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In this article, Sheppard compares two different settlement options offered to partnerships and partners involved in syndicated conservation easement transactions.

I. Introduction

The IRS has recently launched its second major effort to dispense with cases involving syndicated conservation easement transactions (SCETs) before litigation in the Tax Court. For partnerships and partners involved with SCETs to make intelligent decisions, they first need to understand the types of challenges the IRS normally raises in SCET disputes, the reasons for and terms of the initial settlement initiative introduced by the IRS back in 2020, the reasons for and terms of the settlement initiative launched in 2024, and the types of partnerships to which the current settlement initiative might appeal. This article, which builds on several earlier ones by the same author, covers these topics and questions whether current IRS efforts focused on SCETs might undermine future IRS efforts in other areas.[1]

II. Conservation Easement Donations in Brief

Taxpayers that own undeveloped real property have several choices. They might hold the property for investment purposes and sell it when it appreciates. Another option is to maximize profitability from the property immediately — regardless of the negative effects on others. One more possibility is to voluntarily restrict future uses of the property to benefit society as a whole. That option, known as donating a conservation easement, often triggers 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, Congress introduced legislation to sweeten the pot. It wanted to expand the rewards for protecting land, mindful of increasing development pressures and decreasing federal budgets for land acquisition. A hearing about the proposed legislation left no doubt that Congress was encouraging private land

[1] Hale E. Sheppard, "California's Settlement Initiative for Conservation Easements," *Tax Notes Federal*, July 24, 2023, p. 543; Sheppard, "Questions Remain About the Conservation Easement Settlement Initiative," *Tax Notes Federal*, Sept. 21, 2020, p. 2219; Sheppard, "Conservation Easement Settlement: More Guidance, More Questions," *Tax Notes Federal*, Nov. 16, 2020, p. 1085.

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

[3] Tax Reform Act of 1969, section 201; H.R. Rep. No. 91-782 (1969) (Conf. Rep.); *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 of 1980, section 6(a); S. Rep. No. 96-1007 (1980).

preservation — and that donors were largely motivated by tax benefits.[5]

Taxpayers cannot donate easements on just any old piece of property and claim a tax deduction; they must demonstrate that the property is worth protecting, meaning that it has one or more acceptable conservation purposes.[6]

Taxpayers memorialize a donation by filing a deed of conservation easement. In preparing the deed, taxpayers often coordinate with a land trust to identify limited activities that can continue on the property after the donation without interfering with the deed and without prejudicing the conservation purpose.[7] These activities are called "reserved rights."[8]

The IRS will not allow a tax deduction stemming from a conservation easement unless the taxpayer provides the land trust, before making the donation, with "documentation sufficient to establish the condition of the property at the time of the gift."[9] This is called the baseline report. It frequently contains surveys, pictures taken from various locations, and a detailed map showing improvements, plants, animals, distinct natural features, and more.[10]

The value of the conservation easement is the fair market value of the property at the time of the donation.[11] The term "fair market value" 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 best evidence of FMV would be the sale price of other easements that are comparable in size, location, usage, and so on. However, even the IRS recognizes that it is difficult, if not impossible, to find comparable sales.[13] Thus, 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 after value, with certain other adjustments, produces the value of the easement donation.

The pivotal concept in easement valuation is HBU, and all parties are supposed to take this into account.[15] A property's HBU is the most profitable use for which it is adaptable and needed in the near future.[16] The term also means the use of property that yields maximum economic benefit, while also being physically, legally, and financially feasible.[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 the construction of a residential community, the creation of a mixed-use development, the mining of minerals, or the establishment of a solar energy farm.

Claiming an easement-related deduction is surprisingly complicated and involves many actions and documents. The taxpayer must obtain a qualified appraisal from a qualified appraiser, demonstrate that the land trust is a qualified organization, obtain an acceptable baseline report, receive a "contemporaneous written acknowledgment" of the donation, and file a timely tax return reporting the charitable tax deduction, enclosing Form 8283, "Noncash

[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 Senator Malcolm Wallop, R-Wyo.).

[6] Section 170(h)(4)(A); reg. section 170A-14(d)(1); S. Rep. 96-1007, at 10.

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

[8] IRS, "Conservation Easement Audit Techniques Guide," at 23 (rev. Nov. 4, 2016); *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); reg. section 1.170A-1(c)(1).

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

[13] IRS, *supra* note 8, at 41.

[14] *Id.*

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

[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).

Charitable Contribution," and the qualified appraisal.[20]

III. Reasons for the First Settlement Initiative

The IRS has proclaimed for more than a half-century that it does not object to conservation easements in general but disapproves of practices that it considers abusive, such as the claiming of large tax deductions based on overvaluations.[21] Grounded in that viewpoint, the IRS started demonizing SCETs in late 2016 by labeling them "listed transactions" and unleashing a compliance campaign.[22]

In an effort to fully disallow tax deductions originating from SCETs, the IRS aggressively challenged supposedly "technical" problems with donations. It pounced on unintentional flaws with deeds, appraisals, baseline reports, Forms 8283, and other documents. The Tax Court ruled in favor of the IRS on several technical issues in early cases, resulting in charitable deductions of zero and large penalties.[23] Encouraged by these victories on non-valuation issues, yet concerned about the massive number of additional easement cases headed its way, the IRS announced its first settlement initiative in June 2020.

IV. Terms of First Settlement Initiative

The IRS introduced the terms of the first settlement initiative in two ways — by issuing a news release, and then by sending offer letters to eligible partnerships.[24] Later, in October 2020, it expanded and clarified matters by releasing a chief counsel notice and a second news release.[25]

A. Early IRS Guidance

Below are the main features of the first settlement initiative, as described in the first news release and offer letters.

1. Which transactions were affected?

The first settlement initiative applied to SCETs and substantially similar transactions, including certain donations of property in fee simple.

2. Were all partnerships eligible?

The first settlement initiative only applied to cases that were already docketed with the Tax Court — that is, cases for which petitions had been filed. It did not apply to partnerships that donated an easement but were not yet under audit, partnerships under audit, or partnerships awaiting review by the Appeals Office directly after an IRS audit.

3. Did all partners have to settle?

The first settlement initiative generally was open only to partnerships in which all partners agreed to concede. However, the offer letters ambiguously stated that "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."

4. What if criminal investigations were underway?

The first settlement initiative ordinarily was not available to any partnership in which one or more partners were under criminal investigation, yet the offer letters vaguely stated that "the IRS might consider offers from the partners in such a partnership who were not under criminal investigation to resolve the case on terms similar to those contained herein."

5. Were all partners treated the same?

The offer letters described two types of partners, who received disparate treatment under the first settlement initiative.

Category one partners were those who engaged in any of the following activities or met any of the following criteria: (1) organized or participated, directly or indirectly, in the sale or promotion of any SCET; (2) received fees for organizing, selling, or promoting any SCET; (3) received fees for providing an appraisal for any

[20] *See* IRS, *supra* note 8, at 24-30; IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements" (Mar. 2016); IRS Publication 526, "Charitable Contributions" (2022); section 170(f)(8) and (11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; T.D. 9836.

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

[22] Notice 2017-10, 2017-4 IRB 544, preamble and section 1.

[23] *See, e.g.*, *Railroad Holdings LLC v. Commissioner*, T.C. Memo. 2020-22; *Oakhill Woods LLC v. Commissioner*, T.C. Memo. 2020-24; *Oakbrook Land Holdings LLC v. Commissioner*, T.C. Memo. 2020-54; *Woodland Property Holdings LLC v. Commissioner*, T.C. Memo. 2020-55; *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019).

[24] IR-2020-130.

[25] CC-2021-001; IR-2020-228.

SCET; (4) received fees for providing legal advice or tax advice for any SCET; (5) received fees for tax return preparation services (including both signing preparers and non-signing preparers) for any SCET; (6) were material advisers for any SCET; (7) were partners in a partnership, or were employees of an entity, who engaged in any of the activities listed above; or (8) were "related" to any of the persons who engaged in any of the activities listed above. To be clear, although the IRS proposed to resolve matters on a partnership-by-partnership basis, partners had to consider all their past behavior, for all partnerships, to determine whether they would be considered category one partners.

By default, category two partners were those who were not category one partners.

6. What was the tax cost?

Under the first settlement initiative, a partnership could not deduct, under section 170 or any other tax provision, any portion of the amount it originally claimed on its tax return for the SCET. Likewise, the partners could not deduct any portion of the amount claimed by the partnership that flowed through to them.

The partnership was obligated to pay the federal income tax liability for each partner, for each year affected by the SCET, calculated as follows. Category one partners could not claim any deduction for contributions of cash or other property to participate in an SCET. In other words, they got a charitable deduction of zero and essentially lost their investment in the partnership. By contrast, category two partners generally could claim an ordinary tax deduction equal to the out-of-pocket costs paid to participate in the SCET, which included both cash and other property contributed in exchange for partnership interests.

7. What was the penalty cost?

The first settlement initiative contemplated accuracy-related penalties. For category one partners, the sanction was the highest penalty asserted by the IRS, either in the notice of final partnership administrative adjustment or by the IRS attorneys later during Tax Court litigation. Generally, this was the 40 percent penalty for "gross valuation misstatement," but the civil fraud penalty of 75 percent sometimes appeared.

For category two partners, the penalty was based on one of three percentages, depending on the return-on-investment ratio. First, if a partner claimed a charitable deduction that was between 1 and 5 times their investment in the partnership that engaged, directly or indirectly, in the SCET, then the penalty was 10 percent of the tax underpayment. Second, if a partner claimed a deduction that was between 5.1 and 8 times their investment in the partnership, then the penalty was 15 percent of the tax underpayment. Third, if a partner claimed a deduction that was more than 8.1 times their investment, then the penalty rose to 20 percent.

The first settlement initiative envisioned further penalties in situations in which Forms 8886, "Reportable Transaction Disclosure Statement," were not submitted to the IRS. The partnership had to provide evidence that it and all its partners filed timely and proper Forms 8886. If any party failed to do so, then the settlement would include a penalty under section 6707A. In the case of listed transactions, like SCETs, the maximum penalty for individual partners was $100,000, while the maximum for entities was $200,000.

8. What was the interest cost?

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

9. When was payment due?

The entire amount (including taxes, penalties, and interest) was due before or when the partnership and its partners submitted executed closing agreements (that is, Form 906, "Closing Agreement on Final Determination Covering Specific Matters") to the IRS.

10. Who signed the closing agreements?

The offer letters stated that the partnership, as well as "all direct and indirect partners," had to execute closing agreements. What did that mean? It is common in SCETs for individual partners to purchase interests in one partnership, which, in turn, makes a capital contribution to the partnership that owns the land and donates the conservation easement. The offer letters indicated that all partners, at all levels, were obligated to execute closing agreements.

11. How were payments treated?

The closing agreements expressly stated that the payments were not refundable. They further indicated that amounts paid under the first settlement initiative were not deductible for federal income tax purposes under any circumstances.

12. Did participation end all problems?

The offer letters emphasized that participation in the first settlement initiative did not affect, limit, or prohibit the IRS from later asserting criminal, promoter, appraiser, return preparer, or other applicable penalties.

13. Was cooperation required?

The partnership and all its partners had to "fully cooperate" with the IRS during the settlement process, which included providing all additional information requested. Cooperation in this scenario encompassed supplying correspondence, emails, communications, and other documentation exchanged between the participating partners and (1) the partnership, (2) other partners, (3) agents or representatives of the partnership, (4) organizers, promoters, or proponents, (5) appraisers, engineers, or others involved with valuing the property, (6) tax return preparers, and (7) tax advisers.[26]

B. Later IRS Guidance

The IRS released additional information about the first settlement initiative four months into things. It came in the form of the chief counsel notice and a second news release.

1. Threats of civil fraud.

The notice warned that if partners decided not to accept the first settlement initiative, they risked getting a charitable deduction of zero, along with potential civil fraud penalties equal to 75 percent of the tax underpayment, "in appropriate cases."[27]

2. Settling without unanimity.

The notice explained that the IRS might consider settling with only a group of partners, as long as that group represented a "significant percentage" of all the ownership interests in the partnership, absolutely all partners in the partnership waived their right to a consistent agreement with the IRS, and the group fully cooperated with the IRS.[28]

3. Consequences of partial participation.

While resolution with unanimity was possible, it triggered a less favorable result for those partners who opted to participate in the first settlement initiative. The notice explained that those participating "must agree to the applicable increased penalty rate," which was 5 percent above the normal rate.[29] 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 first settlement initiative would increase from 10 percent to 15 percent.[30]

4. Take it or leave it.

The notice indicated that the partnership and all participating partners must ultimately memorialize their participation in the first settlement initiative by executing a closing agreement with the IRS, and executing a decision document for the Tax Court.[31] The notice vanquished any thoughts about personalizing terms with the IRS based on unique circumstances. It explained that "no provision of either document [was] subject to negotiation."[32]

5. Full payment required.

The notice was clear that the partnership, or group of participating partners, had to fully pay the settlement amount (consisting of taxes, penalties, and interest) when they executed the closing agreement with the IRS.[33]

6. No finality for category one partners.

The offer letters stated that participation in the first settlement initiative would not have an effect, limitation, or prohibition against the IRS on later asserting criminal penalties, promoter penalties,

[26] CC-2021-001, Q&A D(1)(b).

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

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

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

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

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

[32] *Id.*

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

appraiser penalties, return preparer penalties, and so on. The notice took matters further. First, it contained a broad description of all the activities that might get a person categorized as a category one partner.[34] Next, it said that the partnership or group of participating partners had to "identify all Category One Partners" for the IRS.[35] Finally, the notice warned that executing a closing agreement did "not preclude the IRS from investigating any associated criminal conduct or recommending prosecution for violation of any criminal statute."[36]

V. Reasons for Second Settlement Initiative

The first settlement offer essentially disappeared in early 2021 without any official announcement or other fanfare by the IRS. The consensus is that the IRS halted this initial program because of minimal participation. That makes sense given the terms described above.

Things changed over time, though, as they usually do. After the Tax Court held that the notice making SCETs "listed transactions" violated the Administrative Procedure Act, the IRS issued proposed regulations in December 2022 to rectify matters.[37] The IRS claims that one hallmark of SCETs is that promotional materials offer potential partners the possibility of being allocated a tax deduction that is at least 2.5 times the amount of their capital contributions.[38] Therefore, the proposed regulations provide that if the promotional materials pledge that economic returns might meet or exceed this threshold and satisfy other criteria, an easement donation will be deemed an SCET, and Form 8886 and Form 8918, "Material Adviser Disclosure Statement," filing duties will apply. The proposed regulations go further, stating that the IRS reserves the right to disallow any conservation easement donation, regardless of its size. They state that "no inference should be drawn from [the proposed regulations] regarding the appropriateness of *any* deduction in any specific case, including cases in which the deduction is *less than two and one-half times* the amount of an investor's investment" (emphasis added).[39]

Another major change, also occurring in December 2022, was that Congress introduced new easement-related rules. The SECURE 2.0 Act of 2022[40] added a new standard for donations, section 170(h)(7), which applies to transactions taking place in 2023 or later. The provision generally states that a partnership will not be entitled to any tax deduction if the amount of the conservation easement donation exceeds 2.5 times the total "relevant basis" of the partners in the partnership (2.5 times disallowance rule).[41] To be clear, SECURE 2.0 does not impose a maximum, or limit a deduction to a certain amount. It serves to fully disallow a donation whose value surpasses the threshold. Congress created three carveouts to this new 2.5 times disallowance rule. First, historic preservation easements are not covered, provided that taxpayers satisfy special reporting duties.[42] Second, the 2.5 times disallowance rule is inapplicable when all, or substantially all, the interests in the partnership making the easement donation are held, either directly or indirectly, by "an individual and members of the family of such individual."[43] Third, donations that satisfy a three-year holding period are unaffected.[44]

Change in leadership at the IRS constitutes another important factor. Daniel Werfel, who seemingly had no prior involvement with conservation easement battles, took over as IRS commissioner in March 2023.[45] He announced from the start that his focus would be on "transforming" how the IRS functions, as well as addressing emerging compliance issues, such as

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

[35] *Id.*

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

[37] REG-106134-22; IRS Announcement 2022-28, 2022-52 IRB 659; Joseph DiSciullo, "Proposed Regs Require Reporting of Conservation Easement Deals," *Tax Notes Federal*, Dec. 12, 2022, p. 1565.

[38] REG-106134-22; prop. reg. section 1.6011-9(b)(1).

[39] REG-106134-22, background, Section VI, at 19.

[40] The SECURE 2.0 Act is a component of the Consolidated Appropriations Act, 2023.

[41] SECURE Act 2.0, section 605(a)(1), new section 170(h)(7)(A). The rules apply to subchapter S corporations and other passthrough entities in the same manner as they do to partnerships. *See* SECURE Act 2.0, section 605(b), new section 170(h)(7)(F).

[42] SECURE Act 2.0, section 605(a)(1), new section 170(h)(7)(E) and new section 170(f)(19).

[43] SECURE Act 2.0, section 605(a)(1), new section 170(h)(7)(D).

[44] SECURE Act 2.0, section 605(a)(1), new section 170(h)(7)(C).

[45] IR-2023-45.

massive numbers of potentially improper employee retention credit claims.[46] Conservation easement issues, which developed before his time, do not appear to be a priority.

Another change worth noting is the growing backlog of cases in the Tax Court, resulting from COVID-19 delays, vast numbers of pending cases filed by taxpayers involved in captive insurance and SCETs, inadequate staffing, and other factors.[47] To put things into perspective, the Appeals Office cleared approximately 7,500 pending Tax Court cases in 2022 alone.[48]

VI. Terms of 2024 Settlement Initiative

Logic dictates that the preceding factors, and perhaps others, led the IRS to issue the second settlement initiative for SCETs in early 2024. Unlike the first settlement initiative, the IRS did not broadcast its most recent approach through news releases, notices, and the like. Instead, the IRS began sending letters to essentially all SCET cases pending in the Tax Court.[49]

A. Description of the Terms

The main terms of the second settlement initiative are as follows. The IRS effectively makes partners pretend that they made a cash donation to the Red Cross or some other acceptable charity instead of making a capital contribution to an SCET partnership. For example, assume that a partner made a capital contribution of $100,000 to a partnership and expected to receive a charitable donation tax deduction of $500,000. Under the second settlement initiative, the partner would essentially have to recalculate their income tax liability for all relevant years, claiming a total deduction of only $100,000.[50] This represents a decrease of $400,000. This decline likely would result in significant federal income taxes for the partner, perhaps over multiple years.

The IRS would then impose a penalty equal to 10 percent of the total federal income tax liability after removing $400,000 in deductions, as described above.

Lastly, the IRS would impose interest charges, not only on the federal income taxes owed, but also on the 10 percent penalty. The interest charges are retroactive in the sense that they started running years ago. For instance, if the conservation easement donation occurred in 2018, then the interest started accruing against an individual partner in early 2019.

B. Silence on State Tax Issues

The second settlement initiative focuses solely on federal income tax issues, which is logical. However, partners who decide to settle with the IRS likely will owe corresponding state amounts, too. Take partners residing in Georgia. State law requires taxpayers with changes at the federal level (caused by filing amended returns, getting audited, participating in settlements, going to Tax Court, etc.) to file corrected state tax returns with the Georgia Department of Revenue within a certain period and pay the resulting amounts.[51] If taxpayers fail to do this voluntarily, the assessment period essentially remains open forever, penalties and interest continue to accrue, the IRS eventually informs Georgia about the partners under a federal-state agreement, and Georgia imposes a liability using the figures supplied by the IRS.[52]

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[46] *See, e.g.*, Testimony of IRS Commissioner Daniel Werfel before the House Appropriations Committee on IRS operations and funding (June 3, 2013); IRS conference spending (June 6, 2013); improvements in IRS operations (Sept. 18, 2013); and IRS operations (Oct. 24, 2023).

[47] Andy Keyso and Lia Colbert, "Memorandum for All Independent Office of Appeals Employees" (Apr. 19, 2022); Joel G. Cohen, "IRS Appeals Has a Solution to Its Tax Court Backlog," *Tax Notes Federal*, June 6, 2022, p. 1587.

[48] Nathan J. Richman, "Appeals Learned Some Things While Clearing Docketed Case Backlog," *Tax Notes Federal*, Mar. 13, 2023, p. 1805.

[49] The author has dozens of these letters on file.

[50] Section 67(a) generally states that an individual taxpayer can only claim itemized deductions to the extent that the total exceeds 2 percent of their adjusted gross income. The settlement offers from the IRS indicate that this limitation will not apply in these circumstances.

[51] 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.

[52] Ga. Code Ann. section 48-7-82(e)(1). This provision states that Georgia can make a state tax assessment based on the change or correction at the federal level within five years of receiving a report from the IRS.

C. Comparing Settlements

The second settlement initiative differs from the first in several important ways. First, it makes no mention of only a group of partners resolving a case — the letters refer to the partnerships as a whole. Second, it does not indicate any restrictions based on the fact that one or more partners are under criminal investigation. Third, and perhaps most notably, it does not feature disparate tax and penalty treatment for category one partners and category two partners, meaning that all partners, regardless of their role with the SCET, can resolve matters with the IRS on the same conditions. Fourth, the accuracy-related penalties are fixed at 10 percent of the tax liability, and they do not increase to 15 percent or 20 percent in situations in which the partners were expecting a higher return-on-investment ratio. Fifth, it contains no threats of separate penalties for unfiled Forms 8886. Sixth, it contemplates resolution by filing a decision document with the Tax Court, while being silent about any obligation of the partnership or partners to execute closing agreements with the IRS, too. Seventh, there is no explicit statement that concluding matters under the second settlement initiative does not prevent the IRS from later asserting criminal, promoter, appraiser, return preparer, or other penalties. This is not necessary, though. Eighth, it does not impose on the partners any "cooperation" duties, such as the need to supply the IRS with copies of all communications, paper and electronic, related to the partnership or easement in any way. Finally, the letters from the IRS issued as part of the second settlement initiative do not demand that the partnership pay the entire liability (made up of taxes, penalties, and interest) at the time it signs a decision document. One would surmise, therefore, that partners might be able to negotiate a payment plan, called an installment agreement, if their financial situation warrants it.

D. What the IRS Considers a Carrot

Based on the tax regulations, case law, administrative rulings, and appraisal standards, partnerships generally argue that the value of a conservation easement should be based on the HBU of the property. They further contend that the property was not being put to its HBU when the partnership acquired it, thereby explaining the low price. The IRS, on the other hand, normally maintains that the property was at its HBU when the partnership obtained it, the value should be determined by considering "comparable sales," or the price that the partnership paid to acquire the property shortly before the easement donation is the best indicator of worth.

The second settlement offer allows partners to claim a tax deduction equal to the capital contributions they made to the partnership. The capital contributions made by the partners tend to be higher than the property-acquisition price paid by the partnerships. This is because due diligence costs, professional fees, commissions, and other amounts are deducted from the former. The second settlement offer also does not decrease the overall easement amount by applying the "after" value to the analysis. At the end of the day, though, the proposed deduction under the second settlement initiative usually is a small percentage of the deduction claimed by the partnerships on their tax returns; the figure often ranges between 15 and 25 percent. Finally, instead of threatening partners with a penalty equal to 40 percent of the tax liability for a gross valuation misstatement or possibly a penalty of 75 percent for fraud, the second settlement offer features a universal sanction of 10 percent.

VII. Conclusion

The first settlement initiative in 2020 got very little traction. However, certain partnerships might be tempted to participate in the second settlement initiative. Potential participants might include (1) partnerships with serious technical flaws in their deeds, baseline reports, Forms 8283, tax returns, or other key documents, which could lead to a deduction of zero; (2) partnerships that obtain expert valuation reports in preparation for trial and discover that the original appraisal, on which the tax deduction was based, was radically inflated and unsupportable; (3) partnerships that have insufficient funds, insurance, marketable assets, or other sources to pay attorneys, expert witnesses, and other trial-related costs; (4) partnerships whose key witnesses are unable or unwilling to testify; and (5) partnerships whose partners are fatigued by the multiyear fighting with the IRS and simply want to throw in the proverbial towel, even though doing so might not render them the best overall financial result.

It is too early to tell how many partnerships will avail themselves of the second settlement initiative, but participation levels are not the most interesting aspect here. What should be remarkable to all taxpayers and tax professionals, even those with no link whatsoever to SCETs, is what the IRS might be jeopardizing with its recent maneuver. The second settlement initiative is more beneficial to taxpayers than the first settlement initiative in various ways. Among other things, all taxpayers (including both category one partners and category two partners) get identical treatment; the accuracy-related penalty is always 10 percent of the tax liability regardless of the return-on-investment ratio; penalties for unfiled Forms 8886 are not imposed; extensive cooperation duties are not mandated; and partners are not required to pay the IRS all taxes, penalties, and interest when they conclude Tax Court litigation by filing a decision document.

By introducing the second settlement initiative, the IRS appears to be breaking one of the major rules of tax enforcement — that is, the IRS should not offer one deal to taxpayers and then offer them a better deal later. Why? If taxpayers believe they can achieve a more favorable result with the IRS by simply waiting, they will be disinclined to participate in settlement programs, and the effectiveness of those programs will plummet. Perhaps more importantly, if tax professionals think that holding strong will generate a superior result with the IRS, they likely will advise their clients accordingly. Time will tell whether the short-term goal of resolving some portion of the pending SCETs cases through the second settlement initiative was worth the risk of undermining future IRS settlement programs. ■