Conservation Easements, Notice 2017-10, Injunction Action, and the Potential Reach of Preparer Penalties Under Code Sec. 6694

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Hale E. Sheppard examines conservation easements, Notice 2017-10, injunction action, and the potential reach of preparer penalties under Code Sec. 6694.

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I. Introduction

There are many signs that the U.S. government has been trying to administratively eradicate the conservation easement industry for years. The steps have been numerous, but perhaps the two most notable are the IRS issuing Notice 2017-10 in December 2016 identifying certain easements as "listed transactions," with all that entails, and the U.S. Department of Justice ("DOJ") filing in December 2018 a Complaint with the District Court asking it to enjoin various entities and individuals from any involvement with easements, impose a long list of penalties (including return preparer penalties under Code Sec. 6694), obligate those accused to disgorge to the U.S. government the gross receipts that they made in connection with easements, and more.

One motive for taking these and other actions, of course, is to scare various parties away from easement transactions, including the accounting firms that prepare the tax returns on which such transactions are reported to the IRS. This has triggered a certain degree of healthy paranoia, which has manifested itself as inquiries about whether accountants who merely prepare Forms 1040 (*U.S. Individual Income Tax Returns*) for individual partners in partnerships that have engaged in "listed transactions" and who receive a Schedule K-1 (Partner's Share of Income, Deductions, Credits, *etc.*) from the partnerships might be subject to penalties under Code Sec. 6694. While anything is possible, particularly when dealing with the IRS and DOJ, this article examines why asserting penalties under this scenario might pose challenges.

II. Notice 2017-10

The term "listed transaction" means a reportable transaction that is the same as, or substantially similar to, a transaction identified by the IRS (by notice, regulation, or some other form of published guidance) as a tax-avoidance transaction.[1]

III. Pursuant to Notice 2017-10, All Syndicated Conservation Easement Transactions That Occurred on or After January 1, 2010, Are Considered Listed Transactions, Such That Participants, Return Preparers, and Material Advisors Are Subject to Additional Reporting, Due Diligence, and Record-Keeping Requirements

A. Description of the Targeted Transaction

Notice 2017-10 broadly defines an SCET as follows:

> An investor receives promotional materials that offer prospective investors in a pass-through entity [such as a partnership] the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The promotional materials may be oral or written … [2]
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> The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property.
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> The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and [then] allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor.
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> Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.

B. Forms 8886, Forms 8918, and Substantially Similar Transactions

Notice 2017-10 requires taxpayers who "participate" in an SCET or a substantially similar transaction to file Form 8886 (*Reportable Transaction Disclosure Statement*). Notice 2017-10 also requires persons who are "material advisors" to an SCET or a substantially similar transaction to file Form 8918 (*Material Advisor Disclosure Statement*).

In this context, the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on similar tax strategy.[3] The regulations indicate that the term "substantially similar" must be broadly construed in favor of disclosure to the IRS.[4]

C. Potential Penalties and IRS Targets

Notice 2017-10 contains multiple threats or warnings, depending on one's perspective, regarding potential penalties for non-compliance.

1. Information Related to "Participants"

Notice 2017-10 begins by warning that "participants" who are required to disclose an SCET by filing a Form 8886 but fail to do so will be subjected to penalties under Code Sec. 6707A. These come in two forms. First, if participants fail to file timely, complete Forms 8886, then the IRS generally can assert a penalty equal to 75 percent of the tax savings resulting from their participation.[5] In the case of a listed transaction, like an SCET, the maximum penalty for individual taxpayers is $100,000, while the maximum for entities is $200,000.[6] The minimum penalty is $5,000 for individuals and $10,000 for entities.[7] Importantly, in the case of a listed transaction, like an SCET, the IRS does not have authority to rescind or abate it.[8] Also, there is no "reasonable cause" exception to this penalty. Second, if a taxpayer participates in a reportable transaction (including listed transactions) and the IRS later disallows the benefits claimed, then the IRS can assess a penalty equal to 20 percent of the tax increase.[9] This penalty rate increases to 30 percent if the participant fails to file a Form 8886.[10]

Notice 2017-10 also indicates that, if a "participant" fails to enclose a Form 8886 with respect to a listed transaction, like an SCET, with a tax return, then the assessment period with respect to the tax return shall remain open until one year after the earlier of (i) when the participant later files Form 8886, or (ii) when the material advisor provides the IRS with the required list of data about reportable transactions in response to the written request from the IRS.[11] The regulations explain the types of taxes, penalties, and interest that the IRS might assess in situations involving participation in listed transactions, such as an SCET, and the non-filing of Forms 8886:

> If the period of limitations on assessment for a taxable year remains open under [Section 6501(c)(10)], the [IRS] has authority to assess *any tax* with respect to the listed transaction in that year. *This includes, but is not limited to, adjustments made to the tax consequences claimed on the return plus interest, additions to tax, additional amounts, and penalties that are related to the listed transaction or adjustments made to the tax consequences. This also includes any item to the extent the item is affected by the listed transaction even if it is unrelated to the listed transaction* …[12]

The regulations also contain the following example, which illustrates the items that the IRS might assess:

> F, an individual, enters into a listed transaction in 2015. F files its 2015 Form 1040 on April 15, 2016, but does not [file a Form 8886]. F's failure to disclose relates to taxable year 2015. Thus, Section 6501(c)(10) applies to keep the period of limitations on assessment open with respect to the tax related to the listed transaction for taxable year 2015 until at least one year after the date F [files a late Form 8886 or a material advisor gives the IRS the requisite list of taxpayers] with respect to F. On July 2, 2020, the IRS completes an examination of F's 2015 taxable year and disallows the tax consequences claimed as a result of the listed transaction. The disallowance of a loss increased F's adjusted gross income. Due to the increase of F's adjusted gross income, certain credits, such as the child tax credit, and exemption deductions were disallowed or reduced because of limitations based on adjusted gross income. In addition, F now is liable for the alternative minimum tax. The examination also uncovered that F claimed two deductions on Schedule C to which F was not entitled. *Under section 6501(c)(10), the IRS can timely issue a statutory notice of deficiency (and assess in due course) against F for the deficiency resulting from (1) disallowing the loss, (2) disallowing the credits and exemptions to which F was not entitled based on F's increased adjusted gross income, and (3) being liable for the alternative minimum tax. In addition, the IRS can assess any interest and applicable penalties related to those adjustments, such as the accuracy-related penalty under sections 6662 and 6662A and the penalty under section 6707A for F's failure to disclose the transaction as required under section 6011 and the regulations under section 6011*. The IRS cannot, however, pursuant to section 6501(c)(10), assess the increase in tax that would result from disallowing the two deductions on F's Schedule C because those deductions are not related to, or affected by, the adjustments concerning the listed transaction.[13]

Notice 2017-10 does not specifically threaten "participants" for record-keeping violations, but, based on the IRS's normal operating procedure, this remains a possibility. The regulations mandate that participants retain a copy of "all documents and other records" related to the transaction disclosed on Form 8886 that "are material to an understanding of the tax treatment or tax structure of the transaction."[14] The participant must retain the materials until the statute of limitations related to the final year for which a Form 8886 must be filed has expired.[15] According to the regulations, the materials that need to be retained include (i) marketing materials, (ii) written analyses used in decision-making related to the transaction, (iii) correspondence and any agreements between the taxpayer and any advisor, lender, or other party to the transaction, (iv) documents discussing, referencing, or demonstrating the purported tax benefits arising from the reportable transaction, and (v) documents referring to the business purposes for the transaction.[16] A participant is not required to retain earlier drafts of a document if the participant retains a copy of the final document (or most recent draft, if no final document was created) and it contains all the information in the earlier drafts that is material to an understanding of the purported tax treatment and structure.[17]

2. Information Related to "Material Advisors"

In addition to pressuring "participants," Notice 2017-10 places "material advisors" on notice that it will be scrutinizing them, too.

The general definition of "material advisor" for these purposes is the following:

> A person is a material advisor with respect to a transaction if the person provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and directly or indirectly derives gross income in excess

> of the threshold amount … for the material aid, assistance, or advice. The term transaction includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan or arrangement, and includes any series of steps carried out as part of a plan.[18]

A person provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction (including a listed transaction) if that person (i) makes or provides a "tax statement" before the first tax return reflecting the benefits of the transaction is filed with the IRS, (ii) to or for the benefit of certain persons, and (iii) derives at least a certain amount of gross income with respect to such tax statement.[19] A "tax statement" is any statement, oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction, including a listed transaction.[20]

Notice 2017-10 indicates that material advisors must file Forms 8918 and maintain certain lists for all SCETs occurring in 2010 or later years. It then warns that the IRS might assert penalties under Code Sec. 6707 for failure to file Form 8918. In the case of a listed transaction, like an SCET, the penalty is equal to the greater of (i) $200,000, or (ii) 50 percent of the gross income derived by the material advisor with respect to the aid, assistance, or advice that is provided with respect to the listed transaction before the date the return is filed.[21] The penalty increases where there is an intentional failure to file Form 8918. In these situations, the penalty equals the greater of (i) $200,000, or (ii) 75 percent of the gross income derived in connection with the aid, assistance, or advice given with respect to the listed transaction.[22] Once the IRS assesses a penalty for a listed transaction, it does not have the authority to rescind it.[23]

Notice 2017-10 also raises the prospect of penalties under Code Sec. 6708 for material advisors who neglect to maintain necessary data or remit it to the IRS upon demand. In addition to filing Form 8918, material advisors must maintain for each reportable transaction a list of information about their clients, the reportable transaction in which they participated, the amount invested by each client, the tax benefits obtained, the material advisors involved, *etc*.[24] Material advisors must retain these lists for seven years and provide them to the IRS upon written request.[25] If any material advisor fails to make the list available to the IRS upon 20 days of the written request, then the IRS generally can assert a penalty of $10,000 per day.[26] However, the penalty will not be imposed if the material advisor had "reasonable cause" for not providing the list in a timely manner.[27]

3. Information Related to Return Preparers and Appraisers

Last, but certainly not least, Notice 2017-10 features some threats for return preparers and appraisers. It states the following in this regard:

> *In addition, the IRS may impose other penalties on persons involved in these transactions or substantially similar transactions, including* the accuracy-related penalty under §6662 or §6662A, *the §6694 penalty for understatements of a taxpayer's liability by a tax return preparer*, and the §6695A penalty for certain valuation misstatements attributable to incorrect appraisals.

D. Concept of Participation

As indicated above, Notice 2017-10 requires taxpayers who "participate" in an SCET or in a substantially similar transaction to file Form 8886. For these purposes, a taxpayer has "participated" in an SCET if the taxpayer's tax return reflects the tax consequences or a tax strategy described in Notice 2017-10. For instance, a partner who receives a Schedule K-1 from a partnership that has engaged in an SCET is considered to have "participated" in the transaction.[28] Notice 2017-10 indicates that "participants" in SCETs include (i) investors/partners, (ii) the passthrough entity that actually engaged in the transaction (any tier, if multiple tiers are involved in the transaction), and (iii) any other person whose tax return reflects tax consequences or a tax strategy described as an SCET.[29]

The regulations clarify that if a reportable transaction results in a loss that is carried back to a previous year, then the taxpayer must enclose Form 8886 with the application for tentative refund or amended return for the previous year.[30] By extension, if a taxpayer participates in an SCET in one year and carries forward a portion of the relevant charitable deduction to later years, then the taxpayer would be "participating" in the SCET in the later years and would thus need to file Forms 8886, as appropriate.

E. Future Challenges by the IRS of SCETs

Notice 2017-10 warns of upcoming challenges by the IRS. It commences by underscoring the obvious, which is that the IRS considers SCETs to be "tax-avoidance transactions."[31] It further states that the IRS intends to challenge the tax benefits of SCETs on grounds that the easements have been overvalued.[32] Lastly, it indicates that the IRS might also contest SCETs based on the partnership anti-abuse rules, the economic substance doctrine, or other unspecified rules or doctrines.[33]

IV. Recent Action for Injunction, Penalties, Fee Disgorgement, and More

The second big action by the U.S. government designed to halt the conservation easement industry, after the issuance of Notice 2017-10, was the filing of a Complaint by the DOJ in a District Court in Georgia in December 2018 ("Complaint"). Most charging documents filed by the DOJ are filled with hyperbole, and the Complaint is no exception. It alleges, for instance, that the named parties are involved in a "scheme [that] amounts to nothing more than a thinly veiled sale of grossly overvalued federal tax deductions under the guise of investing in a partnership."[34]

To be clear, none of the parties identified by the DOJ in the Complaint is an accountant or accounting firm. Certain allegations and language in the Complaint have some accountants on edge nevertheless. Below are various examples:

- Paragraph 6 of the Complaint indicates that it is aimed at enjoining the named parties "and any other person or persons in active concert or participation with them" from all easement-related activities.
- Paragraph 61 of the Complaint describes what the DOJ considers the main steps in the alleged easement "scheme," including two that involve preparation of tax returns.

> Step Ten: A return preparer prepares the LLC's tax return, Form 1065 and accompanying schedules reporting the conservation easement as a charitable contribution. As part of this process, the return preparer also prepares the Schedules K-1 for each customer/LLC member on which the customer's share of the conservation easement deduction is reported. As part of the Form 1065, the LLC files a Form 8283 (appraisal summary), which must be signed by the appraiser and the land trust (or other organization to which the conservation easement was donated). The appraiser also prepares a supplemental statement to accompany the Form 8283 and submits a copy of the final appraisal to the LLC with the knowledge that it will be used to support a charitable contribution deduction reported on the Form 1065 and ultimately claimed by the individual customers.
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> Step Eleven: Customers [*i.e.*, the individual partners] file their income tax returns, Forms 1040, reporting overvalued charitable contribution deductions arising from the conservation easements. The customers receive copies of their Schedules K-1, Forms 8283 (appraisal summaries), supplemental statements, and appraisal reports from the LLC and submit them with their income tax returns as support for the improper and overstated deductions claimed. The improper and overstated deductions ultimately reduce the customers' reported tax liabilities.

- Paragraphs 201 through 2010 of the Complaint allege that (i) the relevant appraiser is a "tax return preparer" for purposes of Code Sec. 6694 because he prepared tax returns or substantial portions of tax returns for compensation and/or provided advice for positions or entries taken on federal tax returns, and (ii) he prepared "portions of the conservation easement syndicates' tax returns," including the Forms 8283 and the appraisal.
- In the Prayer for Relief (*i.e.*, the portion of the Complaint in which the DOJ describes the remedies that it is seeking), the DOJ asks the District Court to do several things, including, but certainly not restricted to, the following: (i) determine that the relevant appraiser has engaged in conduct that can be penalized under Code Sec. 6694, (ii) enjoin all parties from preparing, or assisting in the preparation of, any federal tax return, or any document that may be filed in support of a tax return, claiming benefits resulting from a conservation easement under Code Sec. 170(h), such as Forms 8283, attachments to Forms 8283, or appraisals, (iii) enjoin all parties from preparing, or assisting in the preparation of, any federal tax return, or any document that may be filed in support of a tax return, that they know will result in the understatement of any tax liability or the overstatement of federal tax refunds, (iv) enjoin all parties from facilitating any donation that is intended to qualify as a tax-deductible easement donation under Code Sec. 170(h), (v) enjoin all parties from advising or representing any individual (*e.g.*, an individual partner in a partnership deemed to be an SCET) before the IRS with respect to any donation that is intended to qualify as a tax-deductible easement donation under Code Sec. 170(h), (vi) enjoin all parties from engaging in any activity that is subject to return preparer penalties under Code Sec. 6694, and (vii) obligate all parties to disgorge to the U.S. government the "gross receipts" that they received from any source as a result of their involvement with the supposed conservation easement "scheme," plus interest.

- Also, in the Prayer for Relief, the DOJ urges the District Court to clarify that any injunction binds not only the named parties, but also all "other persons who are in active concert or participation with" any of the named parties.

V. Preparer Penalties Under Code Sec. 6694

To grasp the concerns by accounting firms triggered by Notice 2017-10 and the Complaint, it is first necessary to understand more about preparer penalties under Code Sec. 6694.

A. Preparer Penalties—General Standards

The IRS generally can penalize a return preparer in situations where (i) the preparer prepared a tax return or refund claim; *and* (ii) the tax return or refund claim included a position; *and* (iii) the position results in an understatement of the taxpayer's liability; *and* (iv) the preparer knew (or reasonably should have known) of the position; *and* (v) the position is with respect to a Tax Shelter (as defined in Code Sec. 6662(d)(2)(C)(ii)) *or* a Reportable Transaction to which Code Sec. 6662A applies (including Listed Transactions), *and* it was not reasonable for the preparer to believe that the position would more likely than not be sustained if challenged by the IRS.[35]

B. Penalty Amount

The penalty for violations equals the larger of $1,000 or 50 percent of the income that the preparer derived (or will derive) with respect to the relevant tax return or refund claim, whichever amount is larger.[36] The penalty increases to $5,000 or 75 percent of the income in cases where the preparer willfully attempts to understate the tax liability on the tax return or refund claim, and where the preparer recklessly or intentionally disregards the rules and regulations.[37]

C. Reasonable Cause and Good Faith Exception

The IRS cannot assert a penalty if the preparer can demonstrate that there was reasonable cause for the tax understatement and the preparer acted in good faith.[38] In other words, even if the position in question involved a Reportable Transaction to which Code Sec. 6662A applies (including Listed Transactions), and it was not reasonable for the preparer to believe that the position would more likely than not be sustained if challenged by the IRS, the preparer can nonetheless avoid penalties if there was reasonable cause for the tax understatement and the preparer acted in good faith.

There is a detailed explanation later in this article about the ability of a preparer to satisfy the reasonable-cause-and-good-faith exception by relying on information and advice provided by taxpayers and others.[39]

In addition to reliance on information and advice from others, Reg. §1.6694-2(e) identifies other factors that the IRS considers in determining whether the reasonable-cause-and-good-faith exception applies. These consist of the following:

- *Nature of the Error Causing the Tax Understatement*. Reasonable cause may exist if the error resulted from a tax provision that was complex, uncommon, or highly technical, and a competent tax return preparer of tax returns or claims for refund of the type at issue reasonably could have made the error. However, reasonable cause does not apply to an error that would have been apparent from a general review of the return or claim for refund by the tax return preparer.[40]
- *Frequency of Errors*. Reasonable cause may exist if the understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error), rather than a number of errors. Although the reasonable-cause-and-good-faith exception generally applies to an isolated error, it does not apply if the isolated error is so obvious, flagrant, or material that it should have been discovered during a review of the return or claim for refund.[41] Furthermore, the exception does not apply if there is a pattern of errors on a return or claim for refund, even though any one error, in isolation, would have qualified for the exception.
- *Materiality of Errors*. Reasonable cause may also exist if the understatement was not material in relation to the correct tax liability. However, even an immaterial understatement may not qualify for the reasonable-cause-and-good-faith exception if the error or errors creating the understatement are sufficiently obvious or numerous.[42]
- *Preparer's Normal Office Practice*. Reasonable cause may exist if the preparer's normal office practice, when considered together with other facts and circumstances, such as the knowledge of the preparer, indicates that the error in question would occur rarely, and the normal office practice was followed in preparing the return or claim for refund in question.[43] Such a normal office practice must be a system for promoting accuracy and consistency in the preparation of returns or claims for refund and

generally would include, in the case of a signing tax return preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures. Notwithstanding these rules, the reasonable-cause-and-good-faith exception does not apply if there is a flagrant error on a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims for refund.[44]

- *Generally Accepted Administrative or Industry Practice*. Reasonable cause may exist if the preparer reasonably relied in good faith on generally accepted administrative or industry practice in taking the position that resulted in the understatement. A tax return preparer is not considered to have relied in good faith if he knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the administrative or industry practice was no longer reliable due to developments in the law or IRS administrative practice since the time the practice was developed.[45]

D. Special Rules for Listed Transactions

As indicated above, the IRS generally can penalize a return preparer in situations where the preparer prepared a tax return or refund claim, it included a position, the position results in an understatement of the taxpayer's liability, the preparer knew (or reasonably should have known) of the position, the position concerns a Reportable Transaction to which Code Sec. 6662A applies (including Listed Transactions), and it was not reasonable for the preparer to believe that the position would more likely than not be sustained if challenged by the IRS.[46] Various issues related to this general rule are examined below.

1. Reasonable Belief

a. General Guidance. Reg. §1.6694-2(b)(1) generally explains the reasonable-to-believe-a-position-is-more-likely-than-not standard as follows:

> If a position is with respect to … a reportable transaction to which Section 6662A applies, it is "reasonable to believe that a position would more likely than not be sustained on its merits" if the tax return preparer analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably concludes in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits. In reaching this conclusion, the possibility that the position will not be challenged by the Internal Revenue Service (IRS) (for example, because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account … .
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> Whether a tax return preparer meets this [reasonable-to-believe-a-position-is-more-likely-than-not] standard will be determined based upon all facts and circumstances, including the tax return preparer's diligence. In determining the level of diligence in a particular situation, the tax return preparer's experience with the area of Federal tax law and familiarity with the taxpayer's affairs, as well as the complexity of the issues and facts, will be taken into account.
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> A tax return preparer may reasonably believe that a position more likely than not would be sustained on its merits despite the absence of other types of authority, if the position is supported by a well-reasoned construction of the applicable statutory provision.
>
> *For purposes of determining whether it is reasonable to believe that the position would more likely than not be sustained on the merits, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer and information and advice furnished by another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), as provided in §§1.6694–1(e) and 1.6694–2(e)(5)*.[47]

b. Tax Authorities Than Can Be Considered. Reg. §1.6694-2(b)(2) clarifies the types of materials that return preparers can review in making their determination regarding the sustainability of a position. It states that "[t]he authorities considered in determining whether a position satisfies the more likely than not standard are those authorities provided in [Treas. Reg.] §1.6662-4(d)(3)(iii)." Such authorities consist of the following: Applicable provisions of the Internal Revenue Code; Proposed, temporary, and final regulations; Revenue Rulings; Revenue Procedures; Tax treaties and Treasury Department and other official explanations of such treaties; Court cases; Congressional intent, as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made before enactment by one of a bill's managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation; Certain

Private Letter Rulings, Technical Advice Memoranda, Action on Decisions, and General Counsel Memoranda; IRS information or press release and notices; and/or Announcements and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin.[48]

c. When a Return Preparer Makes a Determination. The return preparer makes the determination about whether there is a reasonable belief that a position satisfies the more likely than not standard on the date that the relevant return is prepared or deemed prepared, *not* at some later point, such as when the IRS eventually audits the return or a court rules on the position.[49]

2. Cross-References to Other Regulations Discussing Reliance on Others

As explained above, Reg. §1.6694-2(b)(1) indicates that a preparer is allowed to rely in good faith on information provided by the taxpayer, as well as information and advice provided by another advisor, another preparer, or another party, without independently verifying the information and/or advice. In doing so, it specifically cross-references the following two regulations, which contain additional data about reasonable reliance and the avoidance of penalties under Code Sec. 6694.

a. First Cross-Reference: Reg. §1.6694-1(e). Reg. §1.6694-1(e)(1) provides the following general guidance:

> *For purposes of Sections 6694(a) and (b) (including demonstrating that a position complied with relevant standards under Section 6694(a) and demonstrating reasonable cause and good faith under §1.6694-2(e)), the tax return preparer generally may rely in good faith without verification upon information furnished by the taxpayer.*
>
> *A tax return preparer also may rely in good faith and without verification upon information and advice furnished by another advisor, another tax return preparer or other party (including another advisor or tax return preparer at the tax return preparer's firm).*
>
> The tax return preparer *is not required* to audit, examine or review books and records, business operations, documents, or other evidence *to verify independently* information provided by the taxpayer, advisor, other tax return preparer, or other party.
>
> The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer.
>
> The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.
>
> Additionally, some provisions of the Code or regulations require that specific facts and circumstances exist (for example, that the taxpayer maintain specific documents) before a deduction or credit may be claimed. The tax return preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition of the claiming of a deduction or credit.

For its part, Reg. §1.6694-1(e)(3) provides the following examples on the topic of reliance and verification:

> **Example 1.** During an interview conducted by *Preparer E*, a taxpayer stated that he had made a charitable contribution of real estate in the amount of $50,000 during the tax year, when in fact he had not made this charitable contribution. *E did not inquire about the existence of a qualified appraisal or complete a Form 8283, Noncash Charitable Contributions, in accordance with the reporting and substantiation requirements under Code Sec. 170(f)(11).* E reported a deduction on the tax return for the charitable contribution, which resulted in an understatement of liability for tax, and signed the tax return as the tax return preparer. *E is subject to a penalty under Code Sec. 6694.*

Example 1 is an application of the following rule from Reg. §1.6694-1(e)(1): "Additionally, some provisions of the Code or regulations require that specific facts and circumstances exist (for example, that the taxpayer maintain specific documents) before a deduction or credit may be claimed. The tax return preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition of the claiming of a deduction or credit."

Notably, Example 1 indicates that the return preparer would be penalized under Code Sec. 6694 because (i) he relied solely on an oral statement from a client without reviewing or requesting any type of substantiation, (ii) he failed to confirm whether the statutory requirements for claiming a deduction (such as attaching a completed Form 8283 and a qualified appraisal to the relevant tax return) had been satisfied, (iii) he signed a return that was deficient from the outset in that it did not have all the enclosures to meet the specific requirements of Code Sec. 170, and (iv) it appears that the taxpayer was engaged in some type of fraud, making false statements to both the return preparer and the IRS. Also, Example 1 does not indicate that the size of the deduction claimed by the taxpayer was a reason for the penalty under Code Sec. 6694. Finally, Example 1 does not involve an SCET because it does not reference a Schedule K-1 received by the taxpayer and then passed to the return preparer; rather, it involves an individual taxpayer supposedly making a personal charitable contribution of real property.

Example 2. While preparing the 2008 tax return for an individual taxpayer, *Preparer F* realizes that the taxpayer did not provide a Form 1099–INT, *Interest Income*, for a bank account that produced significant taxable income in 2007. When F inquired about any other income, the taxpayer furnished the Form 1099–INT to F for use in preparation of the 2008 tax return. *F did not know* that the taxpayer owned an additional bank account that generated taxable income for 2008, *and the taxpayer did not reveal* this information to the tax return preparer notwithstanding F's general inquiry about any other income. F signed the taxpayer's return as the tax return preparer. *F is not subject to a penalty under Code Sec. 6694*.

Example 2 is an application of the following rules from Reg. §1.6694-1(e)(1): "[T]he tax return preparer generally may rely in good faith without verification upon information furnished by the taxpayer" and "The tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party."

Importantly, in Example 2, the return preparer asked the taxpayer about interest income, the taxpayer provided only one Form 1099-INT when he should have provided additional Forms 1099-INT, and the return preparer relied on the incomplete information from the taxpayer, without conducting any additional due diligence, such as accessing the taxpayer's "Wage & Income Transcript" from the IRS to see all Form 1099, Form W-2, and other data. Also, Example 2 made no comment about the fact that the return preparer accepted, at face value and with no further inquiry, the figures on the one Form 1099-INT that the taxpayer supplied.

Example 3. In preparing a tax return, for purposes of determining the deductibility of a contribution by an employer for a qualified pension plan, *Accountant G relies on a computation of the Code Sec. 404 limit on deductible amounts made by the enrolled actuary for the plan*. On the basis of this calculation, G completed and signed the tax return. It is later determined that there is an understatement of liability for tax that resulted from the overstatement of the Code Sec. 404 limit on deductible amounts made by the actuary. *G had no reason to believe that the actuary's calculation of the limit on deductible contributions was incorrect or incomplete, and the calculation appeared reasonable on its face*. G was also not aware at the time the return was prepared of any reason why the actuary did not know all of the relevant facts or that the calculation of the limit on deductible contributions was no longer reliable due to developments in the law since the time the calculation was given. *G is not subject to a penalty under Code Sec. 6694. The actuary, however, may be subject to penalty under Code Sec. 6694* if the calculation provided by the actuary constitutes a substantial portion of the tax return within the meaning of Reg. 301.7701-15(b)(3).

Example 3 is an application of the following rules from Reg. §1.6694-1(e)(1): "A tax return preparer also may rely in good faith and without verification upon information and advice furnished by another advisor, another tax return preparer or other party (including another advisor or tax return preparer at the tax return preparer's firm)" and "The tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party" and "The tax return preparer must make reasonable inquiries [only] if the information as furnished appears to be incorrect or incomplete."

b. Second Cross-Reference: Reg. §1.6694-2(e)(5). Reg. §1.6694-2(e) provides guidance about the non-imposition of preparer penalties under Code Sec. 6694 where the tax understatement was due to reasonable cause and the preparer acted in good faith. In describing the factors to consider, Reg. §1.6694-2(e)(5) indicates the following about reliance on information and advice from others:

> *For purposes of demonstrating reasonable cause and good faith, a tax return preparer may rely without verification upon advice and information furnished by the taxpayer and information and advice furnished by another advisor, another tax return preparer or other party, as provided in §1.6694-1(e).*

> *The tax return preparer may rely in good faith on the advice of, or schedules [including Schedules K-1] or other documents prepared by, the taxpayer, another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), who the tax return preparer had reason to believe was competent to render the advice or other information*.
>
> The advice or information may be written or oral, but in either case the burden of establishing that the advice or information was received is on the tax return preparer.
>
> A tax return preparer is *not* considered to have relied in good faith if (i) *The advice or information is unreasonable on its face*; (ii) The tax return preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts; or (iii) The tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the advice or information was no longer reliable due to developments in the law since the time the advice was given.

The Preamble to the proposed regulations provides confirmation and clarity regarding the ability of a preparer to avoid penalties under Code Sec. 6694 by relying on a Schedule K-1. It states the following:

> *Another commentator stated that this provision should cover the situation where a preparer, in preparing a taxpayer's return, relies on a Schedule K-1 that has been prepared by another preparer. No change is necessary to permit reliance on a Schedule K-1 prepared by another preparer as the proposed and final regulations both permit a preparer to rely on "the advice of, or schedules prepared by" another preparer (or by a person who would be considered a preparer had the advice or schedules constituted preparation of a substantial portion of the return or claim for refund)*.[50]

3. Guidance from IRS About Form 8283 and Reliance on Schedules K-1

Consistent with the regulations addressed above, the Instructions for Form 8283 support the position that it is acceptable for a return preparer to rely on a Schedule K-1 issued by a partnership that donated an easement as part of an SCET.[51] Page 1 on the Instructions for Form 8283 seems to anticipate that the individual taxpayer or return preparer for the Form 1040 will have limited information about the charitable contribution and will simply refer to, and rely on, the Schedule K-1. It states the following:

> Partnerships and S corporations. A partnership or S corporation that claims a deduction for noncash gifts of more than $500 must file Form 8283 with Form 1065, 1065-B, or 1120S … The partnership or S corporation must give a completed copy of Form 8283 to each partner or shareholder receiving an allocation of the contribution deduction shown in Section B of Form 8283 of the Form 8283 of the partnership or S corporation.
>
> Partners and shareholders. *The partnership or S corporation will provide information about your share of the contribution on your Schedule K-1 (Form 1065 or 1120S)*. If you received a copy of Form 8283 from the partnership or S corporation, attach a copy to your tax return. *Use the amount shown on your Schedule K-1, not the amount shown on the Form 8283, to figure your deduction*. If the partnership or S corporation is not required to give you a copy of its Form 8283, combine the amount of noncash contributions shown *on your Schedule K-1* with your other noncash contributions to see if you must file Form 8283. *If you need to file Form 8283, you do not have to complete all the information requested in Section A for your share of the partnership's or S corporation's contributions. Complete only column (h) of Line 1 with your share of the contribution and enter "From Schedule K-1 (Form 1065 or 1120S)" across columns (d) – (g)*."

4. Guidance from IRS About Schedules K-1

Also, consistent with the regulations addressed above, Partner's Instructions for Schedule K-1 (Form 1065) (2017) support the position that it is acceptable for a taxpayer and a return preparer to rely on a Schedule K-1 issued by a partnership that donated a conservation easement. Page 1 explains that partners are expected to place on their tax returns the data from the partnership in the manner characterized by the partnership:

> Generally, you must report partnership items shown on your Schedule K-1 (and any attached statements) the same way that the partnership treated the items on its return … If the treatment on your original or amended return is inconsistent with the partnership's treatment, or if the partnership was required to but has not filed

> a tax return, you must file Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR), with your original or amended return to identify and explain any inconsistency (or to note a partnership return has not been filed).

Broadly speaking about Part III (Partner's Share of Current Year Income, Deductions, Credits, and Other Items), Page 6 of Partner's Instructions for Schedule K-1 (Form 1065) (2017) states the following:

> The amounts shown in boxes 1 through 20 reflect your share of income, loss, deductions, credits, and other items from partnership business or rental activities without reference to limitations on losses or adjustments that may be required … If you are an individual and the passive activity rules do not apply to the amounts shown on your Schedule K-1, take the amounts shown and enter them on the lines on your tax return as indicated in the summarized reporting information shown on page 2 of Schedule K-1.

With respect to Box 13 (Other Deductions) of Part IIII of Schedule K-1, Page 9 of Partner's Instructions for Schedule K-1 (Form 1065) (2017) provides as follows:

> Code C. Noncash contributions (50%). If property other than cash is contributed, and if the claimed deduction for one item or group of similar items of property exceeds $5,000, the partnership must give you a copy of Form 8283, Noncash Charitable Contributions, to attach to your tax return. Do not deduct the amount shown on Form 8283. It is the partnership's contribution. Instead, deduct the amount identified by code C, box 13, subject to the 50% AGI limitation, on line 17 of Schedule A (Form 1040).

Finally, regarding Code Z (Other Information) for Box 13 (Other Deductions) of Part III of Schedule K-1, Page 16 of Partner's Instructions for Schedule K-1 (Form 1065) (2017) contemplates that a taxpayer will use the data from Schedule K-1, notwithstanding the fact that a reportable transaction (including a listed transaction, like an SCET) is involved. It states the following:

> Code Z. Other Information. The partnership will report the following … Any information you need to complete a disclosure statement for reportable transactions in which the partnership participates. If the partnership participates in a transaction that must be disclosed on Form 8886, Reportable Transaction Disclosure Statement, both you and the partnership may be required to file Form 8886 for the transaction. The determination of whether you are required to disclose a transaction of the partnership is based on the category(s) under which the transaction qualifies for disclosure and is determined by you and the partnership.

VI. Potential Code Sec. 6694 Penalties and Preparers of Forms 1040

In its zeal to curb the conservation easement industry, it is possible that the IRS might attempt to assert Code Sec. 6694 penalties against an accountant who merely prepares a Form 1040 for an individual partner in a partnership that participated in an SCET. The argument might go something like this. While a tax return preparer generally can rely in good faith on the advice of, or schedules (including Schedules K-1) and other documents prepared by, the taxpayer, a competent advisor, a competent tax return preparer, or another competent party, a tax return preparer cannot do so if the advice or document is "unreasonable on its face." The IRS identified SCETs as a listed transaction in Notice 2017-10, which might be interpreted to mean that it is not reasonable for a tax return preparer to rely on another preparer's opinion. If that is the case, then the accountant preparing the Form 1040 for the individual partner would be required to conduct his own independent analysis of the SCET in order to determine whether the reasonable-to-believe-a-position-is-more-likely-than-not standard has been met. The accountant, taking into account the position expressed by the IRS in Notice 2017-10, the size of the charitable deduction showing on Schedule K-1, and the data on Form 8283, might conclude that the SCET is not more likely than not to be upheld if challenged by the IRS. If so, then the accountant could be subject to Code Sec. 6694 penalties if he were to prepare the Form 1040.

A. The Argument by the IRS Regarding Code Sec. 6694 Penalties Has Some Potential Shortcomings, Though. These Weaknesses, Based on the Regulations and Other IRS Guidance Described Above, Are as Follows.

- Generally, granting a conservation easement and claiming the related charitable deduction is supported by Congress, as evidenced by Code Sec. 170(h).

- Reg. §1.6694-2(b)(1), Reg. §1.6694-1(e)(1), and Reg. §1.6694-2(e)(5) all expressly state that return preparers generally can rely without verification on information, advice, schedules (such as Schedules K-1) and other documents provided by a taxpayer, a competent advisor, a competent return preparer, or another competent party for purposes of demonstrating that a tax position complied with the relevant standard under Code Sec. 6694, and demonstrating that the return preparer acted with reasonable cause and in good faith.
- Example 1, Example 2, and Example 3 in Reg. §1.6694-1(e)(3) support general notions of unverified reliance on others and limited due diligence by return preparers.
- The Preamble to the proposed Code Sec. 6694 regulations expressly states that a return preparer can rely on a Schedule K-1 prepared by another preparer. As explained above, the Preamble indicates that "[n]o change is necessary to permit reliance on a Schedule K-1 prepared by another preparer as the proposed and final regulations both permit a preparer to rely on 'the advice of, or schedules prepared by' another preparer … "[52]
- The IRS's Instructions to Form 8283 indicate that (i) a partnership claiming certain deductions, such as those stemming from an SCET, must provide the partners with a copy of its Form 8283 and a Schedule K-1, (ii) partners should use the figures on Schedule K-1 to figure their share of the deduction to be claimed on their Forms 1040, and (iii) the Forms 8283 that partners file do not need to be complete and should expressly cross-reference the data from the partnership by writing "From Schedule K-1 (Form 1065)."
- Partner's Instructions for Schedule K-1 (Form 1065) (2017) indicate that (i) taxpayers generally must report partnership items shown on their Schedules K-1, including deductions derived from easement donations, the same way that the partnership treated the items on its Form 1065, (ii) taxpayers should report on their Forms 1040 the amount of the noncash charitable contribution identified in Box 13 of Schedule K-1, not the amount shown on the Form 8283, and (iii) the fact that a reportable transaction is involved, and the partnership and partners must file Forms 8886, does not change the preceding guidance from the IRS.
- Reg. §1.6694-2(e)(5) indicates that a return preparer will not be considered to have acted in good faith in several scenarios, including where the information or documentation provided by a taxpayer, a competent advisor, a competent tax return preparer, or another competent party is "unreasonable on its face." However, the fact that the IRS administratively decided to label SCETs as "listed transactions" in Notice 2017-10 does not necessarily mean that a return preparer cannot rely on others or that the easement-related documentation provided by others (such as a Schedule K-1, Form 8283, deed of conservation easement, appraisal, baseline report, *etc.*) is "unreasonable on its face."
- If IRS's position were correct in that the mere labeling of a transaction as a "listed transaction" automatically means that any documentation prepared in connection with the transaction (such as a Schedule K-1) is "unreasonable on its face," then before completing a Form 1040, return preparers would be required to conduct their own independent tax, valuation, and/or legal analysis of the 36 different transactions that the IRS has thus far identified as "listed transactions." This, of course, would be unfeasible for most return preparers from an economic, human resource, and liability perspective, the likely result of which would be that many individual taxpayers who participated in a listed transaction would simply be unable to find a return preparer to complete their Forms 1040.
- The fact that the IRS has identified an SCET as a "listed transaction" in Notice 2017-10 does not necessarily mean that it is unreasonable for a return preparer to believe that positions taken by taxpayers with respect to an SCET would more likely than not be sustained if challenged. The IRS regularly challenges easement-related partnerships, and taxpayers have prevailed in a significant number of cases during examination, appeal, or litigation. Moreover, in many cases won by the IRS, the problem focused solely on the failure by the partnership to meet a long list of technical requirements in Code Sec. 170 and the corresponding regulations. In other words, the IRS's victory was unrelated to the valuation/appraisal and thus unrelated to the figures provided to the partners on Schedules K-1.
- Reg. §1.6694-2(b)(5) specifically states that the return preparer makes the determination about whether there is a reasonable belief that a position satisfies the more likely than not standard on the date that the relevant tax return is prepared or deemed prepared, not at a later point, such as at the end of a long tax dispute, after the audit, appeal, and/or litigation. The fact that the IRS ultimately prevails in an easement case, after a multi-year tax dispute during which the relevant precedent has evolved, does not mean that a return preparer could not have had a reasonable belief years earlier when he prepared the Form 1040 for the partner.

- The IRS's position fails to consider the reasonable cause and good faith exception to return preparer penalties, which is set forth in Code Sec. 6694(a)(3) and Reg. §1.6694-2(e)(5).

VII. Conclusion

Notice 2017-10 and the Complaint, in conjunction with the extreme positions that the IRS is taking in many current partnership disputes, demonstrate that the IRS continues its quest to halt SCETs and is willing to raise creative arguments to achieve its goal. This has fueled concern about potential penalty exposure among certain members of the tax community, including accountants whose sole involvement is preparing Forms 1040 for individual partners who participate in SCETs. As this article demonstrates, the IRS and DOJ might encounter several factual, practical, and legal challenges if it were to pursue Code Sec. 6694 penalties against such accountants.

ENDNOTES

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1 Code Sec. 6707A(c)(2); Reg. §1.6011-4(b)(2).

2 For purposes of Notice 2017-10, promotional materials include "written materials, including tax analyses or opinions, relating to each reportable transaction that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any person who acquired or may acquire an interest in the transactions, or to their representatives, tax advisors, or agents, by the material advisor or any related party or agent of the material advisor." Reg. §301.6112-1(b)(3)(iii)(B).

3 Reg. §301.6011-4(c)(4).

4 Reg. §301.6011-4(c)(4).

5 Code Sec. 6707A(a), (b); Reg. §301.6707A-1(a).

6 Code Sec. 6707A(b)(2); Reg. §301.6707A-1(a).

7 Code Sec. 6707A(b)(3); Reg. §301.6707A-1(a).

8 Code Sec. 6707A(d)(1).

9 Code Sec. 6662A(a).

10 Code Sec. 6662A(c).

11 Code Sec. 6501(c)(10).

12 Reg. §301.6501(c)-1(g)(7).

13 Reg. §301.6501(c)-1(g)(8) (Example 14).

14 Reg. §1.6011-4(g)(1).

15 Reg. §1.6011-4(g)(1).

16 Reg. §1.6011-4(g)(1).

17 Reg. §1.6011-4(g)(2).

18 Reg. §301.6111-3(b)(1).

19 Code Sec. 6111(b)(1)(A).

20 Reg. §301.6111-3(b)(2)(ii).

21 Code Sec. 6707(a), (b)(2); Reg. §301.6707-1(a)(1)(ii)(A).

22 Code Sec. 6707(a), (b)(2); Reg. §301.6707-1(a)(1)(ii)(B).

23 Code Sec. 6707(c); Reg. §301.6707-1(e)(1)(i).

24 Code Sec. 6112; Reg. §301.6112-1.

25 Code Sec. 6112(b)(1); Reg. §301.6112-1(b), (d), and (e).

26 Code Sec. 6708(a)(1); Reg. §301.6708-1(a).

27 Code Sec. 6708(a)(2); Reg. §301.6708-1(g), (h).

28 Reg. §1.6011-4(e)(1).

29 Notice 2017-10, Code Sec. 3.

30 Reg. §301.6707A-1(c)(1) and (c)(2), Example 3.

31 Notice 2017-10, Preamble.

32 Notice 2017-10, Code Sec. 1.

33 Notice 2017-10, Code Sec. 1.

34 *N. Zak, C. Clark III, EcoVest Capital Inc., A.N. Solon, R.M. McCullough, and R.R. Teal*, Case No. 1:18-cv-05774-AT, D.C. N.D. Georgia, Complaint filed Dec. 18, 2018.

35 Code Sec. 6694(a)(1) and Code Sec. 6694(a)(2) indicate that the IRS can assert penalties in the following two additional situations: (i) The position is *not* with respect to a Tax Shelter (as defined in Code Sec. 6662(d)(2)(C)(ii)) or Reportable Transaction to which Code Sec. 6662A applies (including Listed Transactions), the position was not adequately disclosed to the IRS, and there was "substantial authority" for the position; *or* (ii) The position is *not* with respect to a Tax Shelter (as defined in Code Sec. 6662(d)(2)(C)(ii)) or Reportable Transaction to which Code Sec. 6662A applies (including Listed Transactions), the position was adequately disclosed, but there was no "reasonable basis" for the position.

36 Code Sec. 6694(a)(1).

37 Code Sec. 6694(b)(1) and (2).

38 Code Sec. 6694(a)(3).

39 *See* the segments of this article, below, called "First Cross-Reference: Treas. Reg. §1.6694-1(e)" and "Second Cross-Reference: Treas. Reg. §1.6694-2(e)(5)."

40 Reg. §1.6694-2(e)(1).

41 Reg. §1.6694-2(e)(2).

42 Reg. §1.6694-2(e)(3).

43 Reg. §1.6694-2(e)(4).

44 T.D. 8382 (Dec. 30, 1991).

45 Reg. §1.6694-2(e)(6).

46 Code Sec. 6694(a)(2)(C).

47 Reg. §1.6694-2(b)(1).

48 Reg. §1.6662-4(d)(3)(iii).

49 Reg. §1.6694-2(b)(5).

50 T.D. 8382 (Dec. 30, 1991).

51 Form 8283 (*Noncash Charitable Contributions*) (Rev. December 2014).

52 T.D. 8382 (Dec. 30, 1991).