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Memorandum

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from: Jennifer Black
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subject: Determining the Fraud Penalty in BBA Syndicated Conservation Easement Cases

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent. This memorandum responds to your question regarding the method by which the Internal Revenue Service (IRS) applies the civil fraud penalty under section 6663(a) for partnerships subject to the centralized partnership audit regime enacted by the Bipartisan Budget Act of 2015 (BBA) that participated in transactions identified in Section 2 of Notice 2017-10, 2017-4 I.R.B. 544, or transactions that are substantially similar, as listed transactions (syndicated conservation easement or SCE transactions).

ISSUE

How does the IRS determine the applicability of the civil fraud penalty in an examination of a BBA partnership that participated in a SCE transaction?

CONCLUSION

The procedures for determining the applicability of the civil fraud penalty against a partnership subject to BBA[1] that participated in a SCE transaction are the same as

[1] For taxable years beginning on or after January 1, 2018, all partnerships are subject to BBA unless they make a valid election out of BBA on their timely filed return for that particular taxable year. I.R.C. § 6221(b); Treas. Reg. § 301.6221(b)-1.

those for establishing civil fraud against a partnership subject to BBA generally; i.e. through all facts and circumstances that establish the willful intent to evade tax at the partnership level. Under BBA, if the IRS determines the applicability of the civil fraud penalty at the partnership level then the partnership is liable for the penalty on any imputed underpayment (IU) computed on the adjustments for that taxable year or, if the partnership elects to push out the adjustments, the reviewed year[2] partners are liable for the fraud penalty on any correction amount[3] that is greater than zero.

BACKGROUND

As described more fully in Notice 2017-10, section 170(f)(3)(B)(iii) of the Internal Revenue Code allows a deduction for a qualified conservation contribution. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. I.R.C. § 170(h)(1)-(5).

However, in some cases, promoters of SCE transactions purport to give partners[4] the opportunity to claim charitable contribution deductions in amounts that significantly exceed the amount invested in the partnership. In such a SCE transaction, a promoter offers prospective partners the possibility of a charitable contribution deduction for the donation of a conservation easement. The promoters then syndicate ownership interests in the partnership that owns the real property, or in one or more of the tiers of pass-through entities, using promotional materials suggesting to prospective partners that a partner may be entitled to a share of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the partner's investment. The promoters obtain an appraisal that purports to be a qualified appraisal as defined in § 170(f)(11)(E)(i), but that greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the real property. After the partners obtain their interests in the partnership, the partnership that owns the real property donates a conservation easement encumbering the property to a tax-exempt entity. Once the donation is made the inflated charitable contribution deduction flows through to the partners.

LEGAL ANALYSIS

Section 6663(a) imposes a penalty equal to 75% of the portion of any underpayment which is attributable to fraud. In any proceeding involving the issue of whether a

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[2] The reviewed year is the partnership taxable year to which the adjustments relate. Treas. Reg. § 301.6241-1(a)(8).

[3] A correction amount is the change in a partner's chapter 1 tax that would have resulted if the partner took into account the partnership adjustments in the first affected year (partner's taxable year that corresponds to the reviewed year of the partnership) and for any changes to tax attributes that would have occurred in any intervening year between that first affected year and the reporting year in which the partner reports the additional reporting year tax. The additional reporting year tax is the total of all correction amounts for each year. See Treas. Reg. § 301.6226-3.

[4] Although promoters have used pass-through entities other than partnerships, as this memorandum provides analysis on partnerships subject to BBA, this memorandum will refer to the entity at issue as a partnership and the investors as partners.

taxpayer has been guilty of fraud, the IRS has the burden of proving fraud and must do so by clear and convincing evidence. I.R.C. § 7454; DiLeo v. Commissioner, 96 T.C. 858, 873 (1991); T.C. Rule 142(b).

Under section 6221(a)[5], the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership-related item (PRI) shall be determined at the partnership level. If a timely petition is filed in response to a notice of final partnership adjustment (FPA), the court has jurisdiction to determine the applicability of any penalty that relates to an adjustment to a PRI. I.R.C. § 6234(c). Therefore, the fraud penalty under section 6663(a), as it relates to fraud on the partnership return, must be determined at the partnership level.

Under BBA, a partnership is liable for an IU calculated on any adjustments to PRIs.[6] I.R.C. § 6225. The IU is assessed and collected as if it were a tax under subtitle A for the adjustment year.[7] I.R.C. § 6232(a). If a penalty, addition to tax, or additional amount is determined to be applicable to any adjustment to a PRI, the partnership is liable for that penalty. The penalty is computed on the IU as if the partnership was an individual and the IU was an actual underpayment or understatement for the year. I.R.C. § 6233(a)(3). In cases where the fraud penalty has been determined, the entire IU is treated as attributable to fraud unless the partnership establishes, by a preponderance of the evidence, that any portion of the IU is not attributable to fraud. Treas. Reg. § 301.6233(a)-1(c)(2)(iv)(A). Any defenses the partnership may have to any fraud penalty asserted during the partnership-level proceeding may only be raised during a partnership-level proceeding. See I.R.C. § 6221(a) (applicability of penalties must be determined at the partnership level). Partnership-level defenses are based on the facts and circumstances applicable to the partnership as if the partnership was the taxpayer. Treas. Reg. § 301.6233(a)-1(c)(2)(iv)(D).

If, instead of paying the IU and any applicable penalties, the partnership elects to push out the adjustments to its reviewed year partners, the applicability of any penalties determined at the partnership level are also pushed out to the reviewed year partners, including notifying the partners which adjustments the penalties apply to. Treas. Reg. § 301.6226-2(e)(6). The reviewed year partners are then liable for those penalties. I.R.C. § 6226(c)(1). The penalties the partners are liable for are computed for each affected year (first affected year and any intervening year) based on each partner's facts and circumstances after taking into account the adjustments pushed out to the partners. Treas. Reg. § 301.6226-3(d). For example, if the civil fraud penalty is determined to be

[5] All Internal Revenue Code sections referenced are to those in effect for partnership taxable years beginning on or after January 1, 2018.
[6] If the partnership fails to pay all amounts owed (e.g., the IU and any penalties and interest) within 10 days of notice and demand the rate of interest will increase by 2 percent and the IRS may assess against the partners of the partnership their proportionate share of the amounts owed by the partnership.
[7] The adjustment year is the partnership taxable year in which: 1) the decision of a court in a proceeding brought in response to an FPA becomes final; 2) an administrative adjustment request is filed; 3) if no petition is filed, the FPA is mailed; or 4) any waiver of the FPA is executed by the IRS.

applicable at the partnership level on all of the adjustments and the partnership elects to push out the adjustments, the partners will be liable for a fraud penalty on any additional reporting year tax[8] due from each partner. If the adjustments are pushed out to a pass-through partner that is liable for an IU on the adjustments pushed out to it, the pass-through partner would be liable for a fraud penalty on the entire IU. See generally Treas. Reg. §§ 301.6226-3(e)(4); 301.6233(a)-1(c)(2)(iv)(A). A reviewed year partner claiming that any penalty is not due because of a partner-level defense must first pay the penalty and file a claim for refund. Treas. Reg. § 301.6226-3(d)(3).

As with all penalties determined at the partnership level, fraud is determined by conduct that occurred at the partnership level. See I.R.C. §§ 6221(a), 6233(a)(3) (treating the partnership as an individual for purposes of penalties); Treas. Reg. § 6233(a)-1(c)(2)(iv)(D); cf. Arbitrage Trading, LLC v. United States, 108 Fed. Cl. 588, 608 (2013) (citing "the legislative intent that penalties be applied to partnership conduct in partnership-level proceedings"); Tigers Eye Trading v. Comm'r, 138 T.C. 67, 91 (2012) (citing the TEFRA legislative history for the proposition that "[w]ith respect to partnerships, the relevant conduct often occurs at the partnership level"). For purposes of penalties, the "partnership conduct," including the partnership's intent, is determined by looking to the conduct and intent of those managing the partnership. See Jade Trading, LLC v. United States, 81 Fed. Cl. 173, 176-77 (2008) (looking to the conduct of the managing member to determine whether the partnership acted negligent); see also Palm Canyon X, LLC v. Comm'r, T.C. Memo. 2009-288 (agreeing that you must examine the conduct of the managing member to determine if the partnership was negligent for purposes of a penalty under section 6662). Likewise, any partnership-level defenses to any penalties must also be determined by the manager's conduct on the partnership's behalf. See Treas. Reg. § 301.6233(a)-1(c)(2)(iv)(D); see also Southgate Master Fund, LLC v. United States, 659 F.3d 466, 493 n.86 (5th Cir. 2011); Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1381 (Fed. Cir. 2010); Am. Boat Co. v. United States, 583 F.3d 471, 479-80 (7th Cir. 2009).

Accordingly, in order to determine the fraud penalty under section 6663(a) with respect to a BBA partnership, the IRS must prove, by clear and convincing evidence, the elements of the fraud penalty based on the partnership-level conduct and intent of the manager(s) of the partnership. If the IRS proves fraud, the partnership is liable for the fraud penalty computed on the IU. If the partnership elects to push out the adjustments, the fraud penalty is applicable to all the partners in the partnership on any positive correction amount resulting from the adjustments to PRIs that are attributable to fraud. Those partners may then raise any partner-level defenses in a refund claim.

Please call me at (202) 317-5216 if you have any further questions.

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[8] For purposes of this example, it is assumed that the correction amount is greater than zero for each affected year. If some correction amounts are negative, the negative correction amount will not offset any penalties for years in which there is a positive correction amount. See Treas. Reg. § 301.6226-3(d)(2) (the correction amount is an underpayment or understatement for each year).