IRS Introduces New Challenge to Tax-Related Insurance: From Easements to Elsewhere

HALE E. SHEPPARD, ESQ.

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Introduction

It might sound glib, but the world is filled with uncertainties, and people take steps to mitigate them. One method is purchasing tax-related insurance. Taxpayers have consistently done this over the years without much fanfare. The trend has increased recently as transactions become more complex, the amounts at stake skyrocket, and the Internal Revenue Service ("IRS") cannot or will not issue timely Private Letter Rulings to give taxpayers the comfort they seek. So-called tax insurance has forged a place in the private market, a reality about which the IRS is not altogether pleased. Indeed, the IRS has been attacking insurance issues in the context of conservation easements as part of its broad compliance campaign.

This article, which constitutes the third in a series, explains why certain taxpayers are acquiring insurance, two major types of coverage, several challenges the IRS is now raising, and why incipient IRS actions should concern *all* companies offering tax-related insurance and all taxpayers obtaining policies, not just those in the easement realm.[1]

Ubiquitous Easement Examinations

The IRS has taken widespread enforcement actions against conservation ease-

Hale E. Sheppard, Esq. (B.S., M.A., J.D., LL.M., LL.M.T.) is a Shareholder in the Tax Controversy Section of Chamberlain Hrdlicka. He specializes in tax audits, tax appeals, and Tax Court litigation. You can reach Hale by phone at (404) 658-5441 or by e-mail at hale.sheppard@chamberlainlaw.com

ment donations the past several years. One result of these efforts is that partnerships that donate easements expect, from the very beginning, that the IRS will examine them, take extreme tax and legal positions, propose the highest possible penalties, and eventually force them into tax litigation. This belief derives from the following building blocks.

First, the IRS issued Notice 2017-10 in December 2016, labeling syndicated conservation easement donations "listed transactions."[2] The IRS warned at that time that it planned to attack donations based on the partnership anti-abuse rules, economic substance doctrine, and other unspecified theories.[3]

Second, the IRS launched a "compliance campaign" centered on conservation easements, devoting dozens of specialized Revenue Agents and other IRS personnel to the cause.[4]

Third, the IRS consistently featured conservation easements among its "dirty dozen."[5]

Fourth, the IRS engaged in a media blitz, disseminating threats in new releases, conference presentations, articles, and elsewhere. The IRS emphasized that it was (i) pursuing promoters, appraisers, return preparers, material advisors, accommodating entities, charitable organizations, and others, (ii) making referrals to the Office of Professional Responsibility, (iii) raising a long list of technical, procedural, legal, and tax arguments in easement disputes, (iv) asserting all possible civil penalties, (v) conducting simultaneous civil examinations and criminal investigations, and (vi) litigating a large number of cases.[6]

Fifth, the IRS began challenging every supposed "technical" flaw in connection with partnerships that donated conservation easements. These consisted of alleged shortcomings with appraisals, Deeds of Conservation Easement, Forms 8283 (Non-Cash Charitable Contributions), and other documents affiliated with donations. The IRS's Audit Technique Guide contains an extensive list of technical items that personnel are encouraged to pursue.[7]

Sixth, the government filed a Complaint in District Court seeking a permanent injunction against alleged organizers and appraisers, along with disgorgement of the proceeds that they obtained from their dealings with conservation easements.[8]

Seventh, the IRS appointed a "Promoter Investigations Coordinator," who is in charge of coordinating with the Civil Division, Criminal Investigation Division, Chief Counsel, and others to develop enforcement strategies.[9] The IRS then initiated various promoter investigations.[10] Building on that momentum, the IRS later announced formation of the "Office of Promoter Investigations," which was designed to expand the ongoing efforts of the Promoter Investigations Coordinator.[11] The IRS underscored in that same announcement that halting improper easement donations ranked first on its list of priorities.[12]

Eighth, the IRS broadcasted that it had established a new "Fraud Enforcement Office" and hired a "National Fraud Counsel."[13] The IRS was not coy about the nexus between its burgeoning fraud team and conservation easements. Indeed, it issued two Chief Counsel Advisories within just a few months describing the methods by which the IRS can apply civil fraud penalties against partnerships donating easements.[14]

Ninth, the IRS announced that the Criminal Investigation Division would be running its own, separate investigations related to conservation easement donations.[15]

Finally, the IRS proclaimed that it plans to attack every single syndicated conservation easement transaction, starting with examinations and ending with litigation. The IRS announced, for example, that it "will not stop in [its] pursuit of everyone involved," it will employ "every available enforcement option," and it is "committing significant examination and investigative resources to vigorously audit the entities and individuals involved in this scheme."[16] If that were not clear enough, the IRS confirmed that it currently examines "100 percent of these deals and plans to continue doing so for the foreseeable future."[17] The National Fraud Counsel also admonished that "the IRS is auditing 100 percent of these cases."[18] Chief Counsel for the IRS, piling on, explained that his troops are prepared "to take each of these [pending easement cases] and all other cases being developed by the IRS to trial."[19]

Acquiring Insurance as a Response to IRS Actions

Given the IRS's uncompromising attacks on conservation easement donations, the size of many tax deductions, and the significant costs of defending a dispute against the IRS, many partnerships have turned to purchasing insurance. It falls into two main categories. The first addresses certain fees and expenses linked to tax audits, administrative appeals with the IRS, and tax litigation ("Tax Defense Insurance"). This type of coverage has no relationship to the ultimate tax liability of the partnership or its partners, as determined by the IRS or the courts. The second product goes by several names, such as tax gap, tax result, tax protection, or tax indemnity insurance ("Tax Result Insurance"). The latter is nothing new; Tax Result Insurance has been around for nearly four decades.[20]

Various Attacks on Insurance

Although few people have noticed, the IRS has started challenging insurance in various ways. This article focuses on just three of them.

Tax Result Insurance Supposedly Undermines Partner Status

The IRS began arguing a few years ago that Tax Result Insurance (not Tax Defense Insurance) supposedly eliminates risks associated with investing in a partnership whose options include donating a conservation easement. The IRS regularly inquires about Tax Result Insurance during audits nowadays. A typical Information Document Request includes the following mandate: "Describe all agreements, guarantees, representations or assurances relating to tax benefits anticipated from the easement donation, including agreements to reimburse or indemnify the partnership or its partners in the event that such tax benefits were not permitted by the [IRS]."

Logic dictates that the IRS is trying to beef up the following syllogism: The bedrock of a partnership is the existence of downside and upside risk for partners; Tax Result Insurance somehow removes such risk; therefore, the entities owning the land and making the easement donations are not "partnerships" for tax

purposes and they cannot benefit from tax deductions triggered by donating easements because of the functioning of the partnership tax rules.[21] The IRS faces several inconvenient realties when advancing this position, two of which are examined below.

IRS Regulations Show Insurance Is Not Problematic

Taxpayers and other parties generally must file various returns, statements, forms, lists, and additional items in accordance with the applicable regulations.[22] In the case of "reportable transactions," the relevant disclosure statements are Forms 8886 (Reportable Transaction Disclosure Statement), which must be filed by those who "participate" in the transactions, and Forms 8918 (Material Advisor Disclosure Statement), which pertain to "material advisors" to the transactions.

The IRS published several versions of regulations years ago in connection with reportable transactions.[23] As shown below, they indicate that the IRS has already analyzed the issue of Tax Result Insurance and concluded that its use is *not* problematic.

Regulations in 2000

The first set of proposed and temporary regulations, published in March 2000, focused on disclosure statements for *corporate* taxpayers.[24]The Preamble stated that the IRS was concerned about the proliferation of tax shelters, and the regulations were intended to give the IRS early notification of large corporate transactions that "may be indicative of such tax shelter activity."[25]

The regulations identified two categories of reportable transactions. First, those that the IRS had specifically identified as tax-avoidance transactions. Second, those that warranted further scrutiny because they possessed characteristics common in corporate tax shelters. Those in the second category consisted of transactions that (i) were expected to reduce a taxpayer's federal income tax liability by more than $5 million in any one year or by more than a total of $10 million, and (ii) had at least two of the five characteristics highlighted by the IRS. The characteristic relevant to this article focused on "contractual protection," as follows:

> The taxpayer has obtained or been provided with *contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained,* including, but not limited to, rescission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer's realization of tax benefits from the transaction, *insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer).*[26]

Regulations in June 2002

The IRS decided to expand the reach of the disclosure requirements in June 2002. From that point forward, they would apply not only to corporations, but also to individuals, trusts, partnerships, and S corporations that participate in reportable transactions.[27]

Regulations in October 2002

The IRS changed course in October 2002 because it discovered, unsurprisingly, that "taxpayers [were] interpreting the five characteristics in an overly narrow manner and [were] interpreting the exceptions in an overly broad manner."[28] To remedy this, the IRS created more objective rules, featuring six new categories of reportable transactions.[29] One of these categories involved insuring tax results; it was called "Transactions with Contractual Protection." The new temporary regulations stated the following:

> *A transaction with contractual protection is a transaction for which the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax consequences from the transaction will not be sustained, including,* but not limited to, rescission rights, the right to a full or partial refund of fees paid to any persons, fees that are contingent on the taxpayer's realization of tax benefits from the transaction, *insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion or offering of the transaction to the taxpayer).*[30]

Public Comments to Regulations

The IRS received significant public input to the proposed and temporary regulations. A large percentage of the written comments came from insurance companies.[31] They, along with a long list of other interested parties, urged the IRS to remove "contractual protection" as an indicia of tax shelter activity.[32]

Regulations in March 2003

The IRS issued final regulations in March 2003.[33] The IRS indicated that, after considering public input, it decided to *remove* Tax Result Insurance from the concept of "contractual protection." The Preamble to the final regulations explained the change of heart by the IRS:

> *Commentators indicated that it was inappropriate to require the reporting of a transaction for which the taxpayer obtains tax insurance. Other commentators suggested that the contractual protection factor would require the reporting of numerous non-abusive types of transactions, such as legitimate business transactions with tax indemnities or rights to terminate the transaction in the event of a change in tax law. In response to these comments, the IRS and Treasury Department changed the focus of the contractual protection factor to whether fees [instead of tax benefits] are refundable or contingent.* However, if it comes to the attention of the IRS and Treasury Department that other types of contractual protection, including tax insurance or tax indemnities, are being used to facilitate abusive transactions, changes to the regulations will be considered.[34]

The final regulations were devoid of talk about Tax Result Insurance and focused solely on contingent fees:

> *A transaction with contractual protection is a transaction for which the taxpayer or a related party . . . has the right to a full or partial refund of fees . . . if all or part of the intended tax consequences from the transaction are not sustained. A transaction with contractual protection also is a transaction for which fees . . . are contingent on the taxpayer's realization of tax benefits from the transaction.* All the facts and circumstances relating to

> the transaction will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to the transaction have not designated as fees or any agreement to provide services without reasonable compensation.[35]

Regulations in 2006

Section 6111, which was enacted in 2004, mandated that "material advisors" disclose their involvement with reportable transactions on Forms 8918. Important for purposes of this article, Congress decided to include parties linked to insuring such transactions as material advisors. Specifically, Section 6111 indicated that the term "material advisor" means "any person who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, *insuring*, or carrying out a reportable transaction, and who directly or indirectly derives gross income in excess of the threshold amount . . . for such aid, assistance, or advice."[36]

The IRS issued proposed regulations approximately two years later.[37] The Preamble confirms that the existence of Tax Result Insurance does *not* create "reportable transaction" status for purposes of Form 8886, but it does trigger reporting for material advisors on Form 8918.

> *Previous comments to the regulations under § 1.6011-4 stated that it is inappropriate to require reporting of transactions under the contractual protection filter . . . for which the taxpayer obtains tax result protection (sometimes referred to as "tax result insurance") because numerous legitimate business transactions with tax indemnities would be subject to reporting. The IRS and Treasury Department removed tax result protection from that category of reportable transaction* but cautioned that if the IRS and Treasury Department became aware of abusive transactions utilizing tax result protection, the issue would be reconsidered.[38]

Previous IRS Guidance Expressly Blesses Insurance

In *Historic Boardwalk Hall v. Commissioner,* the Third Circuit Court of Appeals held that a member was not a bona fide partner for federal income tax purposes, and thus was not entitled to receive an allocation of historic rehabilitation credits from the partnership.[39] The primary reason for this decision was that the member had the right to receive a guaranteed reimbursement of its investment if it did not receive the anticipated tax credits. This, concluded the Third Circuit Court of Appeals, meant that the member did not incur any entrepreneurial risks and did not adequately participate in the financial upside or downside of the partnership's business, such that it was not a "partner." In the words of the Third Circuit Court of Appeals, "because [the member] lacked a meaningful stake in either the success or failure of [the partnership], it was not a bona fide partner."[40]

In response to the decision in *Historic Boardwalk Hall,* the IRS issued Revenue Procedure 2014-12, which established a "safe harbor" for structuring historic rehabilitation credit transactions. Revenue Procedure 2014-12 described certain "permissible guarantees" and "impermissible guarantees."[41] The latter category includes a restriction against any person involved in the transaction guaranteeing or otherwise insuring the ability of the partner to claim the tax credits, the cash equivalent of such credits, or the repayment of any portion of the partner's contribution to the partnership due to the inability to claim the credits, if the IRS were to challenge the transactional structure of the partnership.[42] It also stated that no person involved with the transaction could guarantee that the partner would receive distributions or consideration in exchange for its partnership interest, except for a sale at fair market value.[43] Importantly, Revenue Procedure 2014-12, referencing the "impermissible guarantees," expressly said that this "does *not* prohibit the [partner] from procuring insurance *from persons not involved with* the rehabilitation or the partnership."[44] In other words, the IRS concluded that obtaining Tax Result Insurance from an independent insurer is not problematic.

A few years later, the IRS issued Revenue Procedure 2020-12, which created a "safe harbor" for partnerships allocating credits for carbon dioxide sequestration.[45] Revenue Procedure 2020-12 featured various warnings, including that no person involved in any part of the company that generates the tax credits can guarantee or otherwise insure, directly or indirectly, an investor's ability to claim the credits, the cash equivalent of the credits, or a repayment of any portion of the investor's contribution because of an IRS challenge.[46] However, Revenue Procedure 2020-12 explicitly stated that such restriction against guaranteed results "does *not* prohibit the investor from procuring insurance, including recapture insurance, *from persons not related to*" the project developer, another investor/partner, the company emitting the carbon dioxide, or a party purchasing qualified carbon dioxide.[47]

No Deductions for Tax Result Insurance Premiums Paid

Doubling down, the IRS recently announced its stance that, regardless of whether Tax Result Insurance serves to eliminate partnership status, the supposed partnerships cannot claim a deduction for the premiums they paid. Two memos released in late 2020 show the IRS's reasoning.

First Memo

Chief Counsel Advice 202050015 ("First CCA") analyzes four tax rules.[48] First, Section 162 generally provides that a taxpayer can deduct all ordinary and necessary expenses paid or incurred during a year "in carrying on a trade or business."[49] Second, Section 212(1) states that individual taxpayers can deduct all ordinary and necessary expenses paid or incurred during a year for the production or collection of income, while Section 212(2) allows deductions for the management, conservation, or maintenance of property they hold for production of income.[50] Third, Section 212(3) contemplates deductions in connection with the determination, collection, or refund of any tax.[51] Expenses for tax counsel or for preparation of returns in connection with proceedings involved in disputing or determining a tax liability normally are deductible.[52] Fourth, Section 275 generally prohibits deductions for federal income taxes paid.[53]

With those basics out of the way, the First CCA addressed just one issue, namely, can a partnership deduct the cost of the Tax Result Insurance? It began with deductibility under Section 162. The First CCA explained that the determination is made at the partnership

level, not at the partner level. It further indicated that, based on two prior Revenue Rulings and a Tax Court case decided over 60 years ago, where an expense involves a contractual arrangement for reimbursement in the event of certain contingencies, the terms of the particular arrangement dictate whether the expense in question is sufficiently related to the taxpayer's trade or business. The IRS concluded as follows:

> The 'tax insurance' premiums . . . are not sufficiently related to the partnership's trade or business to support a deduction under Section 162(a). In the event of any adjustment to the deduction claimed for a charitable contribution, the policy will reimburse the partners for any difference between the tax benefits they claimed and the tax benefits they are entitled to receive, regardless of any trade or business activity of the partnership. For this reason, the partnership may not deduct its 'tax insurance' premiums under Section 162(a).

With regard to treatment under Section 212(1) and Section 212(2), the First CCA recalled that the relevant expenses must be reasonable in amount and must have a reasonable and proximate relation to the production or collection of income or to the management, conservation, or maintenance of property held for income production. The First CCA indicated that such criteria are not met when it comes to Tax Result Insurance:

> The 'tax insurance' premiums . . . are not sufficiently related to the partnership's income-producing activities to support a deduction under Section 212(1)-(2). In the event of any adjustment to the deduction claimed under Section 170, the policy will reimburse the partners for any difference between the tax benefits the claimed and the tax benefits they are entitled to receive, regardless of any trade or business activity of the partnership. For this reason, the partnership may not deduct its 'tax insurance' premiums under Section 212(1)-(2).

Finally, in terms of deductibility under Section 212(3), the First CCA emphasized that Section 275 prohibits taxpayers from deducting amounts of federal income taxes paid, and the Tax Result Insurance serves to pay such taxes for the partners: "The 'tax insurance' premiums . . . are not deductible as an expense related to the determination, collection, or refund of any tax under Section 212(3). The policy does not provide, fund, or reimburse any services or materials related to preparing returns, determining a tax liability, or contesting such liability; it reimburses the partners for their proper federal income tax, an amount not deductible under Section 275. For this reason, the partnership may not deduct its 'tax insurance' premiums under Section 212(3)."

Second Memo

Chief Counsel Advice 202053010 ("Second CCA") addressed the same issues as the First CCA, but in more depth.[54]

It first concluded that the partnership could not deduct premium payments under Section 162 because they "are unrelated to any [of its] purported trade or business activities." The IRS reasoned that, as long as the partnership fulfills its limited obligations under the insurance policy, it is entitled to payments related to the amount of easement deductions disallowed. This result, emphasized the IRS, would occur regardless of whether the partnership had any expenses related to any trade or business. The IRS went on to underscore that the contingency triggering the insurance payout did not pertain to business activities, but rather the actions of the IRS or another tax authority, and that the partnership could suspend any or all business activities without affecting its entitlement to a payout under the policy. Finally, the IRS argued that any payment would go to the partners, as the policy specifically names them as the insured parties, which demonstrates that the Tax Result Insurance is "necessarily unrelated to any trade or business activities at the partnership level."

NOTES

1 This current article supplements earlier ones by the same author. *See* Hale E. Sheppard, "Conservation Easements, Legitimate Risks, and Potential Issues Related to Tax Result Insurance," 31(4) *Taxation of Exempts* 10 (2020); 47(3) *Journal of Real Estate Taxation* 31 (2019); Hale E. Sheppard, "Three New Challenges to Tax Result Insurance in Conservation Easement Disputes," 134(6) *Journal of Taxation* 18 (2021); 49(1) *Real Estate Taxation* 4 (2021); 33(1) *Taxation of Exempts* 26 (2021).

2 IRS Notice 2017-10, 2017-4 Internal Revenue Bulletin 544 (Dec. 23, 2016).

3 IRS Notice 2017-10, Section 1.

4 IRS Information Release 2020-130 (June 25, 2020).

5 *See, e.g.*, IR-2019-47 (March 19, 2019).

6 Nathan J. Richman, "Multiple Divisions Coming for Syndicated Conservation Easements," 2019 Tax Notes Today 220-3 (Nov. 13, 2019); William Hoffman, "Conservation Easement Crackdown a Portent, Rettig Says," 2019 Tax Notes Today 221-9 (Nov. 14, 2019); Kristen A. Parillo, "IRS Is Building Up Its Easement Toolbox," 2019 Tax Notes Today 222-6 (Nov. 15, 2019); Kristen A. Parillo, "IRS Looking for Promoter Links as Easement Crackdown Grows," Tax Notes Today, Doc. 2019-47134 (Dec. 13, 2019); Kristin A. Parillo, "Syndicated Easement Players Getting Referred to OPR," 2020 Tax Notes Today Federal 223-5 (Nov. 18, 2020).

7 Internal Revenue Service. Conservation Easement Audit Techniques Guide. (Rev. 11/4/16), pgs. 78-81.

8 *United States v. Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal*, Case No. 1:18-cv-05774, D.C. N.D. Ga, Complaint filed Dec. 18, 2018.

9 Kristen A. Parillo. "IRS Assigns Point Person on Promoter Investigations," Federal Tax Notes Today Doc. 2020-6890 (Feb. 25, 2020); IR-2020-41 (Feb. 24, 2020).

10 Kristen A. Parillo, "IRS Looking for Promoter Links as Easement Crackdown Grows," Tax Notes, Doc. Number 2019-47134 (Dec. 13, 2019).

11 IR-2021-88 (April 19, 2021); William Hoffman, "IRS Names Acting Chief of Office of Promoter Investigations," 2021 Tax Notes Today Federal 75-1 (April 20, 2021).

12 IR-2021-88 (April 19, 2021).

13 IRS News Release IR-2020-49 (March 5, 2020); IR-2020-102 (May 26, 2020).

14 IRS Chief Counsel Memorandum AM-2020-010 (Oct. 5, 2020) (called "Determining the Fraud Penalty in TEFRA Syndicated Conservation Easement Cases"); "IRS Describes Penalty Procedures for Conservation Easement Transactions," 2020 Tax Notes Federal Today 197-42 (Oct. 5, 2020); IRS Chief Counsel Memorandum AM-202044009 (Oct. 23, 2020) (called "Determining the Fraud Penalty in BBA Syndicated Conservation Easement Cases").

15 Nathan J. Richman, "Multiple Divisions Coming for Syndicated Conservation Easements," 2019 Tax Notes Today Federal 220-3 (Nov. 13, 2019); IRS Information Release 2019-182 (Nov. 12, 2019); Nathan J. Richman, "IRS Is Talking to Prosecutors about Conservation Easements," 2020 Tax Notes Today Federal 223-6 (Nov. 18, 2020)

16 IR-2019-182 (Nov. 12, 2019).

17 IR-2020-125 (June 10, 2022).

18 Nathan J. Richman. "IRS Shifting Tack on Fighting Syndicated Conservation Easements," Tax Notes Doc. 2022-3795 (Feb. 7, 2022).

19 IR-2019-213 (Dec. 20, 2019).

With respect to Section 212(1) and Section 212(2), the IRS recognized in the Second CCA that these provisions do not require the partnership to be engaged in a trade or business, but do mandate a profit motive. In addition, the IRS stressed that these provisions require that the expense bear a reasonable and proximate relation to the applicable activity or property. The IRS reasoned that the Tax Result Insurance and its premiums were simply unrelated to any income-producing activity or property of the partnership: "Neither the deduction itself, nor any insurance payout for its disallowance, arises as a result of any purported investment activity, or is correlated to the success or failure of such activity." In an anticipatory move, the Second CCA indicated that the IRS's conclusion would be the same, regardless of whether the partnership's plan were to contemplate future sale of the property subject to the easement or continued leasing of such property.

Finally, regarding Section 212(3), the Second CCA admitted that the standard here is the lowest of all, because there is no business or nexus requirement. It further acknowledged that no court has yet ruled on the deductibility of contracts resembling insurance under Section 212(3). However, the IRS indicated that courts have denied deductions under analogous, predecessor provisions for other types of contractual arrangements on grounds that the expenses were nothing more than "the contractual relabeling of non-deductible tax." Then, the IRS seemed to reason that the premiums are not deductible because they relate to Tax Result Insurance, as opposed to Tax Audit Insurance, without going so far as to expressly confirm that the IRS would allow deductions in either scenario:

> There is no indication that any portion of the premium paid for the policy is specifically allocated to professional expenses incurred contesting a tax deficiency. In fact, while the policy requires [the partnership] to secure written consent from the insurer prior to entering any settlement agreement that would result in a loss, the insurer has no obligation under the policy to defend or pay the defense costs of any proceeding against [the partnership] related to the deduction. Moreover, the costs of such defense are excluded from the policy's definition of loss. Because the insurer is under no obligation to perform any services related to a tax proceeding, no portion of the premium can be regarded as consideration for such services. Thus, we conclude the contract explicitly contemplates the reimbursement of non-deductible tax and penalty amounts.

Tax Defense Insurance Supposedly Eliminates Penalty Mitigation

As explained above, the IRS began by suggesting that Tax Result Insurance eliminated partner status, such that the entities donating conservation easements, which relied on the partnership rules to accomplish their goals, should get a tax deduction of $0. Now, the IRS appears to have broadened its stance, stating in various Examination Reports that the mere existence of Tax Defense Insurance (not Tax Result Insurance) prevents taxpayers from avoiding penalties.[55]

In a normal conservation easement case, the IRS proposes a long list of alternative penalties, ranging in severity. These often include sanctions for negligence, substantial valuation misstatements, gross valuation misstatements, or reportable transaction understatements.[56] Indeed, one of the "audit tips" provided to IRS personnel is that Examination Reports generally should include "a tiering of proposed penalties with multiple alternative positions."[57]

Some penalties can be avoided if the taxpayer can demonstrate there was "reasonable cause" for the violation.[58] Other penalties will not be asserted if the value in question was based on a qualified appraisal by a qualified appraiser and the taxpayer made a good faith investigation of the value of the property.[59] Finally, certain penalties, like the one for making a gross valuation misstatement, cannot be overcome by evidence of reasonable cause. It is mathematical in nature; that is, if the value of the easement originally claimed by the taxpayer exceeds the value ultimately determined by the Tax Court by a certain percentage, then the penalty applies, period.[60]

In recent Examination Reports involving conservation easements, the IRS acknowledges that the partnerships under scrutiny hired several legal, accounting, property and valuation professionals on the front end, and fully disclosed the easement donation to the IRS by filing all the required returns. Despite this, the IRS suggests that the partnerships should be penalized *solely* because they acquired Tax Defense Insurance. Below are samples of the IRS's observations and reasoning:

> The [insurance] contract provides for the Taxpayer to be reimbursed for all defense expenses up to $1,000,000 for claims from proceedings initiated

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[20] Walter T. Coppinger, "Legislative Direction and Tax Compliance: A Tax Policy and Philosophy at Odds," 6 Taxes – The Tax Magazine 710 (1983).

[21] The IRS has made similar arguments about risk and partner status in the past. *See Virginia Historic Tax Credit Fund v. Commissioner*, T.C. 2009-295.

[22] Section 6011(a); Treas. Reg. § 301.6011-1

[23] *See* T.D. 8875 (March 2, 2000); T.D. 8876 (March 2, 2000); T.D. 8877 (March 2, 2000); T.D. 8896 (Aug. 16, 2000); T.D. 8961 (Aug. 7, 2001); T.D. 9000 (June 18, 2002); T.D. 9017 (Oct. 22, 2002); T.D. 9018 (Oct. 22, 2002); T.D. 9046 (March 4, 2003); T.D. 9108 (Dec. 30, 2003); T.D. 9350 (Aug. 3, 2007).

[24] T.D. 8877 (March 2, 2000); REG-103735-00.

[25] T.D. 8877 (March 2, 2000), Preamble.

[26] T.D. 8877 (March 2, 2000), Preamble; Temp. Reg. § 1.6011-4T(b)(3)(B) (emphasis added).

[27] T.D. 9000 (June 18, 2002), Preamble; Temp. Reg. § 1.6011-1T(a)(1).

[28] T.D. 9017 (Oct. 22, 2002), Preamble.

[29] *Id.*

[30] T.D. 9017 (Oct. 22, 2002); Temp. Reg. § 1.6011-4T(b)(4) (emphasis added).

[31] Sheryl Stratton, "Sole Witness Testifies before IRS on Tax Shelter Regs.," 2003 Tax Notes Today 5-3 (Jan. 8, 2003). Comments were submitted to the IRS by the American Council on Life Insurers, Association for Advanced Life Underwriting, National Association of Insurance and Financial Advisors, Association of Financial Guaranty Insurers, Financial Security Assurance, Security Financial Life Insurance Company, and The Hartford.

[32] Sheryl Stratton, "Sole Witness Testifies before IRS on Tax Shelter Regs.," 2003 Tax Notes Today 5-3 (Jan. 8, 2003).

[33] T.D. 9046 (March 4, 2003).

[34] T.D. 9046 (March 4, 2003), Preamble (emphasis added).

[35] T.D. 9046 (March 4, 2003); Treas. Reg. § 1.6011-4(b)(4)(i).

[36] Section 6111(b)(1)(A); Treas. Reg. § 301.6111-3(b)(1). The original bill introduced in the House of Representatives did not contain the word "insuring;" it was later added by the Senate amendment to bill, without an explanation as to why. *See* House of Representatives, American Jobs Creation Act of 2004, 108th Congress, 2nd Session, Conference Report 108-755 (October 7, 2004), pgs. 606-609.

by the [IRS] to investigate, examine, or audit a tax return filed by the Taxpayer for a conservation easement donated by the Taxpayer.

The Taxpayer did not act in good faith that the amount on the tax return was correct, as the Taxpayer obtained an insurance policy to reimburse its costs in the case the deduction on the tax return was audited. Therefore, the 20% addition to tax shall be applied to imputed underpayment as the Taxpayer was negligent in determining the correct deduction amount.

The Taxpayer did not have the belief that its treatment of the conservation easement transaction was proper as the Taxpayer obtained an indemnity contract to be reimbursed for its defense expenses pertaining to an IRS audit of the transaction. Therefore, the reasonable cause and good faith exception do not apply, and the reportable transaction understatement penalty shall be imposed.[61]

Conclusion

So, where are we? The IRS has argued, in the context of its prolonged efforts to halt conservation easement donations, that the existence of Tax Result Insurance might deprive an entity of partnership status, taxpayers cannot claim deductions for premiums paid for Tax Result Insurance, and purchasing Tax Defense Insurance supposedly demonstrates that taxpayers lack reasonable cause for their positions and they are not acting in good faith, such that penalties apply. The IRS has focused these arguments thus far on partnerships donating easements, but such extreme positions should concern *all* insurers and taxpayers for several reasons. First, in certain instances, the IRS is now taking positions that directly contradict those that it adopted earlier in regulations and Revenue Procedures. Second, the use of Tax Result Insurance is increasing dramatically in many areas, particularly major business transactions, for legitimate reasons. Finally, if the IRS were to convince the courts to accept any of three positions that it is currently advocating in the easement field, history shows that the IRS likely would attempt to apply such positions to the detriment of taxpayers in many other situations, too. ●

NOTES

37 REG-103039-05 (Nov. 2, 2006).

38 REG-103039-05 (Nov. 2, 2006) (emphasis added).

39 *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3rd Cir. 2012), *rev'g* 136 T.C. 1 (2011).

40 *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425, 463 (3rd Cir. 2012), *rev'g* 136 T.C. 1 (2011).

41 Revenue Procedure 2014-12, Section 4.05.

42 Revenue Procedure 2014-12, Section 4.05(2)(a).

43 *Id.*

44 Revenue Procedure 2014-12, Section 4.05(2)(a) (emphasis added).

45 Revenue Procedure 2020-12, Section 1.

46 Revenue Procedure 2020-12, Section 4.08(1).

47 Revenue Procedure 2020-12, Section 4.08(1) (emphasis added).

48 Chief Counsel Memo 202050015 (Dec. 11, 2020); Tax Notes Doc. No. 2020-48469. Please note that, from 2018 through 2025, individuals cannot deduct Section 212 expenses because of Section 67(g), as enacted by the Tax Cuts and Jobs Act of 2017 (Public Law 115-97, Section 11045(a)).

49 Section 162(a); Treas. Reg. § 1.162-1(a).

50 Section 212; Treas. Reg. § 1.212-1(a); Treas. Reg. § 1.212-1(d).

51 Section 212; Treas. Reg. § 1.212-1(a).

52 Treas. Reg. § 1.212-1(l).

53 Section 275(a)(1); Treas. Reg. § 1.164-2(a).

54 Chief Counsel Advice 202053010 (Dec. 31, 2020); 2021 Tax Notes Federal Today 1-34.

55 This article uses the term "Examination Report" for the sake of clarity. In the context of certain partnerships, the equivalent document is called the "Notice of Preliminary Partnership Examination Changes."

56 Section 6662; Section 6662A.

57 Internal Revenue Service Conservation Easement Audit Techniques Guide (Rev. 11/4/2016), pg. 77.

58 Section 6664(c)(1); Section 6664(d)(1); Treas. Reg. § 1.6664-4; *Neonatology Associates., P.A. v. Commissioner*, 115 T.C. 43, 99.

59 Section 6664(c)(3); Treas. Reg. § 1.6664-4.

60 *Id.*

61 The relevant "Notices of Preliminary Partnership Examination Changes" are on file with the author.

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