

How to Get Your Easement Audit-Ready

by John Hackney

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In this article, Hackney explains why and how taxpayers should prepare to fight for their charitable conservation deductions.

The IRS is stepping up its war on syndicated conservation easements, recently announcing that it will be increasing its enforcement efforts and coordinating that enforcement across multiple divisions.¹ Thomas A. Cullinan, counselor to IRS Commissioner Charles P. Rettig, said at a recent American Bar Association conference that enforcement teams are holding 80-person conference calls to discuss strategy, share new arguments, and raise new issues.² Using the data submitted through Notice 2017-10, 2017-4 IRB 544, and other sources, the IRS is also looking to refer “questionable conduct” to the Office of Professional Responsibility and, potentially, the Criminal Investigation division.³

Where does this increased enforcement leave taxpayers? Taxpayers remain interested in easement deductions. Yet, those same taxpayers

can be assured the IRS will review their donations and potentially impose penalties. Because of this increased scrutiny, taxpayers (and their advisers) need to be ready to fight for every penny of their deductions.

I. Recent IRS Victories

The IRS has been celebrating a series of recent victories in the conservation easement world. On December 20, 2019, the IRS issued a notice that highlighted its win in *TOT Holdings*.⁴ In a bench opinion, the Tax Court denied the entire deduction based on a technical default in the easement deed. The court relied on *Coal Property Holdings*⁵ to hold that the easement failed to protect the property in perpetuity.⁶ Even though the court disallowed the deduction on technical grounds, it still reviewed the parties’ valuations to determine whether the 40 percent gross valuation misstatement penalty applied.⁷ On the valuation front, the court rejected the taxpayer’s appraisal as greatly inflated, adopted the IRS expert’s opinion of approximately 10 percent of the reported deduction as the most reasonable, and imposed the 40 percent penalty. Rettig said the *TOT Property Holdings* decision confirms that “aggressive syndicated easement transactions will not survive scrutiny,” and the IRS will seek “the imposition of all available civil penalties and, when appropriate, various criminal options for those involved.”⁸

In furtherance of the IRS’s fight against easements, the Justice Department has been

¹ See IR 2019-182.

² See 2019 T.R.P. 50-2.

³ *Id.*

⁴ *TOT Property Holdings LLC v. Commissioner*, No. 5600-17 (Dec. 13, 2019).

⁵ *Coal Property Holdings LLC v. Commissioner*, 153 T.C. No. 7 (2019).

⁶ *Id.*, at 14-21.

⁷ *Id.*, at 21.

⁸ IR-2019-213.

focusing on organizers. It recently won a series of motions to dismiss in *Zak*.⁹ In December 2018 the Justice Department filed a suit against several individuals it alleged organized, promoted, and sold syndicated conservation easements. Through the complaint, the Justice Department sought to enjoin the defendants from organizing or promoting conservation easements, enjoin specific defendants from preparing appraisals to be used for tax purposes, and disgorge the gross receipts the defendants earned in their conservation easement practices.

The defendants have vigorously contested the Justice Department's allegations. In response to the complaint, two of the defendants filed motions to dismiss several of the counts against them. On December 10, 2019, the court effectively denied the relief sought by the defendants. For one defendant, the court granted a dismissal as to one count, but left the door open for the Justice Department to refile the complaint with more facts. For the other defendant, the court allowed all counts to proceed. The court also limited the Justice Department's discovery requests to eight states and 15 depositions per side instead of the 45 states and 50 depositions per side that the Justice Department sought. While this remains a procedural victory for the Justice Department and IRS, this case remains far from over.

II. Getting Your Easement Audit-Ready

With a high percentage of cases headed to litigation and the IRS ramping up enforcement efforts, taxpayers should take every step to protect themselves now.

A. Study the Audit Techniques Guide

In early 2018, the IRS published a revised Conservation Easement: Audit Techniques Guide. The IRS publishes audit techniques guides to help revenue agents understand legal issues and methods specific to particular industries. The conservation easement guide lays out the various legal elements as well as the IRS's view of the law. The guide also discusses areas that the IRS 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 arguments the IRS may advance.

B. Sweat the Technicalities

Reg. section 1.170A-13 and -14 contain numerous technical foot faults for unwitting taxpayers. The IRS is increasingly relying on ambiguous language in these provisions to invalidate contributions in their entirety. Case law can provide a helpful window into recent IRS arguments and taxpayers' defenses. Taxpayers should review their easement documents in light of the ever-evolving law in this area to prepare for the IRS's newest theories.

For instance, reg. section 1.170A-14(g)(6)(ii) describes how the proceeds from a judicial extinguishment of the conservation easement deed must be divided. The IRS has argued that deeds that do not exactly track the regulation fail. They have won this argument both at the Tax Court and in the Fifth Circuit.¹⁰ While this issue may be resolved in the Fifth Circuit, other taxpayers will likely appeal this issue to other circuits.

Similarly, reg. section 1.170A-13 requires taxpayers to include the cost basis of the donated property on Form 8283. The IRS has argued that a donation without this information on Form 8283 fails. The Tax Court and D.C. Circuit sided with the IRS's argument.¹¹

Taxpayers have punched back at these hyper-technical arguments, asserting that the regulations are invalid.¹² The Tax Court held in favor of the IRS and refused to invalidate the regulations. Although many of these questions will not be resolved until multiple courts of appeal weigh in, taxpayers should consistently monitor case law and IRS statements to better defend their donations.

¹⁰ See, e.g., *PBBM-Rose Hill Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018); *Coal Property Holdings*, 153 T.C. No. 7; and *TOT Property Holdings LLC v. Commissioner*, No. 5600-17 (Dec. 13, 2019).

¹¹ See *Blau v. Commissioner*, 924 F.3d 1261 (D.C. Cir. 2019), *aff'd*, *RERI Holdings I LLC v. Commissioner*, 149 T.C. 1 (2017).

¹² See, e.g., *Dasher's Bay at Effingham LLC v. Commissioner*, No. 4078-18 (Dec. 10, 2019).

⁹ *United States v. Zak*, No. 1:18-cv-05774-AT (N.D. Ga. 2019).

C. Double-Check Your Appraisal

While the IRS continues to push technical arguments, valuations still matter. If a partnership loses the deduction on a technical violation, it may still face a valuation trial to determine if the 40 percent gross valuation misstatement penalty applies.

Taxpayers should ask themselves whether they 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 should begin to search for comparable transactions and other data that would support the original valuation. Taxpayers should think of creative ways in which they improved the property before the donation. As these cases may end up before a judge, taxpayers should also identify and hire a second or third appraiser to help the court reach the right answer.

D. Cast a Broad Net on Conservation Purposes

Conservation easement deeds must protect one or more conservation purposes. The IRS will disallow any easement that fails to protect the designated conservation purpose in perpetuity. For instance, the IRS takes a dim view of golf course easements designed to protect relatively natural habitats when the easement allows the use of pesticides.¹³

As the audit approaches, taxpayers should 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 conservation purposes. Taxpayers should also check with the conservation group that holds the easement deed to ensure all monitoring reports have been completed. As with the appraisal, it may also be a good idea to identify biologists and other experts that can help the court understand the importance of the property.

Many taxpayers file their conservation easement deeds near the end of the year. If the taxpayer completed their baseline report during this same period, the natural wildlife may have

been understated. Taxpayers may increase their conservation purposes by having an updated study completed during warmer, more vibrant months.

E. Get Your Documents Ready

Exam teams ask for the same documents in nearly every case through a series of standardized information document requests. Agents are also seeking to enforce document requests via summons and summons enforcement proceedings. Organizing your documents ahead of time can decrease the cost of responding.

F. Confirm the Correct TMP

The 1982 Tax Equity and Fiscal Responsibility Act still applies to audits for tax years beginning before January 1, 2018. Under the TEFRA rules, the tax matters partner speaks for the partnership and often brings suit in the Tax Court for the partnership. The code and regulations set forth specific rules on who may qualify as the tax matters partner. Those rules may conflict with state law. For instance, Delaware allows a nonmember 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's conclusion.

Partnerships with tax years beginning on or after January 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. Some partnerships with tax years ending before January 1, 2018, may elect to have the BBA apply to new audits. Taxpayers should consult with counsel about whether to pursue this option.

G. 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

¹³ See, e.g., *Champions Retreat Golf Founders LLC v. Commissioner*, T.C. Memo. 2018-146, slip op. at 30.

proceeding and final partnership administrative adjustment to other partners within a specified time frame.¹⁴ While the failure to keep partners informed will not affect the audit, it can affect a partner's desire to contribute to ongoing defense efforts. Many partnerships escrow funds to pay defense costs. Taxpayers will need to hire counsel for trial and potentially new experts. The escrowed funds may not cover all the costs of a trial. Partners that have all relevant information will likely be more willing to contribute if needed.

H. Be Wary of Third-Party Contacts

Section 7602(c) allows the IRS to contact third parties after providing reasonable notice to the taxpayer. The legislative history of section 7602(c), the IRS's own pronouncements, and the Internal Revenue Manual provide that the taxpayer should be given the opportunity to provide the requested information before the IRS seeks to contact third parties. Regardless, taxpayers can be sure that agents will reach out to other participants in the transaction to get their side of the story instead of asking the taxpayer for this same data first. Taxpayers should keep all participants informed of the audit so that they can have the same information as the IRS examiners.

I. Hire Experienced CPAs and Counsel

Most conservation easement audits end in litigation. Taxpayers should recognize that handling an audit on their own may result in disaster. The IRS 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. Recent victories and statements by Rettig show that the IRS is serious about pursuing easement transactions. Taxpayers should take all the steps they can to be ready for a challenge to their easement transaction. ■

¹⁴ See, e.g., reg. section 301.6223(g)(1).

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