

## Conservation Easement Tax Issues: IRS Enforcement, Structuring and Defending Easement Transactions

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# Conservation Easement Tax Issues: Recent IRS Enforcement, Structuring and Defending Easement Transactions

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**STEVEN TOSCHER** specializes in civil and criminal tax controversy and litigation. He is a Certified Tax Specialist in Taxation, the State Bar of California Board of Legal Specialization, a Fellow of the American College of Tax Counsel and has received an “AV” rating from Martindale Hubbell. In addition to his law practice, Mr. Toscher has served as an Adjunct Professor at the USC Marshall School of Business since 1995, where he teaches tax procedure. He has also served on the faculty of the American Bar Association Criminal Tax Fraud Program since 1998. He is a former Internal Revenue Agent with the Internal Revenue Service and a trial attorney with the Tax Division of the United States Department of Justice in Washington where he received its Outstanding Attorney Award.

Mr. Toscher is past-Chair of the Taxation Section of the Los Angeles County Bar Association and served as a member of the Editorial Board for the Los Angeles Lawyer during 1996-1999. He is a member of the Accounting and Tax Advisory Board of California State University, Los Angeles, Office of Continuing Education.

Mr. Toscher was the 2018 recipient of the Joanne M. Garvey Award. The award is given annually to recognize lifetime achievement and outstanding contributions to the field of tax law by a senior member of the California tax bar.

Mr. Toscher is a frequent lecturer to professional groups and author on civil and criminal tax controversy topics. He is frequent contributor to the Los Angeles Lawyer, The Journal of Tax Practice and Procedure and Tax Management Bureau of National Affairs. He is a co-author of “Tax Crimes,” Bureau of National Affairs - Tax Management, Publication 636 2nd.

Mr. Toscher received his Bachelor’s Degree in Accounting from the University of Nevada, Las Vegas (with honors), and received his Law Degree from the University of San Diego (summa cum laude). Mr. Toscher is a member of the State Bars of California, Nevada, and Colorado. Mr. Toscher has been a member of the Faculty of the ABA Criminal Fraud Program for many years.



**AVRAM SALKIN**, the “Tax Lawyers Tax Lawyer,” is a founding member of the firm. He is recognized for his unparalleled excellence and integrity in the practice of tax law. He has over fifty years of extensive experience in resolving complex Federal and state tax controversies and disputes, in structuring and negotiating complex transactional matters (including the acquisition and disposition of real estate and businesses), family wealth planning, estate planning and probate. Avram Salkin is a Certified Specialist in both Taxation and Estate Planning, Trust and Probate Law, by the State Bar of California Board of Legal Specialization.

Avram Salkin’s many lectures include presentations at the ABA Section of Taxation, the University of Southern California Institute on Federal Taxation; California CPA Education Foundation Conferences (Member, Planning Committee, Pass-Thru Entities Conference); the Los Angeles County and Beverly Hills Bar Associations; programs by the California Continuing Education of the Bar on real estate taxation, professional corporations, partnership taxation, and tax procedure; and the California State University Continuing Education Program in real estate taxation.

He has also written extensively on many tax-related subjects, including real estate taxation, S corporations, operating loss carryovers, employment tax issues, attorney-client privilege matters, and partnership tax issues.

Recognizing a lifetime of achievements and contributions to the field of taxation, in 2018 Mr. Salkin received the Bruce I. Hochman Award from the UCLA Tax Controversy as part of the 34th Annual Tax Institute in recognition of his life time achievement in the practice of tax law.



**MICHEL R. STEIN** is a principal at Hochman Salkin Toscher Perez, specializing in controversies, as well as tax planning for individuals, businesses and corporations. For almost 20 years, he has represented individuals with sensitive issue civil tax examinations where substantial penalty issues may arise, and extensively advised individuals on foreign and domestic voluntary disclosures regarding foreign account and asset compliance matters.

Mr. Stein is well respected for his expertise and judgment in handling matters arising from the U.S. Government's ongoing enforcement efforts regarding undeclared interests in foreign financial accounts and assets, including various methods of participating in a timely voluntary disclosure to minimize potential exposure to civil tax penalties and avoiding a criminal tax prosecution referral. He has assisted hundreds of individuals who have come into compliance with their foreign reporting requirements through the OVDP, Streamline or otherwise.

Throughout his career, Mr. Stein has represented thousands of individual, business and corporate taxpayers involved in civil examinations and administrative appeals, tax collection matters as well as with possible assertions of fraudulent conduct and in defending criminal tax investigations and prosecutions at every administrative level within the IRS. He has litigated tax cases in the U.S. Tax Court, the U.S. District Court, and various U.S. Circuit Courts of Appeal. He continues to provide tax advice to taxpayer's and their advisors around the world.

# Overview

1. Basics - What is a Conservation Easement?
2. Charitable Deduction Rules Applicable to Conservation Easements
3. Key Tax Issues Concerning Conservation Easements
  - Technical Compliance Issues
  - Valuation Issues
4. IRS Enforcement Efforts Regarding Conservation Easements
5. Potential Penalties Applicable to Conservation Easement Transactions
6. Pending Legislation Regarding Conservation Easements

# BASICS – CONSERVATION EASEMENT

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# Basics – What is a Conservation Easement?

- An interest in real property established by agreement between landowner and qualified organization
  - Agreement restricts the use of the property to achieve conservation purposes
  - Ownership of the real property remains with the landowner, subject to the use restriction
  - Easement is recorded in the chain of title
  - Enforceable in perpetuity by the qualified organization against current and future owners

# Basics – Why Grant an Easement?

- Achieve environmental objectives by constraining certain uses of the property
- Achieve land enjoyment objectives by preventing development (i.e., scenic view)
- Obtain a charitable tax deduction upon grant of the easement

# Basics – Conservation Easement Transaction

- Need property suitable to conserve and desire to protect for future generations by precluding future development of the property.
- Taxpayer owns or acquires the property and decides to conserve the property by granting a qualified charitable organization (usually an environmental conservation organization) an easement in the property which restricts the use of the property for qualified conservation purposes.
- Properties over which conservation easement can be placed (Examples)
  - Golf Course
  - Undeveloped land
  - Farmland

# CONSERVATION EASEMENT CHARITABLE DEDUCTION RULES

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# Charitable Easement Deduction - Statute

- IRC Section 170(a) provides a charitable deduction for contributions to tax exempt organizations
- Section 170(f)(3)(A) generally disallows the deduction for any transfer that is less than a taxpayer's entire interest in property
- Section 170(f)(3)(B)(iii) creates an exception for a “qualified conservation contribution”
- Section 170(h)(1) defines “qualified conservation contribution” as:
  - A qualified real property interest
  - To a qualified organization
  - Exclusively for conservation purposes
- Treasury Regulation Section 1.170A-14

# Charitable Easement Deduction – Required Elements

## 1. Contribution

- Donative Intent
- Appraisal
- Properly documented

## 2. Qualified real property interest – Section 170(h)(2)

- Conservation easement
- Can be either:
  - Entire interest (other than mineral rights)
  - Remainder interest
  - Restriction on Use Granted in Perpetuity

# Charitable Easement Deduction – Required Elements (cont.)

3. Qualified organization – Section 170(b)(1)(A)
  - Publicly supported charity (i.e., Section 501(c)(3))
  - Land Trust
  - Sufficient resources to enforces restrictions
4. Exclusively for conservation purposes – Section 170(h)(4); Treasury Reg 1.170-14(d)
  - Preservation of land areas for recreation or education
  - Protection of significant natural habitat or ecosystem
  - Preservation of open space
  - Preservation of historically important land areas or structures
5. Protection in perpetuity - Section 170(h)(5)
  - Must be in writing
  - Subject to legally enforceable restrictions (recorded)
  - Mortgagee must subordinate rights
  - Retained rights cannot conflict with conservation purpose

# Charitable Easement Deduction – Example

## Charitable Easement Deduction Example:

- Taxpayer contributes money to a partnership in exchange for a membership interest  
IRC §721
- Partnership buys undeveloped land and places conservation easement over part of the land
- Appraiser determines that the land's highest and best use is residential development – specifically a 174 unit condominium project.
- Condominium project is legally permissible, physically possible, financially feasible, and maximally productive use of the property
  - Also prepares a subdivision analysis to further analyze and supplement valuation of conservation easement
- Partnership donates the conservation easement to a §170(b)(1)(A) organization and deducts the value of the conservation easement
- Value of the CE is computed through a before-and-after methodology
- Aggregate charitable contribution is flowed through to the taxpayer in proportion to his capital interest on his K1.



# KEY TAX ISSUES CONCERNING CONSERVATION EASEMENTS

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# Tax Issues – Perpetuity Requirement

## Perpetuity Requirement

I.R.C. § 170(h)(5)(A) Conservation Purpose Must Be Protected In Perpetuity — A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.

The conservation easement must protect the donee organization's interest in perpetuity

Two Requirements:

- 1) Property use must be restricted in perpetuity
- 2) Conservation purpose must be protected in perpetuity

Examples of Conservation Easement Violating Perpetuity Requirements:

1. Retention of Development Rights
2. Substitution Rights
3. Indeterminate Borders
4. Proceeds from Extinguishment Clause

# Perpetuity – Retention of Development Rights

1. Retention of Development Rights - A donor's retention of development rights can violate the perpetual restriction requirement if building areas are not fixed at outset.

## 1.170A-14 Qualified conservation contributions.

(a) Qualified conservation contributions. A deduction under section 170 is generally not allowed for a charitable contribution of any interest in property that consists of less than the donor's entire interest in the property

# Perpetuity – Retention of Development Rights (cont.)

## Tax Court Cases Dealing with Retention of Development Rights

1. Carter v. Comm., TC Memo 2020-21. A partnership conveyed an easement that restricts the use of the covered property and generally prohibits the construction or occupancy of any dwellings. Donor retained the right, however, to build single-family dwellings in specified "building areas", the locations of which were to be determined, subject to Land Trust's approval. Because the restrictions applicable within the building areas permit uses that are antithetical to the easement's conservation purposes, those restrictions are disregarded in determining whether the easement is included in the definition of "qualified real property interest" by reason of I.R.C. sec. 170(h)(2)(C); consequently, Taxpayer were not entitled to charitable contribution deductions of a partial interest in the underlying property.
2. Pine Mountain Pres., LLLP v. Comm., 151 T.C. 247 (2018) Taxpayer conveyed land to a qualified land trust in 2005, 2006, and 2007. Each easement defined a conservation area that was to be restricted in perpetuity from commercial and residential development, with a carve-out in the 2005 and 2006 easements for 16 reserved "building areas," within each of which P could construct a single-family residence. The 2006 easement did not specify the location of the building areas, and the 2005 easement permitted taxpayer (with the trust's consent) to move the building areas from their initially designated locations to any other location within the conservation area. The court held the 2005 and 2006 easements did not restrict a specific, identifiable piece of real property because they allowed supposedly conserved land to be taken back and used for residential development. Because neither easement constituted "a restriction (granted in perpetuity) on the use which may be made of the real property," I.R.C. sec. 170(h)(2)(C), neither easement constituted a "qualified real property interest" that could give rise to a charitable contribution deduction under I.R.C. sec. 170(h)(1)(A)

# Perpetuity – Substitution Rights

## 2. Substitution Rights

Regulations under 1.170A-14(b)(2) provide the following with respect to section 170(h)(2)(C):

“A perpetual conservation restriction is a qualified real property interest. A perpetual conservation restriction is a restriction granted in perpetuity on the use which may be made of real property — including, an easement or other interest in real property that under state law has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude).”

Tax Court Case Dealing with Substitution Rights:

Belk v. Comm., 140 T.C. 1 (2013) Married couple was denied a deduction for charitable donation of conservation easement on golf course to land trust. Contribution could not satisfy “qualified real property interest” that it be subject to use restriction in perpetuity under section 170(h)(2)(c), because CE agreement permitted substitution of property subject to easement.

# Perpetuity – Indeterminate Borders

## 3. Indeterminate Borders

When the boundaries of the border are indeterminate there may be no defined parcel of property that is subject to a perpetual use restriction.

Tax Court Case addressing Indeterminate Borders:

Balsam Mountain Invest. V. Comm., TC Memo 2015-43 Partnership granted a perpetual conservation easement on a 22-acre parcel of land to a nonprofit corporation. For the next five years B had the right to change the boundaries of the restricted area. B's right to change the boundaries was subject to the following conditions. First, the total area restricted by the easement had to remain 22 acres. Second, at least 95% of the original 22-acre parcel had to remain within the boundaries of the restricted area. Held: The easement is not a "qualified real property interest" of the type described in I.R.C. sec. 170(h)(2)(C)

# Perpetuity – Proceeds from Extinguishment Clause

## 4. Proceeds from Extinguishment Clause

Under the regulation Section 1.170A14(g)(6)(ii), “a “donee \* \* \* must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction” or else this limited exception to the perpetual use restriction of the conservation easement is not satisfied, and the donor has failed to meet the requirement that the conservation purpose of the contribution be protected in perpetuity.

Provisions whereby proceeds from extinguishment (through condemnation or eminent domain of property) diminish the proportionate share of the proceeds that the recipient donee organization would receive violates this regulation.

# Perpetuity – Proceeds from Extinguishment Clause (cont.)

Tax Court Cases addressing Proceeds from Extinguishment Clause:

1. Railroad Holdings T.C. Memo. 2020-22

Proceeds from Extinguishment Clause diminished the proceeds that the Donee would receive since the formula used excludes subsequent appreciation in value for Donee.

2. Coal Property Holdings, LLC v. Commissioner, 153 T.C. No. 7 (2019)

Deed provided that the donee's share of the proceeds of a judicial extinguishment would be calculated by using the easement's proportion of value, as determined at the time of the gift, but multiplying it not against the property's total fair market value at the time of sale but rather against the property's fair market value at the time of sale "minus any increase in value after the date of th[e] grant attributable to improvements".

# Tax Issues – Valuation Issues Qualified Appraisal and Qualified Appraiser IRC § 170(f)(11)(e)

- Appraiser must meet minimum education and experience requirements
- Appraisal must be signed by qualified appraiser and include:
  - Valuation highest and best use
    - In an informative piece surveying the court decisions on valuation and highest and best use in conservation easement cases over the last 10 years published in Tax Notes on July 22, 2019, the author concluded that the taxpayers determination of value and highest and best use was more often closer to the value as determined by the Court. \*
  - Highest and best use standard
    - Appraisers generally use the before-and-after method for valuation of conservation easements
    - Highest and best use can be any realistic, objective potential use of the property. If different from current use, a proposed highest and best use requires closeness in time and reasonable probability
    - Depending on the classification of the “HBU” this can impact the valuation of the conservation easement dramatically

\*See Ware, “Valuing Conservation Easements: An Empirical Analysis of Decided Cases,” Tax Notes Federal, July 22, 2019.

## Tax Issues – Valuation Requirements for a Charitable Deductions for Conservation Easement IRC § 1.170A-14(h)

- The value of the contribution is the fair market value of the perpetual conservation restriction at the time of the contribution. See § 1.170A-7(c).
- If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the fair market value of the donated easement is based on the sales prices of such comparable easements. If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

## Tax Issues – Valuation Requirements for a Charitable Deductions for Conservation Easement IRC § 1.170A-14(h) (cont.)

- If before and after valuation is used, the fair market value of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use. Further, there may be instances where the grant of a conservation restriction may have no material effect on the value of the property or may in fact serve to enhance, rather than reduce, the value of property. In such instances no deduction would be allowable.
- Example 7 from the Regulations.---C owns Greenacre, a 200-acre estate containing a house built during the colonial period. At its highest and best use, for home development, the fair market value of Greenacre is \$300,000. C donates an easement (to maintain the house and Green acre in their current state) to a qualifying organization for conservation purposes. The fair market value of Greenacre after the donation is reduced to \$125,000. Accordingly, the value of the easement and the amount eligible for a deduction under section 170(f) is \$175,000 (\$300,000 less \$125,000).

## Tax Issues – Valuation Requirements for a Charitable Deductions for Conservation Easement IRC § 1.170A-14(h) (cont.)

- Valuation is a matter which is subject to expert opinion and it is up to the court to determine and evaluate the helpfulness of the opinion in reaching the factual question of value. The valuation expert should use common sense and must analyze all the facts and circumstances and maintain a “reasonable attitude in recognition of the fact that valuation is not an exact science.” Rev. Rul. 59-60, Sec. 3.01, 1959-1 C.B.237,238.
- Critical in the valuation of the donated conservation easement is the determination of the highest and best use of the property before the placing of the easement on the property.

## Tax Issues – Recent Court Decisions Relating to Valuation and Highest and Best Determination

- Pine Mountain Preserve v. Commissioner, T.C. Memo 2018-24. Tax Court determined that highest and best use was residential development as argued by taxpayer and determined value of contribution close to value claimed by taxpayer.
- TOT Property Holdings v. Commissioner, Docket No. 5600-17, December 13, 2019. Tax Court determined that highest and best use was not residential development as urged by taxpayer but timbering and recreation and found a value of conservation easement of \$496,000 compared to value of \$6.9 million claimed by the taxpayer.

# IRS ENFORCEMENT EFFORTS REGARDING CONSERVATION EASEMENTS

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# IRS Enforcement Efforts

- Listing of Syndicated Conservation Easement Transactions as “listed transaction” in Notice 2017-10 (2016), stating that IRS intends to challenge the purported tax benefits from this transaction based on overvaluation of the conservation easement.
- December 2018 civil injunction suit in US v. Zak No. 1:18-cv-05774-AT, brought by Department of Justice. DOJ Press Release 18-1672 (December 19, 2018) stating that the appraisals in that case were “based on willfully false valuations.”
- In IR-2019-182 (11/13/19), IRS announces coordinated examinations across the key operating divisions of the IRS, including SB/SE, LB&I and TE/GE.

# POTENTIAL CIVIL PENALTIES

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# Potential Penalties Overview

1. Negligence Penalty – IRC § 6662(b)(1)
2. Substantial Understatement Penalty – IRC § 6662(b)(2)
3. Valuation Misstatement Penalties – IRC § 6663(b)(3)
  - A. Substantial Misstatement
  - B. Gross Misstatement
4. Reportable Transaction Penalties – IRC § 6662A
5. Failure to Report Reportable Transactions – IRC § 6707 / 6707A
6. Reasonable Cause Defenses

# Negligence Penalty - IRC § 6662(b)(1)

1. The negligence or disregard of the rule penalties under IRC §6662(b)(1) apply when a taxpayer fails to make a reasonable attempt to comply with the tax code.
2. The term disregard includes carelessness, recklessness, and intentional disregard. IRC §6662(c)

# Substantial Understatement Penalty – IRC § 6662(b)(2)

1. Applies when the understatement of the income tax resulting from the adjustments is more than \$5,000 or 10% of the tax required to be shown on the return for the tax year.
2. The understatement can be reduced by an amount that was disclosed on the face of the tax return or in a statement.
3. A substantial authority exception will not apply to this penalty if the taxpayer was engaged in a tax shelter.

# Valuation Misstatement Penalties – IRC § 6662(b)(3)

1. Penalty assessed on the portion of any underpayment of tax plus interest which is attributable to a substantial valuation misstatement penalty.
2. Substantial Misstatements – 20% of the understatement of tax plus interest
  - A. If the value of any property claimed on a tax return is 150% or more of the amount determined to be the correct amount of such valuation - IRC §6662(e).
  - B. The IRS and courts will look to the valuation of the conservation easement deduction to determine what percentage it is greater than the IRS appraisal of the conservation easement.
3. Gross Misstatements - 40% of the understatement of tax plus interest
  - A. If the property value is overstated by 200% or more, the penalty is increased from 20% to 40% IRC §6662(h).
  - B. This penalty is a strict liability penalty. IRC §6664 reasonable cause does not apply.

# Reportable Transaction Understatement Penalties

## IRC § 6662A

IRC §6662A provides for a 20% accuracy-related penalty to reportable transaction understatements.

A 30% penalty applies for reportable transaction understatements if the transaction is NOT disclosed IRC §6664(d)(3)(A). The regulations under IRC 6011 require that a Form 8886 is to be filed to disclose reportable transactions.

# Reportable Transaction Information Penalty – IRC § 6707 and § 6707A

Any taxpayer that fails to include on a tax return or statement any information with respect to a reportable transaction is subject to a \$10,000 penalty (or \$50,000 for business entities).

This penalty is applicable if the taxpayer fails to file a complete Form 8886.

This penalty can be imposed in addition to any other penalty imposed with the accuracy related penalty.

This penalty is a strict liability penalty. IRC §6664 reasonable cause does not apply.



# REASONABLE CAUSE DEFENSE

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# Reasonable Cause Defense – In General

Taxpayer will need to show reasonable cause for the understatement and that the taxpayer acted in good faith.

Circumstances that indicate reasonable cause and good faith include honest misunderstanding of the fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer.

Reliance on a tax professional may demonstrate reasonable cause and good faith depending upon when taxpayer entered into transaction.

For substantial valuation misstatement penalties, the reasonable cause defense can apply.

## Reasonable Cause Defense and Gross Valuation Misstatement Penalties

Congress eliminated reasonable cause defense for gross valuation misstatement penalties attributable to IRC §170 charitable contributions.

If the taxpayer can reduce the valuation misstatement from gross to substantial, then IRC §6664(c)(3) provides a safe harbor for the taxpayer to use the reasonable cause defense.

# Reasonable Cause Defense and IRC § 6662A

IRC §6664(d)(1) provides a reasonable cause exception for reportable transaction understatements.

Limitations - IRC §6664(d).

1. IRC §6664(d)(2) – Reasonable cause does not apply to non-economic substance transactions defined in IRC §6662(b)(6).
  
2. IRC §6664(d)(3) states that the reasonable cause exception in IRC §6664(d)(1) does not apply unless:
  - (a) the transaction was disclosed
  - (b) had substantial authority and
  - (c) the taxpayer reasonably believed that the treatment was more likely than not the proper treatment.

## IRC §6662A and IRC §6662 Penalties Not Stacked

Congress does not want the IRS to assert multiple penalties on understatements involving reportable transactions.

IRC §6662 does not apply to the portion of any underpayment which is attributable to a reportable transaction understatement on which a penalty is imposed under IRC §6662A.

IRC §6662A does not apply to the portion of any understatement on which a penalty is imposed under IRC §6662 if the gross valuation misstatement penalty applies.

# PENDING LEGISLATION REGARDING CONSERVATION EASEMENTS

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# Conservation Easement Pending Legislation

- There has been bi-partisan support for the conservation easement charitable deduction since first enacted in 1980, including legislation which has expanded the available tax benefits.
- In 2019, the Senate introduced S. 170, the Charitable Conservation Easement Program Integrity Act of 2019. The bill limits the aggregate amount of a partner's annual tax deductions for qualified conservation contributions of a partnership to 2.5 times the partner's adjusted basis in the partnership. The legislation is pending.
- Because of the broad support for conservation and the concern that the current statutory and regulatory scheme is dependent upon standards for valuation that could allow for abuses, many believe that legislation which can protect the important Congressional policy of encouraging the protection and conservation of our natural resources and curb the potential valuation abuses, is the proper mechanism for resolving the pending controversies.

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