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Lawyers' Group Protests The Appraiser Penalties

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The Pension Protection Act of 2006 (PPA)[1] imposes new penalties on appraisers that are deemed to have made substantial or gross valuation misstatements. These stiff penalties are articulated in new Internal Revenue Code Section 6695A (see "Go to the Source," p. 28) and apply not only to professional appraisers but also, as the PPA states, to "a[ny] person who prepares an appraisal." Once imposed, the only way to avoid them is "if the person who prepared the appraisal can establish to the satisfaction of the Secretary [of the U.S. Treasury] that the value established in the appraisal was more likely than not the proper value." And somehow this is to be accomplished after the Internal Revenue Service already has determined that a penalty should be imposed.

A task force of the Business Planning Group of the American Bar Association Section of Real Property, Probate and Trust Law, which task force we chair, submitted comments on Feb. 14 to the IRS regarding new IRC Section 6695A. Here are the questions we've raised, some insight into our concerns about whether the Service can fairly and equitably implement its provisions, and our recommendations on how these problems might be addressed.

- **Will Section 6695A apply to estate and gift tax valuations or solely to income tax valuations?**

  The PPA's legislative history[2] suggests that the genesis of new IRC Section 6695A was the act's amendments to IRC Section 170, which relates to Chapter 1 income tax charitable contribution deductions. The PPA amendments to IRC Section 170 relate to, among other things, income tax charitable contributions of capital gain real property made for conservation purposes and income tax charitable contribution deductions for certain easements in registered historic districts.

  New IRC Section 6695A appears to have been enacted primarily to alleviate perceived problems relating to appraisals of property for charitable contributions for income tax purposes under Section 170, and, in particular, certain difficult-to-appraise property, such as conservation easements, intangible assets and possibly closely held stock. That said, PPA Section 1219 states that it applies to income and estate and gift tax valuations, including the elimination of the reasonable cause exception for gross misstatements. The inconsistency between the apparent legislative intent (income tax valuations) and the PPA provisions (income, estate and gift tax valuations) needs to be clarified — and the new Section 6695A needs to be adjusted.

  Section 6695A should be limited to qualified appraisals of property prepared for charitable contributions for income tax purposes under IRC Chapter 1. The primary focus of the changes to IRC Sections 170, 6662, 6664 and 6696, along with the enactment of new Section 6695A, appear to have been perceived abuses in the valuation of property for income tax purposes — not estate and gift tax purposes.

- **What is the reach and scope of Section 6695A's "any person" language?**

  Section 6695A(b) simply refers to "any person" being subject to the imposition of penalties under subsection (a). Does "any person" mean only a "qualified appraiser" as that term is defined under IRC Section 6664? Or does it include any appraiser? Does the term have a broader meaning than appraiser? For example, does "person" mean any individual, trust, estate, partnership, association, company or corporation as defined under IRC Section 7701? Does "person" include someone who is not an appraiser by profession but is required to report the value of assets on a tax return? For example, does it include an individual who signed or prepared a gift or income tax return when assets were required to be valued? Does it include the personal representative of an estate who signed an estate tax return? Does it include an individual who had minimal involvement or interaction with an appraiser? For example, does it include a CPA, lawyer or realtor who merely supplied information to an appraiser? At what level of involvement in the appraisal or reporting process will a person be subject to the penalties under IRC Section 6695A? What is the demarcation line for "involvement"?

  The term "person" as used in IRC Section 6695A should be limited to "qualified appraisers" as defined under IRC Section 6664. "Qualified appraiser" is a defined term and its meaning is certain, clear and unambiguous. The appraisal process involves the gathering of information and data from many sources and from many persons. Limiting the scope of IRC Section 6695A to qualified appraisers would facilitate the appraisal process and make enforcement easier. Third parties would not be reluctant to provide information or data to appraisers for fear of being subject to penalties under Section 6695A. As written, the scope and reach of the "any person" language in Section 6695A is unlimited and may unwittingly subject persons to liability who are only tangentially involved in the appraisal process.

  Section 6695A creates the same uncertainty about what constitutes the preparation of an "appraisal." For example, have any of these people "prepared an appraisal" for purposes of Section 6695A: a taxpayer reporting a "best guess" value on a gift or estate tax return; a CPA using a real estate property tax statement value who inserts it on a gift or estate tax return; a taxpayer's attorney sending a letter to the CPA stating what she understands the value to be? The term "appraisal" under Section 6695A also should be limited to "qualified appraisals" as defined under IRC Section 170.

- **Will Section 6695A apply only to individual appraisers in a firm, the appraisal firm as a whole — or both?**

  Section 6695A does not indicate whether appraiser penalties will befall only individual appraisers, or whether the actions of an individual appraiser will be imputed to an appraiser's entire firm. If the latter, will that occur only under certain circumstances? And, if so, what are those circumstances? Also, will the Section 6695A penalties apply to each appraiser in an appraisal firm who signs off on the appraisal (for example, a review appraiser)?

  The provisions of Section 6695A should be limited to the appraisal firm and the opining appraiser who signs the final appraisal report, whether that person is an individual appraiser, a managing partner or a principal in the appraisal firm. Section 6695A's reach should not extend to those who merely participated in the preparation of the final product, but did not take ultimate responsibility for it, and did not sign off on the final report.

- **To what extent will Section 6695A come to bear on appraisers relying upon expert opinions about the nature of the property interest to be appraised?**

  Very often, appraisers need to rely upon expert opinions about the nature of the property interest to be appraised. It's unclear whether such reliance would protect them from the penalties under Section 6695A.

  For example, if an appraiser (Appraiser #1) is valuing an interest in an entity (Entity Valuation) that owns real estate, may Appraiser #1 rely on the opinion of a qualified real estate appraiser (Appraiser #2) with respect to the value of the underlying real property (Real Estate Valuation)?

  If Appraiser #1 relies on Appraiser #2's Real Estate Valuation to prepare Appraiser #1's Entity Valuation, will

both appraisers be subject to the penalties under Section 6695A?

What if Appraiser #1 limits the scope of his appraisal to the Entity Valuation, exclusive of the Real Estate Valuation?

What if Appraiser #2's property appraisal is the bad appraisal that results in the imposition of penalties under Section 6695A? Will Appraiser #1 be held equally liable, even though his report is solid?

Also, if a lawyer opines that an interest to be appraised is an assignee interest in a family limited partnership and not a limited partnership interest, may the appraiser rely on that advice to value the assignee interest? The concern is that the Service will challenge the characterization of the appraised interest as an assignee interest and therefore challenge the overall appraisal of the interest. Would a valuation adjustment as a result of such a recharacterization of the interest by the Service subject an appraiser to Section 6695A penalties?

Section 6695A should be imposed on a targeted but equitable basis, taking into account the realities of the appraisal process, which many times requires one appraiser to rely on one or more ancillary appraisal reports before issuing a final report. Only the appraisal firm and the opining appraiser who signs the final appraisal report should be held liable for penalties under Section 6695A. Opinions or information obtained from third parties (such as lawyers, CPAs and realtors) who aren't qualified appraisers but who provide information to qualified appraisers as to the nature or character of a property interest should not be held liable for Section 6695A penalties. Also, the appraiser who obtained information from the third party should not be held liable for Section 6695A penalties if he exercised reasonable diligence and good judgment in obtaining, verifying and using such information.

Each appraisal report should stand on its own and be judged independently from all other appraisal reports used or incorporated into any final report that is submitted to the Service for review. For example, in our hypothetical, Appraiser #1 should not be held liable by implication, assuming his report standing alone is accurate and would not otherwise be subject to Section 6695A penalties simply because Appraiser #2's appraisal report (standing on its own and reviewed independently) may be subject to Section 6695A penalties. Put simply, there should be no automatic piggybacking or sharing of liability if multiple appraisals are involved. Such an approach would have a chilling effect on appraiser collaboration.

- **Does the penalty calculation constitute false precision, particularly when different assets have dramatically different valuation variances?**

There is concern about the seemingly arbitrary nature of the penalty calculation. Section 6695A imposes penalties based on valuation misstatements. The section defines a valuation misstatement using fixed percentages. For example: 150 percent over the “correct amount.” Different classes of assets have different valuation variances. Also, commercial real estate has a narrower valuation variance than a hard-to-value asset, such as closely held stock or certain stock options.

The percentage approach to the penalty calculation demands false precision. Although the percentage test is certainly easier for the Service to administer, it does not consider the reality of valuation variances of different asset types.

This same concern is equally valid with respect to IRC Section 6662(g)'s accuracy-related valuation penalties, which effectively subject the taxpayer to strict liability for an estate and gift tax valuation understatement in spite of the valuation variances. However, unlike Section 6695A, Section 6664(c) provides a reasonable cause exception for all accuracy-related penalties under IRC Section 6662(g). Section 6664(c)(1) states that no penalty is imposed with respect to any portion of an underpayment for accuracy-related penalties under Section 6662 (or under Section 6663 relating to fraud penalties) if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith with respect to such portion.

To be consistent, this same reasonable cause exception should apply to Section 6695A penalties. The task force is recommending that this adjustment be made. In the alternative, Section 6695A penalties should be imposed only after the appraiser fails to establish that the appraisal in his reasonable belief was more likely

than not a proper value.

- **Will Section 6695A penalties be imposed after a case has been resolved?**

  The timing of a penalty could have a profound impact on an appraiser's livelihood. Consider the *McCord* case,[3] in which the U.S. Court of Appeals for the Fifth Circuit ultimately found the taxpayer's appraisal to be reasonable. Had a penalty been imposed at the outset of the controversy, the appraiser would have had to shoulder the burden of the penalty while the litigation process took years to complete.

  Consider also the impact of disbarment upon an appraiser's existing clientele. What are the protections for those who have engaged an appraiser before he was disbarred?

  In fairness, Section 6695A penalties should be imposed only after a final resolution of the tax controversy case and all appeal rights have expired. Imposing penalties before such time puts an unreasonable financial burden on appraisers and their clientele.

- **Do the Section 6695A penalty provisions also apply to appraisers relied upon by the government in tax controversy matters?**

  Often, taxpayers and the Service use appraisers whose conclusions regarding value differ dramatically. In fairness, appraisers working for the Service who assert an unreasonably high or low value also should be subjected to Section 6695A penalties. If they aren't, the uneven playing field could encourage appraisers to appraise assets at a value higher or lower simply to provide some cushion in the event of an audit or an unreasonably high or low appraisal being asserted by the government. This inequity would undermine the well-established Revenue Ruling 59?60, which outlines the general approach, methods and factors to be considered in valuing interests in closely held business entities for estate tax and gift tax purposes. Section 6695A penalties should be imposed equally against the government's as well as the taxpayer's appraisers.

- **How can the exception to Section 6695A be implemented when the determination of whether a valuation was “more likely than not a proper value” is made after the Service already has determined a penalty should be imposed?**

Section 6695A has an exception that appears to be completely ineffective. It's difficult to imagine a situation in which a person could establish to the satisfaction of the IRS that the valuation in question “was more likely than not” a “proper value” after the Service is on the record expressing its opinion to the contrary by imposing a penalty. We hope that IRS guidance on Section 6695A will clarify how appraisers might actually avail themselves of the section's exception.

A related issue: a court may have made the final determination of the “correct value” or a taxpayer may have settled with the government without giving an appraiser a chance to make arguments to support his conclusion. In such cases, will the government be forced to litigate the valuation issue a second time so the appraiser may have due process? Alternatively, will the taxpayer's due process be restricted by requiring him to use the original appraiser in the subsequent litigation, just to bring the appraiser into the proceedings?

The reasonable cause exception under Section 6664(c) should apply to Section 6695A penalties. In the alternative, Section 6695A penalties should be imposed only after an appraiser fails to establish that the appraisal in his reasonable belief was more likely than not a proper value.

GUIDANCE NEEDED

The new Section 6695A raises a number of practical problems for appraisers, professionals and anyone else who might be involved in the appraisal process. Significant guidance is needed from the Service so that all have a better understanding of Section 6695A's scope and breadth.

Without such guidance, these new provisions could have a real, negative effect on the appraisal process and those involved in it. Information gathering may take longer and be more difficult because of fear that those providing

information will be drawn into the clutches of the section's penalty provisions. Appraisal costs could increase precipitously, because of appraisers' real or perceived risk. We urge the IRS to act quickly — and judiciously.

Finally, if there is no clear and workable exception provision, the penalty provisions of new Section 6695A will put the taxpayer at a real strategic disadvantage when interacting and negotiating with the Service. We encourage all appraisers and professionals who interact with the Service on these issues to make their concerns about Section 6695A known to the IRS.

Endnotes

1. The Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) (PPA).
2. PPA, PL 109-280, Aug. 17, 2006, Joint Committee on Taxation Report [JCX-38-06].
3. *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006).

GO TO THE SOURCE

This is what IRC Section 6695A now says:

“Substantial and gross valuation misstatements attributable to incorrect appraisals.

“(a) Imposition of penalty. If (1) a person 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 (2) the claimed value of the property on a return or claim for refund which is based on such appraisal results in a substantial valuation misstatement under chapter 1 (within the meaning of section 6662(e)), or a gross valuation misstatement (within the meaning of section 6662(h)), with respect to such property, then such person shall pay a penalty in the amount determined under subsection (b).

“(b) Amount of penalty. The amount of the penalty imposed under subsection (a) on any person with respect to an appraisal shall be equal to the lesser of (1) the greater of (A) 10 percent of the amount of the underpayment (as defined in section 6664(a)) attributable to the misstatement described in subsection (a)(2), or (B) $1,000, or (2) 125 percent of the gross income received by the person described in subsection (a)(1) from the preparation of the appraisal.

“(c) Exception. No penalty shall be imposed under subsection (a) if the person establishes to the satisfaction of the Secretary that the value established in the appraisal was more likely than not the proper value.”

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