

NEWS ANALYSIS

Clamping Down on Conservation Easement Shelters

by Lee A. Sheppard

The walls are closing in. Again.

President Trump deducted charitable gifts of conservation easements, which are the subject of an investigation by New York Attorney General Letitia James, who was elected to her post in 2017 on a promise to pursue the president. In a case seeking to depose Eric Trump, who runs the family real estate, James filed a memorandum of law questioning whether the value of the Seven Springs estate in Westchester County was improperly inflated to claim a \$21.1 million federal income tax deduction for a conservation easement in 2015. (Prior coverage: *Tax Notes Federal*, Aug. 31, 2020, p. 1711.)

James's filing mentioned that Trump also claimed a \$25 million charitable deduction in 2014 for an easement on 12 acres near the Trump National Golf Club Los Angeles, overlooking the Pacific Ocean. Timothy Lindstrom, a Virginia lawyer who has written for *Tax Notes Federal*, suggested that the president's easement doesn't qualify for a deduction. Lindstrom hinted that the perpetuity requirement is the vulnerability because other taxpayers lost their cases with the same drafting, which was common at the time (*The Wall Street Journal*, Sept. 2, 2020). (Prior analysis: *Tax Notes Federal*, Aug. 24, 2020, p. 1409.)

As this article was being written, the Second Circuit stayed enforcement of the Manhattan district attorney grand jury subpoena for Trump's tax returns in a different investigation, while the president's lawyers appeal the merits of the district court decision allowing the subpoena to go forward. The district court noted that grand jury materials are secret, but the working assumption on all sides seems to be that the president's returns will be leaked (*Trump v. Vance*, No. 1:19-cv-08694 (S.D.N.Y. 2020)). There will be a hearing on September 25. (Related coverage: p. 1920.)

Why are conservation easements suddenly newsworthy? The Senate Finance Committee just released a report on the abuse of charitable contributions of conservation easements in syndication, and some legislators are thinking about legislation to restrain this tax shelter. The tempest over conservation easement shelters is overblown and is adequately addressed using current tools.

The federal government is throwing everything it has against conservation easement tax shelters, after what looks like years of neglect. It shouldn't need any additional tools. The IRS has a settlement offer out, and taxpayers are settling their cases. The legislation could free up IRS resources to audit partnerships that are up to other forms of mischief. The revenue at stake is a piffling \$2 billion annually, but we still might get a new law because legislators want to preserve the integrity of this tax break.

The Tax Shelter

The IRS is going at conservation easement shelters with a scorched-earth litigation strategy.

The Finance Committee report points out that the land involved in the shelters was mostly in the Southeast, where federal courts have been making law for several years. Shelter activity accelerated around 2013, when the deals started being sold as SEC Reg D private placements. The IRS started scrutinizing the deals around the same time. The conservation easement donation deduction was made permanent in 2015, after which shelters really took off, to the consternation of conservation proponents in Congress (section 170(h)).

Promoters got excited when the Tax Court sustained a conservation easement over a golf course located on gorgeous coastal property (*Kiva Dunes Conservation LLC v. Commissioner*, T.C. Memo. 2009-145). Yup, golf courses count, even though they use a lot of chemicals. The law merely requires that the easement protect a "significant relatively natural habitat," which could include habitats for rare, threatened, or endangered fish,



Remember to look out for the golf balls!
(rck_953@Bigstock.com)

plants, or wildlife (section 170(h)(4)(A); reg. section 1.170A-14(d)(3)(i)). Has the government thought about trying to keep pretty pictures out of evidence?

Earlier this year, the Eleventh Circuit reversed a Tax Court decision denying deductions for a conservation easement over a whole golf course on public policy grounds. The Georgia land was developed into a golf course designed by famous pros, with homesites on one side and a conservation easement on the other. Inspired by *Kiva Dunes*, the developer gathered some investors and granted another conservation easement over the entire golf course, including the driving range, except for the buildings. Birds live there; it doesn't have to be left in its natural state so it's a conservation area (*Champions Retreat Golf Founders LLC v. Commissioner*, No. 18-14817 (11th Cir. 2020)).

Syndicated conservation easements are already a listed transaction, and deals going back to 2010 are covered (Notice 2017-10, 2017-4 IRB 544). Promoters lobbied Congress against the notice. Many are specialized, with conservation easements their only business. These deals are on the IRS "Dirty Dozen" list (IR-2019-47). Inside the Large Business and International Division, the IRS has a tax shelter promoter investigation program run by Brendan O'Dell, promoter investigations coordinator, Office of the Deputy Commissioner, Services and Enforcement. LB&I is spending a lot of time auditing conservation easement cases.

What has been the audit experience from the listed transaction notice? If nothing else, it helped the IRS find the deals. The IRS hopes to audit every conservation easement partnership for which deductions were claimed since 2016. Some promoters filed Form 8918, the material adviser disclosure statement, for their deals, including older deals, after the notice came out. Some investors filed Form 8886 disclosure. But others may not have.

There is a civil settlement program for docketed Tax Court cases. The taxpayer must concede the full income tax benefits of the deal, after deduction of costs, and pay a penalty of 10 percent of the understatement. The partnership must make a lump sum payment of tax, interest, and penalties. Service providers must pay a 40 percent penalty with no deduction for costs. Terms will be stated in letters that will be mailed to eligible taxpayers. Originally, all participants in a partnership had to agree to settle, but if fewer than all settle, they will receive less favorable terms, such as a 20 percent penalty (IR-2020-130).

The IRS just announced the first settlement with Coal Property Holdings LLC and its partners, who agreed to the regular terms of the notice and made required payments. "We are seeing movement on these settlements," said IRS Chief Counsel Michael J. Desmond. "Given the potential for significant penalties, we anticipate more taxpayers will take similar actions and ultimately accept these offers, and we encourage them to do so."

Christopher S. Rizek, who along with Scott D. Michel, both of Caplin & Drysdale Chtd., represented Coal Property, said their client decided to take advantage of the assured penalty reduction in the IRS settlement initiative. There will be a stipulated decision and a closing agreement in the case (IR-2020-196).

There are 80 docketed cases, and Thomas A. Cullinan, counselor to the IRS commissioner, says the IRS is prepared to fight them. "We have won just about every technical issue we've raised. Even for those few cases that can show complete compliance with section 170, we're going to win on value," he said at a July 14 webinar hosted by the American Bar Association Section of Taxation. (Prior coverage: *Tax Notes Federal*, July 20, 2020, p. 534.)

The Charitable Conservation Easement Program Integrity Act of 2019 (S. 170; H.R. 1992), introduced in both the House and the Senate and sponsored by Rep. Mike Thompson, D-Calif., chair of the House Ways and Means Select Revenue Measures Subcommittee, would limit qualifying conservation easement deductions to amounts not exceeding 2½ times a partner's adjusted basis in his partnership interest if his holding period is less than three years (new section 170(h)(7)).

"Certain bad actors have engaged in transactions that abuse this important conservation tool in an attempt to create a profit for investors. This bill shuts down those abuses and ensures the integrity of the program for generations to come," Thompson stated at the time. "We cannot allow the abusive actions of a small minority to erode the integrity of this important program."

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Thompson represents scenic Napa, Sonoma, and Contra Costa counties. He is devoted to conservation issues and has sponsored legislation to expand federal conservation efforts. But he's not averse to hunting and fishing. When he led the effort to make the provision permanent, Congress thought it was giving ranchers and other landowners a means to make conservation contributions, not enabling tax shelter deals. Thompson is also a member of the Blue Dog Coalition.

Thompson's very short bill would effectively limit deductible contributions made by partnerships even when there was no valuation issue. It would conclusively presume that more than a 250 percent increase in value over a three-year period is abusive. But because it hooks into partnerships and overlaps with penalties, it has surprising ramifications. Thompson might have been better off with a one-sentence bill prohibiting deductions for conservation easements over golf courses and residential developments.

What's the magic of 2½ times adjusted basis? That's the usual pitch in the listed transactions described in Notice 2017-10. The shelter is 2 to 1. That is, the customer is able to claim \$2 of tax savings for every \$1 invested. That's not a lot of juice. Readers, your correspondent is old enough to remember when the IRS offered to settle real estate shelter cases for 2 to 1. The shelters at issue in the big case discussed below offered tax benefits of more than 4 to 1.

The Injunction Case

The government has the power to enjoin promoters of abusive shelters.

The Justice Department has brought an injunction case against executives of promoter EcoVest Capital, conservation consultant Nancy Zak, and appraiser Claud Clark III (*United States v. Nancy Zak*, No. 1:18-cv-05774 (N.D. Ga. 2018)), seeking to enjoin further sales of shelters and disgorgement of receipts (sections 7402, 7407, and 7408). The promoter did 96 deals, resulting in nearly \$2 billion of claimed deductions. The consultant was an investor in some deals. *Zak* is a big case, but there are other large, specialized promoters with docketed cases.

Disappointed customers are suing. *Zak* moved to dismiss a customer lawsuit alleging fraud, breach of fiduciary duty, and RICO violations for failure to state a claim and lack of particularity (*Lechter v. Aprio LLP*, No. 1:20-cv-01325 (N.D. Ga. 2020)). Investors buy these deals in December, when they're conferring with their preparers. Do the customers for such deals even have charitable intent? The government has been unable to prove they don't (*McGrady and Antoniaci v. Commissioner*, T.C. Memo. 2016-233).

Zak is ultimately a valuation case. The government also argued that the defendants made gross valuation overstatements and that the deals lacked economic substance. "Defendants knew or had reason to know that the valuation statements they made were false as well as gross valuation overstatements," the complaint intones.

"Defendants' conservation easement syndication scheme amounts to nothing more than a thinly veiled sale of grossly overvalued federal tax deductions under the guise of investing in a partnership," the Justice Department argued, going on to accuse the

defendants of making or causing others to make false statements about the amount of deductions customers are entitled to. The complaint equates an overvaluation with a false statement.

An injunction with a request for disgorgement is a drastic remedy that can put the defendant out of business or prompt consent to the injunction to reduce disgorgement. Courts have given the government broad leeway with injunctions, but usually in cases in which the facts are clear. (Prior analysis: *Tax Notes*, May 20, 2019, p. 1147.)

The district court dismissed one count against the conservation consultant, Zak. The dismissed count was the appraiser penalty because this penalty applies only to appraisers and not to those who assist them (section 6695A). Appraiser Clark also moved for dismissal, but no counts against him were dismissed (*Zak*, No. 1:18-cv-05774). His counterclaim for improper disclosure of his personal return information was dismissed for lack of a factual basis (*Id.*).

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“For nearly twenty years Mr. Clark’s appraisals have been submitted to the IRS in support of tax deductions, and to date no valuation misstatement penalty has ever been sustained,” Niles Elber of Caplin & Drysdale said on behalf of Clark, whose work was cited in the Senate Finance report and who surrendered his appraiser license following a complaint by the state board. The Justice Department accused Clark of using inappropriate assumptions and valuation methods to inflate values. Readers will note this is one of those times when a defense lawyer has to make a public statement. (Prior analysis: *Tax Notes*, Oct. 29, 2018, p. 559.)

What about fraud? If the promoters and their advisers keep doing the same thing over and over again, can the government argue fraud? In its complaint in *Zak*, the Justice Department does not use the word fraud except to say that some statements were false or fraudulent. There are no explicit fraud charges. The injunction statute that is being invoked is normally used to enjoin explicit fraud, but fraud is not required.

Valuation

The conservation easement tax shelter is primarily a valuation shelter, so why are we here?

The government is winning cases, which are heavily factual, usually on valuation. Claimed value can be contradicted by similar sales, such as in the case of the Florida parcel sold to investors for \$125 million, then valued for contribution at \$550 million — while the state bought a larger nearby tract for conservation for \$10 million (Peter Elkind, “The Billion-Dollar Loophole,” *ProPublica*, Dec. 20, 2017).

Proponents of conservation easement shelters argue that the property should be valued according to its hypothetical highest and best use, even if there is no likelihood that it would ever be so used (reg. section 1.170A-14(h)). “A conservation easement’s value is the value of the development rights that are forfeited in perpetuity when an easement is placed. Treasury’s own regulations require that these rights be valued based on the land’s highest and best use,” Robert Ramsay of the Partnership for Conservation argued. (Prior analysis: *Tax Notes Federal*, Apr. 27, 2020, p. 639.)

But the valuations are so high that financial engineering, subdivision, and indulgent appraisals must produce overvaluation of easements, according to tax accountant William E. Ellis of William E. Ellis & Associates LLC. “How can these valuations be possible? Again, the only possible answer is twofold: a valuation method that solely uses a hypothetical highest and best use discounted cash flow forgone approach, and the more important partnership structuring, with each separate parcel treated as an independent deal and the only new entrant to the marketplace,” he wrote. (Prior analysis: *Tax Notes State*, June 15, 2020, p. 1331.)

Appraisers in shelter deals seem to jump to residential valuation. Highest and best use must be probable, taking into account comparable sales, zoning, and the local market. It does not mean whatever possible value would be most lucrative. The pertinent regulation requires that valuation before and after the contribution of a conservation easement take into account “how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning,

conservation, or historic preservation laws that already restrict the property's potential highest and best use" (reg. section 1.170A-14(h)(3)(ii)).

The premise of conservation easement valuation is that the grant reduces the value of property subject to it. Weirdly, neither the Tax Court nor any circuit court of appeals has held that the grant of a conservation easement effects a per se reduction in the fair market value of the underlying property (*Scheidelman v. Commissioner*, 755 F.3d 148 (2d Cir. 2014)). In one case, the Tax Court held that there was a quid pro quo, hence no charitable gift, because the easement actually increased the value of residential property (*Wendell Falls Development LLC v. Commissioner*, T.C. Memo. 2018-45).

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Valuation arguments are painful and expensive for the government to make. But in the penalty phase, some judges are considering the argument that the value of the land before the easement is granted is best reflected by the investors' acquisition cost in their partnership interests. Because the holding period tacks, land is aged in the hands of the promoter. What the investor pays includes acquisition cost, gain to the promoter, and various fees. These can be stripped out to get to the pre-easement value of the land (reg. section 1.170A-1(c)).

After disallowing the charitable deduction, Tax Court Judge David Gustafson held that the fair market value of a rural Tennessee property was not the \$4 million claimed before the grant of the easement, but a more modest \$1.1 million for purposes of the gross valuation misstatement penalty (section 6662(e), (h)). The highest and best use, recreation and timber harvesting, remained the same before and after the easement was granted (*TOT Property Holdings LLC v. Commissioner*, No. 5600-17 (Dec. 13, 2019)).

Coal Property also had a valuation penalty issue. Investors paid \$33 million for 99 percent of the partnership, but three days later, they claimed a charitable donation of \$155 million when the easement was granted. The claimed value before the easement was \$161 million, based on a highest

and best use for strip mining, which the easement banned (*Coal Property Holdings LLC v. Commissioner*, No. 27778-16 (T.C. filed on June 15, 2020)).

Having already disallowed the deduction, Judge Albert Lauber saw no need to value the easement except for application of the 40 percent gross valuation misstatement penalty. He ordered the petitioner to respond to the IRS motion for summary judgment on the value of the property — usually a factual issue. To avoid the penalty, the petitioner would have to show that the property appreciated by \$45 million in three days, otherwise the judge would rule for the government.

Some conservation easement claimants try to have it both ways. Land is highly valued for residential use and the easement is granted, but the terms of the easement permit residential development within the conservation area. "I'd say that's truly having your cake and eating it too," Ellis wrote.

Perpetuity

Allowing inconsistent uses of conservation easement property would violate the perpetuity requirement.

A "qualified conservation contribution" must be of a "qualified real property interest" made exclusively for conservation purposes and have legally enforceable restrictions that prevent inconsistent use of the retained interest (section 170(h)(2)(C)). The donor has to document the baseline condition of the property, and a qualified appraiser has to give a qualified appraisal (section 170(f)(11)).

The perpetuity requirement is violated when the boundaries of the easement can be changed, or other property substituted for easement property. The Fourth Circuit held that "a conservation easement must govern a defined and static parcel" (*Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014)). But the government lost a big case on the perpetuity and documentation requirements in addition to valuation misstatements.

The Fifth Circuit was not bothered that the homesites on a subdivided Texas ranch could be swapped out for some initially protected areas. The promoter compared the homesite map to Swiss cheese. Nor was the court bothered that

activities of homeowners could interfere with conservation of a habitat for the gold-cheeked warbler. The extensive reserved rights included constructing buildings, recreational facilities, utilities, hunting stands, and roads. The court believed that section 170(h) should be broadly interpreted (*BC Ranch II v. Commissioner*, 867 F.3d 547 (5th Cir. 2017)).

Other conservation easement deals have failed the perpetuity requirement because the deed did not guarantee the grantee a proportionate share of the proceeds if the easement were extinguished by a court and the property sold. (Prior coverage: *Tax Notes Federal*, Aug. 31, 2020, p. 1712.) This is the issue that Lindstrom identified that could potentially disqualify the Trump California easement.

In settling, Coal Property Holdings and its partners agreed to disallowance of the entire \$155 million deduction for an easement on a 3,700-acre Tennessee tract that had gas wells and cell towers. Last year, the government prevailed in Tax Court on a motion for partial summary judgment that the “judicial extinguishment” provisions of the easement deed did not satisfy the perpetuity requirement (section 170(h)(5)(A), reg. section 1.170A-14(g)(6)). The deed failed to guarantee that the grantee would receive its proportionate share of the proceeds if the easement were judicially extinguished and the property sold (*Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019)).

The government is making other technical arguments in these cases, because, like in all tax shelters, the participants inevitably become careless about documentation and details. Sometimes donors condition their gifts on eligibility for a charitable deduction, so there is no completed charitable gift (*Oakbrook Land Holdings LLC v. Commissioner*, T.C. Memo. 2020-54, and *Graev v. Commissioner*, 140 T.C. 377 (2013)). And in one case, preexisting encumbrances on the donated property meant that the donor couldn’t confer an easement (*R.P. Golf v. Commissioner*, T.C. Memo. 2016-80, *aff’d*, 860 F.3d 1096 (8th Cir. 2017)).

Partnerships

The use of partnerships is not even necessary to the tax shelter. But the Thompson bill would raise partnership issues.

A partnership is a handy vehicle to whack up ownership of a parcel of land into smaller salable pieces. But there’s nothing in a conservation easement shelter that requires a partnership. The deal is to acquire a parcel of land and collectively donate it to a land trust. There is no allocation of debt or special allocations of tax items. Investors could just as easily accomplish the goal using an agent, or as tenants in common in the parcel. They just don’t want to form a transfer vehicle that is a separate taxpayer, like a corporation.

Notice 2017-10 warns that the IRS could assert the partnership antiabuse rule (reg. section 1.701-2). The regulation generally says that a partnership must have a business purpose and substance. Using a partnership to make a gift does require a business purpose. The regulation allows the partnership to be disregarded, but that wouldn’t make much difference in conservation easement syndications.

The Senate report suggested that a partnership formed to purchase and donate land for a conservation easement had no business purpose. But the cases show that wealthy individuals and farmers, who individually donate land for conservation easements, are fully capable of failing the donation requirements without the use of partnerships. And promoters argue that use of partnerships makes access to the deduction more democratic, as they did with tax shelters in the 1970s and 1980s.

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“For decades, the IRS took the position that a partner is entitled to deduct a charitable contribution made by a partnership even if the deduction exceeds the partner’s investment in the partnership. Congress codified this rule in 2017. The IRS’s recent change of heart, which is limited to conservation easements donated by partnerships, is flatly contradicted by the law,” Ramsay argued. But the issue was whether the partnership’s charitable contribution of appreciated property in kind should require a reduction of the basis of the partnership interest

equal to the fair market value or the partnership's basis in the property (discussed below).

The Justice Department has challenged some partnerships as shams. In *Zak*, it argued that the characterization of the partnership for tax purposes was a false statement because the defendants were just selling tax deductions and did not intend to conduct a business, and the easements did not qualify as qualified conservation easements. It seems focused on the passthrough aspect, apparently assuming that the vehicle would be reclassified as a corporation, so investors would be blocked from charitable deductions. It argued that a partnership is the only way to transfer deductions associated with the land.

The tax opinion provided to investors merely states that the partnership will be treated as such for tax purposes. Appraisal documents are the real documents that support the amount of the claimed tax deductions. So the tax opinions are unnecessary. If the partnership were ignored, it wouldn't affect the deduction because the investors as tenants in common would have granted an easement.

Although the contribution of the easement is already negotiated when partnership interests are sold to investors, formalities are observed, so that the conservation consultant recommends the deal at the closing, and the investors vote on whether to make the contribution. Then the appraiser finalizes the gigantic markup as a final appraisal of the value of the contribution and prepares a statement for Form 8283 to be filed with the partnership return. Sometimes there are tiers of partnerships, so the upper-tier partnership, owned by investors, owns 90 percent of the lower-tier partnership, which owns the land.

The quick turnaround makes the deals look bad. The promoters buy land and contribute it to a partnership, the interests of which are sold to investors at a gain, usually deferred until the promoters cash out. Shortly thereafter an easement is granted to a land trust, allowing investors to deduct an amount that is a multiple of their acquisition price. All this happens according to plan in a relatively short period of time because the holding period is tacked (section 170(e)(1)). The partnership has a limited life.

The easement deal is pending when the partnership is sold to investors, so what did they really purchase? Did they purchase land, or did they purchase federal tax deductions and possibly also state tax credits? In *Zak*, the Justice Department argued that the deals were the sale of tax deductions, which it argued is "prohibited." So a statement that the vehicle is a partnership is false, according to this view.

Leaving aside the feasibility of transferring deductions, subchapter K does have a way to deal with the problem in the form of the disguised sale rule (section 707(a)(2)(B) and reg. section 1.707-3 and -6). It could be argued that the partnerships are selling federal tax deductions to investors, generating gain to the partnership (reg. section 1.707-6). What would that accomplish? When investors overpay for partnership interests, and then the property is appraised at a multiple of what they paid, the extra value is ascribed to the conservation easement, so a disguised sale would tax that extra value back to the partnership and from there to the investors.

But the Fifth Circuit reversed a Tax Court decision that a disguised sale of certain deeded property was present. The appellate court reversed on a disguised sale of the appurtenant rights and did not address whether there was a disguised sale of federal tax benefits of the donation by the partnership to the investors (*BC Ranch II*, 867 F.3d 547).

A large Texas ranch had been subdivided into homesites and a conservation easement; each investor in the partnership bought the right to a homesite and a charitable deduction for the easement. Homesites were distributed and deeded to investors within months of the partnership formation, enabling the government to argue disguised sale based on but-for transfer and lack of entrepreneurial risk (section 707(a)(2)(B), reg. section 1.707-3(b)(1), (c)(1)). Homesite distributions were conditioned on investors' agreement to contribute the easement.

The Tax Court found a disguised sale of homesite land and appurtenant rights — but not a disguised sale of tax benefits, which it had knocked out — without measuring the income from the sale. The homesites were assessed for local taxes at \$28,000 each, but sold to investors for \$350,000 to \$550,000 each, so the government

argued that \$100,000 of each sale was a payment for the charitable deduction (*Bosque Canyon Ranch LP v. Commissioner*, T.C. Memo. 2015-130). The Fifth Circuit reversed on both the sale, for failure to measure income, and the charitable contribution deduction. “We need not consider the potential circularity of the argument that the tax benefit itself of a charitable deduction is taxable value,” Judge Jacques L. Wiener Jr. wrote.

Could the federal tax deduction be property subject to a disguised sale? A deduction is not a separately transferable thing, but state tax conservation credits clearly are property, and state law permits transfer of them. Some federal conservation easement deals also involved state tax credits.

Courts have held that there was a disguised sale of state tax credits by a partnership because the transfer of credits is a transfer of property. The Fourth Circuit held that credits are property because they were an inducement to invest for a guaranteed, fixed 2-1 shelter (*Route 231 LLC v. Commissioner*, 810 F.3d 247 (4th Cir. 2016)). The disguised sale argument allows the court to assume that the partnership is bona fide (*Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011)).

Even for partners settling their cases under the IRS settlement offer, there are subchapter K questions. A charitable contribution reduces a partner’s basis in his partnership interest by the partnership’s basis in the donated property, so that basis would probably be lower than the acquisition cost the settlement means to allow. So the IRS would have to ignore the contribution or time it exquisitely to permit a deduction at cost (section 704(d)). (Prior coverage: *Tax Notes Federal*, July 6, 2020, p. 131.)

A similar question would arise if the Thompson bill were enacted to limit charitable gifts to 2½ times cost. On a partnership’s charitable contribution of appreciated property, a partner’s outside basis in his partnership interest must be reduced by his share of the partnership’s inside basis in the property, not the fair market value, because the appreciation is not taxed upon the contribution. So the IRS worked to preserve nontaxation of that appreciation (sections 703(a)(2)(C), 705(a)(2)(B), Rev. Rul. 96-11, 1996-1 C.B. 140).

Conversely, should the IRS act to preserve taxation of gain if the Thompson bill is enacted? In the ruling, the IRS explained that reducing the partner’s basis by the fair market value of the contributed property would cause the partner to recognize gain upon a later disposition of his partnership interest, attributable to built-in gain in the property at the time of contribution. What if the fair market value of contributed property exceeds 2½ times cost, and the Thompson bill prohibits deduction of the excess value? Should the IRS say that for contributions of conservation easements, a partner’s basis is reduced by fair market value, to ensure taxation of that excess value upon a later sale of the property and to further reduce the incentives for these deals?

Conservation easement partnerships are straightforward deals with no debt or special allocations. There’s a private offering in which each investor buys a partnership interest entitling him to a proportionate interest in the partnership assets and a proportionate charitable deduction when the easement is granted.

Sometimes the promoters have purchased the parcel of land before forming the partnership, after which they sell it to the partnership at a gain. Or the partnership may collect cash from investors and then purchase the property. The Thompson bill appears to assume that investors made cash contributions and then the partnership used them to acquire the property. Otherwise, there would be no logical correlation between the value of contributed property and its tax basis.

But what if the partnership acquired the property by means of a contribution in kind, and the property had a large built-in gain? The investors would take a carryover basis, so that the 2½ times cost threshold could be exceeded. The resulting excess value would not be deductible for tax purposes, and most likely nondeductible for book purposes, too. Presumably the nondeductible excess value would be a non-capital nondeductible expense, but that seems odd because it is a donation and not an expense.

The partners’ book and tax capital accounts, along with the inside and outside tax bases, may need some adjustments to account for the excess value that reduces the partnership property but is not deductible by the partnership and is not distributed to the partners. Determining how a

statutorily limited charitable deduction should be presented in capital accounts and bases is a chicken-and-egg problem.

Investors usually come into the partnership at the same time. But what if a new partner enters just before the grant of the easement, causing the other partners' distributive shares to vary? Should a reapportionment of the charitable gift be made to that new partner?

The IRS has the power to designate the charitable contribution as an extraordinary item that cannot be apportioned. An extraordinary item is an item that must be apportioned to the partners who were partners at the time the event that created it occurred — in this case, the time the easement was granted. That apportionment must be in proportion to their interests at that time regardless of any other method used by the partnership. Rehabilitation credits, COD income, and tort settlements are examples of extraordinary items (reg. section 1.706-4(e)).

The Thompson bill would not apply to partnerships in which “substantially all” of the interests are owned by individuals who are related (section 152(d)(2)). What does that mean?

Penalties

Can't current-law penalties handle these cases? Why haven't the valuation penalties and some criminal cases been sufficient to curb abuses?

The Finance Committee report was written with the assistance of academics, who threw around the word fraud, despite knowing that it has a specific legal meaning. If everything the academics said was fraud really was fraud, the tax system would be able to handle it with civil or criminal penalties.

The *Zak* defendants did a lot of shelter deals, so it may be appropriate for the government to try to enjoin them (sections 6700, 7408). The tax shelter behavior to be enjoined can be either a false statement about entitlement to a tax benefit or a gross valuation overstatement (section 6700(a)(2), (b)(1)). The government asserted the appraiser penalty and the broad injunction for interference with administration of the tax law (sections 6695A, 7402). Because at least two of the defendants were preparers, the government

asserted the preparer penalty and sought to enjoin further return preparation (sections 6694, 7407).

The gross valuation overstatement penalty was successfully asserted in a Tenth Circuit case (*Roth v. Commissioner*, No. 005544-12 (10th Cir. 2019)). But the Fifth Circuit reversed and remanded a Tax Court decision sustaining gross valuation overstatement penalties (*BC Ranch II*, 867 F.3d 547). Valuation cases are a crapshoot, because a court could be enchanted by photos of a scenic plot of land. But if the promoter prevails on valuation, how would a false statements charge be an effective backstop?

In *Zak*, the Justice Department griped that the appraiser automatically valued parcels for residential use, regardless of whether that use was probable or realistic, using unsuitable data and ignoring relevant comparable sales. The government accused the appraiser of inflating value by more than 200 percent, the threshold for gross valuation misstatement (section 6662(h)). The threshold for substantial valuation misstatement is 150 percent (section 6662(e)).

In each deal, the appraiser prepared Form 8283 for the partnership. Preparation of Form 8283 on behalf of the investors makes the appraiser a preparer — to say nothing of the promoters and consultants. The preparer penalty is quite high and was asserted in *Zak* (sections 6694, 7407). Other participants could be drawn into the preparer net, because a tax return preparer is any person who prepares for compensation any return of tax or any claim for refund of tax of a return or claim for refund (section 7701(a)(36), reg. sections 1.6694-1, 301.7701-15). In *Zak*, the district court was not persuaded that Clark was not a preparer on his motion to dismiss that count.

Why haven't the valuation penalties and some criminal cases been sufficient to curb abuses?

The government asserted the appraiser penalty against Clark in *Zak* (section 6695A). In January the IRS notified appraisers that examiners have sole discretion to impose the penalty. In May appraisers were notified that they must agree to extend the statute of limitations to

the end of 2021 or face immediate assessment of penalties.

How about the bog-standard accuracy-related penalty? Investors may be able to avoid penalties because of good-faith reliance on qualified appraisers and conservation experts, even if the easement was overvalued and they lost the valuation case on the merits (*Palmer Ranch Holdings Ltd. v. Commissioner*, T.C. Memo. 2014-79). The partnership went to the friendly Eleventh Circuit and got a remand (*Palmer Ranch v. Commissioner*, 812 F.3d 982 (11th Cir. 2016)). On remand, the Tax Court sustained their valuation (*Palmer Ranch Holdings Ltd. v. Commissioner*, T.C. Memo. 2016-190). And yes, for a partnership or an investor to go back to court several times is not uncommon.

Penalties are being asserted, so some taxpayers who lost on the merits are in court arguing that approval for the penalties did not comply with procedural requirements (section 6751(b)(1)). Weirdly, the Tax Court is divided on this issue (*Graev*, 147 T.C. 460 (2016), and *Belair Woods LLC v. Commissioner*, 154 T.C. No. 1 (2020)).

The Thompson bill would complicate assertion of penalties if corresponding changes were not made. If the new section 170(h)(7) is enacted as proposed, then any partner claiming a charitable deduction greater than 2½ times adjusted basis is not only overvaluing the property, but is also acting contrary to a statute. This appears to be true even if the value claimed can be substantiated. There is no out for proof that the easement really is worth more than that.

As the cases demonstrate, an appraisal is an educated opinion. Certainly the IRS knows this from its bitter experience with transfer pricing and estate valuations. If the taxpayer deducts more than 2½ times adjusted basis and can substantiate that value, does a substantial understatement penalty automatically apply? Or should a credible appraisal of a higher value excuse the taxpayer from the penalty even if the statute applies to deny the deduction? Could the taxpayer correct the problem by filing a qualified amended return?

Would parallel changes have to be made to the preparer penalty (sections 6662, 6694)? As the *Zak* charges demonstrate, an income tax return preparer can include a non-signing preparer who

provides substantial advice on the valuation transaction (reg. section 3301.7701-15). That would include lawyers, even though they like to say that they are not preparers under that regulation.

If the IRS is so upset about these deals, why not argue economic substance in any of the litigated cases? The economic substance penalty might be raised in an appropriate case (section 6662(i)).

Examiners have asserted the penalty in cases involving listed tax shelter transactions that individuals were on notice not to pursue. And the IRS's own internal guidance on the criteria to assert the economic substance penalty emphasizes structured, marketed shelter transactions and confines the penalty to rich individual cases (LB&I-04-0711-015).

The codified economic substance penalty is strict liability if the case is decided based on it (section 7701(o)). Judges remain free to determine whether economic substance is relevant to the transaction being analyzed (section 7701(o)(5)(C)). In *Zak*, the Justice Department argued that the deals had no economic substance, but did not specifically assert the penalty. ■