NATIONAL TAXPAYERS UNION

Issue Brief

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Open Season – Again – on Conservation-Minded Taxpayers

This week marked the 50th Anniversary of Earth Day, a time when we are all reminded about what we can do to help nurture our planet.

Apparently the Internal Revenue Service didn't get the memo.

An important analysis (subscription) from tax administration expert and attorney Hale Sheppard recently exposed another weapon the government has deployed against conservation-minded taxpayers who embody the best spirit of Earth Day (without all the politics). Unfortunately, the latest weapon, delivered via "Interim Guidance" by the IRS, can trace its lineage to an age-old tactic of tax collectors: when in doubt, inflict collateral damage. In this instance, the victims are the appraisers who help to value land that taxpayers are setting aside for conservation and enjoyment of future generations.

Throughout National Taxpayers Union's 40-plus years of working on IRS reform, we have witnessed the collateral damage ploy in many forms. In the past, even acquaintances haven't been safe. One of the most notorious cases that led to passage of the first Taxpayer

Key Facts:

The IRS has consistently subverted Congressional intent in its scrutiny of "conservation easements," a tax deduction for those who set aside land for environmental conservation reasons.

The IRS's pursuit of overzealous enforcement and penalties on conservation easements runs roughshod over taxpayers' rights and has a chilling effect on other conservationists.

The IRS should roll back Notice 2017-10, which triggered heightened scrutiny for land conservationists.

Bill of Rights in 1988 was that of Pennsylvania businessman Tom Treadway, who lost his business due to a bogus $247,000 tax assessment that was later thrown out on appeal. The tax agency didn't just go after Treadway though – his girlfriend's bank account was raided in the process as well.

Incidents like those surrounding Treadway have become increasingly rare, but various forms of intimidation persist. Customers of business owners under audit have been confronted with a raft of "routine questions" about how they conducted transactions with the taxpayer being investigated. Perfectly innocent and unrelated third parties to transactions under IRS scrutiny have been bombarded with Information Document Requests and tax form filing requirements. Advisors as well as professionals who perform arm's-length services for compiling information to substantiate a tax deduction are threatened with penalties and other disciplinary actions.

Nowhere are these tendencies on uglier display than in the IRS's attempt to subvert Congressional intent behind Section 170(h) of the Tax Code, a provision of statutory law that allows taxpayers to receive a federal income tax deduction for donations of land for conservation purposes. As we have noted many times before, the IRS's contempt for time-honored tax administration principles toward partnership-based conservation easement arrangements has proven to be a harbinger for wider abuses of taxpayer rights that NTU has worked hard to secure over the past 40-plus years.

Sheppard's well-researched piece, appearing in the May 2020 *Journal of Taxation* (subscription), provides an excellent overview of how the IRS has relentlessly evolved its methods of pursuing taxpayers who claim a conservation easement deduction, especially those who do so as a partnership of less-than wealthy individuals rather than as one single, often super-rich donor. That evolution, ongoing since the government designated what it pejoratively calls "syndicated easements" as a "listed transaction" in 2016, is motivated by the fact that the IRS has lost in court on so many 170(h) challenges that it must get creative to justify its crusade. Among the areas Sheppard identified, which are familiar to many NTU readers:

• Advancing Technical Arguments – Longstanding features of easement agreements suddenly become items of contention which, the IRS asserts, are grounds for disallowing a tax deduction. Standard amendment clauses, merger clauses, and proceeds clauses if an easement is extinguished, are just some of the "foot faults" the IRS has attempted to call.

• Questioning Conservation Purpose – Conservation can happen in many forms and Section 170(h) recognizes such, but the IRS has at times assumed its own judgment of what a "legitimate" attempt at preserving land for conservation is.

• Going Out on a Legal Limb – Sheppard recounted a highly technical proceeding against a conservation easement partnership involving matters such as "disguised sales" of deductions that "showed [the IRS'] willingness to raise novel legal/tax positions in Tax Court litigation."

• Challenging Valuations – One integral element to a conservation easement's valuation for tax deduction purposes has always been its "Highest and Best Use". This "HBU" calculation is generally necessary because in most cases, there is no comparable sale of an easement elsewhere upon which to base its fair market value. As Sheppard notes, the IRS acknowledged this principle in its own guide for auditors, but over the past few years the Service has argued for more exotic valuations that are favorable to the government, such as local property tax assessments.

But it is the fifth category of IRS actions Sheppard identified in this space that has undergone a quiet and very recent procedural transformation: penalties. Although the IRS has aggressively threatened penalties in the past against taxpayers and what it expansively calls "material advisors" in easement transactions, the appraisers who are charged with conducting objective valuations of the easements themselves are also under increasing pressure. The latest culprit is "Interim Guidance" the IRS issued with zero fanfare on

January 22 that strips away the due-process protections that appraisers have had when the IRS questions their professional judgment and seeks to levy diligence penalties. Because these penalties can severely impact an appraiser's livelihood, a penalty case review procedure involving a methodical justification for the IRS's position, oversight by several levels of managers, and an opportunity for the accused appraiser to respond is essential.

The latest interim guidance gives the IRS a shortcut. By Sheppard's estimation, a penalty assessment process that formerly involved input "by at least five experienced IRS employees" can now move forward on the initiative of just one Revenue Agent, "who likely has no training or education whatsoever in the field of valuation, making this decision alone, or at most with input from just one Examining Appraiser."

Why is this change so important? For one, it is a 180-degree departure from the direction that NTU and its allies in Congress have pursued on IRS reform since the 1970s: build in more checks and balances to enforcement actions which, if based on flawed information, could ruin an innocent taxpayer's life. It is the reason NTU pushed for provisions such as requiring IRS Area Director approval and judicial review for government seizures of primary residences, or managerial sign-offs for the levying other types of penalties. Without these types of safeguards, arbitrary or unjustified enforcement will become more prevalent.

Equally important is that the Interim Guidance is yet another way to create a "chilling effect" on a tax deduction that Congress has repeatedly strengthened and reaffirmed since its creation in the late 1970s. Appraisers are now under notice that the IRS has much greater latitude to question their professional judgment and punish them. How many appraisers, fearful of this imbalance of power, will simply quit valuations of conservation easements? Time will tell, but without qualified appraisals, most easements could not be transacted and as a result, a lawful deduction established by Congress would be effectively nullified by the tax agency. This outcome should be unthinkable for lawmakers. As Sheppard neatly summarizes:

> Revocation of procedural protections is always troublesome, but it acquires additional significance in the easement context, where the IRS 1) operates a 'compliance campaign' to audit every 'syndicated' easement, 2) concludes in virtually every case (regardless of the amount of due diligence conducted, the strength of appraisals offered by taxpayers, the quality and economic potential of the property donated, etc.) that the easement-related deduction should be $0, 3) argues that the donations are based on gross valuation misstatements, and 4) instructs Revenue Agents to evaluate appraisal issues while conducting the income tax audit.

The dangerous behavioral patterns the IRS has displayed toward conservation easement deductions must be addressed now; some have already infected the larger world of tax administration, by eroding key taxpayer rights laws and by violating basic principles such as avoiding retroactive enforcement. The following are practical steps that can and should be taken right away:

- **Roll back the retroactive "Listed Transaction."** IRS Notice 2017-10, which made certain partnership easement deductions subject to massive scrutiny, also took the highly unusual action of reaching back years into transactions that were once deemed perfectly legitimate. This enforcement approach should be unacceptable to taxpayers in any context. In a piece earlier this month for *Tax Notes* (subscription), attorneys Guinevere Moore and Elizabeth Yablonicky cogently argued that on the retroactivity basis alone, Notice 2017-10 may be invalid. The IRS could repeal, suspend, or modify the notice at any time, and by doing so could redesign an oversight process for Section 170(h) deductions that is more sensible.

- **Hold the IRS accountable for recent Executive Orders.** NTU has praised the Trump Administration for issuing two executive orders late last year that introduced transparency, accountability, and protections against informal guidance and arbitrary enforcement actions taken by federal agencies. Officials in both the executive and legislative branches should call upon the IRS to justify certain provisions of the Interim Guidance in January as well as certain provisions of IRS Notice 2017-10 in light of these orders. For example, Executive Order 13892 specifies that an agency "must avoid unfair surprise not only when it imposes penalties but also whenever it adjudges past conduct to have violated the law." Prior to Moore's and Yablonicky's article, Jenny L. Johnson Ware presented even more detail (subscription) on how these two Executive Orders ought to impact the IRS's ill-advised course.

- **Create a "Safe Harbor."** As my colleague Mattie Duppler wrote about in February, the National Taxpayer Advocate of the IRS has recommended that instead of pursuing more waves of litigation, the Service should work to develop clear guidelines as well as acceptable language for conservation easement agreements that will be acceptable in preventing government enforcement action against taxpayers. This suggestion, coming from the top IRS oversight official in the Executive Branch, is the clearest indication yet that the tax agency can properly balance compliance concerns with taxpayer rights in a way that benefits everyone.

- **Protect the recently established appeals process.** An article last week in Law360 painted a troubling picture of the independent tax audit appeals process, one that NTU strongly supported during debate and final passage of the Taxpayer First Act last year. Specifically, as author Joshua Rosenberg recounted, "Appeals already faces tremendous challenges in executing its mission, and the coronavirus pandemic, which has led the agency to temporarily shutter offices across the country, is set to exacerbate those difficulties." Those challenges include the lack of face-to-face meetings between appeals staff and practitioners that often result in quick settlements, the lack of IRS staff access to individual case files at closed government offices, and lack of available technology to process appeals efficiently.

  For the sake of all taxpayers, including those under audit for conservation easement deductions, it is important for the IRS to prioritize personnel and other resources so the new Office of Independent Appeals can function properly. Otherwise, the IRS will need to take remedial measures, such as agreeing quickly to "time-outs" on appeal cases that cannot be effectively resolved in the COVID-19 shutdown. Statutory interest that accrues on unpaid amounts in dispute during appeals should be suspended, with Congress's blessing.

Officials throughout the federal government can take other measures that would preserve Congressional intent behind Section 170(h) and establish best practices for oversight. NTU made many such recommendations here and here, including more common training standards for valuation of easements and a public-private sector "valuation panel" that could work out specific quirks in easement donations much in the way a similar body has functioned for donations of art.

Economically challenging times such as these make it all the more vital for both government and taxpayers to conserve precious financial resources. How ironic that the IRS's ill-advised attacks on a tax deduction intended to conserve land and historic structures is draining those resources. It need not be that way.

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