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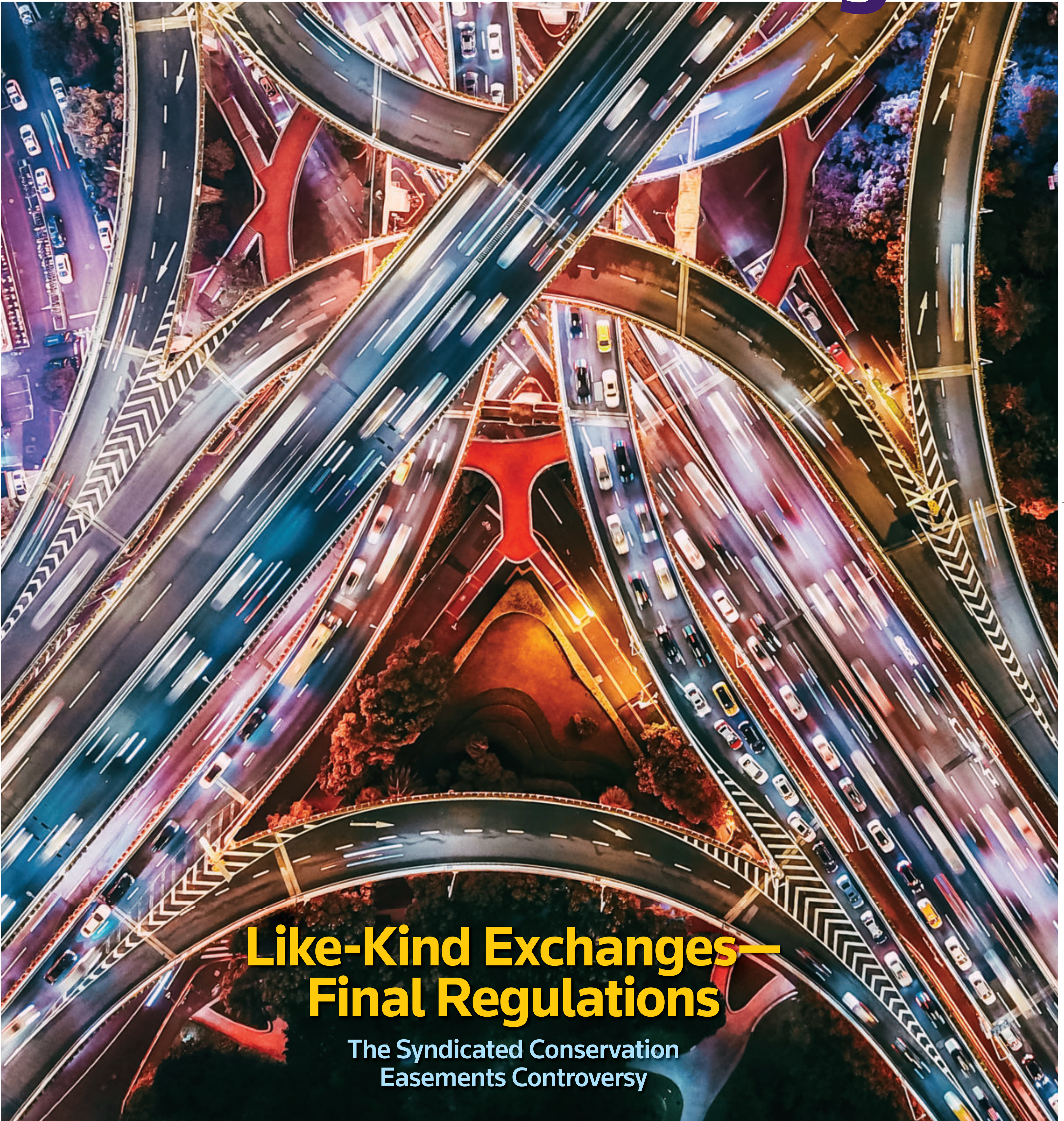
Practical Tax Strategies



Like-Kind Exchanges—Final Regulations

The Syndicated Conservation Easements Controversy

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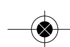

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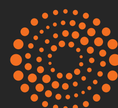

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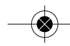

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IRS says taxpayers are not required to amend 2020 returns to get unemployment compensation exclusion

In a News Release (IR 2021-71, 3/31/2021), the IRS announced that taxpayers who already filed their 2020 individual tax return, without taking advantage of the 2020 unemployment benefit exclusion, do not need to file an amended return to take advantage of the exclusion. However, the IRS points out that, in some cases, it will be beneficial for taxpayers who did not take advantage of the exclusion to file an amended 2020 return.

The American Rescue Plan Act of 2021 (ARPA), which was signed into law on 3/11/2021, provides that, for taxpayers whose 2020 modified adjusted gross income is less than $150,000, the first $10,200 of unemployment compensation received in 2020 is not included in the taxpayer's 2020 gross income. In the case of a joint return, the first $10,200 per spouse is not included in gross income. (Code Section 85(c)(1), as amended by ARPA section 9042(a))

For those taxpayers who already have filed and figured their 2020 tax based on the full amount of unemployment compensation received in 2020, the IRS will determine the correct taxable amount of unemployment compensation and tax. Any resulting overpayment of tax will be either refunded or applied to other outstanding taxes owed.

Some taxpayers, however, may still want to file an amended return. The IRS says that there is no need for taxpayers to file an amended return unless the calculations make the taxpayer newly eligible for additional federal credits and deductions not already included on the original tax return. The IRS also suggests that taxpayers who did not take advantage of the exclusion when they filed their 2020 federal return may want to review their state tax returns as well.

IRS impersonation scam targets university students and staff

The IRS has warned of an ongoing IRS impersonation scam that appears to primarily target educational institutions, including students and staff who have ".edu" email addresses. (IR 2021-68, 3/30/2021)

The IRS said that it has been receiving a stream of complaints about the impersonation scheme in recent weeks. "The phishing emails appear to target university and college students from both public and private, profit and non-profit institutions," the IRS stated.

The suspect emails display the IRS logo and use various subject lines such as "Tax Refund Payment" or "Recalculation of Your Tax Refund Payment." Recipients are asked to click on a link and submit a form to claim their refund. The phishing website asks for the following information: Social Security number; full name; date of birth; prior year annual gross income; driver's license number; complete current address; and Electronic Filing PIN.

The IRS warned that people who receive such an email should not click on the link it contains.

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THE FINAL LIKE-KIND EXCHANGE REGULATIONS: ISSUES ANSWERED AND UNANSWERED

MICHAEL C. WALCH

Though the final regulations are beneficial in clarifying a number of questions involved in like-kind exchanges, they frustratingly leave many issues perhaps even less clear than before. The adoption of the state and local law standard to define real property is far from a clear standard.

Section 1031 of the Internal Revenue Code was substantially amended in 2017 by the legislation commonly known as the Tax Cuts and Jobs Act ("TCJA").[1] Section 13303 of the TCJA amended this statute to eliminate the statutory provisions allowing for exchanges of personal property and to limit the application of Section 1031 to exchanges of real property, and further made some modifications to the statutory definition of real property.

To implement these amendments, on 6/12/2020 the Treasury Department and the IRS issued proposed regulations affecting Section 1031.[2] After receiving and considering comments on the proposed regulations, the Treasury Department and IRS modified the proposed regulations and issued final regulations on 12/2/2020, and these final regulations were published in the Federal Register on that date.

The final regulations[3] mostly refine and clarify the definitions of real property for applying the provisions of Section 1031. In largest part, they provide that property will be considered real property for Section 1031 purposes if it is defined as real property under the laws of the state or locality where that property is located. They also eliminate any requirement that the property contribute to the production of income unrelated to use or occupancy of space, and apply the regulatory definitions to both tangible and intangible properties.[4]

Guidance regarding personal property incidental to real property involved in a like-kind exchange is also provided. Lastly, the final regulations provide that their terms apply only for purposes of Section 1031, and that no inferences are intended for classifying or characterizing real or other property for any other purposes under the Internal Revenue Code.

Real property definitions

One longstanding issue in applying Section 1031 has been that the statute has never included a definition of the term "real property," and the TCJA did not add one. The TCJA Conference Report does state that Congress "intended that real property eligible for like-kind exchange treatment under present [pre-TCJA] law will continue to be eligible for like-kind exchange treatment under the [amended] provision[s]".[5] In the absence of a statutory definition of real property, and in keeping with this directive to not further limit the types of real property eligible for Section 1031

MICHAEL C. WALCH is a shareholder at Kirton McConkie, a Utah law firm.

transactions, the final regulations provide some guidance in defining real property by reference to state and local law definitions, eliminating any requirement of a purpose or use test applicable to real property, defining inherently permanent structures which are considered real property, addressing the status of offshore platforms and pipelines, addressing carpeting and wiring with respect to the definition of real property, and considering other tangible assets that might be considered real property.

State and local law definitions. The final regulations provide a general rule that for purposes of Section 1031, property will be considered real property if, on the date it is transferred in an exchange transaction, the property is classified as real property under the law of the state or other local jurisdiction in which that property is located.[6] This test is applied to both tangible and intangible property. However, as described below, the final regulations provide both some limitations and some expansions of this definition.

The adoption of state and local law definitions of real property can lead to some inconsistent outcomes. For example, a relinquished property in one jurisdiction could be considered real property and qualify as real property for a like-kind exchange, but substantially identical property in another jurisdiction might not be considered real property under the laws of that jurisdiction, and thus not qualify as replacement property in the exchange. As adopted, the final regulations accepted this possible difference in the application of the state and local law standard in favor of a rule making substantially identical properties always qualify as like-kind for Section 1031 purposes.

This reliance on state and local law creates a number of uncertainties in its application to like-kind exchange transactions. First, it assumes a consistency in state and local law definitions of real property that may not exist. For example, a state may have different definitions for real and personal property for Uniform Commercial Code security interest purposes than it uses for property taxation. Second, it can create situations where identical types of property in different states are ineligible for like-kind exchange treatment because the respective state laws define them differently.

Third, it does not address whether this general rule applies in situations in which federal law already provides a definition of real property, but where applicable state law classifies the asset as personal property.[7] Lastly, in at least one matter, the IRS determined that property qualified for a like-kind exchange transaction even where state law defined it as personal property, not real property, and the new regulation does not indicate whether this rule should continue to apply.[8] The final regulations do not clarify how these differences or ambiguities in state and local law definitions of real property are to be resolved under this rule.

The final regulations also stress that they address the issue of real property definitions, and do not consider whether certain properties are of like-kind,[9] but this distinction does not exist where previous rulings have already determined that certain types of properties are of like-kind. For example, the Service has ruled that certain development rights are defined as like-kind to real property for Section 1031 purposes.[10] The Tax Court has determined that coal supply contracts were equivalent to covenants running with real property, and thus could be considered real property qualifying for a like-kind exchange.[11] The final regulations do not consider whether their adoption of state and local definitions for defining real property undo or are subject to these existing determi-

The final regulations mostly refine and clarify the definitions of real property for applying the provisions of Section 1031. In largest part, they provide that property will be considered real property for Section 1031 purposes if it is defined as real property under the laws of the state or locality where that property is located.

1 The legislation was actually never given this name; it is officially simply P.L. 115-97, 131 Stat. 2054 (12/22/2017).
2 Notice of Proposed Rulemaking, REG-117589-18, published in the Federal Register at 85 F.R. 35835 (2020).
3 TD 9935, 12/2/2020.
4 This has been referred to as the "purpose or use test."
5 H.R. Conf. Rept. 115-466, at 396, fn. 726 (2017).
6 Reg. 1.1031(a)-3(a)(1).
7 *Id.*
8 CCA 2012-38-027 (9/21/2012).
9 TD 9935, Section I.H.
10 Ltr. Rul. 200805012; Ltr. Rul. 200901020.
11 *Peabody Natural Resources Co.,* 126 TC 261 (2006). This determination was based on a definition of New Mexico real property law.

nations of what constitutes real property for Section 1031 purposes.

This adoption of state and local law definitions to define real property for purposes of Section 1031 was done despite the existence of some real property definitions elsewhere in the Code. In particular, Section 856 and Reg. 1.856-10 contain a detailed and well-developed definition of real property for real estate investment trust (REIT) purposes; though this regulation states the definition only applies for REIT issues, since Section 1031 does not contain a definition of real property at all it would not have been difficult for the final regulations to adopt this one. In addition, Sections 48 and 512 contain existing real property definitions that could have guided a definition for Section 1031, but they are not even referenced in the final regulations.

Property expressly excluded from like-kind treatment. Prior to amendment by the TCJA, Section 1031(a)(2) contained a list of certain types of assets expressly excluded from like-kind exchange treatment. The TCJA amended this statutory provision to eliminate the list. However, TD 9935 takes the position that in order to be consistent with the legislative history stating Congress' intent that real property eligible for like-kind exchange treatment before the TCJA would continue to be eligible,[12] property that was *ineligible* for like-kind exchange treatment before the TCJA would continue to be ineligible.

The adoption of state and local law definitions of real property can lead to some inconsistent outcomes.

Accordingly, these listed assets, though no longer referenced in the statute itself or expressly addressed in the final regulations, are considered not to be real property by the IRS and thus precluded from like-kind exchange treatment despite not being referenced in either the statute or the regulations. This is arguably inconsistent with Congressional intent and action in removing the exceptions from the statute, and with the standards for making real property determinations under the express statutory and regulatory language.

The final regulations apply this exclusion only to property described in the Section 1031 regulations; they do not address exclusions from the definition of the term "property" elsewhere in the Code. For example, Reg. 1.263(a)-4(c)(1)(vi) states that leasehold interests are not considered "real property" for Section 263's capitalization rules. Prop. Reg. 1.332-2(b) excludes zero-equity property (*i.e.,* property encumbered by debt equal to or greater than its value) from the definition of property included in corporate subsidiary liquidations, and Prop. Reg. 1.351-1(a)(1)(iii) excludes zero-basis property from "property" which can be contributed to a corporation in exchange for the corporation's stock without recognizing income. The final regulations do not address whether or not equity in relinquished property is required for such property to qualify for like-kind exchange treatment.

Specific definitions. The final regulations also allow property to be considered real property for Section 1031 purposes if the property is specifically listed as real property in the final regulations. This is evidently intended to include the specific items referenced in the examples provided in the regulations under Section 1031. In addition, the final regulations provide for the possibility that property can be considered real property "based on all the facts and circumstances" under the factors provided in the final regulations. These provisions make it possible that property that is defined as personal property under applicable state or local law may still be considered real property eligible for like-kind exchange treatment.

No purpose or use test; inherently permanent structures. The final regulations do not incorporate any consideration of the purpose or use of property in determining whether it should be considered as real property in applying Section 1031.[13] Instead, the final regulations consider the degree of attachment of items of property to real property and the expected duration of that attachment in making the determination of property. Items of property expected to remain affixed for an indefinite period, as well as structural components integrated into an inherently permanent structure, are given as examples of items that will be considered real property. The purpose, function, or use of such items is not a relevant consideration in making this determination.

[12] *See* Conference Report at 396, fn 726; TD 9935 at Summary Section II.A.2.

[13] Prop. Regs. 1.1031(a)-3(1) and (2) both contained numerous provisions and examples seeking to define improvements and structures as real property based on their use, function, or degree of attachment to land, and their contribution to producing income unrelated to the use or occupancy of space. These provisions are not included in the final regulations.

Under this analysis, it is possible for items often considered personal property, such as machinery and equipment, to be considered real property in like-kind exchanges if they constitute an inherently permanent structure or are a structural component.[14] This standard in the final regulations also makes it possible for items of intangible property to satisfy the test to be considered real property under Section 1031.[15]

For this analysis, the final regulations define the term "inherently permanent structure" to mean "any building or other structure that is a distinct asset (within the meaning of Reg. 1.1031(a)-3(a)(4)) and is permanently affixed to real property and that will ordinarily remain fixed for an indefinite period of time."[16] Unfortunately, the terms "permanently affixed" and "indefinite period of time" are not defined in the final regulations. However, the final regulations do reference language in Reg. 1.856-10(d)(2)(i), which for purposes of defining real property for real estate investment trusts, provides that "[I]f the affixation is reasonably expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanent." While leaving open the question of whether the reasonable expectation standard is to be applied subjectively or objectively, this REIT standard is effectively incorporated into the like-kind exchange definition of real property.[17]

The final regulations include a number of examples of structures satisfying the definition of inherently permanent structures. Offshore oil platforms, whether for drilling or production, are specifically named,[18] as are pipeline transmission systems comprised of underground pipelines, isolation valves and vents, and pressure control and relief valves.[19] Aboveground pipelines, bridges, paved parking areas and parking structures, and fences are also expressly defined as real property.[20] The determination of whether meters and compressors should be considered real property is not made by the final regulations, but is left to be determined based on their particular facts and circumstances.[21]

The final regulations do not take a position as to whether a number of items included in residential properties should or should not be defined as real property. Rather than establish a rule regarding the classification of items such as installed household appliances, carports and sheds, wi-fi and antenna systems, and trade fixtures, the final regulations leave those items to be classified in accordance with state or local law or the factor tests included in the regulations.[22] Similarly, the determination of whether carpeting and wiring should be considered real property is left to be determined by these same standards.

The adoption of state and local law definitions to define real property for purposes of Section 1031 was done despite the existence of some real property definitions elsewhere in the Code.

This lack of guidance is doubly problematic for practitioners; not only does it not indicate which standard (state or local law or factor test) should be applied in making a determination, it also ignores the possibility that these standards could lead to different conclusions.

Intangible assets. In addition to fee ownership, the final regulations expressly include a number of other interests within the definition of real property. Co-ownership, leaseholds, options to acquire real property, and easements are considered real property as described in Section 1031.[23] Stock in a co-operative housing corporation and land development rights are also expressly defined as real property.[24] In addition, licenses, permits, and other similar rights which pertain solely to the use, enjoyment, or occupation of land, and which

[14] Such items could also constitute real property for Section 1031 purposes if they satisfy the applicable state or local law definition of real property.

[15] *See* section I.E *infra*.

[16] Reg. 1.1031(a)-3(a)(2)(ii)(A).

[17] This also raises the question of why other real property definitions from the REIT regulations were not adopted to further clarify real property definitions for Section 1031 purposes.

[18] Reg. 1.1031(a)-(a)(2)(ii)(C).

[19] Reg. 1.1031(a)-3(b)(10) (Example 10). This example concludes that the meters and compressors associated with the transmission system are not real property, because they are not expensive and time-consuming to install and remove, they are not specifically designed for the particular transmission system, and their removal does not damage the pipelines or asset.

[20] Reg. 1.1031(a)-3(a)(2)(ii)(C).

[21] *Id.*

[22] The factors considered in the examples are the manner, time, and expense of installing and removing the item; whether the item is designed to be moved; the damage resulting from the removal; and whether the item is installed during the construction of the structure. Regs. 1.1031(a)-3(a)(2)(ii)(C), 1.1031(a)-3(a)(2)(iii)(B).

[23] Reg. 1.1031(a)-3(a)(1).

[24] Reg. 1.1031(a)-3(a)(5).

are similar to a leasehold or easement, are generally considered real property for purposes of Section 1031.[25]

One class of intangible assets not considered in the final regulations but often relevant to like-kind transactions is interests in single-member limited liability companies. Revenue Ruling 99-6[26] treats the purchase of all of the ownership interests of an entity taxed as a partnership as a purchase of the entity's assets, which can be relevant to a like-kind exchange when the entity holds real property. Ltr. Rul. 200807005 allowed a partnership interest to be the replacement property in a like-kind exchange where Rev. Rul. 99-6 applied. Further, Ltr. Rul. 200909008 allowed the safe harbor parking in accordance with Rev. Proc. 2000-37[27] of a partnership interest that would become the replacement property in a transaction to which Rev. Rul. 99-6 applied. Evidently these concepts still apply to like-kind exchange transactions, though they are not addressed at all in the final regulations.

Distinct-asset test and three-property rule. The final regulations require that each distinct asset in a transaction must be considered and analyzed separately from each other distinct asset in determining whether each of the assets should be treated as real property.[28] However, for purposes of the three-property rule for identifying replacement property in Reg. 1.1031(a)-3(a)(4), the distinct-asset rule is to be applied only to determine whether a property is considered real property under Section 1031, and is not intended to affect the existing three-property rule. This could have the effect of further limiting the limitation of the three-property rule by creating more distinct properties and thus narrowing available replacement properties.

Incidental property determinations

Commonly like-kind exchange transactions will necessarily include an amount of personal property incidental to but included with the real property. To address the effect of this reality in exchange transactions, Reg. 1.1031(k)-(1)(g)(7)(iii) states that, for exchanges involving a qualified intermediary, personal property that is considered incidental to the replacement real property will be disregarded in determining whether the exchanger's rights to obtain the benefits of non-like-kind property (including money) held by the qualified intermediary are expressly limited, as required by Reg. 1.1031(k)-1(g)(6). This does not change the rule that such incidental property, being classified as personal property, cannot be like kind to real property and thus will usually be taxable in a like-kind exchange under Section 1031(b).[29] The final regulations do provide clarity that an exchange accommodator's use of exchange proceeds to acquire incidental real property will not disqualify the remainder of the transaction from the intended tax-deferred treatment.

To be considered incidental to real property, the personal property must be typically transferred with the real property in standard commercial transactions, and the aggregate fair market value of the personal property cannot be greater than 15% of the aggregate fair market value of the replacement real property.[30] It is worth noting that neither the TCJA nor the final regulations' rules regarding incidental real property modified Code Section 1031(b), which still requires recognition of gain with respect to any non-real property received in an exchange, even that which is considered "incidental."[31]

In a helpful clarification for taxpayers, the 15% rule is applied on an aggregate basis as opposed to a property-by-property basis.[32] If the value of the total amount of personal property involved in the exchange is less than 15% of the value of the total amount of real property involved in the exchange, the exchange complies with the incidental personal property rule of Section 1031, even if the amount of personal property included with one of the real properties exceeds this limit.[33]

[25] Reg. 1.1031(a)-3(a)(5)(ii). Interestingly, the final regulations do not contain any provisions regarding the duration of these interests, on the basis that the regulations are to define real property and not whether certain property interests should be considered like kind, which is the effect of differences in duration.

[26] Rev. Rul. 99-6, 1999-1 CB 432.

[27] Rev. Proc. 2000-37, 2000-2 CB 308.

[28] Reg. 1.1031(a)-3(a)(4)(i).

[29] Reg. 1.1031(k)-1(g)(7)(iii).

[30] Reg. 1.1031(k)-1(g)(7)(iii)(B). While this is consistent with the amount of personal property which can be included with real property without losing real estate investment trust status under Sections 856(d)(1)(C) and 856(c)(9)(A)(ii), the IRS stated that these provisions were not the basis for the 15% rule. The IRS also stated that the term "commercial" refers to the type of transaction, not the type of property, so that non-commercial property may be involved in such transactions, though this language is not included in the final regulations.

[31] One effect of this requirement is a likely increase in the need for appraisals in like-kind exchanges, to ensure that the real property involved constitutes at least 85% of the total value involved and that the personal property involved does not exceed 15% of that value.

[32] Reg. 1.1031(k)-1(g)(7)(iii)(B).

The final regulations do not address a number of issues which the IRS considered to be outside the scope of the TCJA amendments. For example, the final regulations do not provide guidance on the timing of gain recognition for exchanges involving installment sales under Section 453, exchanges involving multiple properties under Reg. 1.1031(j)-1, the effect of exchanges involving encumbered property on partnership capital accounts, whether interests in Delaware statutory trusts should be considered real property, and the interaction between the bonus depreciation rules of Section 168 and the like-kind exchange rules.

Effective date

The final regulations are effective for exchanges beginning after 12/2/2020, their date of publication in the Federal Register.

Conclusion

Though the final regulations are beneficial in clarifying a number of questions involved in like-kind exchanges, they frustratingly leave many issues perhaps even less clear than before. The adoption of the state and local law standard to define real property is far from a clear standard, given the differences in such definitions not only between states but also within states, depending on whether security interest, property tax, water or mineral rights, or other statutes are involved.

The final regulations also give little guidance on when the state and local law standard is to be superseded by the inherently permanent structure definitions, the particular-facts-and-circumstances test, or prior legal determinations. One place where the comments on the final regulations are definitive—property specifically ineligible for like-kind exchange treatment prior to the TCJA—may be of questionable validity because of the statutory repeal of the specified exceptions.

While helpful in some ways, the final regulations will still leave practitioners with many unanswered questions in structuring compliant like-kind exchanges. ■

[33] The IRS also stated that the 15% rule is not meant to be a bright-line test, and that the determination of whether a transaction does or does not meet the criteria for a Section 1031 exchange is still to be determined by all of the relevant facts and circumstances, but this does not seem entirely consistent with the "cannot exceed" language of the final regulations.

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GIMME, GIMME TAX SHELTER: THE SYNDICATED CONSERVATION EASEMENT CONTROVERSY

ADINE S. MOMOH

This article examines conservation easements and, more specifically, the tax shelter controversy concerning syndicated conservation easements. Syndicated conservation easements can present various traps for the unwary given the increased scrutiny that these transactions are now under. If the basic mechanics of conservation easement contributions are not followed, the IRS can challenge the syndicated transaction.

Introduction

"Gimme Shelter" is the classic opening track to the Rolling Stone's 1969 album *Let It Bleed.* As the lyrics go:

Ooh, a storm is threatening
My very life today
If I don't get some shelter
Ooh yeah I'm gonna fade away . . .
Mmm, a flood is threatening
My very life today
Gimme, gimme shelter
Or I'm gonna fade away[1]

No, Mick Jagger, Keith Richards, and the Rolling Stones were of course not making a statement about shelter in the context of tax and the Internal Revenue Code. But there are parallels.

Tax shelters are matters of "legislative grace."[2] Taxpayers use tax shelters, i.e., tax-saving tools, mainly to decrease, offset, or delay their tax burdens. Indeed, a taxpayer has the right to minimize his or her taxes by structuring his or her transaction in any legally permissible manner.[3] Courts have recognized that right, but stated that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[4] This is known as the Economic Substance Doctrine.

Where a transaction lacks any significant economic purpose other than tax avoidance, the transaction will not be respected for federal income tax purposes, and the court will look beyond the form of such transaction and will apply the tax law in accordance with the substance of the transaction.[5] Thus, while tax shelters can provide tax savings, there are limits, especially when those shelters become abusive.

An increasingly popular, albeit controversial, tax-savings tool known as a conservation easement is a permanent agreement between a property owner and a land trust, nonprofit, or government entity through which the owner gives up some of its rights of ownership in order to advance conservation purposes.[6] Assuming the owner taxpayer meets the criteria in the Internal Revenue Code and corresponding Treasury Regulations, the conservation easement allows the property owner to claim a federal tax deduction for the fair market value of the easement up to 50% of the owner's adjusted gross income (AGI) (and 100% if the owner is a rancher or farmer). The fair market value and ultimate deduction are based on an appraisal.

ADINE S. MOMOH, ESQ. is an equity partner and trial attorney at Stinson LLP in Minneapolis, where her practice consists of banking and securities litigation, estates and trusts litigation, and creditors' rights and bankruptcy in the firm's business and commercial litigation group.

And that deduction can oftentimes raise questions. Data from the IRS shows that "total deductions for conservation easement contributions by taxpayers tripled between 2012 and 2014—rising from $971 million in 2012 to $1.1 billion in 2013 to $3.2 billion in 2014."[7]

The IRS is well aware that conservation easements and the deductions that follow are ripe for debate, abuse, and controversy, starting at the beginning with whether the contribution constitutes a "qualified conservation purpose" all the way to the appraisal, who conducts the appraisal, and who ultimately benefits. Indeed, in December 2017,[8] new tax legislation was enacted with the introduction of the Tax Cuts and Jobs Act. Some had hoped that the legislation would further limit conservation easements. But no such limits were put in place.

A new area of abuse has taken hold as of recent years, and the antennas of the IRS, Department of Treasury ("Treasury Department"), and U.S. Department of Justice ("Justice Department") are up. This area is commonly known as a conservation easement syndication. A typical conservation easement syndication is one in which promotors (otherwise known as syndicators) provide opportunities for investors in a partnership or other pass-through entity to purchase an interest in real property.[9] That property is then subject to a conservation easement, allowing the investors to claim charitable contribution deductions often well in excess of the amount of their investment.[10] In addition to grossly overstating the value of the easement that is purportedly donated to charity, these transactions often fail to comply with the basic requirements for claiming a charitable deduction for a donated easement.

On the one hand, litigation surrounding conservation easements has most often dealt with the technical flaws in the easements and how those transactions were executed. On the other hand, litigation has focused on the substance of the transaction, including the appraisal, the methodology used to determine the appraisal, the appraiser used, and the amount of the charitable deduction ultimately claimed on a taxpayer's return. Now, according to the IRS and Justice Department, litigation has been increasing to deter the abuse of such tax shelters, in particular, the use of syndicated conservation easements.

This article analyzes the legal environment surrounding conservation easements, generally, and the rise of syndicated conservation easements, specifically. The article outlines the mechanics of conservation easement contributions and, to help those understand the risks associated with such transactions, illustrates those fundamental principles through a case study of *RP Golf, LLC, SB Golf, LLC, Tax Matters Partner*, TCM 2012-282.

The article then outlines the mechanics of syndicated conservation easements and illustrates this potentially abusive tax shelter through a case study of *Zak*, a case brought by the Justice Department on behalf of the United States that (as of the date of writing this article) is currently pending in the U.S. District Court for the Northern District of Georgia. The article addresses the implications of *Zak* as the case remains pending. The article concludes by summarizing the discussion and offering insight into the future of syndicated conservation easement transactions.

Gifts and charitable contributions of conservation easements

History. In 1980, Congress enacted Section 170(h) of the Internal Revenue Code.[11] Section 170(h) permits a tax deduction for the charitable contribution of a conservation easement.[12] In as recently as 2015, Congress amended the conservation easement statutory scheme and in particular, the tax base to which the deduction applies, as will be discussed below.[13] The

[1] The Rolling Stones, "Gimme Shelter" lyrics, https://www.metrolyrics.com/gimme-shelter-lyrics-rolling-stones.html.

[2] *See INDOPCO, Inc.*, 503 U.S. 79, 84 (S Ct 1992).

[3] *Gregory*, 293 U.S. 465, 469 (S Ct 1935).

[4] *Id.* at 469.

[5] *See Frank Lyon*, 435 U.S. 561, 580 (S Ct 1978).

[6] *Greenberger*, 283 F. Supp. 3d 1354, 1358 (N.D. Ga. 2017).

[7] Looney, *Estimating the Rising Cost of a Surprising Tax Shelter: The Syndicated Conservation Easement*, The Brookings Institute, 12/20/2017, https://www.brookings.edu/blog/up-front/2017/12/20/estimating-the-rising-cost-of-a-surprising-tax-shelter-the-syndicated-conservation-easement/.

[8] Tax Cuts and Jobs Act ("TCJA"), P.L. 115-97, 12/22/2017.

[9] Kuhn, "Conservation Easements: Congress Giveth and the IRS & Tax Court Taketh Away," JackCamps Blog (May 2018), available at https://www.jackscamp.com/conservation-easements-congress-giveth-and-the-irs-tax-court-taketh-away/.

[10] *Id.*; *see also* Notice 2017-10, 2017-4 IRB 544.

[11] Unless otherwise indicated, references to "Sections" are to sections of the Internal Revenue Code of 1986, as amended.

[12] Section 170(h).

[13] *See* P.L. No. 114-113, Title I, section 111(a), 129 Stat. 3046 (2015) (making permanent the 50% income limitation (up from 30%)).

[14] *BC Ranch II, L.P.*, 867 F.3d 547, 551 (CA-5, 2017).

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federal income tax deduction for the charitable contribution of conservation easements has "enjoyed decades of bipartisan support."[14] Section 170(h) was adopted:

> (1) at the behest of conservation activists, not property-owning, potential-donor taxpayers (2) by an overwhelming majority of Congress (3) in the hope of adding untold thousands of acres of primarily rural property for various conservation purposes—acreage that would never become available for conservation if land-owning potential donors were limited to the traditional method of conveyance, i.e., transferring the full fee simple title of such properties.[15]

"Congress thus made and codified a public policy decision in favor of conserving lands and preserving natural resources, and did so despite the loss of significant tax revenue."[16] Through the use of conservation easements, taxpayers (including individuals, families, and partnerships) have permanently conserved more than 27.7 million acres of land in the United States.[17]

An increasingly popular, albeit controversial, tax-savings tool known as a conservation easement is a permanent agreement between a property owner and a land trust, nonprofit, or government entity through which the owner gives up some of its rights of ownership in order to advance conservation purposes.

Charitable contributions generally. *Definition.* A charitable contribution is a contribution (or gift) to or for the use of a qualifying organization.[18] The contribution must be made with charitable intent and without receipt of adequate consideration.[19] The contribution must also be made without expectation of a direct or indirect benefit to the donor (i.e., no quid quo pro) to constitute a "charitable" contribution. That contribution can be cash or other property.

A conservation easement is a contribution of other property. Generally, a conservation easement is a permanent restriction on the use of land or a building. For purposes of Section 170(h), a deductible conservation easement is an easement granted for at least one of the following purposes:

1. Preservation of land areas for outdoor recreation by, and education of, the general public.
2. Protection of a "relatively natural habitat" (e.g., to protect endangered species).
3. Preservation of open space (e.g., to protect scenic views).[20]
4. Preservation of historically important land area, buildings, or certified historic structure.

The first purpose, preservation of land for outdoor recreation, is an area often ripe for abuse and can provide lucrative deductions. Reg. 1.170A-14(d)(2)(i) provides that the preservation of a water area for the use of the public for boating or fishing, or a nature or hiking trail for the use of the public, satisfy the first purpose.[21]

Amount of deduction. For charitable contributions of capital gain property, the deduction is generally limited to 30% of an individual's contribution base.[22] The contribution base of an individual is generally AGI.[23]

In the case of conservation easements, an individual may deduct a qualified conservation easement contribution up to 50% of the individual's contribution base.[24] For qualified farmers and ranchers, the deduction can be up to 100%.[25]

Carryovers. Taxpayers generally can carry over unused charitable contributions for up to five years.[26] For conservation easements, the carryover period is 15 years.[27]

Partial interest rule. Typically, no charitable contribution deduction will be allowed for a contribution of a partial interest, which is an

[15] *Id.* at 553.

[16] Def. Zak's Mem. of Law in Supp. of Mot. to Dismiss [Doc. No. 31-1] at 4.

[17] *See id.* (citing National Conservation Easement Database, at https://www.conservationeasement.us/).

[18] *See* Section 170(c).

[19] *See* Reg. 1.170A-1(h).

[20] The open space must yield significant public benefit, such as for scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy. *See* Section 170(h)(4)(A)(iii)(II).

[21] Some have argued that a golf course easement, where taxpayers want to use the encumbered property as a *private* golf course, can satisfy this purpose as well. *E.g.*, *Kiva Dunes Conserv., LLC*, TCM 2009-145. In *Kiva*, partners in a partnership claimed a valuation of $30.5 million for a conservation easement on a golf course and took a charitable contribution deduction for the donation. The IRS challenged the deduction on multiple grounds and imposed accuracy-related penalties. Following a trial on the merits, the Tax Court found that the fair market value of the easement was $28.6 million. *See infra* note 36.

[22] Section 170(b)(1)(B).

[23] Section 170(b)(1)(G).

[24] Section 170(b)(1)(E)(i).

[25] Section 170(b)(1)(E)(iv).

[26] Section 170(d)(1).

[27] Section 170(b)(1)(E)(ii).

interest that consists of less than the donor's entire interest in the property.[28] However, Section 170(f)(3)(B)(iii) permits a deduction for a partial interest provided that it is a qualified conservation contribution.[29]

Qualification requirements for qualified conservation easements. To qualify as having made a qualified conservation contribution under Section 170(h)(1), the taxpayer must have a qualified real property interest that is granted in perpetuity to a qualified organization and the property must be used exclusively for conservation purposes. In other words, the contribution must be granted in perpetuity and enforced in perpetuity.[30]

Qualified real property interest (Section 170(h)(2)). Any of the following interests in real property constitute a "qualified real property interest": (1) a transfer of an entire interest in property except for a qualifying mineral interest; (2) a remainder interest in real property; or (3) a restriction on the use of the real property granted in perpetuity. The terms "easement," "conservation restriction," and "perpetual conservation restriction" have the same meaning.[31]

Granted in perpetuity (Section 170(h)(2)(C)). Perpetuity is a fundamental requirement. A conservation easement must be granted in perpetuity.[32] A perpetual use restriction must attach to a defined parcel of real property rather than "simply some or any (or interchangeable parcels of) real property."[33] State law controls whether the restriction protecting the property was so granted in perpetuity.

Qualified organization (Section 170(h)(3)). The easement is given to a qualified not-for-profit, often a land trust, that is capable of enforcing it. Generally, a qualified organization is a public charity described in Section 501(c)(3) or a government unit described in Section 170(b)(1)(A)(v) and (vi).

Exclusively for conservation purposes (Section 170(h)(5)(A)). A qualified conservation contribution must be exclusively for conservation purposes.[33.1] Exclusively for conservation purposes is another way of saying "protected in perpetuity."[34] The interest must also be enforceable in perpetuity.[35] The donor's interest in the property must be subject to legally enforceable restrictions (e.g., deed recordation) that will prevent uses of the property that are inconsistent with the conservation purposes of the contribution.

Substantiation requirements for qualified conservation easements. When it comes to conservation easements, the IRS is likely to challenge the conservation easement's value primarily because the determination of the easement's value is inherently subjective.[36] In case there is an audit of the taxpayer, five documents are essential to substantiate the conservation easement's value, and hence, its charitable deduction: (1) deed of easement; (2) contemporaneous written acknowledgment; (3) qualified appraisal; (4) Form 8283; and (5) baseline documentation report. If any of these documents are missing, the taxpayer will risk total disallowance of the deduction claimed.[37] Each document will be discussed in turn, as each creates an additional basis for the IRS to challenge the deduction.

Deed of easement. The deed of easement, which is typically 20 to 35 pages, describes the

A typical conservation easement syndication is one in which promotors (otherwise known as syndicators) provide opportunities for investors in a partnership or other pass-through entity to purchase an interest in real property. That property is then subject to a conservation easement, allowing the investors to claim charitable contribution deductions often well in excess of the amount of their investment.

[28] Section 170(f)(3).

[29] *See* Section 170(f)(3)(B)(iii).

[30] *See* Section 170(h)(2)(C).

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

[32] Section 170(h)(5)(A).

[33] *Belk*, 774 F.3d 221, 225 (CA-4, 2014).

[33.1] Section 170(h)(1)(C).

[34] Defined in Section 170(h)(5)(A); *see also* Section 170(f)(3)(B)(iii), (h)(1).

[35] *See* Reg. 1.170A-14(g).

[36] Levitt et. al, "Kiva Dunes–A Guide to Donating Conservation Easements and Substantiating Their Value," 13 Valuation Strategies 28, at 29 (2010). While the issue of whether conservation easements can ever be granted on certain types of property, such as golf courses, remains hotly contested, this issue is beyond the scope of this article.

[37] While beyond the scope of this article, it is important to note that some flexibility is permitted to remedy the omission of some of these documents. For example, if a taxpayer fails to file Form 8283 or files an incomplete form, the charitable contribution deduction will be disallowed unless the failure was due to a "good-faith omission," the donor-taxpayer otherwise complied with Reg. 1.170A-13(c)(3) and (c)(4) (including completion of a timely qualified appraisal), and the IRS requests that the donor submit a fully completed form within 90 days of the request, and the donor complies. *See* Reg. 1.170A-13(c)(4)(iv)(H).

conservation purpose(s), restrictions, and permissible use of the subject property. To be effective, it must contain legally binding restrictions enforceable by the donee organization.[38] Further, the deed must be granted in perpetuity and enforced in perpetuity. To be enforceable, the deed must be recorded in land records of the jurisdiction where the subject property is located.

Contemporaneous written acknowledgment. According to Section 170(f)(8)(A), no charitable conservation easement deduction shall be allowed unless the taxpayer substantiates the contribution with a "contemporaneous written acknowledgment of the contribution by the donee organization."[39] "Contemporaneous" means that the taxpayer must obtain the acknowledgment by the earlier of the date on which the taxpayer files his or her tax return claiming the charitable contribution deduction, or the due date (including extensions) for the return.[40]

The IRS is likely to challenge a conservation easement's value primarily because the determination of the easement's value is inherently subjective.

The contemporaneous written acknowledgment "need not take any particular form."[41] However, it must meet the following requirements: (1) identify the amount of cash and describe (but not value) the property received by the donee; (2) contain a statement of whether the donee provided any goods or services in consideration in whole or in part, for the gift; and (3) provide a description and good faith estimate of those goods or services, other than intangible religious benefits.[42]

Qualified appraisal. Qualified appraisals are required for all contribution deductions for conservation easements valued at more than $5,000.[43] The appraisal must not be made more than 60 days before the contribution date and received by filing of the tax return. To be a "qualified appraisal," an appraisal of property (1) must be treated as a qualified appraisal under regulations or other guidance prescribed by the Secretary of the Treasury Department, and (2) must be conducted (i.e., prepared, signed, and dated) by a "qualified appraiser" in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.[44]

"Qualified appraiser" means an individual with verifiable education and experience in valuing the type of property for which the appraisal is performed measured on the date that the appraiser signs the appraisal.[45] Certain persons, no matter their competence, are disqualified from being qualified appraisers, including but not limited to the donor, donee of the property, and certain parties to the transaction in which the donor acquired the property.[46] No impermissible appraisal fees can be paid.

Additionally, the appraisal must satisfy specific content requirements.[47] The appraisal identifies the fair market value of the easement, which is the difference between the "highest and best use" valuation of the property and its value as encumbered by the easement (i.e., the value of the property after the restriction is placed). A property's highest and best use is the highest and most profitable use for which it is

[38] *See* Reg. 1.170A-14(g)(1).

[39] Section 170(f)(8)(A). Note that the contemporaneous written acknowledgement requirement applies to charitable contributions of $250 or more (in cash or property).

[40] Section 170(f)(8); Reg. 1.170A-13(f)(3), and Publication 1771, Charitable Contributions—Substantiation and Disclosure Requirements.

[41] *See Schrimsher*, TCM 2011-71 (quoting H.R. Conf. Rept. No. 103-213, at 565 n. 32 (1993), 1993-3 C.B. 393, 443).

[42] Section 170(f)(8)(B)(i)-(iii); *see also* Conservation Easement Audit Techniques Guide (1/24/2018), *available at* https://www.irs.gov/pub/irs-utl/conservation_easement.pdf [hereinafter Conservation Easement Guide].

[43] Section 170(f)(11)(C).

[44] *See* Section 170(f)(11)(E)(i)-(ii); *see also* Conservation Easement Guide, *supra* note 42, at 28-29; IRS Publication 561 (Determining the Value of Donated Property); and Reg. 1.170A-17.

[45] For contributions made on or after 1/1/2019, see Reg. 1.170A-17 issued in 2018. The education and experience requirements can be satisfied by coursework or professional designations. "[A]lthough an appraiser's technical education and licenses are important, it is at least equally important that the appraiser has extensive knowledge of the specific geographic area and market of the property being appraised." Levitt, *supra* note 36, at 35.

[46] Additional disqualified persons include independent contractors regularly used as appraisers by any of the previously identified disqualified persons and who do not perform a majority of their appraisals for others; related persons to any of the previously identified disqualified persons such as certain family members, owners or employees; persons who receive a prohibited fee; and persons prohibited from practicing before the IRS at any time during the three-year period before date of appraisal.

[47] These include (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation, including methods used to determine value; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser as to the type of property being valued, including education and experience; and (5) the signature and taxpayer identification number of such appraiser – the appraiser can provide a SSN or EIN obtained by the appraiser if a sole proprietor; otherwise should use the EIN of the employer/entity. *See* Conservation Easement Guide, *supra* note 42, at 29.

adaptable and needed or likely to be needed in the reasonably near future.[48] The highest and best use "can be *any* realistic, objective potential use of the property."[49]

The appraisal determines the deduction. Moreover, any enhancement in the value of a donor's other property resulting from the easement contribution, or of property owned by certain related persons, reduces the amount of the contribution deduction.[50] If the deduction claimed is disallowed in part or in its entirety based on the easement's valuation, and the taxpayer challenges that determination, a presumption in favor of the IRS applies. The IRS's determination of value will usually be presumed correct, and the taxpayer will bear the burden of proving that the determination is incorrect.[51]

Form 8283. Form 8283 (Noncash Charitable Contributions), Section B, with supplemental statement, is a document that has to be fully completed and attached to the return for noncash charitable contributions greater than $5,000.[52] Common errors that taxpayers make when completing Form 8283 include describing the subject property inadequately, missing information, missing signatures, and inserting inconsistent dates. With respect to the property description, the property description must have sufficient detail for a person unfamiliar with the type of property to ascertain that the property being appraised is the property that was contributed.[53]

Baseline documentation report. The donor of a conservation easement must provide baseline documentation (sometimes referred to as the baseline study) to the donee before the time the donation is made.[54] This documentation should provide specific information about the conservation values of the subject property. At the time of the contribution, the parties have to agree on the condition of the property.

Case study: *RP Golf, LLC, SB Golf, LLC, Tax Matters Partner.* In 2012, the Tax Court examined the issue of substantiation in *RP Golf, LLC, SB Golf, LLC, Tax Matters Partner*, and whether the taxpayer had satisfied the requirements of Section 170(f)(8). In that case, RP Golf, LLC donated a conservation easement on a portion of real property owned by its limited liability company, the National Golf Club of Kansas City.[55] In December 2003, National Golf executed an agreement entitled "Grant of Permanent Conservation Easement" granting a conservation easement to Platte County Land Trust, a Missouri not-for-profit corporation.[56] National Golf operated two private golf courses on the property. The agreement stated in relevant part:

> WHEREAS, Grantor desires to protect and preserve the natural values of the property by making permanent arrangements for the conservation of the open space, scenic natural resources, natural habitat and aesthetic qualities of the Property and to limit the future use thereof to such purposes * * *
>
> NOW, THEREFORE, . . . , Grantor on behalf of itself and its heirs, successors and assigns, in consideration of the premises contained herein and other valuable consideration paid to its full satisfaction, does freely give, grant, sell, transfer, convey and confirm forever unto [PLT] . . . a perpetual conservation easement (as more particularly set forth below) in that certain tract of land containing approximately three hundred (300) acres, more or less, being more particularly described in Schedule A and illustrated on Schedule B attached hereto and incorporated herein. . . .[57]

According to the agreement, the easement's purpose was twofold The easement's primary purpose was to "further the policies of the State of Missouri designed to foster the preservation of open space or open areas, conservation of the state's forest, soil, water, plant and wildlife habitats, and other natural and scenic resources." Further, the easement was to implement certain objectives set forth in the Missouri Statute, which included preserving and maintaining open areas and spaces in the light of encroaching urban and metropolitan development.[58]

[48] *Kiva Dunes Conservation, LLC*, TCM 2009-145. For example, in *Esgar Corp.*, TCM 2012-35, aff'd, 744 F.3d 648 (CA-10, 2014), where the IRS issued notices of deficiency to taxpayers based on them having allegedly contributed a valueless conservation easement, the U.S. Tax Court decided the fair market value of the conservation by determining whether the land on which the easements were granted was better suited for gravel mining or for agriculture.

[49] *Id.* (emphasis added) (citing *Symington*, 87 TC 892, 896 (1986)).

[50] 1.170A.

[51] *Kiva Dunes*, TCM 2009-145 (citing Rule 142(a)). However, a burden-shifting scheme also applies. Pursuant to Section 7491(a)(1), the burden of proof on factual issues that affect the taxpayer's tax liability may shift to the IRS where the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the alleged tax liability.

[52] The Deficit Reduction Act of 1984 and Reg. 1.170A-13(c)(4) refer to Form 8283 as an "appraisal summary."

[53] Conservation Easement Guide, *supra* note 42, at 27; *see also* Reg. 1.170A-13(c)(4)(ii)(B).

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

[55] *RP Golf, LLC, SB Golf, LLC, Tax Matters Partner*, TCM 2012-282.

[56] *Id.*

[57] *Id.*

[58] *Id.*

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To ensure National Golf's compliance with the statutory objectives and agreement terms, the land trust agreed to inspect and, if necessary, enforce the easement for an annual fee of approximately $15,000. A representative of the land trust also signed an attachment to the agreement, and consequently, the land trust had accepted the easement and agreed to its covenants and restrictions. The easement was later recorded at the end of December 2003.[59]

The IRS is committed to putting an end to abusive syndicated conservation easement transactions and holding accountable the individuals and entities who promote, assist with, or participate in these schemes.

RP Golf claimed a charitable contribution deduction in the amount of $16.4 million on its 2003 federal income tax return, which was timely filed. It also attached to the return Form 8283, which reported the easement's value and basis information and included an appraiser's declaration stating that the easement's appraised fair market value was $16,400,000.[60] RP Golf did not, however, complete the column entitled "for bargain sales, enter amount received." The land trust's vice president signed the form under "Donee Acknowledgment" attesting to its status as a qualified organization under Section 170(c) and its receipt of the easement in December 2003. Nearly five years later, in April 2008, the land trust thanked RP Golf and its partner, National Golf, for the easement. The land trust also stated in the letter that it, the land trust, did not provide any goods or services in exchange for the easement.[61]

In August 2008, the IRS disallowed the charitable contribution deduction in its entirety in a notice of final partnership administrative adjustment. RP Golf filed a timely petition to challenge the determination, and the IRS filed a motion for summary judgment. RP Golf argued that the agreement was a written acknowledgment that complied with the requirements of Section 170(f)(8). The IRS argued that the agreement was not in compliance, because it lacked a statement that no goods or services were exchanged for the easement. Neither party alleged that the land trust provided goods or services to National Golf in exchange for the easement.

Ultimately, the Tax Court granted in part and denied in part the IRS's motion.[62] Focusing on the agreement (which the court considered to be a "conservation deed") and its plain language, the court found that the agreement satisfied the requirements of Section 170(f)(8).

The agreement stated that the conservation easement was made "in consideration of the covenants and representations contained herein and for other good and valuable consideration." The agreement then described the property's conservation value as its aesthetic, open space, scenic, recreational, and natural resource values, but did not include consideration of any value other than the preservation of the property. Lastly, the agreement stated that it constituted the entire agreement between the parties regarding the contribution of the conservation easement.[63] Thus, although omitted, the court concluded that the agreement, taken as a whole, stated that no goods or services were received in exchange for the contribution.[64]

The lesson from *RP Golf* is that when a deed of conservation easement does not explicitly state whether the donee provided goods or services in exchange for the charitable contribution, the deed taken as a whole can and must prove compliance with Section 170(f)(8)(B)(ii).[65]

Syndicated conservation easements

Conservation easement contributions are legitimate tax-planning tools that can be used to lessen one's taxes while benefiting a tax-exempt entity. However, as illustrated by the earlier discussion, conservation easements are ripe for abuse, mostly because of the inherent subjectivity that these transactions involve with respect to the subject contributed property's value.

Conservation easements are also ripe for abuse when individuals (called promoters) syndicate those conservation easement trans-

[59] *Id.*

[60] *Id.* According to the supplemental information attached to Form 8283, the fair market value of the subject property before the easement was $17.4 million and the fair market value after the easement was $1 million. *Id.*

[61] *Id.*

[62] In deciding whether to grant summary judgment, the court had to view all factual inferences in favor of the nonmoving party, i.e., RP Golf and National Golf.

[63] This provision is commonly referred to as a merger clause.

[64] The court also held that genuine issues of material fact existed as to whether the conservation easement was made "exclusively for conservation purposes."

[65] *French*, TCM 2016-53.

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actions and purport to give investors the opportunity to obtain charitable contribution deductions and corresponding tax savings that significantly exceed the amount an investor invested. Those conservation easements are known as syndicated conservation easements. What follows is a discussion of the fundamentals of syndicated conservation easements, the response by the IRS, Treasury Department, and Justice Department, and a recent case that the Justice Department is currently litigating.

The fundamentals of syndicated conservation easements. Syndicated conservation easements typically are created and proceed as follows. A promoter either identifies a pass-through entity that owns real property, or forms a pass-through entity to acquire real property. Thereafter, the promoter sends promotional materials to prospective investors in the pass-through entity pitching the possibility that by investing in the entity, the investor could receive a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment.[66] The promotional materials may be oral or written.[67]

The promoter obtains an appraisal that purports to be a "qualified appraisal" as defined in Section 170(f)(11)(E)(i).[68] However, from the IRS's perspective, the appraisal greatly inflates the value of the conservation easement based on unreasonable conclusions about the real property's development potential.[69] The investor then purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property.[70]

Next, the pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity (i.e., a qualified organization) and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor.[71] The investor then reports that amount as a charitable contribution deduction on his or her federal income tax return.[72]

This scheme provides an additional tax incentive. Investors who hold their direct or indirect interests in the pass-through entity for one year or less can 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).[73] In return, the promoter receives a fee or other consideration with respect to the promotion, which may be in the form of an interest in the pass-through entity.[74]

The IRS's and Department of Justice's responses to conservation easement abuse. The IRS is committed to putting an end to abusive syndicated conservation easement transactions and holding accountable the individuals and entities who promote, assist with, or participate in these schemes.[75] Seeing the need to challenge the purported tax benefits from abusive conservation easement transactions, in December 2016, the IRS issued Notice 2017-10. That Notice designates certain

The IRS announced that it would be significantly increasing the amount of enforcement actions for syndicated conservation easement transactions.

syndicated conservation easements (such as the one described earlier) as recognized abusive and listed transactions that the IRS deems to be tax avoidance transactions and that must be disclosed and otherwise reported under Sections 6111 and 6112 and Reg. 1.6011-4(b)(2).[76] "Participants" in such a transaction (including a substantially similar transaction) are required to file disclosure statements with the IRS (Form 8886, Reportable Transaction Disclosure Statement). "Material advisors" with respect to such a transaction are required to file disclosure statements with the IRS (Form 8918, Material Advisor Disclosure Statement) and main-

66 Notice 2017-10, 2017-4 IRB 544. For purposes of Notice 2017-10, promotional materials include, but are not limited to, documents described in Reg. 301.6112-1(b)(3)(iii)(B).

67 *Id.*

68 *Id.*

69 *Id.*

70 *Id.* The Notice further provides that investors who held their direct or indirect interests in the pass-through entity for one year or less can 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). *Id.*

71 *Id.*

72 *Id.*

73 *Id.*

74 *Id.; see* Sections 6111-6112; Reg. 1.6011-4(b)(2).

75 IRS Increases Enforcement Action on Syndicated Conservation Easements, https://www.irs.gov/newsroom/irs-increases-enforcement-action-on-syndicated-conservation-easements.

76 *Id.* A near real-time list of "listed transactions" can be found on the IRS's website: http://www.irs.gov/Businesses/Corporations/Listed-Transactions—LB&I-Tier-I-Issues.

77 *Supra* note 75.

tain client lists regarding such transactions. The Notice is effective for transactions entered into on or after 1/1/2010.

Since then, the IRS has been challenging the purported tax benefits from these transactions based on the alleged overvaluation of the conservation easement, as well as the partnership anti-abuse rule, economic substance, or other rules or doctrines.[77] For example, in *BC Ranch II*, the IRS disallowed all of the charitable deductions that partnerships had identified in their respective tax returns based on conservation easement contributions they had made.[78]

Two partnerships, BCR I and BCR II, had acquired thousands of acres of land in 2003 and 2005 respectively. BCR I marketed limited partnership interests to investors beginning in early 2005. The partnership eventually admitted 24 limited partners, and in late-2005 donated a conservation easement with respect to most of the acreage it held.[79] BCR II marketed limited partnership interests to additional investors, eventually admitting 23 limited partners, and then donated a conservation easement on most of its land in mid-2007.[80]

Various penalties under the Code may apply to those who participate in a syndicated conservation easement transaction.

The IRS disallowed all of the charitable deductions claimed with respect to both partnerships and imposed gross valuation misstatement penalties. Following trial, the Tax Court denied the deductions because it concluded that, among other things, (1) certain reserved rights caused the conservation easement donations to fail the perpetuity requirement, (2) the required "baseline documentation" failed to satisfy the regulatory requirements, and (3) the transactions with the partners involved disguised sales.[81] Ultimately, however, the Fifth Circuit vacated those holdings and concluded that the conservation easements satisfied both the perpetuity and baseline documentation requirements, and remanded the case to the Tax Court for further fact finding consistent with its rulings.[82]

Even so, in March 2019, the IRS announced that it was including syndicated conservation easements on its 2019 "Dirty Dozen" list of tax scams to avoid.[83] During that same month, on 3/27/2019, Senate Finance Committee Chairman Chuck Grassley (R-Iowa) and Ranking Member Ron Wyden (D-Ore.) launched an investigation into the potential abuse of syndicated conservation easement transactions.[84] "There are very legitimate purposes for the conservation easement provisions of the tax code. But when a handful of individuals cook up a scheme to cash in at the expense of federal revenue and in violation of Congress's intent, something needs to change. There's no reason that the rest of the taxpaying American public should be left with such a raw deal," Senator Grassley said.[85] "This is just our first step in getting to the bottom of how these tax provisions are being abused, and it will inform what else ought to be done to fix the problem."[86]

Then in November 2019, the IRS announced that it would be significantly increasing the amount of enforcement actions for syndicated conservation easement transactions.[87] The IRS has warned that it is committing significant examination and investigative resources to audit the entities and individuals involved in this scheme vigorously.[88] Following those audits, those who are involved in such transactions (including those who failed to disclose their participation properly) will face the risk of criminal and civil prosecution, payment of all taxes owed, along with "stiff" penalties and interest, and imprisonment.[89] The IRS has reported that it is litigating more than 80 cases involving abusive syndicated conservation easements in the Tax Court.[90]

The Justice Department, and specifically its Tax Division, has also taken interest in investigating and ultimately halting abusive conserva-

[78] *BC Ranch II, L.P.*, 867 F.3d 547, 551 (CA-5, 2017).

[79] *Id.* at 550.

[80] *Id.*

[81] *Id.* at 551, 555.

[82] *Id.* at 556–60. *Cf. Pine Mountain Pres. LLLP*, 151 TC No. 14 (2018) (overruling IRS challenge to conservation easements deductions sought by partnership with multiple investors).

[83] "Abusive Tax Shelters, Trusts, Conservation Easements Make IRS' 2019 `Dirty Dozen' List of Tax Scams to Avoid," https://www.irs.gov/newsroom/abusive-tax-shelters-trusts-conservation-easements-make-irs-2019-dirty-dozen-list-of-tax-scams-to-avoid.

[84] "Grassley, Wyden Launch Probe of Conservation Tax Benefit Abuse," https://www.finance.senate.gov/chairmans-news/grassley-wyden-launch-probe-of-conservation-tax-benefit-abuse.

[85] *Id.*

[86] *Id.*

[87] *Supra* note 75.

[88] *Id.*

[89] *Id.* The qualified organization (i.e., charitable donee) may not be treated as a party to or participant in the transaction. *See* Tax Planning for Family Wealth Transfers: Analysis, Forms, Charitable Conservation Easements, ¶ 5.10 (2020).

tion easements syndicates. Richard E. Zuckerman, the Tax Division's Principal Deputy Assistant Attorney General, has stated, "The Department of Justice is working with our partners in the Internal Revenue Service to shut down fraudulent conservation easement shelters, which in this case were based on willfully false valuations."[91] He cautioned, "Individuals investing in these schemes with benefits that seem too good to be true should ensure they are paying their proper federal income tax liability."[92]

The Justice Department has reported that generally, in the past decade, its Tax Division "has obtained injunctions against hundreds of unscrupulous tax preparers and tax scheme promoters."[93] The Tax Division has also sought damages. With respect to conservation easement litigation, the Tax Division has pursued these cases on the theory that participants either allegedly overvalued the subject conservation easement, failed to follow the requirements for conservation easements under the Code and corresponding Regulations, or both.

Case Study: Zak. *Zak* is one such case where the Justice Department on behalf of the United States (i.e., the Government) has pursued litigation to halt the organizing, promoting, or selling of an allegedly abusive conservation easement syndication tax scheme.[94] On 12/18/2018, the Government filed an 80-page Complaint (with 164 detailed allegations) in the U.S. District Court for the Northern District of Georgia against a network of tax advisers, attorneys, appraisers, and syndicators who have attempted to syndicate conservation easement contributions.[95]

The Government brought its lawsuit under Sections 7402, 7407, and 7408 and is seeking both injunctive relief and damages through disgorgement of the gross receipts received resulting from the alleged schemes.[96] The Defendants generally contend that the Government is overreaching based on gross misrepresentations of the facts and, presumably, an undervaluing of the purposes and bi-partisan congressional support of conservation easements.[97]

According to the Complaint, Nancy Zak ("Zak") is a "conservation manager," "consultant," and "project manager" who assists in the planning and execution of conservation easement donations and conservation easement syndicates through various entities.[98] Claud Clark, III ("Clark") is a "real property appraiser and is a certified appraiser in multiple states, including the State of Georgia."[99] Clark was also the appraiser of the subject property in *Kiva Dunes.* EcoVest Capital, Inc.[100] ("EcoVest") "offers and sponsors real estate investments focused on conservation, including conservation easement syndicates."[101] It "functions and communicates" through Defendants Alan Solon, Robert McCullough, Ralph Teal, and other individuals.[102]

The Government summarized the alleged workings of the Defendants and their conservation easement syndicate in the Complaint, and alleges that since 2009, the Defendants collectively organized, promoted, or sold (or assisted in the organization, promotion, and sale of) ownership interests in a conservation easement syndication that was "nothing more than a thinly veiled sale of grossly overvalued federal tax deductions under the guise of investing in a partnership."[103]

Specifically, the Government alleges that the syndication consisted of at least 96 conservation easement syndicates involving partnerships and real property, primarily vacant and unimproved parcels, in the states of Alabama, Georgia, Indiana, Kentucky, North Carolina, South Carolina, Tennessee, and Texas. Clark, as the appraiser (and possibly other appraisers), allegedly valuated the real property held by those various partnerships, as well as the conservation easements that followed.

According to the Government, Clark would reach a pre-determined highest and best use of

90 IRS Increases Enforcement Action on Syndicated Conservation Easements, https://www.irs.gov/newsroom/irs-increases-enforcement-action-on-syndicated-conservation-easements. The IRS also stated that the charitable donee will not be treated as a party to or participant in the transaction.

91 Justice Department Sues to Shut Down Promoters of Conservation Easement Tax Scheme Operating out of Georgia, https://www.justice.gov/opa/pr/justice-department-sues-shut-down-promoters-conservation-easement-tax-scheme-operating-out (12/19/2018).

92 *Id.*

93 *Id.*

94 *Zak*, No. 1:18-cv-05774 (N.D. Ga. 12/18/2018), https://www.justice.gov/opa/press-release/file/1121451/download.

95 The complete list of Defendants includes Nancy Zak, Claud Clark III, EcoVest Capital, Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal Jr.

96 Compl. [Doc. No. 1] ¶ 6; *id.* at 73–79.

97 *See supra* note 16 at 2–5.

98 Compl. [Doc. No. 1] ¶ 12.

99 *Id.* ¶ 19.

100 "Since 2012, EcoVest or its affiliates, organized, promoted, or sold (or assisted in the organization, promotion, and sale of) at least 51 conservation easement syndicates." *Id.* ¶ 44.

101 *Id.* ¶ 37.

102 *Id.* ¶ 38.

103 *Id.* ¶ 2.

EXHIBIT 1 The Zak Case

Defendant	Number of Syndicated Conservation Easements	Federal Tax Deductions Reported by Those Syndicates as "Partners' Distributive Share Items"
Nancy Zak	42	$381,268,644
Claud Clark III	58	$1,855,235,588
EcoVest Capital, Inc.	51	$1,708,222,000
Alan N. Solon	51	$1,607,841,485
Robert M. McCullough	42	$1,504,962,000
Ralph T. Teal, Jr	45	$1,594,323,000

a rural residential development. He would also allegedly rely on at least one inappropriate methodology "by using a discounted cash flow analysis while ignoring relevant comparable sales, including the sale of easements or property subject to easements."[104] In the end, the conservation easement's value would exceed the allegedly correct value of the conservation easement by 200%.[105] Those syndicates resulted in over $2 billion of federal tax deductions reported by the syndicates.

Further, of those 96 conservation easement syndicates and over $2 billion of tax deductions, the Government alleges that each Defendant has organized, promoted, or sold (or assisted in the organization, promotion, and sale of) the number of syndicates and associated tax deductions listed in Exhibit 1.[106] The deductions were then "passed through" and split among the Defendants' "customers" in 45 different states and the District of Columbia.

Simply put, the Government alleges that the Defendants "implemented an abusive scheme around a legitimate tax deduction."[107] According to the Government, the conservation easements lack economic substance, are shams, and serve only as a conduit to transfer overvalued and otherwise improper tax deductions to customers. Thus, according to the Government, the subject conservation easements do not meet the requirements for a "qualified conservation contribution" under the Code. Therefore, the Defendants knew, or had reason to know, that the statements they made to customers regarding the tax benefits from the "qualified conservation contribution" were false or fraudulent.

With respect to the procedural history of this matter, the matter is still pending before the court. Despite this case being relatively in its infancy, its docket is rather lengthy, which highlights the importance of this case for both sides.[108] Throughout 2019, the parties filed various non-dispositive and dispositive motions, including Zak's and Clark's respective motions to dismiss, the Defendants' motions to stay discovery given the filed dispositive motions, and the Government's motion to strike some of the Defendants' answers to the Complaint. Oppositions to these motions have been filed.

While the court denied the Defendants' motions to stay discovery in June 2019, thereby allowing documentary discovery to proceed, the court stayed other discovery until further order of the court. The court has noted that it would extend the discovery period as necessary to ensure no prejudice inures to the parties. The parties would only be authorized to engage in limited discovery.

104 *Id.* ¶ 91.

105 *Id.* ¶ 92.

106 *Id.* ¶ 5.

107 Government's Opp'n Mem. at 5.

108 *See* Rodenberg, "Conservation Easement Promoter Slams DOJ Lawsuit Delay," https://www.law360.com/articles/1232429/conservation-easement-promoter-slams-doj-lawsuit-delay (1/8/2020). EcoVest has claimed that the Government has delayed the case unnecessarily for two years because the Government has "brought a baseless case, which the government lawyers know they will lose." *Id.* The Justice Department has responded that they have "proposed a schedule that is commensurate with the needs of this case." *Id.*

In July 2019, the Government inquired as to whether third-party discovery could commence. At the court's request, the Government informed the court of its plans to engage in robust, third-party discovery. Finding the Government's proposal to reach "too broadly," the court ordered the Government to limit its third-party discovery to 10 subpoenas for the time being. A large focus of the discovery, including expert discovery, revolves around the subject real property and whether representative samples of properties exist to evaluate the appraisal reported.

In December 2019, the court granted Zak's motion to dismiss in part, and denied it in part.[109] Zak sought to dismiss all counts of the Complaint except Count III. She argued that Counts I and IV should be dismissed "because they fail to satisfy the pleading requirements of Rule 9(b)[.]"[110] Zak further sought to dismiss Count II because the relevant section of the Code applies only to persons who "prepare" appraisals, and therefore does not apply to her.[111] Lastly, Zak argued that Count V must be dismissed because it was untimely, failed to satisfy the requirements of Rule 9(b), and constituted an excessive fine in violation of the Eighth Amendment.[112]

The court granted the dismissal of only Count II of the Complaint with respect to Zak. The court agreed that the Government had failed to establish an adequate factual basis to allege that Zak was an appraiser under the Code.

Clark moved to dismiss all counts except Count II.[113] As to Counts I, IV, and V, Clark simply joined those portions of Zak's motion. The court denied Clark's motion to dismiss in its entirety.

Having ruled on those motions, an eight-month discovery period commenced and remains in place.[114]

Implications of Zak and the current legal landscape

As the *Zak* case illustrates, conservation easements, while legitimate tax shelters, are ripe for abuse, controversy, and unlawfulness. Taxpayers oftentimes believe their activities surrounding the creation and contribution of conservation easements are lawful and allowed by the Code. At the same time, the Government often believes those activities unlawfully exploit a portion of the Code. Further, in the context of conservation easement syndicates, the Government may believe that by causing false statements to be filed in the income tax returns of their "investors," taxpayers have defrauded the investors and the Government itself.

While the fate of *Zak* remains unknown, its implications could be longstanding. If the court ultimately rules in favor of the Government, the wax of conservation easements generally, and conservation easement syndicates specifically, could wane. Those tempted to benefit and profit illegally at the public's expense could be deterred. Such a decrease in activity could have an impact on many involved in this sector, from appraisers to broker-dealers to prospective investors to conservation managers alike.

However, despite their well-intended purpose, such litigation efforts could also negatively affect the creation of legitimate conservation easements. As conservation easements become more heavily scrutinized, those involved in the sector may find any improvements to land conservation not worth the cost, time, and risk of an audit or worse, imprisonment.

But even in the absence of a decision in *Zak*, taxpayers who participate in syndicated conservation easements should pause. Various penalties under the Code may apply to those who participate in the transaction.[115]

For instance, a Section 6695A penalty can be assessed against a person who "prepares an appraisal of the value of property and such person knows, or reasonably should have known, that the appraisal would be used in connection with a return or a claim for refund," and "the claimed value of the property on a return or claimed for refund which is based on such appraisal results in a substantial valuation mis-

[109] The court granted the dismissal of the Government's Count II of the Complaint with respect to Zak, which alleged that Zak (and Clark) had engaged in conduct subject to penalty under Section 6695A and should be enjoined under Section 7402.

[110] *Supra* note 16 at 2.

[111] *Id.* at 1–2.

[112] *Id.* at 2.

[113] Def. Clark's Mem. in Supp. of Mot. to Dismiss [Doc. No. 41-1] at 2.

[114] On 3/17/2020, the court issued an Order providing notice and guidelines with respect to matters currently pending before Judge Amy Totenberg in light of the Covid-19 pandemic. It is likely that various dates in the *Zak* matter will continue to be extended.

[115] While beyond the scope of this article, penalties can also include penalties related to ethics and course of conduct. Under section 10.60 of Circular 230, the Office of Professional Responsibility has jurisdiction over an appraiser for disqualification purposes whenever a penalty has been assessed against an appraiser under the Code. Although assessment is not defined within that section, assessment usually means the recording of the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary. *See* Section 6203.

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statement or a gross valuation misstatement with respect to such property."

Similarly, under Section 6701, a penalty can be assessed against a person (1) who aids or assists in, procures or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document; (2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws; and (3) who knows such portion would result in an understatement of the liability for tax of another person.[116] This authority certainly applies to "qualified appraisers," but it may have broader application.

Conclusion

This article analyzed the legal environment surrounding conservation easements, generally, and the rise of syndicated conservation easements, specifically. Syndicated conservation easements generally follow the basic mechanics of conservation easement contributions under Section 170(h). *RP Golf, LLC, SB Golf, LLC, Tax Matters Partner* illustrated these basic principles.[117] However, taxpayers need to understand that syndicated conservation easements can present various traps for the unwary given the increased scrutiny that these transactions are now under.

First and foremost, if the basic mechanics of conservation easement contributions are not followed, the IRS can challenge the syndicated transaction. The IRS will investigate whether the transaction serves a "qualified conservation purpose," whether a "qualified appraiser" was used, and whether a "qualified appraisal" was given. The IRS will also investigate who ultimately benefits from the transaction. Secondly, if the IRS, Justice Department, or both get any whiff of liberties taken with the syndicated transaction, the syndicated transaction and all parties involved may be investigated as *Zak* illustrates.

At the end of the day, the question is whether it is worth it to participate in a syndicated conservation easement. What public purpose or benefit is truly being served? Is any improvement to land conservation worth the cost, time, and risk given that an audit, or worse, imprisonment, might be right around the corner? Only time will tell. ■

[116] Section 6701.
[117] TCM 2012-282.

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SUMMARY OF TAX PROVISIONS IN THE AMERICAN RESCUE PLAN ACT OF 2021

The following is a summary of the tax provisions in the American Rescue Plan Act of 2021 (ARPA, P.L. 117-2, 3/11/2021).

Recovery rebate credits (stimulus checks). ARPA provides a third round of nontaxable stimulus checks directly payable to individuals. The payments are structured as refundable tax credits against 2021 taxes but will be paid in 2021 (not 2022).

The maximum payments are $1,400 per eligible individual ($2,800 for married joint filers) and $1,400 for each dependent (which, unlike the first two stimulus payments, includes older children and adult dependents). The payment phases out proportionally between $75,000 and $80,000 adjusted gross income (AGI) for single filers, $112,500 and $120,000 for head of household filers, and $150,000 and $160,000 for married joint filers.

Rules for identification, for payments made notwithstanding no filing of 2019 and 2020 returns, and for limitations on offsets apply. Eligibility is based on information from 2020 income tax returns (or 2019 returns, if 2020 returns have not been filed when the advanced credit is initially issued). For households whose payment was based on 2019 income data, and who would be eligible to receive a larger payment based on 2020 data, the IRS is directed to issue a supplementary payment.

Child tax credit. For 2021 (1) qualifying children include 17-year-olds, (2) the credit is increased to $3,000 per child ($3,600 for children under six years of age), but the increase is subject to modified AGI phaseout rules (and the existing modified AGI phaseout rules for eligibility for any credit at all continue to apply), (3) the credit is refundable, and (4) the IRS will make periodic advance payments totaling 50% of its estimate of the credit in the last half of 2021.

Earned income tax credit (EITC). (1) For 2021 the credit is increased for taxpayers with no qualifying children, and age restrictions for those taxpayers are relaxed; (2) after 2020 taxpayers that have a qualifying child but cannot meet the identification requirements for the qualifying child are nevertheless allowed the credit; (3) taxpayers may use the greater of their 2019 or 2021 earned income in calculating the credit for 2021; (4) after 2020, the amount of investment income that a taxpayer can have and still earn the credit is increased; and (5) after 2020 there is broadening of the existing exception to the credit's joint filing requirement under which separated married people eligible to file jointly are allowed the credit even if they do not file jointly.

Child and dependent care credit. For 2021 (1) the credit is refundable; (2) the amount of qualifying expenses taken into account for the credit is increased from $3,000 to $8,000 if there is one qualifying care recipient and from $6,000 to $16,000 if there are two or more; (3) the maximum percentage of qualifying expenses for which the credit is allowed is increased to 50% from 35%; and (4) phasedown rules, based on AGI, are changed.

The increased dependent care assistance program exclusion amount (see below) under Code Section 129 will also affect the child and dependent care credit, as the amount of expenses taken into account for the credit is reduced by the amount excludable from the taxpayer's income under Section 129.

Dependent care assistance programs. For 2021, the amount excludible under a dependent care assistance program is increased to $10,500 (or $7,500 for a married taxpayer filing a separate return). Retroactive plan amendments are allowed to facilitate the increase.

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Health care premium assistance credit. For 2021 and 2022, the credit will be available for a larger percentage of insurance premiums, and individuals whose income is greater than 400% of the poverty line will be eligible for (rather than barred from) the credit. For 2020, individuals who were provided advances of the credit under the Patient Protection and Affordable Care Act in excess of the credits to which they are entitled are not obligated to pay back the excess. In addition, notwithstanding any other rules, individuals who receive unemployment compensation during 2021 are eligible for the credit (and under rules that increase the amount of the credit).

Income exclusion for unemployment benefits. For 2020, taxpayers with modified AGI less than $150,000 can exclude from gross income $10,200 of their unemployment benefit. The exclusion is available to each spouse if a joint return is filed. For taxpayers who already filed 2020 returns and did not exclude unemployment benefits, the IRS said that taxpayers should not file an amended return and that additional guidance will be provided.

Student loan forgiveness. Beginning in 2021 and continuing through 2025, the forgiveness of many types of loans for post-high school education will not result in income inclusion for the forgiven amounts.

Payroll tax credits. The paid sick leave and family leave credits are extended to apply to wages paid through 9/30/2021 (instead of 3/31/2021). There are also changes to these credits, including:

- During the two-quarter extension period the credits are applied against the employer Medicare portion of payroll taxes instead of the OASDI (Social Security) portion. The Medicare taxes taken into account are those for all employees, not just employees to whom qualifying leave wages are paid. However, the credits continue to be refundable (and, thus, allowed in excess of the Medicare taxes) and advance refundable (they can be applied against any employment taxes, including income tax withholdings, for the quarter in which eligible leave wages are being paid, with any remaining credit refundable at the end of the quarter).
- The allowable credit can be increased by both the amount of the OASDI taxes paid and Medicare taxes paid with respect to eligible leave wages, instead of just the Medicare taxes.
- Rules are provided that coordinate the leave credits with second draw Payroll Protection Program loans and certain government grants.
- The no-double benefit rule, which disallows claiming both (1) either of the above credits and (2) the income tax credit for family or medical leave is expanded to include similar coordination with certain other income and payroll tax credits.
- An employer is ineligible for the leave credits if, in providing paid leave, the employer discriminates in favor of highly compensated or full-time employees or on the basis of employment tenure.
- The IRS is allowed an extended limitation-on-assessment period for deficiencies due to claiming either of the leave credits.
- ARPA allows employers who voluntarily provide 80 hours of emergency paid sick leave and 12 weeks of emergency family leave beginning after 3/31/2021 to claim the leave credits, thereby resetting the leave bank regardless of whether the employee used leave previously or has exhausted leave.
- The employee retention credit is extended to apply to wages paid before 1/1/2022 (instead of 7/1/2021). The result is that as a general rule there is allowed a maximum per employee credit for 2021 of $28,000 ($10,000 of wages taken into account per quarter multiplied by the credit rate of 70%).
- There are modifications to this credit. For the last two calendar quarters of 2021 there is allowed a maximum $50,000 credit per quarter to certain small start-up businesses (and under relaxed eligibility rules). This change makes a limited credit available to some businesses that could not qualify for the credit at all because they cannot meet either the full/partial suspension or 20% drop-in-gross-receipts requirements. In addition, during those two quarters certain distressed businesses will be able to treat all wages as eligible (up to the $10,000 per quarter limit), enabling employers with more than 500 employees, who can ordinarily treat only wages paid to laid-off workers as eligible, to treat any wages as eligible.
- The change to applying the credit to Medicare taxes (discussed above for the paid sick and family leave credits) also applies (along with the continuing refundability and, for employers with no more than 500 employees, advance refundability of the credit).
- The relieved amounts are not included in the income of the individuals and there is imposed by the Internal Revenue Code a penalty on individuals that fail to report the end of their eligibility.

Self-employment sick and family leave credits. These credits, which are creditable against

the income tax, have been extended to apply to eligible days through 9/30/2021 (instead of 3/31/2021). Both credits treat as reasons for eligible leave the obtaining of or recovering from COVID-19 immunization. Also, for the family leave credit, reasons for eligible leave are expanded to include all qualifying reasons for taking sick leave.

In determining whether the 10-day per tax year limit for the sick leave credit is complied with, only days after 12/31/2021 are taken into account (thus restarting the count and often increasing the cumulative number of eligible days). In addition, a major change to the family leave credit is that the maximum number of eligible days per tax year is increased from 50 to 60, again with only days after 3/31/2021 taken into account (resetting the count and often increasing the cumulative number of eligible days).

Excess business losses. The disallowance of excess business losses is extended to run through 2026 instead of 2025.

Deduction disallowance for over $1 million employee remuneration. For tax years beginning after calendar year 2026, the $1 million annual cap on the deductibility of remuneration paid to certain categories of employees of publicly held corporations is expanded to include as a new category the five highest compensated employees not included in other categories.

Tax treatment of certain nontax relief. ARPA provides favorable tax consequences for targeted Economic Injury Disaster Loan (EIDL) advances made by the Small Business Administration (SBA) under the Economic Aid to Hard-Hit Small Businesses, Non-Profits and Venues Act. The advances are not included in income, and the income exclusion does not result in deduction disallowances, denial of basis increases, or reduction of other tax attributes. The same treatment applies to SBA Restaurant Revitalization Grants.

Pension plans. ARPA relaxes some funding standards and other Internal Revenue Code or ERISA rules for multiple employer pension plans. For single employer plans, Internal Revenue Code or ERISA rules are relaxed for amortizing funding shortfalls, and the pension

funding stabilization percentages are changed. Also changed are the special rules that apply to community newspaper plans.

Reporting by third party settlement organizations. ARPA tightens the de minimis exception to tax reporting by third party settlement organizations (TPSOs, e.g., PayPal) by excluding from reporting only transactions that do not exceed $600 (and eliminating the 200-transaction threshold). ARPA also clarified that TPSO reporting obligations are limited to transactions involving goods and services.

Foreign tax. Code Section 864(f), which provided a one-time election under which, effectively, corporate groups could allocate some interest expense from foreign to domestic corporations and reduce the effect of limits on the foreign tax credit, is repealed. The repeal is retroactive to the election's effective date (i.e., for tax years beginning after 12/31/2020). ■

TREASURY DEPARTMENT REPORT ON PRESIDENT BIDEN'S TAX PLAN

The Treasury Department has issued The Made in America Tax Plan Report (the Report), which describes President Biden's Made in America Tax Plan (the Plan). The Plan has the goal of making American companies and workers more competitive by eliminating incentives to offshore investment, substantially reducing profit shifting, countering tax competition on corporate rates, and providing tax preferences for clean energy production.

The following are some of the key elements of the Plan:

Raising the corporate income tax rate to 28%. The Plan will increase the corporate tax rate from 21% to 28%. The Report notes that the United States raises less corporate tax revenue (as a share of gross domestic product (GDP)) than almost all of the advanced economies in the Organization for Economic Co-operation and Development (OECD). "Raising the corporate income tax rate would modestly increase corporate revenues relative to GDP, still leaving them below those of our trading partners," the Report said.

Reversing tax-based incentives for moving production overseas. The Report says that the Plan makes fundamental changes to the global intangible low-tax income (GILTI) regime introduced by the Tax Cuts and Jobs Act (TCJA). The Plan "would eliminate the incentive to offshore tangible assets" by ending the tax exemption for the first 10% return on foreign assets. It would also calculate the GILTI minimum tax on a per-country basis, "ending the ability of multinationals to shield income in tax havens from U.S. taxes with taxes paid to higher tax countries."

The Plan would also increase the GILTI minimum tax to 21% (up to three-quarters of the proposed new 28% corporate tax rate, as opposed to the current one-half ratio). In addition to these reforms to GILTI, the plan would disallow deductions for the offshoring of production and "put in place strong guardrails against corporate inversions." The Plan also proposes to repeal and replace the Base Erosion and Anti-Abuse Tax (BEAT), as discussed below.

The Report says that these proposals would bring well over $2 trillion in profits over the next decade back into the U.S. corporate tax base.

Ending the "race to the bottom" around the world. The Report states that a race to the bottom among countries has driven down corporate tax rates substantially over the last two decades. The average statutory corporate rate among OECD countries was 32.2% in 2000; by 2020 this had fallen to 23.3%.

Under the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting, the United States and the international community are pursuing a comprehensive agreement on corporate minimum taxation, providing for minimum tax rules worldwide. Under the agreement, home countries of multinational corporations would apply a minimum tax when offshore affiliates are taxed below an agreed upon minimum tax rate.

The Plan would replace the BEAT with the SHIELD (Stopping Harmful Inversions and Ending Low-tax Developments), which denies multinational corporations U.S. tax deductions by reference to payments made to related parties that are subject to a low effective rate of tax. The low effective rate of tax would be defined by reference to the rate agreed upon in the multilateral agreement. However, if the SHIELD is in effect before such an agreement has been reached, the default rate trigger would be the tax rate on the GILTI income, as modified by the Plan.

"As a backstop to this new anti-base erosion regime," the Plan would strengthen the

anti-inversion rules by generally treating a foreign acquiring corporation as a U.S. company based on a reduced 50% continuing ownership threshold or if a foreign acquiring corporation is managed and controlled in the United States.

Repealing the FDII. Subject to a limitation based on taxable income (Section 250(a)(2)), a domestic corporation may deduct an amount equal to 37.5% of the foreign-derived intangible income (FDII) of the domestic corporation for the tax year (Section 250(b)). Noting that FDII creates incentives to locate economic activity abroad, the Plan repeals FDII.

Instituting a "minimum book tax." Under this proposal, there would be a minimum tax of 15% on book income, i.e., on the profit firms generally report to their investors. Firms would make an additional payment to the IRS for the excess of up to 15% on their book income over their regular tax liability. For example, a firm with zero federal income tax liability computed based on its taxable income would still face a minimum tax of 15% on book income. Firms would be given credit for taxes paid above the minimum book tax threshold in prior years, for general business tax credits (including R&D, clean energy, and housing tax credits), and for foreign tax credits.

Replacing subsidies for fossil fuels with incentives for "clean energy" production. The Plan would do the following:

- Remove subsidies for fossil fuel companies.
- Provide a 10-year extension of the production tax credit and investment tax credit for clean energy generation and storage.
- Create a new tax incentive for long-distance transmission lines.
- Expand the tax incentives available for electricity storage projects.
- Provide tax incentives for state-of-the-art carbon capture and sequestration projects.
- Provide specific supports for clean energy manufacturing, including an extension of the Section 48C tax credit program.
- Include a blender's tax credit for sustainable aviation fuel.
- Provide incentives to encourage people to switch to electric vehicles and efficient electric appliances.
- Provide tax incentives for investments to increase the resilience of households and small businesses to droughts, wildfires, and floods.
- Penalize polluters through tax disincentives, restoring a tax on polluters to pay for EPA cleanup costs associated with Superfund sites.

Increasing IRS's enforcement budget. The Plan would increase the IRS's enforcement budget. It envisions a well-resourced team of revenue agents that can be hired and trained to identify when corporations—and the wealthy individuals who own them—underpay taxes. This proposal is part of a broader overhaul of tax administration that would give the IRS the resources it needs to collect the taxes that are owed by wealthy individuals and large corporations. ■

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IRS EXAMINATION QUESTIONS

ISRAEL BLUMENFRUCHT

Sick pay and unemployment compensation

Debby broke her leg on 1/15/2020 and was unable to work for three months. During this time she received $2,500 in sick pay from her employer. She also received $1,000 from her personally purchased accident policy. She returned to work in May 2020 but was laid off in July 2020. She received $9,600 in unemployment benefits for the rest of the year. Her adjusted gross income (AGI) for 2020, before including any of these benefits, is $95,000. How much of these benefits is taxable income to Debby in 2020?

a. $0
b. $2,500
c. $12,100
d. $3,500

Solution: The correct choice is "b."

Generally, amounts received by an employee through an accident or health insurance plan, also referred to as "sick pay," for which the employer has paid the premiums for the policy is included in the gross income of the employee (Section 105(a)). Moreover, these payments are subject to FICA taxes for the first six months. Payments made after six months following the last month in which the employee worked is excluded from FICA taxes. Clearly, these payments must be included in gross income even though they are excluded from FICA taxes. Note also that special rules apply for 2020 for sick pay related to COVID-19.

However, there are three important exceptions under which the qualifying employee is entitled to exclude such benefits: (1) benefits received to reimburse the employee for medical expenses he incurred for himself, his spouse, or his dependents; (2) benefits received for loss of a limb or permanent disfiguration of the employee, his spouse, or his dependents, so long as the benefits are not related to absence from work; and (3) any amounts received as workers compensation for an occupational sickness or injury, provided that they are paid under a workers compensation act or statute.

A taxpayer realizes no taxable income from the benefits of an accident or a health insurance plan for which he or she has personally paid the premiums. If both the employer and the employee paid for the premiums, the amount of benefits to be excluded is generally determined by the percentage of premiums paid by the employee.

With respect to the unemployment benefits, the general rule is that unemployment benefits are included in gross income. However, the American Rescue Plan Act, enacted on 3/11/2021, provides for an exclusion of up to $10,200 of unemployment benefits received in 2020.

This exclusion is only available to taxpayers whose AGI is less than $150,000, not including the unemployment benefits and other modifications. This $150,000 threshold applies to every filing status. However, married taxpayers filing a joint return can claim a separate $10,200 exclusion for each spouse receiving unemployment benefits. Therefore, if both spouses received at least $10,200 of unemployment benefits, they can exclude a total of $20,400 provided that their AGI was less than $150,000.

It is important to note that the IRS is still requiring the taxpayer to report the gross amount of unemployment benefits received and separately subtract the amount to be excluded from income (on Schedule 1 of Form 1040, line 8, by using the abbreviation "UCE"). Also, many states that have local income taxes, such as New York State, are not conforming with this Federal exclusion and are requiring that the full amount of unemployment benefits be included in taxable income for state and local purposes.

Accordingly, Debby must include in gross income the $2,500 of sick pay she received from her employer during the three months she was unable to work as a result of her broken leg. However, the $1,000 she received from her personally purchased accident policy is not

ISRAEL BLUMENFRUCHT, Ph.D., CPA, is the chairperson of the Department of Accounting and Information Systems at Queens College of the City University of New York.

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taxable and can be excluded from gross income. Similarly, the $9,600 of unemployment benefits she received in the last six months are excluded from taxable income since her AGI is less than $150,000. ■

Rental payments

Wilma Smith leased a building for four years beginning in March 2020 for $1,500 per month. On 3/1/2020, Mrs. Smith paid her landlord $33,000 in rent. How much can she deduct on her 2020 tax return?

a. $33,000

b. $18,000

c. $0

d. $15,000

Solution: The correct choice is "d."

In general, taxpayers must include in gross income all gross rents from rental property. In addition, advance rental payments must be included in gross income regardless of the accounting method used by the taxpayer or the period for which the rent is paid. Thus, both cash-basis and accrual-basis taxpayers must include any advance rental payments in gross income (Reg. 1.61-8).

Security deposits, however, need not be included in gross income. A security deposit is an amount received which is not in lieu of rent. Thus, taxpayers must be careful not to require that the security deposit be used as a payment of the last month's rent. Security deposits used as final payments are considered advance rental payments and must be included in gross income when received. Only those security deposits which are refunded at the end of the rental period are excluded from gross income.

Furthermore, any payments made by a tenant to a landlord to cancel, modify, or amend a lease are treated as rental income. Similarly, if the tenant pays any of the landlord's expenses, the payments are also treated as rental income which must be included in gross income.

With respect to deducting rental expenses, the rules are different. Unlike advance rental payments received by a taxpayer, payments made by a taxpayer cannot be deducted in the year paid but rather must be deducted ratably over the life of the lease by both cash-basis and accrual-basis taxpayers. For example, if a taxpayer pays $24,000 on 1/2/2020 to rent an office for two years, only one-half of the payment, or $12,000, is deductible in 2020.

Accordingly, Wilma Smith's payment of $33,000 to her landlord on 3/1/2020 to lease a building is, in part, an advance payment since the lease only provides for a payment of $1,500 per month. Thus, she actually paid for 22 months of her lease ($33,000/$1,500). However, she can only deduct in 2020 the actual amount of lease payments that she was required to pay for the 10 months (March – December) she used the building or $15,000 ($1,500 × 10 months). ■

The problems presented in this column are adapted from the official, verbatim texts of IRS Special Enrollment Examination questions. The answers were prepared by Prof. Blumenfrucht. The examination covers tax topics about which the IRS expects tax practitioners to be extremely knowledgeable.

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IRS PLEDGES TO INVESTIGATE COVID-19 FRAUD

The IRS Criminal Investigation Division (IRS-CI) marked the one-year anniversary of the Coronavirus Aid, Relief and Economic Security Act (CARES Act, P.L. 116-136, 3/27/2020) by pledging in a News Release its continued commitment to investigating COVID-19 fraud. (IR-2021-65, 3/25/2021)

Since the enactment of the CARES Act, IRS-CI has been combatting COVID-19 fraud related to the Economic Impact Payments, Paycheck Protection Program (PPP), and Employee Retention Credit. The agency has investigated more than 350 tax and money laundering cases nationwide totaling $440 million. These investigations covered a broad range of criminal activity, including fraudulently obtained loans, credits, and payments meant for American workers, families, and small businesses.

"Criminals have tried funding their lavish lifestyles with money intended to provide Americans relief during one of the most difficult times in recent history", said Jim Lee, Chief of IRS Criminal Investigation. "We have investigated cases of criminals flaunting stolen money to buy fancy cars, boats, and pay for luxury apartments while families and businesses struggle to make ends meet. IRS-CI special agents have done an extraordinary job identifying millions in stolen money and our work is far from over. We will not cease until every fraudulently obtained dollar is accounted for and the individuals behind the schemes are prosecuted to the fullest extent of the law."

IRS-CI encourages the public to share information regarding known or suspected fraud attempts against any of the programs offered through the CARES Act. To report a suspected crime, taxpayers may visit IRS.gov.

The CARES Act was enacted to provide emergency financial assistance to millions of Americans suffering the economic effects of the COVID-19 pandemic. One source of relief provided by the CARES Act was the authorization of up to $349 billion in forgivable loans to small businesses for job retention and certain other expenses, through the PPP. In April 2020, Congress authorized over $300 billion in additional funding, and in December 2020, another $284 billion.

The PPP allows qualifying small businesses and certain other organizations to receive loans with a maturity of two to five years and an interest rate of 1%. Businesses must use PPP loan proceeds for payroll costs, interest on mortgages, rent, and utilities. The PPP allows the interest and principal to be forgiven if businesses spend the proceeds on these expenses within a set time period and use at least a certain percentage of the loan towards payroll expenses. ■

IRS PROPERLY CERTIFIED TAXPAYER'S "SERIOUSLY DELINQUENT" TAX DEBT

In *Rowan*, 156 TC No. 8 (2021), the Tax Court held that the IRS properly certified to the Treasury Secretary that a taxpayer's tax debt was "seriously delinquent." The Tax Court found that Section 7345 does not violate the Fifth Amendment Due Process Clause or the Universal Declaration of Human Rights because it merely provides for the certification of certain tax-related facts; it does not restrict in any manner the right to international travel.

Section 7345 authorizes the IRS to send to the Treasury Secretary a certification that an individual has a "seriously delinquent tax debt." The Treasury Secretary in turn transmits that certification to the Secretary of State for "action with respect to denial, revocation, or limitation of a passport." (Section 7345(a))

With certain exceptions, a "seriously delinquent tax debt" is an individual's unpaid, legally

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enforceable federal tax liability, which has been assessed and which is greater than $50,000 (adjusted for inflation) and with respect to which the IRS has filed a Notice of Lien (for which the collection appeals rights have been exhausted or lapsed) or issued a levy. (Section 7345(b))

Section 7345(d) requires the IRS to contemporaneously notify a taxpayer of any certification. Once the IRS notifies a taxpayer that a Section 7345(a) certification has been made, the taxpayer may challenge that certification in a civil action filed either in the Tax Court or in a federal district court. The court first acquiring jurisdiction over a certification challenge has sole jurisdiction over that action. (Section 7345(e)(1))

Once the Secretary of State (SOS) receives notice of the certification, the SOS is required (absent emergency or humanitarian considerations) to deny a passport (or renewal of a passport) to the certified taxpayer and is permitted to revoke any passport previously issued to such person. (section 32101(e)(1)(B) of the Fixing America's Surface Transportation (FAST) Act. (P.L 114-94, 12/4/2015))

In the instant case, for more than two decades, Dr. Robert Rowan failed to pay his federal taxes. Rowan, a U.S. citizen, is a medical doctor licensed to practice in California. He frequently travels to developing countries to offer medical services free of charge to populations that would not otherwise have access to adequate medical care. He also has family members in Singapore and mainland China, where he travels for personal reasons.

After Rowan ran up a $474,846 unpaid tax bill, which the IRS tried to collect without success, the IRS certified to the Treasury Secretary that he had a seriously delinquent tax debt ("certification"). In turn, the Treasury Secretary notified the SOS of the certification. Rowan held a valid passport when the certification was made, and as of August 2020, the SOS had not taken any action to revoke Rowan's passport.

When Rowan received notice of the certification, he petitioned the Tax Court to determine that the IRS's certification of his tax debt as "seriously delinquent" was invalid. Rowan claimed that Section 7345 is unconstitutional because it infringes on the right to international travel and, therefore, violates the Due Process Clause of the Fifth Amendment to the U.S. Constitution. Rowan also claimed that Section 7345 violated his human right to travel under the Universal Declaration of Human Rights (UDHR).

The IRS responded that it did not err in certifying Rowan's tax liabilities as seriously delinquent tax debt because: (1) Section 7345 is constitutional; (2) UDHR cannot be used to invalidate Section 7345; and (3) his tax debts are enforceable.

In this first case to consider the merits of a Section 7345 certification, the Tax Court agreed with the IRS that it did not err in certifying Rowan's tax liabilities as seriously delinquent tax debt.

The Tax Court rejected as meritless Rowan's claims that Section 7345 is unconstitutional because it infringes on his right to international travel. The court held that a plain reading of the text of Section 7345 shows that it does not impose any restriction on international travel, but merely provides a way for the IRS to certify the existence of a seriously delinquent tax debt and for the Treasury Secretary to transmit that certification to the SOS. All passport-related decisions are left to the SOS, and the SOS's authority to revoke a passport does not derive from Section 7345, so Section 7345 does not restrict the right to international travel.

Similarly, the court summarily rejected Rowan's arguments regarding the UDHR. Because Section 7345 does not impose a limit on the right to travel, the UDHR's protection of the right to travel as a "human right" cannot provide any ground for invalidating the IRS's certification of Rowan's tax debt as seriously delinquent under Section 7345.

Finally, the court found that the IRS produced Form 4340, Certificate of Assessments, Payments, and Other Specified Matters, for Rowen's tax years at issue. These and other documentation in the record showed that the period of limitations on collection remained open for all relevant years. Therefore, Rowan's tax debts were enforceable.

The court noted that the constitutionality of the authority granted to the SOS by FAST Act section 32101(e) was not an issue in the case and, therefore, the court expressed no view on that issue. ■

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IRS PROVIDES GUIDANCE TO EMPLOYERS CLAIMING EMPLOYEE RETENTION CREDIT FOR 2021

The IRS, in Notice 2021-23, 2021-16 IRB xxx, has provided guidance to employers on how to determine their eligibility for, and the amount, of the employee retention credit (ERC) they may claim, for the first two quarters of 2021. (See also IR 2021-74, 04/2/2021.) Notice 2021-23 amplifies the guidance in Notice 2021-20, 2021-11 IRB 922, which provided guidance to employers on claiming the ERC for 2020.

Section 2301(a) of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136, 3/27/2020) created a refundable payroll tax credit ("the Employee Retention Credit" or "ERC"). For 2020, the ERC could be claimed by eligible employers who paid qualified wages after 3/12/2020 and before 1/1/2021, if they experienced a full or partial suspension of their operations or a significant decline in gross receipts ("eligible employers"). The credit is equal to 50% of qualified wages paid, including qualified health plan expenses. The maximum credit per employee is $5,000.

In December 2020, the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA; P.L. 116-260, 12/27/2020) extended the ERC to qualified wages paid after 12/31/2020 and before 7/1/2021, and modified the calculation of the ERC for qualified wages paid in 2021. (TCDTRA section 207)

In March 2021, the IRS issued Notice 2021-20, which provided guidance for employers claiming the ERC for 2020. Notice 2021-20 did not address the extension of the ERC into 2021.

The IRS has now provided guidance to employers claiming the ERC in 2021. Notice 2021-23 explains the changes to the Employee Retention Credit for the first two calendar quarters of 2021 (2021 Q1 and Q2), including the following:

Increase in maximum credit amount. For 2021 Q1 and Q2, the ERC equals 70% of qualified wages that an eligible employer pays in a calendar quarter. The maximum amount of qualified wages an employer may use to calculate the ERC is $10,000 per employee. Thus, the maximum ERC is $7,000 per employee for 2021 Q1 and Q2. (Notice 2021-23, section 3.D)

Expansion of category of employers that may be eligible to claim credit. A governmental entity that is a college or university or whose principal purpose or function is to provide medical or hospital care is treated as satisfying the trade or business requirement (to be an eligible employer, the employer must be in a "trade or business") and, therefore, is an eligible employer assuming they satisfy the other requirements to be an eligible employer. (Notice 2021-23, section 3.B)

Modifications to gross receipts test. For purposes of the 2021 Q1 and Q2 ERC, whether an employer is an eligible employer based on a significant decline in gross receipts is determined separately for each calendar quarter and is based on an 80% threshold, i.e., the employer's gross receipts are less than 80% of what they were in the same calendar quarter in 2019 (or 2020) ("gross receipts test"). (Notice 2021-23, section 3.C)

An employer may generally determine if it meets the gross receipts test for a calendar quarter in 2021 by comparing gross receipts for the immediately preceding calendar quarter with those for the corresponding calendar quarter in 2019, substituting 2020 for 2019 if the employer did not exist as of the beginning

of that quarter in 2019. (Notice 2021-23, section 3.C)

Revisions to definition of qualified wages. Notice 2021-23 clarifies that since the TCDTRA removed certain limitations on the amount of qualified wages paid by large employers to claim the ERC, Notice 2021-20, section 3.G does not apply for determining the ERC for 2021 Q1 and Q2. (Notice 2021-23, section 3.E)

New restrictions on ability of eligible employers to request advance payment of credit. For calendar quarters in 2020, there was no restriction on the types of eligible employers that could claim an advance payment, nor was there a maximum advance amount other than the amount of the employee retention credit eligible to be claimed, subject to the requirement that an eligible employer reduce its payroll tax deposits in anticipation of the credit before requesting an advance. (Notice 2021-23, section 3F)

Under the TCDTRA, only 2021 small eligible employers may elect to receive an advance payment of the employee retention credit in an amount not to exceed 70% of the average quarterly wages paid in calendar year 2019. The requirement to reduce deposits in anticipation of the credit before requesting an advance continues to apply to 2021 small eligible employers. (Notice 2021-23, section 3.F)

Other guidance. Notice 2021-23 also provides guidance on determining average quarterly wages in 2021 for small eligible employers that are seasonal employers, and employers that were not in existence in 2019. (Notice 2021-23, section 3.F) ■

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PROPOSED QUALIFIED OPPORTUNITY FUND REGULATIONS REGARDING CERTAIN FOREIGN INVESTORS

The IRS has issued proposed regulations (REG-121095-19, 4/12/2021) that include requirements that certain foreign persons and certain foreign-owned partnerships must meet in order to elect special rules for capital gains invested in qualified opportunity funds. The proposed regulations also contain rules that allow, under certain circumstances, for the reduction or elimination of withholding on transfers that give rise to gain that is deferred under the qualified opportunity fund rules. Finally, the proposed regulations contain additional guidance regarding the 24-month extension of the working capital safe harbor in the case of federally declared disasters.

Section 1400Z-2 provides a few tax incentives to encourage investment in qualified opportunity zones (QOZs). First, a taxpayer, upon making a valid election, may generally defer, until the earlier of an inclusion event or 12/31/2026, certain gains in gross income that would otherwise be recognized in the tax year if the taxpayer invests a corresponding amount in a qualifying investment in a qualified opportunity fund (QOF) within 180 days of the date of the sale or exchange. (Section 1400Z-2(b)(1)(A); Section 1400Z-2(b)(1)(B))

The taxpayer may potentially exclude 10% of such deferred gain from gross income if the taxpayer holds the qualifying investment in the QOF for at least five years. (Section 1400Z-2(b)(2)(B)(iii)) An additional 5% of such gain may potentially be excluded from gross income if the taxpayer holds the qualifying investment for at least seven years. (Section 1400Z-2(b)(2)(B)(iv)) In addition, a taxpayer, upon making a second valid election under Section 1400Z-2(c), may also exclude from gross income any appreciation on the taxpayer's qualifying investment in the QOF if the qualifying investment is held for at least 10 years.

A taxpayer qualifies for deferral under Section 1400Z-2(a) only if the taxpayer is an eligible taxpayer. (Reg. 1.1400Z2(a)-1(a)(1)) An eligible taxpayer is defined as a person that is required to report the recognition of gains during the tax year under federal income tax accounting principles. (Reg. 1.1400Z2(a)-1(b)(13)) If an eligible taxpayer that is a partnership does not elect to defer gain, a partner of such partnership may elect to defer its distributive share of the gain. (Reg. 1.1400Z2(a)-1(c)(8))

Only gains that are eligible gains may be deferred. In general, an eligible gain is gain that (1) is treated as a capital gain or is a qualified Section 1231 gain, (2) would be recognized for federal income tax purposes and subject to income tax before 1/1/2027, if Section 1400Z-2(a)(1) did not apply to defer the gain, and (3) does not arise from a sale or exchange of property with certain related persons. (Reg. 1.1400Z2(a)-1(b)(11)) Thus, e.g., a nonresident alien individual or foreign corporation generally may make a deferral election with respect to an item of capital gain that is effectively connected with a U.S. trade or business, because this gain otherwise is subject to federal income tax.

When a partnership chooses to make a deferral election, the regulations provide an exception to the general requirement that gain be subject to federal income tax in order to constitute eligible gain, subject to an anti-abuse rule. (Reg. 1.1400Z2(a)-1(b)(11)(ix)(B))

Foreign persons are generally subject to U.S. income tax on amounts that are effectively con-

nected with the conduct of a trade or business within the United States (ECI). A foreign person that directly or indirectly is engaged in a trade or business in the United States must file a U.S. income tax return and pay any tax due.

To ensure the collection of tax, in certain circumstances, the Code imposes withholding requirements on payments or allocations of ECI to foreign persons. (Section 1445; Section 1446(a); Section 1446(f) Ñ "the withholding sections") The amount of withholding under these provisions is intended to serve as a proxy for the amount of the foreign person's substantive tax liability and may not match the actual amount of tax due. The amount withheld may be claimed as a credit against the amount of tax due and shown on the foreign person's tax return.

Specifically, Section 1445(a) requires a transferee to withhold tax on a disposition of a United States real property interest (as defined in Section 897(c)) (U.S. real property interest) by a foreign person. Generally, the transferee must withhold 15% of the amount realized and deposit the tax with the IRS within 20 days of the transfer. Certain exceptions and reductions to the rate of withholding can apply, including by the foreign person obtaining a withholding certificate from the IRS to reduce or eliminate the amount required to be withheld on the transfer.

Section 1445(e)(1) requires a domestic partnership, trust, or estate that disposes of a United States real property interest to withhold on any portion of the gain that is allocable to a foreign partner or beneficiary. The rate of withholding is the highest rate of tax in effect under Section 11(b) (currently 21%).

Section 1445(e)(2) requires a foreign corporation that recognizes gain on the distribution of a United States real property interest to withhold on the gain at the highest rate of tax in effect under Section 11(b). Section 1445(e)(3) requires a domestic corporation that is or has been a United States real property holding corporation to withhold 15% of a distribution to a nonresident alien or foreign corporation. Section 1445(e)(6) requires a qualified investment entity to withhold at the highest rate of tax specified in Section 11(b) on the amount of the distribution that is treated as gain from the sale or exchange of a United States real property interest.

Section 1446(a) generally requires a partnership to withhold tax on effectively connected taxable income as determined under Reg. 1.1446-2 (ECTI) allocable to a foreign partner, with limited adjustments, regardless of whether the income is distributed to the partner (Section 1446(a) tax). A partnership must generally withhold Section 1446(a) tax on a foreign partner's allocable share of ECTI at the highest rate of tax specified in Section 1 (for a foreign partner other than a corporation) or Section 11(b) (for a foreign partner that is a corporation). A partnership is generally required to pay the Section 1446(a) tax in four installment payments. The partnership may consider certain partner-level deductions and losses as a reduction to the ECTI on which it must withhold Section 1446(a) tax. (Reg. 1.1446-6)

Section 1446(f) requires withholding under certain circumstances in connection with a disposition of a partnership interest. Specifically, if, on a disposition (which includes a distribution from a partnership to a partner) of a partnership interest, Section 864(c)(8) treats any portion of a foreign partner's gain as effectively connected gain, Section 1446(f) requires the transferee to withhold tax equal to 10% of the amount realized, unless an exemption or reduced rate of withholding applies. The transferee must deposit the tax with the IRS within 20 days of the transfer. (Reg. 1.1446(f)-2) For purposes of Section 1446(f), a transferor may in certain cases certify to the transferee that the transfer is not subject to withholding or otherwise qualifies for an exception to withholding or an adjustment to the amount required to be withheld. (Reg. 1.1446(f)-2)

Under Section 33 and Section 1462, a foreign person subject to withholding under the withholding sections may credit the amount withheld against the amount of income tax liability shown on the person's tax return.

QOFs, in general, must invest in QOZ businesses. A QOZ business is, in general, a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is QOZ business property (as defined in Section 1400Z-2(d)(2)(D)). (Section 1400Z-2(d)(3))

An entity must meet certain requirements to be a QOZ business, including the requirement of Section 1397C(b)(8) that less than 5% of the average of the aggregate unadjusted bases of the entity's property be attributable to nonqualified financial property, as defined in Section 1397C(e). Section 1397C(e) excludes from nonqualified financial property reasonable amounts of working capital that are held

in cash, cash equivalents, or debt instruments with a term of 18 months or less.

The Section 1400Z-2 regulations provide QOZ businesses with a safe harbor for treating an amount of working capital as reasonable for purposes of Section 1397C(e) ("working capital safe harbor"). One of the safe harbor requirements is that there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business of the assets. (Reg. 1.1400Z2(d)-1(d)(3)(v)(B)) A QOZ business may extend the working capital safe harbor period to a maximum 62-month period if certain additional requirements are met. (Reg. 1.1400Z2(d)-1(d)(3)(vi))

If a QOZ business is located in a QOZ within a federally declared disaster area, the QOZ business may receive not more than an additional 24 months to expend its working capital assets, as long as the QOZ business otherwise meets the requirements of the working capital safe harbor. (Reg. 1.1400Z2(d)-1(d)(3)(v)(D))

The existing Section 1400Z-2 regulations do not coordinate the deferral election under Section 1400Z-2(a) with the withholding rules in the withholding sections. Generally, these withholding provisions subject a foreign person to withholding to ensure the collection of tax due to the increased risk of noncompliance by a person that is not a United States person. In general, the withholding may be claimed as a credit or refund when the foreign person files its return and pays any substantive tax due. Thus, a foreign person subject to withholding that elects to defer gain under Section 1400Z-2(a) may be entitled to apply the credit for withholding against tax on other income or claim a refund for the year in which withholding was applied, as the foreign person will not be required to pay substantive tax on all or a portion of the deferred gain until the gain is recognized upon the earlier of an inclusion event or 12/31/2026.

In these circumstances, the withholding will not serve its intended purpose to ensure that the substantive tax is collected. To address the risk of noncompliance by certain foreign persons with respect to their U.S. tax obligations related to deferred gain under Section 1400Z-2(a), the IRS has determined that coordination is needed between Section 1400Z-2 and the withholding sections.

To ensure that the compliance purposes of the withholding sections are not undermined when a foreign person elects to defer gain under Section 1400Z-2(a), the proposed regulations provide that security-required persons (certain foreign persons and foreign-owned partnerships) investing gain that is a security-required gain may not make a deferral election under Section 1400Z-2(a) unless an eligibility certificate is obtained with respect to that gain.

At the same time, the proposed regulations eliminate or reduce withholding under the withholding sections on security-required persons that obtain an eligibility certificate and provide security to the IRS before the transaction giving rise to the gain. A security-required person that does not obtain an eligibility certificate before the transfer, and thus is withheld upon, must still obtain an eligibility certificate to make a deferral election under Section 1400Z-2(a). The security-required person (or, if applicable, its partner, owner, or beneficiary) may also claim a credit or refund for the amount withheld on the deferred gain when filing its return. The IRS intends to require any claim for credit or refund for amounts withheld under the withholding sections on deferred gain under Section 1400Z-2(a) to include a copy of the eligibility certificate for the covered transfer (or a statement providing that the transfer was not a covered transfer).

Requirement to obtain eligibility certificate. The proposed regulations provide that a taxpayer that is a security-required person may not make a deferral election under Section 1400Z-2(a) with respect to part or all of a security-required gain from a covered transfer unless the taxpayer obtains an eligibility certificate from the IRS with respect to such security-required gain by the date on which the deferral election is filed with the IRS. (Prop. Reg. 1.1400Z2(a)-1(a)(3)) The eligibility certificate must specify the permitted deferral amount, and the taxpayer may not make a deferral election with respect to the security-required gain in an amount that exceeds the permitted deferral amount. (Prop. Reg. 1.1400Z2(a)-1(a)(3))

Security-required persons. A security-required person means a person that is either (1) a foreign person other than a partnership or (2) a specified partnership. (Prop. Reg. 1.1400Z2(a)-2(b)(1)) A specified partnership is a partnership, foreign or domestic, that meets three tests with respect to a transfer that pro-

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duces a security-required gain: an ownership test, a closely-held test, and a gain or asset test. (Prop. Reg. 1.1400Z2(a)-2(b)(3))

The ownership test is met if, at the time of transfer, 20% or more of the capital or profits interests in the partnership are owned (directly or indirectly through one or more partnerships, trusts, or estates) by one or more nonresident aliens or foreign corporations. (Prop. Reg. 1.1400Z2(a)-2(b)(3)(i))

The closely-held test is met if, at any time during a look-back period, a partnership has 10 or fewer direct partners that own 90% or more of the capital or profits interests in the partnership, with any related partners (within the meaning of Section 267(b) or Section 707(b)(1)) being treated as a single partner. For purposes of the closely-held test, the look-back period is the period that begins on the later of the date that is one year before the date of the transfer or the date on which the partnership was formed, and that ends on the date of the transfer. Further, a partner that is a partnership or trust is considered a direct partner. (Prop. Reg. 1.1400Z2(a)-2(b)(3)(ii))

The gain or asset test is met if either: (1) the amount of security-required gain from the transfer exceeds $1 million (the gain test) or (2) at any time during a look-back period, the value of the partnership's assets that are U.S. real property interests or assets used in a U.S. trade or business exceeds 25% of the total value of the partnership's assets (the asset test).

For purposes of the asset test, the look-back period is the same as the look-back period for purposes of the closely-held test. The partnership is allowed to determine the value of an asset on the last day of the tax year preceding the year in which the look-back period begins or, for any asset acquired after this date (including upon formation of the partnership), on the date of acquisition.

The proposed regulations also provide rules for looking through interests in other partnerships to value assets that are held indirectly. Finally, the proposed regulations state that the value of each asset will be measured according to its gross fair market value. (Prop. Reg. 1.1400Z2(a)-2(b)(3)(iii))

Covered transfer and security-required gain. A covered transfer is defined as: (1) a disposition by, or a distribution to, a security-required person that is subject to withholding under Section 1445; (2) a disposition by, or a distribution to, a security-required person that is subject to withholding under Section 1446(f); (3) a disposition by a specified partnership of property, other than an interest in another partnership or

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a U.S. real property interest, or a distribution to a specified partnership, if any gain that arises is included in computing ECTI; or (4) a disposition by a partnership that is not a specified partnership of property, or a distribution to such a partnership, if any gain that arises is included in determining the allocable share of a security-required person's ECTI. (Prop. Reg. 1.1400Z2(a)-2(c)(2)(i))

A transfer subject to Section 1445 or Section 1446(f) is not a covered transfer if an exception to withholding applies under those provisions. However, in order to impose the eligibility certificate requirements on security-required persons that are domestic specified partnerships, if the exception to withholding is based on the non-foreign status of the transferor, the transfer will continue to be treated as a covered transfer. For the same reason, a domestic specified partnership is treated as a foreign person in determining whether a transfer is a covered transfer. (Prop. Reg. 1.1400Z2(a)-2(c)(2)(ii))

Security-required gain is certain gain that arises from a covered transfer. For a covered transfer defined in Prop. Reg. 1.1400Z2(a)-2(c)(2)(i)(C), the amount of security-required gain is the gain that is included in computing ECTI under Reg. 1.1446-2, disregarding Reg. 1.1446-2(b)(4)(i). For a covered transfer defined in Prop. Reg. 1.1400Z2(a)-2(c)(2)(i)(D), the amount of security-required gain is the gain that is included in computing ECTI under Reg. 1.1446-2 that is allocable to the security-required person. (Prop. Reg. 1.1400Z2(a)-2(c)(1))

Application for an eligibility certificate and acceptable security. To obtain an eligibility certificate with respect to any security-required gain, a security-required person must submit an application to the IRS. (Prop. Reg. 1.1400Z2(a)-2(d)(2)) The IRS is considering requiring electronic submission of the application.

The application must generally include the following: (1) certain information about the security-required person and the covered transfer; (2) an agreement for the deferral of tax and provision of security (deferral agreement); (3) an agreement with a U.S. agent (as defined in Prop. Reg. 1.1400Z2(a)-2(d)(4)(ii)(D)); and (4) acceptable security that secures the amount of security-required gain for which the eligibility certificate is being obtained. (Prop. Reg. 1.1400Z2(a)-2(d)(3))

The application includes the requirement to provide a U.S. taxpayer identification number. If applicants do not yet have a U.S. taxpayer identification number, additional time should be allocated to ensure that a U.S. taxpayer identification number can be obtained. The IRS may prescribe in forms or instructions or in publications or guidance published in the Internal Revenue Bulletin procedures for obtaining a U.S. taxpayer identification number under these circumstances.

Acceptable security is defined as an irrevocable standby letter of credit issued by a U.S. bank that meets certain capital and other requirements specified in the proposed regulations. The IRS may identify in published guidance additional financial institutions that may qualify as issuers of letters of credit. (Prop. Reg. 1.1400Z2(a)-2(d)(6)(ii))

Deferral agreement and events of default. In general, under the deferral agreement, the security-required person agrees to do the following: (1) timely file a federal income tax return and pay any tax liability due on the security-required gain for which the security-required person seeks to defer gain under Section 1400Z-2(a) when required; (2) report any security-required gain in accordance with the regulations under Section 1400Z-2; (3) provide security to the IRS with respect to any tax liability due on security-required gain for which the security-required person seeks to defer gain under Section 1400Z-2(a); and (4) appoint a U.S. person to act as the security-required person's limited agent for certain purposes specified in the deferral agreement. (Prop. Reg. 1.1400Z2(a)-2(d)(4)(ii)) The deferral agreement must conform to the template provided in guidance published in the Internal Revenue Bulletin. (Prop. Reg. 1.1400Z2(a)-2(d)(4)(i))

An event of default under the deferral agreement is an inclusion event that triggers recognition of the security-required gain for which the security-required person seeks to defer gain under Section 1400Z-2(a). Defaults, upon which an event of default may be based, will be specified in the deferral agreement, and may include the following: (1) a determination that the security is no longer adequate to protect the IRS's interests; (2) a change in the creditworthiness of the issuer of a letter of credit; and (3) a failure by the security-required person to file returns or attach an eligibility certificate (when required) during the period covered by the deferral agreement. In addition, the deferral agreement will specify whether notice of default and an opportunity to cure will be provided to the security-re-

quired person before an event of default arises. (Prop. Reg. 1.1400Z2(a)-2(d)(4)(ii)(E))

Maximum security amount for eligibility certificate. An eligibility certificate will be issued for a permitted deferral amount. (Prop. Reg. 1.1400Z2(a)-2(d)(1). If a security-required person provides security in an amount equal to the maximum security amount, the permitted deferral amount is the total amount of security-required gain. If a security-required person provides security in an amount less than the maximum security amount, the permitted deferral amount is the total amount of security-required gain multiplied by the ratio of the amount of security provided over the maximum security amount. (Prop. Reg. 1.1400Z2(a)-2(d)(7)(i))

The proposed regulations provide specific rules for determining the maximum security amount, which is generally computed by reference to either a percentage of the amount realized on the covered transfer or the amount of tax due on the security-required gain. (Prop. Reg. 1.1400Z2(a)-2(d)(7)(ii))

The maximum security amount on a direct disposition by, or a distribution to, a security-required person that is subject to withholding under Section 1445 is the lesser of: (1) the amount realized multiplied by the rate specified under Section 1445(a) (or, for transfers subject to Section 1445(e)(1), Section 1445(e)(2), or Section 1445(e)(6), the rate specified in the applicable provision) or (2) the security-required gain multiplied by the highest rate of tax applicable to the gain, based on the type of property, the holding period, and the classification of the security-required person. (Prop. Reg. 1.1400Z2(a)-2(d)(7)(ii)(A))

The maximum security amount on a direct disposition by, or a distribution to, a security-required person that is subject to withholding under Section 1446(f) is the lesser of: (1) the amount realized multiplied by the rate specified under Section 1446(f)(1), or (2) the security-required gain multiplied by the highest rate of tax applicable to the gain based on the type of property, the holding period, and the classification of the security-required person. (Prop. Reg. 1.1400Z2(a)-2(d)(7)(ii)(B))

If a direct disposition of a partnership interest is subject to withholding under both Section 1445 and Section 1446(f), the proposed regulations provide that the rate specified in Section 1445 is used for purposes of determining the maximum security amount. (Prop. Reg. 1.1400Z2(a)-2(d)(7)(ii)(A); Prop. Reg. 1.1400Z2(a)-2(d)(7)(ii)(B))

For a direct disposition of property, other than an interest in another partnership or a U.S. real property interest, by a specified partnership, or a distribution to a specified partnership, the maximum security amount is the security-required gain multiplied by the highest rate of tax applicable to the gain, treating the specified partnership as an individual for this purpose, and taking into account the type of property and holding period. (Prop. Reg. 1.1400Z2(a)-2(d)(7)(ii)(C)) Therefore, a specified partnership that has gain arising from the direct sale or exchange of an asset used in a U.S. trade or business (other than a U.S. real property interest) will generally be required to obtain an eligibility certificate for such gain if it wants to elect to defer all or part of the gain by investing in a QOF.

For a disposition of property (including an interest in another partnership or a U.S. real property interest) by a partnership that is not a specified partnership, or a distribution to such a partnership, that gives rise to gain that is included in determining the allocable share of a security-required person's ECTI, the maximum security amount is the security-required gain multiplied by the highest rate of tax applicable to the gain, taking into account the type of property, the holding period, and the classification of the security-required person. (Prop. Reg. 1.1400Z2(a)-2(d)(7)(ii)(D))

Elimination or reduction of withholding based on an eligibility certificate. The proposed regulations allow a security-required person to use an eligibility certificate as a basis for reducing or eliminating withholding under the withholding sections on a covered transfer. (Preamble to Prop Reg REG-121095-19)

For purposes of Section 1445, a security-required person may apply for a withholding certificate from the IRS based on an eligibility certificate. For purposes of Section 1446(f), the proposed regulations add a rule to allow a transferee to rely on an eligibility certificate to qualify for an exception or adjustment to withholding.

Reg. 1.1446-3 currently allows a partnership to consider certain partner-level deductions and losses certified in accordance with Reg. 1.1446-6 in determining its Section 1446 tax. The proposed regulations modify the rules in Reg. 1.1446-3 and Reg. 1.1446-6 to allow a partnership to also consider in determining its

Section 1446 tax the permitted deferral amount of an eligibility certificate submitted by a partner. When determining installments of Section 1446 tax, to ensure that the reduction in effectively connected items by the permitted deferral amount is fully taken into account, the eligibility certificate must be considered before the effectively connected items are annualized. (Prop. Reg. 1.1446-3(b)(2)(i)(B)(1); Prop. Reg. 1.1446-6(c)(1)(iv))

Because the withholding requirement on a transfer or distribution with respect to an interest in a publicly traded partnership (PTP) is generally imposed on a broker (or nominee), and it would be administratively difficult for a broker to timely obtain an eligibility certificate, the procedures for using an eligibility certificate to reduce or eliminate withholding do not apply for these purposes. A security-required person that has gain arising from a disposition or distribution with respect to a PTP interest is, however, still required to obtain an eligibility certificate to defer security-required gain.

Federally declared disaster. After the major disaster declarations issued in response to the ongoing COVID-19 pandemic, commenters expressed a need for additional regulatory guidance regarding the operation of the 24-month extension for the working capital safe harbor included in the Section 1400Z-2 regulations for federally declared disasters. Although the final regulations provide a QOZ business an additional 24 months to expend its working capital assets, the QOZ business must do so in a manner substantially consistent with the original, pre-disaster written designation in which the amount of working capital assets subject to the safe harbor are designated and according to the original, pre-disaster written schedule for expending such amounts. In some cases, the post-disaster environment facing the QOZ business may render the original plan suboptimal or even not feasible.

In response, the proposed regulations add three new sentences at the end of Reg. 1.1400Z2(d)-1(d)(3)(v)(D) that provide flexibility for QOZ businesses to revise or replace the original written designation and written plan, provided that the remaining working capital assets are expended within the original regulatorily required 31-month period, increased by the 24 additional months provided in response to the federally declared disaster. (Prop. Reg. 1.1400Z2(d)-1(d)(3)(v)(D))

Applicability date. The proposed regulations relating to covered transfers, including the requirement for eligibility certificates, will apply to any covered transfer that occurs after the date that the regulations are published as final regulations in the Federal Register. Taxpayers should not submit applications for eligibility certificates before the date that these regulations are published as final regulations in the Federal Register. Any applications submitted before such date will not be processed by the IRS. (Prop. Reg. 1400Z2(a)-1(g)(2)(ii); Prop. Reg. 1400Z2(a)-2(f); Prop. Reg. 1400Z2(b)-1(j)(3); Prop. Reg. 1446-6(f); Prop. Reg. 1446-7; Prop. Reg. 1446(f)-2(f))

The three new sentences regarding federally declared disasters are proposed to apply to tax years beginning after the date the regulations are published as final regulations in the Federal Register. Additionally, a taxpayer may rely on the three new sentences proposed to be added at the end of Reg. 1.1400Z2(d)-1(d)(3)(v)(D) for tax years beginning after 12/31/2019. (Prop. Reg. 1400Z2(d)-1(e)(2)(ii)) ■

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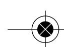

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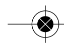

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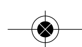

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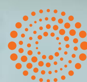

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