Newest IRS Action in Conservation Easement Disputes: Same Data Used Against Different Parties

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Partnerships and others under attack by the IRS as part of its "compliance campaign" against conservation easement and substantially similar transactions need to be aware of relevant Chief Counsel directives and implement appropriate defense strategies from the very start of the audit process.

Just when one begins to think that the IRS cannot possibly take any more unilateral steps in its efforts to attack so-called syndicated conservation easement transactions ("SCETs") and substantially similar transactions ("SSTs"), it does. In September 2020, the IRS instructed its personnel to gather and utilize, for multiple purposes and proceedings, all data possible about SCETs and SSTs. The IRS also indicated that such multi-tasking and data sharing, involving lots of unrelated parties and transactions, would not violate the general prohibition against disclosure of returns and return information found in Section 6103. The IRS, in essence, announced that it will attempt to present as much evidence as possible, relating to partnerships, promoters, appraisers, accommodating parties, and others, in overlapping tax audits, investigations, and litigation.

This article summarizes conservation easement donations and related tax deductions, identifies the parties that the IRS is now pursuing, explains the non-disclosure rules and applicable exceptions, unpacks three IRS pronouncements attempting to justify potential violations of taxpayer protections and evidentiary rules, and reminds partnerships and others affiliated with SCETs and SSTs of the importance of understanding the IRS's strategies and implanting processes to defend against them from the outset.

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Overview of Conservation Easement Donations and Deductions

Taxpayers who own valuable undeveloped real property have several choices. For instance, they might (i) hold the property for investment purposes, selling it when it appreciates sufficiently, (ii) determine how to maximize profitability from the property and do that, regardless of the negative effects on the local environment, community, or economy, or (iii) voluntarily restrict certain future uses of the property, such that it is protected forever for the benefit of society. The third option, known as donating a "conservation easement," not only achieves the goal of environmental protection, but also triggers another benefit, tax deductions for donors.[1]

As one would expect, taxpayers cannot donate an easement on any old property and claim a tax deduction; they must demonstrate that the property was worth protecting. A donation has an acceptable "conservation purpose" if it meets at least one of the following requirements: (i) it preserves land for outdoor recreation by, or the education of, the general public; (ii) it preserves a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem; (iii) it preserves open space (including farmland and forest land) for the scenic enjoyment of the general public and will yield a significant public benefit; (iv) it preserves open space (including farmland and forest land) pursuant to a federal, state, or local governmental conservation policy, and will yield a significant public benefit; or (v) it preserves a historically important land area or a certified historic structure.[2]

Taxpayers memorialize the donation to charity by filing a public Deed of Conservation Easement ("Deed"). In preparing the Deed, taxpayers often coordinate with a land trust to identify certain limited activities that can continue on the property after the donation, without interfering with the Deed, without prejudicing the conservation purposes, and without jeopardizing the tax deduction.[3] These activities are called "reserved rights." The IRS openly recognizes, in its Conservation Easement Audit Techniques Guide ("ATG"), that reserved rights are ubiquitous.[4]

The IRS will not allow the tax deduction stemming from a conservation easement unless the taxpayer provides the land trust, before making the donation, "documentation sufficient to establish the condition of the property at the time of the gift."[5] This is called the Baseline Report. It may feature several things, including, but not limited to, (i) a map from the U.S. Geological Survey, showing the property line and other contiguous or nearby protected areas, (ii) a map showing all existing man-made improvements or incursions, vegetation, flora and fauna (*e.g.*, locations of rare species, animal breeding and roosting areas, and migration routes), land use history, and distinct natural features, (iii) an aerial photograph of the property taken as close as possible to the date of the donation, and (iv) on-site photographs taken at various locations.[6]

Properly claiming the tax deduction stemming from an easement donation is surprisingly complicated.

The value of the conservation easement is the fair market value ("FMV") of the property at the time of the donation.[7] The term FMV ordinarily means the price on which a willing buyer and willing seller would agree, with neither party being obligated to participate in the transaction, and with both parties having reasonable knowledge of the relevant facts.[8] The IRS explains in its ATG that the best evidence of the FMV of an easement would be the sale price of other easements that are comparable in size, location, etc. The ATG recognizes, though, that it is difficult, if not impossible, to find comparable sales of properties encumbered by easements.[9]

Consequently, appraisers often must use the before-and-after method instead. This means that an appraiser must determine the highest and best use ("HBU") of the property *and* the corresponding FMV twice. First, the appraiser calculates the FMV if the property were put to its HBU, which generates the "before" value. Second, the appraiser identifies the FMV, taking into account the restrictions on the property imposed by the easement, which creates the "after" value.[10] The difference between the "before" value and "after" value, with certain other adjustments, produces the value of the easement donation.

A key concept mentioned in the preceding paragraph is a property's HBU. This is the most profitable use for which the property is adaptable and needed in the reasonably near future.[11] The term HBU also means the use of property that is physically possible, legally permissible, financially feasible, and maximally productive.[12] Importantly, valuation in the easement context does not depend on whether the owner has actually put the property to its HBU in the past.[13] The HBU can be *any* realistic potential use of the property.[14] Common HBUs are construction of a residential community, creation of a mixed-use development, or mining.

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1 Section 170(f)(3)(B)(iii); Reg. 1.170A-7(a)(5); Section 170(h)(1); Section 170(h)(2); Reg. 1.170A–14(a); Reg. 1.170A–14(b)(2).

2 Section 170(h)(4)(A); Reg. 170A-14(d)(1); S. Rep't 96–1007, at 10 (1980).

3 Reg. 1.170A-14(b)(2).

4 Internal Revenue Service, *Conservation Easement Audit Techniques Guide* (rev. 11/4/2016), pg. 23; *see also* Reg. 1.170A-14(e)(2) and (3).

5 Reg. 1.170A-14(g)(5)(i).

6 *Id.*

7 Section 170(a)(1); Reg. 1.170A-1(c)(1).

8 Reg. 1.170A-1(c)(2).

9 Internal Revenue Service, *Conservation Easement Audit Techniques Guide* (rev. 11/4/2016), pg. 41.

10 *Id.*

11 Olson v. United States, 292 U.S. 246, 255 (1934).

12 Esgar Corp., 744 F.3d 648, 659 n.10 (CA-10, 2014).

13 *Id.* at 657.

14 Symington, 87 TC 892, 896 (1986).

Properly claiming the tax deduction stemming from an easement donation is surprisingly complicated. It involves a significant amount of actions and documents. The main ones are as follows: The taxpayer must (i) obtain a "qualified appraisal" from a "qualified appraiser," (ii) demonstrate that the land trust is a "qualified organization," (iii) obtain a Baseline Report adequately describing the condition of the property at the time of the donation and the reasons why it is worthy of protection, (iv) complete a Form 8283 (Noncash Charitable Contributions) and have it executed by all relevant parties, including the taxpayer, appraiser, and land trust, (v) assuming that the taxpayer is a partnership, file a timely Form 1065, enclosing Form 8283 and the qualified appraisal, (vi) receive from the land trust a "contemporaneous written acknowledgement," both for the easement itself and for any endowment/stewardship fee donated to finance perpetual protection of the property, and (vii) send all the partners their Schedules K-1 (Partner's Share of Income, Deductions, Credits, etc.) and a copy of Form 8283.[15]

Expansion of Parties Under Attack

Congress has endorsed conservation easements for decades. Even a recent congressional report strongly criticizing easements had to acknowledge that "the conservation-easement tax incentive under [Section 170(h)] has enjoyed broad bipartisan support."[16] Notwithstanding this widespread backing by the legislative branch, the IRS persists in attacking partnerships involved in what it considers SCETs or SSTs. Partnerships are not the only ones under fire; the IRS has also started hounding a long list of others. Details follow.

The IRS launched a "compliance campaign" in 2017, devoting dozens of Revenue Agents and other IRS personnel to the cause. The goal of the IRS is to audit *every* partnership that engaged in an SCET and SST, presumably until it exhausts the funding and/or human resources.[17]

The IRS also emphasized (via news releases, tax conferences, and articles) that it intended to pursue promoters, appraisers, return preparers, material advisors, accommodating entities, charitable organizations, and others.[18] Many of these plans have come to fruition lately. For example, the IRS recently began its assault on appraisers, which was marked by the revocation of long-standing procedural protections. The Internal Revenue Manual has historically featured a multi-level review process designed to ensure that an appraiser has engaged in a high degree of wrongdoing before the IRS seeks punishment.[19] At least five experienced IRS employees (*i.e.*, the Revenue Agent, Examining Appraiser, Primary Review Appraiser, Secondary Review Appraiser, and Review Manager) had to agree before Section 6695A penalties could be assessed.[20] Then, in January 2020, the IRS issued a memo called "Interim Guidance on IRC 6695A Penalty Case Reviews," which eliminated the multi-layer review process.[21] The prior procedures required concurrence by at least five experienced IRS employees before seeking penalties, but now a Revenue Agent, who likely has no valuation training or education whatsoever, can make this decision alone, or with input from just one Examining Appraiser.

Next, in February 2020, the IRS appointed a new "Promoter Investigations Coordinator," who is in charge of interacting with the Civil Division, Criminal Investigation Division, Chief Counsel, and Office of Professional Responsibility ("OPR") to develop and implement promoter enforcement, on both an individual and strategic level.[22]

Finally, in March 2020, the IRS formed the new "Fraud Enforcement Office," whose leader works closely with the new "Promoter Investigations Coordinator."[23]

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15 *See* Internal Revenue Service, *Conservation Easement Audit Techniques Guide* (rev. 11/4/2016), pgs. 24-30; IRS Publication 1771, *Charitable Contributions—Substantiation and Disclosure Requirements*; IRS Publication 526, *Charitable Contributions*; Section 170(f)(8); Section 170(f)(11); Reg. 1.170A-13; Notice 2006-96; TD 9836.

16 U.S. Senate, Committee on Finance, Syndicated Conservation Easement Transactions, 116th Cong., 2d Sess., Senate Report 116-44 (August 2020), pg. 1; *See also* Conservation Easement Incentive Act of 2015, Senate 330, 114th Cong,; Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 2015, JCS-1-16* (March 2016).

17 *See, e.g.*, Hoffman, "Conservation Easement Crackdown a Portent, Rettig Says," 2019 Tax Notes Today Federal 221-9 (Nov. 14, 2019); Richman, "Multiple Divisions Coming for Syndicated Conservation Easements," 2019 Tax Notes Today Federal 220-3 (Nov. 13, 2019); Internal Revenue Service, *IRS Increase Enforcement Action on Syndicated Conservation Easements, IR-2019-182* (Nov. 12, 2019); Parillo, "IRS Is Building Up Its Easement Toolbox," 2019 Tax Notes Today Federal 222-6 (Nov. 15, 2019).

18 Internal Revenue Service, *IRS Increase Enforcement Action on Syndicated Conservation Easements, IR-2019-182* (Nov. 12, 2019); Internal Revenue Service, *IRS Continues Enforcement Efforts in Conservation Easement Cases Following Latest Tax Court Decision, IR-2019-213* (Dec. 20, 2019); Richman, "Multiple Divisions Coming for Syndicated Conservation Easements," 2019 Tax Notes Today 220-3 (Nov. 13, 2019); Hoffman, "Conservation Easement Crackdown a Portent, Rettig Says," 2019 Tax Notes Today 221-9 (Nov. 14, 2019); Parillo, "IRS Is Building Up Its Easement Toolbox," 2019 Tax Notes Today 222-6 (Nov. 15, 2019); Parillo, "IRS Looking for Promoter Links as Easement Crackdown Grows," Tax Notes Today, Doc. 2019-47134 (Dec. 13, 2019).

19 IRM section 20.1.12.7 (12/18/2017).

20 IRM section 20.1.12.7.4 (12/18/2017).

21 Tax Notes Doc. 2020-3440 (Jan. 22, 2020), consisting of LB&I-20-0120-001; *see* Sheppard, "Analyzing Five Obscure IRS Actions in 2020 with Serious Implications for Conservation Easement Disputes," 133 JTAX 11 (July 2020).

22 Parillo, "IRS Assigns Point Person on Promoter Investigations," Federal Tax Notes Today Doc. 2020-6890 (Feb. 25, 2020).

23 IRS News Release IR-2020-49 (March 5, 2020).

24 Section 6103(a).

25 Section 6103(b)(1).

26 Section 6103(b)(2)(D).

27 Section 6103(h)(1). The term "tax administration" means (i) the administration, management, conduct, direction, and supervision of the application of federal tax laws and treaties (ii) the development of federal tax policy related to existing or proposed federal tax laws or treaties, and (iii) assessment, collection, enforcement, litigation, publication, and statistical gathering functions under such laws or treaties. *See* Section 6103(b)(4)(A)(i); Section 6103(b)(4)(A)(ii); Section 6103(b)(4)(B).

28 Section 6103(h)(4)(A).

29 Section 6103(h)(4)(B).

30 Section 6103(h)(4)(C).

31 Section 6103(l)(4)(B).

32 IRS Chief Counsel Directive 2006-003 (Oct. 25, 2005).

33 IRS Chief Counsel Directive 2006-003 (Oct. 25, 2005), section 1.

34 IRS Chief Counsel Directive 2006-003 (Oct. 25, 2005), section 2.

35 Section 6103(h)(4)(B).

36 IRS Chief Counsel Directive 2006-003 (Oct. 25, 2005), section 3. Citing ACM, TC Docket No. 10472-93 (Aug. 18, 1995).

Protecting Taxpayer Data and Relevant Exceptions

Section 6103 generally requires the IRS to safeguard the confidentiality of "returns" and "return information."[24]

As one would expect, in the spirit of protecting sensitive data, the relevant definitions are broad. The term "return" means any original or amended tax return, information return, or claim for refund, including all corresponding schedules, attachments, statements, lists, etc.[25]

For its part, the phrase "return information" encompasses the following: (i) a taxpayer's identity; (ii) the nature, source, or amount of a taxpayer's income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, taxes withheld, deficiencies, overassessments, or tax payments; (iii) whether the taxpayer's return was, is being, or will be examined or investigated; (iv) any other data received by, recorded by, prepared by, furnished to, or collected by the IRS with respect to a return or a determination of the existence of a liability of any person for any tax, penalty, interest, fine, forfeiture, or other imposition; (v) any part of a written determination (or any related background document) that is not open to public inspection; and (vi) a Closing Agreement or similar agreement, along with any relevant background data.[26]

There are several exceptions to the general prohibition against the IRS disclosing "returns" and/or "return information." The following five exceptions are relevant to this article.

First, IRS personnel ordinarily have access to returns and return information if their official duties require inspection or disclosure for "tax administration" purposes ("Tax Administration Test").[27]

Second, IRS personnel can reveal a return or return information in a judicial or administrative proceeding, provided that such proceeding pertains to tax administration, and the taxpayer is a party to the relevant proceeding ("Party Test").[28]

Third, disclosure is permitted in a judicial or administrative proceeding related to tax administration, if "the treatment of an item reflected on [a third-party's return] is directly related to the resolution of an issue in the proceeding" ("Item Test").[29]

Fourth, a return or return information of a third-party can be disclosed in a judicial or administrative proceeding related to tax administration, in situations where it "directly relates to a transactional relationship between a person who is a party to the proceeding and [the third-party] and directly affects the resolution of an issue in the proceeding" ("Transactional Test").[30]

Fifth, outside the area of "tax administration," IRS personnel are authorized to disclose returns and return information when they will be used in, or in preparation for, an administrative action or proceeding under Circular 230, to the extent that such disclosure is necessary to advance or protect U.S. government interests ("OPR Assistance Test").[31]

In summary, Section 6103 ordinarily mandates that the IRS not disclose, internally or externally, any taxpayer "returns" or "return information," as these concepts are broadly defined. However, the IRS might disregard the general nondisclosure when the situation meets the Tax Administration Test, Party Test, Item Test, Transactional Test, or OPR Assistance Test.

The IRS launched a "compliance campaign" in 2017, devoting dozens of Revenue Agents and other IRS personnel to the cause.

Series of IRS Notices

The IRS has issued a series of notices over the years about disclosure of data, and the effect of Section 6103, in the situations involving "tax shelter matters."

First Notice—October 2005

The first notice was Chief Counsel Directive 2006-003 ("First CCD").[32] The IRS indicated that its purpose was to provide guidance regarding (i) disclosure under Section 6103 of returns and return information gathered by the IRS in civil examinations and other investigations of "tax shelter promoters" and "tax shelter investors," and (ii) disclosure of such data in judicial or administrative tax proceedings.[33]

The IRS explained in the First CCD that, during the course of a promoter, criminal, and/or injunction investigation, the IRS often obtains information about not only the promoters but also the investors. As for the former, the IRS might acquire items that promoters provided to multiple investors, such as promotional materials, promises about tax or financial results, descriptions of fees, etc. With respect to the latter, the IRS might get their names, prospectuses, and sales contracts. The First CCD indicated that this type of data often shows a "pattern or practice." For instance, it might show a "consistent lack of bona fide business purpose" among the investors in the same or substantially similar arrangements.[34]

Focus on the Item Test. As explained above, the Item Test usurps the general prohibition against disclosure, and allows the IRS to reveal taxpayer data in a judicial or administrative proceeding, if "the treatment of an item reflected on [a third party's] return is directly related to the resolution of an issue in the proceeding."[35] The IRS, citing to an earlier Tax Court decision, stated in the First CCD that it can disclose information about taxpayers who participated in substantially similar transactions involving the same promoter.[36]

The First CCD explained that the question of whether third-party data directly relates to an issue depends on the nature of the particular proceeding. By way of illustration, the First CCD argued that the manner in which a third-party reported a loss on a tax return can directly relate to the issue of whether the taxpayer at issue (*i.e.*, the one who is a party in the relevant proceeding) should be allowed to claim a loss from

a substantially similar transaction. This is because the collective conduct of *all* the investors (*i.e.*, the "pattern evidence") can be used by the IRS to demonstrate that *none* of the investors could have a bona fide business purpose for investing in the alleged tax shelter.

Expanding on this notion, the IRS stated in the First CCD that information it obtains while auditing a third-party (such as promotional materials from the same promoter, and responses to Information Document Requests inquiring about the third-party's non-tax purposes for investing in a substantially similar transaction) directly relates to the resolution of an issue in the taxpayer's proceeding. Therefore, the First CCD concludes that the IRS is entitled to disclose the data about the third-party in a judicial or administrative tax proceeding involving the taxpayer pursuant to the Item Test.[37]

The First CCD contained the following example about the Item Test and pattern evidence:

> In a judicial proceeding, the [IRS] argues that Investor A engaged in an abusive transaction for the sole purpose of tax avoidance. Investor A responds that the transaction was motivated by the non-tax purpose of portfolio diversification and was tailored to effect this specific purpose. The [IRS] refutes Investor A's contention by showing that the transaction was not unique and that other taxpayers (Investors B, C, D, E and F) all participated in substantially similar transactions through the same promoter, all reported similar items of income, deduction and loss, and all claimed a similar non-tax purpose for entering into the transaction.
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> The treatment of an item reflected on Investor B, C, D, E and F's returns is directly related to the resolution of an issue in Investor A's proceeding (whether the loss reported by Investor A arose from a transaction that was a sham in substance because it lacked independent economic substance or business purpose). As a result, in Investor A's judicial proceeding, the disclosure of tax information obtained during the [IRS's] examinations of Investors B, C, D, E and F regarding their reporting of the tax shelter loss is permissible as pattern evidence.[38]

The IRS has issued a series of notices over the years about disclosure of data, and the effect of Section 6103, in the situations involving "tax shelter matters."

Focus on the Transactional Test. The First CCD explored one more exception to the normal prohibition against disclosure of return or return information, the Transactional Test. This allows the IRS to reveal data when it "directly relates to a transactional relationship between a person who is a party to the proceeding and [a third-party] and directly affects the resolution of an issue in the proceeding."[39] With no additional explanation, the First CCD simply presented an example of this exception:

> In [an] injunction action against Promoter A, the [IRS] intends to disclose certain tax information of Investor B relating to his participation in the tax shelter promoted to him by Promoter A. This return information consists of the information provided to Investor B by Promoter A outlining the details of the shelter and the details of Investor B's specific investment in the tax shelter . . . Investor B's tax information can be introduced in the injunction action against Promoter A . . . since it directly relates to a transactional relationship between Promoter A and Investor B and directly affects the resolution of an issue in the injunction proceeding.[40]

Second Notice—November 2005

The IRS next issued Chief Counsel Directive 2006-006 ("Second CCD"), whose sole function was to supply additional definitions and examples of the principles described previously in the First CCD.[41]

Clarifying key terms. The Second CCD clarified that the *administrative* tax proceedings to which the exceptions to the non-disclosure rules of Section 6103 apply consist of every process designed to resolve taxpayer issues arising under the Internal Revenue Code. They broadly include "all measures and procedures undertaken in connection with . . . examinations, appeals, collection proceedings, and ruling requests."[42]

Likewise, the Second CCD expansively defined the concept of *judicial* tax proceedings under Section 6103 to cover actions with the Tax Court, District Court, or Court of Federal Claims, summons enforcement actions, and other litigation arising out of the IRS's examination, collection, or other enforcement activities.[43]

Examples involving the Item Test. After addressing those two definitional matters, the Second CCD provided a significant number of examples. They have been divided, labeled, and otherwise modified below in an effort to facilitate review and clarify what, exactly, the IRS was trying to say. The examples are dense even after these improvements, but readers should persevere because the lessons are important in the context of defending SCETs and SSTs.

The Second CCD features four examples centered on the Item Test, all of which conclude that the IRS should enjoy unrestrained disclosure.

> Item Test—First Example
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> Facts. Investor A files a Tax Court petition claiming that the [IRS] wrongfully disallowed a loss related to a transaction promoted by law firm B. In conjunction with the examination of investor A, the [IRS] obtained promotional material and an opinion letter given by promoter B to investor A, which materials conclude that the tax consequences of the transaction have substantial authority. The promotional material also informs prospective investors of the anticipated amount of loss that is associated with various dollar amounts invested.
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> More Facts. The [IRS] has also opened an examination on investor C with respect to a transaction that was also promoted by B and that is substantially similar to A's transaction.

During investor C's examination, the [IRS] obtained an opinion letter and promotional material issued by B to C that uses language or has other features in common with A's promotional material and opinion letter with the exception of the investors' names, addresses, and dollar amounts. C's opinion letter and promotional material tend to prove that B had a routine practice of promoting a set of transactions the purpose of which was to generate a tax loss without any economic effect to the taxpayer.

Issue. May the [IRS] disclose C's opinion letter and promotional material in A's Tax Court litigation?

Conclusion by the IRS. Yes.

Appropriate Proceeding. The Tax Court litigation instituted by A is a judicial proceeding pertaining to tax administration.

Appropriate Information. The promotional material and opinion letter issued by B to C is C's tax information because it was obtained by the [IRS] in conjunction with C's examination.

Reasoning by the IRS. C's documents satisfy [the Item Test]. The documents relate to the liability of A, not merely similarly situated third parties, because C's documents are evidence that A purchased a "cookie cutter" deal lacking a valid business purpose and thus support the basis for the proposed adjustment at issue in the Tax Court. The documents also directly relate to an element of A's claim at issue in the proceeding, *e.g.*, C's documents provide pattern evidence that A's transaction lacked a business purpose.[44]

Item Test—Second Example

Facts. During the course of an examination of Investor D for a Section 351 transaction promoted by E and executed by accommodation party F, the [IRS] obtains documents and testimony from F pursuant to a summons, including a document that states that these Section 351 transactions do not reflect economic reality and that the investors G, H and I, in addition to D, are entering into these transactions to generate a capital loss. The document produced by F tends to show that the transactions that E promoted and F participated in as an accommodating party—which are similar to D's, G's, H's and I's transactions—lacked economic substance.

Issue. Can the document produced by F be disclosed in a refund suit filed by investor G, a taxpayer who invested in a transaction promoted by E and accommodated by F, and whose transaction was substantially similar to that of investor D's?

Conclusion by the IRS. Yes.

Appropriate Proceeding. G's refund suit is a judicial proceeding pertaining to tax administration.

Appropriate Information. The document produced by F is D's tax information because it was obtained by the [IRS] in conjunction with the determination of D's tax liability.

Reasoning by the IRS. D's document satisfies [the Item Test]. The document relates to the liability of G, not merely similarly situated third parties. The document evidences the lack of economic substance of the Section 351 transactions promoted by E and accommodated by F, including G's transaction. Also, the document directly relates to an element of G's claim at issue in the proceeding, *i.e.*, the capital loss.[45]

Item Test—Third Example

Facts. In 2000, taxpayer H enters into a listed transaction … During investor H's examination, the [IRS] obtains from H a fact-sheet issued by co-promoter/bank I to co-promoter/law firm J. This fact-sheet describes in detail the types of entities and transactions that will be used to effectuate H's transactions and the losses for years 1998 through 2000, and contains a fee schedule that includes both a payment to J for J's legal opinion and a fee to J for monitoring these transactions (J's fee is based on the percentage of losses incurred by investors). The document shows that H knew that law firm J is not a disinterested party because of J's planned continuing involvement with respect to the transaction after J issued its opinion letter to H, and that investor H may not rely on J's opinion letter to avoid penalties under Section 6662.

More Facts. Subsequently, as part of a Section 6700 [promoter] examination of J, the [IRS] issues an Information Document Request for documents relating to any transaction marketed by J, or any substantially similar transactions. In response, J forwards information relating to 33 taxpayers, including copies of the fact-sheet relating to 30 taxpayers.

Yet More Facts. The [IRS] is also examining investor K, in conjunction with a 1999 transaction, which is substantially similar to the transaction entered into by H, and co-promoted by I and J. During K's examination, the [IRS] obtains the opinion letter issued by J to K, but is unable to obtain the fact-sheet described above setting forth details of the transactions and the fees paid to J.

Issue. May the [IRS] disclose the fact-sheet obtained during H's examination to K?

Conclusion by the IRS. Yes.

Appropriate Proceeding. K's examination is an administrative proceeding pertaining to tax administration.

Appropriate Information. The document issued by co-promoter I detailing the transactions and fee schedule is H's tax information because it was obtained by the [IRS] in conjunction with H's examination.

Reasoning by the IRS. H's fact-sheet satisfies [the Item Test]. The document relates to the liability of K, not merely similarly situated third

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37 IRS Chief Counsel Directive 2006-003 (Oct. 25, 2005), section 3.

38 *Id.*

39 Section 6103(h)(4)(C).

40 IRS Chief Counsel Directive 2006-003 (Oct. 25, 2005), section 4.

41 IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005).

42 IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 1. It cites to several cases, including Abelein v. United States, 323 F.3d 1210 (CA-9, 2003), which held that a TEFRA partnership audit is an "administrative proceeding" for purposes of the Item Test and Transactional Test.

43 IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 2.

44 IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 3.

45 IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 4.

parties. The fees paid to J reflected on the schedule pertain not only to H's transaction, but to various transactions that were substantially similar to H's and that were promoted by I and J. The document directly relates to an element of K's claim at issue in the proceeding, *e.g.*, that K may avoid accuracy-related penalties by relying on J's opinion letter as a disinterested party with respect to losses from a listed transaction claimed on K's return.[46]

Item Test—Fourth Example

Facts. During a summons enforcement action against investor L, L asserts attorney-client privilege for the opinion letter issued to L by promoter/law firm M in conjunction with a Son of Boss transaction. During the examination of taxpayer N, who invested in a Son of Boss transaction that was promoted by M and that was substantially similar to L's transaction, the [IRS] obtained an e-mail issued by M that revealed that M routinely disclosed its opinion letters to co-promoters responsible for executing the transactions.

Issue. May the e-mail be disclosed in L's summons enforcement action?

Conclusion by the IRS. Yes.

Appropriate Proceeding. L's summons enforcement action is a judicial proceeding pertaining to tax administration.

Appropriate Information. The e-mail issued by M is N's tax information because it was obtained by the [IRS] in conjunction with N's examination.

Reasoning by the IRS. The e-mail satisfies [the Item Test]. The e-mail relates to the liability of L, not merely similarly situated third parties. The e-mail provides evidence that the opinion letter was disclosed to third parties. The e-mail directly relates to an element of L's claim at issue in the proceeding, *e.g.*, whether L may assert attorney-client privilege for the opinion letter.[47]

Examples involving the Transactional Test. The Second CCD also contains two examples addressing the Transactional Test. As with the Item Test, the IRS concludes in all instances that the exception to the general non-disclosure rules in Section 6103 applies.

Transactional Test—First Example

Facts. The [IRS] is beginning an examination of Promoter F under Section 6708 for penalties relating to investor lists required to be maintained with respect to three separate tax shelter transactions with investors C, D, and E.

Issue. May F's examination team disclose investor C's, D's and E's tax information related to the respective transactions in the soft letter (Section 6112 letter) issued to F?

Conclusion by the IRS. Yes.

Appropriate Proceeding. Promoter F's examination is an administrative proceeding pertaining to tax administration.

Reasoning by the IRS. Investor C's, D's, and E's tax information related to the investments in the respective shelter transactions meets [the Transactional Test] with regard to each investor's transaction with F who is being examined. Investors entered into transactional relationships with the promoter when the investors purchased interests in tax shelters organized and marketed by the promoter. Tax information regarding the transaction between the investors and F directly affects the outcome of the examination of the promoter, in which potential penalties relating to the transactions are the focus of the proceedings. Accordingly, the investor C's, D's and E's tax information may be included in the soft letter issued to F.[48]

Transactional Test—Second Example

Facts. During an examination of Employer T, the [IRS] obtains documents in connection with T's deduction for payments to a trust arrangement ("Plan") that is purportedly a welfare benefit fund described in Section 419A(f)(6). The documents consist of generic promotional materials, the Plan trust agreement, an opinion letter, T's enrollment package, individual insurance contracts purchased by the trust, and transactional and accounting records for the Plan and trust. These documents demonstrate the operations of the Plan and how T and other employers interact with the Plan. These documents demonstrate that the individual employers do not share the economic risk of their participation in the Plan, and consequently the Plan fails to satisfy the Section 419A(f)(6) exception to the Section 419 deduction limits.

More Facts. The [IRS] is also examining S, another employer that made and deducted payments to the Plan. S's deduction also depends on the theory that the Plan satisfies the Section 419A(f)(6) exception.

Issue. May the [IRS] disclose the documents obtained in T's examination to S?

Conclusion by the IRS. Yes.

Appropriate Proceeding. S's examination is an administrative proceeding pertaining to tax administration.

Appropriate Information. The documents are T's tax information because they were obtained by the [IRS] in conjunction with T's examination.

Reasoning by the IRS. T's documents satisfy [the Transactional Test]. By participating in the Plan and purporting to share economic risk, S and T have a transactional relationship. The documents pertain to the economics of the Plan, to which S and T have both made payments. The documents also directly relate to the resolution of S's claim in the proceeding, *i.e.*, T's documents provide direct evidence that employers participating in the Plan do not share economic risk, so that the Plan fails to satisfy Section 419A(f)(6) and S cannot rely on that section in support of its claim that its payments to the Plan are deductible.[49]

NOTES

46 IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 5.

47 IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 6.

48 IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 7.

49 IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 8.

50 IRS Chief Counsel Directive 2020-008 (Sept. 8, 2020); *See also* Parillo, "IRS Explains Contours of Disclosing Syndicated Easement Info," 2020 Tax Notes Today Federal 176-2 (Sept. 11, 2020).

51 IRS Chief Counsel Directive 2020-008 (Sept. 8, 2020), Question and Answer 1.

52 IRS Chief Counsel Directive 2020-008 (Sept. 8, 2020), Question and Answer 2.

53 IRS Chief Counsel Directive 2020-008 (Sept. 8, 2020), Question and Answer 3.

Third Notice—September 2020

After 15 years, the IRS decided to "supplement" the First CCD and Second CCD by issuing Chief Counsel Directive 2020-008 ("Third CCD").[50] Its purpose was to add five more examples, all of which pertain to SCETs and SSTs.

The Third CCD is more comprehensive than its two predecessors in that it addresses the Tax Administration Test, Party Test, Item Test, and OPR Assistance Test. Again, in an effort to decipher and more clearly present the information that the IRS is trying to convey, the examples below have been divided, labeled, and changed somewhat.

Item Test Example

Facts. For a particular taxable year, a partnership engaged in [an SCET] and claimed a charitable deduction on its return. The charitable deduction claimed on the partnership return was supported by an appraisal prepared by Appraiser. [IRS] examination determined that the appraisal substantially overvalued the property for which the charitable contribution was claimed.

More Facts. The IRS subsequently opens an examination of Appraiser under Section 6695A.

Issue. Pursuant to Section 6103, can return information of the partnership be disclosed to Appraiser in a penalty examination of Appraiser under Section 6695A?

Conclusion by the IRS. Yes.

Appropriate Proceeding. For purposes of Section 6103(h)(4), administrative tax proceedings include every process within the IRS designed to resolve taxpayer issues arising under the Internal Revenue Code, including the examination of an appraiser for a civil penalty.

Appropriate Information. Third-party return information in such circumstances could involve information from examination files of investors who claimed a deduction on their tax returns based on an appraisal done by Appraiser.

Reasoning by the IRS. Pursuant to [the Item Test], information regarding the deduction claimed on the investors' returns that directly affects the resolution of the examination of the appraiser with regard to a potential Section 6695A penalty (*i.e.*, whether the appraisal resulted in a substantial valuation misstatement or gross valuation misstatement) may be disclosed to the subject of the penalty examination as part of that examination.[51]

Party Test Example

Facts. In a Tax Court case, the [IRS] asserts that A, a partnership subject to TEFRA, committed civil tax fraud, based on the conduct of its managing member TMP A LLC. Promoter organized TMP A LLC and is a partner in TMP A LLC.

More Facts. Promoter organized ten other LLCs to act as managing members and TMPs in ten other LLCs, which are also partnerships subject to TEFRA. Promoter is a direct or indirect partner in all ten of the other LLCs. Each of those ten other LLCs engaged in [an SCET] and were examined by the IRS. In each case, the land at issue was purchased in an unencumbered state in an arm's length transaction (*i.e.*, via the investors' acquisition of LLC) followed shortly thereafter by a conservation easement appraisal concluding that the unencumbered value was multiple times higher than the value established in that prior arm's length transaction. Each TMP LLC retained the same appraiser to provide the appraisal in each of the ten other SCET transactions.

Issue. Can the IRS introduce return information from the ten LLCs regarding their SCETs in the Tax Court case [involving A]?

Conclusion by the IRS. Yes.

Appropriate Information. An intent to mislead that may be inferred from a pattern of conduct is an indicator of fraud. As stated above, Promoter is a direct or indirect partner in all of the LLCs through the ten different TMP LLCs. Under TEFRA, each direct and indirect partner in a TEFRA partnership is a party to any judicial or administrative proceeding under TEFRA . . . Therefore, all return information generated in the examinations of the ten other LLCs is the return information of those direct and indirect partners, which includes Promoter.

Reasoning by the IRS. [The Party Test] authorizes the IRS to disclose in any administrative or judicial tax administration proceeding the return information of anyone who is a party to the proceeding. Promoter is a party to the proceeding involving A because Promoter is a direct or indirect partner through TMP A LLC. Therefore, Promoter's return information, including the return information of Promoter from the examinations of the ten other LLCs, may be disclosed in this proceeding.[52]

The IRS explained in the First CCD that, during the course of a promoter, criminal, and/or injunction investigation, the IRS often obtains information about not only the promoters but also the investors.

OPR Assistance Test Example

Issue. Pursuant to Section 6103, can third-party returns or return information be disclosed to the [OPR] as part of a referral or investigation of a tax return preparer or appraiser?

Conclusion by the IRS. Yes.

Reasoning by the IRS. The OPR is the office responsible for interpreting and applying the regulations governing practice before the IRS (*i.e.*, Treasury Department Circular 230, issued under 31 U.S.C. 330). The OPR has exclusive responsibility for practitioner conduct and discipline, including instituting disciplinary proceedings and pursuing sanctions . . . OPR personnel have access to returns and return information of subjects of referrals or investigations and of other taxpayers, such as clients of the preparer or appraiser, whose returns or return information are relevant to the proper administration of these responsibilities. OPR personnel have access to returns and

return information under [the OPR Assistance Test].[53]

Tax Administration Test Example

Issue. Pursuant to Section 6103, can third-party returns or return information be disclosed to the IRS Director and staff of the Office of Fraud Enforcement ("OFE") or the IRS Promoter Investigations Coordinator, as part of an examination or investigation of another person, such as a partnership, promoter, tax return preparer, or appraiser?

Conclusion by the IRS. Yes.

Reasoning by the IRS. The IRS Director of the OFE reports to the Deputy Commissioner for Services and Enforcement ("DCSE") and provides executive leadership and direction in the design, development, and delivery of major activities within the OFE in support of the IRS's agency-wide efforts to detect and deter fraud. If, as part of the Director's oversight of Fraud Enforcement activities, the Director has a need to know about an investigation of a partnership, promoter, return preparer, or appraiser, the Director may be provided returns and return information of the partnership, promoter, return preparer, or appraiser that is the subject of the investigation and any third party return information that may be relevant to such investigation, which he or she can then disclose as needed to appropriate staff of the OFE. The Director and staff of the OFE have access to returns and return information under [the Tax Administration Test] as part of their tax administration duties.

More Reasoning by the IRS. Likewise, the IRS Promoter Investigations Coordinator reports to the DCSE and is responsible for coordinating promoter investigation activity agency wide. The Promoter Investigations Coordinator works with the Business Operating Divisions ("BODs"), OPR, Criminal Investigation ("CI"), the Office of Chief Counsel, and other functions to ensure coordination of on-going investigations, develop new approaches to identify promoters of abusive tax arrangements, and assist the BODs in developing and resolving cases both individually and with a view toward strategic promoter enforcement. To the extent the Promoter Investigations Coordinator has a need to know about an investigation of a partnership, promoter, return preparer, or appraiser, he or she may be provided returns and return information of the partnership, promoter, return preparer, or appraiser that is the subject of the investigation and any third party returns or return information that may be relevant to such investigation. The Promoter Investigations Coordinator has access to returns and return information under [the Tax Administration Test] as part of his or her tax administration duties.[54]

The Second CCD features four examples . . . all of which conclude that the IRS should enjoy unrestrained disclosure.

Tax Administration Test and Party Test Example

Facts. Promoter is a promoter of [SCETs]. Promoter is under both criminal investigation by CI with respect to its SCETs and under a civil investigation by Exam under Sections 6700 and 6701.

More Facts. Partnership Z and several other investor partnerships are under civil examination for their investments in SCETs promoted by the Promoter. All partnerships are TEFRA partnerships.

Issue. Pursuant to Section 6103, can the Revenue Agent working the partnership income tax examinations access the Promoter's tax information obtained in the criminal investigation and the promoter investigation of Promoter to determine whether the partnerships properly claimed a charitable contribution for a conservation easement?

More Issues. Can the Revenue Agent working the Partnership Z income tax examination disclose the Promoter's tax information to Partnership Z as part of conducting the examination of Partnership Z?

Conclusion by the IRS about the Tax Administration Test. Yes. Everything obtained, received, or generated by either CI or Exam with respect to determining Promoter's liability under [the Internal Revenue Code], including penalties under Sections 6700 and 6701, is Promoter's return information. [The Tax Administration Test] authorizes disclosure of returns and return information to IRS employees necessary for the employees to perform their official tax administration duties. Thus, disclosure of Promoter's return information to the Revenue Agent examining the partnerships to assist with the partnership return audits is authorized.

Conclusion by the IRS about the Party Test. If Promoter is a partner in TEFRA Partnership Z, then Promoter is a party to the Partnership Z audit and Promoter's return information, including return information relating to investments in other SCETs as a partner in other TEFRA partnerships, may be disclosed within the Partnership Z exam proceeding pursuant to [the Party Test].[55]

Conclusion

Taken together, the IRS reveals a lot of information in the First CCD, Second CCD, and Third CCD that is valuable to partnerships that engaged in SCETs or SSTs, as well as to those defending them. Logic dictates that the First CCD, Second CCD, and Third CCD contain a certain degree of hyperbole and posturing by the IRS; this is a major component of its recent playbook when it comes to SCETs and SSTs. However, taking the information at face value, one can glean several lessons.

One important lesson is that the IRS intends to cross-reference and multitask to the greatest extent possible, (i) presenting evidence during income tax audits, criminal investigations, promoter actions, appraiser penalty examinations, injunction lawsuits, summons enforcement proceedings,

OPR disciplinary hearings, and Tax Court litigation, (ii) about multiple unrelated partners, their relationships with alleged promoters, and pre-donation actions by assorted tax/legal professionals and accommodating parties, and others, (iii) in a manner that supposedly does not violate the general non-disclosure rules under Section 6103 thanks to the Tax Administration Test, Party Test, Item Test, Transactional Test or OPR Assistance Test.

Perhaps more importantly, though, is what the IRS does *not* say in the First CCD, Second CCD, and Third CCD. Conspicuously absent is legal support (in the form of identification and analysis of caselaw, legislative history, administrative rulings, secondary resources, etc.) for the position that the Tax Administration Test, Party Test, Item Test, Transactional Test and/or OPR Assistance Test will be applicable in the context of SCETs and SSTs. Stated more bluntly, just because the IRS unilaterally announces a position does not necessarily make it so.

Moreover, the First CCD, Second CCD, and Third CCD never mention to the IRS personnel tasked with doing the actual disclosing that any unauthorized release of return or return information is a crime (punishable by a fine, imprisonment, and termination from the IRS), or that taxpayers have an express right to file a lawsuit against the IRS seeking compensation in the case of improper disclosure.[56]

Finally, the First CCD, Second CCD, and Third CCD only focus on efforts by the IRS to circumvent the general non-disclosure rules in Section 6103. They are silent on the more critical issue, which is how, precisely, the IRS plans to overcome a long list of prohibitions in the Federal Rules of Evidence and the Tax Court Rules of Practice and Procedure against introducing evidence that is irrelevant, unduly prejudicial, confusing, misleading, unfounded, unauthenticated, privileged, hearsay, limited in scope, etc.[57]

Partnerships and others under attack by the IRS as part of its "compliance campaign" against SCETs and SSTs need to be hyperaware of the First CCD, Second CCD, and Third CCD and implement appropriate defense strategies from the very start of the audit process.

NOTES

[54] IRS Chief Counsel Directive 2020-008 (Sept. 8, 2020), Question and Answer 4.

[55] IRS Chief Counsel Directive 2020-008 (Sept. 8, 2020), Question and Answer 5.

[56] Section 7213(a); Section 7431(a).

[57] For more information about potential evidentially challenges for the IRS, *see* Larson, "Tax Evidence: A Primer on the Federal Rules of Evidence As Applied by the Tax Court," 53 Tax Law 181 (1999); Larson, "Tax Evidence II: A Primer on the Federal Rules of Evidence As Applied by the Tax Court," 57 Tax Law 371 (2004); Larson, "Tax Evidence III: A Primer on the Federal Rules of Evidence As Applied by the Tax Court," 62 Tax Law 555 (2009); Larson, "A Practitioner's Guide to Tax Evidence," Second Edition, American Bar Association Section of Taxation (2017).