ISSUE BRIEF

“Abusive Tax Shelters” or Abuse of Taxpayers? IRS Should Learn Difference

by Pete Sepp | July 16, 2018

It may not have made headlines in the mainstream media, but many in the tax-administration world took notice on Friday when a few findings leaked from an Internal Revenue Service claim that certain taxpayers who had deductions for “syndicated conservation easements” were receiving massive, unwarranted windfalls. Over the weekend NTU had the opportunity to review what was made available at the request of Members of the Senate Finance Committee, and added to what we’ve long known, we believe taxpayers should take greater note of this seemingly obscure issue. The IRS’s claim appears to be emblematic of the way the tax agency too often uses blunt tools for jobs that need refined instruments.

Here at NTU, we have a history of looking deeply into the administrative machinery of the tax system and figuring out how its gears can function more smoothly without grinding up taxpayers' rights in the process. We have submitted comments on IRS rules ranging from family estate valuations for tax purposes to the use of outside counsel in audit situations. We've also made detailed recommendations on how to

prevent the IRS from using extraordinary powers such as the designated summons or designating cases for litigation, which if misapplied can stamp out legitimate taxpayer rights to appeal audit results. It was during research on the latter problem several months ago that we first encountered a curious decision by the tax agency.

We have long argued that IRS designation prerogatives should be carefully backed up by chain of command approvals, and generally limited to precedential cases involving only those tax schemes that are blatantly, truly abusive. Among these are what the IRS calls "listed transactions" -- essentially a dishonor roll of tax strategies that in the government's judgment appear motivated by greed rather than "economic substance" (more on that below). Those taxpayers who claim these items on their returns are subjected to harsher scrutiny as well as excruciating reporting requirements throughout the year.

Ticking through this list, you'll find exotic items for which the IRS likely made the right call in labeling as abusive, such as "Corporate Distributions of Encumbered Property " (known as "BOSS"), "Inflated Partnership Basis Transactions" ("son of BOSS") and application of Internal Revenue Code Section 935 to "Guamian trusts". Imagine our surprise when we came across the 36th and final listed transaction involving a highly conventional activity: "conservation easements." What could be going on here? For taxpayers concerned about due process and sound, simple compliance procedures, the answer is not encouraging.

The concept of "conservation easements" – allowing a landowner to donate or grant certain specific rights of use to others while still retaining the property – is centuries old. A specific federal tax deduction for conservation-based easements also has an impressive pedigree. First created 40 years ago by an act of Congress, it recognizes the social and economic contribution toward environmental preservation when taxpayers decide to set aside land in perpetuity for ecological protection purposes of benefit to the public (other purposes such as public recreation or historical preservation are also recognized). States have likewise adopted such programs. Under this arrangement, a donor can make an agreement that specifies the terms of how the land is to be conserved and stewarded for environmental purposes. The deduction subsequently went through several permutations and refinements, most recently through the widely-supported (and NTU-backed) Protecting Americans from Tax Hikes (PATH) Act of 2015.

Recently, however, egged on by a few Members of Congress as well as tax practitioners who've made a living off advising clients to set up conservation easements in one particular way, the IRS adopted the vaguely sinister epithet of "syndicated" to describe easement deductions that are structured to allow groups of people to contribute land to conservation and share the tax incentive benefits. From this followed a contorted train of assumptions that led the IRS to issue a listed transaction notice in December of 2016 and then report on taxpayers' forms only a narrow calculation of deduction numbers with no context reflecting the quality and quantity of land conserved. Why is this decision troubling for the integrity of tax administration writ large? There are a few possibilities.

From a practical, fiscal standpoint, the deduction is more efficient than government-driven spending programs. A fundamental driving principle of the charitable contributions tax deduction is that it recognizes the value of private sector initiatives for the betterment of society, often at a far greater return for every dollar spent than government programs could possibly achieve. The efficiency gains for numerous environmental purposes – such as wildlife habitat, air quality, or clean water – are considerable, as they avoid lengthy bureaucratic processes normally associated with government-driven environmental programs. More than 40 million acres of land have been put under private stewardship through this policy. Like any deduction (e.g. write-offs for teachers' out of pocket school supplies, or restaurant donations to food banks) conservation easements mean that the Treasury collects less than 100 percent of the statutory tax rate. But what of the value of this private sector activity to taxpayers, which helps to offset even more federal expenditures on schools, hunger programs, and land preservation?

It should be no surprise to taxpayers that federal stewardship of property can be negligent. After all, since 2003 the Government Accountability Office has designated "managing federal real property" on its high-risk list for waste. Beyond buildings and the land they sit on, however, Washington has also been deficient in how it runs conservation-focused land programs. Over many years, our colleagues at the Cato Institute, the Heritage Foundation, and the Property and Environment Research Center have shown how agencies such as the National Park Service and the Bureau of Land Management simply can't effectively oversee the roughly 640 million acres over which they have jurisdiction.

A fair accounting of the deduction's overall impact would therefore include considerations such as:

- Value to the environment of preserved land such as carbon sinks, water supplies, and natural flood barriers (the latter being a huge consideration to taxpayers already on the hook for billions through the National Flood Insurance Program).
- Foregone governmental administrative costs by leaving the stewardship of the lands a private responsibility; and
- The value to local economies of bottom-up community planning, whereby residents and concerned citizens drive land-use decisions more than government officials.

In any case, the IRS's estimates of "revenue loss" due to the conservation easement deduction have been highly speculative and led to colossal revisions. In March of this year, the IRS informed the Senate Finance Committee that the total aggregate deductions involved with syndicated conservation easements could be $230 billion. This figure was subsequently adjusted by hundreds of billions to about $20 billion (!). Where the exact figure lies is unknown, but wild swings in estimates such as these are certainly not conducive to rational policymaking.

From NTU's perspective, what is perhaps even more worrisome than just the fiscal calculus is what the IRS's behavior toward easement deductions augurs for sound tax administration. The process for determining what is and isn't a listed transaction is not necessarily straightforward. It may or may not be informed by public hearings, preliminary guidance, rulemakings, or other traditional deliberative mechanisms that help to prevent surprises to taxpayers and their advisors. In the case of listing certain conservation easement deduction transactions, the IRS has leapfrogged over some of these safeguards. Worse, the agency applied its decision retroactively to transactions dating back as far as 2010, a terribly disruptive move that will impose millions of dollars in deadweight costs on taxpayers who had been led to believe they were in compliance with the law. The IRS's subsequent amendment to its December 2016 rule, granting an extra four months of time for those affected by hurricanes to submit to the new regime, is of minimal comfort.

Furthermore, it's important to understand just what this listed transaction designation can entail for compliance purposes. Failure to properly report such activity can result in huge penalties to taxpayers under Section 6707A; additional penalties under Sections 6707 and 6708 could fall upon tax advisors, along with other accuracy and understatement penalties. These rival the harshest penalties in all of federal tax law.

Avoiding these penalties is not simply a matter of following clear-cut dictates of the law. To determine the legitimacy of the transaction, it may be subject to what is known as the economic substance doctrine. One prong of this often-litigated test is designed to determine whether a taxpayer is engaging in a particular action because it makes good business, financial, or social sense over and above its immediate tax consequence. This is far more difficult than it may seem. As an April 1 article in The Tax Adviser from Kathryn Proper, et al. astutely put it: “Unfortunately, facts supporting a credible business purpose that would allow the taxpayer to refute the application of the economic substance doctrine and avoid strict liability for penalties are difficult to imagine in the typical syndicated conservation easement transaction.” To do so, the authors explain, a taxpayer might have to produce something akin to a development plan for a given piece of land, with specific enumerated improvements and construction timetables, crafted well before an easement deduction was even considered.

The economic substance doctrine, while useful in some circumstances, can be taken to absurd extremes in cases like these. It essentially requires a taxpayer to prove their motivation in taking a deduction. Imagine if donations of, say, high-quality used microscopes to local nonprofit science clubs became listed transactions. In order to satisfy part of the economic substance doctrine, a science buff who genuinely wants to pass along a gift to studious children might have to demonstrate that he intended to use that very microscope for verifying the chemical structure of a new formula that could have netted him thousands of dollars in extra income. How could he substantiate such a thing? Taped phone conversations with a firm interested in his formula? A dissertation quantifying the potential social value of his discovery, rounded to the nearest thousand dollars? And the headaches would only compound if the donation of the microscope were made in 2010, as the science buff would have to piece together such a history that has faded into distant memory.

No, donating a microscope is not as complex or monetarily significant as most land contributions between a donor and a nonprofit organization. Yet at least some common principles behind both situations exist, and they cannot be ignored. How does a taxpayer prove pureness of heart, or more absurdly for tax law purposes, disprove that he had anything but pureness of heart? And how competent is government to serve as an arbiter of the long-term economic value of a charitable contribution? A used microscope may have a retail value that can be readily ascertained, but suppose that one donation from a science buff gave one student the

impetus to complete an experiment that revolutionized health care, or energy production, or environmental quality?

At the heart of this matter is the thorny issue of determining exactly how ecologically and economically valuable setting aside a given parcel of land can be, and therefore how large the deduction should be. Adding the word "syndicated" to the term "conservation easement" may be a clever rhetorical hot-button tactic, but whether one person, a family, a group of like-minded people, or a nonprofit participates in the process is not all that relevant. Instead of waging a war of words whose collateral damage will be the legitimate purpose of land conservation that Congress intended when it created and expanded the deduction, it is time for more practical approaches. The IRS could withdraw the notice creating the listed transaction, and take more practical approaches:

- The IRS could have issued a "job aid" – a process that facilitates dialogue within the preparation community on technically complex compliance matters – on questions of valuation and accurate appraisals. NTU made just such a recommendation two years ago for a different issue: valuation discounts with family-owned businesses for estate tax purposes.
- The agency could also have issued additional guidance on how practitioners in this area could avoid penalties surrounding valuation and appraisals. A strongly crafted memorandum could actually encourage tax advisors and taxpayers to rely on land appraisers with more solid professional credentials and more conservative estimation techniques. Working with Congress, the IRS could even develop best practices and training requirements for appraisers.
- Taxpayers could be better educated and informed about the need for multiple appraisal opinions and arms-length attorney reviews of all donation agreements with the nonprofit organizations that will manage the land conservation. Appraisers themselves could receive additional training in this area.
- Much in the way that the IRS created an "Art Advisory Panel" of outside experts to mediate the values of art donations for tax purposes, the agency could create a similar entity for conservation easements. According to Senators Christopher Murphy (D-CT) an Richard Blumenthal (D-CT), who suggested this concept in a February 2016 letter to then-IRS Commissioner John Koskinen, the Art Advisory Panel resolved more than 95 percent of disputed cases brought before it, "without an audit process that is lengthy and expensive for the Service, taxpayer, and donor."

In February of 2016, Senators Murphy and Blumenthal also did an important public service in pointing out a "trend recounted by a number of constituents" audited over their easement deductions who described the process as "antagonistic, aggressively adversarial, lengthy, and expensive – even when the final result is a 'no change' letter from the Service." Readers should note that the Senators penned their letter some ten months beforethe IRS issued its notice of listed transaction.

Since that time, matters appear not to have improved, and indeed seem to be deteriorating as the IRS continues to play take cheap shots at taxpayers instead of looking at whether they were in substantial compliance with the law. In a Law 360 article from less than two weeks ago, tax experts Gregory Rhodes and Tucker Thoni warned of six "IRS attacks" on the easement deduction that have evolved through recent litigation and other activities. One example they cite as "troubling" is the IRS's position of taking issue with "amendment clauses" in easement agreements, which allow both parties, by mutual consent, to make prudent adjustments that ensure evolving realities are taken into account for preserving land in perpetuity. Amendment clauses are common, hitherto noncontroversial features of many easement agreements.

Why spill all this electronic equivalent of ink over what seems to be an arcane tax issue and hurt an important policy that is working and can be improved? Because arcana is the very heart of tax administration. And in the tax world, what's arcane today can become commonplace tomorrow: doctrines, theories, and enforcement tactics developed for one area of the tax system have a way replicating themselves. For this reason, NTU will keep a watchful eye on developments across many areas of tax policy in Congress, the IRS, and the tax practitioner community. *How* you pay taxes can be as important as *how much* you pay in taxes.