Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Carolyn A. Schenck
National Fraud Counsel and
Assistant Division Counsel (International), SB/SE

from: Jennifer Black
Senior Counsel
(Procedure & Administration)

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subject: Determining the Fraud Penalty in TEFRA 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 unified partnership procedures enacted by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) that participated in transactions identified in Section 2 of Notice 2017-10, 2017-4 I.R.B. 544 as listed transactions (syndicated conservation easement or SCE transactions).

ISSUE

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

CONCLUSION

The procedures for determining the applicability of the civil fraud penalty against a partnership subject to TEFRA that participated in a SCE transaction are the same as those for establishing civil fraud against a partnership subject to TEFRA generally; i.e. through all facts and circumstances that establish the willful intent to evade tax at the partnership level. Under TEFRA, the IRS determines the applicability of the civil fraud

penalty at the partnership level and then the penalty is directly assessed on the partners of the partnership through a notice of computational adjustment.

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 syndicated conservation easement transactions purport to give partners[1] 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 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[2], the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item shall be determined at the partnership level. If a timely petition is filed in response to an FPAA, the court has

[1] Although promoters have used pass-through entities other than partnerships, as this memorandum provides analysis on partnerships subject to TEFRA, this memorandum will refer to the entity at issue as a partnership and the investors as partners. Under TEFRA, the term "partner" refers to not only those who own a direct interest in the partnership but also those whose tax liability is determined in whole or in part by taking into account the partnership items of the partnership. I.R.C. § 6231(a)(2).

[2] TEFRA was repealed for taxable years beginning on or after December 31, 2017, by the Bipartisan Budget Act of 2015. All Internal Revenue Code sections referenced are to those in effect for partnership taxable years subject to TEFRA.

jurisdiction to determine the applicability of any penalty that relates to an adjustment to a partnership item. I.R.C. § 6226(f). Therefore, the fraud penalty under section 6663(a), as it relates to fraud on the partnership return, must be determined at the partnership level, even if there are partner-level determinations that may need to subsequently be made. Omega Forex Grp. LC v. United States, 906 F.3d 1196, 1211-12 (10th Cir. 2018); see also United States v. Woods, 571 U.S. 31, 39-41 (2013).

If fraud is established at the partnership level, then all partners will be liable for the fraud penalty on any underpayments of tax resulting from the adjustments to partnership items that are attributable to fraud (assuming the IRS can establish that the partner has an actual underpayment and assuming there are no partner-level defenses). In addition, if the IRS can also establish that an individual partner has an additional underpayment (unrelated to the adjustments to the partnership items that are attributable to fraud) for the same taxable year, that additional underpayment may be treated as attributable to fraud and subject to the section 6663(a) penalty. See I.R.C. § 6663(b).

Under TEFRA, any penalties that are determined to be applicable are directly assessed following the conclusion of the TEFRA proceeding. See I.R.C. § 6230(a)(2)(A)(i) (providing that deficiency procedures do not apply to penalties). The partners would then have six months from the date of the notice of computational adjustment to file a claim to argue that the IRS erroneously imposed the penalty (including to raise any partner-level defenses they may have to the penalty). I.R.C. § 6230(c)(1)(C), (2)(A). In a claim under section 6230(c), the applicability of the penalty determined at the partnership level is conclusive, and the partners may only raise partner-level defenses as to why the penalty should not be imposed. I.R.C. § 6230(c)(4). With respect to the fraud penalty on the partnership items that are attributable to fraud, this includes a reasonable cause defense. See I.R.C. § 6664(c)(1). With respect to the fraud penalty that may be applied to additional underpayments (unrelated to the adjustments to the partnership items that are attributable to fraud) for the same year, the taxpayer may avoid the penalty by establishing (by a preponderance of the evidence) that the additional underpayments are not attributable to fraud. See I.R.C. § 6663(b).

As with all penalties determined at the partnership level, fraud is determined by conduct that occurred at the partnership level. See 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"); H.R. Rept. 105–148, at 594 (1997), 1997–4 C.B. (Vol.1) 319, 915–916. 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 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 TEFRA partnership, the IRS must prove, by clear and convincing evidence, the partnership-level elements of the fraud penalty based on the conduct and intent of the manager(s). If the IRS proves fraud, the fraud penalty is applicable to all the partners in the partnership on any underpayments of tax resulting from the adjustments to partnership items that are attributable to fraud, and any additional underpayments for the same year. Those partners may then raise any partner-level defenses in a refund action under section 6230(c).

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