. However, the economic reprieve will be brief, as any of those arrangements will contemplate full payment in no more than 12 months.[59]

### G. Can Taxpayers Change Their Minds Later?

Taxpayers cannot file a claim for refund regarding any supposed overpayments made to the FTB as part of the resolution process. Likewise, taxpayers waive all rights to later appeal or otherwise contest, in any forum, administrative or judicial, the validity of the relevant SCETs or the amounts paid to the FTB. The notice adds that the closing agreement executed under the resolution process "will permanently resolve all tax, penalties, and interest associated with the taxpayer's participation" in the SCET. Most importantly, the notice warns that "subsequent federal adjustments with respect to the [SCET] will have no effect on the terms or finality of" the closing agreement with the FTB.[60] In other words, if a California partner in a partnership that engaged in an SCET settles with the FTB now under the resolution process, and the partnership later prevails on federal tax issues in the Tax Court, the partner is out of luck.

## IX. Conclusion

The IRS has tried to halt SCETs with both sticks and carrots. The latter consisted of the IRS's initial suggestion to taxpayers that they file QARs, which would have obligated them to voluntarily relinquish all federal income tax benefits from the SCETs in exchange for a penalty waiver. That was followed by the settlement initiative, terms of which were less favorable for taxpayers. Those who decided to participate had to pay not only all federal income taxes, but also a penalty of 10, 15, 20, or 40 percent of the tax liability, depending on the circumstances. The settlement initiative, which quietly disappeared, likely had few takers. Reasons for minimal participation were plentiful, with a major one being that not all partners in a given partnership were willing to accept a tax deduction of $0 and penalties without a fight. This attitude garnered strength in situations in which partnerships conducted substantial due diligence before engaging in an SCET, obtained a compelling appraisal, relied on various independent professionals, and possessed transactional documents devoid of serious technical flaws.

The FTB has adopted a similar course of action, first advising California partners to file the state equivalent of a QAR, and later introducing the resolution process. Importantly, these actions by the FTB have occurred while the majority of partnerships that engaged in SCETs are still battling the IRS. Final determinations have not been made, taxes and penalties have not been assessed, and trials have been significantly delayed because of COVID. The FTB, in other words, is forcing many California partners to

[57] FTB, Notice 2023-02.

[58] *Id.*

[59] *Id.*

[60] *Id.*

make major financial decisions regarding SCETs before all the evidence has been presented, and before the IRS and Tax Court have had an ample opportunity to weigh in.

The FTB is offering six different settlement terms under the resolution process, which are contingent on the status of disputes related to SCETs. There are commonalities with all terms, though. They contemplate total or partial reversal of the tax benefits derived from SCETs, a prohibition against favorable tax treatment of any amounts paid for planning or carrying out SCETs, imposition of certain penalties, application of interest, and demand for full payment. Perhaps most critically, California taxpayers who execute a closing agreement as part of the resolution process surrender their right forevermore to challenge, administratively or in court, the validity of the SCETs in which they were partners or the amount of taxes, penalties, and interest they must pay the FTB. In other words, if a California partner in a partnership that engaged in an SCET settles with the FTB now under the resolution process, and the partnership later secures a good outcome on federal tax issues with the IRS Appeals Office or in Tax Court, the partner is simply out of luck when it comes to state issues.

Partnerships, partners, practitioners, the IRS, and other state tax agencies are sure to be tracking this California experiment. ■