COMPARING FEDERAL AND STATE PROPOSALS FOR RESOLVING CONSERVATION EASEMENT DISPUTES

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Federal income tax disputes regarding SCETs rage on — many federal partnership-level disputes likely will not end for years.

The IRS has been attacking partnerships that participate in what it calls syndicated conservation easement transactions ("SCETs") for more than half a decade. The partnerships generally conduct significant amounts of predonation due diligence for each property, fully disclose the donations to the IRS on various tax and information returns, hire and rely on a long list of experts in various fields, and do their best to comply with all rules found in Section 170, the corresponding tax regulations, published IRS rulings, court decisions, and other sources of guidance. This reality often leads to prolonged audits, administrative appeals, Tax Court trials, and appellate litigation. Such disputes have a huge cost — not only to the partnerships, but also to the IRS and the entire judicial system. For instance, even after diverting lots of personnel to its multiyear compliance campaign aimed at SCETs, the IRS recently acknowledged that it was still severely understaffed and intended to spend even more to hire, integrate, and train 200 additional experienced attorneys.[1]

At this juncture, it is worthwile reviewing alternative solutions by the IRS and state tax authorities for resolving SCET cases. This article analyzes the conservation easement donation process, the role of a qualified amended return ("QAR"), a prior settlement initiative offered by the IRS, and the current approach for partners in California.

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Overview of conservation easement donations

To grasp the issues addressed in this article, readers first need to understand the basics of conservation easement donations.

Taxpayers who own undeveloped real property have several choices. They might (1) hold the property for investment purposes, hoping it appreciates significantly in value; (2) determine how to maximize profitability from the property and do that regardless of negative effects on the local environment, community, or economy; or (3) voluntarily restrict certain future uses of the property, such that it is protected forever for the benefit of society. The third option, known as donating a "conservation easement," not only achieves environmental protection, but it also triggers tax deductions for donors.[2]

Taxpayers cannot place an easement on just any property and claim a tax deduction; they must demonstrate that the property has at least one ac-

ceptable "conservation purpose."[3] Common purposes include preserving land for public recreation or education, safeguarding a relatively natural habitat for plants and animals, maintaining open space for scenic enjoyment by the public, and utilizing property pursuant to a government conservation policy.[4]

Taxpayers memorialize the donation by filing a deed of conservation easement or similar document ("deed"). In preparing the deed, taxpayers often coordinate with a land trust to identify certain limited activities that can continue on the property after the donation, without prejudicing the conservation purposes.[5]

The IRS will not allow the tax deduction stemming from a conservation easement, unless the taxpayer obtains, shortly before making the donation, documentation establishing the condition and characteristics of the property ("baseline report").[6]

The value of the conservation easement is the fair market value ("FMV") of the property at the time of the donation.[7] The term FMV ordinarily means the price on which a willing buyer and willing seller would agree, if neither party were obligated to participate in the transaction, and if both parties had reasonable knowledge of the relevant facts.[8] The best evidence of the FMV of an easement would be the sale prices of other conserved properties that are comparable in size, location, and so forth. The IRS recognizes, however, that it is difficult, if not impossible, to find them.[9] Consequently, appraisers often must use the before-and-after method instead. This means that they must determine the highest and best use ("HBU") of the property *and* the corresponding FMV twice. First, the appraisers calculate the FMV as if the property had been put to its HBU, which generates the "before" value. Second, the appraisers identify the FMV, taking into account the serious restrictions on the property imposed by the conservation easement, which creates the "after" value.[10] The difference between the "before" and "after" values of the property, with certain adjustments, produces the amount of the donation.

Claiming the tax deduction from an easement donation is surprisingly complicated. It involves a significant amount of actions and documents. Among other things, the taxpayer must obtain a qualified appraisal from a qualified appraiser, demonstrate that the land trust is a qualified organization, obtain a baseline report, complete a Form 8283 (noncash charitable contributions), file a timely Form 1065 (U.S. return of partnership income) with all necessary enclosures and disclosures, and receive a written acknowledgment of the donation from the land trust.[11]

QARs

To compare and contrast the settlement methods used by the IRS and the California Franchise Tax Board ("FTB"), readers also must have some knowledge about QARs.

Overview of relevant law. In situations where a tax underpayment is attributable to one of several things, the IRS generally can assert an accuracy-related penalty equal to a percentage of the underpayment.[12] The standard penalty is 20 percent of the underpayment amount.[13] However, in certain cases — such as when the underpayment results from a "gross valuation misstatement" — the penalty increases to 40 percent.[14] An important exercise, therefore, is defining an "underpayment" in this context.

A little-known mechanism exists whereby a taxpayer can reduce or eliminate the tax "underpayment" after filing the original Form 1040 with the IRS. This is called a QAR.

In the case of an individual taxpayer, an "underpayment" generally means the difference between the tax liability that the taxpayer reported on his Form 1040 (U.S. Individual Income Tax Return) and the tax liability he should have reported, if he

1 IR-2022-17 (Jan 21, 2022).

2 Section 170(f)(3)(B)(iii); Treas. Reg. Section 1.170A-7(a)(5); Section 170(h)(1); Section 170(h)(2); Treas. Reg. Section 1.170A–14(a);Treas. Reg. Section 1.170A–14(b)(2).

3 Section 170(h)(4)(A); treglink>; S. Rept. 96–1007, at 10 (1980).

4 *Ibid.*, Section 170(h)(4)(A), Treas. Reg. Section 170A–14(d)(1).

5 IRS Conservation Easement Audit Techniques Guide (Rev. Nov 4, 2016): 23; see also Treas. Reg. Section 1.170A-14(b)(2); Treas. Reg. Section 1.170A-14(e)(2) and (3).

6 Treas. Reg. Section 1.170A-14(g)(5)(i).

7 Section 170(a)(1); Treas. Reg. Section 1.170A-1(c)(1).

8 Treas. Reg. Section 1.170A-1(c)(2).

9 IRS Conservation Easement Audit Techniques Guide (Rev. Jan 24, 2018): 43.

10 *Ibid*.

11 *Op. cit.* note 9, p. 24–31; "Charitable contributions — substantiation and disclosure requirements," IRS Publication 1771. Available at: https://www.irs.gov/pub/irs-pdf/p1771.pdf; "Charitable contributions," IRS Publication 526. Available at: https://www.irs.gov/pub/irs-pdf/p526.pdf; Section 170(f)(8); Section 170(f)(11); Treas. Reg. Section 1.170A-13; Notice 2006-96; TD 9836.

12 Section 6662(a).

13 Section 6662; Section 6662(b).

14 Section 6662(h).

had completed his Form 1040 correctly.[15] For instance, where the taxpayer's true tax liability was $100,000 but he only reported $80,000 on his Form 1040, then the IRS ordinarily could assert a penalty of $4,000 (i.e., a $20,000 tax understatement multiplied by 20 percent).[16]

A little-known mechanism exists whereby a taxpayer can reduce or eliminate the tax "underpayment" *after* filing the original Form 1040 with the IRS. This is called a QAR. In essence, if a taxpayer files a Form 1040 and later realizes that it showed an improperly low tax liability, he might have a limited opportunity to submit a QAR to rectify the situation. The purpose of the original QAR rules was "to encourage voluntary compliance by permitting taxpayers to avoid accuracy-related penalties by filing a [Form 1040X] before the IRS begins an investigation of the taxpayer or the promoter of a transaction in which the taxpayer participated."[17]

According to the regulations, for purposes of determining the applicability or size of accuracy-related penalties, the tax liability shown on the original Form 1040 includes the amount of additional tax reflected on the QAR.[18] Modifying the basic example noted previously, if the taxpayer filed a Form 1040 showing a tax liability of $80,000 but subsequently submitted a QAR indicating a revised liability of $100,000 and a payment of $20,000, then no "underpayment" would exist, and the IRS would thus have no grounds for asserting an accuracy-related penalty. It is important to note, however, that the ability to eliminate an underpayment by filing a QAR is unavailable where the position taken on the Form 1040 triggering the underpayment was fraudulent.[19]

Meeting the QAR parameters. One of the biggest challenges for taxpayers is convincing the IRS and/or the courts that the Form 1040X (Amended U.S. Individual Income Tax Return) that they file constitutes a QAR.[20] A Form 1040X ordinarily will *not* be a QAR, unless the taxpayer files it *before* any of the following:[21]

- the date on which the IRS contacts the taxpayer concerning a civil examination or criminal investigation with respect to the relevant Form 1040;[22]
- the date on which the IRS contacts "any person" concerning a tax shelter "promoter" investigation under Section 6700 for an activity with respect to which the taxpayer claimed any tax benefit on his Form 1040 directly, or indirectly through an entity, plan, or arrangement;[23]
- in the case of items attributable to a pass-through entity (e.g., partnership), the date on which the IRS first contacts the entity in connection with a civil examination of the relevant return, such as Form 1065;[24]
- the date on which the IRS serves a summons relating to the tax liability of a person, group, or class that includes the taxpayer (or a pass-through entity of which the taxpayer is a partner) with respect to an activity for which the taxpayer claimed any tax benefit on his Form 1040, directly or indirectly; and[25]
- the date on which the IRS announces a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction, and the taxpayer participated in the listed transaction during the relevant year.[26]

Sample court decisions. Decisions refusing to classify particular Forms 1040X as QARs abound.[27] For instance, in *Perrah v. Commissioner*, the Tax Court rejected QAR status because the Forms 1040X were filed after the IRS had commenced an examination

[15] Section 6664(a); Treas. Reg. Section 1.6664-2(a). The definition of "underpayment" is considerably more complicated, but a simplified and abbreviated version suffices to make the critical points in this article, without unnecessarily confusing the reader.

[16] Section 6664(c)(1). Penalties would not apply if the "underpayment" is due to "reasonable cause" and the taxpayer acted in good faith.

[17] T.D. 9186 (Mar 2, 2005), Preamble, Background.

[18] Treas. Reg. Section 1.6664-2(c)(2).

[19] *Ibid*.

[20] To follow the evolution of the QAR criteria, see: TD 8381 (Dec 31, 1991), Notice 2004-38 (May 24, 2004), TD 9186 (Mar 2, 2005), and TD 9309 (Jan 9, 2007).

[21] Treas. Reg. Section 1.6664-2(c)(3)(i).

[22] Treas. Reg. Section 1.6664-2(c)(3)(i)(A).

[23] Treas. Reg. Section 1.6664-2(c)(3)(i)(B); *Op. cit.* note 17 Preamble, Explanation of Provisions (stating that these criteria apply "regardless of whether the IRS ultimately establishes that such person violated Section 6700").

[24] Treas. Reg. Section 1.6664-2(c)(3)(i)(C).

[25] Treas. Reg. Section 1.6664-2(c)(3)(i)(D)(1).

[26] Treas. Reg. Section 1.6664-2(c)(3)(i)(E); an expanded set of criteria applies in situations involving an "undisclosed listed transaction," which means one that is the same as, or substantially similar to, a listed transaction, and which was not revealed to the IRS on a Form 8886. See Treas. Reg. Section 1.6664-2(c)(3)(ii).

[27] See, for example, *Perry v. Commissioner*, T.C. Memo 2016-172 (taxpayer filed relevant Form 1040X after the IRS notified her of an examination); *Planty v. Commissioner*, T.C. Memo 2017-240 (taxpayer filed Form 1040X after start of examination); *Scully v. Commissioner*, T.C. Memo 2013-229 (taxpayer filed Forms 1040X and otherwise changed tax positions during the trial); *Sampson v. Commissioner*, T.C. Memo 2013-212 (taxpayer filed relevant Forms 1040X after the IRS notified him of an examination).

[28] *Perrah v. Commissioner*, T.C. Memo 2002-283.

[29] *Wilkerson v. Commissioner*, T.C. Summ. Op. 2004-99.

[30] *Bergmann v. Commissioner*, 137 T.C. 136 (2011).

[31] For details regarding the evolution of the settlement initiative, see: Sheppard, H.E., Questions remain about the conservation easement settlement initiative, *Tax Notes Federal* 168, no. 12 (Sept 21, 2020):

of the taxpayer.[28] Likewise, in *Wilkerson v. Commissioner*, the Tax Court refused to classify Forms 1040X as QARs when the taxpayer filed them with the appeals office after the IRS issued a notice of deficiency and after the taxpayer filed a petition with the Tax Court.[29] Finally, in *Bergmann v. Commissioner*, 137 T.C. 136 (2011), the Tax Court held that the taxpayer had not filed QARs because by the time the Forms 1040X reached the IRS, it had already started a promoter investigation and issued summonses related to the pertinent transactions and years.[30]

Efforts by the IRS to settle cases

After prevailing in several early Tax Court cases on "technical" issues (i.e., supposed flaws with deeds, baseline reports, qualified appraisals, Forms 8283, and other documentation associated with easement donations), the IRS tried to capitalize on its momentum. It did so by introducing a settlement initiative in June 2020.[31]

The IRS first described the settlement initiative through a news release and by sending offer letters to eligible partnerships.[32] The initial guidance from the IRS had several holes. The IRS tried to plug those by publishing a Chief Counsel Notice ("Notice"), along with the second news release.[33] Important aspects of all such IRS guidance is summarized as follows.[34]

Eligibility standards. The IRS initially explained that the settlement initiative only applied to cases that were "docketed" with the Tax Court; that is, those cases for which petitions had already been filed with the Tax Court. Stated another way, the settlement initiative did not apply to partnerships that donated an easement but were not yet under audit, partnerships 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."[35] However, the IRS cautioned that it would consider "a number of factors" in determining whether a particular partnership merited this preferential treatment, including whether the partnership, its partners, and representatives cooperated during the audit. The IRS also warned that just because a partnership that becomes "docketed" in the future gets 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."[36]

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 Notice that the IRS "might consider" offers from those partners who were not personally being scrutinized criminally.[37]

Unanimous participation. The IRS began by resolutely stating that the settlement initiative generally was only open 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 where fewer than all partners in the partnership agreed to enter into the settlement. The IRS admonished, however, that it in such situations "greater penalties" might be imposed against the partners.[38]

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.

The Notice later exhibited some flexibility from the IRS. It revealed that the IRS might consider settling with just a group of partners, as long as (1) the group represented a "significant percentage" of all the ownership interests in the partnership, (2) absolutely all partners in the partnership, even those refusing the settlement initiative, waived their right

2219–2228. Available at: https://www.chamberlainlaw.com/assets/htmldocuments/Questions%20Remain%20about%20CE%20Settlement%20Initiative.pdf; Sheppard, H.E., Conservation easement settlement: More guidance, more questions, *Tax Notes Federal* 169, no. 7 (Nov 16, 2020): 1085–1098. Available at: https://www.chamberlainlaw.com/assets/htmldocuments/CE%20settlement%20initiative%20-%20more%20IRS%20guidance%20more%20uncertainty.pdf.

32 IRS information release 2020-130 (June 25, 2020).

33 IRS Chief Counsel Notice CC-2021-001 (Oct 1, 2020); IRS news release IR-2020-228 (Oct 1, 2020); IRS provides more details on conservation easement initiative, *Tax Notes Today Federal* 191-32 (Oct 1, 2020).

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

35 *Op. cit.* note 33 Question and Answer B(5).

36 *Ibid*.

37 *Op. cit.* note 33 Question and Answer B(1).

38 *Ibid*.

to a consistent agreement with the IRS, and (3) the group cooperated with the IRS by supplying all requested information and documentation.[39]

Disparate treatment. The offer letters from the IRS described two types of partners, as follows.

Category One Partners were those who engaged in any of the following activities or who 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 in *any* 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) was a recipient of a conservation easement or a fee simple property interest in *any* SCET; (7) was a "material advisor" with respect to *any* SCET; (8) was a partner in a partnership, or was an employee of an entity, that engaged in any of the activities listed previously when he participated in the SCET; or (9) was "related" to *any* of the persons that/who engaged in *any* of the activities listed previously. Accordingly, partners were forced to consider *all* their past behavior, with respect to *all* partnerships, to determine whether the IRS would deem them Category One Partners.

By default, Category Two Partners were those who were *not* Category One Partners.

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. These elements are further described as follows.

First cost—taxes: Under the settlement initiative, the partnership could not deduct, under Section 170 or any other tax provision, any of the charitable deduction that it originally claimed on its Form 1065 with respect to the SCET. Likewise, the partners were prohibited from deducting on their Forms 1040 the allocation of the charitable deduction that flowed through to them.

The partnership had 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, Category One Partners got a charitable deduction of $0 and 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 money and other property contributed in exchange for partnership interests.

Second cost—penalties: The partnership had to aggregate all penalties, for all partners, for all affected years, in calculating the settlement amount.

The settlement initiative contemplated accuracy-related penalties.[40] For Category One Partners, the highest penalty that the IRS asserted in the Notice of Final Partnership Administrative Adjustment or the highest penalty asserted by the IRS attorney later during Tax Court litigation would apply. Generally, this was the 40 percent penalty for "gross valuation misstatement."[41]

With respect to Category Two Partners, the accuracy-related penalty depended on the return on investment (ROI) ratio. First, if the partner claimed a charitable deduction that was between 1.0 and 5.0 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 and 8.0 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 attempted to pressure all partners to the table by creating rules that prejudiced participating partners in situations where not all their colleagues were willing to settle. The Notice explained that partners participating in the settlement initiative had to agree to a penalty increase of 5 percent where unanimity was lacking.[42] For instance, if a partner acquired an interest in a partnership that engaged in an SCET with a ROI ratio of 4.5 to 1, then the penalty under the settlement initiative would increase from 10 percent to 15 percent.[43] The IRS then hedged somewhat in the Notice, acknowledging that it might not insist on the increased penalty in cases with "extraordinary circumstances."[44] The IRS did not provide examples of what it might deem "extraordinary," of course.

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

Full payment. The 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 (consisting

of taxes, penalties, and interest) when they execute the Form 906 (closing agreement), for the IRS and the decision document for the Tax Court.[45] The Notice also specified the only acceptable mode of payment, which was a check payable to the "United States Treasury."[46]

No modifications. The Notice quelled any thoughts about partnerships and partners personalizing terms with the IRS, based on their supposedly unique circumstances. Indeed, the Notice explained that "no provision" of the Form 906 or decision document "was subject to negotiation."[47]

Unresolved issues. The offer letters emphasized that participation in the settlement initiative would not have an effect, limitation, or prohibition against the IRS on later asserting criminal penalties, promoter penalties, appraiser penalties, return preparer penalties, discipline under Circular 230, or any other penalty. If that was not clear enough, the offer letters went 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]."[48]

Ongoing cooperation. The partnership and the partners also had to commit to "fully cooperate" with the IRS. Cooperation in this scenario included, but was not limited to, supplying the IRS with following items designed to facilitate audits and/or investigations of others involved with SCETs: 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 advisors.[49]

Uneventful end. The IRS introduced the settlement initiative with gusto but later eliminated it discreetly, without an announcement or fanfare. To the best of the author's knowledge, the IRS simply stopped sending offer letters to partnerships at some point in 2021, leaving many to speculate that such an abrupt termination was attributable to the low level of participation by partnerships and partners. The IRS certainly would not want those types of statistics surfacing, as this would undermine its aggressive enforcement actions.

Impossible eligibility. Before the IRS unveiled the settlement initiative in June 2020, it encouraged individual partners in partnerships that engaged

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in SCETs to resolve their issues with the IRS by filing a QAR. Specifically, in a news release disseminated about six months before the appearance of the settlement initiative, the IRS commissioner directed taxpayers to file QARs, with insinuations of penalty mitigation in exchange for full, voluntary concessions by taxpayers of all tax benefits:

> 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*. Our continued use of ever-changing technologies would suggest that waiting is not a viable option for most taxpayers . . . *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.*[50]

[39] *Op. cit.* note 33 Chief Counsel Notice CC-2021-001 Question and Answer B(2).

[40] The settlement initiative also contemplated penalties for situations where the partnership and/or certain partners failed to file Forms 8886. The IRS provided the following guidelines in this regard: (1) The partnership had to provide evidence that the partnership and all of its partners filed timely and proper Forms 8886; and (2) if any party failed to do so, the settlement amount would include a penalty under Section 6707A.

[41] IRM 8.19.12 Final Partnership Administrative Adjustment (April 19, 2016).

[42] *Op. cit.* note 33 Chief Counsel Notice CC-2021-001 Question and Answer B(3).

[43] *Ibid.*, Question and Answer B(3) and C(7)(b).

[44] *Op. cit.* note 33 Chief Counsel Notice CC-2021-001 Question and Answer B(3).

[45] *Ibid.*, Question and Answer F(1).

[46] *Op. cit.* note 33 Chief Counsel Notice CC-2021-001 Question and Answer F(1).

[47] *Ibid.*, Question and Answer E(1)(a).

[48] *Op. cit.* note 33 Chief Counsel Notice CC-2021-001.

[49] *Ibid.*, Question and Answer D(1)(b).

[50] "IRS increases enforcement action on syndicated conservation easements," IR-2019-182 (Nov 12, 2019) (emphasis added) (press release). Available at: https://www.irs.gov/newsroom/irs-increases-enforcement-action-on-syndicated-conservation-easements; see also "IRS continues enforcement efforts in conservation easement cases following latest Tax Court decision," IR-2019-213, (Dec 20, 2019) (emphasis added) (press release). Available at: https://www.irs.gov/newsroom/irs-continues-enforcement-efforts-in-conservation-easement-cases-following-latest-tax-court-decision.

This is a fine sentiment, indeed. The problem, however, is that the actions by the IRS made it impossible for many individual taxpayers to file Forms 1040X that met the QAR standards. This resulted from the ongoing compliance campaign, pursuant to which the IRS is (1) attempting to audit every single SCET; (2) pursuing promoters, appraisers, return preparers, material advisors, accommodating entities, charitable organizations, and others; (3) making referrals to the Office of Professional Responsibility; (4) raising a long list of technical arguments in disputes, while constantly trying to develop more; (5) asserting all possible civil penalties; (6) conducting simultaneous civil examinations and criminal investigations; and (7) litigating hundreds of cases in Tax Court.[51] As explained previously, a Form 1040X ordinarily will *not* be a QAR unless the taxpayer files it *before* the IRS contacts that taxpayer about a civil examination or criminal investigation; *before* the IRS contacts any person about a "promoter" investigation; *before* the IRS contacts the partnership that donated the conservation easement; *before* the IRS issues a summons related to an SCET; and *before* the IRS announces something like the settlement initiative.[52]

While the compliance campaign might have dashed the possibility for many partners of filing Forms 1040X, all is not lost. The regulations expressly state that the IRS commissioner, via a revenue procedure, may "prescribe the manner in which the rules . . . about [QARs] apply to particular classes of taxpayers."[53] Thus, the IRS commissioner seemingly could exercise his discretion to publish special guidance enumerating the conditions under which Forms 1040X filed now by individual partners will be treated as QARs, notwithstanding actions taken by the IRS as part of its compliance campaign. This has not occurred.

Efforts by California to settle cases

The settlement initiative only addressed federal income tax and corresponding matters (i.e., issues with the IRS); it did *not* cover state income tax issues. In other words, while participation in the settlement initiative allowed a partnership and its partners to rectify federal income taxes related to an SCET, it did not resolve 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 and decision documents. Moreover, many states, like Georgia and California, have laws requiring taxpayers to file amended state income tax returns within a limited amount of time when changes occur at the federal level.[54]

Many states are content to allow the IRS to do the heavy lifting and then benefit, with little to no effort, after the partners start filing amended state income tax returns to reflect the outcome with the IRS. However, 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.[55]

California introduced rules in 2018 to conform, to a certain degree, to the federal partnership-level audit rules enacted by Congress as part of the Bipartisan Budget Act, which took effect in 2018.[56] Such rules provide certainty regarding how federal partnership audit adjustments affect California income tax liabilities, the related reporting obligations to the FTB, and the elections available. However, the rules did not otherwise change the normal procedures in California applicable to audits of partnerships or individual partners.[57]

Relevant California rules. The following is a peek at some of the relevant California rules:

Shared definition: Any item that the IRS identifies as a "listed transaction," such as an SCET, will be one for California purposes, too.[58]

Form 8886 for participants: Generally, participants in a reportable transaction, including listed transactions, must attach a Form 8886 (Reportable Transaction Disclosure Statement) to their original California income tax return for each taxable year in which they participate in a reportable transaction. Additionally, a participant must also mail a copy of a Form 8886 to the abusive tax shelter unit ("ATSU") of the FTB for the initial year of participation.[59] Failure to file timely, complete Forms 8886 triggers a penalty of $15,000 per violation, which increases to $30,000 in situations involving listed transactions.[60]

Form 8918 for material advisors: Material advisors normally must file a Form 8918 (Material Advisor Disclosure Statement) with the ATSU. This duty applies to any material advisor who (1) is organized in California; (2) conducts business in California; (3) derives income from sources in California; or (4) provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out a reportable transaction to a taxpayer who is organized in California, does business in California, or derives income from sources in California.[61] Failure to comply with Form 8918 duties triggers penalties. The standard penalty is $50,000. In situations

involving a listed transaction, the penalty increases to a larger amount of $200,000, or 50 percent of the material advisor's gross income for aid, assistance, or advice provided with respect to the transaction.[62]

Amended returns: Taxpayers must rectify matters with the FTB if there is a change at the federal level, because of a dispute with the IRS, or because of voluntarily filing a Form 1040X. Specifically, the law requires taxpayers to file an amended California income tax return within six months of the federal event.[63] If taxpayers ignore this obligation, the FTB can send a notice of proposed deficiency resulting from a federal adjustment "at any time."[64]

Extended assessment periods: There is an extended assessment period in cases involving an abusive tax avoidance transaction ("ATAT"), which includes a tax shelter, reportable transaction that is not properly disclosed on Form 8886, listed transaction, *or* transaction lacking economic substance.[65] As SCETs are listed transactions, they are considered ATATs for California purposes. If a taxpayer participates in an ATAT, the FTB has 12 years from the time that the taxpayer files the relevant California income tax return to issue a notice of proposed deficiency.[66]

Letters to individual partners. The FTB has started sending letters to individual partners, who are California residents and who supposedly claimed federal income tax deductions stemming from an SCET on their Forms 1040.[67] Why does the FTB care? Well, claiming such deductions lowers the federal adjusted gross income of the partners, which is the starting point for completing the Form 540 (California Resident Income Tax Return) and determining the state income tax liability.

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 state 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 several 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.[68]

The FTB warns in the letters that it is increasing enforcement activity regarding SCETs, which includes deploying several teams to start additional examinations. The FTB further admonishes that such examinations might result in a tax deduction of $0,

The problem, however, is that the actions by the IRS made it impossible for many individual taxpayers to file Forms 1040X that met the QAR standards.

plus a long list of penalties, including the noneconomic substance transaction understatement penalty, reportable transaction penalty, accuracy-related penalty, and interest-based penalty.[69] Finally, it ominously reminds partners that the FTB has 12 years after a taxpayer files a Form 540 to audit and propose additional taxes, penalties, and interest related to SCETs, as they supposedly constitute ATATs.[70]

The FTB then offers the following general advice 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."[71]

51 Richman, N.J., Multiple divisions coming for syndicated conservation easements, *Tax Notes Today* (Nov 13, 2019): 220–223; Hoffman, W., Conservation easement crackdown a portent, Rettig says, *Tax Notes Today* (Nov 14, 2019) 221–229; Parillo, K.A., IRS is building up its easement toolbox, *Tax Notes Today* (Nov 15, 2019): 222–226; Parillo, K.A., IRS looking for promoter links as easement crackdown grows, *Tax Notes Today*, Doc. 2019-47134 (Dec 13, 2019).

52 *Op. cit.* note 21.

53 Treas. Reg. Section 1.6664-2(c)(4)(ii).

54 O.C.G.A. Section 48-7-82(e)(1); California Revenue and Taxation Code Section 18622.

55 The author of this article does not hold a license to practice law in California, does not practice law in California, and is not opining or advising on California law by publishing this article. Readers should engage California legal counsel if they must confirm or update any information in this article, obtain a legal opinion about any issue raised in this letter, get any guidance on which they can rely regarding California law, and/or deal with the FTB.

56 Bipartisan Budget Act of 2015, Public Law 114-74 (Nov 2, 2015); California Senate Bill 274 (Sept 23, 2018).

57 *Ibid*., California Senate Bill 274.

58 California Chief Counsel Announcement 2003-1 (Dec 31, 2003).

59 California Revenue and Taxation Code Section 18407.

60 California Revenue and Taxation Code Section 19772.

61 California Revenue and Taxation Code Section 18628; Franchise Tax Board Notice 2005-7 (Dec 3, 2005).

62 California Revenue and Taxation Code Section 19182.

63 *Op. cit.* note 54 California Revenue and Taxation Code.

64 California Revenue and Taxation Code Section 19060(a).

65 California Revenue and Taxation Code Section 19753.

66 California Revenue and Taxation Code Section 19755(a)(2).

67 Letter AUD 1521 PASS (Rev. 09-2016).

68 *Ibid*.

69 *Op. cit.* note 65 (citing California Revenue and Taxation Code Sections 19774, 19164.5, 19164, and 19777).

70 *Ibid*.

71 *Op. cit.* note 65.

The letters then underscore two potential solutions. First, if a partner has decided not to claim deductions or other tax benefits related to SCETs on Forms 540 in the future, he must send a letter to the FTB identifying the prior years for which he claimed benefits and enclosing a sworn declaration.

While participation in the settlement initiative allowed a partnership and its partners to rectify federal income taxes related to an SCET, it did not resolve past issues with any state tax authority.

The FTB states that it will "take into account" whether the partner actually sends such a letter when "deliberating" potential compliance actions.[72] Second, in situations where a partner is interested in not only avoiding future issues but also rectifying past issues on preferable terms, he can file amended Forms 540, erasing any previous deductions or other benefits related to SCETs. The letters clarify that these returns will be considered QARs, such that the partner would eliminate penalty exposure. Avoiding any chance for confusion in this regard, the letters dangle the following carrot: "If you plan to file [QARs] we will not assess the penalties discussed in this letter."[73]

The timing is short, as one would expect. The letters demand a response within 30 days and remind the partners that if the FTB were to start an examination in the meantime, they would no longer be eligible to file QARs.[74]

Conclusion

So, where are we exactly? Federal income tax disputes regarding SCETs rage on, the IRS offered and then apparently terminated the settlement initiative for partnerships, and the IRS has given no signs that it intends to issue a revenue procedure allowing individual partners to resolve their personal matters by filing QARs, if they were so inclined. Meanwhile, many federal partnership-level disputes (carried out in the appeals office, Tax Court, and various courts of appeal) likely will not end for years, such that there have not yet been any final determinations regarding the proper valuation of the conservation easements, size of the related charitable tax deductions, potential penalties and corresponding defenses, and so forth. In other words, as far as the IRS is concerned, there are currently no liabilities due with respect to many partnerships. Nevertheless, the FTB is sending letters to California partners in such partnerships, threatening them with audits and abysmal outcomes while prodding them to stop claiming tax benefits stemming from SCETs and to file QARs to rectify past matters. The FTB, in essence, is asking California partners to voluntarily concede all charitable tax deductions previously taken and pay the resulting state tax liabilities now, *before* any of the key issues have been resolved. Partnerships, partners, and practitioners will be watching to see whether Californians take the bait. ■

[72] *Ibid.*

[73] *Op. cit.* note 65.

[74] *Ibid.*