

Prepare For Greater IRS Scrutiny On Conservation Easements

By **Barbara Kaplan, Michelle Ferreira and Jennifer Vincent**

While the Internal Revenue Service has been focused on syndicated conservation easements for over 10 years, earlier this year IRS Commissioner Chuck Rettig announced several campaign issues on which the IRS would heighten its focus. These campaigns included compliance in the areas of cryptocurrency, syndicated conservation easements, captive insurance companies, offshore filings and more.

Following through on this promise, on Nov. 12 the IRS announced a significant increase in enforcement action for syndicated conservation easements.[1] The Small Business and Self-Employed, Large Business and International, and Tax Exempt and Government Entities IRS divisions announced coordinated examinations between them. Separately, investigations have been initiated by the Criminal Investigation Division of the IRS.

The IRS announcement said the audits and investigations of syndicated conservation easements “cover billions of dollars of potentially inflated deductions as well as hundreds of partnerships and thousands of investors. ... Abusive syndicated conservation easement transactions undermine the public’s trust in private land conservation and defraud the government of revenue.”

What is a syndicated conservation easement?

Generally, a charitable deduction is not allowed for a gift of property that consists of less than the donor’s entire interest in the property. However, Internal Revenue Code Sections 170(h)(1) through (h)(5) and Section 1.170A-14 of the U.S. Department of the Treasury regulations[2] provide an exception for a qualified conservation contribution.

A qualified conservation contribution is a contribution of a qualified real property interest that includes a restriction, granted in perpetuity, on the use of the real property. The contribution must exclusively be used for conservation purposes. A charitable contribution deduction is allowed for the fair market value of the conservation easement donated to certain charitable organizations.

The principles supporting a charitable deduction for the donation of a conservation easement are fairly simple. However, in practice, taxpayers often run into limitations on the amount of the charitable deduction they can actually take.

Generally, taxpayers are limited in the amount of a charitable deduction they may utilize by a ceiling of 50% of their adjusted gross income. Rather than allow this limitation to prevent full use of a potential tax deduction, promoters and advisers set up syndications to purchase land for the purpose of applying for conservation easements.

These structures often involve pass-through and tiered entities that hold or acquire real property, allowing several investors to share in the charitable deduction, spreading the



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deduction amongst the owners of the entity so no taxpayer is likely to reach their 50% limitation on the contribution.

In many cases, after acquisition by the syndication, property valuations and appraisals greatly inflate the value of the easement based on unreasonable conclusions about the development potential of the real estate. Then the pass-through entity donates an easement encumbering the property to a tax-exempt entity, claiming a holding period of more than one year.

Generally, the deductions claimed by investors in these transactions significantly exceed the amounts the investors invested. The conservation easements often generate deductions of up two and a half times the invested amount.

The IRS is now allocating significant resources toward ending these transactions.

In 2016, the IRS issued Notice 2017-10, labeling these transactions "listed transactions."^[3] The notice applies to certain transactions where promotional materials suggest to potential investors that they may be entitled to a share of a charitable contribution deduction that equals or exceeds two and a half times the amount invested.

Per the notice, individuals entering into these and substantially similar transactions must disclose them to the IRS via a disclosure statement on Form 8886.^[4] In addition, the notice created disclosure and record maintenance obligations for material advisers to those transactions.

In 2018, syndicated conservation easements were added to the list of the IRS Large Business and International Division's compliance campaigns. The IRS moved these transactions from entity- and individual-based audits to issue-based treatment using highly trained revenue agents. The Conservation Easement Audit Techniques Guide includes almost 100 pages of instructions for revenue agents to use in examining charitable contributions of conservation easements.

These transactions are also included in the IRS' 2019 dirty dozen list of scams to avoid.^[4] The IRS stated that syndicated conservation easements "start with a legitimate tax-planning tool that is improperly distorted ... by a promoter to produce benefits that are too good to be true."

The IRS has also stated it is using innovation labs to develop new, more extensive enforcement tools that employ advanced technologies to discover additional abusive syndicated conservation easement transactions.

While hunting for syndicated conservation easements continues at the IRS level, the IRS has gained strength as the U.S. Tax Court continues to render favorable decisions for the government.

For example, in *Wendell Falls Development LLC v. Commissioner*,^[5] issued in November 2018, the court found that where an easement was donated for park use, but the highest and best use of the underlying land was as parkland, the easement had no value and should not have generated any deduction.

Also, in *Graev v. Commissioner* ^[6] the Tax Court found that where a conservation easement was donated conditioned on the receipt of the anticipated tax benefits, it was not an actual gift of the interest in the property and the deduction was denied.

In addition, the U.S. Department of Justice recently filed a complaint against promoters and organizers seeking permanent injunctions halting these transactions and seeking to disgorge the defendants of their ill-gotten gains.[7]

Aside from the many cases in which decisions have already been rendered in the IRS' favor, over 80 other syndicated conservation easement cases remain pending in Tax Court, likely to conclude with more precedent helpful to the IRS in its enforcement campaign against conservation easements.

Regardless, the IRS recently stated[8] that taxpayers may avoid the imposition of penalties relating to improper contribution deductions if they fully remove the improper contribution and related tax benefits by timely filing a qualified amended return or timely administrative adjustment request. In other words, participants in syndicated conservation easements must come forward before audit or investigation to potentially qualify for reduced or no penalties.

Conclusion

The IRS has announced that it will not stop in its pursuit of "everyone involved in the creation, marketing, promotion and wrongful acquisition of artificial, highly inflated deductions based on these aggressive transactions." The service further stated that "every available enforcement option will be considered," including both civil penalties and criminal investigations.

With enhanced enforcement efforts ongoing by the IRS, and IRS favorable precedent being generated in U.S. Tax Court, taxpayers engaged in any syndicated conservation easement transaction should determine the best course of action. The IRS is not only searching for those who took deductions, but also promoters, appraisers, tax return preparers and any others involved in the transactions.

Taxpayers should consider how to come into compliance and whether they may be vulnerable to civil or criminal investigation or penalties. Taxpayers should heed Rettig's warning and take steps to get back into compliance before they hear from the IRS.

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[1] Issue Number IR-2019-182.

[2] Internal Revenue Code section 170(h) and Treasury Regulations Section 1.170A-14.

[3] IRS Notice 2017-10, <https://www.irs.gov/pub/irs-drop/n-17-10.pdf>.

[4] Treasury Regulation Section 1.6011-4(d).

[5] <https://www.irs.gov/newsroom/irs-concludes-dirty-dozen-list-of-tax-scams-for-2019-agency-encourages-taxpayers-to-remain-vigilant-year-round>.

[5] Wendell Falls Dev. LLC v. Commissioner, (2018) TC Memo 2018-45, RIA TC Memo ¶2018-045, supplemented & reconsideration den (2018) TC Memo 2018-193, RIA TC Memo

¶2018-193.

[6] Lawrence G. Graev, et ux. v. Commissioner (Graev I), (2013) 140 TC 377, aff'd, (2017) 147 TC No. 16, at ¶ 66,625.01(50) (Graev II), rev'd in part, 149 TC No. 23, ¶149.23 TCR (Graev III) (reversing penalty application, not reversing decision regarding conservation easement deduction).

[7] United States v. Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough and Ralph R. Teal, No. 1:18-cv-05774-AT (N.D. Ga. 2018).

[8] Issue Number IR-2019-182, <https://www.irs.gov/newsroom/irs-increases-enforcement-action-on-syndicated-conservation-easements>.