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In this article, Himmelstein and Pastore evaluate the IRS's new position that characterizes as ordinary income the gains enjoyed by promoters of syndicated conservation easements, and they warn that other types of partnership transactions could be at risk of similar treatment.

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Those of us following the Tax Court know that it has an endless supply of conservation easement cases to decide. Most involve partnerships that donated conservation easements over land for which they claimed charitable contribution deductions. Some of the partnership transactions were "syndicated" and promoted to potential investors — what the IRS has dubbed "syndicated conservation easement transactions" and put on its "Dirty Dozen" list.[1] Most of the cases involve the partnerships' right to the claimed deductions, but some involve the promoters of the transactions.

Many partners that invested in the transactions did so through promoters that identified land suitable for a conservation easement, formed a partnership to acquire that land, and issued promotional materials advertising the potential for investors to receive a share of a deduction.[2] The promoters seem to have made lots of money.[3] How should that money be taxed?

The easement promoters generally made money by selling partnership interests. They reported the income as capital gain under section 741; it seems clear on its face that gain from the "sale or exchange of an interest in a partnership" is taxed as capital gain.[4] But the IRS recently announced a controversial position in internal guidance and in *Marlin Woods*, an ongoing Tax Court case.[5]

The IRS announced its view that section 1221 treats the promoters' gains as ordinary income

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[1] *See* Notice 2017-10, 2017-4 IRB 544; IR-2024-105 (Apr. 11, 2024).

[2] *See* Notice 2017-10 at 2.

[3] U.S. Department of Justice, "Two Tax Shelter Promoters Sentenced to 25 Years and 23 Years in Billion-Dollar Syndicated Conservation Easement Tax Scheme; Two More CPAs Plead Guilty" (Jan. 9, 2024) (alleging that some promoters made millions of dollars).

[4] *See* Kristen A. Parillo, "IRS Can Assert Easement Promoter Sold Partnership Interests," *Tax Notes Federal*, May 13, 2024, p. 1299.

[5] ILM 202309015; *Marlin Woods Capital LLC v. Commissioner*, Nos. 30894-21 and 30896-21 (T.C. 2021).

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and that section 1221 effectively trumps section 741.[6] The IRS has urged that this position is necessary to "harmonize" section 741 with section 1221. In this article, we explain how we got here and why taxpayers should pay attention.

I. Legal Background

The legal issue in *Marlin Woods* and other cases requires a basic understanding of section 741, section 751, section 1221, and relevant legislative history and case law.

A. The Relevant Statutes

The issue begins with section 741. The statute is captioned, "Recognition and character of gain or loss on sale or exchange." It provides that "in the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner."[7] The statute then states that such gain or loss "shall be considered as gain or loss from the sale or exchange of a capital asset, except as provided in section 751."

Again, on its face, section 741 is clear. Whenever a partner sells an interest in a partnership, any resulting gain is characterized as capital gain. The statute includes a single exception: "except as otherwise provided in section 751."

Section 751 addresses "unrealized receivables and inventory items," which are sometimes referred to as "hot assets." That section details those two concepts. The term unrealized receivables includes "goods delivered," "services rendered," and a litany of enumerated items.[8] Inventory items include "property of the partnership of the kind described in section 1221(a)(1)."[9]

The final provision at issue is section 1221, which defines the term "capital asset" to include "property held by the taxpayer." Unlike section 741, this statute provides a long list of things that are not capital assets, despite otherwise being property held by the taxpayer. The relevant exception here is in subsection (a)(1), which carves out "stock in trade of the taxpayer . . . or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[10]

The IRS has homed in on the second half of the sentence in subsection (a)(1). In the IRS's view, easement promoters hold partnership interests "primarily for sale to customers in the ordinary course." While a partnership interest — like corporate stock — might generally resemble a capital asset, section 1221(a)(1) supposedly clarifies that a partnership interest is not a capital asset if it is held "primarily for sale to customers in the ordinary course."

B. Brief History

Congress enacted section 741 as part of the Internal Revenue Code of 1954.[11] Congress's primary goal was to clear up the partnership regime, which it declared to be "the most confused in the entire income tax field."[12] The Tax Court went further, calling the state of the regime at that time "chaos which permeated the partnership area under the 1939 Code."[13]

Some of the chaos resulted from the lack of uniformity on how to tax sales of partnership interests. At one point the IRS argued that in a sale of a partnership interest, the transferor partner was selling an undivided interest in the partnership's assets and that courts should look at each asset individually to characterize income.[14] But several courts rejected this position,[15] and the IRS returned to the drawing board.

By 1950 the IRS had not only retreated but also announced its view that "the sale of a partnership interest should be treated as the sale of a capital asset."[16] The IRS did not set forth any exceptions but did clarify that "the application of this rule

[6]For prior analysis, see Robert Willens, "Sale of LLC Interests Should Have Led to Capital Gains," *Tax Notes Federal*, Mar. 13, 2023, p. 1767; and Monte A. Jackel, "Statutory Conflicts, Interpretation Animate Recent IRS Guidance," *Tax Notes Federal*, Mar. 20, 2023, p. 1981.

[7]Section 741.

[8]Section 751(c).

[9]Section 751(d)(1).

[10]Section 1221(a)(1).

[11]Internal Revenue Code of 1954, chapter 736.

[12]S. Rep. No. 83-1622 at 89 (1954).

[13]*Pollack v. Commissioner*, 69 T.C. 142, 145 (1977).

[14]*Id.* at 146.

[15]*See United States v. Shapiro*, 178 F.2d 459, 460 (8th Cir. 1949) (noting that the IRS's position was "contrary to the overwhelming weight of authority").

[16]GCM 26379, 1950-1 C.B. 58.

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should, of course, be limited to those cases in which the transaction in substance and effect . . . is essentially the sale of a partnership interest."[17] As long as the transferor partner actually sold a partnership interest, that sale would generate capital gain (or capital loss).

Congress became fearful, though, that partnerships would be used as "devices" to avoid taxes. For example, the House expressed that reforming the partnership regime was necessary "to prevent the use of the sale of an interest in a partnership as a device for converting rights to income into capital gain."[18] The Senate agreed that reform was needed "to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests."[19] Congress thus drafted an exception through section 751, carving out hot assets from the ambit of section 741. But Congress clarified that it was otherwise "retain[ing] the general rule of present law that the sale of an interest in a partnership is to be treated as the sale of a capital asset."[20]

C. *Pollack* and the *Corn Products* Doctrine

Litigation continued, despite Congress's pronouncements in the 1954 code, in part because of the doctrine from the Supreme Court case *Corn Products Refining Co.*[21]

In *Corn Products*, the Supreme Court held that corn futures contracts were not capital assets, even though the exceptions in section 117 (the predecessor to section 1221) did not include "corn futures." The Court explained that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." To do so, the Court held that "losses arising from the everyday operation of a business [must] be considered as ordinary income or loss rather than capital gain or loss."[22]

Litigation ensued on the breadth of the *Corn Products* doctrine. In *Pollack*, the interaction between section 741 and the doctrine came to a head.[23] The taxpayer bought an interest in a partnership through which the partner would furnish consulting services to failing businesses. When the venture failed, the taxpayer sold his partnership interest at a loss and argued that *Corn Products* triggered ordinary loss treatment.

The Tax Court held that the *Corn Products* doctrine had no place in the dispute. The court explained that "the plain language of the statute itself" confirms that the sale of a partnership interest results in capital treatment "without regard to section 1221."[24] The Tax Court has since, on several occasions, confirmed that *Corn Products* does not affect the application of section 741.[25]

II. A Return to Chaos?

Since *Pollack* was issued in 1977, the issue has been largely dormant.[26] That changed in March 2023, when the IRS released an internal chief counsel advice memorandum.[27] Relying on the *Corn Products* doctrine, the memo concluded that despite section 741 and its legislative history, proceeds earned by promoters of syndicated easement transactions are taxable as ordinary income rather than capital gain.[28] Notably, the memo omitted any discussion of *Pollack*.[29]

The IRS acknowledged in the memo that courts have consistently rejected its pre-1954

[17] *Id.*

[18] H.R. Rep. No. 83-1337 at 70 (1954).

[19] S. Rep. No. 83-1622 at 98.

[20] *Id.* at 96.

[21] *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955).

[22] *Id.*

[23] *Pollack*, 69 T.C. 142.

[24] *Id.* at 147.

[25] *See Pappas v. Commissioner*, 78 T.C. 1078, 1087 (1982) (holding that "section 741 codified the treatment to be the sale of a capital asset"); *O'Brien v. Commissioner*, 77 T.C. 113, 117 (1981) (holding that "section 741 treats the loss on the sale or exchange of a partnership interest as a loss on the sale or exchange of a capital asset"); and *Baker v. Commissioner*, T.C. Memo. 1997-442 (holding that "section 741 operates independently of section 1221").

[26] Similar issues were litigated in *Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner*, 149 T.C. 63 (2017), *aff'd*, 926 F.3d 819 (D.C. Cir. 2019). The principal issue there was whether *Pollack* correctly applied the "entity theory." The court did not address *Corn Products* or section 1221. The court did note, though, that "section 741 acknowledges one exception ('except as otherwise provided in section 751')" and that this exception "would be superfluous" if "Congress had intended section 741 to be interpreted as a look-through provision." *Grecian Magnesite*, 149 T.C. at 78-79.

[27] ILM 202309015.

[28] *Id.* Interestingly, the memo did not note that the *Corn Products* doctrine was significantly limited in a subsequent Supreme Court decision, *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). The Court held that *Corn Products* stands "for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of section 1221."

[29] As Jackel astutely noted, the memo likely referenced *Pollack* in the redacted section discussing the hazards of litigation. Jackel, *supra* note 6.

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position. But the IRS explained that those cases are not applicable because they dealt with different facts. In the IRS's view, "the courts were not given the opportunity to consider whether capital gain or ordinary income treatment would apply when a taxpayer was engaged in the business of holding partnership interests for sale to customers." That distinction, the IRS stated, "harmonizes" sections 741 and 1221.

The IRS is now applying the chief counsel advice memo to active litigation. In *Marlin Woods*, the IRS originally asserted that the taxpayer's proceeds from selling partnership interests are taxable as ordinary income under section 751.[30] The IRS accordingly recharacterized about $56 million as ordinary income. But in March 2024 the IRS moved for leave to amend its answer to assert its new position: If section 751 does not apply, section 1221 does. In its motion for leave, the IRS represented that its new theory "is consistent with its position articulated in [the chief counsel advice memo]."[31] Over the taxpayer's objection, the Tax Court allowed the IRS to advance that theory.[32] In response to the taxpayer's argument that the IRS's position was meritless, the court invited the taxpayer to file a motion for summary judgment.[33]

III. Evaluation

In an era when courts are willing to hold the IRS to the plain text of a statute, the IRS's interpretation of section 741 will likely face significant challenges. The Tax Court could arguably dispose of the issue with a literal reading of section 741.[34] The statute states that if a partner sells a partnership interest, the resulting "gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset."[35] Provisions that use the term "shall" impose mandatory rules.[36] The sole exception specifically included in section 741 is for transactions falling within the ambit of section 751.

Section 751 provides for ordinary treatment when the partnership has unrealized receivables and inventory items. As relevant here, section 751(d)(1) defines inventory items to include "property of the partnership of the kind described in section 1221(a)(1)." Section 751 thus includes a specific reference to section 1221, but only in the context of defining inventory items. If Congress intended for section 1221 to apply more broadly to section 741, it presumably would not have limited the application of section 1221(a)(1) to determining whether property of the partnership is inventory for purposes of section 751. Congress knew how to draft an exception to section 741, and courts may therefore be reluctant to read an unwritten exception into the statute.[37]

In the chief counsel advice memo, the IRS attempted to buttress its position by relying on the *Corn Products* doctrine and alluding to the harmonization principle.

The *Corn Products* doctrine instructs courts to look at the nature of the taxpayer's business to determine whether sale proceeds are taxed as ordinary income or capital gain. *Corn Products* involved corn futures contracts, which were not enumerated in section 1221.[38] The Supreme Court held that the corn futures contracts generated ordinary income, reasoning that the proceeds "arising from the everyday operation of a business [must] be considered as ordinary income or loss rather than capital gain or loss."[39]

But the *Corn Products* doctrine does not apply in cases involving section 741. The Tax Court made that clear in *Pollack*. The court stated that

[30] *See* Parillo, *supra* note 4.

[31] Motion for Leave to File Amended Answer Out of Time, *Marlin Woods*, No. 30894-21 at 3 (T.C. Mar. 11, 2024).

[32] Order, *Marlin Woods*, Nos. 30894-21 and 30896-21, at 3-4 (T.C. May 7, 2024).

[33] *Id.* at 3.

[34] *See* Arthur Willis, Philip Postlewaite, and Jennifer Alexander, *Partnership Taxation*, para. 12.02[3] (2024) ("The divided statutory characterization of gain or loss on the disposition of a partnership interest appears complete on the face of the Code. Unless the safeguard provision of section 751(a) focused on ordinary income property applies, the Code under section 741 mandates a capital characterization.").

[35] Section 741.

[36] *See Kingdomware Technologies Inc. v. United States*, 579 U.S. 162, 172 (2016) ("When a statute distinguishes between 'may' and 'shall,' it is generally clear that 'shall' imposes a mandatory duty.").

[37] *See Catterall v. Commissioner*, 68 T.C. 413, 421 (1977) ("Under the maxim expressio unius est exclusio alterius, if a statute specifies exceptions to a general rule, an intention to exclude any further exceptions may be inferred."), *aff'd sub nom. Vorbleski v. Commissioner*, 589 F.2d 123 (3d Cir. 1978).

[38] The IRS has stated that section 1221(a)(7), which deals with hedging transactions, "supersedes" *Corn Products*. *See* LTR 202140016.

[39] *Corn Products*, 350 U.S. at 52.

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"Congress intended [section 741] to operate independently of section 1221."[40] The court reiterated that more recently, confirming that "section 741 operates independently of section 1221."[41] And the Supreme Court seems to have limited the *Corn Products* doctrine even further.[42]

Ironically, it was the IRS in *Pollack* that argued that section 741 operates independently from section 1221. In response to the taxpayer's argument that the sale generated an ordinary loss, the IRS urged that "except for specific exceptions not relevant herein [viz., the exceptions carved out in section 751], section 741 mandates the loss be characterized as a capital loss."[43] The IRS's position in *Pollack*, moreover, was not new, and the IRS has held that position for many years.[44] Critical of conservation easement promoters, the IRS is now changing its view.

In the memo, the IRS also alluded to the harmonization principle, stating summarily that its interpretation harmonizes sections 741 and 1221. If two code provisions conflict — that is, they are not in harmony — "the last expression of the sovereign" controls.[45] If there is a conflict between sections 741 and 1221, section 741 would take precedence as "the last expression of the sovereign."[46] Indeed, one court even suggested that "section 741 overrides section 1221."[47]

That said, courts attempt to read two statutes in a manner that harmonizes them — that is, they "construe earlier and later provisions in a way that is consistent with the intent of each and that results in an absence of conflict between the two."[48] For example, in *Pappas*, the Tax Court concluded that sections 741 and 1031 were in harmony.[49] The court explained that section 741 is "a characterization provision," whereas section 1031 is "a nonrecognition provision." In other words, the court stated that a sale of a partnership interest could be treated as the sale of a capital asset under section 741 but result in no capital gain under section 1031.[50]

Here, though, the taxpayer will likely argue that the IRS has not harmonized section 741 with section 1221. It will likely argue that the IRS has done the opposite — rewriting section 741 to harmonize the statute with its own interpretation.

IV. Parting Thoughts

The IRS has not kept its views of conservation easements a secret: It does not like them, and it does not like what it views as abuses of subchapter K.[51] One chief counsel attorney even said that "all of these [easement cases] are fraud."[52] But despite its earnest desire to shut these transactions down, the IRS will likely struggle to revive its dead theory about section 741. If the IRS believes that promoters abused the partnership regime, it should think about invoking one of the judicial doctrines.[53] Presumably, the IRS did not do so in *Marlin Woods* because doing so requires more work — it must prove something abusive, which is intensely factual.

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[40] *Pollack*, 69 T.C. at 145; *see also id.* at 147 n.7 ("Having concluded that sec. 1221, I.R.C. 1954, is not applicable, we need not consider whether the Corn Products doctrine exception to that section is applicable in this case.").

[41] *Baker*, T.C. Memo. 1997-442.

[42] *See supra* note 28 (discussing *Arkansas Best*).

[43] *Pollack*, 69 T.C. at 145.

[44] *See, e.g.*, Rev. Rul. 59-109, 1959-1 C.B. 168 (discussing section 751 as the only exception to capital gain treatment); reg. section 1.741-1(a) (same).

[45] *See Adams Challenge (UK) Ltd. v. Commissioner*, 156 T.C. 16, 44 (2021) (quoting *Chae Chan Ping v. United States*, 130 U.S. 581 (1889)).

[46] Section 117 — the predecessor to section 1221 — was part of the 1934 version of the code. Congress renumbered section 117 in the 1954 version.

[47] *Pappas*, 78 T.C. at 1086.

[48] *Adams Challenge*, 156 T.C. at 45 (quoting S. Rep. No. 100-445 at 317 (1988)). Congress has indicated that "courts may harmonize two provisions by resort to the principle that as between a generally applicable and a specifically applicable provision, the specifically applicable provision applies." S. Rep. No. 100-445 at 316. In the case of sections 741 and 1221, section 741 would be the "specifically applicable provision."

[49] *Pappas*, 78 T.C. at 1086.

[50] Congress recently revised section 1031 to apply only to exchanges of "real property."

[51] *See, e.g.*, IR-2023-71 (Apr. 5, 2023) (describing syndicated easement transactions as "bogus tax avoidance strategies"); and IR-2023-166 (Sept. 8, 2023) (describing the IRS's "effort to restore fairness in tax compliance by shifting more attention onto high-income earners, partnerships, large corporations and promoters abusing the nation's tax laws").

[52] *See* Order, *Sydney Roads LLC v. Commissioner*, No. 30287-21 (T.C. Feb. 23, 2024); Erin McManus, "IRS Still Seeking Damage Control From Group Chat Gaffe," *Tax Notes Federal*, Mar. 4, 2024, p. 1889.

[53] For example, the IRS might have argued that the promoters, in substance, sold something other than a partnership interest (like land).

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The IRS's strategy in *Marlin Woods* also makes one wonder why the IRS is fighting promoters through a nonbinding chief counsel advice memo rather than through regulations. There are many ongoing cases involving the validity of regulations, and the IRS has lost several recently when a regulation was used to "fix" a perceived statutory loophole.[54] Maybe the IRS recognizes that regulations cannot insulate the agency from the charge that a statute forecloses its position, especially now in light of the Supreme Court's decision overruling *Chevron*.[55]

Taxpayers should monitor *Marlin Woods* and keep the IRS's position in mind when planning transactions that involve partnerships. Although the IRS is targeting partnerships that promoted conservation easement transactions, other types of partnerships are not immune from attack. The IRS suggested in the memo that any partnership sale could generate ordinary income if the taxpayer sells partnership interests in the ordinary course of business. It therefore would not be surprising to see similar disputes arise outside the conservation easement context. ■

[54] *See, e.g.*, *FedEx Corp. v. United States*, No. 20-cv-02794 (W.D. Tenn. Mar. 31, 2023).

[55] *See Loper Bright Enterprises v. Raimondo*, No. 22-451 (U.S. 2024).

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