Conservation Easements, "Substantially Similar" Transactions, and the Potential Reach of Notice 2017-10

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This article discusses conservation easements, the particulars of Notice 2017-10 and the related reporting obligations, and IRS guidance and recent cases addressing the concept of "substantially similar."

The IRS has been attacking partnerships that donate conservation easements to charities for several years, using a variety of tools. Among its most powerful was the issuance of Notice 2017-10, 2017-4 IRB 544, which identifies syndicated conservation easement transactions ("SCETs") as "listed transactions." This triggers several consequences, including the need for participants in SCETs to file Forms 8886 (Reportable Transaction Disclosure Statement) and for materials advisors to file Forms 8918 (Material Advisor Disclosure Statement). These duties apply not only to SCETs, but also to transactions that are "substantially similar." Overt disclosure to the IRS generates audits, and audits can lead to large tax liabilities and penalties. Some taxpayers, cognizant of this unpleasant reality, are seeking ways to arrange matters such that they accomplish their economic, tax, environmental, and philanthropic goals, while not being considered, by the IRS and/or the courts, "substantially similar" to an SCET. This article discusses conservation easements, the particulars of Notice 2017-10 and the related reporting obligations, and IRS guidance and recent cases addressing the concept of "substantially similar."

Overview of Conservation Easements—Terms, Concepts, and Filings

One must first have a basic understanding of the applicable rules and termi-

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nology in order to appreciate the significance of this article.

What Is a Qualified Conservation Contribution?

Taxpayers generally may deduct the value of any charitable contribution that they make during a year.[1] However, taxpayers are not entitled to deduct donations of property, if they consist of less than their entire interest in such property.[2] One important exception is that taxpayers can deduct a donation of a partial interest in property (instead of an entire interest), provided that it constitutes a "qualified conservation contribution."[3] To meet this critical definition, taxpayers must show that they are (i) donating a qualified real property interest ("QRPI"), (ii) to a qualified organization, (iii) exclusively for conservation purposes.[4]

What Is a QRPI?

A QRPI can be one of several things, including a restriction, granted in perpetuity, on the use of a particular piece of real property.[5] This is known by many names, among them "conservation easement" and "conservation restriction."[6] Regardless of what you call them, QRPIs must be based on legally enforceable restrictions, memorialized in a Deed of Conservation Easement filed with the proper court or other location, preventing uses of the property, forever, which are inconsistent with the conservation purposes.[7]

For What Purposes Can Land Be Conserved?

A donation has a "conservation purpose" if it meets 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.[8] Such conservation purposes must be protected forever in order to trigger the tax deduction. Indeed, a donation is not treated as "exclusively for conservation purposes," unless the conservation purposes are "protected in perpetuity."[9]

Can Taxpayers Reserve Rights in the Protected Property?

A taxpayer can retain certain "reserved rights," still make a qualified conservation contribution, and thus qualify for the tax deduction. However, in keeping something for themselves, taxpayers must ensure that the reserved rights do not unduly conflict with the conservation purposes.[10] The IRS openly recognizes, in its Conservation Easement Audit Techniques Guide ("ATG"), that reserved rights are ubiquitous. The ATG states the following about taxpayer holdbacks:

> *All conservation easement donors reserve some rights to the property.* Depending on the nature and extent of these reserved rights, the claimed conservation purpose may be eroded or impaired to such a degree that the contribution may not be allowable. A determination of whether the reserved rights defeat the conservation purpose must be determined based on all the facts and circumstances.[11]

The regulations provide more specifics about reserved rights and uses that might be inconsistent with the conservation purpose of an easement.

> [A] deduction will not be allowed if the contribution would accomplish one of the enumerated conservation purposes but would permit destruction of other significant conservation interests . . . . However, this requirement is not intended to prohibit uses of the property, such as selective timber harvesting or selective farming if, under the circumstances, those uses do not impair significant conservation interests . . . . A use that is destructive of conservation interests will be permitted only if such use is necessary for the protection of the conservation interests that are the subject of the contribution . . . . A donor may continue a pre-existing use of the property that does not conflict with the conservation purposes of the gift.[12]

How Do Taxpayers Prove the Condition of the Property at Donation Time?

In situations involving the donation of a QRPI where the donor reserves certain rights, the tax deduction will not be allowed unless the donor "makes available" to the easement-recipient, before the donation is made, "documentation sufficient to establish the condition of the property at the time of the gift."[13] This is generally called the Baseline Report.

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1 Section 170(a)(1); Reg. 1.170A-1(a).
2 Section 170(f)(3)(A); Reg. 1.170A-7(a)(1).
3 Section 170(f)(3)(B)(iii); Reg. 1.170A-7(a)(5).
4 Section 170(h)(1).
5 Section 170(h)(2); Reg. 1.170A-14(a); Reg. 1.170A-14(b)(2).
6 Reg. 1.170A-14(b)(2).
7 Reg. 1.170A-14(g)(1); Turner, 126 TC 299, 311 (2006).
8 Section 170(h)(4)(A); Reg. 1.170A-14(d)(1); S. Rep't No. 96-1007, 96th Cong., 2d Sess,, at 10 (1980).
9 Section 170(h)(5)(A); Reg. 1.170A-14(e)(1).
10 Reg. 1.170A-14(b)(2).
11 Internal Revenue Service, Conservation Easement Audit Techniques Guide (rev. 11/4/2016), pg. 23.
12 Reg. 1.170A-14(e)(2) and (3).
13 Reg. 1.170A-14(g)(5)(i).
14 Reg. 1.170A-14(g)(5)(i).
15 Reg. 1.170A-14(g)(5)(i).
16 Reg. 1.170A-14(g)(5)(i); Internal Revenue Service, Conservation Easements Audit Techniques Guide (rev. 11/4/2016), pg. 24.
17 Section 170(a)(1).
18 Section 170(a)(1); Reg. 1.170A-1(c)(1).
19 Reg. 1.170A-1(c)(2).
20 Reg. 1.170A-14(h)(3)(i).
21 Internal Revenue Service, Conservation Easement Audit Techniques Guide (rev. 11/4/2016), pg. 41.
22 Internal Revenue Service, Conservation Easement Audit Techniques Guide (rev. 11/4/2016), pg. 41.
23 Stanley Works, 87 TC 389, 400 (1986); Reg. 1.170A-14(h)(3)(i) and (ii).
24 Olson, 292 U.S. 246, 255 (1934).
25 Esgar Corp., 744 F.3d 648, 659 n.10 (CA-10, 2014).
26 Esgar Corp., 744 F.3d 648, 657 (CA-10, 2014).
27 Symington, 87 TC 892, 896 (1986).
28 *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, 2006-2 CB 902; TD 9836, 7/27/2018.
29 Notice 2017-10, 2017-4 IRB 544, Preamble and Section 1.
30 Section 6707A(c)(2); Reg. 1.6011-4(b)(2).

The Baseline Report "may" (but not "must") include (i) the appropriate survey maps from the U.S. Geological Survey, showing the property line and other contiguous or nearby protected areas, (ii) a map of the area drawn to scale showing all existing man-made improvements or incursions (*e.g.*, roads, buildings, fences, or gravel pits), vegetation and identification of 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 at an appropriate scale taken as close as possible to the date of the donation, and (iv) on-site photographs taken at appropriate locations on the property.[14] If the easement contains restrictions regarding a particular natural resource, such as water or air quality, then the condition of the resource at or near the time of the donation must be established.[15] The Baseline Report "must be accompanied by a statement signed by the donor and a representative of the [easement-recipient] clearly referencing the [Baseline Report] and in substance" confirming that the property description and the natural resources inventory are accurate.[16]

What Is an Easement Worth?

Generally, a deduction for a charitable donation is allowed in the year in which it occurs.[17] If the donation consists of something other than money, then the amount normally is the fair market value ("FMV") of the property at the time the taxpayer makes the donation.[18] For these purposes, 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.[19]

The regulations provide special rules for calculating a deduction stemming from the donation of a conservation easement.[20] The IRS provides the following summary and hints about valuation to its personnel in the ATG. It explains that the best evidence of FMV of an easement is the sale price of easements comparable to the easement in question, but, "in most instances, there are no comparable easement sales."[21] Appraisers, therefore, often must use the before-and-after method. The ATG acknowledges that this effectively means that an appraiser must determine the highest and best use ("HBU") *and* the corresponding FMV of the relevant property twice: (i) first, without regard to the easement, which generates the "before" value, and (ii) again, taking into account the restrictions on the property imposed by the easement, which creates the "after" value.[22]

As indicated in the preceding paragraph, in deciding the FMV of property, appraisers and courts must take into account not only the current use of the property, but also its HBU.[23] A property's HBU is the highest and most profitable use for which it is adaptable and needed, or likely to be needed, in the reasonably near future.[24] The term HBU has also been defined as the reasonably probable use of vacant land or improved property that is physically possible, legally permissible, financially feasible, and maximally productive.[25] Importantly, valuation does not depend on whether the owner has actually put the property to its HBU.[26] The HBU can be *any* realistic potential use of the property.[27]

A donation is not treated as "exclusively for conservation purposes," unless the conservation purposes are "protected in perpetuity."

How Do Taxpayers Claim an Easement-Related Tax Deduction?

Properly claiming the tax deduction triggered by an easement donation is 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 easement-recipient is a "qualified organization," (iii) obtain a Baseline Report 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 easement-recipient, (v) assuming that the taxpayer is a partnership, file a timely Form 1065, enclosing the Form 8283 and qualified appraisal, (vi) receive from the easement-recipient a proper contemporaneous written acknowledgement, both for the easement itself and for any endowment/stewardship fee donated to finance the perpetual protection of the property, (vii) ensure that all mortgages on the relevant property have been satisfied or subordinated to the easement, and (viii) send all the partners their Schedule K-1 (Partner's Share of Income, Deductions, Credits, etc.) and a copy of the Form 8283.[28] Moreover, as explained below, all parties who "participated" in the easement donation, as well as all "material advisors" to such donation, have additional information-reporting duties.

Certain Easements Become Listed Transactions

In December 2016, the IRS announced in Notice 2017-10 that it intended to challenge what it has coined SCETs on grounds that they supposedly constitute "tax-avoidance transactions" that involve overvaluations of donations.[29] The effect of Notice 2017-10 was that SCETs became what are known as "listed transactions."[30] Accordingly, participants, material advisors, and others involved with SCETs that occurred during or after 2010 are subject to additional reporting, due diligence, and record-keeping requirements.

Description of SCETs

Notice 2017-10 broadly defines an SCET as follows:

> An investor receives promotional materials [oral or written] that offer prospective investors in a pass-

through entity [such as a partnership] the possibility of a charitable contribution deduction[31]

[And such deduction] equals or exceeds an amount that is two and one-half times the amount of the investor's investment . . . .

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.

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.

Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.[32]

Notice 2017-10 also identifies "tacking" of the holding period of the relevant property as one of the hallmarks of an SCET. It describes this concept in the following manner: "Investors who hold their direct or indirect interests in the pass-through entity for one year or less may rely on the pass-through entity's holding period in the underlying real property to treat the donated conservation easement as long-term capital gain property under [Section] 170(e)(1)."[33]

Finally, Notice 2017-10 indicates that the inflated values of the easement donation are attributable to "unreasonable conclusions about the development potential of the real property."[34]

Effect on Participants

Notice 2017-10 had various effects on those who participated in SCETs.

Concept of participation. Notice 2017-10 requires taxpayers who "participate" in an SCET or 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.[35]

Notice 2017-10 indicates that "participants" in SCETs include (i) investors/partners, (ii) the pass-through entity that actually engaged in the transaction, which includes any tier, if the transaction is conducted through a multi-tier structure, with one partnership on top of another, and (iii) any other person whose tax return reflects tax consequences or a tax strategy described as an SCET.[36]

Participation in past and future years. If a reportable transaction results in a loss that is *carried back* to a prior year, then the taxpayer must enclose Form 8886 with the application for tentative refund or amended return for the prior year.[37] On the other hand, 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.

Questions asked on Form 8886. Form 8886 contains certain questions that participants answer begrudgingly, for obvious reasons. The most notable ones are set forth below:

- Line 6—Enter below the name and address of each individual or entity to whom you paid a fee with regard to the transaction if that individual or entity promoted, solicited, or recommended your participation in the transaction, or provided tax advice related to the transaction.
- Line 7b—Further describe the amount and nature of the expected tax treatment and expected tax benefits generated by the transaction for all affected years. Include facts of each step of the transaction that related to the expected tax benefits, including the amount and nature of your investment. Include in your description your participation in the transaction and all related transactions, regardless of the year in which they were entered into. Also, include a description of any tax result protection with respect to the transaction.

Protective Form 8886. Participants are allowed to file a "protective" Form 8886 by checking the box on Line C called "protective disclosure," if they are uncertain as to whether a particular transaction is considered an SCET.[38] Provided that it is completed in full, the IRS will not treat a "protective" Form 8886 any differently than a standard one.[39]

Potential penalties. Notice 2017-10 contains multiple threats about the downsides of non-compliance. First, it explains that 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.[40] The IRS generally reserves this type of big penalty for situations involving fraud by taxpayers.[41] In the case of a listed transac-

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31 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).

32 Notice 2017-10, Section 2.

33 Notice 2017-10, Section 1.

34 Notice 2017-10, Section 1.

35 Reg. 1.6011-4(e)(1).

36 Notice 2017-10, Section 3.

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

38 Reg. 1.6011-4(f)(2).

39 Reg. 1.6011-4(f)(2).

40 Section 6707A(a), (b); Reg. 301.6707A-1(a).

41 Section 6663.

42 Section 6707A(b)(2); Reg. 301.6707A-1(a). The minimum penalty is $5,000 for individuals and $10,000 for entities. *See* Section 6707A(b)(3); Reg. 301.6707A-1(a).

43 Section 6707A(d)(1).

44 *See, e.g.,* Barzillai, 137 Fed. Cl. Ct. 788, 121 AFTR2d 2018-1582 (2018); Larson, 888 F.3d 578, 121 AFTR2d 2018-1598 (CA-2, 2018).

45 Section 6662A(a).

46 Section 6662A(c).

47 Section 6501(c)(10).

48 Reg. 301.6501(c)-1(g)(7).

49 Reg. 301.6501(c)-1(g)(8) (Example 14) (emphasis added).

50 Reg. 1.6011-4(g)(1).

51 Reg. 1.6011-4(g)(1).

52 Reg. 1.6011-4(g)(1).

53 Reg. 1.6011-4(g)(2).

tion, like an SCET, the maximum penalty for individual taxpayers is $100,000, while the maximum for entities is $200,000.[42]

Importantly, the IRS does *not* have authority to rescind or abate a penalty assessed against a listed transaction, like an SCET.[43] Also, there is *not* a "reasonable cause" exception to this penalty. Thus, if the IRS assesses Form 8886 penalties, then participants generally cannot fight them as they would other penalties, by filing a Protest Letter and addressing matters with the Appeals Office and/or by filing a Petition with the Tax Court. Rather, they must dispute the penalties through the collection process or by fully paying the penalties, filing a Claim for Refund, and, if the IRS ignores or rejects the Claim for Refund, by filing a refund suit in federal court.[44]

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.[45] This penalty rate increases to 30 percent if the participant fails to file a Form 8886.[46]

Unlimited assessment period for non-filers. In addition to financial penalties, if a "participant" fails to enclose a Form 8886 with a tax return, then the assessment period with respect to the tax return shall remain open until one year after, the earlier of, when the participant eventually files Form 8886, or when the material advisor provides the IRS with the required list of data about the SCET in response to the written request from the IRS.[47] The regulations explain the types of taxes, penalties, and interest that the IRS might assess in situations involving an SCET and unfiled 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 . . . .[48]

Properly claiming the tax deduction triggered by an easement donation is complicated.

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.[49]

Record retention for participants. 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."[50] The participant must retain the materials until the assessment-period related to the final year for which a Form 8886 must be filed has expired.[51] The items that need to be retained may 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.[52] 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.[53]

Effect on Material Advisors

The issuance of Notice 2017-10 had consequences for materials advisors, too.

Definition. A "material advisor" for purposes of listed transactions 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.[54]

There are several exceptions to the definition of "material advisor," none of which are relevant to this article.[55]

Material aid, assistance, or advice. A person provides material aid, assistance, or advice 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, described below, and (iii) derives at least a certain amount of gross income for making or providing such tax statement.[56]

Tax statement. 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.[57] In order to be a "tax statement" for the purposes of the material advisor regulations, the statement must be made to, or for the benefit of, one or more of the following persons: (i) A taxpayer who either is required to disclose the transaction by filing Form 8886 because it is a listed transaction or a transaction of interest; (ii) A taxpayer who the potential material advisor knows is, or reasonably expects to be, required to disclose the transaction by filing a Form 8886 because it is or is reasonably expected to become a listed transaction; (iii) A material advisor who is required to disclose the transaction by filing Form 8918 because it is a listed transaction or a transaction of interest; or (iv) A material advisor who the potential material advisor knows is, or reasonably expects to be, required to disclose the transaction by filing Form 8918 because it is or is reasonably expected to become a listed transaction.[58]

Questions asked on Form 8918. Form 8918, like Form 8886 described above, contains certain questions that most material advisors answer with considerable reluctance. These include the following:

- Line 6a—Provide a brief description of the type of material aid, assistance, or advice you provided.
- Line 6b—Describe the role of any other entity(ies) or individual(s) who you know or have reason to know provided material aid, assistance, or advice to this transaction and include each entity's and individual's complete name, identifying number (if known), and address.
- Line 13—Describe the reportable transaction for which you provided material aid, assistance, or advice, including but not limited to the following: the nature of the expected tax treatment and expected tax benefits generated by the transaction for all affected years, the years the tax benefits are expected to be claimed, the role of the entities and individuals mentioned in Lines 7a or 8a (if any) and the role of the financial instruments mentioned in line 9 (if any). Explain how the Internal Revenue Code sections listed in line 12 are applied and how they allow the taxpayer to obtain the desired tax treatment. Also, include a description of any tax result protection with respect to the transaction.

Potential penalties. Substantial penalties can be imposed on material advisors for not filing 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.[59] To be clear, the failure to file Form 8918 triggers at least a penalty of \$200,000 per violation, per year.

The penalty increases where not filing Form 8918 was intentional. 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.[60]

Once the IRS assesses a Form 8918 penalty for a listed transaction, it does *not* have the authority to rescind or abate it.[61]

Protective disclosures. If a *potential* material advisor is uncertain whether his/her/its involvement in a transaction must be disclosed, then Form 8918 can be filed on a protective basis. Line B of Form 8918 specifically asks if the Form 8918 constitutes a "protective disclosure." The IRS will not treat Forms 8918 filed on a protective basis any differently than other Forms 8918.[62]

List-maintenance requirements. In addition to filing Form 8918, material advisors are required to maintain for each reportable transaction a list of information about their clients, the transaction in which they participated, the amount invested by each client, the tax benefits obtained, the material advisors

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54 Reg. 301.6111-3(b)(1) (emphasis added).
55 Reg. 301.6111-3(b)(2)(iii)(A). For example, the term "material advisor" generally does not include a person who makes a "tax statement" solely in the person's capacity as an employee, shareholder, partner, or agent of another person; any "tax statement" made by such person will be attributed to the employer, corporation, partner, or principal.
56 Section 6111(b)(1)(A).
57 Reg. 301.6111-3(b)(2)(ii).
58 Reg. 301.6111-3(b)(2)(i).
59 Section 6707(a), (b)(2); Reg. 301.6707-1(a)(1)(ii)(A).
60 Section 6707(a), (b)(2); Reg. 301.6707-1(a)(1)(ii)(B).
61 Section 6707(c); Reg. 301.6707-1(e)(1)(i).
62 Reg. 301.6111-3(g).
63 Section 6112; Reg. 301.6112-1.
64 Section 6112(b)(1); Reg. 301.6112-1(b), (d), and (e).
65 Section 6708(a)(1); Reg. 301.6708-1(a).
66 Section 6708(a)(2); Reg. 301.6708-1(g), (h).
67 Reg. 1.6011-4(c)(4).
68 Reg. 1.6011-4(c)(4).
69 Reg. 1.6011-4(c)(4), Example 1 (emphasis added).
70 Reg. 1.6011-4(c)(4), Example 2 (emphasis added).
71 *See, e.g.*, Ltr. Rul. 201017076 (substantial similarity to Notice 95-34, 1995-1 CB 309), Field Service Advice 200218014 (substantial similarity to Notice 2001-16, 2001-1 CB 730), Chief Counsel Advice 200712044 (substantial similarity to Notice 2005-13, 2005-1 CB 630), and Chief Counsel Advice 200929005 (substantial similarity to Notice 2004-8, 2004-4 CB 333).
72 *See, e.g.*, Polowniak, TCM 2016-31 (substantial similarity to Notice 2004-8, 2004-4 CB 333), Blak Investments, 133 TC 431 (2009) (substantial similarity to Notice 2000-44, 2000-2 CB 255), and Our Country Home Enterprises, Inc., 145 TC 1 (2015) (substantial similarity to Notice 2007-83, 2007-2 CB 960).
73 Turnham, 123 AFTR2d 2019-2042 (DC Ala., 2019).

involved, etc.[63] Materials advisors must retain these lists for seven years and provide them to the IRS upon written request.[64]

If any material advisor fails to make the list available to the IRS within 20 days of the written request, then the IRS generally will assert a penalty of $10,000 per day, starting after the 20th day.[65] However, the penalty will not be imposed if the material advisor had "reasonable cause" for not providing the list in a timely manner.[66]

Concept of "Substantially Similar" Transactions

As indicated above, the standards in Notice 2017-10, as well as the duties to file Forms 8886 and Forms 8918, apply not only to SCETs, but also to all transactions that are "substantially similar" to SCETs.

What Do the Tax Regulations Say?

This term broadly encompasses any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on a similar tax strategy.[67] The regulations underscore the following about the concept: (i) The term "substantially similar" must be broadly construed in favor of making disclosures to the IRS; (ii) Receipt of a tax/legal opinion regarding the tax consequences of a transaction is not relevant to the issue of whether such transaction is the same as or substantially similar to another transaction; and (iii) A transaction may be substantially similar to a listed transaction, even though it involves different entities and/or applies different provisions of the Internal Revenue Code.[68]

The regulations contain the following two examples demonstrating how liberally the IRS will interpret the notion of substantially similar:

> Notice 2000-44 . . . sets forth a listed transaction involving offsetting options transferred to a partnership where the taxpayer claims basis in the partnership for the cost of the purchased options but does not adjust basis under Section 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the options. *Transactions using short sales, futures, derivatives or any other type of offsetting obligations to inflate basis in a partnership interest would be the same as or substantially similar to the transaction described in Notice 2000-44. Moreover, use of the inflated basis in the partnership interest to diminish gain that would otherwise be recognized on the transfer of a partnership asset would also be the same as or substantially similar to the transaction described in Notice 2000-44.*[69]
>
> Notice 2001-16 . . . sets forth a listed transaction involving a seller (X) who desires to sell stock of a corporation (T), an intermediary corporation (M), and a buyer (Y) who desires to purchase the assets (and not the stock) of T. M agrees to facilitate the sale to prevent the recognition of the gain that T would otherwise report. Notice 2001-16 describes M as a member of a consolidated group that has a loss within the group or as a party not subject to tax. *Transactions utilizing different intermediaries to prevent the recognition of gain would be the same as or substantially similar to the transaction described in Notice 2001-16.* An example is a transaction in which M is a corporation that does not file a consolidated return but which buys T stock, liquidates T, sells assets of T to Y, and offsets the gain on the sale of those assets with currently generated losses.[70]

What Do the IRS Pronouncements Say?

The IRS, consistent with the regulations described above, has issued multiple Private Letter Rulings, Field Service Advisories, General Counsel Memos, and Chief Counsel Advisories concluding that particular transactions are "substantially similar" to one listed transaction or another.[71]

What Do the Courts Say?

The courts, likewise, have broadly interpreted the concept of "substantially similar" transaction in upholding IRS penalties assessed for unfiled Forms 8886 and/or Forms 8918. There are numerous cases on point, but we focus in this article on just the two most recent.[72]

Turnham (May 2019). The first case, *Turnham v. United States*, involved a medical doctor, his single-shareholder S corporation ("Medical Practice"), the substantial contributions that the Medical Practice made to a health and welfare trust plan ("Prepare Plan"), and the lack of Forms 8886.[73]

The IRS audited 2009, 2010, and 2011, determined that the doctor should have file Forms 8886 with respect to the Prepare Plan, and assessed penalties for each year. The doctor paid the penalties, filed a timely Claim for Refund, and then waited. The IRS did not respond within six months, so the doctor filed a refund lawsuit in District Court. The IRS, in turn, filed a Motion for Summary Judgement on the issue of whether the doctor participated in a listed transaction when he made payments to the Prepare Plan, such that he was obligated to enclose Forms 8886 with his tax returns. As explained below, the District Court found that the Prepare Plan in which the doctor participated was the same as or substantially similar to the transaction that the IRS characterized as a listed transaction in Notice 95-34, 1995-1 CB 309 (Tax Problems Raised by Certain Trust Arrangements Seeking to Qualify for Exemption from Section 149). Consequently, the District Court denied the penalty refund to the doctor.

The doctor joined the Prepare Plan, which was marketed by CJA & Associates, in 2009. He paid approximately, $284,000, $284,000, and $273,000 to the Prepare Plan during the first three

The IRS announced in Notice 2017-10 that it intended to challenge what is has coined SCETs on grounds that they supposedly constitute "tax-avoidance transactions" that involve overvaluations of donations.

years. The representatives of CJA & Associates told the doctor that (i) the contributions would be tax deductible, (ii) the assets held in the Prepare Plan would be protected from creditors, (iii) the covered employees would receive death benefits that would not be subject to income tax or estate tax, and (iv) death benefits would be fully paid at the doctor's retirement and were projected to increase substantially. A small portion of the doctor's contributions went to administrative fees, with three percent of the remaining amount paying the premiums for group term life insurance and 97 percent going toward a group annuity contract.

The District Court explained that, because the Internal Revenue Code provides favorable tax treatment for payments by employers to welfare benefit funds that are part of a 10-or-more-employer plan, the IRS issued Notice 95-34 to caution taxpayers against relying on certain plans, offered by promoters, that supposedly met the narrow definition in Section 419(A)(f)(6). Notice 95-34 then explained the main aspects of the targeted transaction. The District Court indicated that the Prepare Plan shared several such aspects. First, it invested in universal life contracts. Second, the contributions by the doctor were very large compared to the cost of the insurance premiums. Third, the trust owned the insurance contracts. Fourth, the employees were told that they could get benefits by selling their share of the annuity for cash value. Finally, the Prepare Plan maintained a separate accounting of assets per employer, which appeared in the accounting and financial records. According to the District Court, "[t]hese are just a few of the similarities between the Prepare Plan and the problematic arrangements described in Notice 95-34."

The District Court also pointed out that other courts had concluded that payments to Prepare Plans are listed transactions. It cited *Vee's Marketing, Inc.*, 816 F.3d 499 (CA-7, 2016).

The doctor argued that (i) there was an issue of fact regarding whether the Prepare Plan was the same as the universal life policy described in Notice 95-34, and (ii) he should not be penalized because he relied on advice from professionals. The District Court swiftly dispensed with both arguments, as follows. With respect to the first position, the District Court pointed out that the Form 8886 filing duty applies where taxpayers participate in the same or a "substantially similar" transaction, the regulations direct taxpayers to broadly construe the term in favor of disclosure to the IRS, and there was no doubt that the Prepare Plan was substantially similar to the transaction in Notice 95-34 in many respects. As to the second position, the District Court emphasized that the Form 8886 penalty is one of strict liability; there is no reasonable cause defense in the applicable tax provision or regulations. Moreover, the District Court noted that the regulations indicate that receipt of a tax/legal opinion regarding the tax consequences of a transaction is not relevant to the issue of whether such transaction is the same as or substantially similar to another transaction.

Interior Glass Systems, Inc. (June 2019). In *Interior Glass Systems, Inc. v. United States*, the taxpayer participated in a Group Life Insurance Term Plan ("GLITP") to fund a cash-value life insurance policy owned by its sole shareholder and only employee.[74] The IRS audited the taxpayer, determined that the GLITP was the same as or substantially similar to the transaction described in Notice 2007-83, 2007-2 CB 960, and assessed penalties for the missing Forms 8886. The taxpayer paid the penalties, filed a Claim for Refund, and found no mercy at the IRS Appeals Office. Therefore, it filed a refund suit with the District Court, which granted the IRS's Motion for Summary Judgment that the penalties were proper.

The taxpayer then sought review by the Ninth Circuit Court of Appeals. It argued, among other things, that the penalties were inappropriate because it did not participate in a listed transaction. The Court of Appeals upheld the earlier actions by the IRS and District Court on the following grounds.

The Court of Appeals explained that the IRS issued Notice 2007-83 (Abusive Trust Arrangements Utilizing Cash Value Life Insurance Policies Purportedly to Provide Welfare Benefits) to halt transactions that improperly allowed small business owners to receive cash and other property on a tax-favored basis. The targeted transaction consisted of two steps: A small business transfers funds to a trust (and the business claims a deduction), and then the trust pays the premium on the cash-value life insurance policy for the business owner (and the business owner does not include the payment in income). A portion of the premium went into an investment account, the policyholder controls how funds are invested, and when the policy terminates, the policyholder can withdraw the surrender value, which is the cash value that has accumulated within the policy. The Court of Appeals explained that transactions described in Notice 2007-83 effectively allow business owners to shift pre-tax earnings from the business into their own personal investment vehicle. Notice 2007-83 indicated that the transactions consist of four main components.

The Court of Appeals, like the IRS and District Court before it, found that the transaction in which the taxpayer participated should have been disclosed on Form 8886. It relied on the following points in making its decision. First, the GTILP transaction was expected to generate the same or similar types of tax consequences, namely, allowing the business to deduct the contributions to the trust as an expense, and then not having the business owner declare the insurance payments by the trust as income.

Second, the GTILP transaction is "factually similar" to the transaction described in Notice 2007-83 and "based on the same or similar tax strategy." They both involve a small business, a cash-value life insurance policy that benefits the business owner, payment of the premiums on the policy through an intermediary, and an attempt to avoid or significantly defer income taxes.

Third, the factual differences identified by the taxpayer between the Notice 2007-83 transaction and the GTILP transaction were immaterial. The taxpayers urged the Court of Appeals to put great stock into the facts that the

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[74] Interior Glass Systems, Inc., 927 F.3d 1081, 123 AFTR 2d 2019-2328 (CA-9, 2019).

GLITP transaction utilized a tax-exempt business league (instead of a trust or welfare benefit fund) and that the tax benefits in the GLITP transaction derive from Section 79 for group term life insurance benefits (instead of from Section 419 for welfare benefits). The Court of Appeals was nonplussed, explaining that the regulations specifically mandate filing of Form 8886 where a transaction is "substantially similar," even if different tax provisions are utilized. Citing to the examples provided by the IRS in the regulations, the Court of Appeals stated that the taxpayer "cannot evade a finding of substantial similarity solely by claiming a deduction on a different basis or by using a different intermediary to complete the transaction."

Lastly, the taxpayer argued that the definition of "substantially similar" violates the Constitution because it is too vague. Describing this position as meritless, the Court of Appeals explained that the definition is constitutionally valid, provided that a person of ordinary intelligence could determine which transactions are substantially similar to the transaction identified in Notice 2007-83. The Court of Appeals concluded that the only differences between the Notice 2007-83 transaction and the GLITP transaction were immaterial, such that the definition of "substantially similar" in the regulations is detailed enough to make the determination easy.

Conclusion

The filing of Forms 8886 and Forms 8918 draw the attention of the IRS to transactions, and long, costly tax disputes often ensue. Hyperaware of this reality, some taxpayers are searching for a manner to avoid characterization of a transaction as an SCET. These include, for example, limiting the number of partners so as not to be considered a "syndicated" transaction, donating land in fee simple so that it does not involve a conservation easement, not preparing or distributing "promotional materials" about a partnership, holding the property for more than a year before making a donation, and making the conservation easement a small component of a partnership's activities in an effort to keep the charitable deduction below two and one-half times the amount of each partner's capital contribution. To be clear, these taxpayers are doing nothing wrong; they are simply trying to adhere to the standards established by the IRS in Notice 2017-10. The challenge, of course, is arranging matters such that they accomplish their goals while not being considered, by the IRS and/or the courts, "substantially similar" to an SCET.

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 [in an SCET].

The regulations, IRS pronouncements, and recent cases broadly interpret the concept of "substantially similar," the penalties and other consequences of not filing Forms 8886 and Forms 8918 when required are severe, and the taxpayers are eager to design alternatives that will not be deemed "substantially similar" to SCETs. This situation surely will trigger disputes in the future providing more guidance on the reach of Notice 2017-10.