EXEMPT

An Overview of Syndicated Conservation Easement Examination Issues

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The IRS and state taxing authorities are stepping up their enforcement against abusive syndicated conservation easement transactions. This article provides an overview of the IRS and California Franchise Tax Board examination process for conservation easements and analyzes three recent Tax Court cases on the issue.

Introduction

Since the passage of the Inflation Reduction Act, which provided the IRS with increased funding of nearly $80 billion, **1** IRS Commissioner Danny Werfel has publicly stated that the IRS will commit to holding wealthy taxpayers accountable. **2** During the Administrative Practice Committee panel at the American Bar Association Virtual 2023 Fall Tax Meeting, IRS Executives revealed additional information on the IRS Strategic Operating Plan and how the additional funds are being allocated. Out of the nearly $80 billion, approximately $45.6 billion, or 57%, has been allocated to IRS enforcement operations to expand enforcement on taxpayers with complex tax filings and high-dollar noncompliance, including the

creation of new audit procedures targeting large partnerships. Among those areas of noncompliance are abusive tax transactions, including syndicated conservation easement (SCE) transactions. The IRS and state taxing authorities are stepping up their enforcement against abusive SCE transactions. This heightened enforcement, and the attention these transactions have drawn from federal legislators, are intended to eliminate the perceived SCE transaction tax loophole.

This article will discuss how a typical SCE examination is conducted and what you can expect during the examination of an SCE transaction. This article will also offer strategies for handling an SCE transaction examination.

Background on Tax Abuse Transactions

In December 2016, with the issuance of **Notice 2017-10** , the IRS identified SCE transactions as listed transactions with the potential for tax evasion. Despite identifying SCE transactions as listed transactions, IRS enforcement has been slow and challenging. This is because of the underfunding of the IRS, the size and complexity of SCE examinations, and because case law in this area has not yet been fully developed, with each case presenting different factual and legal issues.

Since 2017, the IRS has been ramping up its SCE transaction enforcement, and the IRS has had a continuous streak of litigation success. Most of the matters which have been litigated have focused on technical issues. The first Tax Court decision fully upholding the IRS's determination denying the tax benefits of an SCE transaction occurred in 2019. **3** Despite recent victories by the government, advisors continue to market SCE transactions.

In 2020, the IRS appointed a new Promoter Investigations Coordinator and formed the Fraud Enforcement Office to target identified promoters. **4** In August 2020, Senate Finance Committee Chairman Chuck Grassley and Ranking Member Ron Wyden released a report on their investigation into the abuse of SCE transactions. **5** This report found various abuses were ongoing despite the issuance of **IRS Notice 2017-10** classifying SCE transactions as listed transactions. In the Consolidated Appropriations Act of 2023, Congress sought to curtail SCE transactions when the law was changed to limit the qualified conservation contribution deduction to 2.5 times the sum of the individual basis in the donated real property interest. **6**

In 2022, the IRS faced significant setbacks when the Sixth Circuit determined that **Notice 2017-10** and other notices, such as **Notice 2016-66** , violated the Administrative Procedure Act and, therefore, were invalid. **7** The IRS did not agree with the decision and held that the notices were valid outside of the Sixth Circuit but nonetheless agreed to no longer enforce the disclosure requirements or penalties. **8** In late 2022, the IRS published a proposed regulation formally making SCE transactions listed transactions. The proposed regulation went through the comment process in 2023; however, the proposed regulations have yet to be finalized as of the date of this article.

Nonetheless, the IRS and certain states, such as California, are ramping up efforts to crack down on

SCE transactions as case law develops.

Navigating Syndicated Conservation Easement Examinations

Overview. The charitable contribution deduction serves as an important means for the government to encourage private individuals to donate to public use. **9** Conservation easements are particularly effective in protecting environmentally and historically significant land. Conservation easements are legally binding agreements in which an easement is voluntarily donated or sold by landowners to a qualified organization for a charitable purpose. The easement limits the use or development of the land while it remains in private hands. This allows landowners to retain many private property rights and possibly receive tax benefits while ensuring the land's conservation for future generations. By its nature, a charitable deduction should not be profitable because the ability to deduct from gross income does not offset the dollar spent on it. **10** However, the IRS has argued for several decades that SCE transactions allow taxpayers to overvalue conservation easement deductions, which generate excessive tax deductions.

The conservation-easement tax incentive was first enacted in the Tax Reform Act of 1976, **11** and at the time of passage it enjoyed bipartisan support. **12** Internal Revenue Code ("I.R.C.") **Section 170(a)(1)** allows a deduction for any charitable contribution made within the taxable year. Generally, a taxpayer cannot deduct a contribution of an "interest in property which consists of less than the taxpayer's entire interest in such property." **I.R.C. Section 170(f)(3)(A)** . **I.R.C. Section 170(f)(3)(B)(iii)** provides an exception to allow a deduction for a "qualified conservation contribution." **I.R.C. Section 170(h)(1)** defines the term "qualified conservation contribution" to mean a contribution (A) of "a qualified real property interest," (B) to "a qualified organization," and (C) "exclusively for conservation purposes."

The IRS examination process. In challenging SCE transactions, the IRS generally focuses on three different categories of potential issues. First, technical and procedural compliance challenges arise when taxpayers fail to adhere to the stringent documentation and substantiation requirements for claiming a charitable contribution deduction. Second, the IRS evaluates the economic substance of SCE transactions, mainly focusing on the intent and purpose of the conservation. Here, the intent and legitimacy of the partnerships, rather than just their tax benefit potential, are scrutinized, applying doctrines like substance-over-form and economic substance to assess the true purpose of these transactions. Third, the IRS closely scrutinizes appraisal values to prevent overvaluation, ensuring that appraisals accurately reflect the easement's worth and comply with professional standards. To effectively navigate the audit process, tax practitioners need to be familiar with the legal requirements for SCE transactions in the Internal Revenue Code and the accompanying regulations. In addition, tax practitioners should be familiar with the unique and aggressive tactics utilized by the IRS and the decisions of the courts that have overseen these challenges.

Beyond valuation: technical and procedural compliance. The Conservation Easement Audit

Technique Guide ("ATG"), published by the IRS, directs its personnel to scrutinize and target technical and procedural flaws in SCE transactions. [13] The IRS aims to disqualify a conservation easement before considering any valuation issues by verifying the adherence to the stringent criteria of "qualified conservation contributions" and the requirements for claiming charitable contribution deductions.

For noncash donations of more than $5,000, a taxpayer has to meet specific statutory requirements in order to claim a charitable deduction. [14] A taxpayer has to provide the IRS with: (1) a contemporaneous written acknowledgment ("CWA") that meets IRS requirements; (2) a qualified appraisal by a qualified appraiser; (3) Form 8283, containing various information about the donor, the donee, and information on the contributed property, with a detailed supplemental statement concerning its cost, fair market value, manner of acquisition, etc. [15]

While the requirements seem straightforward, in practice, the IRS demands substantial or strict compliance, and any deviation may result in the complete denial of the claimed deduction.

Contemporaneous written acknowledgement. The IRS requires that the CWA satisfy the "contemporaneous" and "acknowledgment" requirements. The taxpayer must obtain a CWA on or before the earlier of the date the taxpayer files the return for the tax year claiming the deduction or the due date of the tax return. [16] For the "acknowledgment" requirement, the CWA must:

- Be in writing.
- Describe the property received by the done.
- Contain a statement of whether the donee provides any goods or services in consideration, in whole or in part, for the donation.
- Provide a description of and an estimated value of goods or services, if any, that the donee provided in return (besides intangible religious benefits). [17]

Since donations are frequently made through the mail or the Internet, leading to potential processing delays, tax practitioners should caution taxpayers to coordinate with the recipient organization to secure a letter that complies with all legal requirements well before the tax return's due date.

In a conservation easement context, as the transfer of the easement is done through a property deed signed by both the donor and donee, the deed itself can serve as the CWA so long as it satisfies the requirements described above. [18] The U.S. Tax Court has held that the CWA must contain an affirmative statement about whether the donee provided any goods or services in exchange for the donation. The omission of such a statement in the CWA would result in the deed failing the CWA acknowledgment requirement. [19] Where the deed includes a merger clause, indicating that it represents the complete agreement, the Tax Court has deemed it sufficient to meet CWA requirements, even where the deed does not explicitly mention that the donee provided any goods or services in exchange. [20] Without the merger clause, in *French*, the IRS was successful in arguing that the CWA was insufficient for the IRS to determine if the taxpayer had received consideration in exchange for the conservation easement, thus failing the strict statutory CWA requirements, resulting in the disallowance of the deduction. [21] So long as the deed contains a merger clause or an affirmative statement of the

consideration amount, such as "for $1.00 and other good and valuable consideration," it would be sufficient to satisfy the requirements of **I.R.C. Section 170(f)** . **22**

Form 8283 - noncash charitable contributions. For any noncash charitable contribution in excess of $500, a taxpayer is required to include Form 8283 with the taxpayer's filed income tax return. For a conservation easement donation where the donation is greater than $5,000, the taxpayer is required to fill out Section B of Form 8283 as required by the regulation. **23** While filling out an informational return may sound simple, failure to properly complete Form 8283, such as inadvertently failing to include the signature of the appraiser or the donee, can cause a total denial of the deduction. **24**

Form 8283 itself acts as the "appraisal summary" and has to include sufficient information such that a person unfamiliar with the transaction can understand the type of property being appraised and contributed. **25** Section B of Form 8283 requires information on the donated property, the appraised value, the manner of acquisition of the property, the donor's adjusted basis, and the bargain sale amount. Instructions to Form 8283 further require that the taxpayer include a statement that identifies the conservation purpose, shows the fair market value before and after the donation, states whether the donation was made in order to obtain land use approval from a governmental agency or as required by contract, and whether the taxpayer or related person holds any interest in a nearby property.

Because a donor reserves certain rights to the property that could potentially impair the conservation easement, prior to the donation, the donor is required to provide the donee a baseline study of the property that contains a survey map, detailed map of the area, photos of the property, and other documentation that allow a person to identify the condition of the property at the time of the donation. **26** This information is also required to be included with Form 8283. This documentation must be signed by the donor and the donee, affirming that the documentation accurately represents the property at the time of the donation. **27**

Qualified appraisal. For a qualified appraisal to be accepted, specific technical requirements must be met. Where a taxpayer claims a charitable deduction of more than $500,000 for an item (or group of similar items) donated to one or more donees, the taxpayer must attach a qualified appraisal of the property to the taxpayer's tax return. **28** The Treasury Regulations provide that the appraisal must be completed by a qualified appraiser, and it must contain 11 items of information. **29** A taxpayer who fails to strictly comply with these requirements may raise substantial compliance as a defense. **30**

In *Emanouil*, the qualified appraisal was missing two requirements: the appraisal failed to include the expected date of the contribution and failed to state that the appraisal was prepared for income tax purposes. **31** The Tax Court held that the absence of these two pieces of information was not fatal because the appraisal had sufficient information to permit the IRS to evaluate the reported contribution at the provided address. **32** Interestingly, the Tax Court commented that the taxpayers in *Emanouil* were donating real estate in fee simple rather than engaging in a tax-abusive transaction, indicating a potentially different holding under different circumstances. **33**

Practitioners should be aware that several other technical issues relating to the qualified appraisal may

arise besides those discussed above. These include, but are not limited to: (1) the requirement that all appraisers who contribute to a single appraisal sign the qualified appraisal and the appraisal summary; **34** (2) the qualified appraiser may be disqualified based on the appraiser's relationship with the taxpayer or expectation that the appraiser would falsely overstate the value of the property; **35** (3) using an appraiser who regularly appraises properties but nonetheless could not be a qualified appraiser; **36** (4) missing the required appraiser declaration; **37** etc. These are just some of the many technical issues that may arise in the SCE context.

The Substance of Conservation Easements

When considering the intricacies of the substantiation requirements for a donation, it is vital that the property transfer constitutes a real donation. This is because the IRS may attempt to deny the deduction by arguing that the donation lacks the substance required by statute. For SCE transactions, there are additional requirements under **I.R.C. Section 170(h)(1)** . These include the requirement that the donation be (A) of "a qualified real property interest," (B) to "a qualified organization," and (C) "exclusively for conservation purposes."

I.R.C. Section 170(h)(2) defines a qualified real property interest as a donation of the entire interest of the donor (other than a qualified mineral interest), a remainder interest, or a restriction on the use of the real property granted in perpetuity. The restriction is what is often referred to as the conservation easement. The granting of the conservation easement must restrict the use of the property in perpetuity (granted in perpetuity requirement) as well as the protection of the conservation easement purpose (protected in perpetuity requirement). **38** The contribution is not deductible if the deed does not meet the double perpetuity requirements. Other issues may arise if the property was subject to a mortgage and the mortgagor and donor failed to enter into a subordination agreement allowing the easement prior to the contribution, **39** or if wording in the deed fails to protect the easement in perpetuity by not guaranteeing the donee a proportionate share of the proceeds should the easement became extinguished. **40**

I.R.C. Section 170(h)(3) defines a qualified organization as the U.S. or a state government, a charity, or certain **I.R.C. Section 501(c)(2)** and (3) organizations. **41**

Lastly, **I.R.C. Section 170(h)(4)(A)** defines conservation purposes as one of the following:

> (1) The preservation of land areas for outdoor recreation by, or the education of, the general public.
> (2) The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.
> (3) The preservation of open space either for a scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy where such preservation yields a significant public benefit.
> (4) The preservation of a historically important land area or a certified historic structure.

In determining whether an easement satisfies a conservation purpose, the court will only consider the purposes stated in the easement deed. **42** SCE primarily involves purposes (2) and (3) as listed above. If the purpose involves the protection of a relatively natural habitat, then the taxpayer should have an expert report detailing the kind of natural habitat that exists and is protected by the conservation easement, as the regulation provides additional limitations that the protected habitat needs to be "not trivial." **43** The taxpayer claiming that the conservation easement is for the preservation of open space similarly has to defend the purpose that there is a significant public benefit from the open space. **44** In addition, the taxpayer has to ensure that a baseline study is sufficiently detailed to document the conservation attributes and to establish the property's condition at the time of the donation. **45**

Besides the specific requirements of the conservation easement donation, the IRS will challenge the substance of the transaction, such as lack of charitable intent, **46** preexisting protection of conservation purposes under the effect of zoning, conservation, or historic preservation laws, **47** certain inconsistent uses, **48** or that the landowner reserves too many rights relating to the donated easement. **49**

Valuation Challenge

Finally, the IRS will also challenge the fair market value of the contributions, often with the help of expert witnesses hired by the IRS. Unlike normal property donations, easements are not typically sold, and each geographical area has its unique attributes, so the "before and after" valuation method is often the only way to value a conservation easement. **50** An appraiser must determine the highest and best use and the fair market value of the property before and after the specific restrictions are imposed on the deed. In reviewing the appraisal, the court will consider whether the use is physically possible, legally permissible, financially feasible, and maximally productive. **51** The change in value is considered the "fair market value" of the contribution. **52** As the valuation process is fact-intensive, this article will instead discuss three recent Tax Court decisions and how the Tax Court reviews valuations.

Mill Road 36 Henry, LLC. In 2023, the Tax Court issued a decision in *Mill Road.* **53** In *Mill Road*, the Tax Court decided a valuation dispute relating to an SCE transaction while also addressing technical issues relating to the donation, and economic substance arguments raised by the IRS. While the taxpayer claimed a deduction of $8,935,000, the Tax Court held that the deduction was worth only $416,563. **54** In reaching its decision, the Tax Court reviewed the taxpayer's expert report and deemed it unreliable, attributing this to the original expert's extraordinary assumptions in arriving at the valuation conclusion. The taxpayer's initial expert, responsible for the report included with the taxpayer's tax return, concluded that the optimal utilization of the land was to develop a 677-unit assisted living and senior housing complex. This determination was made solely on the basis that the local zoning board had initially approved the land for use as an assisted living facility. The expert then determined the value by comparing it to other senior development properties and current market offerings, arriving at an estimated value of $13,500 per unit.

The Tax Court in *Mill Road* agreed with the IRS expert, who rejected the assumption that it was unlikely

the local government would approve a 677-unit assisted living facility when an appropriate capacity for an assisted living facility was between 60 and 120 units. Furthermore, the court held that a more appropriate comparison would be the cost of acquiring a similarly desirable alternative, specifically, the price of a comparable undeveloped lot in the area, which was $900,000, rather than deriving the value based on unit prices offered by other properties. However, before the property was contributed to the partnership for the donation, it was part of the inventory owned by the partners of the partnership, who are real estate professionals. Because of this, under the rules of **I.R.C. Section 170(e)(1)(A)** , the maximum allowed deduction value for the donation was limited to the partnership's cost basis, which was $416,563. The Tax Court determined that the taxpayer was not subject to the fraud penalty under **Section 6663** , as the taxpayer had fully disclosed the transaction through a properly completed Form 8283, and the IRS failed to demonstrate fraud with "clear and convincing" evidence required by **I.R.C. Section 7454(a)** and Tax Court Rule 142. However, the Tax Court found the taxpayer liable for a 40% gross valuation misstatement penalty pursuant to **I.R.C. Sections 6662(e)(1)(A)** & (h), as the misstatement between $900,000 and $8,935,000 exceeded 200%. **55**

Murphy. In the second case, *Murphy*, the Tax Court determined the valuation of two conservation easements to be approximately $2.89 million, in contrast to the taxpayer's claimed $8.3 million deduction. **56** The properties in question were two tracts of land used as golf courses. The taxpayer's expert determined that each tract's highest and best use was to convert one into a residential development, provided that the adjacent tract continued to operate as a golf course. The easement valuation involved comparing the land's value "before" - when its best use was considered to be a potential conversion into residential development - and "after" - when a permanent easement was applied, restricting any such development. Conversely, the IRS's expert maintained that the best use for both parcels was for the parcels to continue to operate as golf courses.

The Tax Court in *Murphy* disagreed with both parties and determined that the best use would involve maintaining one tract as a golf course and converting the other into a residential development. For tract one, the IRS expert criticized the taxpayer's report for overlooking certain costs, which would have rendered the development much less profitable. For tract two, the court concluded that because it would remain a golf course, the only feasible development, without altering its current state, was the construction of five lots, which resulted in an easement value of only $100,000.

Oconee Landing Property. In the third recent case, *Oconee*, Judge Lauber completely disallowed the conservation easement deduction of $20.67 million for two independent reasons but still discussed the valuation of the property for the purpose of penalty application. **57** For the first reason, Judge Lauber determined that although the appraisers who signed off on the appraisal met all the necessary criteria specified in the tax code, they were nonetheless deemed unqualified under a specific regulatory exception. **58** This exception was triggered due to evidence showing that the taxpayer (the donor) communicated with the appraisers through a promoter, leading the taxpayer to acquire "knowledge" that could expect the appraisers to inaccurately inflate the property's value. **59** Accordingly, because the taxpayer did not have a qualified appraisal and there was no reasonable cause for such failure, it was a fatal defect that disallowed the charitable deduction in full. **60**

For the second reason, the partnership acquired the property through a series of intermediary entities from the managing partner, who was engaged in real estate development and treated the property as inventory. **61** Consequently, the partnership's deduction would be restricted to the basis of the property as held by the partner. **62** However, since the partnership failed to carry its burden of proving the basis, the basis was deemed to be zero. **63**

Finally, the court was required to determine the property's valuation for the purpose of assessing the accuracy-related penalty. **64** Initially, the court examined expert opinions from both the IRS and the taxpayer to ascertain the highest and best use of the property before its donation. After considering the reasonableness of the opinions, the court concluded that the property's highest and best use was to hold it speculatively for future mixed-use development. **65** Subsequently, the court found the IRS's expert opinion to be more credible, as it relied on historical records instead of speculative future data. **66** Additionally, its valuation method was more reasonable by comparing sales within the local area. **67** At the conclusion, the taxpayer was held liable for the gross valuation misstatement penalty for claiming a value for the easement in excess of $4,972,002. **68**

In the above three cases, the Tax Court properly considered the valuation reports and testimonies of the experts retained by all parties, including the original experts who prepared the report for the tax returns at issue. The court carefully reviewed the reports to understand the facts and assumptions that the experts relied on and determined whether to accept or disregard their opinions. **69** The court also considered external factors, including past dealings of the parties involved, that could potentially disqualify an appraiser. **70** In summary, valuation cases are essentially the battle of the experts, with the experts' testimony and their credibility affecting the outcome. **71**

Challenging Penalties under I.R.C Section 6751(b)

As tax practitioners involved in tax disputes, a crucial aspect of our role is to ensure the IRS adheres to applicable rules and procedures. Following an audit, especially if the IRS uncovers questionable tax practices, the IRS often proposes multiple penalties to encourage future compliance and discourage misconduct. **I.R.C Section 6751(b)** provides:

> "no penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher-level official as the Secretary may designate." **72**

Each penalty must receive separate supervisory approval, with ongoing case law development across various circuits dictating the timing of this approval during the audit and assessment process. **73** In the Second and Tenth Circuits, penalty approval by an immediate supervisor is required no later than when the Statutory Notice of Deficiency is mailed. **74** In the Ninth and Eleventh Circuits, the approval is required at the earlier of the assessment of the penalty or before the supervisor loses discretion to

approve the penalty assessment. [75] If the penalties were first raised in a Tax Court answer or amended answer, approval by an immediate supervisor must be obtained before the pleading is filed. [76]

At the American Bar Association 2024 Midyear Tax Meeting, a panel of experts delved into recently uncovered IRS misconduct relating to **I.R.C. Section 6751(b)** , and offered valuable advice on examining penalty approval forms and formulating requests relating to penalty approval under the Freedom of Information Act (FOIA). [77] The panel shared experiences where the IRS was found to have backdated penalty forms or where the penalty approval form contained information that could not have existed at the time the form was allegedly signed. [78] Accordingly, it is important for tax practitioners to draft a detailed FOIA request that would allow the practitioner to obtain the documents needed to properly review and examine the penalty supervisory approval issue.

First, understand that it can take a long time to receive a response to a FOIA request, and as such, a FOIA request should be made early in the appeal process. Second, to verify an electronic signature, the request should ask for documents in their native electronic format rather than a printed copy or a PDF version. Third, the request should include not only the penalty approval form but also the examination workpaper index and workpapers, the examining officer's activity records, appeals transmittal and case memo, communications between the auditor and any supervisor, and any proposed adjustment worksheet. Fourth, pay attention to various versions of the penalty form and whose signature appears on each form. In some cases, there may be multiple versions of the penalty approval form being signed by an IRS agent other than the examiner. In such situations, it might be necessary to submit a supplemental FOIA request for specific workpapers corresponding to specific IRS employees identified by their employee standard identifier (SEID). Fifth, it may be necessary to conduct a "digital forensic examination" on the native penalty form to determine if the form was electronically altered or manipulated. Sixth, if you are already in a litigation posture, you can request all the documents listed above directly from IRS or DOJ counsel through both informal and formal discovery requests, including requests for the production of documents and requests for admissions relating to the content of the penalty form.

In summation, the panel emphasized the importance of not taking IRS penalty forms at face value due to instances of misconduct. The panel participants stressed that tax practitioners should carefully review penalty approval forms and related documents to ensure that proper procedures were followed.

IRS Enforcement Actions

In addition to the above litigation points, the IRS also employs several aggressive enforcement efforts, from media campaigns to additional IRS departments combating tax abuse. [79] Two particular enforcement actions will be discussed here.

When the IRS needs to obtain documents, it typically initiates the process by issuing an Information Document Request (IDR). If necessary, it then escalates the situation through three steps: first, by

issuing a Delinquency Notice, then a Pre-Summons Letter, and finally, if compliance is not met, a Summons may be issued. The IRS has since removed these requirements for SCE transactions, and instead, the IRS issued a legal memorandum instructing its examiners to issue Summonses promptly. [80] As a result, the IRS has been overzealous and forceful in using Summonses. [81]

Furthermore, the Treasury Department's proposed regulations, among other additional rules, added the Disallowance Rule, which provides that a contribution exceeding 2.5 times the sum of the partner's relevant basis will not be treated as a qualified conservation contribution. [82] This can potentially shift the historical focus of the litigation away from the valuation of the donation to the basis of the partnership by disqualifying the donation as a "qualified conservation contribution" under **Section 170(f)(3)** . [83]

Given the government's increasingly aggressive tactics, it is critical for taxpayers and tax practitioners to remain vigilant and informed.

California's Special Enforcement

Following the aggressiveness of the IRS and its recent success in several Tax Court cases, states have stepped up their own enforcement of SCE transactions. The California Franchise Tax Board ("FTB") recently launched a formal settlement initiative in late May 2023 under FTB Notice 2023-02. [84] Although this initiative closed on 1/31/2024, the initiative demonstrates the aggressiveness of the FTB and the FTB's desire to resolve SCE transaction disputes through a formal resolution program. The FTB's initiative was open for taxpayers under examination by the FTB or the IRS regarding their participation in an SCE transaction or micro-captive insurance transaction. FTB Notice 2023-02 offered taxpayers the opportunity to reverse the tax benefits of the SCE transaction in exchange for abatement of certain penalties, depending on the stage of the taxpayer's audit with the FTB or IRS. FTB Notice 2023-02 further suggested that should the taxpayer choose not to settle, the FTB has a 12-year assessment statute of limitation to audit taxpayers who engage in abusive tax avoidance transactions. [85] Before delving into the resolution proposed in FTB Notice 2023-02, it is helpful for practitioners to understand the approach adopted by the California Franchise Tax Board in conducting audits.

Overview of California Franchise Tax Board Audit Procedures. Although California acknowledges the federal audit regulations and procedures established by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the more recent Bipartisan Budget Act of 2015 (BBA) for partnerships, California does not generally conform with these federal audit rules. In California, the audit procedures typically applied to individuals subject to the state's personal income tax are also applicable to partnerships. This means that any adjustments to a partnership's reported income, gains, losses, deductions, or credits are evaluated on a per-partner basis, both administratively and judicially. Therefore, adjustments to a partnership's flow-through tax attributes are addressed in distinct actions for each partner, with each partner subject to its own separate statute of limitations. However, where there is an applicable partnership adjustment or election at the federal level, it is generally also binding on the taxpayer in California. [86]

The FTB selects returns for audit based on various criteria, such as the Form 8886 disclosure of reportable transactions. FTB audits proceed similarly to IRS audits; the FTB requests information and documents, and also solicits legal arguments. Upon the conclusion of the audit, the FTB will issue a Notice of Proposed Assessment (NPA). Failure to respond to the NPA will lead to an assessment of tax. The taxpayer can file a protest to the NPA, which will be handled by the FTB's protest unit, who will review the protest and conduct further investigation as needed to render a final administrative decision called a Notice of Action (NOA). **87** If the taxpayer disagrees with the NOA, the taxpayer can further appeal the decision by filing a petition with the Office of Tax Appeals (OTA), which is California's version of the Tax Court. **88**

OTA proceedings are heard by three administrative law judges who issue a decision at the conclusion of a hearing. The OTA seeks to operate informally and requires that the parties work together to exchange information. **89** However, one significant difference between the OTA and the Tax Court is that with the OTA, there is a lack of formal discovery devices outside of the use of a motion to compel and the issuance of a subpoena, and with the OTA, taxpayers may not be able to introduce additional evidence, like impeachment evidence, during the hearing. If the taxpayer disagrees with an OTA decision, the taxpayer can protest by filing a petition for rehearing with the OTA within 30 days. **90** Additionally, the taxpayer may pay the resulting amount, pursue an administrative refund claim, and thereafter file suit in Superior Court. **91** The standard for such a suit is a *de novo* review. **92** Unlike the Tax Court, the OTA is merely an administrative agency, and the general consensus amongst the California bar is that the OTA generally defers to the FTB. It is also worth noting that the OTA does not have the authority to overrule the FTB's regulations. **93**

During the protest stage or pending an OTA hearing, the taxpayer can discuss settlement with the FTB Settlement Bureau. **94** The Settlement Bureau can engage in confidential settlement discussions to try to settle the case based on the risk and hazard of litigation. It should be emphasized that while the FTB Settlement Bureau operates similarly to the IRS Independent Office of Appeals, less guidance and procedures are in place compared to the IRS. This structural difference, combined with less formal procedures at the OTA, often leads to less litigation risk for the FTB, which can result in the Settlement Bureau offering a smaller concession.

FTB Settlement Initiative in Detail. FTB Notice 2023-02 outlined six different terms for settlement, which vary based on the procedural posture of the tax matter with either the FTB or the IRS.

> (1) For taxpayers who received a Notice of Proposed Assessment (NPA) at the conclusion of an FTB audit, taxpayers were required to pay the full amount of tax shown on the NPA. In exchange, the FTB would abate the Noneconomic Substance Transaction Understatement (NEST) penalty, which is 40% of the understatement or 20% if the transaction is adequately disclosed. The FTB will certainly argue that the transaction was not adequately disclosed, even where a Form 8886 was filed. In one case, the FTB stated that a fully completed Form 8886 must include the identities and any fees paid to any individual or entity that provides tax advice related to the transaction as well as the identity of "all individuals, tax-exempt, foreign,

or related entities involved in the transaction."

(2) For taxpayers who received the NPA and already resolved the tax issues with the IRS pursuant to a formal settlement initiative, the FTB resolution reduced the tax benefits to the same extent they were reduced pursuant to the IRS settlement initiative. The FTB also abated the 40% NEST penalty but not any other penalties proposed in the NPA.

(3) For taxpayers whom the FTB or the IRS has contacted regarding an audit of a tax return on which they claimed tax benefits from the SCE but had not received an NPA, the taxpayers were required to fully remove the tax benefits from the SCE and pay the resulting income tax liability and interest, along with a 20% accuracy-related penalty. **95** In exchange, the FTB would not assess the 40% NEST penalty, the 20% reportable transaction accuracy-related penalty, and the 100% interest-based penalty that effectively doubles the interest from the due date of the return to the date the NPA is mailed.

(4) For taxpayers who had not been contacted by either the FTB or the IRS regarding an audit of a tax return on which they claimed tax benefits from the SCE, the taxpayer was required to remove the tax benefit from the SCE and pay the resulting income tax liability and interest. In exchange, the FTB would not assess any penalties.

(5) For taxpayers who did not receive an NPA and already resolved the tax issues with the IRS pursuant to a formal settlement initiative, the taxpayers were required to reverse the tax benefits to the extent they were reversed in the IRS settlement initiative. The FTB would not assess additional penalties besides those that were imposed by the IRS.

(6) For taxpayers who resolved the tax issues with the IRS in some method other than pursuant to a formal IRS settlement initiative, the taxpayers were required to reverse the tax benefits to the extent they were reversed at the federal level. The FTB would assess penalties depending on whether the taxpayers had received the NPA as provided in the other terms.

FTB Notice 2023-02 also required, except to the extent allowed by a federal change or settlement, that taxpayers remove any previous deduction taken for expense, fee, capital cost, or addition to the basis for amounts paid to promoters, material advisors, attorneys, accountants, or appraisers to plan or to carry out the transaction. All taxpayers who utilized the FTB Notice 2023-02 resolution were required to pay the full resulting amount or enter into a 12-month installment agreement from the date the settlement was entered into. The terms further provided that the taxpayers waived any appeal or refund rights.

The FTB Notice 2023-02 resolution, excluding the reduction of the 40% NEST penalty and other fines, was unduly severe. In the context of a federal review, the core issue in a conservation easement tax dispute is valuation, provided that the basic criteria for charitable donations are satisfied. Therefore, most taxpayers should, at minimum, be eligible for a deduction equal to their property's basis value. Yet, according to the FTB's settlement terms, taxpayers would be required to revoke all tax benefits associated with the SCE and also eliminate any deductions for transaction costs.

As the FTB does not conform to the IRS's TEFRA or BBA partnership audit procedures, the FTB will likely continue to target individual tax returns. Those currently under IRS examination are strongly encouraged to obtain legal representation to address FTB inquiries and to seek a deferral of the state

audit until the federal review concludes. However, in the absence of an ongoing IRS audit, acceptance of the FTB Notice 2023-02 resolution may have been advantageous, considering the OTA operates less formally than the Tax Court and tends to make rulings that favor the California tax agencies. It remains to be seen if the FTB will accept the outcome of federal audits.

Conclusion

This article aims to offer an insightful summary of some crucial aspects of the examination of SCE transactions, a field marked by its complex nature and evolving legal precedents that have yet to be definitively resolved. With federal and state governments intensifying enforcement strategies, tax professionals must be especially diligent in working through the audit process to ensure fair treatment for their clients.

1 Congress has recently clawed back $20 billion of the $80 billion under the Fiscal Responsibility Act of 2023, H.R. 3746.

2 IRS, "*More than $482 million recovered from 1,600 millionaires who have not paid tax debts*," News Release IR 2024-9 (1/12/2024).

3 IRS, "*IRS Continues Enforcement Efforts in Conservation Easement Cases Following Latest Tax Court Decision*," News Release IR 2019-213 (12/20/2019).

4 IRS, "*O'Dell to serve as IRS Promoter Investigations Coordinator*," News Release IR 2020-41 (2/24/2020); IRS, "*IRS Criminal Investigation veteran selected as new Fraud Enforcement Director*," News Release IR 2020-49 (3/5/2020).

5 "Finance Committee Releases Report on Syndicated Conservation-Easement Transactions" (8/25/2020), https://www.finance.senate.gov/chairmans-news/finance-committee-releases-report-on-syndicated-conservation-easem

6 Consolidated Appropriations Act for 2023, Pub. L. No. 117-328, 136 Stat. 5393 (enacted 12/29/2022).

7 *CIC Services* (for **Notice 2016-66**); *Green Valley Investors* (for **Notice 2017-10**).

8 IRS Announcement 2022-28; See Announcement 2023-11 (specifically stating that the IRS is obsoleting **Notice 2016-66** and will no longer enforce the disclosure or penalties).

9 Scott Hodge, "*Would Americans Make Charitable Donations without Tax Incentives?*," Tax Foundation (12/20/2022), https://taxfoundation.org/blog/charitable-deduction-tax-incentives/.

10 Generally, at the federal individual top tax bracket of 37%, a dollar deduction will only generate a 37-cent tax saving.

11 Pub. L. No. 94-455, 90 Stat. 1520.

12 *See* Conservation Easement Incentive Act of 2015, S. 330, 114 Cong. (2015), sponsored by Sen. Heller, Stabenow, and 50 other Senators.

13 IRS, Publication 5464: *Conservation Easement Audit Techniques Guide* (rev. 1/21/2021).

14 **I.R.C. Section 170(f)(8)** .

15 **Reg. 1.170A-16(d)** .

16 Reg. 1.170-13(f).

17 Reg. 1.170-13(f).

18 *See e.g., Averyt*, **TCMemo 2012-198** ; *Simmons*, **TCMemo 2009-208** , *aff'd* 656 F.3d 6 (D.C. Cir. 2011).

19 *See Averyt*, **TCMemo 2012-198** , at *14; *Id.* at *10 (**I.R.C Section 170(f)(8)(B)** requires strict compliance).

20 *See e.g., Averyt*, **TCMemo 2012-198** , at *12 (the deed provided that the conservation easement is an unconditional gift with no mention of consideration provided in exchange); *R.P. Golf, LLC*, **TCMemo 2012-282** , at *10 (the deed stated that the conservation easement was made in consideration of certain covenants and representations without mentioning consideration given in exchange).

21 *See French*, **TCMemo 2016-53** , at *13.

22 *See e.g., 310 Retail, LLC*, **TCMemo 2017-164** *; Big River Dev., L.P.*, **TCMemo 2017-166** .

23 Reg. 1.170A-13(c) .

24 See Form 8283 requirements under **Reg. 1.170A-13** . However, a taxpayer with reasonable cause and good faith omission of certain requirements may still obtain the deduction. **Reg. 1.170A-13(c)(4)(iv)(C)** . The IRS may follow up with an incomplete Form 8283 and request that the donor submit a fully completed Form 8283 within 90 days. **Reg. 1.170A-13(c)(4)(iv)(H)** ; *See also* IRS Publication 5464.

25 Reg. 1.170A-13(c)(4) ; **Reg. 1.170A-13(c)(4)(ii)(B)** .

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

27 Reg. 1.170A-14(g)(5)(i)(D) .

28 I.R.C. Section 170(f)(11)(D) .

29 Reg. 1.170A-13(c)(3) .

30 See e.g., *Emanouil*, **TCMemo 2020-120** .

31 *Id.*

32 *Id.* at *44.

33 *Id.* at *37.

34 Reg. 1.170A-13(c)(5)(iii) ; *But see Mill Rd 36 Henry, LLC*, **TCMemo 2023-129** , at *45 (an appraiser who is a subordinate of another need not sign the appraisal).

35 Reg. 1.170A-13(c)(5)(ii) ; *See e.g., Mill Rd 36 Henry, LLC*, **TCMemo 2023-129** , at *42-45 (IRS arguing that the taxpayer had knowledge that the appraiser would overstate the value because of their past relationship of hiring the appraiser for other appraisals).

36 Reg. 1.170A-17(b)(5) .

37 Reg. 1.170A-13(c)(4)(ii)(K) and (L).

38 The two perpetuity requirements under **I.R.C. Section 170(h)(2)(C)** and **I.R.C. Section 170(h)(5)(A)** are not the same where the former requires that the granting of the easement is in perpetuity, while the latter deals with the conservation interest and to ensure that the use of the property does not interfere with the conservation easement purpose; *See e.g. Pine Mt. Pres*, 978 F.3d 1200 , n. 4 (11 Cir. 2020).

39 *See e.g., Minnick*, **TCMemo 2012-345** , *aff'd*, 796 F.3d 1156 (9th Cir. 2015).

40 *See e.g., Carroll*, **146 T.C. 196** (2016); *Coal Property Holdings, LLC*, **153 T.C. 126** (2019).

41 Reg. 1.170A-14(c)(1) .

42 *See Murphy*, **TCMemo 2023-72** , at *42-43; *Mill Rd 36 Henry, LLC*, **TCMemo 2023-129** , at *30.

43 Reg. 1.170A-14(d)(3)(ii) (adding the word "significant" to the requirement); See *Champions Retreat Golf Founders, LLC*, 959 F.3d 1033 , 1036 (11th Cir. 2020), *vacating and remanding* **TCMemo 2018-146** (some level of significance is needed); *Mill Rd 36 Henry, LLC*, **TCMemo 2023-129** , at *33-34 (more than trivial but not high-quality habitat).

44 *See e.g., Mill Rd 36 Henry, LLC*, **TCMemo 2023-129** , at *35-38 (a quarter mile of pine tree forest along the highway for the scenic enjoyment of the general public yields a significant public benefit).

45 Reg. 170A-14(g)(5).

46 *See e.g.*, *Triumph Mixed Use Investments III, LLC*, **TCMemo 2018-65** , at *31-42 (taxpayer donating a conservation easement in exchange for approval of a zoning app); *Mill Rd 36 Henry, LLC*, **TCMemo 2023-129** , at *27-28 (IRS unsuccessfully argued that the transaction lacked donative intent as the private placement memo circulated by management members promised a tax benefit because the members still have the option to pursue other strategic investment options).

47 Reg. 1.170A-14(h)(3)(ii) ; *See e.g., 1982 East, LLC*, **TCMemo 2011-84** (easement of a townhouse was not more restrictive than New York Landmarks Law); *Gorra*, **TCMemo 2013-254** .

48 Reg. 1.170A-14(e)(2) and (3).

49 *See e.g., Butler*, **TCMemo 2012-72** , at*31-35 (IRS unsuccessfully argued that the landowner may exercise the reserved rights that would be inconsistent with the conservation easement at some point

in the future).

50 Reg. 1.170A-14(h)(3)(i) .

51 *See Mill Rd 36 Henry, LLC*, **TCMemo 2023-129** , at *48; *See also* IRS Publication 5464 - Section IX, F.

52 Reg. 1.170A-14(h)(3)(ii) .

53 *Mill Rd 36 Henry, LLC*, **TCMemo 2023-129** (10/26/2023).

54 *Id.* at *2.

55 *Id.* at *68 (The Tax Court imposes the penalty using the $900,000 amount because the final allowable deduction of $416,563 was not based on a valuation issue but a limitation of the cost basis based on the character of the property as inventory).

56 *Murphy*, **TCMemo 2023-72** (6/15/2023).

57 *Oconee Landing Prop.*, **TCMemo 2024-25** (2/21/2024).

58 *Id.* at *43 (**Reg. 1.170A-13(c)(5)(ii)** .

59 *Id.* at *44 (although there was no explicit communication, Judge Lauber found that evidence established that there was an agreement that the appraisal would be close to an agreed upon amount between the donor and the promoter).

60 *Id.* at *45-46.

61 *Id.* at *49-53.

62 *Id.* at *55 (**IRC Section 170(e)(1)** limits the donation to basis if it was an ordinary income property).

63 *Id.* at *56-57.

64 *Id.* at *74 (**IRC Section 6662(h)** imposes a 40% penalty in case of gross valuation misstatement).

65 *Id.* at *59-66.

66 *Id.* at *66-72.

67 *Id.*

68 *Id.* at *75.

69 See *Casey*, **38 T.C. 357** , 381 (1962) (absent the finding of bad faith, the court will weigh the estimates by examining the factors relied on by the experts in reaching their conclusion).

70 *See e.g., Oconee Landing Prop.*, **TCMemo 2024-25** at *44 (2/21/2024).

71 *See e.g., Boltar, LLC*, **136 T.C. 326** , 338-340 (2011) (the Tax Court fully rejected the taxpayer's expert report because of the expert's overzealous advocacy and unreasonable persistence in the position that the original appraisal was correct despite admitting to factual errors).

72 **I.R.C. Section 6751(b)** (this requirement does not apply to certain additions to tax and penalties that are automatically calculated through electronic means).

73 *See Sells*, **TCMemo 2021-12** , *26-27 (citing *Palmolive Bldg. Inv'rs, LLC*, **152 T.C. 75** , 79 n.3, 83-84 (2019)) (if an examiner determines the gross valuation misstatement penalty applies, but alternatively asserts the negligence penalty, substantial understatement of income tax penalty, and substantial valuation misstatement penalty, the examiner must secure written supervisory approval for each of these penalties).

74 *See Chai*, 851 F.3d 190 (2d. Cir. 2017); *See also Minemyer*, **131 AFTR 2d 2023-364** (10th Cir. 1/19/2023).

75 *See Laidlaw's Harvey Davidson Sales*, 29 F.4th 1066 (9th Cir. 2022), *rev'g and remanding* **154 T.C. 68** (2020); *See also Kroner*, 48 F.4th 1272 (11th Cir. 2022), *rev'g* **TCMemo 2020-73** ; *Carter*, **130 AFTR2d 2022-5978** (11th Cir. 2022), *rev'g* **TCMemo 2020-21** .

76 *See Roth*, **TCMemo 2017-248** , at *11, *aff'd*, 922 F.3d 1126 (10th Cir. 2019).

77 "The Power of Metadata: Challenging Penalties under **Section 6751(b)** " organized by the Tax

Practice & Technology Committee.

78 *See e.g., Lakepoint Land II, LLC*, **TCMemo 2023-111** (IRS submitted erroneous declaration regarding the penalty lead sheet); *Arden Row Assets, LLC*, Tax Court Docket No. 3817-23.

79 Hale E. Sheppard, "*30 Wrongs Do Not Make a Right: Revealing Extraordinary IRS Actions in Conservation Easement Disputes*," 33 Tax'n Exempts 8 (2021), republished in 135 J. Tax'n 21 (2021).

80 *See* former I.R.M. § 4.46.4.6.3 (12/13/2018); IRS, "*Use of Summons and Summons Enforcement in Syndicated Conservation Easement Cases, Reportable Transactions, and Other Abusive Tax Avoidance Transactions*," 11/16/2020, https://www.irs.gov/pub/irs-utl/summons_document_dcse.pdf.

81 See e.g., Tax Notes, "*Court Enforces IRS Summonses Related to Easement Donations*," 8/3/2023 (Court upholds broad IRS summons due to the low threshold that the information might be relevant to the inquiry); *Norcave Prop., LLC, No. 23-mc-23-SNLJ*, complaint filed 11/6/2023 (E.D. Mo.) (taxpayer suing to quash IRS examiner's 37 summonses even after the IRS already made its determination on the taxpayer's tax liability).

82 See REG-112916-23 (11/20/2023).

83 A taxpayer cannot deduct donations of an "interest in property which consists of less than the taxpayer's entire interest in such property" unless it is a qualified conservation contribution. **IRC Section 170(f)(3)** .

84 This settlement initiative, which also applied to micro-captive insurance, was initially offered from 7/10/2023 to 11/17/2023, and was extended to 1/31/2024.

85 Cal. Rev. & Tax Code § 19755(a)(2).

86 See e.g., Cal. Rev. & Tax. Code § 18622.5(a).

87 Cal Rev. & Tax. Code § 19041.

88 Technically, the OTA is not a "court" but an administrative agency that handles income and sales & use tax appeals in California.

89 Cal. Code Regs. Tit. 18 § 30214.

90 Cal. Code Regs. Tit. 18 § 30602.

91 FTB 985 Publication. Cal. Rev. & Tax. Code § 19381 (30 days for the OTA decision to become final and 60 days to file the suit, with some exceptions). It is also worth noting that a taxpayer can forgo the OTA process altogether by paying the NPA or NOA amount in full, filing an administrative refund claim, and where denied or after six months, the taxpayer may sue in California Superior Court. *See* Cal. Rev. & Tax. Code §§ 19382-19385.

92 OTA Appeals Procedure Publication, https://ota.ca.gov/wp-content/uploads/sites/54/2019/03/OTA-Appeals-Procedures.rev1.pdf.

93 *See In the Matter of the Appeal of Janus Capital Group, Inc. and Subsidiaries*, California Office of Tax Appeals, No. 20096605, 2023-OTA-443.

94 Cal. Rev. & Tax. Code § 19442 (authorizes the settlement of civil tax matters in dispute that are the subject of protests, appeals, or refund claims, including matters before the OTA).

95 "Contact" is defined in Reg. 1.6664.2(c)(3)(i) to mean a contact by the IRS or FTB to the taxpayer, the partnership, or the promoter about the transaction or the return.

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