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

In this article, Sheppard examines developments in syndicated conservation easements, including their treatment as listed transactions, and reviews public comments on the 2022 proposed regulations.

I. Introduction

They say that timing is everything, and this rings true when it comes to tax guidance. After several courts held that the IRS violated the law when it issued Notice 2017-10, 2017-4 IRB 544, categorizing syndicated conservation easement transactions (SCETs) as "listed transactions," the IRS scrambled to salvage the situation. In particular, it released proposed regulations in early December 2022 that reaffirmed and expanded earlier concepts.[1] The proposed regulations focused on information reporting requirements for those involved with SCETs.

About three weeks later, in the final days of 2022, Congress enacted new rules in the Secure 2.0 Act.[2] That legislation did not address disclosure duties for SCETs; rather, it identified easement donations that would get a tax deduction of $0 if their value surpassed a specific amount. The disparate objectives, timing, terminology, and standards in the proposed regulations and Secure Act have unleashed chaos among easement stakeholders.

This article describes Notice 2017-10, recent cases invalidating it, the proposed regulations, the Secure Act, and various public comments directed at the proposed regulations but essentially covering the entire affair.

II. Flagging Easements Donations

In December 2016 the IRS announced in Notice 2017-10 that it intended to challenge what it calls SCETs on grounds that they supposedly constitute "tax avoidance transactions" that involve serious overvaluations.[3]

A. Description

Notice 2017-10 claimed that SCETs involve the following four steps:

- *Step 1:* "An investor receives promotional materials that offer prospective investors in a pass-through entity [such as a partnership] the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment."
- *Step 2:* "The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds the real property."
- *Step 3:* "The pass-through entity that holds the real property contributes a conservation easement to a tax-exempt entity [like a land trust] and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor."

[1] REG-106134-22, Syndicated Conservation Easement Transactions as Listed Transactions (Dec. 8, 2022).

[2] P.L. 117-328, Division T, Secure 2.0 Act. The Secure Act is a component of the Consolidated Appropriations Act of 2023.

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

- *Step 4:* "Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement."[4]

B. Effect on Participants

The effect of Notice 2017-10 was that SCETs became "listed transactions," which triggered various reporting duties and potential penalties for those who participate in SCETs.[5]

1. Scope of participation.

In this context, "participants" include:

- the partnership that owns the property and donates the easement;
- the upper-tier partnership, if the transaction involves a multitier structure, with one partnership atop another;
- the investors or partners who receive Schedules K-1, "Partner's Share of Income, Deductions, Credits, etc.," from the partnership showing their allocation of the charitable tax deduction; and
- any other person whose tax return reflects tax consequences or tax strategies described as an SCET.[6]

An appropriate party must receive the easement donation in order to trigger the tax deduction, meaning a government, private, or specific tax-exempt entity that is committed to protecting the conservation purposes and that possesses sufficient resources to enforce the restrictions (qualified organization).[7] A land trust often serves as the qualified organization. Importantly, Notice 2017-10 stated that the qualified organization (that is, the land trust) that receives the easement would not be treated as a "party" to the transaction under section 4965 and would not be a "participant" in the transaction under Notice 2017-10.[8] This meant that the land trust would not be hit with excise taxes or the need to file Form 8886, "Reportable Transaction Disclosure Statement."

2. Filing duties and penalties.

Participants in SCETs that occurred during or after 2010 generally had to file Forms 8886 with the IRS.[9] When it came to future transactions, participants needed to enclose Forms 8886 with their tax returns for every year of participation as well as send copies for the first year to the Office of Tax Shelter Analysis.[10] Those who objected to SCET status but feared potential penalties had the option of filing "protective" Forms 8886 instead.[11]

Noncompliance by participants triggers several consequences. If participants fail to file timely, complete Forms 8886, the IRS generally can assert a penalty equal to 75 percent of the tax savings resulting from their participation.[12] For a listed transaction like an SCET, the maximum penalty for individual taxpayers is $100,000, while the maximum for entities is $200,000.[13] Notably, the IRS does *not* have authority to rescind or abate a penalty assessed against a listed transaction, and no "reasonable cause" exception exists.[14]

The IRS can punish in other ways, too. If a taxpayer participates in a reportable transaction and the IRS later disallows the benefits claimed, the IRS can impose a penalty under section 6662A equal to 20 percent of the tax increase (reportable transaction penalty).[15] The rate increases to 30 percent if the participant fails to file a Form 8886.[16]

In addition to financial penalties, if a participant does not enclose a Form 8886 with a tax return, the assessment period for the tax return can remain open for a long time: The assessment period extends until one year after the participant eventually files Form 8886 or a material adviser remits the relevant records to the

[4] Notice 2017-10, section 2.

[5] Section 6707A(c)(2); reg. section 1.6011-4(b)(2).

[6] Reg. section 1.6011-4(e)(1).

[7] Section 170(h)(3); reg. section 1.170A-14(c)(1).

[8] Notice 2017-10, section 3.

[9] Notice 2017-10, section 3; reg. section 1.6011-4(a); reg. section 1.6011-4(d).

[10] Notice 2017-10, section 33.

[11] Reg. section 1.6011-4(f)(2).

[12] Section 6707A(a), (b); reg. section 301.6707A-1(a).

[13] Section 6707A(b)(2); reg. section 301.6707A-1(a). The minimum penalty is $5,000 for individuals and $10,000 for entities. *See* section 6707A(b)(3); reg. section 301.6707A-1(a).

[14] Section 6707A(d)(1); *Barzillai v. United States*, 137 Fed. Cl. 788 (Apr. 30, 2018); *Larson v. United States*, 888 F.3d 578 (Apr. 25, 2018).

[15] Section 6662A(a).

[16] Section 6662A(c).

IRS, whichever occurs earlier.[17] During the prolonged assessment period, the IRS has the authority to assess any taxes, penalties, and interest, regardless of whether they are directly related to the listed transaction.[18]

C. Effect on Material Advisers

The issuance of Notice 2017-10 had consequences for material advisers, too.

1. Key definitions.

The IRS, unsurprisingly, defines the term material adviser broadly. It generally means a person who provides material aid, assistance, or advice regarding organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and such person derives a specific amount of gross income for doing so.[19]

A person has material involvement in this context if he (1) makes or provides a written or oral "tax statement," (2) either directly to, or for the benefit of, certain taxpayers or other material advisers, (3) before the first tax return reflecting the benefits of the reportable transaction is filed with the IRS, and (4) derives a specific amount of income for doing so.[20]

2. Filing duties and penalties.

Persons categorized as material advisers normally must file Forms 8918, "Material Advisor Disclosure Statements," or at least protective ones to alert the IRS to their involvement.[21] The IRS asserts penalties when violations occur, of course. In the case of listed transactions, like SCETs, the penalty for an unfiled Form 8918 is $200,000 or 50 percent of the gross income that the material adviser obtained, whichever amount is larger.[22] The penalty increases when there is an intentional failure. In these situations, the penalty equals the greater of $200,000 or 75 percent of the gross income.[23] Once the IRS assesses a Form 8918 penalty for a listed transaction, it cannot rescind it.[24]

3. List-maintenance duties and penalties.

In addition to filing Forms 8918, material advisers must maintain for each reportable transaction a list of information about their clients, the transactions in which they participated, the amount invested by each client, the tax benefits derived, etc.[25] Material advisers must retain these lists for seven years and provide them to the IRS upon written request.[26] If any material adviser fails to supply the list within 20 days of a written request, the IRS can assert penalties of $10,000 per day.[27]

III. Tax Court Invalidates Notice 2017-10

Green Valley Investors[28] is a Tax Court case centered on four conservation easement donations generating about $90 million in tax deductions. It addressed the validity or invalidity of Notice 2017-10.

A. Background and Court Filings

The donations in this case occurred in 2014 and 2015, several years before the IRS issued Notice 2017-10 labeling SCETs listed transactions. The IRS audited and took the position that the partnerships were entitled to $0 in deductions because they allegedly failed to satisfy all technical requirements. The IRS also claimed that the partnerships deserved various sanctions. The partnerships disagreed and filed a petition with the Tax Court.

The IRS then upped the ante, so to speak, by asserting in its answer to the petition that the partnerships should face the reportable transaction penalty under section 6662A because the tax understatements related to SCETs.

The parties eventually filed multiple cross-motions for partial summary judgment on

[17] Section 6501(c)(10).

[18] Reg. section 301.6501(c)-1(g)(7); *see also* reg. section 301.6501(c)-1(g)(8), Example 14.

[19] Reg. section 301.6111-3(b)(1).

[20] Section 6111(b)(1)(A); reg. section 301.6111-3(b)(2)(i); reg. section 301.6111-3(b)(2)(ii).

[21] Section 6111(a); reg. section 301.6111-3(a); reg. section 301.6111-3(d)(1); reg. section 301.6111-3(g).

[22] Section 6707(a), (b)(2); reg. section 301.6707-1(a)(1)(ii)(A).

[23] Section 6707(a), (b)(2); reg. section 301.6707-1(a)(1)(ii)(B).

[24] Section 6707(c); reg. section 301.6707-1(e)(1)(i).

[25] Section 6112; reg. section 301.6112-1.

[26] Section 6112(b)(1); reg. section 301.6112-1(b), (d), and (e).

[27] Section 6708(a)(1); reg. section 301.6708-1(a).

[28] *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5 (2022).

assorted issues, including whether the IRS could impose a reportable transaction penalty.

B. Analysis of Critical Issue

The key issue in the case was whether the IRS violated the Administrative Procedure Act in issuing Notice 2017-10 so that it was invalid from the outset. The Tax Court's analysis filled nearly 40 pages; this article limits itself to the main points.

The Tax Court explained that the APA involves a three-step procedure, dictating that agencies, like the IRS, must (1) issue a general notice to the public about proposed rulemaking, (2) allow interested persons to provide input by submitting comments or participating in hearings, and (3) feature in the final rule a "concise general statement" of its "basis and purpose." The Tax Court then acknowledged the existence of exceptions, including that the APA does not apply to "interpretive rules." Finally, the Tax Court recognized that Congress reserved the right to modify the APA requirements, but it warned that a statute enacted after the APA cannot be interpreted as modifying or superseding the APA unless "it does so expressly."[29]

The IRS first argued that Notice 2017-10 was an interpretive rule, not a legislative rule, so that it is not covered by the APA.

The Tax Court began by defining legislative rules as those that impose new rights or duties and that change the legal status of parties. By contrast, interpretive rules simply inform the public of the interpretation by an agency, like the IRS, of a statute that it is in charge of administering. The Tax Court quickly determined that Notice 2017-10 is a legislative rule for two reasons. First, the Sixth Circuit held in 2021 that a similar notice issued by the IRS, labeling specific trust arrangements as listed transactions, was a legislative rule. Second, after citing the statutes in which Congress empowered the IRS to create rules about filing returns and identifying reportable transactions, the Tax Court offered the following broad conclusion:

> The act of identifying a transaction as a listed transaction by the IRS, by its very nature, is the creation of a substantive (i.e., legislative) rule and not merely an interpretive rule. Identifying a transaction as a listed transaction does not merely provide the IRS's interpretation of the law or remind taxpayers of pre-existing duties. Rather, as we will detail below, identifying a transaction as a listed transaction imposes new duties in the form of reporting obligations and record-keeping requirements on both taxpayers and their advisors. Notice 2017-10 exposes these individuals to additional reporting obligations and penalties to which they would not otherwise be exposed but for the Notice. Creating new substantive duties and exposing taxpayers to penalties for non-compliance "are hallmarks of a legislative, not interpretive, rule."[30] [Internal citations omitted.]

The Tax Court then devoted several pages to specifying the long list of filing and recordkeeping duties that Notice 2017-10 imposed on both participants in and material advisers to SCETs. The Tax Court also highlighted the potential penalties for violations. It then concluded:

> In sum, by its issuance, Notice 2017-10 creates new substantive reporting obligations for taxpayers and material advisors, including [the partnerships in *Green Valley Investors*], the violations of which prompts exposure to financial penalties and sanctions — the prototype of a legislative rule. We cannot see how Notice 2017-10 could be considered an interpretive rule; consequently, we find it to be a legislative rule.[31]

Because Notice 2017-10 is a legislative rule that has the force and effect of law, the Tax Court clarified that it was subject to the general three-step procedure created by the APA.

[29] *Id.* at 7-8.

[30] *Id.* at 9-10.

[31] *Id.* at 15.

C. Scope of Tax Court Decision

When it comes to the specific taxpayers in *Green Valley Investors*, the result is that the IRS cannot assert the reportable transaction penalty under section 6662A. The Tax Court implied that its decision should have much wider applicability, though. It stated that it "intends to apply this decision setting aside Notice 2017-10 *to the benefit of all similarly situated taxpayers who come before us*."[32] (Emphasis added.)

IV. Other APA-Based Decisions

Green Valley Investors represents just one in a growing list of APA-related problems for the IRS. Here are some others:

- A district court held that the IRS violated the APA when it issued Notice 2016-66, 2016-47 IRB 745, identifying specific microcaptive insurance arrangements as "transactions of interest."[33]
- Likewise, the Sixth Circuit held that the IRS improperly ignored the APA when it published Notice 2007-83, 2007-45 IRB 960, calling trusts that use cash life insurance policies listed transactions.[34]
- Another district court determined that the IRS failed to comply with the APA in issuing temporary regulations for the dividends received deduction under section 245A.[35]
- The government filed an answer in a district court case admitting that Notice 2017-10 is a legislative rule, the IRS did not follow the notice and comment procedures of the APA, and the IRS was not exempt from such procedures.[36] The district court later agreed, declaring Notice 2017-10 "unlawful" and setting it aside, but only regarding the taxpayer in that case.[37]
- Finally, the IRS issued a chief counsel advisory indicating that the IRS cannot argue that taxpayers must file both Forms 8275, "Disclosure Statement," and Forms 8886 to avoid the increased economic substance penalty for undisclosed transactions because the sole source of this double duty, Notice 2010-62, 2010-40 IRB 411, contravenes both the APA and the IRS's own policy statement.[38]

V. Proposed Regulations: Disclosure Duties

In view of the APA-related snags described above, the IRS swiftly issued proposed regulations in December 2022 in an effort to legally make SCETs listed transactions.[39] Much of the proposal is analogous to the earlier Notice 2017-10; this article focuses solely on the new.

A. Lingering Defiance

The IRS issued the proposed regulations to hedge against future court losses in the Sixth Circuit and Tax Court, but it warned that it continues "to defend the validity of Notice 2017-10 and other Notices identifying transactions as listed transactions" elsewhere.[40] The IRS also admonished that, from its perspective, the duty to file Forms 8886 and Forms 8918, as well as to maintain specific records, remains in effect under Notice 2017-10 until the IRS can finalize the proposed regulations.[41]

If that were not clear enough, the IRS underscored that the proposed regulations "do not revoke or modify Notice 2017-10."[42] On a broader note, the IRS declared that it still adheres to its position that listed transactions, such as

[32] *Id.* at n.22.

[33] *CIC Services LLC v. IRS*, No. 3:17-cv-00110 (E.D. Tenn. 2022).

[34] *Mann Construction Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022). *But see Govi & Associates Inc. v. United States*, No. 2:22-cv-22-00579 (D. Ariz. Mar. 23, 2023) (holding that the decision in *Mann Construction* "cannot fairly be read as having nationwide scope [such that] the court will not treat Notice 2007-83 as a legal nullity"); and Kristen A. Parillo, "Court: *Mann Construction* Didn't Vacate Listing Notice Nationwide," *Tax Notes Federal*, Apr. 3, 2023, p. 142.

[35] *Liberty Global Inc. v. United States*, No. 1:20-cv-03501 (D. Colo. 2022).

[36] Government's answer in *GBX Associates LLC v. United States*, No. 1:22-cv-00401 (May 20, 2022).

[37] *GBX Associates LLC v. United States*, No. 1:22-cv-00401 (N.D. Ohio Nov. 14, 2022).

[38] ILM 202244010 (Nov. 4, 2022); IRS, "Policy Statement on the Tax Regulatory Process" (Mar. 8, 2019).

[39] 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.

[40] REG-106134-22, at 14.

[41] *Id.*, Background, Section VII (Purpose of Proposed Regulations), at 20.

[42] *Id.*, Explanation of Provisions, Section VIII (Effect on Other Documents), at 32.

SCETs, "can be identified by Notice or other Subregulatory Guidance and that the APA's notice-and-comment procedure does not apply to such transactions."[43]

B. Fee Simple Donations

Notice 2017-10 broadly stated that it covered both SCETs and "substantially similar transactions," as defined in the relevant regulations. However, it was silent on items that might fall into the latter category. The proposed regulations take a different approach, explaining in the preamble that some fee simple donations of real property are substantially similar to SCETs.[44]

C. 2.5 Times Reporting Rule

The IRS claims that one hallmark of SCETs is that the 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 contribution to the partnership (2.5 times reporting rule).[45] Thus, if the promotional materials pledge that economic returns might meet or exceed the 2.5 times reporting rule and satisfy the other three criteria established by the IRS, an easement donation will be deemed an SCET, and Form 8886 and Form 8918 filing duties will apply.

Things do not stop there, though. The proposed regulations reserve the IRS's right to dislike *any* conservation easement donation regardless of its size. They state that "no inference should be drawn from Notice 2017-10 (or these 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."[46] (Emphasis added.)

D. Calculating the 2.5 Times Reporting Rule

The proposed regulations feature three new rules regarding how taxpayers determine their return on investment.

1. Aiming high.

The proposed regulations clarify the 2.5 times reporting rule. In situations in which the promotional materials suggest or imply *a range* of possible tax deductions, the *highest* amount in such range will govern.[47] Moreover, when inconsistency exists, and one piece of promotional material indicates a higher return than another, the *larger* figure counts for purposes of the 2.5 times reporting rule.[48]

2. Presumption of SCET status.

When promotional materials are questionable, nonexistent, or unavailable, the proposed regulations create a rebuttable presumption that the partnership violated the 2.5 times reporting rule if the charitable donation occurred within three years after a partner made his capital contribution and the partner claims a tax deduction that is 2.5 times or more than his initial investment.[49] The IRS introduced the presumption "to address taxpayers and promoters who may not be forthcoming about the content or receipt of promotional materials."[50] The partnership supposedly can rebut the presumption by establishing, to the satisfaction of the IRS, that none of the promotional materials contained a suggestion or implication that partners might receive tax deductions of 2.5 times or greater.[51]

3. Anti-stuffing rule.

For the purposes of calculating the amount of a partner's capital contribution in the context of the 2.5 times reporting rule, the proposed regulations offer a mechanism aimed at stopping abuse (anti-stuffing rule).[52] The partner's investment in the partnership is restricted to the

[43] IRS Announcement 2022-28.

[44] REG-106134-22, Explanation of Provisions, Section I (Definition of Syndicated Conservation Easement Transactions), at 21.

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

[46] REG-106134-22, Background, Section VI (Syndicated Conservation Easement Transactions and Notice 2017-10), at 19.

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

[48] *Id.*

[49] REG-106134-22; prop. reg. section 1.6011-9(b)(2).

[50] REG-106134-22, Explanation of Provisions, Section II, at 23-24.

[51] *Id.* at 24.

[52] REG-106134-22; prop. reg. section 1.6011-9(b)(3).

amount attributable to the portion of the real property on which the partnership places an easement. Stated another way, if a portion of a partner's investment is directed to something *other than* the real property on which the easement is donated (such as other real property, cash, cash equivalents, digital assets, securities, etc.), that portion is *not* counted in determining the applicability of the 2.5 times reporting rule.[53]

The proposed regulations offer an example of how the anti-stuffing rule functions.

Facts: A, an individual, purchased an interest in a Partnership that owns both real property with a fair market value of $500,000 and marketable securities with an FMV of $500,000. A is one of four equal investors in Partnership, each of whom purchased his interest for $250,000. The promotional materials stated that the Partnership expected to allocate a charitable contribution deduction of $500,000 to each investor — that is, two times the amount invested. After all four investors purchased their interests, the Partnership donated a conservation easement to a qualified organization and reported a $2 million charitable contribution deduction on its Form 1065, "U.S. Return of Partnership Income," based on an appraisal it obtained. The Schedule K-1 that the Partnership furnished to A indicated that the Partnership allocated him a charitable contribution deduction of $500,000.

Analysis: Applying the anti-stuffing rule, the amount of A's investment in the Partnership that is attributable to the real property on which a conservation easement was donated is $125,000 (that is, 50 percent of his total investment of $250,000). A's investment for purposes of the 2.5 times reporting rule was $125,000, and A's expected tax deduction according to the promotional materials was $500,000. Consequently, the expected return was four times A's investment, which exceeds the 2.5 times reporting rule and makes the transaction an SCET.[54]

E. Promotional Materials Expanded

As explained above, the definition of SCET contemplates, among other things, that the potential partner received "promotional materials." Notice 2017-10 simply cross-referenced existing regulations, which define the term "promotional materials" as tax analyses, tax opinions, and other written items:

> that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any person who acquired or may acquire an interest in the transaction, or to their representatives, tax advisors, or agents, by the material advisor or any related party or agent of the material advisor.[55]

The proposed regulations expand on this notion. They indicate that "promotional materials" encompass everything in the prior definition, plus any other written or oral communication provided to potential investors, such as marketing materials, appraisals (preliminary, draft, or final), websites, deeds, private placement memoranda, operating agreements, subscription agreements, and statements about the anticipated value of the conservation easement or charitable deduction.[56]

F. Focus on Tax-Exempt Entities

Much of the proposal is devoted to actual and potential changes affecting tax-exempt entities, such as land trusts, in their role as qualified organizations receiving easement donations. Readers need some background to understand such changes.

1. Overview of excise taxes.

The proposed regulations warn of potentially grave consequences for misbehaving tax-exempt entities and those managing them.

The proposed regulations explain that section 4965 is intended to deter tax-exempt entities from

[53]REG-106134-22; prop. reg. section 1.6011-9(d)(3).

[54]REG-106134-22; prop. reg. section 1.6011-9(d)(4). The author modified the example for clarity.

[55]Reg. section 301.6112-1(b)(3)(iii)(B).

[56]REG-106134-22; prop. reg. section 1.6011-9(c)(4).

enabling tax shelter transactions, which include listed transactions.[57] If a transaction is a tax shelter transaction at the time a tax-exempt entity becomes a "party" to it, the entity must pay excise taxes.[58] An entity is considered a "party" if it facilitates a transaction by reason of its tax-exempt, tax-indifferent, or tax-favored status.[59]

The amount of excise taxes depends on the circumstances. When the tax-exempt entity "unknowingly" becomes a party to a tax shelter transaction, the tax generally is the greater of (1) the highest tax rate under section 11 (which is currently 21 percent) multiplied by the "net income" of the tax-exempt entity that is attributable to the tax shelter transaction, or (2) the highest tax rate multiplied by 75 percent of the "proceeds" received by the entity that are attributable to the transaction.[60] The excise taxes increase in cases in which the tax-exempt entity "knew or had reason to know" that a specific transaction was a tax shelter.[61]

The "entity manager" is also subject to excise taxes if that manager approves the entity as a party (or otherwise causes the entity to be a party) to a tax shelter transaction and knows, or has reason to know, the status of the transaction.[62] The excise taxes imposed against an entity manager are straightforward. The IRS can collect $20,000 for each violation.[63]

When it comes to reporting, a tax-exempt entity subject to excise taxes must file Form 4720, "Return of Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code," an entity that is a party to a tax shelter transaction must file a Form 8886-T, "Disclosure by Tax-Exempt Entity Regarding Prohibited Tax Shelter Transaction," and an entity that is party to a tax shelter and is required to file a Form 990, "Return of Organization Exempt From Income Tax," must disclose its role therein.[64]

2. Land trusts as potential 'parties.'

Consistent with Notice 2017-10, the proposed regulations state that a qualified organization to which an easement is donated, such as a land trust, will *not* be treated as a "party" to the SCET for excise tax purposes and will *not* be considered a "participant" for purposes of filing Form 8886 or Form 8918.[65] That might change, though.

The proposed regulations indicate that the IRS has received tens of thousands of Forms 8886 and Forms 8918 since it issued Notice 2017-10 in December 2016. The IRS claims that such disclosures show that "a small number of qualified organizations facilitate abusive [SCETs], sometimes for several hundreds of investors per year." The IRS suggests that eliminating or limiting the exceptions to excise taxes for qualified organizations might deter them from further enabling SCETs.[66]

The proposed regulations acknowledge that good actors exist, referring to land trusts that take "affirmative steps" to avoid abuses. Such steps include refusing to participate in a conservation easement transaction in which the appraisal shows a value exceeding the basis in the property by 2.5 times or more, the partnership donates the easement within 36 months of acquiring the property, or the value of the donation exceeds $1 million. The proposed regulations solicit comments on specific ways that qualified organizations can conduct their due diligence to avoid involvement with SCETs.

The proposed regulations also ask for public comments on the potential elimination of the current rule that qualified organizations are not "parties" to SCETs. In particular, they seek input about situations in which an entity knows, or should have reason to know, that a particular donation is an SCET. The proposed regulations also seek thoughts about the possibility of

[57] Section 4965(e)(1)(A); REG-106134-22, at 12.

[58] Section 4965(a)(1); REG-106134-22, at 12.

[59] Reg. section 53.4965-4(a)(1); REG-106134-22, at 13.

[60] Section 4965(b)(1)(A); REG-106134-22, at 13. The terms "net income" and "proceeds" for these purposes are defined in reg. section 53.4965-8.

[61] Section 4965(b)(1)(B); REG-106134-22, at 13.

[62] Section 4965(a)(2); reg. section 53.4965-6; REG-106134-22, at 12.

[63] Section 4965(b)(2); REG-106134-22, at 13.

[64] Reg. section 53.6011-1; reg. section 1.6033-5; reg. section 1.6033-2; REG-106134-22, at 14-15.

[65] REG-106134-22; prop. reg. section 1.6011-9(e)(3) and (f).

[66] REG-106134-22, Explanation of Provisions, Section V (Party to a Prohibited Tax Shelter Transaction), at 26-27.

narrowing the exception instead of discarding it altogether. They explain that the IRS might not treat as "parties" those qualified organizations that complete "an adequate amount of due diligence before entering into a transaction." Along with enlightening the IRS about what constitutes sufficient due diligence, the proposed regulations ponder whether any surviving exception should be open only to qualified organizations that "have not been previously involved" with SCETs.[67]

3. Land trusts as actual 'material advisers.'

The proposed regulations explain that promoters, appraisers, return preparers, and others who make any tax statement regarding an SCET are material advisers. This status triggers the duty to file Forms 8918 and maintain lists for IRS audits as well as exposure to penalties for noncompliance. Notice 2017-10 previously indicated that the IRS would *not* treat qualified organizations, like land trusts, as material advisers. The proposed regulations completely reverse course here, eliminating the previous exclusion for land trusts.[68] They also seek comments on (1) whether land trusts and other qualified organizations are receiving fees in exchange for material aid, assistance, or advice regarding SCETs, (2) the nature of any services provided, and (3) reasons why the IRS should or should not exempt qualified organizations from material adviser status.[69]

VI. Congress Intervenes

The IRS issued the proposed regulations on December 8, 2022. They focused on reporting requirements for SCETs and substantially similar transactions — that is, who has to file Forms 8886 and Forms 8918. About three weeks later, Congress changed things dramatically, introducing new easement-related rules in the Secure Act.[70] That legislation did not address reporting requirements. Instead, it identified easement donations that will be ineligible for tax deductions, three exceptions, and related rules. Taxpayers thus received two significant pieces of guidance in rapid succession, the former by the IRS and the latter by Congress. They covered some of the same issues, broke new ground, and created a degree of chaos.

A. General Disallowance Rule

The Secure Act added a new standard for donations, section 170(h)(7). It 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 aggregate "relevant basis" of the partners in the partnership (2.5 times disallowance rule).[71] To be clear, the Secure Act is not imposing a maximum or limiting a deduction to a certain amount. It serves to *fully disallow* a donation whose value surpasses the threshold.

The new section 170(h)(7) mimics the calculation previously introduced in the proposed regulations, with some changes. For instance, the proposed regulations require reporting to the IRS if the tax deduction is 2.5 or more times the "capital contribution" made by the partners, whereas the Secure Act focuses on the "relevant basis" of the partners.

B. Three Exceptions

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 (historic preservation exception).[72]

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

[67] REG-106134-22, Explanation of Provisions, Section V (Party to a Prohibited Tax Shelter Transaction), at 29.

[68] *Id.*, Explanation of Provisions, Section IV (Material Advisors), at 25-26.

[69] *Id.*

[70] P.L. 117-328, Division T, Secure 2.0 Act of 2022. The Secure Act is a component of the Consolidated Appropriations Act of 2023.

[71] *Id.*, 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* P.L. 117-328, Division T, Secure 2.0 Act of 2022, section 605(b). New section 170(h)(7)(F).

[72] P.L. 117-328, Division T, Secure 2.0 Act of 2022, section 605(a)(1). New section 170(h)(7)(E). Transactions benefiting from the historic preservation exception have specific disclosure duties under the Secure Act. *See* new section 170(f)(19).

individual," as this relationship is specifically defined (family limited partnership exception).[73]

Third, the 2.5 times disallowance rule does not affect any donation that satisfies a complex three-year holding period (three-year hold exception). The Secure Act provides that a partnership enjoys immunity if it makes the donation at least three years *after* the *latest* of the following actions: (1) the last date on which the partnership acquired any portion of the property on which it later placed the easement; (2) the last date on which any direct partner obtained an ownership interest in the partnership; and (3) in situations involving a layered structure when the ultimate partners hold an *indirect* interest in the donor partnership through an upper-tier partnership, the last date on which the upper-tier partnership secured an interest in the donor partnership, or the last date on which the partners invested in the upper-tier partnership.[74]

C. Additional Content

The Secure Act says that the IRS "shall" issue regulations or other guidance, as necessary and appropriate, to carry out the preceding rules.[75]

The Secure Act creates a penalty, too. It indicates that the IRS can impose a gross valuation misstatement penalty equal to 40 percent of the tax underpayment when a tax deduction triggered by an easement donation is disallowed because it does not comply with the new 2.5 times disallowance rule. Moreover, the Secure Act clarifies that taxpayers cannot raise a "reasonable cause" defense, including reasonable reliance on qualified professionals, when trying to fend off this penalty.[76]

Congress tried to preemptively restrict strategic uses of the Secure Act by taxpayers in the future. The new law says that "no inference is intended as to the appropriate treatment of [easement donations] made in taxable years ending *on or before*" the Secure Act took effect.[77] It further indicates that "no inference is intended as to . . . any [easement donation] for which a deduction is not disallowed by reason of" the new 2.5 times disallowance rule.[78] In other words, Congress is trying to put the anticipatory kibosh on two arguments: (1) the size of the return on investment should have no applicability whatsoever to easement donations made on or before December 29, 2022, the date on which the Secure Act was enacted, and (2) easement donations made afterward should be accepted by the IRS as long as they fall beneath the 2.5 times disallowance rule.

VII. Thoughts About Proposed Regulations

The IRS requested public input on the proposed regulations about reporting duties. Among those commenting were organizers of SCETs, organizers of historic preservation easement transactions, conservation alliances, attorneys, appraisal groups, land trust coalitions, individual land trusts, and taxpayer advocacy organizations.[79] The observations and proposed solutions differ depending on the slant of each commentator, of course. Below is a summary of the main ideas proffered to the IRS about the proposed regulations. They can be divided into three principal categories.

A. First Category: Criticisms of Shortsightedness

Several commentators started with admonitions, pointing out that past enforcement actions by the IRS have backfired and seeking rational future actions keeping in mind the bigger picture of land conservation.

One group noted that the IRS's focus on technical issues has generated unwanted

[73] P.L. 117-328, Division T, Secure 2.0 Act of 2022, section 605(a)(1). New section 170(h)(7)(D).

[74] P.L. 117-328, Division T, Secure 2.0 Act of 2022, section 605(a)(1). New section 170(h)(7)(C).

[75] P.L. 117-328, Division T, Secure 2.0 Act of 2022, section 605(a)(1). New section 170(h)(7)(G).

[76] P.L. 117-328, Division T, Secure 2.0 Act of 2022, section 605(a)(2). New section 6662(b)(10), new section 666(h)(2)(D), and amended section 6664(c)(2).

[77] P.L. 117-328, Division T, Secure 2.0 Act of 2022, section 605(c)(2).

[78] *Id.*

[79] "Collected Comments on Proposed Regs: Conservation Easement Transactions," *Tax Notes Today Federal*, Feb. 27, 2023; Parillo, "Critics Question Need for Proposed Syndicated Easement Regs," *Tax Notes Federal*, Feb. 27, 2023, p. 1400; Land Trust Alliance comments on proposed conservation easement regulations (Feb. 5, 2023); Fox Rothschild LLP comments (Feb. 6, 2023); Heritage Preservation Trust Public comments (Feb. 3, 2023); Partnership for Conservation comments (Feb. 2, 2023); Wiggam Law comments (Feb. 5, 2023); National Taxpayers Union comments (Feb. 6, 2023); Appraisal Institute comments (Feb. 14, 2023); Dentons Sirote PC comments (Feb. 6, 2023); Rubicon Capital LLC comments (2023); GBX Group LLC comments (Feb. 6, 2023); and GBX Group LLC supplemental comments (Feb. 6, 2023).

consequences — namely, insecurity for all conservation easement donations and the parties involved. It explained the problem as follows:

> Certain IRS positions in litigation (and corresponding Tax Court decisions) have upset longstanding land trust practices (which the IRS and Treasury had not previously indicated were problematic). *Despite the laudable intent of these arguments when made by the IRS and when adopted by the court in striking down abusive transactions, the end result has been to inject uncertainty into legitimate land conservation easements*. This is all the more so when these strained interpretations are eventually rejected in [appellate] Courts, as with the IRS's *misguided interpretations* of the Section 170(h)(2)(C) perpetuity requirement and easement amendment clauses rejected [by the appellate court].[80] [Emphasis added.]

Another group, which largely supports the Secure Act, proposed regulations, and aggressive IRS enforcement, shared the negative opinion about prior enforcement actions gone awry. It described the situation this way:

> As the IRS considers the comments to the Proposed Regulations and additional actions it might take to halt abusive syndicated conservation easement transactions, the [group] urges it to avoid additional unintended adverse impacts that can result in stifling legitimate conservation transactions. *In its pursuit to combat abusive syndicated conservation easement transactions, the IRS has overreached beyond the Treas. Regs. and upset longstanding industry conservation practices pertaining to the perpetuity or conservation purpose tests*. Examples include IRS disqualifications of claimed conservation deductions based on the proceeds clause, building rights, amendment clauses, inconsistent uses, and baseline documentation reports. Distortions of long-standing, legitimate and valid practices, and an overriding focus on technical deficiencies, stifle legitimate conservation efforts.[81] [Emphasis added.]

B. Second Category: Scrap It and Start Over

Other commentators offered a comprehensive proposal, suggesting that the IRS roll up its sleeves and start anew. Because Congress passed the Secure Act *after* the IRS issued the proposed regulations, because the Secure Act deals with tax deduction disallowance while the proposed regulations center on Form 8886 and Form 8918 filing duties, because parts of the Secure Act render aspects of the proposed regulations moot, because the content of these two items is inconsistent in many ways, and because statutory rules sit above regulatory ones on the guidance hierarchy, the IRS should abandon the proposed regulations altogether or, at the very least, withdraw, retool, and reissue them.

C. Third Category: Changes if No Rescission

Assuming that the IRS will ignore cries to simply rescind the proposed regulations, several other commentators contributed the following thoughts:

- The IRS should keep the definitions of participant, party, and material adviser and *not* adopt those espoused in the proposed regulations because modifying the entire existing regulatory regime to halt a few "bad" land trusts facilitating aggressive SCETs will cause confusion, trigger lots of litigation, and impede legitimate conservation efforts in the future.
- Land trusts should not be considered material advisers because they generally do not play a role in the tax treatment of an easement donation; do not give financial, tax, or legal advice to donors; do not prepare appraisals or otherwise opine on valuation; do not possess tax expertise; and do not receive money from donors other than relatively minor amounts for producing a baseline report or for protecting an easement forever.

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[80] Montana Association of Land Trusts Comments on Proposed Rulemaking Syndicated Conservation Easement Transactions as Listed Transactions (Feb. 6, 2023).

[81] Land Trust Alliance comments (Feb. 5, 2023).

- Appraisers should not be considered material advisers either because they do not provide "advice" or "promotional materials" in connection with potential easement donations. Instead, they offer objective, impartial, independent opinions on value, consistent with the appraisal rules and standards. The proposed regulations should be modified accordingly.
- The proposed regulations should reconcile the 2.5 times reporting rule and the 2.5 times disallowance rule.
- The proposed regulations should not impose Form 8886 and Form 8918 reporting requirements on SCETs exceeding the 2.5 times disallowance rule because those transactions would already be fully disallowed under the Secure Act.
- Congress mandated that the IRS publish "safe harbor deed language" within 120 days of the enactment of the Secure Act to address just two specific matters. However, the IRS should proactively expand the scope and issue comprehensive "safe harbor deed language" to provide clear guidance on all key issues. This would serve to foment land conservation, eliminate ambiguity, and avoid costly future disputes, particularly over technical issues.
- The Secure Act created three exceptions to the 2.5 times disallowance rule: the historic preservation exception, family limited partnership exception, and three-year hold exception. Because they were issued beforehand, the proposed regulations do not contemplate these congressional carveouts, and they must do so.
- The proposed regulations should exclude from SCET status easement donations whose claimed value falls below a specific figure, like $1 million.
- The proposed regulations should also exclude from SCET status easement donations made by partnerships whose partners consist of a small group of friends or colleagues.
- The proposed regulations should address valuation issues evenhandedly by adding a penalty for revenue agents, managers, and IRS engineers who use internal valuations during an audit (alleging a value of $0 or close thereto) that are later struck down by the Tax Court or court of appeals for being meritless.
- The proposed regulations are devoid of guidance regarding the pivotal issue, acceptable valuation standards. They should contain enhanced rules for easements, including possible establishment of a specialized body similar to the Art Advisory Panel created by the IRS many decades ago.
- The proposed regulations focus exclusively on donations by partnerships and other passthrough entities, even though an easement donation by an individual could be manipulated in the same way, particularly when it comes to valuation.
- Subjecting land trusts and their managers to potential excise taxes under section 4965 will create a massive, expensive, and untenable compliance burden, diminish the number of land trusts willing to accept any easement donations from any party regardless of how worthy they might be, and dissuade talented individuals from taking critical leadership positions with land trusts.
- The IRS should not eradicate the exemption of land trusts from being "parties" to an SCET because section 4965 was created to prevent tax-exempt organizations from using their status to shift otherwise taxable income to themselves as a true *party* to a transaction, not as a recipient of a charitable donation. SCETs reduce the taxable income to donors (via a charitable deduction) without creating a corresponding income recognition event for land trusts.
- The proposed regulations indicate that when promotional materials are questionable, nonexistent, or unavailable, there is a rebuttable presumption that the partnership violated the 2.5 times reporting rule if the easement donation occurred within three years after a partner made his capital contribution and the partner claims a tax deduction that is 2.5 times or more his initial investment. The notion that taxpayers could successfully refute that legal

presumption is laughable given the IRS's unwavering position that every single SCET should get a $0 deduction for supposed technical violations, insufficient conservation purposes, and lack of qualified appraisals.

- The anti-stuffing rule in the proposed regulations is superfluous after the enactment of the Secure Act because the new section 170(h)(7) generally states that a partnership will not be entitled to any tax deduction if the amount of the easement donation exceeds 2.5 times the aggregate "relevant basis" of the partners in the partnership.[82] The focus on relevant basis by the Secure Act — instead of the capital contributions as in the proposed regulations — allows the IRS to address situations in which a partnership holds multiple assets, not just the property on which it donates an easement.
- The proposed regulations, if they are finalized, should apply only to transactions entered into after December 29, 2022, consistent with the Secure Act. One commentator urged people to ponder matters from a broader perspective: "If federal agencies [like the IRS] can violate the notice-and-comment requirements of the APA, subsequently issue an APA-compliant proposed regulation, and [then] impose retroactive obligations in the proposed regulation back to the date of the initial violation, this would render the APA meaningless."[83]
- The proposed regulations violate the Constitution in various ways too convoluted and dense for this article to adequately explore.
- Conservation easements are a critical component of the "America the Beautiful" initiative of the Biden administration, whose goal is to protect at least 30 percent of the country's land and water by 2030. Recent studies by environmental organizations conclude that easements over the past four years have significantly protected endangered species and threatened habitats. The proposed regulations (especially the burdens, costs, and risks placed on donors and land trusts) will decrease conservation efforts and undermine lofty national objectives.
- The term "promotional materials" in the proposed regulations is broadly defined to encompass a deed of conservation easement. The result is that many real estate attorneys with no tax experience, with no information about easement valuation, with no contact with organizers or partners, and with no involvement in the transaction aside from memorializing the donation to a land trust might be considered materials advisers. These unsuspecting attorneys are likely oblivious to the Form 8918 filing duty, leaving them susceptible to large penalties.
- Historic preservation easements are "fundamentally different" from SCETs and should be treated accordingly. After paying various fees and expenses, much of the money contributed by the partners to a partnership involved in a typical SCET goes to acquiring the land. This all occurs before the easement is donated. By contrast, partnerships engaged in historic preservation easements use only a portion of the funds to purchase the relevant building, then they donate the easement, and later they must direct additional capital to rehabilitate the building and maintain its historic character. Thus, when it comes to partnerships used in historic preservation easement transactions, some capital is deployed before the donation, while the lion's share is used after the donation. The result is that the anti-stuffing rule in the proposed regulations unfairly and negatively affects historic preservation easements because it only considers the amount invested in the pertinent property (be it vacant land or historic buildings) before the donation.
- Because historic preservation easements are "fundamentally different" from SCETs, they

[82]P.L. 117-328, Division T, Secure 2.0 Act of 2022, 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* P.L. 117-328, Division T, Secure 2.0 Act of 2022, section 605(b). New section 170(h)(7)(F).

[83]Heritage Preservation Trust comments (Feb. 3, 2023).

should not be governed by the proposed regulations at all. The IRS should create a separate set of rules for them.
- The proposed regulations lack sufficient clarity, to the detriment of taxpayers, regarding what transactions will be considered "substantially similar" to SCETs.
- The proposed regulations inappropriately classify donations of real property in fee simple as "substantially similar" to SCETs, when the Secure Act makes no such claim.
- The proposed regulations, like Notice 2017-10 before them, use a four-factor test to define an SCET. However, when one introduces the idea that the proposed regulations also reach "substantially similar" transactions, such a test becomes meaningless because essentially any easement or fee simple donation could become an SCET in the IRS's eyes.

VIII. Conclusion

How will the IRS rectify issues with the proposed regulations? To what extent, if any, will it incorporate the public comments described above? Will it rescind the proposed regulations altogether? Will it withdraw them and start from scratch, issuing a new version in harmony with the Secure Act? While retooling the proposed regulations dealing with information reporting duties, will it craft a separate set addressing the new tax deduction disallowance rule, as expressly mandated by Congress in the new section 170(h)(7)? Those are among the questions that persist as easement guidance evolves. ■