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In this article, Sheppard explores recent IRS challenges to charitable donations of conservation easements, artwork, ownership interests in special purpose entities, and closely held businesses.

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I. Introduction

Things move quickly these days, misinformation abounds, and many people have trouble making connections between events that at first glance might seem unrelated. That is certainly true when it comes to tax issues, and it is problematic for taxpayers. Case in point, the IRS has been challenging various types of charitable donations for years, raising some standard arguments, evolving during the process, and expanding its focus. What started as the IRS scrutinizing donations that it considered patently abusive has morphed into frequent challenges to charitable gifts that are, by most accounts, routine.[1]

II. Overview of Charitable Donations

Taxpayers normally can claim a tax deduction for the charitable donations they make during a year.[2] If the donations consist of something other than money, the amount of the deduction is the fair market value of the property.[3] Ordinarily, the term FMV means the price on which a willing buyer and willing seller would agree if neither party was obligated to participate in the transaction and if both parties had reasonable knowledge of the relevant facts.[4]

When the value of donated property exceeds a certain amount, taxpayers cannot claim a deduction unless they obtain a qualified appraisal and attach it to the relevant tax return.[5] An appraisal must satisfy a long list of requirements to be "qualified" for these purposes. It must: (1) be prepared no earlier than 60 days before the donation, and no later than the due date of the tax return on which the deduction is first claimed; (2) be prepared, signed, and dated by a qualified appraiser; (3) include a significant amount of information on the experience, education, and

[1] Earlier coverage of these issues can be found in the following articles and others: Hale E. Sheppard, "Evaluating Three Conservation Easement Settlement Offers," *Tax Notes Federal*, Aug. 5, 2024, p. 1083; Sheppard, "IRS Attacks on Art Donations: Old Techniques, New Hurdles," *Tax Notes Federal*, Nov. 13, 2023, p. 1221; Sheppard, "Is the 'Ultimate Tax Plan' Nearing Ultimate Rejection by the Tax Court?" *Tax Notes Federal*, Mar. 6, 2023, p. 1509.

[2] Section 170(a)(1); reg. section 1.170A-1(a).

[3] Section 170(a)(1); reg. section 1.170A-1(c)(1).

[4] Reg. section 1.170A-1(c)(2).

[5] Section 170(f)(11)(D).

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other credentials of the appraiser; and (4) not involve a "prohibited appraisal fee."[6]

Claiming tax deductions for charitable donations involves many actions, aside from obtaining a qualified appraisal. The taxpayer, for example, must demonstrate that the recipient of the donation is a qualified organization, complete a Form 8283, "Noncash Charitable Contributions," and have it executed by all relevant parties, file a timely tax return enclosing the qualified appraisal and Form 8283, and receive from the charity a so-called contemporaneous written acknowledgement (CWA).[7]

III. Attacks on Four Types of Donations

The IRS has been challenging charitable donations for many years; this is nothing new. What is novel are the enforcement campaigns that the IRS has been carrying out recently, some with lots of fanfare and others more subtle. Many taxpayers are aware of discrete actions by the IRS, but most do not appreciate the bigger picture of the evolving and related IRS attacks in four different areas. These are examined below.

A. Conservation Easement Donations

Congress has offered tax incentives for donating conservation easements since 1969, and it codified that notion as section 170(h) in 1980.[8] This provision, as one would suspect, indicates that taxpayers cannot donate easements on just any old property and claim a tax deduction. They must demonstrate that the property is worth protecting, meaning that it has one or more acceptable "conservation purposes."[9] Taxpayers also must memorialize a donation by filing a deed of conservation easement or similar document.[10] Also, the IRS will not allow a tax deduction unless the taxpayer, before making the donation, supplies the land trust with "documentation sufficient to establish the condition of the property at the time of the gift."[11] That is called the baseline report. It usually includes surveys, pictures taken from various locations, and a detailed map showing man-made improvements, plants, animals, and natural features.[12]

The value of the conservation easement is the FMV at the time of the donation.[13] The best evidence of the FMV of an easement would be the sale price of other easements that are comparable in size, location, usage, etc. Even the IRS recognizes that it is difficult, if not impossible, to find comparable sales.[14] Appraisers, therefore, normally must use the before-and-after method instead. In simplified terms, that means an appraiser must determine the highest and best use of the property and the corresponding FMV twice. First, the appraiser calculates the FMV as if the property were put to its highest and best use, which generates the "before" value. Second, the appraiser computes the FMV, taking into account the restrictions imposed by the easement, which creates the "after" value.[15] The difference between the "before" value and "after" value, with other adjustments, produces the FMV of the easement donation.

The IRS officially started attacking what it calls syndicated conservation easement transactions (SCETs) in late 2016. At that time, it released Notice 2017-10, 2017-4 IRB 544, labeling them "listed transactions" and unleashed the corresponding compliance campaign.[16] The main allegation by the IRS was that SCETs often rely on appraisals that "greatly inflate the value of the

[6] Section 170(f)(11); reg. section 1.170A-13(c)(3)(i); Notice 2006-96, 2006-2 C.B. 902; T.D. 9836, 83 F.R. 36425 (July 30, 2018); reg. section 1.170A-17.

[7] *See* IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements" (Mar. 2016); IRS Publication 526, "Charitable Contributions" (Feb. 14, 2023); section 170(f)(8); section 170(f)(11); reg. section 1.170A-13; Notice 2006-96; T.D. 9836.

[8] Tax Reform Act of 1969, section 201; H.R. Rep. No. 91-782 (1969) (Conf. Rep.); *see also* Tax Reform Act of 1976, section 2124(e); *see also* Tax Reduction and Simplification Act of 1977, section 309; *see also* Tax Treatment Extension Act of 1980, section 6(a); S. Rep. No. 96-1007 (1980).

[9] Section 170(h)(4)(A); reg. section 170A-14(d)(1); S. Rep. 96-1007, at 10 (1980).

[10] Reg. section 1.170A-14(b)(2).

[11] Reg. section 1.170A-14(g)(5)(i).

[12] *Id.*

[13] Section 170(a)(1); reg. section 1.170A-1(c)(1).

[14] IRS, "Conservation Easement Audit Techniques Guide," at 41 (rev. Nov. 4, 2016).

[15] *Id.*

[16] Notice 2017-10, 2017-4 IRB 544, preamble and section 1.

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conservation easement based on unreasonable conclusions about the development potential of the real property."[17]

The IRS started with grand expectations about its enforcement abilities. It stated, for instance, that it would audit "100 percent of these deals."[18] The National Fraud Counsel, likewise, admonished that "the IRS is auditing 100 percent of these cases."[19] Finally, chief counsel for the IRS explained that they were prepared "to take each of these [pending easement cases] and all other cases being developed by the IRS to trial."[20]

One early strategy by the IRS was to challenge all supposed "technical" problems with easements. It pounced on unintentional flaws with deeds, qualified appraisals, baseline reports, Forms 8283, and other documents. The Tax Court initially held in favor of the IRS on several technical issues, resulting in charitable deductions of $0 and large penalties.[21]

Things changed for the IRS, though. For example, the Tax Court held in a case that the IRS had violated the Administrative Procedure Act (APA) when it issued Notice 2017-10, so that some filing obligations and related penalties were inapplicable.[22] Similarly, the government filed an answer in a district court case admitting that Notice 2017-10 is a legislative rule, the IRS did not follow the notice and comment procedures of the APA, and the IRS was not exempt from such procedures.[23] The district court agreed, declaring Notice 2017-10 unlawful and setting it aside regarding the taxpayer in that case.[24] Another significant blow to the IRS and its SCET campaign was the Tax Court opinion that the infamous proceeds-upon-extinguishment regulation, on which the IRS had relied so often to deny tax deductions, was invalid because the IRS ignored the APA in publishing it.[25]

The Tax Court continues to release opinions concerning SCETs. All cases involve different facts, properties, issues, valuation methods, and more. Those disparities lead to different results, and no two cases are identical. With that said, recent Tax Court opinions show that taxpayers have prevailed on various challenges by the IRS pertaining to technical issues. Taxpayers have also overcome numerous IRS questions about whether the original valuation met the qualified appraisal standards. Taxpayers have further experienced considerable success demonstrating that the relevant property had at least one acceptable "conservation purpose."

On the other hand, the IRS has prevailed on valuation issues in several cases, raising arguments centered on: (1) whether the property on which the easement was placed constituted "inventory" in the hands of the taxpayer; (2) the proper highest and best use of a property; (3) the correct inputs for calculating FMV in specific cases, including costs, timing, price, quantity, market demand, and more; (4) the need to do a valuation based on comparable sales, instead of one based on discounted cash flow; (5) the "uniqueness" of a property compared with others in the vicinity; (6) the significance of the price paid by a partnership, directly or indirectly, for the pertinent property shortly before it donated an easement on such property; and (7) the impact of the "substitution principle."[26]

Mindful of the court opinions described above, the massive number of SCET disputes in line for Tax Court litigation, the resources required to handle cases of this size and

[17] Notice 2017-10, section 1.

[18] IR-222-125 (June 10, 2022).

[19] Nathan J. Richman, "ABA Section of Taxation Meeting: IRS Shifting Tack on Fighting Syndicated Conservation Easements," *Tax Notes Federal*, Feb. 7, 2022, p. 898.

[20] IR-2019-213 (Dec. 20, 2019).

[21] *See, e.g.*, *Railroad Holdings LLC v. Commissioner*, T.C. Memo. 2020-22; *Oakhill Woods LLC v. Commissioner*, T.C. Memo. 2020-24; *Oakbrook Land Holdings LLC v. Commissioner*, T.C. Memo. 2020-54; *Woodland Property Holdings LLC v. Commissioner*, T.C. Memo. 2020-55; *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019).

[22] *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5 (2022).

[23] Answer, *GBX Associates LLC v. United States*, No. 1:22-cv-00401 (N.D. Ohio May 20, 2022).

[24] *GBX Associates LLC v. United States*, No. 1:22-cv-401 (N.D. Ohio 2022).

[25] *Valley Park Ranch LLC v. Commissioner*, 162 T.C. No. 6 (2024).

[26] *See, e.g.*, *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2023-82; *Mill Road 36 Henry LLC v. Commissioner*, T.C. Memo. 2023-129; *Oconee Landing Property LLC v. Commissioner*, T.C. Memo. 2024-25; *Savannah Shoals LLC v. Commissioner*, T.C. Memo. 2024-35; *Valley Park Ranch LLC*, 162 T.C. No. 6; *Buckelew Farm LLC v. Commissioner*, T.C. Memo. 2024-52; *Excelsior Aggregates LLC v. Commissioner*, T.C. Memo. 2024-60; *Oconee Landing Property LLC v. Commissioner*, T.C. Memo. 2024-73; *Corning Place Ohio LLC v. Commissioner*, T.C. Memo. 2024-72; and *JL Minerals v. Commissioner*, T.C. Memo. 2024-93.

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complexity, and other factors, the IRS introduced in 2024 two different settlement offers.[27] One offer applies only to SCET cases that are already pending before the Tax Court, while the other is limited to similar disputes that are still in the audit or administrative appeal phase.[28]

The IRS has yet to announce any results from those settlement offers, and any statistics offered later will probably have some degree of positive spin for the IRS. Given the fundamental disagreement between taxpayers and the IRS about the proper valuation method to be used in conservation easement cases, enormous amounts of money at issue, divergent opinions among individual partners about whether to surrender or fight, and pending issues before various courts of appeal, easement litigation is likely to persist for many years. Judicial decisions in easement cases surely will affect charitable donation battles in other contexts, as examined below.

B. Art Donations

The IRS announced in October 2023 that taxpayers should beware of "promotions involving exaggerated art donation deductions." It threw in some loaded terms, such as "inflated values," "questionable appraisals," "unscrupulous promoters," and tax results that are "too good to be true."[29]

The IRS instructed taxpayers to be on the lookout for the following scenario: Promoters who (1) encourage high-income taxpayers to buy various types of art, usually at a "discounted" price; (2) provide additional services for which they can charge fees, like shipping, storage, or appraising; (3) identify charities willing to accept the art; (4) instruct taxpayers to hold the art for a minimum of one year before donating it, thereby making it long-term capital gain property; and (5) assist taxpayers in claiming tax deductions based on FMVs that far exceed the amount they paid for the art.[30]

The IRS also warned that the reasonable-reliance defense to penalties might be questioned if taxpayers claim excessive values on artwork. Here, the IRS announcement stated that "taxpayers should remember [that] they are always responsible for the information reported on their tax returns." The IRS, always inclusive, added that charities must be careful that they do not "enable these schemes." The IRS further declared that it was ready for valuation battles. In this regard, the announcement explained that the IRS has a team of "professionally trained appraisers" in its Art Appraisal Services, which is often augmented by the Art Advisory Panel.[31] According to the IRS, dozens of taxpayer examinations and promoter investigations centered on questionable art donations were already in process.[32]

C. Ultimate Tax Plan

Like donations of conservation easements and artwork, participating in The Ultimate Tax, Estate, and Charitable Plan (Ultimate Tax Plan) has drawn the ire of the IRS. The leading case in this space is *Lim and Chu*,[33] which triggered an interesting Tax Court opinion in 2023.

The taxpayers were the sole shareholders in a corporation (Integra) during the relevant years. A person, who will be referred to in this article as the consultant, made a presentation to the taxpayers about the Ultimate Tax Plan. The taxpayers, persuaded, signed an agreement with the consultant to advance the process. It indicated that the consultant would form a special-purpose charitable limited liability company (CLLC), create documents to transfer specific assets from the taxpayers to the CLLC, generate additional documents to memorialize a transfer of "units" in the CLLC to a charity, and supply an appraisal.

The consultant formed a CLLC for the taxpayers, as agreed. About a week later, the

[27] "Appeals Memo Outlines Steps to Shrink Tax Court Case Backlog," 2022 *Tax Practice Expert* 22-14 (May 30, 2022); Joel G. Cohen, "IRS Appeals Has a Solution to Its Tax Court Backlog," *Tax Notes Federal*, June 6, 2022, p. 1587; Richman, "Appeals Learned Some Things While Clearing Docketed Case Backlog," *Tax Notes Federal*, Mar. 13, 2023, p. 1805 (explaining that the Appeals Office cleared about 7,500 pending Tax Court cases in 2022 alone).

[28] IR-2024-174 (June 26, 2024); *see also* Kristen A. Parillo, "IRS Expands Easement Settlements to Nondocketed Cases," *Tax Notes Federal*, July 1, 2024, p. 111.

[29] IR-2023-185 (Oct. 5, 2023); Chandra Wallace, "Beauty Is in the Eye of Auditors for Art Donations, IRS Warns," *Tax Notes Federal*, Oct. 9, 2023, p. 333.

[30] IR-2023-185.

[31] *Id.*

[32] *Id.*

[33] *Lim and Chu v. Commissioner*, T.C. Memo. 2023-11.

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taxpayers and their original company, Integra, executed another agreement. It named Integra as sole owner of the CLLC, the taxpayers as its managers, and the consultant as its registered agent. Attached to the agreement were five promissory notes that obligated Integra to pay the CLLC about $2 million over seven years. The agreement identified a charitable organization to which Integra would transfer units in the CLLC (Foundation).

In January 2017, the consultant issued a document showing the supposed FMV of the units in the CLLC that were donated (the appraisal). The only assets that the CLLC held at the time of the donation were the five promissory notes. The appraisal concluded that the units, and thus the corresponding tax deduction, were worth approximately $1.6 million. The appraisal had several shortcomings, including that it named incorrect parties, contained grammatical faults, did not specify the number of units donated, failed to value the promissory notes, omitted the fact that the notes were not due for seven years, and applied a valuation discount for lack of control even though the Foundation supposedly held all the units in the CLLC.

Integra filed a timely Form 1120-S, "U.S. Income Tax Return for an S Corporation," for 2016, the year of the donation. It attached a copy of the appraisal and Form 8283, both of which the consultant had prepared. The charitable deductions claimed by Integra flowed through to the taxpayers as shareholders. They reported the maximum deduction allowed on their Form 1040, "U.S. Individual Income Tax Return," for 2016 and then carried forward the remainder for use in future years.

The IRS audited the taxpayers for 2016 and 2017, eventually concluding that they should get a deduction of $0 in both years. The taxpayers disputed the IRS's initial determinations by filing a petition in Tax Court. Thereafter, before trial, the IRS filed a motion for partial summary judgment, asking the Tax Court to rule that the taxpayers deserve a deduction of $0 for various reasons.

The Tax Court addressed two main issues in rendering its opinion on the motion for partial summary judgment filed by the IRS. It began by explaining that a taxpayer can claim a charitable donation for the year during which it surrenders dominion or control over the relevant property. Accordingly, Integra had to prove that it adequately transferred units in the CLLC to the Foundation in 2016. The taxpayers conceded during the pretrial discovery process that the *only* evidence of the alleged transfer was the CWA from the Foundation, which itself was problematic in a few ways. First, the CWA was not addressed to the supposed donor, Integra, but rather to the taxpayers individually. Second, a representative of the Foundation might not have signed it. Third, the CWA did not refer to the property that Integra supposedly donated to the Foundation (that is, units in the CLLC), but rather to units in an unrelated entity that was not even formed until weeks after the supposed donation.

The Tax Court warned the taxpayers that they "would face a decidedly uphill task" trying to show that Integra transferred anything, much less units in the CLLC, to the Foundation in 2016. However, viewing the facts in the manner most favorable to the taxpayers, as it must do when ruling on a motion for partial summary judgment filed by the IRS, the Tax Court declined to rule against the taxpayers before trial on this issue.

The Tax Court then turned to whether a "qualified appraisal" exists. The IRS suggested that the consultant was not a qualified appraiser and could not have issued a qualified appraisal for multiple reasons. For instance, he was a party to the transaction in which Integra purportedly transferred units in the CLLC to the Foundation, he did not disclose the number of units transferred, he misrepresented his qualifications, and he prepared the appraisal in exchange for a "prohibited appraisal fee." The Tax Court only had to consider the last allegation.

The Tax Court began by citing the regulation establishing that "no part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property."[34] It pointed out that the relevant contract indicated that the consultant would get 6 percent of the deductible amount up to $1 million, and 4 percent thereafter. The contract further stated that the consultant would be paid $84,000, which presupposed that

[34] Reg. section 1.170A-13(c)(6)(i).

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the "deductible amount" would be $1.6 million. Thus, the Tax Court determined that the consultant's fee for the appraisal was based on a percentage of the value of the donated property, in direct violation of the rules.[35]

The Tax Court offered a slight reprieve at this point. It recognized that the failure to meet all reporting requirements, including the need to attach a qualified appraisal to the relevant tax return, can be excused if the taxpayers can show that their deficiencies were "due to reasonable cause and not to willful neglect."[36] In other words, if the taxpayers can establish an acceptable justification, they might avoid a deduction of $0 on grounds of no qualified appraisal.[37] The taxpayers asserted that in gauging the appropriateness of the Ultimate Tax Plan, they relied on a certified public accountant, as well as an attorney specializing in tax planning and asset protection. The Tax Court recognized that the taxpayers might "conceivably" show that they received, and reasonably relied on, acceptable professional advice. That issue involves disputes over material facts, so the Tax Court could not resolve it before trial by way of a motion for partial summary judgment.

Lim and Chu is still pending with the Tax Court. If litigation ultimately occurs, the IRS likely will argue that: (1) the taxpayers cannot prove that Integra donated units in the CLLC to the Foundation; (2) even if a donation occurred, the taxpayers continued to maintain control over the relevant entities and assets thereafter; (3) the units in the CLLC were not worth $1.6 million; (4) the taxpayers have no reasonable cause for not obtaining a qualified appraisal; (5) the Form 8283 was defective because it mischaracterized the manner in which the property was transferred, misstated the basis, and insufficiently described the property; and (6) Integra did not meet all the substantiation requirements because the CWA was issued to an improper party, lacked a signature, and inaccurately described the property donated.[38] The IRS might raise other issues, too.

D. Donations of Business Interests

What originated with the Ultimate Tax Plan seems to have gone farther, much farther. The IRS issued an alert in December 2024, warning taxpayers to avoid persons promoting a tax plan involving donations of ownership interests in closely held businesses.[39]

The IRS alert described the troublesome transaction in the following manner: Promoters encourage high-income taxpayers to create limited liability companies, contribute cash or other assets to the LLCs, donate a majority of the nonvoting and nonmanaging ownership interests in the LLCs to a charity, claim a charitable tax deduction, and still enjoy personal use of the cash or other assets, either directly or indirectly, after the donation. The alert explained that promoters of such transactions often facilitate matters by forming the LLCs, creating transactional documents, supplying an appraisal, identifying charities willing to accept the ownership interests, and executing an exit strategy for taxpayers that involves them buying back their earlier contributions at a reduced price after a waiting period. The alert added the following admonition:

> Generally, taxpayers cannot deduct a charitable contribution of *less than their entire interest* in property, and *retaining rights to control the donated interests or buy back assets* will disqualify the transaction as a deductible charitable donation . . . A valid charitable contribution requires the taxpayer *to give control* over the donated assets to the charity.[40] [Emphasis added.]

The alert had more to say. It offered a broad list of "potential red flags" of which taxpayers should be aware. Among the warning signs were (1) persons marketing transactions featuring charitable tax deductions and ways to supposedly increase wealth on a tax-free basis, (2) the

[35] *Lim and Chu*, T.C. Memo. 2023-11, at 13.

[36] Section 170(f)(11)(A)(ii)(II).

[37] *See Belair Woods LLC v. Commissioner*, T.C. Memo. 2018-159.

[38] *Lim and Chu*, T.C. Memo. 2023-11, at 4-5, 10, 11-12, footnotes 3 and 4.

[39] IR-2024-304 (Dec. 4, 2024).

[40] *Id.*

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establishment of entities solely for purposes of facilitating charitable donations, (3) donating an ownership interest in an LLC that later loans cash or other assets back to the taxpayer or a related party, (4) situations in which the charity, after receiving a donation of a majority ownership interest in an LLC, does not have actual control over the entity or its assets, (5) persons assisting in the creation of intellectual property to fund the LLC before making a donation, (6) taxpayers using funds of the LLC to purchase life insurance policies benefiting their relatives or related parties, (7) requirements that taxpayers hire specific appraisers or donate to specific charities, (8) taxpayers retaining the ability to reclaim from the charity at less than FMV the ownership interests or other assets that they previously donated, and (9) appraisals that do not take into account the relevant facts and circumstances of a transaction as a whole.

No alert would be complete without some statistics. In this case, the IRS announced that it is using "compliance tools to combat abusive donations," including audits, promoter investigations, and criminal actions. The IRS then said that it has already identified "hundreds of tax returns filed with this abusive charitable contribution scheme," and earlier enforcement efforts have led to convictions and guilty pleas.[41]

Ending with its standard one-two punch, the IRS reminded taxpayers in the alert that while they might be "targets" of "unscrupulous promoters," they are, in the end, "always responsible for the accuracy of information reported on their returns." The IRS did not overlook the charities, of course. The alert instructed them to "be careful" not to unknowingly enable improper donations.

IV. Conclusion

The main takeaway here is that the IRS is currently challenging — and likely will continue to scrutinize — various types of charitable donations. Some targets of the IRS are predictable, while others are surprising. Putting aside opinions on scope, the important thing to understand is that the legal, tax, and procedural arguments that the IRS is now raising in different contexts have some similarities, but they are evolving and expanding. Thus, taxpayers serious about protecting their donations and corresponding tax deductions should be working with professionals with significant, ongoing experience in defending all four types of donations described here. ■

[41] *Id.* (referencing Department of Justice press releases 24-427, 24-515, 24-1431, and 19-435).

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