IRS SHINES A SPOTLIGHT ON SYNDICATED CONSERVATION EASEMENTS

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U.S. Tax Reform Resources Alert

The IRS has ramped up its enforcement efforts on syndicated conservation easements. On September 10, 2018, the IRS announced five new Large Business and International Division ("LB&I") compliance campaigns, including a campaign focused on syndicated conservation easement transactions. This intensified scrutiny comes roughly 18 months after the IRS identified syndicated conservation easement transactions as listed transactions that require disclosure statements to the IRS by both investors and material advisors. This new effort will enhance IRS enforcement of those disclosure requirements as well as the structure and easement valuation requirements of the transactions themselves.

LB&I has overhauled its approach to audits to more efficiently deploy increasingly limited resources by identifying issues most likely to result in examination adjustments. Issues are identified through LB&I data analysis and suggestions from IRS employees. The announcement of a campaign focused on syndicated conservation easement transactions puts these transactions squarely among the list of priority issues where LB&I has decided to focus its resources. Individuals investing in or marketing such transactions should consider this heightened risk and ensure that the transaction is properly vetted and supported.

WHAT IS A SYNDICATED CONSERVATION EASEMENT?

Conservation easements are used for land conservation purposes by restricting the use of the land. Easements might be used to preserve a wildlife habitat, a scenic view, water quality or agricultural property. A standard conservation easement is created when a real property owner grants a restriction on the use of the property, in perpetuity, to a qualified organization exclusively for conservation purposes. The nature of the restriction is often a point of negotiation and can allow some productive use of the property while restricting others. For example, an easement may be placed on agricultural property that allows farming but forbids future residential development. This new use restriction will lower the value of the subject parcel, and federal tax law allows for an income tax deduction equal to that change in value. Notably, the change in value includes the value of the lost development potential of the property due to the new use restriction, not just the change in current fair market value. The deduction can be used to offset up to 50% of a taxpayer's adjusted gross income in a tax year. The IRS further allows taxpayers to carry over contributions that exceed adjusted gross income. For a qualified conservation transaction, the time limit on those carry-overs is 15 years.

Syndicated conservation easement transactions can take many forms but generally involve a pass-through entity that is used to acquire real property on behalf of multiple investors. A conservation easement is then created on the property, and the tax benefits of that easement are allocated among the investors. These transactions must be carefully structured to ensure compliance with the substantial economic effect doctrine that generally requires income and tax benefits be allocated among partners in the same proportion as the partners' interests in the

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partnership unless there is "substantial economic effect" for a different allocation. To ensure accurate valuations of the property for purposes of determining the contribution amount, appraisals must be performed by a qualified appraiser that complies with Treasury regulations governing qualified appraisals.

IRS SCRUTINY

Syndicated conservation easements have attracted increased IRS attention in recent years, prompting enhanced enforcement action. The IRS is concerned that allocations of contributions to investors may be based on investors' abilities to reduce their tax liabilities rather than in accordance with their ownership interests. Inflated property appraisals that rely on development potential to show large increases in property values in short time frames in order to increase contribution amounts are another concern of the agency; because of the inclusion of lost development value in the valuation of the easement, the corresponding tax deduction is generally much higher than the initial investment to purchase the property. According to the IRS, in 2017 the average deduction return for each dollar invested in these transactions was $4.74.

In December of 2016 IRS Notice 2017-10 identified syndicated conservation easements as tax avoidance, or "listed," transactions. This designation did not change the actual law governing syndicated conservation easements, but taxpayers participating in such transactions in any year since 2010 where the value of the deduction is at least 2.5 times the investment are now required to meet certain disclosure requirements. Investors face significant penalties for failure to disclose. Failure to disclose participation in a listed transaction will result in a penalty of 75% of the tax savings obtained through such transactions, with a minimum penalty of $5,000 for natural persons ($10,000 for other taxpayers). In addition, investors who fail to disclose the transactions will face heightened penalties for understating their tax liability.

Transaction material advisors also have disclosure obligations. A "Material Advisor" is defined as any person or entity that provides any material aid, assistance, or advice with respect to the listed transaction and directly or indirectly receives or expects to receive gross income in excess of $10,000 for a transaction that provides substantially all of the tax benefits to individuals or $25,000 for all other transactions. A material advisor that fails to properly disclose a listed transaction is subject to a penalty of the greater of (i) $200,000 or (ii) 50% of the advisor's gross income attributable to aid, assistance, or advice provided with respect to the transaction before the date the information return that includes the transaction is filed (75% in the case of intentional disregard).

While conservation easements are already often subject to audit, LB&I's new compliance campaign can be expected to result in an increased rate of audits focused on disclosure requirements along with overvaluation of easements and potential violations of the economic substance doctrine, partnership anti-abuse rules, and other rules and doctrines. Along with increased examinations, the IRS has also identified other potential compliance treatments including soft notices/letters, voluntary self-correction, practitioner outreach, and, potentially, published guidance.

Please contact any member of the K&L Gates tax policy and tax teams to assist in determining the impact of the new campaign on you and your business. This new scrutiny is likely to change the risk assessment for syndicated conservation easements in significant ways, and now is the time to ensure you are prepared.

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