

Daily Tax Report ®
Aug. 21, 2024, 4:40 AM EDT

IRS Conservation Easement Fumbles Mirrored in Covid Fraud Fight

By Caleb Harshberger

Deep Dive

- Lack of new rules stymied IRS crackdown on tax strategy
- Lawyers say it's repeating the mistake with Covid credit fraud

Cracking down on syndicated conservation easement scams was a slam dunk for the IRS.

Groups of wealthy investors assembled by aggressive tax planners were claiming tax deductions for charitable donations of land that were so outsized that they practically invited investigation.

Yet a series of missteps—including a refusal to issue regulations for taxpayers to follow, relying on older rules vulnerable to legal challenges, and being caught backdating documents in a key case—has jammed up the IRS's efforts to stamp out what it calls an abusive tax shelter that has cost the government billions of dollars.

"Missed opportunity is the right way to think about it," David Foster, a partner at Kirkland & Ellis LLP who's represented donors in many syndicated conservation easements fights, said about the IRS's strategy.

"There were a lot of judgments made that, one by one, you could defend but that collectively when you look at them all together didn't work out the way anybody—or the government—thought they would it.

"There was just a sort of fundamental strategic miscalculation in how to approach enforcement with respect to easements."

Tax lawyers say the agency is now repeating a key mistake in what may be its next big fight against billions of dollars in allegedly fraudulent claims for Covid-era employer tax credits.

The IRS didn't provide comments or make an official available for an interview after several requests.

Original Sins

Syndicated conservation easement abuse in some cases could be staggering and defied common sense. How can a charitable deduction for four, five, even six times what a piece of land is worth possibly be legal? How can anyone claim scrub brush in Arkansas is worth as much as oceanfront property?

Still, outgunned early on by the highly experienced lawyers hired by easement sponsors and investors, IRS agents struggled with how to address the growing flood of cases across the board, rather than battle each claimed deduction on its specifics.

The IRS homed in on abusive deductions as early as 2010 and could have written rules to meet the moment, said Michelle Levin, a shareholder at Dentons who has represented easement donors. But instead, the agency dusted off old regulations in an effort to disallow large numbers of easements at once, tax lawyers said. That decision would come back to bite the agency.

“One of the things the IRS did terribly wrong in the easement situation is they did not prepare any guidance,” Levin said. “They’ve had plenty of time putting together regulations, and that would’ve been a better way to administer this issue.”

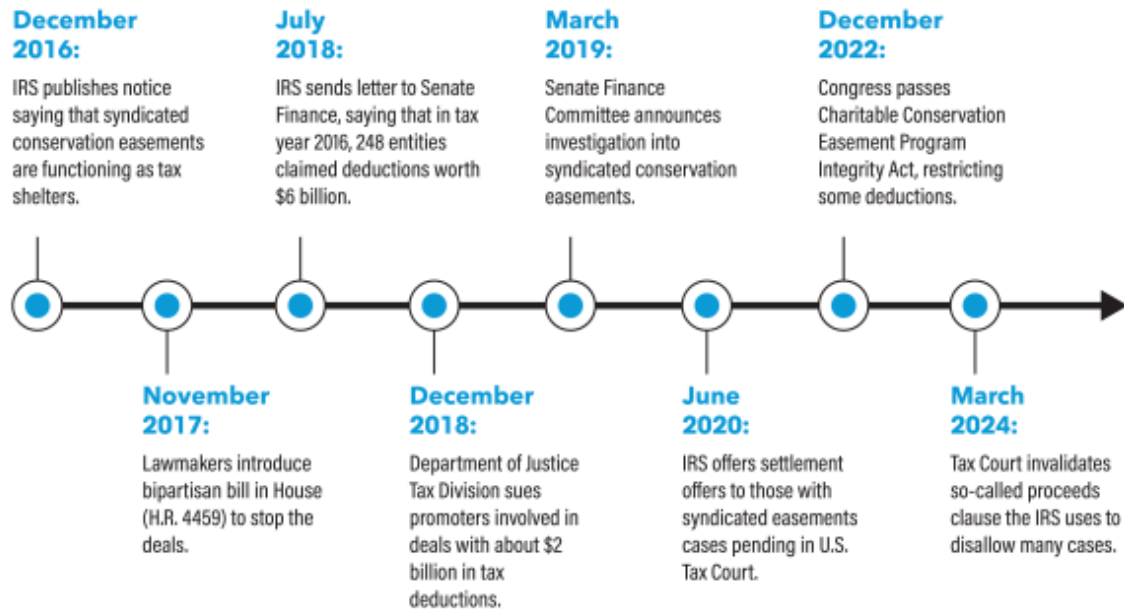
Perhaps the most notable of the old regulations that the IRS leaned on was Treas. Reg. 1.170A-14(g)(6)(ii)—also known as the proceeds clause. It’s a rule dating to the 1980s that required all charitable donations to be done in perpetuity for a taxpayer to claim the deduction.

Critics of the IRS approach say the agency used this rule to pounce on anything that could potentially be read as infringing on that requirement. “There’s no way for them to distinguish between the good and the bad, so they just treat them all the same,” Levin said.

Say, for example, “there’s a road across the property, but the landowner retains the right to repair the road or move the road in case of damage to the road. And it’d be like, ‘Well, that’s not a perpetuity then,’ and so that would take down the entire thing,” said Adam Looney, a University of Utah professor and former Treasury Department official.

“So you can imagine that if you’re a bona fide land trust doing a good transaction, the risk that your whole transaction could get blown up by some stupid technicality, it made it very hard to operate,” Looney said.

Land Deals Face Years of Growing Scrutiny



Bloomberg Tax & Accounting

Proceeds Clause

Had the agency issued guidance on how it would use the proceeds clause, the approach may have worked, Foster said. Instead, it left itself open to procedural challenges that culminated in a March ruling by the US Tax Court that the rule itself was invalid, because the agency failed to consider all comments in accordance with the Administrative Procedures Act.

That forced the agency to fight each case on the valuations claimed for each easement.

“If the government was legitimately concerned about what the proceeds clause could have looked like or what it should have looked like, then it could have very easily said, ‘If your proceeds clause reads like this, we don’t have an issue,’” Foster said. “They didn’t choose to do that. But to be clear, that’s because the proceeds clause litigation was never about the proceeds clause, and it was about a government strategy to zero out large swaths of claims.”

New rules are a common way for IRS to bolster areas of concern in the code, and its rule-writing process in recent years has been forged through legal challenges and strict adherence to APA requirements.

“They’ve done that in other contexts, with charitable remainder trust and charitable lead trusts, right? They say issue guidance and say, ‘Here are the terms you need to include in these trusts in order for them to comply,’ and they should have done that,” said Nancy McLaughlin, a University of Utah law professor.

Congress finally stepped in in 2022, passing a law limiting conservation easement deductions to 2.5 times the basis for properties owned for less than three years. That year, the IRS got to work on regulations that limit partnerships' and pass-throughs' ability to claim conservation easement deductions, and finalized those rules in June.

But by then, a growing mountain of cases had amassed at US Tax Court. The court is still dealing with at least 750 such cases, Judge Ronald Buch wrote in a recent opinion.

Wins Come In

Oddly enough, recent Tax Court rulings effectively dragged the IRS into its first winning streak against conservation easements in years, said Russ Shay, an independent consultant and former public policy director at the Land Trust Alliance, which advocates for land trusts and conservation organizations.

The agency has been racking up a series of wins that practitioners credit to a new approach focused on valuations rather than quirks in the law.

"It's really Tax Court judges that pushed the IRS to abandon their long-term aversion to dealing with valuations and looking for their shortcut ways to disqualify cases which they haven't found," Shay said.

Diana Norris, the alliance's Conservation Defense Network and Tax Manager, said the IRS has also found some success digging into the operations of the donor to find potentially disqualifying issues.

"We've seen the IRS focus more on the business models in the abusive transactions rather than winning on hypertechnical arguments affecting land conservation," she said. "More cases on valuations; more cases on how the partnerships hold these interests and how they're classified; are they investments or inventory?"

Still, it's unclear whether the IRS has adjusted its strategic thinking on tax avoidance through conservation easements or is merely reacting to Tax Court decisions.

The agency's next big fight—employee retention credit fraud—dwarfs the problem of conservation easement abuse. The agency reported 1.4 million backlogged ERC claims as of last month and said up to 70% have shown signs of an unacceptable level of risk, though it has gotten pushback on its estimates.

The IRS has tried to cut down on the number of cases it will have to potentially argue in court by offering partial amnesty to taxpayers who don't want to risk an audit of their claims.

Bigger Fights

To be sure, there are massive differences between ERC claims and conservation easement deductions.

Conservation easements have been in place for decades, while Congress passed the ERC program and the IRS hurriedly implemented it to get money to businesses trying to survive the Covid-19 global pandemic. That left little time to write regulations, and by the time the agency realized that was a problem, it felt it was too crunched for time to go through the rulemaking process, said Christopher Ferguson, a partner at Kostelanetz LLP.

But, as with conservation easements early on, the IRS has relied on subregulatory guidance for ERCs. It still has yet to propose formal regulations to police the space. And after US Supreme Court decisions in *Loper Bright* and *Corner Post*, which cleared previous limits on legal challenges to agency regulations, the IRS's subregulatory guidance on ERC could be more vulnerable to legal challenges than if it had issued official regulations, Ferguson said.

This approach contrasts to the agency's recent efforts to write rules addressing other areas of potential abuse, particularly by partnerships.

The IRS issued proposed regulations on basis shifting in June, saying it expected the change to raise more than \$50 billion over 10 years. Its spring regulatory agenda listed three other rule writing projects underway—including those on disguised sales of partnership interests, transactions involving equity interests of a partner, and the definition of a limited partner for material participation.

Levin at Dentons said the agency could write rules on the employee retention credit if it wants to, and might save itself some trouble if it does.

"They have the authority," she said. "They just haven't learned from their mistake."

To contact the reporter on this story: Caleb Harshberger at charshberger@bloombergindustry.com

To contact the editors responsible for this story: Bernie Kohn at bkohn@bloomberglaw.com; Martha Mueller Neff at mmuellerneff@bloomberglaw.com

© 2024 Bloomberg Industry Group, Inc. All Rights Reserved