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CONSERVATION EASEMENT DISPUTES AND THE SECTION 7525 TAX PRACTITIONER PRIVILEGE

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This article explains the evolving attacks against conservation easement deductions by the IRS, describes the scope and limitations of the Section 7525 federally authorized tax practitioner privilege, and identifies the theories recently raised by the IRS in its effort to gather all potentially pertinent data, including communications with accountants.

Introduction

The IRS, consistent with repeated public announcements, continues to implement aggressive actions in its challenges of partnerships making conservation easement donations. Grounded in its unproven theory that many unrelated parties involved with a typical easement donation (*e.g.*, organizers, landowners, accountants, appraisers, land trusts, etc.) somehow collaborated to do something improper, the IRS has become more insistent about seeking copies of pre-donation communications between parties, particularly accountants, whose roles vary considerably.

For example, accountants might provide tax and/or information return preparation services, bookkeeping, compliance assistance, tax advice, entity formation, financial and tax calculations, due diligence of various sorts, or something else entirely. Section 7525 establishes a safeguard for accountants and others, called the federally authorized tax practitioner ("FATP") privilege. It states that, when it comes to tax advice, the confidentiality protections that have long applied to communications between taxpayers and attorneys generally extend to communications between taxpayers and FATPs. There are limitations, of course, including that the FATP privilege yields no help when communications deal with "tax shelters."

This article provides an overview of the easement donation process and related tax rules, explains the evolving attacks by the IRS, describes the scope and limitations of the FATP privilege, summarizes the most recent federal case addressing the tax shelter exception, and identifies the theories recently raised by the IRS in its effort to gather all potentially pertinent data, including communications with accountants before the partnership files its Form 1065 (U.S. Return of Partnership Income) claiming the easement deduction.

Overview of conservation easement donations and tax deductions

Taxpayers who own undeveloped real property have several choices. For instance, they might (1) hold the property for investment purposes, selling it when it appreciates sufficiently, (2) determine how to maximize profitability from the property and do that, regardless of the negative effects on

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the local environment, community, and economy, or (3) donate an easement on the property to a charitable organization, such that it is protected forever for the benefit of society.

The third option, known as donating a "conservation easement," not only achieves the goal of environmental protection, but also triggers another benefit, tax deductions for donors. Taxpayers generally must donate their entire legal interest in a particular piece of property, not just part of their interest, in order to qualify for a tax deduction.[1] This is a critical concept, as taxpayers who own all attributes of a piece of real property (*i.e.*, they own it in "fee simple") do not donate the property outright to a charitable organization in the easement context. Instead, they retain ownership of the property, but convey an easement on such property to an independent, non-profit organization with the ability, capacity, willingness, and resources to safeguard the property forever. This is usually a land trust. Provided that the easement, which is just a partial interest in property, constitutes a "qualified conservation contribution," taxpayers are entitled to the tax deduction.[2]

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

Taxpayers memorialize the donation to charity by filing a public Deed of Conservation Easement ("Deed"). In preparing the Deed, taxpayers often coordinate with the land trust to identify certain limited activities that can continue on the property after the donation, without interfering with the Deed, without prejudicing the conservation purposes, and without jeopardizing the tax deduction.[4] These activities are called "reserved rights." The IRS openly recognizes, in its Conservation Easement Audit Techniques Guide ("ATG") and elsewhere, that reserved rights are ubiquitous in Deeds.[5]

The IRS will not allow the 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."[6] This is called the Baseline Report. It may feature several things, including, but not limited to, (1) the survey maps from the U.S. Geological Survey, showing the property line and other contiguous or nearby protected areas, (2) a map of the area drawn to scale showing all existing man-made improvements or incursions, vegetation, flora and fauna (*e.g.*, locations of rare species, animal breeding and roosting areas, and migration routes), land use history, and distinct natural features, (3) an aerial photograph of the property at an appropriate scale taken as close as possible to the date of the donation, and (4) on-site photographs taken at various locations on the property.[7]

The IRS has been attacking partnerships that make easement donations in a variety of ways.

The value of the conservation easement is the fair market value ("FMV") of the property at the time of the donation.[8] The term FMV ordinarily means the price on which a willing buyer and willing seller would agree, with neither party being obligated to participate in the transaction, and with both parties having reasonable knowledge of the relevant facts.[9] The IRS explains in its ATG that the best evidence of the FMV of an easement would be the sale price of other easements that are comparable in size, location, usage, etc. The ATG recog-

1 Section 170(a)(1); Reg. 1.170A-1(a); Section 170(f)(3)(A); Reg. 1.170A-7(a)(1).
2 Section 170(f)(3)(B)(iii); Reg. 1.170A-7(a)(5); Section 170(h)(1); Section 170(h)(2); Reg. 1.170A-14(a); Reg. 1.170A-14(b)(2).
3 Section 170(h)(4)(A); Reg. 170A-14(d)(1); S. Rept. 96-1007, at 10 (1980).
4 Reg. 1.170A-14(b)(2).
5 IRS, "Conservation Easement Audit Techniques Guide" (Rev. 11/4/2016), p. 23; *see also* Reg. 1.170A-14(e)(2) and (3).
6 Reg. 1.170A-14(g)(5)(i).
7 Reg. 1.170A-14(g)(5)(i).
8 Section 170(a)(1); Reg. 1.170A-1(c)(1).
9 Reg. 1.170A-1(c)(2).

nizes, though, that it is difficult, if not impossible, to find comparable sales.[10] Consequently, appraisers often must use the before-and-after method instead. This means that an appraiser must determine the highest and best use ("HBU") of the property *and* the corresponding FMV twice. First, the appraiser calculates the FMV 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.[11] The difference between the "before" value and "after" value, with certain other adjustments, produces the value of the easement donation.

As indicated above, in calculating the FMV of property, appraisers and courts must take into account not only the current use of the property, but also its HBU.[12] A property's HBU is the most profitable use for which it is adaptable and needed in the reasonably near future.[13] The term HBU has also been defined as the use of property that is physically possible, legally permissible, financially feasible, and maximally productive.[14] Importantly, valuation in the easement context does not depend on whether the owner has actually put the property to its HBU in the past.[15] The HBU can be *any* realistic potential use of the property.[16] Common HBUs are construction of a residential community, creation of a mixed-use development, or mining.

As conservation easement battles continue, a conflict with the IRS often arises when partnerships that engage in conservation easements decline to provide copies of certain pre-donation communications with advisors on grounds that they are protected by the Section 7525 privilege.

Properly claiming the tax deduction stemming from an easement donation is surprisingly complicated. It involves a significant amount of actions and documents. The main ones are as follows: The taxpayer must (1) obtain a "qualified appraisal" from a "qualified appraiser," (2) demonstrate that the land trust is a "qualified organization," (3) obtain a Baseline Report adequately describing the condition of the property at the time of the donation and the reasons why it is worthy of protection, (4) complete a Form 8283 (Noncash Charitable Contributions) and have it executed by all relevant parties, including the taxpayer, appraiser, and land trust, (5) assuming that the taxpayer is a partnership, file a timely Form 1065 (U.S. Return of Partnership Income), enclosing Form 8283 and the qualified appraisal, (6) receive from the land trust a "contemporaneous written acknowledgement," both for the easement itself and for any endowment/stewardship fee donated to finance perpetual protection of the property, and (7) send all the partners their Schedules K-1 (Partner's Share of Income, Deductions, Credits, etc.) and a copy of Form 8283.[17]

Past and current attacks by the IRS

The U.S. government has been attacking partnerships that make easement donations in a variety of ways. For instance, it (1) identified them as "listed transactions" in Notice 2017-10, (2) mandated the filing of Forms 8886 (Reportable Transaction Disclosure Statement) and Forms 8918 (Material Advisor Disclosure Statement) by various parties, (3) launched a "compliance campaign" consisting of dozens of specialized Revenue Agents and other IRS personnel, (4) filed a complaint in District Court seeking a permanent injunction against certain organizers and appraisers, (5) featured easement transactions on the IRS's "dirty dozen" list, (6) started an inquiry by the Senate Finance Committee on potential abuses, and (7) initiated a widespread practice of issuing audit reports claiming that tax deductions should be $0 and imposing severe penalties, regardless of the amount of pre-donation due diligence conducted by taxpayers, the magnitude of the conservation values of the properties, the attainment of multiple independent appraisers, etc.

[10] IRS, "Conservation Easement Audit Techniques Guide" (Rev. 11/4/2016), p. 41.

[11] IRS, "Conservation Easement Audit Techniques Guide" (Rev. 11/4/2016), p. 41.

[12] *Stanley Works & Subs.*, 87 TC 389, 400 (1986); Reg. 1.170A-14(h)(3)(i) and (ii).

[13] *Olson*, 292 U.S. 246, 255 (1934).

[14] *Esgar Corp.*, 744 F.3d 648, 659, n.10 (CA-10, 2014).

[15] *Esgar Corp.*, 744 F.3d 648, 657 (CA-10, 2014).

[16] *Symington*, 87 TC 892, 896 (1986).

[17] *See* IRS, "Conservation Easement Audit Techniques Guide" (Rev. 11/4/2016), pp. 24-30; IRS Publication 1771, Charitable Contributions – Substantiation and Disclosure Requirements; IRS Publication 526, Charitable Contributions; Section 170(f)(8); Section 170(f)(11); Reg. 1.170A-13; Notice 2006-96; TD 9836.

The IRS, through the Commissioner, Chief Counsel, and other high-ranking officials, began intensifying the rhetoric and warnings in late 2019. This messaging has manifested itself in the form of IRS new releases, public statements at tax conferences, and articles. The IRS has emphasized that it is (1) pursuing promoters, appraisers, return preparers, material advisors, accommodating entities, charitable organizations, and others, (2) making referrals to the Office of Professional Responsibility ("OPR"), (3) raising a long list of technical, procedural, legal and tax arguments in disputes, while constantly trying to develop more, (4) asserting all possible civil penalties, (5) conducting simultaneous civil examinations and criminal investigations, (6) contracting with a significant number of appraisers from the private sector to handle the workload, and (7) litigating a large number of cases in Tax Court.[18]

Supplementing the blatant actions described above, the IRS introduced in 2020 some more subtle ways of attacking conservation easements. For instance, the IRS announced in February 2020 that it had put in place a temporary "Promoter Investigations Coordinator," who would be in charge of collaborating with the Civil Division, Criminal Investigation Division, Chief Counsel, and Office of Professional Responsibility to develop and implement promoter enforcement, on both an individual and strategic level.[19] On a related note, in March 2020, the IRS indicated that it had formed the new "Fraud Enforcement Office," whose leader would be working closely with the "Promoter Investigations Coordinator."[20]

In addition, the IRS introduced a new Form 8886 (Reportable Transaction Disclosure Statement) in early 2020, which forces those who participate in a conservation easement transaction to provide the IRS data about the "total investment or basis" in the relevant partnership and the "total anticipated dollar amount of all [tax benefits] over the entire anticipated life of the transaction."[21] Concerns abound that the IRS will try to characterize a minor omission or mistake on new Form 8886 as a justification to impose huge penalties and keep assessment-periods open.

Finally, in January 2020, the IRS issued a memorandum called "Interim Guidance on IRC 6695A Penalty Case Reviews" ("Interim Guidance").[22] It seemed like another tedious procedural modification at first glance, but the Interim Guidance deprives appraisers, including those valuing conservation easements, of crucial safeguards.[23] The prior procedures required analysis and agreement by at least five experienced IRS employees (*i.e.*, the Revenue Agent, Examining Appraiser, Primary Review Appraiser, Secondary Review Appraiser, and Review Manager) before Section 6695A penalties could be assessed. Now, under the Interim Guidance, the Revenue Agent, who might have little to no training in the field of valuation, makes this decision alone or with input from just one Examining Appraiser.[24]

A new battleground – Section 7525 and the FATP privilege

As conservation easement battles continue, the IRS has become more aggressive in its efforts to gather all potentially relevant data, despite the fact some might be confidential. This scenario often arises when partnerships that engage in conservation easements decline to provide copies of certain pre-donation communications with advisors on grounds that they are protected by Section 7525.

Overview of FATP privilege. Section 7525 generally provides that, with respect to tax advice, the protections that apply to communications between taxpayers and their attorneys shall extend to com-

[18] IR-2019-182, "IRS Increases Enforcement Action on Syndicated Conservation Easements," 11/12/2019; IR-2019-213, "IRS Continues Enforcement Efforts in Conservation Easement Cases Following Latest Tax Court Decision," 12/20/2019; Richman, "Multiple Divisions Coming for Syndicated Conservation Easements," 2019 Tax Notes Today 220-3 (11/13/2019); Hoffman, "Conservation Easement Crackdown a Portent, Rettig Says," 2019 Tax Notes Today 221-9 (11/14/2019); Parillo, "IRS Is Building Up Its Easement Toolbox," 2019 Tax Notes Today 222-6 (11/15/2019); Parillo, "IRS Looking for Promoter Links as Easement Crackdown Grows," Tax Notes Today, Doc. 2019-47134 (12/13/2019).

[19] Parillo. "IRS Assigns Point Person on Promoter Investigations," Federal Tax Notes Today Doc. 2020-6890 (2/25/2020).

[20] IRS News Release IR-2020-49 (3/5/2020).

[21] Instructions for Form 8886 (Reportable Transaction Disclosure Statement) (Rev. Dec. 2019), p. 1. The "What's New" portion of the Instructions for Form 8886 state that "[n]ew Lines 7b, 7c and 7d request total dollar amounts of your tax benefit(s), number of years of anticipated benefit, and your total investment or basis in the reportable transaction."

[22] Tax Notes Doc. 2020-3440 (1/22/2020), consisting of LB&I-20-0120-001.

[23] Tax Notes Doc. 2020-3440 (1/22/2020), consisting of LB&I-20-0120-001.

[24] For additional information on the Interim Guidance, *see* Sheppard, "Conservation Easement Enforcement: IRS Quietly Eliminates Procedural Protections for Appraisers," 132(5) Journal of Taxation 17 (2020), republished in 31(6) Taxation of Exempts 13 (2020).

munications between taxpayers and FATPs.[25] This broad, general rule faces several limitations, only a few of which are evident from reading Section 7525 itself. The provision clarifies that the expanded protections *only* apply to (1) "tax advice," not return-preparation and other services, (2) provided by a person who qualifies as an FATP, such as a certified public accountant, enrolled agent, registered tax return preparer, and others, (3) involving non-criminal matters, (4) in connection with an administrative or judicial tax matter, where the IRS or Department of Justice is a party, and (5) not regarding "tax shelters."[26]

Clarifications on scope of FATP privilege. Congress enacted Section 7525 more than two decades ago, in 1998, but the IRS never issued corresponding regulations. Therefore, one must turn to other sources, such as legislative history, to get more details about the magnitude of the FATP privilege.

Civil federal tax matters only. Section 7525 explains that the FATP privilege can only be asserted in "any noncriminal matter before the [IRS], and any noncriminal tax proceeding in federal court brought by or against the United States."[27] Stated another way, the FATP privilege does not apply to state tax disputes, civil disputes between private parties, and matters with non-tax government agencies. Affected groups raised this issue when the FATP privilege was being debated in Congress:

> [G]uidance is needed with respect to the impact of the confidentiality provision on state tax proceedings or cases involving private litigants. The written communications between a CPA or enrolled agent and a taxpayer might be subject to discovery in such proceedings without any privilege protections. Under these circumstances, once the accountant's papers have been made available in a state proceeding or to a private litigant, the IRS (arguably) would have a right of access to those otherwise confidential papers.[28]

The relevant congressional report, quoted below, shows that Congress did not incorporate into Section 7525 the concerns emphasized by the affected groups:

> The [FATP] privilege may not be asserted to prevent the disclosure of information to any regulatory body other than the IRS. The ability of any other regulatory body, including the Securities and Exchange Commission (SEC), to gain or compel information is unchanged by this provision. No privilege may be asserted under this provision by a taxpayer in dealings with such other regulatory bodies in any administrative or court proceeding.[29]

This issue has been tested in at least one case, where the court ruled that the FATP privilege did not shield a taxpayer in a proceeding to challenge an administrative summons issued by the Department of Labor, despite the fact that the Department of Labor could later share the information that it obtained from the taxpayer with the IRS.[30]

FATP privilege can be waived. The FATP privilege, like others, is not absolute. It can be waived unintentionally when parties are not cautious. The legislative history states the privilege is inapplicable where a communication is made to one party, like an FATP, such that he can convey it to another party.[31] It also explains that the privilege can be relinquished when an FATP reveals an otherwise protected communication from a taxpayer to third parties—for instance, by copying them on an e-mail.[32]

FATP privilege does not expand existing protections. The legislative history clarifies that the FATP privilege does not enlarge any existing privileges; its sole effect is to expand their use to non-attorneys. Notably, it confirms that data provided in connection with preparing a return does not become privileged, merely by supplying it to an attorney or FATP:

> [T]he privilege does not apply to any communication between [an FATP] and such individual's client (or prospective client) if the communication would not have been privileged between an attorney and the attorney's client or prospective client. For example, information disclosed to an attorney for

[25] Section 7525(a)(1).

[26] Section 7525(a)(1), Section 7525(a)(2), Section 7525(a)(3); Section 7525(b); 31 U.S.C. section 330; and 31 C.F.R. 10.3.

[27] Section 7525(a)(2).

[28] IRS Restructuring. U.S. Senate Committee on Finance, Hearing 105-529 (1998), p. 239 (statement by National Society of Accountants). The notion of increased confidentiality for non-attorney tax professionals received support, unsurprisingly, from various groups whose members would benefit. For example, various groups testified and/or provided written statements at congressional hearings expressing support, along with comments or concerns. These included high-ranking representatives of the American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Society of Accountants, and the Tax Executive Institute. *Id.* at pp. 97, 98, 239, 256, and 257.

[29] U.S. Senate, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-174 (4/22/1998), pp. 70-71.

[30] *Chao v. Koresko*, 2005 WL 2521886 (CA-3, 2005).

[31] U.S. House of Representatives, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-599 (6/24/1998), p. 267.

[32] U.S. House of Representatives, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-599 (6/24/1998), p. 269.

> the purpose of preparing a tax return is not privileged under present law. Such information would not be privileged under [Section 7525], whether it was disclosed to an attorney, certified public accountant, enrolled agent, or enrolled actuary.[33]

Raising FATP privilege defense might backfire. The legislative history subtly warns that relying on the FATP privilege could potentially backfire, particularly if the "tax advice" provided was akin to legal advice, which only licensed attorneys can provide. The congressional report instructs FATPs to tread lightly, emphasizing that "[n]o inference is intended as to whether aspects of federal tax law practice covered by the new [FATP] privilege constitute the authorized or unauthorized practice of law under various state laws."[34]

Tax shelter exception. The most important limitation on the FATP privilege, for purposes of this article, is the "tax shelter exception." The FATP privilege does *not* apply to (1) any written communication, (2) between an FATP and certain individuals or entities (*i.e.*, any person, any director, officer, employee, agent, or representative of such person, or any other person holding a capital or profits interest in such person), (3) in connection with the "promotion" of the participation of the person, either directly or indirectly, (4) in any "tax shelter."[35]

When first passed in 1998, the tax shelter exception was aimed solely at "corporate tax shelters." Soon thereafter, though, Congress broadened the coverage, clarifying that the exception affected all "tax shelters," regardless of the type of taxpayer participating. Congress, in introducing the amended law in 2004, explained that it applied "to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity."[36]

The IRS or Department of Justice, as appropriate, must supply the court with enough evidence to satisfy each element of the tax shelter exception.[37] However, it is unnecessary for the government to demonstrate that a crime or fraud occurred.[38]

For purposes of this exception to the FATP privilege, the term "tax shelter" is broadly defined to encompass (1) any partnership, corporation, trust or other entity, investment plan or arrangement, or other plan or arrangement, (2) "a significant purpose" of which is avoiding or evading federal income tax.[39] Importantly, this standard has become more comprehensive over time, with Congress changing just two critical words: The key phrase changed from "the principal" purpose to "a significant" purpose, as described further below.

The relevant provision originally stated that no tax shelter existed unless "the principal purpose" of the entity, plan, or arrangement was to avoid or evade federal income tax.[40] The corresponding regulations explained this key phrase in the following manner:

The most important limitation on the Section 7525 privilege, for purposes of this article, is the "tax shelter exception."

> The principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose. Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, *overvalued assets* or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.[41]

> The principal purpose of an entity, plan or arrangement is *not* to avoid or evade Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits *in a manner consistent with the statute and Congressional purpose.* For example, an entity, plan or arrangement does *not* have as its principal purpose the avoidance or evasion of Federal income tax solely as a result of the following uses of tax benefits provided by the

[33] U.S. House of Representatives, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-599 (6/24/1998), pp. 268-269.

[34] U.S. House of Representatives, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-599 (6/24/1998), p. 269.

[35] Section 7525(b).

[36] U.S. House of Representatives, American Jobs Creation Act of 2004, 108th Congress, 2d Session, Conference Report 108-755 (10/7/2004), p. 605.

[37] *BDO Seidman, LLP*, 100 AFTR2d 2007-5052, 492 F.3d 806 (DC CA, 2007).

[38] *Ibid*.

[39] Section 7525(b)(2); Section 6662(d)(2)(C)(ii); Reg. 1.6662-4(g)(2)(i).

[40] The IRS and Tax Court broadly interpreted the phrase "tax shelter" under the original standard. See, e.g., Rev. Rul. 89-74 (ruling that two supposed "churches," which primarily benefited its founders financially, were tax shelters) and *Tweeddale*, 92 TC 501 (1989) (holding that the claim by a taxpayer that he was exempt from tax because of his status as a church "minister" and his vow of poverty constituted a tax shelter).

[41] Reg. 1.6662-4(g)(2)(i) (emphasis added).

[42] Reg. 1.6662-4(g)(2)(ii).

> Internal Revenue Code: The purchasing or holding of an obligation bearing interest that is excluded from gross income under Section 103; taking an accelerated depreciation allowance under Section 168; taking the percentage depletion allowance under Section 613 or Section 613A; deducting intangible drilling and development costs as expenses under Section 263(c); establishing a qualified retirement plan under Sections 401-409; claiming the possession tax credit under Section 936; or claiming tax benefits available by reason of an election under Section 992 to be taxed as a domestic international sales corporation ("DISC"), under Section 927(f)(1) to be taxed as a foreign sales corporation ("FSC"), or under Section 1362 to be taxed as an S corporation.[42]

The standard changed in 1997 to the detriment of taxpayers, when the phrase was loosened to capture situations with merely "a significant purpose" of dodging federal income taxes.[43] The IRS has not defined the phrase "a significant purpose" in the context of Section 6662, where the term "tax shelter" is found when dealing with the FATP privilege. However, the IRS has supplied guidance on this elsewhere, two decades ago, in issuing regulations concerning mandatory registration of "confidential corporate tax shelters." Under the law in place at that time, a "confidential corporate tax shelter" was any entity, plan, arrangement, or transaction that satisfied three criteria, one of which was that "a significant purpose" of the structure was the avoidance or evasion of federal income tax.[44] The regulations featured the following data about "a significant purpose."

> First, the avoidance or evasion of Federal income tax is considered a significant purpose of the structure of a transaction if the transaction is the same as or substantially similar to one of the specified types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction for purposes of Section 6111.[45]
>
> Second, the avoidance or evasion of Federal income tax is generally considered a significant purpose of the structure of a transaction if the present value of the participant's reasonably expected pre-tax profit . . . from the transaction is insignificant relative to the present value of the participant's expected net Federal income tax savings from the transaction . . .[46]
>
> Third, the avoidance or evasion of Federal income tax is generally considered to be a significant purpose of the structure of a transaction if the transaction has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction and the tax shelter promoter (or other person who would be responsible for registration under this section) reasonably expects the transaction to be presented (in the same or substantially similar form) to more than one potential participant. However, a transaction does not come within this third category if the promoter reasonably determines that the potential participant is expected to participate in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and the promoter reasonably determines that there is a long-standing and generally accepted understanding that the expected Federal income tax benefits from the transaction (taking into account any combination of intended tax consequences) are allowable under the Code for substantially similar transactions.[47]

Recent case involving tax shelter exception

The tax shelter exception has been the subject of some litigation in the past, with much of it focusing on whether the FATP was involved with the "promotion" of a tax shelter and/or whether the FATP was providing "tax advice."[48]

[43] Taxpayer Relief Act of 1997, Public Law 105-34, section 1028(c)(2); U.S. House of Representatives, Taxpayer Relief Act of 1997, 105th Congress, 1st Session, Conference Report 105-220 (7/30/1997), pp. 541-543.

[44] Temporary Regulations, T.D. 8876 (3/2/2000), Preamble.

[45] *Ibid*.

[46] *Ibid*.

[47] *Ibid*.

[48] *See, e.g., Countryside Limited Partnership*, 132 TC 347 (2009) (Tax Court denied motion filed by the IRS to compel discovery of documents because the FATP was acting in his role as a long-standing tax advisor and not as a "promoter" of the transaction at issue); *Santander Holdings USA, Inc. & Subsidiaries*, 110 AFTR2d 2012-5481 (DC MA, 2012) (District Court denied motion filled by the Department of Justice to compel discovery of certain documents related to changes in tax law and unwinding a supposed tax shelter because the FATP was not engaged in "promotion"); *Valero Energy Corp.*, 100 AFTR2d 2007-6473 (DC IL, 2007) and 102 AFTR2d 2008-5916 (DC IL, 2008) (District Court held that the tax shelter exception applied, thereby forcing the FATP to reveal documents related to a transaction designed to trigger foreign currency losses, because a significant purpose the transaction was to avoid or evade federal income tax and the FATP was engaged in the "promotion" of such transaction); *Salem Financial, Inc.*, 102 Fed. Cl. 793 (2012) (Court of Federal Claims ruled that the tax shelter exception did not apply and rejected the IRS's arguments that "promotion" should be broadly interpreted to include "encouraging" participation in a tax shelter and that post-transaction communications with an FATP could still be considered "in connection with the promotion" of a tax shelter); *Textron, Inc. & Subsidiaries*, 100 AFTR2d 2007-5848 (DC RI, 2007) (District Court refused to apply the tax shelter exception where a company's internal accountants, acting as tax advisors, prepared tax accrual workpapers regarding a tax shelter transaction in which the company had already engaged, without their involvement); *KPMG, LLP*, 92 AFTR2d 2003-6498 (DC CO, 2003) (District Court determined that the tax shelter exception applied to documents containing business advice or investment advice, documents related to return preparation, and tax opinion letters, but not to memos and letters related to "tax advice").

The most recent case, from January 2020, is *Microsoft Corporation.*[49] The District Court provided the following background. Microsoft, aware that certain U.S. tax incentives related to manufacturing in Puerto Rico through a foreign subsidiary were expiring, began exploring other opportunities. One of the larger accounting and advisory firms, KPMG, assisted with this process. Specifically, Microsoft hired KPMG to provide "tax consulting services" for a "feasibility phase," which entailed modeling of anticipated tax benefits over a 10-year period. KPMG presented Microsoft with various tax-deferral and reorganization strategies, central to which were cost-sharing arrangements between related entities.

The IRS audited Microsoft for 2004, 2005, and 2006. One of the main issues was the cost-sharing arrangements related to the transfer of intellectual property between foreign and domestic subsidiaries of Microsoft. The IRS believed that the cost-sharing arrangements were improper and had the effect of shifting otherwise taxable income out of the United States. Microsoft refused to provide the IRS with certain documents during the audit, claiming that they were confidential on several grounds, among them the FATP privilege. Therefore, the IRS issued a summons to Microsoft, and later filed an action with the District Court, seeking its assistance in making Microsoft comply.

The District Court examined the applicability of several potential protections, including FATP privilege, which it described as "the crux" of the case. The focus of the District Court was the tax shelter exception, particularly whether KPMG was involved in the "promotion" of a tax shelter and whether "a significant purpose" of the cost-sharing arrangement was tax avoidance or evasion.

With respect to the first issue, the District Court determined that "a significant purpose, if not the sole purpose" of Microsoft's transactions was to avoid or evade federal income tax, in that it was shifting otherwise taxable revenue outside the United States. The District Court noted that Microsoft was unable to show "any business purpose" for the particular cost-sharing arrangement and that tax savings drove the decision-making process.

[49] *Microsoft Corporation*, 125 AFTR2d 2020-547 (DC WA, 2020).

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In terms of the second issue, the District Court concluded that KPMG "promoted" the transaction and, with the exception of some self-interested testimony, (1) there was "no indication that the plans for the transactions originated with Microsoft," (2) KPMG "drove the structuring of the transactions," and (3) were it not for "promotion" by KPMG, Microsoft would not have participated in the transactions. The District Court also pointed out that, even after Microsoft first engaged in the transactions, KPMG continued to make adjustments to maximize revenue shifting and minimize operational costs. The District Court ruled that KPMG provided services "only to promote Microsoft's avoidance of tax liability and [therefore] all of KPMG's written communications were [made] in connection with promotion of a tax shelter."

The District Court, likely anticipating recriminations, explained that its decision serves the public interest because, while Congress enacted the FATP privilege to safeguard certain communications, such privilege is not absolute, and when an FATP's advice "strays from compliance and consequences to promotion of tax shelters, the privilege falls away."

Conclusion

In issuing information document requests and summonses demanding copies of written communications between taxpayers and accountants related to easement donations, the IRS often encounters resistance, in the form of the FATP privilege, when it is dealing with a knowledgeable tax defense professional. Recently, the IRS has attempted to overcome the FATP privilege by arguing, among other things, that (1) the accountants were not providing "tax advice" in the first place, (2) even if they were offering "tax advice," the privilege was later waived, by the partnership and/or the accountants, when the relevant information was forwarded to third parties, (3) the transactions rise to the level of civil fraud or a crime, (4) syndicated conservation easement transactions are "listed transactions" and thus "tax shelters" pursuant to Notice 2017-10, (5) "a significant purpose" of easement transactions is federal income tax avoidance, and (6) the accountants were involved in the "promotion" of easement transactions, as this term is broadly defined in *Microsoft Corporation* and elsewhere.

Numerous counterarguments to the IRS's positions exist, and there are several safeguards that accountants and partnerships can implement to strengthen the applicability of the FATP privilege from the outset. A detailed discussion of these issues exceeds the scope of this article. Suffice it here for taxpayers and their advisors to be aware of the newest information-gathering strategies utilized by the IRS in the conservation easement arena, especially reliance on the "tax shelter exception" to the FATP privilege, such that they can be better situated to defend the partnerships, charitable donations, and related tax deductions. ■