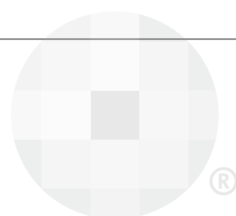
Conservation Easements, Partnerships, Risks, and Profitability: U.S. Government Takes Contradictory Positions in Tax and Securities Cases

By Hale E. Sheppard*

Hale E. Sheppard analyzes the inconsistent positions that the Securities Exchange Commission and the Internal Revenue Service take regarding conservation easement partnerships.



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I. Introduction

The U.S. government has been aggressively attacking partnerships making conservation easement donations for the past several years. It has also been pursuing others affiliated with such transactions, including certain appraisers and organizers. This belligerence has created a potential issue for the U.S. government of which few people are aware.

In taking tax-related enforcement actions, the Internal Revenue Service ("IRS") and Department of Justice ("DOJ") have raised a long list of tax and legal positions. These include that entities involved in conservation easements are not true partnerships for tax purposes, they exist solely as a way to "sell" tax deductions, they engage in sham transactions, and/or they lack economic substance. By contrast, as part of its efforts to punish certain organizers for securities-related violations, the SEC has argued that the partners invest their money and risk financial loss, they are involved in a common enterprise, they have a legitimate expectation of profit, and they rely on the efforts of third-parties to generate such profit. In other words, the IRS and DOJ, on one hand, and the SEC, on the other hand, have taken positions regarding conservation easement partnerships before different courts that might be characterized as contradictory.

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This article examines the key issues with conservation easements, the positions raised by the IRS and DOJ in the tax context in cases, administrative

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pronouncements, and injunction actions, and the contrary arguments made by the SEC in a recent securities enforcement action.

II. Overview of Conservation Easements and Pertinent Issues

To appreciate the significance of the issues addressed in this article, one must first have a basic understanding of the applicable rules and terminology.

A. What Is a Qualified Conservation Contribution?

Taxpayers generally may deduct the value of a charitable donation that they make during a year.[1] However, taxpayers are not entitled to deduct a donation of property, if it consists of less than their entire interest in such property.[2] One important exception is that taxpayers can deduct a donation of a partial interest in property (instead of an entire interest), provided that it constitutes a "qualified conservation contribution."[3] To meet this critical definition, taxpayers must show that they are (i) donating a qualified real property interest ("QRPI"), (ii) to a qualified organization, (iii) exclusively for conservation purposes.[4]

B. What Is a QRPI?

A QRPI can be one of several things, including a restriction, granted in perpetuity, on the use of a particular piece of real property.[5] These can be known by many names, among them "conservation easement," "conservation restriction," and "perpetual conservation restriction."[6] Regardless of what you call them, QRPIs must be based on legally enforceable restrictions (such as those memorialized in a Deed of Conservation Easement filed in the appropriate public record) that will prevent uses of the property, forever, which are inconsistent with the conservation purpose of the donation.[7] Stated differently, a donation is not treated as "exclusively for conservation purposes," unless the conservation purposes are "protected in perpetuity."[8]

The IRS will not disallow a tax deduction merely because the interest granted to the charitable organization might be defeated in the future as a result of some act or event, provided that, on the date that the easement is granted, it appears that the possibility that such act or event will take place is "so remote as to be negligible."[9] For instance, the fact that state law requires use restrictions, like conversation easements, to be re-recorded every 30 years to remain in force does not, alone, make easements non-perpetual.[10] Another example is where a taxpayer donates land to a city government for as long as such land is used as a park. If, as of the date of the donation, the city plans to use the land for a park, and the possibility that it could be used for another purpose is negligible, then the donation is considered perpetual, and the taxpayer is entitled to a deduction.[11]

C. For What Purposes Can Land Be Conserved?

A contribution has an acceptable "conservation purpose" if it meets one or more of the following requirements: (i) It preserves land for outdoor recreation by, or the education of, the general public; (ii) It protects 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.[12]

D. Can Taxpayers Still Use the Protected Property?

A taxpayer can retain certain "reserved rights," still make a qualified conservation contribution, and thus qualify for the tax deduction. However, in keeping something for themselves, taxpayers must ensure that the reserved rights do not unduly conflict with the conservation purposes.[13] The IRS openly recognizes in its Audit Technique Guide ("ATG") that reserved rights are ubiquitous, explaining the following about taxpayer holdbacks:

> All conservation easement donors reserve some rights to the property. Depending on the nature and extent of these reserved rights, the claimed conservation purpose may be eroded or impaired to such a degree that the contribution may not be allowable. A determination of whether the reserved rights defeat the conservation purpose must be determined based on all the facts and circumstances.[14]

The ATG later provides some examples for IRS personnel about reserved rights, including the following:

> Taxpayers are permitted to reserve some development rights on a portion of the property, such as construction of additional homes or structures, installation of utilities, and building of fences or roads, provided that the conservation purposes are protected. Depending on the facts and circumstances, retention of these

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rights may result in disallowance [of the charitable contribution tax deduction related to the easement].[15]

The regulations provide yet more specifics about reserved rights and uses that might be inconsistent with the conservation purpose of an easement:

> [A] deduction will not be allowed if the contribution would accomplish one of the enumerated conservation purposes but would permit destruction of other significant conservation interests … However, this requirement is not intended to prohibit uses of the property, such as selective timber harvesting or selective farming if, under the circumstances, those uses do not impair significant conservation interests … A use that is destructive of conservation interests will be permitted only if such use is necessary for the protection of the conservation interests that are the subject of the contribution … A donor may continue a pre-existing use of the property that does not conflict with the conservation purposes of the gift.[16]

E. What Is an Easement Worth?

Generally, a deduction for a charitable contribution is allowed in the year in which it occurs.[17] If the contribution consists of something other than money, then the amount of the contribution normally is the fair market value ("FMV") of the property at the time the taxpayer makes the donation.[18] For these purposes, the term FMV ordinarily means the price on which a willing buyer and willing seller would agree, with neither party being obligated to participate in the transaction, and with both parties having reasonable knowledge of the relevant facts.[19]

Reg. §1.170A-14(h)(3) ("Easement-Valuation-Methods Regulation") provides special rules for calculating a deduction stemming from the donation of a conservation easement, which is a partial (not a full) interest in property. The relevant portion of the Easement-Valuation-Methods Regulation, broken down to enhance readability, is set forth below[20]:

> [*Sentence 1*] The value of the contribution under Section 170 in the case of a charitable contribution of a perpetual conservation restriction is the [FMV] of the perpetual conservation restriction at the time of the contribution.
>
> [*Sentence 2*] If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the [FMV] of the donated easement is based on the sales prices of such comparable easements.
>
> [*Sentence 3*] If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the [FMV] of a perpetual conservation restriction is equal to the difference between the [FMV] of the property it encumbers *before* the granting of the restriction and the [FMV] of the encumbered property *after* the granting of the restriction.
>
> [*Sentence 4*] The amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor and the donor's family (as defined in Section 267(c)(4)) is the difference between the [FMV] of the entire contiguous parcel of property before and after the granting of the restriction.
>
> [*Sentence 5*] If the granting of a perpetual conservation restriction … has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the deduction for the conservation contribution shall be reduced by the amount of the increase in the value of the other property, whether or not such property is contiguous.

The IRS provides the following summary and hints about valuation to its personnel in the ATG. It explains that the best evidence of FMV of an easement is the sale price of easements comparable to the easement in question, but, "in most instances, there are no comparable easement sales."[21] Appraisers, therefore, often must use the before-and-after method. The ATG acknowledges that this effectively means that an appraiser must determine the highest and best use ("HBU") *and* the corresponding FMV of the relevant property *twice*: (i) first, without regard to the easement, which generates the before value, and (ii) again, taking into account the restrictions on the property imposed by the easement, which creates the after value.[22]

As indicated in the preceding paragraph, in deciding the FMV of property, appraisers and courts must take into account not only the current use of the property, but also its HBU.[23] A property's HBU is the highest and most profitable use for which it is adaptable and needed, or likely to be needed, in the reasonably near future.[24] The term HBU has also been defined as the reasonably probable use of vacant land or improved property that is physically possible, legally permissible, financially feasible, and maximally productive.[25] Importantly, valuation does

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not depend on whether the owner has actually put the property to its HBU.[26] The HBU can be any realistic, objective potential use of the property.[27]

The Easement-Valuation-Methods Regulation provides additional guidance in situations where the appraiser uses the before-and-after method, described in Sentence 3, above. It states the following[28]:

> If before and after valuation is used, the [FMV] of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of 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.
>
> Further, there may be instances where the grant of a conservation restriction may have no material effect on the value of the property or may in fact serve to enhance, rather than reduce, the value of the property. In such instances, no deduction would be allowable.
>
> In the case of a conservation restriction that allows for any development, however limited, on the property to be protected, the [FMV] of the property after contribution of the restriction must take into account the effect of the development.
>
> Additionally, if before and after valuation is used, an appraisal of the property after contribution of the restriction must take into account the effect of restrictions that will result in a reduction of the potential [FMV] represented by [HBU] but will, nevertheless, permit uses of the property that will increase its [FMV] above that represented by the property's current use.

The regulations contain a dozen illustrations of how values of donated property should be determined, at least from the IRS's perspective. Below is a simple example in the conservation easement context:

> C owns Greenacre, a 200-acre estate containing a house built during the colonial period. At its [HBU], for home development, the [FMV] of Greenacre is $300,000. C donates an easement (to maintain the house and Greenacre in their current state) to a qualifying organization for conservation purposes. The [FMV] of Greenacre after the donation is reduced to $125,000. Accordingly, the value of the easement and the amount eligible for a deduction under Section 170(f) is $175,000 ($300,000 less $125,000).[29]

F. How Do Taxpayers Prove the Condition of the Property at Donation Time?

In situations involving the donation of a QRPI where the donor reserves certain rights whose exercise might impair the conservation purposes, the tax deduction will not be allowed unless the donor "makes available" to the easement-recipient, before the donation is made, "documentation sufficient to establish the condition of the property at the time of the gift."[30] This is generally called the Baseline Report.

The Baseline Report "may" (but not "must") include (i) the appropriate survey maps from the U.S. Geological Survey, showing the property line and other contiguous or nearby protected areas, (ii) a map of the area drawn to scale showing all existing man-made improvements or incursions (*e.g.*, roads, buildings, fences, or gravel pits), vegetation and identification of flora and fauna (*e.g.*, locations of rare species, animal breeding and roosting areas, and migration routes), land use history, and distinct natural features, (iii) an aerial photograph of the property at an appropriate scale taken as close as possible to the date of the donation, and (iv) on-site photographs taken at appropriate locations on the property.[31] If the easement contains restrictions regarding a particular natural resource, such as water or air quality, then the condition of the resource at or near the time of the donation must be established.[32] The Baseline Report "must be accompanied by a statement signed by the donor and a representative of the [easement-recipient] clearly referencing the [Baseline Report] and in substance" confirming that the property description and the natural resources inventory are accurate.[33] The ATG seconds this notion, stating that "[t]he baseline study must be signed by the donor and donee."[34]

G. How Do Taxpayers Claim an Easement-Related Tax Deduction?

Properly claiming the tax deduction triggered by an easement donation is, well, 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 easement-recipient is a "qualified organization," (iii) obtain a timely Baseline Report, generally from the easement-recipient, describing the condition of the property at the time of the donation and the reasons for which

it is worthy of protection, (iv) complete a Form 8283 (*Noncash Charitable Contributions*) and have it executed by all relevant parties, including the taxpayer, appraiser, and easement-recipient, (v) assuming that the taxpayer is a partnership, file a timely Form 1065, enclosing Form 8283 and the qualified appraisal, (vi) receive from the easement-recipient a contemporaneous written acknowledgment, both for the easement itself and for any endowment/stewardship fee donated to finance the perpetual protection of the property, (vii) ensure that all mortgages on the relevant property have been subordinated before granting the easement, and (viii) send to all partners their Schedule K-1 (*Partner's Share of Income, Deductions, Credits, etc.*) and a copy of the Form 8283.[35]

III. Normal IRS Positions

There were times, in the past, when the IRS would be straightforward with taxpayers, describing in its notice of Final Partnership Administrative Adjustment ("FPAA") the specific grounds on which it was demanding a change or imposing a penalty. The IRS does not follow that procedure any longer, at least when dealing with conservation easements. The standard approach by the IRS now is to fully disallow the easement-related deduction claimed by the relevant partnership based on several "technical" arguments under Code Sec. 170, and then, as a backup plan, fully disallow the deduction for supposed valuation problems. Many FPAAs nowadays limit themselves to the following description:

> It has not been established that all the requirements of I.R.C Section 170 have been satisfied for the non-cash charitable contribution of a qualified conservation contribution. Accordingly, the charitable contribution deduction is decreased by [the entire amount claimed on the Form 1065].
>
> Alternatively, if it is determined that all the requirements of I.R.C Section 170 have been satisfied for all or any portion of the claimed non-cash charitable contribution, it has not been established that the value of the contributed property interest was greater than zero … Accordingly, the charitable contribution is decreased by [the entire amount claimed on the Form 1065].

Based in the vague and incomplete descriptions above, the IRS then proposes several alternative penalties in an FPAA, ranging in severity. These often include negligence, substantial understatement of income tax, substantial valuation misstatement, gross valuation misstatement, or reportable transaction understatement penalty.[36]

This behavior by the IRS is problematic because (i) there is legal presumption that what the IRS claims in the FPAA is correct, (ii) taxpayers normally cannot "go behind the FPAA" and present evidence to the Tax Court related to the audit (such as the Examination Report, Summary Report, or Notice of Proposed Adjustments), which contain detail about the IRS's positions, and (iii) taxpayers ordinarily have the burden of proof during a Tax Court trial, meaning that they have the duty to present sufficient evidence to overcome the presumed correctness of the IRS, as reflected in its FPAA.[37] Thus, the reality is that, unless the IRS later identifies and/or narrows the issues that it is truly contesting *via* responses to discovery requests issued by the taxpayer during Tax Court litigation, a Stipulation of Facts, a Stipulation of Settled Issues, or a Pre-Trial Memorandum, the taxpayer is obligated to present evidence at trial that it satisfied every single requirement on an extremely long list to be granted a deduction for a "qualified conservation contribution" under Code Sec. 170. The magnitude of this endeavor is illustrated by the ATG, which contains a chart spanning four pages called the "Conservation Easement Issue Identification Worksheet."[38] This represents an enormous evidentiary burden on the Partnership, as well as an inefficient use of Partnership, IRS, and Tax Court resources.

Such conduct by the IRS is also troublesome because of special penalty-defense rules. Some penalties can be avoided if the taxpayer can demonstrate that there was "reasonable cause" for the violation.[39] Others can be mitigated only if the value was based on a qualified appraisal prepared by a qualified appraiser, and the taxpayer made a good faith investigation of the value of the property.[40] Finally, under current law, certain penalties, like the one for calculating an easement-related deduction based on a gross valuation misstatement by an appraiser, cannot be overcome by evidence of "reasonable cause." This valuation-based penalty is mathematical in nature; that is, if the value of the easement/deduction originally claimed by the taxpayer on the Form 1065 (and enclosed Form 8283) exceeds the value ultimately determined by the Tax Court by a certain percentage, then the significant penalty applies, period.[41]

IV. Tax and Legal Positions Threatened by the IRS

The IRS has been threatening for years to raise new theories for attacking conservation easements. These are

"novel" in the sense that they generally do not originate in Code Sec. 170 or its regulations, but rather in theories developed by the courts.

The IRS announced in Notice 2017-10 that it intended to challenge syndicated conservation easement transactions ("SCETs") on grounds that they supposedly constitute "tax-avoidance transactions" and involve inflated valuations.[42] The IRS further stated in Notice 2017-10 that it might also attack SCETs based on the partnership anti-abuse rules, the economic substance doctrine, or other unspecified rules and judicial doctrines.[43]

More recently, in a Complaint filed by the DOJ in District Court in December 2018 seeking an injunction against certain individuals and entities in the easement industry, the DOJ alleged that the entities involved in SCETs were not true partnerships for federal tax purposes, they exist solely as conduits to "sell" tax deductions, they are "shams," and they "lack economic substance."[44]

Following this path, the IRS initially raised several novel theories in attacking parties affiliated with a conservation easement in a recent Tax Court case, *Champions Retreat*. The theories in that case consisted of the following: (i) The easement donation was not a QRPI; (ii) The land trust was not a "qualified organization"; (iii) The partnership granting the easement donation actually made a "disguised sale" of tax deductions to the investment partnership; (iv) The allocation of the easement-related deduction to the partners did not have substantial economic effect and thus should not be respected; and (v) Each partner's deduction should be limited to the amount of his or her capital contribution to the partnership.[45]

V. Securities Case Focused on Conservation Easement Partnerships

The linchpin for many of the theories identified by the IRS and/or DOJ in the tax context, particularly those involving economic substance, is demonstrating that the partnerships making conservation easement donations serve no purpose other than facilitating tax benefits. In other words, the IRS and DOJ must prove, to the satisfaction of the relevant court, that the partnerships were not legitimate investment vehicles and they lacked the possibility of generating profit for the partners. The problem, as described below, is that other members of the same U.S. government, through the SEC, have advanced the exact opposite position.

A. Background and Allegations by the SEC

The SEC alleged the following in a recent case involving conservation easements, which lasted more than four years.[46] The defendant was a certified public accountant, tax planner, return preparer, and investment advisor ("Defendant"). He first learned about conservation easements in 2011 from an easement specialist and registered representative of a broker-dealer ("Specialist"). At that time, the Specialist was in the business of organizing private placement offerings of ownership units in partnerships ("InvestCos"), which invested in other partnerships that held large tracts of undeveloped land ("PropCos"). The promotional materials made it clear that the PropCos had several options for the land, including engaging in residential development, holding for long-term appreciation, or granting a conservation easement. The reality is that the PropCos often donated conservation easements to qualified organizations, such as land trusts, thereby generating large tax deductions.

The offerings in the InvestCos often required a minimum level of investment, a figure that was sometimes beyond the amount that Defendant's individual clients could or would shell out. Therefore, in order to reach the threshold and allow his clients to participate, Defendant would create special-purpose partnerships, pool money from various clients, and then invest such consolidated funds into one of the InvestCos ("Pooling Partnerships"). The idea was that Defendant, who was the managing member for each of the Pooling Partnerships, the preparer of Forms 1065 for the Pooling Partnerships, and the preparer of Forms 1040 for the individual clients, would take the *total* tax deduction directed to a particular Pooling Partnership and then allocate it among all the individual clients on a *pro rata* basis.

Defendant was not doing this work out of the goodness of his heart; he seems to have benefited in two ways at the outset: (i) charging a flat transaction fee to each of the individual clients; and (ii) personally investing in the Pooling Partnerships, such that he received a portion of the tax deduction.

B. First Pooling Partnership

In 2011, Defendant formed the First Pooling Partnership, located 10 individual clients interested in investing, pooled their funds, charged them each a flat transaction fee of approximately $5,000 for his services, added some of his personal funds, and made a capital contribution to an InvestCo, thereby giving First Pooling Partnership a 20 percent interest. The InvestCo, in turn, made a capital

contribution to a PropCo. Soon thereafter, in 2011, the PropCo granted a conservation easement and generated a tax deduction, a portion of which flowed first to InvestCo, then to First Pooling Partnership, and, ultimately, to the individual clients and Defendant. He prepared the Form 1065 and Schedules K-1 for First Pooling Partnership, showing an accurate allocation of the deduction on a *pro rata* basis.

C. Second Pooling Partnership

Things changed the next year, 2012. The Specialist notified Defendant about another PropCo holding a significant tract of land, which, if placed under easement, likely would produce a tax deduction of about 4.25 times the amount of each partner's capital contribution. However, the Specialist explained to Defendant that the broker-dealer was imposing two additional requirements on Defendant because of his use of the Pooling Partnerships. First, he could not charge his individual clients a flat transaction fee. Second, he must provide the broker-dealer certain data about each individual client, such that it could confirm that everyone was an "accredited investor." This means a person who is allowed to deal in securities that might not be registered with financial authorities, like the SEC, because he or she is financially sophisticated and has a reduced need for protection provided by normal disclosure filings. A person is an "accredited investor" if he or she satisfies certain standards regarding income level, net worth, asset value, and/or professional experience.

Defendant created the Second Pooling Partnership in 2012 and identified 17 individual clients who wanted to invest, plus him. Consistent with his methodology the previous year, Defendant allegedly informed the individual clients that their funds would be pooled for purposes of investing in a PropCo (indirectly through an InvestCo), the PropCo likely would grant a conservation easement on its property, thereby generating a large tax deduction, and such deduction would be allocated to all individual clients, on a *pro rata* basis, based on the size of their capital contribution to the Second Pooling Partnership. The individual clients invested a total of $632,500, and Defendant added $16,802 of his own funds into an account held by the Second Pooling Partnership. Notably, Defendant did not charge each client an upfront transaction fee of approximately $5,000 because the broker-dealer had prohibited this practice.

To confirm that each individual client was eligible to invest in 2012, the Specialist gave Defendant the paperwork to complete. It asked several things, including the annual income of each potential investor and the "amount of purchase" in the Second Pooling Partnership. Defendant distributed this paperwork to each of the 17 clients, who accurately completed it and returned it to Defendant. However, instead of submitting the paperwork for all 17 clients to the Specialist, he only did so for 14 of them. Defendant then wired $543,552 to the Specialist for further investment in the PropCo, which was comprised of the investment by the 14 clients who were disclosed to the Specialist. Defendant did not send to the Specialist the remaining combined investment of $130,000 by the three undisclosed individual clients. Moreover, Defendant listed his own contribution as $41,052, even though he only invested $16,802 of his personal funds.

Defendant also provided the Specialist with a "Schedule of Contributions by Person," as well as a copy of the Operating Agreement for the Second Pooled Partnership, which included a "Schedule of Investors." Both documents revealed only 14 investors (instead of 17), indicated that the total investment was $543,552 (instead of $632,500), and stated that the contribution by Defendant was $41,052 (instead of $16,802).

In late 2012, the PropCo donated a conservation easement to a land trust and claimed a charitable tax deduction of approximately $10 million. Just over 20 percent of this amount was allocated to the InvestCo and then up the ownership chain to the Second Pooling Partnership. Defendant then prepared the Form 1065 for the Second Pooling Partnership, which enclosed Schedules K-1 for all 17 of the individual clients, not just the 14 who had been disclosed to the Specialist. Defendant also prepared and filed Forms 1040 for each of the 17 individual clients, using the Schedules K-1.

The SEC alleged that Defendant "stole" the $130,000, prepared Schedules K-1 and Forms 1040 for the 14 investors understating their easement-related deductions, and prepared Schedules K-1 and Forms 1040 for the three undisclosed clients overstating their deductions, which should have been $0 since their funds were never really invested in the InvestCo or PropCo.

D. Third Pooling Partnership

Defendant formed the Third Pooling Partnership in 2012, too. Its purpose was the same as that of the First Pooling Partnership and Second Pooling Partnership. The material differences were the following. Instead of charging a flat transaction fee of approximately $5,000 per individual client, Defendant earned a "tax-service fee" of roughly the same amount. There were six individual clients who made capital contributions to the Third Pooling Partnership, they invested in a PropCo (indirectly through an InvestCo), the PropCo decided to grant an easement on its property, and the six clients were allocated their *pro*

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rata share of the deduction. Defendant did not personally participate in the transaction, and the SEC did not allege any improprieties regarding the information provided to the broker-dealer or the allocation of the deduction.

E. Allegations by the SEC

Based solely on the allegations made by the SEC, it appears that Defendant was trying to achieve one thing; that is, getting paid by the individual clients for his efforts. With respect to the First Pooling Partnership, he charged each client a flat transaction fee. After the Specialist notified Defendant that he could not charge such fees in 2012, it seems that Defendant changed methodologies, altering the amount of individual clients and funds sent to the Second Pooling Partnership in order to render a benefit to Defendant, through obtaining a portion of the un-invested capital contributions and an increased tax deduction. Finally, with respect to the Third Pooling Partnership, the allegations indicated that Defendant simplified the procedure, charging each individual client a "tax-services fee," instead of flat transaction fee. Regardless of the method used by Defendant, the filings in the SEC enforcement action tend to suggest that the individual clients had no complaints; they expected to receive tax deductions and they expected to compensate Defendant in some manner for making this occur.

The SEC did not view the Defendant's behavior as innocuous, of course. It alleged that Defendant engaged in unregistered broker-dealer activity, fraudulent offerings, and misappropriation of investor funds, thereby violating various aspects of the Securities Act of 1933, Securities Exchange Act of 1934, Investment Advisers Act of 1940, and Investment Company Act of 1940. The SEC filed an Order instituting an administrative cease-and-desist proceeding in September 2014.

F. Focus on Partnership Concepts During the SEC Proceeding

Defendant denied the allegations by the SEC, with his principal defense being that the transactions at issue did *not* involve the "purchase or sale of a security," as defined in the Securities Act.[47] Without the existence of a "security," many of the charges by the SEC disintegrate. Therefore, the SEC and the Defendant devoted considerable time to this topic.

The SEC argued that the offerings organized by Defendant were "securities" because they constitute "investment contracts" designed to pool funds from individual clients for singular investments in a separate, third-party, real estate offering, namely, the InvestCos. For purposes of determining whether an instrument is a "security" under the Securities Act and the Securities Exchange Act, one must analyze the substance rather than the form, with an emphasis on economic reality. Referencing two U.S. Supreme Court cases, the SEC argued that an "investment contract" is a contract, transaction, or scheme whereby a person (i) invests his money, (ii) in a common enterprise, (iii) and expects profits, (iv) solely from the efforts of the promoter or a third-party.

The SEC stated the following about the first prong. A person invests his money if he subjects himself to financial loss, which is what allegedly occurred in connection with the conservation easements:

> [Defendant] solicited individuals to provide funds to the [Pooling Partnerships], promising each individual would receive his or her pro rata interest in the total ownership units that the [Pooling Partnerships] purchased through the real estate investment offerings sponsored by [the broker-dealer]. The offering summaries for the companies selling the ownership units through [InvestCos] explained that the company manager would recommend to the members of each entity whether to pursue an investment proposal, such as the development of land into residential lots for sale, or, in the alternative, a conservation easement proposal. Further, … the offering summaries explained that the companies were under no obligation to grant a conservation easement for any interest in the land the companies acquired. Because [Defendant's] clients committed funds and subjected themselves to the risk of financial losses, the first of [the three prongs] is satisfied.[48]

The SEC then addressed the second prong; that is, the need for a "common enterprise." It explained that this concept has been interpreted by courts differently. Some have held that vertical commonality suffices. This means that the profits of the investors (*i.e.*, the individual clients) must be directly related to the profits of the promoter (*i.e.*, Defendant). Other courts demand horizontal commonality, which requires profits to be distributed on a *pro rata* basis to investors whose assets are pooled together. The SEC applied this standard to Defendant's situation in the following manner:

> [T]here clearly is horizontal commonality between the various individuals who contributed funds to the [Pooling Partnerships], as [the individual clients] wrote checks to the bank accounts identified by [Defendant]. Subsequently, [Defendant] used those pooled funds to make purchases of ownership units in

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> [InvestCos]. As a result, [the individual clients] who held ownership interests in the [Pooling Partnerships] were entitled, based on their pro rata purchases of ownership interests, to any profits or losses achieved by [InvestCos]. Further, investors in the [Pooling Partnerships] ultimately shared in the net profits they achieved through pro rata tax deductions that reduced their individual taxable income and led ultimately to a greater savings in taxes paid than the funds they initially invested.[49]

The analysis by the SEC of the third prong and fourth prong is perhaps the most interesting, and is unquestionably the most expansive. As indicated above, to be considered a security, the investor must expect profits solely from the efforts of the promoter or a third-party. The SEC devoted time to summarizing the evolving caselaw regarding the relationship between tax benefits and the existence of an "investment contract" for securities purposes. It then argued, in various filings, that the individual clients reasonably expected profits in various ways: (i) They were becoming indirect partners in the InvestCos, which held land that might be profitably developed as a residential subdivision; (ii) If the conservation easement option were selected by the partners, then they would receive tax benefits exceeding their initial capital contribution to the Pooling Partnerships; and (iii) Even if the property were conserved, it could still be held for long-term appreciation and sold at a later date, thereby generating some financial gain. Given the importance of the issue of expectation of profits by the individual clients, the SEC addressed it in many different documents. Set forth below are some of the most relevant excerpts:

> [T]here are two ways in which [Defendant's] clients reasonably expected profits from the efforts of others. First, the clients reasonably expected profits from their participation in the [Pooling Partnerships] because the offering summaries for the third-party offerings in which the [Pooling Partnerships] intended to buy ownership units explained that the issuers intended to acquire a controlling interest in land which, under one scenario, could be developed for profit through the development and sale of residential lots. Separately, [Defendant's] clients also reasonably expected profits from the efforts of others because [Defendant] induced his clients to invest in the [Pooling Partnerships] by emphasizing that each client would receive a tax deduction and corresponding decrease in income taxes owed of greater value than each client's initial investment, *i.e.*, a net profit earned through participation in the anticipated conservation easements.[50]
>
> Finally, even if the conservation easement option was selected by members, they would continue to retain a percentage ownership interest in the underlying real estate, which could be sold at a later date.[51]
>
> Here, the possibility of profit from development was anything but remote. The [InvestCos] provided members with Investment Proposals, based on professional land appraisals, outlining in writing the possibility of multi-million dollar appreciations … The proposals suggested an "investment strategy" of "holding the Property for appreciation and eventual sale to a developer who could execute a development plan of its choosing."[52]
>
> Regardless of whether the third-party entities at issue in this matter ultimately chose to develop the land for profit or seek tax deductions through conservation easements, any such profits or tax deductions would be garnered by the efforts of others, *i.e.,* [Defendant], as manager of and investment adviser to the [Pooling Partnerships], as well as by [InvestCos]. Any earnings expected, whether profits or tax deductions, would come from the efforts of others, as [Defendant's] clients' only meaningful role was to write checks and wait for their *pro rata* profit. Once [Defendant's] clients provided their investment funds to the [Pooling Partnerships], they had no role in the success or failure of the ventures. [Defendant] was the only manager and had complete control over the [Pooling Partnerships'] interactions with [the broker-dealer] and [InvestCos]. He went on to wire investor funds contributed to the [Pooling Partnerships] to the escrow accounts for the real estate offerings. In the case of [the Second Pooling Partnership], [Defendant] also misappropriated $130,000 from the entity's account over which he exercised total control. In each of the three offerings, once land was preserved through a conservation easement, a tax deduction was transmitted to the [Pooling Partnerships], through which [Defendant] subsequently issued Schedule K-1s in order to prepare the taxes (including the resulting tax deduction generated by the easements) for his individual clients. *As such, the investor funds provided to the [Pooling Partnerships] meet the third prong of the Howey test because there was clearly a reasonable expectation of profits on the part of [Defendant's] clients who invested in the [Pooling Partnerships].*[53]

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G. Decision by Administrative Law Judge

The Administrative Law Judge ("ALJ"), in responding to the Motion for Summary Disposition filed by the Defendant, held that the interests that Defendant sold in the Pooling Partnerships "were *not* securities."[54] The Defendant prevailed, in other words, and the SEC was prevented from further pursuing certain claims.

The ALJ underscored the following points in coming to this conclusion. First, the offering materials "clearly show that the conservation easement donation was the purpose of the scheme."[55] Second, there were preliminary negotiations with the relevant land trust to accept the conservation easement.[56] Third, the InvestCos provided an estimated contribution deduction amount, which was presumably shared with the individual clients, before the easement was granted.[57] Fourth, the offering materials contained a lengthy tax opinion from a law firm concerning the tax consequences of donating an easement.[58] Fifth, the offering materials explained steps taken and costs incurred in connection with the conservation easement, such as a survey, appraisal, baseline report, and legal work.[59] Sixth, the offering materials indicated that the InvestCos had set aside funds for IRS audits and warned of increased IRS scrutiny of deductions related to conservation easements.[60] Seventh, the individual clients provided affidavits indicating that they all understood that the investment in the Pooling Partnerships was to grant a conservation easement and obtain the resulting tax benefits.[61] The ALJ concluded by stating that "[t]here can be no other interpretation from these facts than that the purpose of the investments was to obtain conservation easement tax deductions."[62]

The ALJ acknowledged, and then quickly dismissed, the argument that the relevant property might have been held by the PropCos for development instead of restricted by an easement. The ALJ characterized the pertinent information in the offering materials as "a boilerplate warning," which was underscored by the fact that development would have required significant additional capital, yet the PropCos did not have the capital, commitments for financing, or plans to pursue any financing opportunities.[63]

VI. Conclusion

As the IRS and DOJ continue their aggressive enforcement activities in the conservation easement realm, they might convert their earlier threats into reality, taking the position with the courts that entities involved in conservation easements are not true partnerships for federal tax purposes, they exist solely as a way to "sell" tax deductions, they engage in sham transactions, and/or they lack economic substance. It will be interesting to see how the IRS and DOJ try to reconcile the fact that other executive agencies, like the SEC, have taken contrary positions in other courts, arguing that (i) the partners invest their money and face a legitimate risk of financial loss, (ii) the partners are involved in a common enterprise, (iii) the partners have an expectation of profit, in the form of gain from real estate development, tax benefits, and/or long-term appreciation, and (iv) such profits result from the efforts of others, namely, those individuals organizing the partnerships and their activities. The fact that the ALJ ultimately rejected the SEC's arguments in *U.S. Securities and Exchange Commission Division of Enforcement v. Lloyd* is of little consequence from a tax perspective. It certainly does not diminish the reality that the U.S. government is taking divergent positions, on the same issue, in different contexts.

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ENDNOTES

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1 Code Sec. 170(a)(1); Reg. §1.170A-1(a).
2 Code Sec. 170(f)(3)(A); Reg. §1.170A-7(a)(1).
3 Code Sec. 170(f)(3)(B)(iii); Reg. §1.170A-7(b)(5).
4 Code Sec. 170(h)(1).
5 Code Sec. 170(h)(2); Reg. §1.170A-14(a); Reg. §1.170A-14(b)(2).
6 Reg. §1.170A-14(b)(2).
7 Reg. §1.170A-14(g)(1); *J.D. Turner*, 126 TC 299, 311, Dec. 56,522 (2006).
8 Code Sec. 170(h)(5)(A); Reg. §1.170A-14(e)(1).
9 Reg. §1.170A-14(g)(3).
10 Reg. §1.170A-14(g)(3).
11 Reg. §1.170A-1(e).
12 Code Sec. 170(h)(4)(A); Reg. §1.170A-14(d)(1); S. Rept. 96–1007, at 10 (1980).
13 Reg. §1.170A-14(b)(2).
14 Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. Nov. 4, 2016), at 23.
15 Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. Nov. 4, 2016), at 63.
16 Reg. §1.170A-14(e)(2) and (3).
17 Code Sec. 170(a)(1).
18 Code Sec. 170(a)(1); Reg. §1.170A-1(c)(1).
19 Reg. §1.170A-1(c)(2).
20 Reg. §1.170A-14(h)(3)(i).
21 Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. Nov. 4, 2016), at 41.
22 Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. Nov. 4, 2016), at 41.
23 *Stanley Works & Subs.*, 87 TC 389, 400, Dec. 43,274 (1986); Reg. §1.170A-14(h)(3)(i).
24 *Olson*, SCt, 292 US 246, 255 (1934).
25 *Esgar Corp.*, CA-10, 2014-1 USTC ¶50,207, 744 F3d 648, 659 n.10.
26 *Esgar Corp.*, CA-10, 2014-1 USTC ¶50,207, 744 F3d 648, 657.
27 *J.W. Symington*, 87 TC 892, 896, Dec. 43,467 (1986).
28 Reg. §1.170A-14(h)(3)(ii).
29 Reg. §1.170A-14(h)(4). Example 7.
30 Reg. §1.170A-14(g)(5)(i).
31 Reg. §1.170A-14(g)(5)(i).
32 Reg. §1.170A-14(g)(5)(i).
33 Reg. §1.170A-14(g)(5)(i).

[34] Internal Revenue Service. Conservation Easements Audit Techniques Guide (Rev. Nov. 4, 2016), at 24.

[35] *See* Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. Nov. 4, 2016), at 24–30; IRS Publication 1771, *Charitable Contributions—Substantiation and Disclosure Requirements*; IRS Publication 526, *Charitable Contributions*; Code Sec. 170(f)(8); Code Sec. 170(f)(11); Reg. §1.170A-13; Notice 2006-96, IRB 2006-46; T.D. 9836.

[36] Code Sec. 6662; Code Sec. 6662A. This is entirely consistent with the IRS's internal guidance to Revenue Agents, which directs them to assert a "tiering of proposed penalties with multiple alternative positions." *See* Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. Nov. 4, 2016), at 77.

[37] Tax Court Rule 142(a); *Greenberg's Express, Inc.*, 62 TC 324, Dec. 32,640 (1974).

[38] Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. Nov. 4, 2016), at 78–81.

[39] Code Sec. 6664(c)(1); Code Sec. 6664(d)(1); Reg. §1.6664-4.

[40] Code Sec. 6664(c)(3); Reg. §1.6664-4.

[41] Code Sec. 6664(c)(3); Reg. §1.6664-4.

[42] Notice 2017-10, Preamble and Code Sec. 1.

[43] Notice 2017-10, Code Sec. 1.

[44] *Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal*, Case No. 1:18-cv-05774, D.C. N.D. Ga, Compliant filed Dec. 18, 2018, at 47.

[45] *Champions Retreat Golf Founders, LLC*, TC Memo. 2018-146, at 21 and footnote 1.

[46] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. The author obtained and reviewed the following documents pertaining to the case in preparing this article: Order Instituting Administrative Cease-and-Desist Proceedings filed September 30, 2014; Answer and Motion by Respondent filed October 27, 2014; SEC's Response in Opposition to Respondent's Answer and Motions filed November 10, 2014; Response by Respondent to SEC's Response in Opposition to Respondent's Answer and Motions filed November 19, 2014; Respondent's Motion for Summary Disposition filed January 21, 2015; Brief in Support of Respondent's Motion for Summary Disposition filed January 21, 2015; SEC's Response in Opposition to Respondent's Motion for Summary Disposition filed January 26, 2015; Brief in Support of SEC's Response in Opposition to Respondent's Motion for Summary Disposition filed January 27, 2015; Respondent's Response to SEC's Response in Opposition to Respondent's Motion for Summary Disposition filed February 2, 2015; Order filed February 27, 2015; SEC's Prehearing Submission filed March 10, 2015; Respondent's Prehearing Brief filed March 16, 2015; SEC's Post-Hearing Brief filed May 4, 2015; Respondent's Post-Hearing Brief filed May 6, 2015; Order Directing Briefing on Certain Issues filed May 6, 2015; SEC's Post-Hearing Reply Brief filed June 1, 2015; Respondent's Post-Hearing Reply Brief filed June 2, 2015; Initial Decision by SEC filed July 27, 2015; Respondent's Proposed Corrections for Manifest Error of Fact in Initial Decision filed August 14, 2015; Respondent's Brief in Support of Proposed Corrections for Manifest Error of Fact in Initial Decision filed August 14, 2015; Order on Motion to Correct Manifest Errors of Fact filed August 18, 2015; Respondent's Petition for Review of Initial Decision filed September 14, 2015; SEC's Petition for Cross Review of the Initial Decision filed September 18, 2015; Order Granting Petition for Review and Scheduling Briefs filed September 28, 2015; SEC's Principal and Response Brief filed December 11, 2015; Respondent's Response and Reply Brief filed December 31, 2015; Order Ratifying in Part and Revising in Part Prior Actions filed January 26, 2018; Respondent's Petition for Review of Initial Decision filed February 21, 2018; SEC's Renewed Petition for Cross Review of the Initial Decision filed February 27, 2018; Respondent's Brief in Support of Renewed Petition for Review filed May 29, 2018; SEC's Response to Respondent's Brief in Support of Renewed Petition for Review filed June 5, 2018; Order Making Findings and Imposing Remedial Sanctions filed December 21, 2018.

[47] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Answer and Motion by Respondent filed October 27, 2014. *See also* Brief in Support of SEC's Response in Opposition to Respondent's Motion for Summary Disposition filed January 27, 2015, at 12–16; SEC's Post-Hearing Brief filed May 4, 2015, at 21–27; SEC's Petition for Cross Review of the Initial Decision filed September 18, 2015, at 6–9; SEC's Principal and Response Brief filed December 11, 2015, at 21–27.

[48] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Answer and Motion by Respondent filed October 27, 2014. SEC's Response in Opposition to Respondent's Answer and Motions filed November 10, 2014, at 4.

[49] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Answer and Motion by Respondent filed October 27, 2014. SEC's Response in Opposition to Respondent's Answer and Motions filed November 10, 2014, at 4–5.

[50] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Answer and Motion by Respondent filed October 27, 2014. SEC's Response in Opposition to Respondent's Answer and Motions filed November 10, 2014, at 6.

[51] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. SEC's Post-Hearing Brief filed May 4, 2015, at 25.

[52] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. SEC's Principal and Response Brief filed December 11, 2015, at 24.

[53] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Answer and Motion by Respondent filed October 27, 2014. SEC's Response in Opposition to Respondent's Answer and Motions filed November 10, 2014, at 8.

[54] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 3.

[55] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 3.

[56] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 3.

[57] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 3.

[58] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 4.

[59] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 4.

[60] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 4.

[61] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 5.

[62] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 5.

[63] *U.S. Securities and Exchange Commission Division of Enforcement v. Paul Edward "Ed" Lloyd, Jr., CPA*, Administrative Proceeding File No. 3-16182. Order filed February 27, 2015, at 4–5.

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