Three New IRS Challenges to Tax Insurance in Conservation Easement Disputes

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This article analyzes three ways in which the IRS is now attacking tax insurance, especially when it comes to syndicated conservation easement transactions, as well as the hurdles that the IRS faces.

The coronavirus has revealed several important things, one of which is how much people crave certainty. This is true for individuals, businesses, governments, economies, markets, etc. Aggressive enforcement actions by the IRS have exasperated the insecurity for some taxpayers, particularly partnerships engaged in so-called syndicated conservation easement transactions ("SCETs") and substantially similar transactions ("SSTs"). In an effort to achieve an acceptable level of certainty, some partnerships have obtained various types of protection. Among them is tax defense insurance, which covers expenses linked to tax audits, administrative appeals, and tax litigation ("Tax Defense Insurance"). Another product goes by several names, such as tax gap, result, protection, or indemnity insurance ("Tax Result Insurance"). The latter is nothing new; Tax Result Insurance has been around for nearly four decades, since the early 1980s.[1] However, the IRS has only recently started challenging it, especially when it comes to SCETs and SSTs.

This article analyzes *three ways* in which the IRS is now attacking Tax Result Insurance, as well as the hurdles that the IRS faces.[2]

Overview of Conservation Easement Donations and Tax Deductions

Taxpayers who own undeveloped real property have several choices. For in-

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stance, they might (i) hold the property for investment purposes, selling it when it appreciates sufficiently, (ii) determine how to maximize profitability from the property and do that regardless of the negative effects on the local environment, community, or economy, or (iii) voluntarily restrict certain future uses of the property, such that it is protected forever for the benefit of society. The third option, known as donating a conservation easement ("CE"), not only achieves the goal of environmental protection, but also triggers another benefit, tax deductions for donors.[3]

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

Taxpayers memorialize the donation to charity by filing a public Deed of Conservation Easement or similar document ("Deed"). In preparing the Deed, taxpayers often coordinate with the land trust to identify certain limited activities that can continue on the property after the donation, without interfering with the Deed, without prejudicing the conservation purposes, and, hopefully, without jeopardizing the tax deduction.[5] These activities are called "reserved rights." The IRS openly recognizes, in its own Conservation Easement Audit Techniques Guide ("ATG"), that reserved rights are ubiquitous.[6]

The IRS will not allow the tax deduction stemming from a CE unless the taxpayer provides the land trust, before making the donation, "documentation sufficient to establish the condition of the property at the time of the gift."[7] This is called the Baseline Report. It may feature several things, including, but not limited to, (i) survey maps identifying the property lines and other contiguous or nearby protected areas, (ii) a map of the area drawn to scale showing existing man-made improvements or incursions, vegetation, flora and fauna, animal breeding and roosting areas, migration routes, land use history, and distinct natural features, (iii) an aerial photograph of the property taken as close as possible to the date of the donation, and (iv) on-site photographs taken at various locations on the property.[8]

The value of the CE is the fair market value ("FMV") of the property at the time of the donation.[9] The term FMV ordinarily means the price on which a willing buyer and willing seller would agree, if neither party were obligated to participate in the transaction, and if both parties had reasonable knowledge of the relevant facts.[10] The best evidence of the FMV would be the sale price of other properties encumbered by CEs that are comparable in size, location, etc. The IRS recognizes, though, that it is difficult, if not impossible, to find such sales.[11] Consequently, appraisers often must use the before-and-after method instead. This means that an appraiser must determine the highest and best use ("HBU") of the property *and* the corresponding FMV twice. First, the appraiser calculates the FMV as if the property were put to its HBU, which generates the "before" value. Second, the appraiser identifies the FMV, taking into account the restrictions on the property imposed by the CE, which creates the "after" value.[12] The difference between the "before" value and "after" value of the property, with certain other adjustments, produces the value of the donation.

A property's HBU is the most profitable use for which it is adaptable and needed in the reasonably near future.[13] The term HBU also means the use of property that is physically possible, legally permissible, financially feasible, and maximally productive.[14] Importantly, valuation in the CE context does not depend on whether the owner has actually put the property to its HBU in the past.[15] The HBU can be *any* realistic potential use of the property.[16] Common HBUs are a residential community, mixed-use development, or mining.

Properly claiming the tax deduction from a CE donation is surprisingly complicated. It involves a significant amount of actions and documents. The main ones are as follows: The taxpayer must (i) obtain a "qualified appraisal" from a "qualified appraiser," (ii) demonstrate that the land trust is a "qualified organization," (iii) obtain a Baseline Report adequately describing the condition of the property at the time of the donation and the reasons why it is worthy of protection, (iv) complete a Form 8283 (Noncash Charitable Contributions) and have it executed by all relevant parties, (v) assuming that the taxpayer is a "Property-Holding-Partnership," file a timely Form 1065, enclosing Form 8283 and the qualified appraisal, (vi) receive from the land trust a "contemporaneous written acknowledgement," both for the CE itself and for any endowment/stewardship fee donated to finance perpetual

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1 Coppinger, "Legislative Direction and Tax Compliance: A Tax Policy and Philosophy at Odds," 6 Taxes—The Tax Magazine 710 (1983).

2 This current article supplements a prior one by the same author. *See* Sheppard, "Conservation Easements, Legitimate Risks, and Tax Result Insurance," 31 Taxation of Exempts 10 (January/February 2020) and 47 Journal of Real Estate Taxation 31 (Second Quarter 2020).

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

4 Section 170(h)(4)(A); Reg. 170A-14(d)(1); S. Rep't No. 96–1007, at 10 (1980).

5 Reg. 1.170A-14(b)(2).

6 IRS, *Conservation Easement Audit Techniques Guide* (rev. 11/4/2016), page 23; *see also* Reg. 1.170A-14(e)(2) and (3).

7 Reg. 1.170A-14(g)(5)(i).

8 *Id.*

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

10 Reg. 1.170A-1(c)(2).

11 *Conservation Easement Audit Techniques Guide, supra* note 6, at page 41.

12 *Id.*

13 Olson v. United States, 292 U.S. 246, 255 (1934).

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

15 *Id.* at 657.

16 Symington, 87 TC 892, 896 (1986).

protection of the property, and (vii) send all the partners their Schedules K-1 (Partner's Share of Income, Deductions, Credits, etc.) and a copy of Form 8283.[17]

Evolving Attacks on "Technical" Issues

The IRS has consistently stated that the main problem with SCETs and SSTs is inflated valuations. However, the primary focus in tax disputes thus far has been on "technical" flaws; that is, issues unrelated to valuation. These ordinarily consist of alleged shortcomings with the Deed, Baseline Report, Qualified Appraisal, Form 8283, or other documents affiliated with the charitable donations.[18] To the dismay of many in the land conservation field and legal community, the Tax Court has ruled in the IRS's favor on technical issues in several cases over the past few years.[19] Below is a partial list of the technical challenges pursued by the IRS, as derived from cases and the ATG:[20]

- The donation of the CE lacked charitable intent, because there was some form of *quid pro quo* between the Property-Holding-Partnership and the charitable organization.
- The donation of the CE was conditioned on receipt by the Property-Holding-Partnership of the full tax deduction claimed on its Form 1065.
- The land trust failed to issue a "contemporaneous written acknowledgement" letter.
- The appraisal was not attached to the Form 1065 filed by the Property-Holding-Partnership.
- The appraisal was not prepared in accordance with the Uniform Standards of Professional Appraisal Practice.
- The appraisal fee was based on a percentage of the CE's value.
- The appraisal was not timely, in that it was not sufficiently proximate to the making of the donation or the filing of the Form 1065.
- The appraisal was not a "qualified appraisal."
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- The Form 8283 was missing, incomplete, or inaccurate.
- Not all appraisers who participated in the analysis signed Form 8283.
- The Baseline Report insufficiently described the condition of the property.
- The CE was not "granted" in perpetuity.
- The CE was not "protected" in perpetuity.
- Any mortgages or other encumbrances on the property were not satisfied or subordinated to the CE before the donation.
- The Deed contains an improper clause regarding how the proceeds from a forced sale of the property upon extinguishment of the CE (*i.e.*, by condemnation, eminent domain, or some other type of governmental taking) would be allocated among the Property-Holding-Partnership and the land trust.
- The Deed contains an amendment clause, which, in theory, might allow the parties to modify the donation, after taking the tax deduction, in such a way as to undermine the conservation purposes.
- The Deed contains a merger clause, as a result of which the fee simple title to the relevant property and the CE might end up in the hands of the same party, thereby undermining the ability to protect the property forever.
- The Deed was not timely filed with the proper court or other location.
- The land trust was not a "qualified organization."
- The property lacks acceptable "conservation purposes" for any number of reasons, including the habitat is not protected in a relatively natural state, there are insufficient threatened or endangered species on the property, the habitat or ecosystem to be protected is not "significant," the public lacks adequate access to the property, the conservation purposes do not comport with a clearly delineated government policy, the Deed allows uses that are inconsistent with the conservation purposes, the partnership has "reserved rights" that interfere with or destroy the conservation purposes, etc.[21]

As explained below, the IRS has recently expanded its "technical" weapons, trying to attack insurance affiliated with CEs in three ways.

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First Insurance Issue

The IRS has been threatening for years to raise "novel" theories for challenging charitable tax deductions stemming from CE donations. For example, the IRS announced in Notice 2017-10, released in December 2016, that it might attack CEs based on the partnership anti-abuse rules, economic substance doctrine, and/or other unspecified rules and doctrines.[22]

Likewise, in the Complaint filed by the Department of Justice ("DOJ") in December 2018 seeking an injunction against various persons involved with CEs, the DOJ alleged that the Property-Holding-Partnerships are not true partnerships for federal tax purposes, they exist solely as a conduit to "sell" tax deductions, they are "shams," and they "lack economic substance."[23]

More recently, in the revised edition of the ATG issued in late 2020, the IRS encouraged its personnel to consider launching new arguments, grounded in the partnership anti-abuse rules, various judicial doctrines (*e.g.*, bona fide partner and partnership, substance over form, and step-transaction doctrine), and the economic substance doctrine codified at Section 7701(o)(1).[24] With respect to the bona fide partner issue, the newest ATG references *Historic Boardwalk*

Hall, LLC, and states the following: "The facts in the case revealed the purported partner *had neither a meaningful downside risk nor a meaningful upside potential*; therefore, the court found that investor was not a bona fide partner."[25]

Rooted in the items described above, the IRS has now started advancing the argument that Tax Result Insurance somehow eliminates risks associated with investing in a Property-Holding-Partnership whose options include donating a CE. The IRS regularly inquires about Tax Result Insurance during audits nowadays. A typical Information Document Request ("IDR") includes the following mandate to Property-Holding-Partnerships:

> 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].

The IRS is trying to beef up the following syllogism: The bedrock of a partnership is the existence of downside and upside risk; Tax Defense Insurance somehow removes risk; therefore, the Property-Holding-Partnerships are not "partnerships" and they cannot benefit from easement-related deductions because of the functioning of the partnership tax rules.[26] The IRS must face several inconvenient realities if it proceeds down this path, as examined below.

Reality #1—Regulations Show that Tax Result Insurance Is Not Problematic

Taxpayers and assorted other parties generally must file various returns, statements, forms, lists, etc. in accordance with the applicable regulations.[27] In the case of "reportable transactions," like certain SCETs, the relevant disclosure statements are Forms 8886 (Reportable Transaction Disclosure Statement), which must be filed by those who "participate" in transactions, and Forms 8918 (Material Advisor Disclosure Statement), which pertain to "material advisors" to a transaction.

The IRS published several versions of proposed, temporary, and final regulations years ago in connection with reportable transactions.[28] 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.[29] 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."[30] 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 single year or by a total of more than $10 million for any combination of years, and (ii) had at least two of 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).*[31]

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17 *See Conservation Easement Audit Techniques Guide, supra* note 6, at pages 24-30; IRS Publication 1771, *Charitable Contributions—Substantiation and Disclosure Requirements*; IRS Publication 526, *Charitable Contributions*; Section 170(f)(8); Section 170(f)(11); Reg. 1.170A-13; Notice 2006-96; TD 9836.

18 For more information about the categories of arguments raised by the IRS in CE cases, *see, e.g.*, Sheppard, "20 Recent IRS Enforcement Actions in Conservation Easement Disputes: Awareness and Preparation Are Key," 134 JTAX 15 (March 2021).

19 *See, e.g.*, Dasher's Bay at Effingham, LLC, Tax Court Docket No. 4078-18, Order, Dec. 10, 2019; Ogeechee River Preserve, LLC, Tax Court Docket No. 2771-18, Order, Dec. 10, 2019; Riverpointe at Ogeechee, LLC, Tax Court Docket No. 4011-18, Order, Dec. 10, 2019; River's Edge Landing, LLC, Tax Court Docket No. 1111-18, Order, Dec. 10, 2019; TOT Property Holdings, LLC, Tax Court Docket No. 5600-17, Order, Dec. 13, 2019; Railroad Holdings, LLC, TCM 2020-22; Oakhill Woods, LLC, TCM 2020-24; Hoffman Properties II, LP, Tax Court Docket No. 14130-15, Decision, May 6, 2019; Oakbrook Land Holdings, LLC, TCM 2020-54; Oakbrook Land Holdings, LLC, 154 TC No. 10 (2020); Woodland Property Holdings, LLC, TCM 2020-55; High Point Holdings, LLC, Tax Court Docket No. 10896-17, Order, May 15, 2020; Coal Property Holdings, LLC, 153 TC 126 (2019); Hewitt, TCM 2020-89; Lumpkin One Five Six, LLC, TCM 2020-94; Lumpkin HC, LLC, TCM 2020-95; Plateau Holdings, LLC, TCM 2020-93; Habitat Green Investments, LLC, Tax Court Docket No. 14433-17, Order, June 30, 2020; Turtle River Properties, LLC, Tax Court Docket No. 14434-17, Order, June 30, 2020; Green Creek, LLC, Tax Court Docket No. 14435-17, Order, June 30, 2020; Harris, Tax Court Docket No. 24201-15, Order June 30, 2020; Village at Effingham, LLC, TCM 2020-102; Riverside Place, LLC, TCM 2020-103; Maple Landing, LLC, TCM 2020-104; Englewood Place, LLC, TCM 2020-105; Smith Lake, TCM 2020-17; Belair Woods, LLC, TCM 2020-12; Cottonwood Place, LLC, TCM 2020-115; Red Oak Estates, LLC, TCM 2020-116.

20 *Conservation Easement Audit Techniques Guide, supra* note 6.

21 *Conservation Easement Audit Techniques Guide, supra* note 6, pgs. 78-81.

22 Notice 2017-10, section 1.

23 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. Ga, Complaint filed 12/18/2018, pg. 47.

24 IRS Publication 5464, *Conservation Easement Audit Techniques Guide* (rev. 11/2020), pgs. 69-72.

25 *Id.* at pgs. 70-71 (emphasis added).

26 The IRS has made similar arguments about risk and partner status in the past. *See* Virginia Historic Tax Credit Fund, TCM 2009-295.

27 Section 6011(a); Reg. 301.6011-1.

28 *See* TD 8875 (3/2/2000); TD 8876 (3/2/2000); TD 8877 (3/2/2000); TD 8896 (8/16/2000); TD 8961 (8/7/2001); TD 9000 (6/18/2002); TD 9017 (10/22/2002); TD 9018 (10/22/2002); TD 9046 (3/4/2003); TD 9108 (12/30/2003); TD 9350 (8/3/2007).

29 TD 8877 (3/2/2000); REG-103735-00.

30 TD 8877 (3/2/2000), Preamble.

31 *Id.*; Temp. Reg. 1.6011-4T(b)(3)(B).

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.[32]

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."[33] To remedy this, the IRS created more objective rules, featuring six new categories of reportable transactions.[34] One of them 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)* . . . .[35]

Public comments to regulations. The IRS received significant public input to the proposed and temporary regulations.[36] A large percentage of the written comments came from insurance companies and groups.[37] They, along with other interested parties, urged the IRS to remove or modify "contractual protection" as an indicia of tax shelter activity. Ideas by various commentators are described below.

Previously published regulations indicate that the IRS has already analyzed the issue of Tax Result Insurance and concluded that its use is *not* problematic.

The Association of Financial Guaranty Insurers focused on indemnity provisions in typical business transactions. It explained that tax indemnity provisions are often included in transactions to address unexpected and unknown tax risks, not to protect tax benefits customary to a tax shelter.[38] Such risks include property taxes, sales taxes, value-added taxes, withholding, etc. The Association of Financial Guaranty Insurers argued that the proposed exception to the "contractual protection" provision was too narrow because principals generally are involved in marketing transactions, by providing financials, engaging brokers, assisting with the preparation of term sheets, and more.[39] The Association of Financial Guaranty Insurers suggested that the IRS amend the proposed regulations to clarify that customary indemnities do not trigger a Form 8886 filing requirement, regardless of whether a principal participated in promoting the transactions, and that a customary indemnity includes coverage for taxes imposed because of (i) a change in law, (ii) breach of a representation, warranty, or covenant, and (iii) potential sales taxes, use taxes, property taxes, value-added taxes, withholding taxes, and other taxes imposed as a result of the transaction.[40]

Similarly, the New York State Bar Association had several recommendations related to the "contractual protection" language, one of which was to exclude from the Form 8886 filing duty customary tax representations, warranties, and indemnities provided by a principal to a transaction in connection with mergers, acquisitions, or spinoffs of entities engaged in an active trade or business.[41] The main reason for the recommendation was that such provisions are commonplace, most principals engage in at least some activities that might be considered "promoting" a transactions, and requiring taxpayers involved in legitimate transactions to file Forms 8886, and forcing the IRS to scrutinize them, would be burdensome and unproductive.[42]

Clark-Bardes Consulting, the Equipment Leasing Association, and Financial Security Assurance centered their comments on the potential application of the "contractual protection" language to leasing transactions. They explained that, in leasing transactions, lessees normally participate in the negotiation of documents, provide financial statements, and supply legal opinions about good corporate standing. Thus, they suggested that the IRS specify in the regulations that a lease containing customary lessee indemnities should not trigger a Form 8886 duty.[43]

The International Swaps and Derivatives Association indicated that traditional financial transactions, entered into in the ordinary course of business, for legitimate business and/or investment purposes, often employ tax indemnities to cope with unexpected consequences. It urged the IRS to narrow the definition of "contractual protection," such that it only applies to indemnities related to unintended federal tax consequences, not foreign or state taxes.[44]

A major law firm wrote on behalf of a managing general agent ("MGA") for several insurance companies in the business of underwriting Tax Result Insurance. It explained that the MGA only gets involved if the taxpayer provides due diligence materials and makes a series of representations similar to those made to the IRS in seeking a private letter ruling ("PLR"), MGA conducts its own underwriting process, and the transaction justifies at least a "should" level tax opinion.[45] The law firm also explained that taxpayers often get Tax Result Insurance as a substitute for a PLR, in situations where the IRS refuses to issue one or the process will take too long.[46] The law firm argued that forcing taxpayers that purchase policies from MGAs to file Forms 8886 is inappropriate for several reasons. First, the mere

act of purchasing Tax Result Insurance does not reveal an improper tax motive because taxpayers are simply seeking to minimize tax risks that would otherwise detract from the viability of a proposed transaction, and the rationales for obtaining Tax Result Insurance are roughly equivalent to those for submitting a PLR request with the IRS.[47] Second, the insurance company is not related to, or affiliated with, any organizer or promoter of the transactions in question; the policies are often sourced by insurance brokers, after being bid by numerous competing underwriters.[48] Finally, MGAs usually price the Tax Result Insurance in the range of five to 15 percent of the dollar value of the tax exposure covered, and it would not be economically viable if the total payout on similar policies were to exceed the relatively low premium payments. Thus, MGAs avoid insuring transactions that have an unacceptably high risk of failure if challenged by the IRS. The MGAs argue that "[t]his independent underwriting may serve as a check for taxpayers on the soundness of a proposed transaction and discourage entry into a transaction that is not suitable for insurance." Based on the preceding, MGAs suggested that the IRS modify the proposed regulations to exclude transactions with "contractual protection" from the Form 8886 obligation, if Tax Result Insurance is provided by, funded by, or otherwise obtained directly or indirectly from a person that is engaged in the insurance business and that did not participate in the promotion or offer of the transaction.[49]

Finally, The Hartford suggested that the IRS amend the proposed regulations to exclude from the concept of "contractual protection" several items, including customary tax indemnity provisions and Tax Result Insurance. Grounds for this recommendation were as follows:

> Tax insurance provides a needed alternative to the expenses, limitations and uncertainties associated with [PLR] requests. Purchasers of tax insurance tend to be conservative, highly risk-averse taxpayers (or their lenders or investors) who choose to reduce or transfer even a modicum of tax risk identified in their transactions in order to increase certainty. Tax insurance was created due to a market need for a financial product to facilitate extraordinary transactions that may not otherwise close within the desired time frame because of the uncertainty with respect to a tax issue . . . .
>
> Tax insurance is underwritten by or with the support of tax attorneys who carefully review a transaction to "weed out" weak tax positions and insure strong tax positions. In stark contrast to certain tax practitioners (and promoters) who generate fees by creative applications of the Tax Code, tax insurance underwriters are "rewarded" for providing a conservative, prudent analysis of a proposed tax position.
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> Thus, tax insurance fills the "gap" caused by the cost, limitations, uncertainties and delays associated with [PLRs] . . . Tax insurance allows customary commercial transactions (albeit complex transactions) to proceed timely and with certainty of the tax consequences. Most importantly, by refusing to insure tax shelters, abusive schemes and weakly supported tax positions, the tax insurance industry injects a distinctly conservative evaluation within the community of tax professionals and helps to cultivate a culture of compliance in which corporate tax shelters are less often created.

Regulations in March 2003. The IRS issued final regulations in March 2003.[50] The IRS indicated that, after considering public input, it decided to narrow the list of reportable transactions.[51] Importantly, the IRS agreed 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 as follows:

> *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.[52]

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*

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[32] TD 9000 (6/18/2002), Preamble; Temp. Reg. 1.6011-1T(a)(1).

[33] TD 9017 (10/22/2002), Preamble.

[34] *Id.*

[35] TD 9017 (10/22/2002); Temp. Reg. 1.6011-4T(b)(4).

[36] Stratton, "Sole Witness Testifies before IRS on Tax Shelter Regs," 2003 Tax Notes Today 5-3 (1/8/2003) (summarizing the hearing and attaching the public comments).

[37] *Id.* 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.

[38] Stratton, "Sole Witness Testifies before IRS on Tax Shelter Regs," 2003 Tax Notes Today 5-3 (1/8/2003).

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] TD 9046 (3/4/2003).

[51] *Id.*

[52] *Id.*, Preamble.

> *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.[53]
>
> [The preceding paragraph] *only applies with respect to fees paid* by or on behalf of the taxpayer or a related party to any person who makes or provides a statement, oral or written, to the taxpayer or related party (or for whose benefit a statement is made or provided to the taxpayer or related party) as to the potential tax consequences that may result from the transaction . . . .[54]

Regulations in 2006. Section 6111, as enacted in 2004, mandated that "material advisors" disclose reportable transactions on Forms 8918. Important for purposes of this article, Congress decided to include parties involved in insuring reportable transactions as "material advisors." 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."[55]

The IRS issued proposed regulations to Section 6111 approximately two years later.[56] 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 [Reg.] 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.[57]

The IRS outright refuses to grant PLRs on many issues fundamental to conservation easement donations, thereby forcing taxpayers to turn elsewhere, such as to private companies offering Tax Result Insurance.

To quench its thirst for more information about Tax Result Insurance, the IRS now instructs participants in certain CE transactions to "include a description of any tax result protection with respect to the transaction" on their Forms 8886.[58] The IRS makes the same demand in the context of Form 8918.[59] Notwithstanding this information-gathering exercise, which has endured for more than a decade, the IRS has never indicated that the existence of Tax Result Insurance creates a reportable transaction.

Reality #2—Taxpayers Cannot Get "Insurance" from the IRS

Those engaged in organizing Property-Holding-Partnerships that might make CE donations desire certainty through manners other than purchasing Tax Result Insurance. The problem, however, is that the IRS has essentially made this impossible. Many taxpayers, including those organizing Property-Holding-Partnerships, would like to obtain "insurance" directly from the IRS, in the form of a positive PLR. The rub is that the IRS outright refuses to grant PLRs on many issues fundamental to CE donations, thereby forcing taxpayers to turn elsewhere, such as to private companies offering Tax Result Insurance. Below is a list of the items on which the IRS will *not* issue a PLR, many of which, remarkably, are identical to the items the IRS is attacking with its "novel" theories, described above, as announced in Notice 2017-10, the Complaint by the DOJ in the injunction lawsuit, and the most recent version of the ATG:

- "Any matter in which the determination requested is primarily one of fact, *e.g.*, market value of property . . . ."[60]
- "Matters relating to the validity of a partnership or whether a person is a partner in a partnership."[61]
- "Whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of [Section] 7701(o)."[62]
- "The results of transactions that lack a bona fide business purpose or have as their principal purpose the reduction of federal taxes."[63]
- "Whether . . . reasonable cause, due diligence, good faith, clear and convincing evidence, or other similar terms that require a factual determination exist."[64]
- "Any matter dealing with the question of whether property is held primarily for sale to customers in the ordinary course of a trade or business."[65]
- "Questions that the [IRS] determines, in its discretion, should not be answered in the general interests of sound tax administration, including due to resource constraints."[66]

Reality #3—Taxpayers Cannot Get "Insurance" from Independent Attorneys

Those involved in forming Property-Holding-Partnerships would also like to secure "insurance" from reputable tax attorneys, in the form of a tax opinion. The insurance-like role of tax attorneys has been described in the following manner:

> Transactional tax lawyers, by rendering tax opinions, provide an element of insurance to clients. This insurance is clearly incomplete, but by providing a tax opinion, a lawyer conditionally agrees to indemnify the client for part of the potential loss the client incurs if the favorable tax treatment described in the opinion is successfully challenged. Thus, tax lawyers serve, at least partly, as tax insurers.[67]

In light of the manner in which penalties stemming from CE donations function, the ability of independent tax attorneys to serve as pseudo-insurers has diminished, or in some instances, disappeared altogether. Here is why. The IRS ordinarily asserts a long list of alternative penalties in CE cases, including those for supposedly relying on a gross valuation misstatement.[68] Property-Holding-Partnerships can avoid certain penalties if they can demonstrate that there was "reasonable cause" for the violation.[69] Others penalties should disappear if the value was based on a qualified appraisal by a qualified appraiser and the Property-Holding-Partnership made a good faith investigation of the value of the property.[70] Finally, Property-Holding-Partnerships simply cannot overcome some penalties by evidence of "reasonable cause," like the one for making a gross valuation misstatement. They are mathematical in nature; that is, if the value of the CE deduction claimed by a Property-Holding-Partnership on its Form 1065 surpasses the value ultimately determined by the Tax Court by a certain percentage, then the penalty applies, period.[71] The fact that the IRS tends to assert the gross valuation misstatement in every CE case effectively means that Property-Holding-Partnerships cannot obtain penalty "insurance" from tax attorneys in the form of an opinion letter attesting to the suitability of a transaction or certain legal/tax aspects thereof.

Reality #4—Tax Result Insurance Is Supported by Academics and Experts

A significant number of scholarly and practitioner articles underscore the legitimate function of Tax Result Insurance. Some notable ones are summarized below.

First article. One article describes the genesis of Tax Result Insurance as follows:

> Despite—or perhaps on account of—the incredibly complex nature of our tax laws, individuals and business organizations face uncertainty as to the tax results of many transactions. Congress and the [IRS], even if they so desired, could not set out rules in sufficient detail to provide certainty as to every possible transaction that may arise in the future. Unless alleviated, this uncertainty will cause some taxpayers to avoid engaging in transactions that would otherwise benefit society or the economy, resulting in a deadweight loss. Thus, it is desirable to derive ways to eliminate or mitigate this uncertainty in order to avoid deterring financially and socially beneficial transactions. *Taxpayers frequently are faced with a choice of either abandoning a project or proceeding with it and accepting the question of the tax liability as one of the risks of the venture. Insurance companies have seen this circumstance as presenting an opportunity for them to enter the market and provide a useful service. To that end, some companies now provide insurance to protect a taxpayer against adverse tax consequences from a proposed transaction.*[72]

After providing this overview of how Tax Result Insurance came to be, the article explains that "insurance" for tax issues has existed for a long time, in a variety of forms. First, the IRS historically issued PLRs, which is a type of protection or insurance against tax uncertainty, but it has become impossible or too time-consuming to obtain a PLR these days.[73] Second, tax return preparers have offered warranties for any mistakes they make, which shift the risk of tax liabilities and defense costs from taxpayers to preparers.[74] Third, agreements effectuating the purchase and sale of businesses normally contain tax indemnity provisions.[75] Fourth, tax advisors, who structure a transaction and provide a legal/tax opinion regarding tax consequences, frequently give warranties to taxpayers that serve to refund fees paid if the IRS challenges and rejects the tax treatment.[76] The article indicates that Tax Result Insurance constitutes a "natural evolution" of the current types of insurance: "Instead of shifting liability risks between contracting parties, such as a buyer, seller, or broker, tax insurance shifts the tax uncertainty risk as to the consequences of a transaction to a neutral third party for a fee."[77]

The article goes on to explain that proponents of Tax Result Insurance argue that its existence does not cause aggressive transactions, just the opposite.

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[53] *Id.*; Reg. 1.6011-4(b)(4)(i).

[54] TD 9046 (3/4/2003); Reg. 1.6011-4(b)(4)(ii).

[55] Section 6111(b)(1)(A); 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 the bill, without an explanation as to why. *See* House of Representatives, American Jobs Creation Act of 2004, 108th Cong., 2d Sess., Conf. Rep't 108-755 (10/7/2004), pgs. 606-609.

[56] REG-103039-05 (11/2/2006).

[57] *Id.*

[58] Form 8886 Item 7b; Instructions to Form 8886, pg. 5; Reg. 1.6011-4(d).

[59] Form 8918 Item 13; Instructions to Form 8918, pgs. 4-5; Reg.301.6111-3(d)(1).

[60] Rev. Proc. 2019-3, section 4.02(1). This is an issue on which the IRS "ordinarily will not rule."

[61] *Id.*, section 3.01(90).

[62] *Id.*, section 3.02(1).

[63] *Id.*, section 3.02(2).

[64] *Id.*, section 3.02(5).

[65] *Id.*, section 4.02(5). This is an issue on which the IRS "ordinarily will not rule."

[66] *Id.*, section 3.02(10).

[67] Field, "Tax Lawyers as Tax Insurance," 50 William & Mary Law Review 2111, 2114 (2019).

[68] *Conservation Easement Audit Techniques Guide, supra* note 6, at pg. 77 (stating that an FPAA "will generally include a tiering of proposed penalties with multiple alternative positions.")

[69] Section 6664(c)(1); Section 6664(d)(1); Reg. 1.6664-4.

[70] Section 6664(c)(3); Reg. 1.6664-4.

[71] Section 6664(c)(3); Reg. 1.6664-4.

[72] Kahn, "Hedging the IRS—A Policy Justification for Excluding Liability and Insurance Proceeds," 28 Yale Journal on Regulation 1 (2009) (emphasis added).

[73] *Id.* at pgs. 4, 7, and 8.

[74] *Id.* at pgs. 4-5.

[75] *Id.* at pg. 7.

[76] *Id.* at pgs. 5-6. The author explains that the IRS has shown hostility towards tax advisor warranty arrangements and has indicated the need for oversight. Evidence includes the prohibition of certain "contingency fees" in Circular 230 and the need for participants in transactions with "contractual protection" to file Forms 8886.

[77] *Id.* at pg. 7.

The line of reasoning goes like this. A proposed transaction is presented to potential insurers, they refer it to a panel of tax and legal experts (both internal and external) who analyze it, and such experts are necessarily conservative when considering tax consequences because it is the assets of the insurers, not of the taxpayers, that will be at risk. In other words, in the open market, the financial interests of the independent insurance companies, which are driven by profit, are in conflict with those of the organizers of transactions, who aim to reduce tax liabilities to the lowest possible cost. Proponents of Tax Result Insurance explain that the willingness of an independent, profit-driven insurance company to offer a policy signals a legitimate tax position, reduces the IRS's auditing responsibilities, and effectively obligates the company to act "as a surrogate for the [IRS] in overseeing that the transaction is taxed properly."[78]

A significant number of scholarly and practitioner articles underscore the legitimate function of Tax Result Insurance.

Second article. A second article makes similar observations and points.[79] In addition to confirming that various types of tax "insurance" have been used for many years, the article emphasizes a key point, which is that Tax Result Insurance is legitimate insurance, offered by independent companies, which involves the shifting of risk, not the elimination of it. The second article states the following on this point:

> [T]ax insurance policies are not warranties. Neither are they merely contractual agreements that allocate risks between two parties who are contracting on other issues. Rather, tax indemnity polices are, as the name suggests, full-fledged insurance policies issued by real insurance companies that are regulated as such. Thus, when a tax insurance policy is purchased, certain tax risks are transferred to an insurance company, which then pools and distributes the risks across its other insureds and which sometimes reinsures some portion of those risks with other insurance companies.[80]

The second article also discusses the case in support of, and against, Tax Result Insurance. It describes the positive view of Tax Result Insurance as follows:

> Interestingly, a decent argument can be made that there is nothing special, and nothing especially troublesome, about privately provided [Tax Result Insurance]. The type of risk-shifting that occurs through [Tax Result Insurance] is merely a natural extension of a type of contractual risk-shifting that has existed for a long time without much controversy: tax indemnity or tax allocation agreements between contacting parties. Such agreements, which are frequently, if not always, a part of corporate merger or acquisition transactions, regularly serve to allocate uncertain tax liabilities between or among parties. For example, a tax indemnity agreement might shift a potential tax liability from a purchaser to a seller or vice versa. These indemnity agreements presumably shift the relevant legal risks to the less risk-averse party to the transaction. In any event, since tax indemnity agreements have existed for a while, the introduction of [Tax Result Insurance] marks a sort of natural evolution of tax indemnity agreements. With the introduction of this new insurance market, if one of the parties is risk-averse with respect to a tax law contingency involved in the deal, instead of just shifting the tax law uncertainty from buyer to seller or vice versa, that legal uncertainty can be moved from the contracting parties to a third-party insurance company whose business is assessing and distributing risks and who can therefore do so relatively efficiently. Viewed this way, [Tax Result Insurance] would seem to be neither more or less objectionable than any other form of commercial liability insurance and should be left alone, or perhaps even encouraged in some way.[81]

The article explains that proponents of Tax Result Insurance emphasize that there is significant legal uncertainty in how the IRS and the courts will apply tax laws, this insecurity can inhibit welfare-enhancing, wealth-creating transactions that would benefit society, the IRS has a policy of not issuing many types of PLRs, which represent the traditional source of tax law risk "insurance," private insurance companies fill the gap, such companies have more resources and more incentive than the IRS to hire talented tax professionals to review proposed transactions, and these private sector professionals do a better job than the IRS in screening against overly aggressive tax positions.[82]

On the other hand, opponents of Tax Result Insurance primarily contend that this mechanism encourages or facilitates tax-avoidance transactions.[83] The second article takes issue with the position of opponents for several reasons, including (i) Tax Result Insurance policies ordinarily contain clauses indicating that payouts will not occur if a transaction is deemed to involve criminal tax evasion, civil tax fraud, or any other type of wrongdoing, and (ii) insurance companies would not sell policies without such clauses because they might get penalized for aiding and abetting improper behavior, and they would not risk the bad publicity associated with insuring abusive transactions.[84]

The second article recommends that, given the increasing complexity of tax laws, the IRS should do several things, among them making available some type of Tax Result Insurance, finding ways of subsidizing it, and recognizing the reality that private insurers can play a valuable role in terms of tax compliance:

> [G]iven the potential efficiency gains from the use of legitimate tax law uncertainty insurance, the government should consider ways of subsidizing it, at least in the short run. Privately provided tax risk insurance not only allows risk-averse taxpayers to shift this uncertainty from themselves to risk-neutral insurers, it creates an incentive for insurers—and their paid expert tax advisors—to serve as a sort of privatized [IRS]. By doing ex ante mini-audits in the form of tax risk underwriting, insurers can fill a void that the [IRS], through its [PLR] policies, is unwilling and probably unable to fill.[85]

Third article. The main premise of the third article is that, if the IRS does not like Tax Audit Insurance and Tax Result Insurance, then it should take a closer look at itself and Congress instead of casting blame on taxpayers.[86] Emphasizing that insurance of these types has been around for several decades, since the early 1980s, the article explains that the supply of, and large demand for, insurance is caused by the "snowballing" complexity of U.S. tax laws and the resulting uncertainties in preparing tax returns.[87] It also underscores that most insurance policies expressly exclude from coverage any liability arising out of a transaction lacking economic substance and/or one whose principal purpose is tax avoidance or evasion.[88] The article also posits that tax insurance is good in three ways: It benefits taxpayers, who can spread their economic risks; it favors insurance companies, which stand to make a profit; and it helps the IRS, which enjoys enhanced monitoring of return preparers, improved tax collection, and increased equity in the overall system because risk-averse and risk-neutral taxpayers will come closer to paying the same amount of taxes.[89]

Harkening back to its demand for more governmental introspection and less finger waving at taxpayers and the insurance industry, the third article concludes as follows:

> If the government wants to kill tax audit insurance, there is a productive and positive way to do so. Audit insurance was born out of complexity and will not survive without it. Radical simplification of the existing system would cause the welcome demise of audit insurance. With reform, taxpayers would understand their obligations. There would be fewer surprises against which to insure. With simplicity comes equity. Similarly situated taxpayers would be more likely to report the same amount of taxable income. For the moment, audit insurance should evoke only one reaction on the part of the government. When taxpayers are so uncertain of the tax laws that they seek insurance, it is time to simplify the tax laws. Do not regulate the insurers; insure that the regulators [*i.e.*, the IRS] administer a system in which taxpayers can tell if they have fulfilled the contractual arrangement with the government to provide tax revenues in exchange for government services.[90]

Other articles and examples. A number of other articles discuss these issues and reach comparable conclusions about the reasons for Tax Result Insurance.[91] Like the three articles explained at length above, one emphasizes how the existence of Tax Result Insurance and the related scrutiny by insurance companies help, not harm, the tax system:

> At bottom, the [tax insurance] underwriting process provides an informed assessment of complex tax risks by a sophisticated, neutral third party—a party with a strong economic incentive to confirm that the tax risk being insured conforms to the tax laws. This is good for our tax system.[92]

A quick search of the Internet reveals that dozens of reputable, independent companies offer some variation of Tax Result Insurance.[93] It also confirms that there are numerous conferences devoted to this financial product.[94]

Reality #5—Previous IRS Guidance Blesses Insurance

In *Historic Boardwalk Hall*, the Third Circuit Court of Appeals held that an investor/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.[95] The primary reason for this decision was that the investor/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 investor/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 he was not a "partner." In the words of the Third Circuit Court of Appeals, "because [the investor/member] lacked a meaningful stake in either the success or failure of [the partnership], it was not a bona fide partner."[96]

Rev. Proc. 2014-12. In response to the decision in *Historic Boardwalk Hall,* the IRS issued Rev. Proc. 2014-12, which established a "safe harbor" for structuring historic rehabilitation credit transactions. Rev. Proc. 2014-12 describes certain "permissible guarantees" and "impermissible guarantees."[97] The latter include a restriction against any person involved in the transaction guaranteeing or otherwise insuring the ability of the partner to claim the historic tax credits, the cash equivalent of such credits, or the repayment of any portion of the partner's contribution to the partnership

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78 *Id.* at pg. 8.

79 Logue, "Tax Law Uncertainty and the Role of Tax Insurance," 25 Virginia Tax Review 339 (2005).

80 *Id.* at pg. 387.

81 *Id.* at pg. 344.

82 *Id.* at pg. 395.

83 *Id.* at pg. 395.

84 *Id.* at pg. 396.

85 *Id.* at pg. 414.

86 Doernberg, "Some Thoughts on Tax Audit Insurance," 17(3) Connecticut Law Review 541 (1985).

87 *Id.* at pgs. 541, 542, 560.

88 *Id.* at pgs. 544-545.

89 *Id.* at pgs. 561-564.

90 *Id.* at pgs. 564-565.

91 *See, e.g.*, Nemo, "Does the IRS's New Ruling Policy on Spin-Offs Enhance the Desirability of Tax Insurance?" 55 Tax Executive 362 (2003); Gray and Hadji. "Tax Insurance: Another Tool for Your Transaction Toolbox," 25 International Tax Review 37 (2014); Gary, "New Opportunity for Tax Lawyers: Insuring Tax Transactions," Tax Analysts Doc. No. 2004-11722 (7/7/2004); Elliott, "Greater Reliance on Tax Liability Insurance Raises Questions," 149 Tax Notes 477 (10/26/2015); Wolfe, "Tax Indemnity Insurance: A Valuable and Evolving Tool for Managing Tax Risks," 739 Practicing Law Institute/Tax 371 (2006); Sheppard, "Does Anyone Need Tax Risk Insurance?" 169 Tax Notes Federal 1547 (12/7/2020); Sheppard, "Do Corporations Need Tax Risk Insurance?" 170 Tax Notes Federal 181 (1/11/2021).

92 Wolfe, "Tax Indemnity Insurance: A Valuable and Evolving Tool for Managing Tax Risks," 739 Practicing Law Institute/Tax 371, 415-416 (2006).

93 *See, e.g.,* websites for Aon, Chubb, Equity Risk Partners, QBE North America, Blue Chip Underwriting Services, Lloyd's of London, Hiscox, M&A Insurance Solutions, Great American Insurance Group, The Hartford, McGriff Seibels & Williams, Marsh & McLennan Companies, American Insurance Group, and Ambridge Partners.

94 *See, e.g.,* the "Transaction Insurance Insights Conference" organized by Advisen, the "M&A, RIW and Transactional Risk Insurance Conference" organized by the American Conference Institute, and "Reps & Warranties and Transactional Liability Insurance Conference" organized by ExecuSummitt, and the "Insurance M&A Symposium" organized by S&P Global.

95 Historic Boardwalk Hall, LLC, 694 F.3d 425 (CA-3, 2012), *rev'g* 136 TC 1 (2011).

96 *Id.*

97 Rev. Proc. 2014-12, section 4.05.

due to the inability to claim the credits, if the IRS were to challenge the transactional structure of the partnership.[98] 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.[99] Importantly, Rev. Proc. 2014-12, referencing its description of "impermissible guarantees," expressly states that this "does *not* prohibit the [partner] from procuring insurance from persons not involved with the rehabilitation or the partnership."[100] In other words, the IRS concluded that obtaining Tax Result Insurance from an independent insurer is not problematic, at least in the historic rehabilitation tax credit context.

Rev. Proc. 2020-12. A few years later, the IRS issued Rev. Proc. 2020-12, which created a "safe harbor" for partnerships allocating credits for carbon dioxide sequestration.[101] The IRS, in supplying general background, emphasized that a partnership occurs where parties acting in good faith and with a business purpose join together to conduct an enterprise, the determination of whether a partnership exists is based on the true facts and circumstances instead of mere labels, and a supposed partner might be recharacterized as a lender to the partnership or a purchaser of partnership assets if such partner lacks any meaningful upside or downside risk in the partnership.[102] Rev. Proc. 2020-12 features 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.[103] Importantly, though, Rev. Proc. 2020-12 expressly states 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.[104]

The IRS has concluded that obtaining Tax Result Insurance from an independent insurer is not problematic, at least in the historic rehabilitation tax credit context.

Second Insurance Issue

Few would disagree that the IRS is being quite ambitious in taking the position, described in the preceding segment of this article, that attainment of Tax Result Insurance by the Property-Holding-Partnership should nullify bona fide partner status and lead to a charitable deduction of $0. The IRS has recently raised another, perhaps less drastic, position with respect to whether Property-Holding-Partnerships can deduct the premiums paid for Tax Result Insurance. Two IRS memos released in December 2020 show its stance.

First Memo

Chief Counsel Advice 202050015 ("First CCA") analyzes four tax rules.[105] 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."[106] The corresponding regulations clarify that deductible business expenses are limited to those "directly connected with or pertaining to the taxpayer's trade or business."[107]

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.[108] The regulations indicate that deductible expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income or to the management, conservation, or maintenance of property held to produce income.[109]

Third, Section 212(3) contemplates deductions in connection with the determination, collection, or refund of any tax.[110] The regulations expand on this notion, stating that individuals ordinarily may deduct the expenses, regardless of the type of tax and regardless of whether the taxing authority is federal, state, or municipal.[111] Accordingly, expenses for tax counsel or preparation of returns in connection with proceedings involved in disputing a tax liability generally are deductible.[112]

Fourth, Section 275 generally prohibits deductions for federal income taxes paid.[113]

With those basics out of the way, the First CCA addressed just one issue, namely, can a Property-Holding-Partnership deduct the cost of Tax Result Insurance?

With respect to deductibility under Section 162, the First CCA explains that the determination is made at the partnership level (not the partner level) and, 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 such arrangement dictate whether the expense in question is sufficiently related to the taxpayer's trade or business. The IRS concluded as follows in the First CCA:

> 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 says 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 had not been met:

> 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 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 212(1)–(2).

Finally, in terms of deductibility under Section 212(3), the First CCA emphasizes 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 minimum 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") addresses the same issues, but the analysis by the IRS is deeper, while still managing to do a whole lot of hedging.[114]

In an attempt to avoid being boxed into potentially unfavorable positions in future disputes, the IRS expressly declines to confront various items in the Second CCA. The IRS, for instance, refuses to opine on whether Tax Result Insurance constitutes "insurance" for federal tax purposes. Moreover, it declines to address if the Property-Holding-Partnership is a bona fide partnership or if its partners are bona fide partners for federal tax purposes. Lastly, the IRS is unwilling to provide guidance regarding whether the Property-Holding-Partnership was engaged in some type of trade or business. Employing some classic evasive techniques, the IRS states the following in the Second CCA: "Given that the deductibility of the . . . premium is, as explained below, determinable regardless of whether Taxpayer engaged in a trade, business, or income-producing activity, issues relating to Taxpayer engaging in a trade, business, or income-producing activity are beyond the scope of this advice."

The Second CCA concludes that the Property-Holding-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 Property-Holding-Partnership fulfilled its limited obligations under the policy, it is entitled to payments related to the amount of CE deductions disallowed. This result, emphasizes the IRS, occurs regardless of whether the Property-Holding-Partnership incurs any expenses related to any trade or business. The IRS goes on to underscore that the contingency triggering the insurance payout does not pertain to business activities, but rather the actions of the IRS or another tax authority, and that the Property-Holding-Partnership could suspend any or all business activities without affecting its entitlement to a payout under the policy. Finally, the IRS argues that any payment will go to the partners, as the policy specifically names them among the insured parties, which demonstrates that the Tax Result Insurance is "necessarily unrelated to any trade or business activities at the partnership level."

With respect to Section 212(1) and Section 212(2), the IRS recognizes in the Second CCA that these provisions do not require the Property-Holding-Partnership to be engaged in a trade or business but do mandate a profit motive. In addition, the IRS stresses 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 Property-Holding-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 indicates that the IRS's conclusion would be the same, regardless of whether the Property-Holding-Partnership's plan were to contemplate future sale of the property subject to the CE or continued leasing of such property.

Finally, regarding Section 212(3), the Second CCA admits that the standard under this provision is the lowest of all because there is no business or nexus requirement. It further acknowledges that, to date, no court has ruled on the deductibility of contracts resembling insurance under Section 212(3). However, the IRS indicates that courts have denied deductions under analogous, predecessor provisions for other types of contractual arrangements on grounds

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98 *Id.*, section 4.05(2)(a).
99 *Id.*, section 4.05(2)(a).
100 *Id.*, section 4.05(2)(a) (emphasis added).
101 Rev. Proc. 2020-12, section 1.
102 *Id.*, section 2 (referencing Culbertson, 337 U.S. 733 (1949), TIFD III-E, Inc. v. United States, 459 F.3d 220 (CA-2, 2006), Historic Boardwalk Hall, LLC,694 F.3d 425, 463 (CA-3, 2012)).
103 Rev. Proc. 2020-12, section 4.08(1).
104 *Id.*, section 4.08(1).
105 Chief Counsel Memo 202050015 (12/11/2020); 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 (P.L. 115-97, section 11045(a)).
106 Section 162(a).
107 Reg. 1.162-1(a).
108 Section 212; Reg. 1.212-1(a).
109 Reg. 1.212-1(d).
110 Section 212; Reg. 1.212-1(a).
111 Reg. 1.212-1(l).
112 Reg. 1.212-1(l).
113 Section 275(a)(1); Reg. 1.164-2(a).
114 Chief Counsel Advice 202053010 (12/31/2020); 2021 Tax Notes Federal Today 1-34.

that the expenses were nothing more than "the contractual relabeling of non-deductible tax." Then, the IRS seems 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 cases involving the latter:

> 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 [Property-Holding-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 [Property-Holding-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.

Overlooked Secondary Sources

There are various academic articles discussing the proper U.S. income tax treatment of premiums paid for, and payments received from, Tax Defense Insurance and Tax Result Insurance.[115] The IRS did not mention, much less address, these authorities in issuing the First CCA and Second CCA.

Third Insurance Issue

Not done quite yet, the IRS has recently, and very discreetly, revealed another of its positions regarding Tax Result Insurance.

The IRS announced a settlement initiative in June 2020 ("Settlement Initiative"). The IRS first described terms of the Settlement Initiative in two ways, by issuing a News Release, which is public, and by sending Offer Letters to eligible partnerships, which are not public.[116] The initial guidance from the IRS had several holes. The IRS tried to plug these in October 2020 by publishing a Chief Counsel Notice, along with a second News Release.[117]

The IRS documents indicate that Property-Holding-Partnerships and all participating partners must ultimately memorialize their participation in the Settlement Initiative by executing a Form 906, *Closing Agreement on Final Determination Covering Specific Matters*, with the IRS, and by executing a Decision Document, for the Tax Court.[118] The IRS quells any thoughts about Property-Holding-Partnerships and partners personalizing terms with the IRS, based on their unique circumstances. Indeed, the IRS explains that normally "no provision of either document is subject to negotiation."[119]

The Forms 906 offered in connection with the Settlement Initiative show that the IRS not only intends to deny deductions for premiums paid by Property-Holding-Partnerships for Tax Result Insurance pursuant to the First CCA and Second CCA, but it also intends to tax any payouts to the partners, at the highest possible rates, as ordinary income. Buried in the Forms 906 is the following language, of which very few people are aware:

> No deduction, loss, or other tax benefit arise from or in connection with the transaction, including the deduction claimed for a non-cash charitable contribution of [insert amount] is allowed to the partnership or its partners for any taxable years, except as expressly provided herein.
>
> *Any of the following amounts received by the partnership or its partners are reportable as ordinary income for the taxable year of receipt . . . amounts paid from audit/litigation reserves, tax-gap policies or insurance policies, funds, or investments created, purchased, or maintained by the partnership in connection with the transaction.*

Conclusion

As this article demonstrates, but many may not know, the IRS is implementing three new ways of challenging aspects of Tax Result Insurance. The IRS asserts that (i) its existence somehow eliminates risk, and with it, *bona fide* partnership and partner status, (ii) Property-Holding-Partnerships should not be able to deduct the premiums paid, as a business expense, as an expense related to income-producing property, or as a tax-determination expense, and (iii) any amounts received by partners from Tax Result Insurance should be taxed, at the highest rate, as ordinary income. Importantly, the IRS has not clearly prevailed on any of these arguments, and some have never been addressed by the courts. The legal, tax, and land conservation communities will be following these critical issues as SCET and SST disputes evolve.

NOTES

[115] *See, e.g.*, Popkin, "Taxing Personal Insurance: The Case of Tax Audit Insurance," 4(2) Virginia Tax Review 379 (1985); Kahn, "Hedging the IRS—A Policy Justification for Excluding Liability and Insurance Proceeds," 28 Yale Journal on Regulation 1 (2009); New York State Bar Association, Committee on Unreported Income and Compliance, "A Report on Tax Audit Insurance," 22 Tax Notes 53 (1/2/1984); Horowitz, "Excludability of Tax Indemnification Payments Threatened by Recent Change in IRS Position: PLR 9014046," 49 Tax Notes 799 (12/12/1990); Zelenak, "The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income," 46 Tax Law Review 381 (1991).

[116] IRS Information Release 2020-130 (6/25/2020).

[117] IRS, Chief Counsel Notice CC-2021-001 (10/1/2020); IRS News Release IR-2020-228 (10/1/ 2020); "IRS Provides More Details on Conservation Easement Initiative," 2020 Tax Notes Today Federal 191-32 (10/1/2020).

[118] Chief Counsel Notice CC-2021-001 (10/1/2020), Question and Answer E(1)(a).

[119] *Id.*