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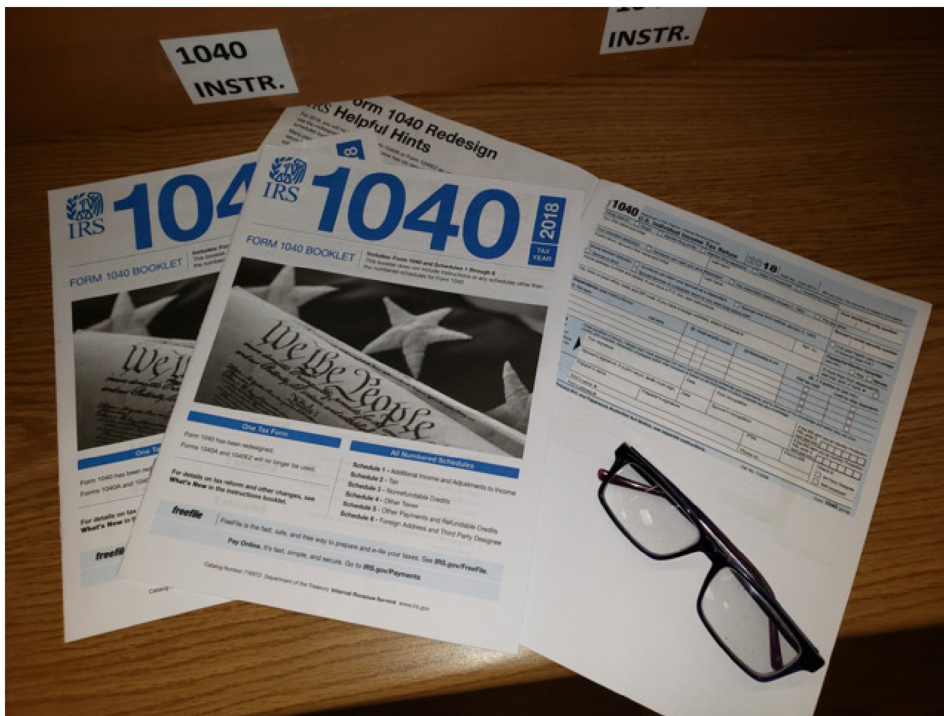
Eight Things to Do When the IRS Wants to Audit Your Conservation Easement

BY JOHN HACKNEY OCTOBER 28, 2019



The IRS has made it clear that it disfavors conservation easements. From naming them a listed transaction, to making their review a nationally coordinated issue, to the U.S. Senate Finance Committee's recent investigation, the Service has greatly increased their enforcement efforts. If you have invested in a conservation easement, or you are thinking about putting one together, you need to be ready to defend your easement deduction when the IRS comes calling.

What is a Conservation Easement?

Special provisions in the Code allow taxpayers to donate certain legal rights associated with their property and obtain a charitable contribution for doing so. Typically, a taxpayer must donate their entire interest in the property to obtain a charitable contribution. With land, that would mean donating the entire parcel. To get landowners to preserve their property without giving up ownership, Congress enacted Section 170(h) which allows for the donation of a conservation easement. A conservation easement perpetually restricts certain uses of the property, like the right to develop or mine the property, but does not transfer the ultimate ownership. The property remains in its natural state and the country benefits from increased greenspace.

To qualify under Section 170(h), the taxpayer must donate: 1) a qualified real property interest; 2) to a qualified organization; and 3) exclusively for conservation purposes. A qualified real property interest includes a conservation easement. To meet the conservation purpose requirement, the easement must preserve or protect one or more of the following in perpetuity:

· land areas for the outdoor recreation or education of the general public;

· the relatively natural habitat of fish, plants, wildlife or a similar ecosystem;

· open space for the scenic enjoyment of the general public that yields a significant public benefit;

· open space pursuant to a clearly delineated federal, state or local governmental conservation policy that yields a significant public benefit; or

· historically important land area or a certified historic structure.

Donations that meet the Code and regulation's strict technical requirements can result in an incredibly valuable deduction. The regulations typically look to the value lost via the easement to determine its fair market value.

Increased IRS Enforcement

The IRS has greatly increased their scrutiny of conservation easements over the years. In the late 2000s and early 2010s, conservation easements began bubbling up all over the country. Instead of landowners making a donation on their property, like-minded conservationists sought to join together through partnerships to make easement donations (known as syndicated conservation easements).

The IRS believed that syndicated conservation easements routinely resulted in overvalued donations. The Service asserted that partners received a deduction that greatly exceeded their investment in the partnership. The IRS released Notice 2017-10 on Dec. 23, 2016 in an effort to combat what it deemed as an abusive transaction. Notice 2017-10 labeled certain syndicated conservation easements as listed transactions, including those transactions: 1) with promotional materials; 2) that offer an investment through a pass-through entity; 3) where the taxpayer receives a deduction that exceeds two and half times the initial investment; and 4) where the investor reports the deduction on their return. Notice 2017-10 incorporates all similar transactions. By naming syndicated conservation easements a listed transaction, the IRS triggered a series of reporting requirements and potentially draconian penalties. The Code requires participants in listed

transactions to file Form 8886, Reportable Transaction Disclosure Statement, with the Office of Tax Shelter Analysis. In addition to the disclosures, participants must retain certain documentation like marketing materials, appraisals, and other relevant materials. The failure to file Form 8886 can trigger penalties up to $200,000, can increase the normal 20 percent accuracy-related penalty to 30 percent, and can unilaterally extend the statute of limitations. Notice 2017-10 required taxpayers to file Forms 8886 for all transactions entered into after Jan. 1, 2010 for tax years with an open statute of limitations.

Notice 2017-10 also triggered filing requirements for organizers and those who assist in the transaction (referred to as material advisors). Material advisors must file Form 8918, Material Advisor Disclosure Statement, and maintain a list of their advisees. A material advisor's failure to file the Form 8918 can subject them to a penalty equal to the greater of $200,000 or 50 percent of the gross income from the transaction. The failure to supply a list of advisees can lead to a $10,000 per day fine.

What to Do When the IRS Comes Calling.

With the increased reporting requirements, IRS audits of easement transactions have greatly increased. Instead of working collaboratively with taxpayers to seek a reasonable resolution, Revenue Agents are being directed to disallow deductions no matter what. With a high percentage of cases headed to litigation, taxpayers need to take every step to protect themselves now.

Study the Audit Techniques Guide.

In early 2018, the IRS published a revised Audit Techniques Guide for Conservation Easements. The Service publishes Audit Techniques Guides to help Revenue Agents understand legal issues and methods specific to certain industries. The Conservation Easement Guide lays out the various legal elements of a conservation easement as well as the IRS' view of the law. The Guide also discusses areas that the Service believes could be fruitful for auditors seeking to deny deductions. For instance, the Conservation Easement Guide provides a lengthy discussion on the failure to comply with the mortgage subordination rules. Studying the Audit Techniques Guide can prepare you for the arguments the IRS may advance.

Review Your Easement Documents in Light of Recent Case Law.

The law on charitable contributions and conservation easements continues to evolve. Supreme Court precedent directs courts to broadly construe charitable inducement provisions, like Section 170(h). *See, e.g. Helvering v. Bliss,* 293 U.S. 144, 149 (1934). However, courts are increasingly taking a hyper-technical view of Code in an effort to deny deductions. For instance, the Fifth Circuit recently invalidated a deduction where the deed included certain language that allows the original grantor to receive a share of the post-donation improvements in the off-chance of condemnation. Even though condemnation remained remote, the Court disallowed the entire deduction because it failed to protect the donation in perpetuity. *See PPM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018). Similarly, in *Blau v. Commissioner*, 924 F.3d 1261 (D.C. Cir. 2019), the Court of Appeals affirmed the disallowance of a deduction where the taxpayer failed to provide basis information on Form 8283. Taxpayers need to review their easement documents in light of the ever-evolving law in this area to prepare for the IRS' newest theories.

Double Check Your Appraisal.

While the IRS continues to push technical arguments, valuations still matter. Taxpayers need to ask themselves whether they truly trust the appraisal. Would they buy the property based on the data provided and at the appraised value? If the taxpayer would pass on the purchase, they need to begin to search for comparable transactions and other data that support the original valuation. Think of creative ways that you improved the property's value prior to the donation. Given that these cases may ultimately end up in litigation, taxpayers may also want to begin to identify and hire a second or third appraiser that can help the court reach the right answer.

Triple Check Your Conservation Purposes.

Conservation easement deeds protect one or more conservation purposes. The Service will disallow any easement that fails to protect the designated conservation purpose in perpetuity. For instance, the Service takes a dim view of golf course easements designed to protect relatively natural habitats where the easement allows the use of pesticides. *See, e.g.*, *Champions Retreat Golf Founders, LLC v. Commissioner*, T.C. Memo. 2018-146, Slip at 30. As the audit approaches, taxpayers need to review their easement deed and baseline report to analyze whether the deed's limitations and reserved rights enhance or harm the stated conservation purposes. A thorough baseline report can go a long way to substantiate your conservation purposes. Taxpayers should also check with the conservation group that holds the easement deed to ensure all monitoring reports have been completed.

Get Your Documents Ready.

As coordinated audits, Exam teams ask for the same documents in nearly every case. Agents are also seeking to enforce document requests via summons and summons enforcement proceedings. Taxpayers need to organize the basic easement documents to be ready for document requests

Confirm You Have the Correct Tax Matters Partner/Partnership Representative.

TEFRA still applies to audits for tax years beginning prior to Jan. 1, 2018. Under the TEFRA rules, the tax matters partner speaks for the partnership and often times brings suit in the Tax Court on behalf of the partnership. The Code and regulations set forth certain rules on who may qualify as the tax matters partner that can conflict with state law. For instance, Delaware allows a non-member to manage a partnership. However, the Code requires the tax matters partner to own an interest in the partnership. The failure to designate the proper tax matters partner can be fatal to your case. If the wrong person files suit, the Tax Court could dismiss it for lack of jurisdiction and preclude the partnership from challenging the IRS' conclusion.

Partnerships with tax years beginning on or after Jan. 1, 2018 will follow the new partnership audit rules under the Bipartisan Budget Act of 2015 ("BBA.") The BBA replaces the tax matters partner with the partnership representative. The failure to properly designate the partnership representative can result in the IRS designating one for you.

Keep Your Partners Informed.

The Code imposes several notice requirements on tax matters partners. For instance, a tax matters partner must send the notice of beginning of proceeding and final partnership administrative adjustment to other partners within a certain time frame. *See, e.g.,* Treas. Reg. § 301.6223(g)(1). While the failure to keep partners informed will not have an impact on the audit, it can impact a partner's desire to contribute to ongoing defense efforts. Many partnerships escrow funds to pay defense costs. Often times these funds may not be sufficient to cover all the costs of a trial. Partners that have all relevant information will likely be more willing to contribute if needed.

Hire Experienced CPAs and Counsel.

Most conservation easement audits end in litigation. Because of this, taxpayers need to recognize that handling an audit on their own may result in disaster. While it may be penny-wise, it is most assuredly pound foolish. The Service will use any and all unhelpful statements against the taxpayer at trial. Taxpayers should hire experienced counsel and CPAs to represent them during the audit and prepare for trial.

An audit is never a pleasant experience. Through these tips, taxpayers will be more ready to defend their easement deductions in an era of increased IRS enforcement.

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