



The New IRS Appraiser Penalties Under Code § 6695A

Fair and Balanced or Simply Unworkable?

By William S. Forsberg and Hugh F. Drake

The Pension Protection Act of 2006 (PPA) imposes new penalties under Internal Revenue Code (“Code”) § 6695A for substantial or gross valuation misstatements. Without question, the need for property to be valued properly is critical under our current transfer tax and income tax system. Estate and trust attorneys often must obtain appraisals of property or property interests when making strategic lifetime gifts for clients as well as on a client’s death. Common lifetime gifting strategies that require an appraisal include transfers to grantor retained annuity trusts and transfers to qualified personal residence trusts. Sales of property to grantor trusts, or gifts of family limited partnership interests, also require an appraisal. Asset transfers to certain types of charitable trusts require appraisals for both income and transfer tax purposes.

At death, the executor of an estate must value all assets owned by a decedent for estate tax purposes. Many of these assets require a formal appraisal. Some of these assets are notoriously more difficult to value than others, for example, interests in closely held businesses, whether C or S corporations, limited liability company interests, and partnership interests. Sometimes the business interest requires more than one appraisal—an appraisal of the underlying business asset and a discounted appraisal of the interest transferred. The valuation of a business interest can determine whether a decedent’s estate qualifies for certain tax benefits, such as Code § 6166 installment payment of estate taxes.

William S. Forsberg is a partner in the Minneapolis, Minnesota, firm of Parsinen Kaplan Rosberg & Gotlieb P.A. and the chair of the Business Investment Entities, Partnerships, LLCs and Corporations Committee. Hugh F. Drake is partner in the Springfield, Illinois, firm of Brown, Hay & Stephens LLP and the chair of the Estate Planning and Administration for Business Owners, Farmers and Ranchers Committee.

Given the pervasive need for quality appraisals of property for transfer tax and income tax purposes, the imposition of new penalties on appraisers under the PPA seems counterproductive. Code § 6695A imposes these new penalties not only on appraisers but also on “a[ny] person who prepares an appraisal.” The only way to avoid these new penalties is “if the person who prepared the appraisal can establish to the satisfaction of the Secretary [of the Treasury of the United States] that the value established in the appraisal was more likely than not the proper value.”

The American Bar Association Section of Real Property, Probate and Trust Law has submitted comments to the Internal Revenue Service on the issues surrounding new Code § 6695A. The uncertainties surrounding the new Code section are troubling not only for professional appraisers but for *any* person involved in the appraisal process, including attorneys and CPAs. This article will discuss the questions raised by the task force about new Code § 6695A and provide some insight into the concerns the task force raised regarding the ability of the IRS to implement its provisions fairly and equitably.

New Internal Revenue Code § 6695A

New Code § 6695A reads as follows:

§ 6695A. 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.

Task Force Comments and Recommendations

Will Code § 6695A Apply to Estate and Gift Tax Valuations or Solely to Income Tax Valuations?

Based on the legislative background, the impetus of new Code § 6695A appears to have been the amendments under the PPA to the charitable income tax deduction provisions of Code § 170. Pension Protection Act of 2006, Pub. L. No. 109-280, Aug. 17, 2006, *Joint Committee on Taxation Report [JCX-38-06]*. The amendments to Code § 170 relate to matters like 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 Code § 6695A alleviates the concerns surrounding appraisals of property for charitable contributions for income tax purposes under Code § 170, and in particular certain difficult-to-appraise property such as conservation easements, intangible assets, and possi-

bly closely held stock. The foregoing notwithstanding, section 1219 of the PPA states that it applies to income and estate and gift tax valuations, which includes the elimination of the reasonable cause exception for gross misstatements. The inconsistency between legislative intent (income tax valuations) and the provisions of the PPA (income, estate, and gift tax valuations) needs clarification.

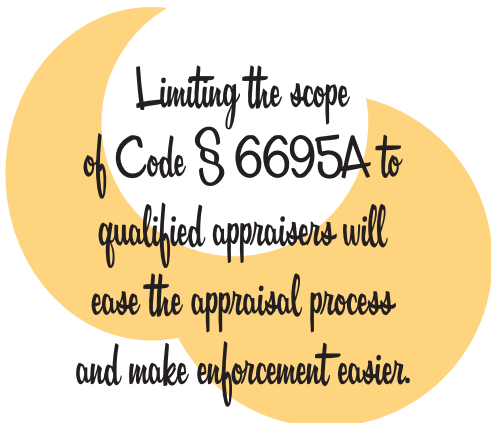
The task force recommends that the provisions of Code § 6695A be limited to qualified appraisals of property prepared for charitable contributions for income tax purposes under Chapter 1 of the Code. The primary focus of the changes to Code §§ 170, 6662, 6664, and 6696, and the enactment of new Code § 6695A under the PPA appears to have been perceived abuses in the valuation of property for income tax purposes, not for estate and gift tax purposes.

What Is the Reach and Scope of the “Any Person” Language of Code § 6695A?

Code § 6695A(b) simply refers to “any person” being subject to the imposition of penalties under subsection (a). Does “any person” only mean a “qualified appraiser” as that term is defined under Code § 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 Code § 7701? Does “person” include someone who is not an appraiser by profession but who 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 in which 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 Code

§ 6695A? What is the “involvement” demarcation line?

The task force recommends that the term “person” as used in Code § 6695A be limited to “qualified appraisers” as defined under Code § 6664 because the term “qualified appraisers” is defined, clear, and unambiguous. The appraisal process involves gathering information from many people. Limiting the scope of Code § 6695A to qualified appraisers will ease the appraisal process and make enforcement easier. Otherwise, third parties will be reluctant to provide information to appraisers for fear of being subject to penalties under Code § 6695A. As written, the scope and reach of the “any person” language in Code § 6695A is unlimited; the section could subject to liability



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even those tangentially involved in the appraisal process.

A related question is what constitutes the preparation of an “appraisal” under Code § 6695A? For example, if a taxpayer simply reports a “best guess” value on a gift or estate tax return, or if a CPA uses a real estate property tax statement value on a gift or estate tax return, or if the taxpayer’s attorney sends a letter to the CPA stating what he or she understands the value of an asset to be, has this person “prepared an appraisal” for purposes of Code § 6695A?

The task force recommends that the term “appraisal” as used in Code § 6695A be limited to “qualified appraisals” as defined under Code § 170 for the same reasons as stated above. By limiting the scope of Code § 6695A to qualified appraisals, third

parties will not be hesitant to assist in the appraisal process and would avoid subjecting themselves to liability simply by playing a relatively minor, albeit necessary, role.

Will Code § 6695A Apply Only to Individual Appraisers in a Firm, the Appraisal Firm as a Whole, or Both?

Code § 6695A does not indicate whether appraiser penalties will apply only to individual appraisers, or whether the actions of an individual appraiser will be imputed to an appraiser’s entire firm. If the actions of an individual appraiser will be imputed to the appraisal firm, will the IRS limit the circumstances during which imputation will occur? And, if so, what are those circumstances? Finally, will the Code § 6695A penalties apply to each appraiser in an appraisal firm who signs off on the appraisal (a review appraiser, for example)?

The task force recommends that the IRS limit applicable penalties of Code § 6695A 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 an appraisal firm. The reach of Code § 6695A should not extend to individual appraisers in the appraisal firm or agents or employees of the opining appraiser or appraisal firm who merely participate in the preparation of the final product, but who do not take ultimate responsibility for the final product. If the firm or individual does not “sign off” on the final appraisal report, Code § 6695A should not penalize those individuals.

To What Extent Will Code § 6695A Come to Bear on Appraisers Relying on Expert Opinions About the Nature of the Property Interest to Be Appraised?

Very often appraisers need to rely on other expert opinions about the nature of the property interest to be appraised. It is unclear how relying on another’s opinion would protect the appraiser from Code § 6695A penalties. 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") for 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 Code § 6695A? What if Appraiser #1 limits the scope of his or her 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 Code § 6695A? Will Appraiser #1 be held equally liable, even though his or her report is solid?

Furthermore, if a lawyer gives an opinion that an interest to be appraised constitutes an assignee interest in a family limited partnership and not a limited partnership interest, may the appraiser rely on that advice and value the assignee interest accordingly? If the IRS challenges the legal characterization of the appraised interest as an assignee interest, it will therefore challenge the overall appraisal of the interest. Would a valuation adjustment as a result of such a re-characterization of the interest by the IRS subject an appraiser to Code § 6695A penalties?

The task force recommends that the IRS impose Code § 6695A penalties only on a targeted but equitable basis, taking into account the realities of the appraisal process. Many times one appraiser must rely on one or more opinions of others. The IRS should not penalize those individuals who provide opinions or other information (for example, lawyers, CPAs, realtors, among others) about the nature or character of a property interest if those individuals are not qualified appraisers. The IRS should only look to the appraisal firm and the opening appraiser who signs the final appraisal report for penalties under Code § 6695A. Also, the appraiser who obtained information from the third party should not be held liable for penalties under Code § 6695A if the appraiser exercised reasonable diligence and good judgment in obtaining, verifying, and using such information.

Each appraisal report should stand on its own. The IRS should judge each appraisal independently from any other appraisal reports used or incorporated into any final appraisal report that is submitted to the IRS for review. For example, in the above example, Appraiser #1 should not be held liable by implication (assuming his or her report standing alone is accurate and would not otherwise be subject to the penalties under Code § 6695A) simply because Appraiser #2's appraisal report (standing on its own and reviewed independently) incurs penalties under



Code § 6695A. The IRS should not automatically "piggyback" or allocate liability among individuals if multiple appraisals are involved. Such an approach would likely have a stultifying effect on appraiser collaboration.

Does the Penalty Calculation Constitute False Precision, Particularly When Different Assets Have Dramatically Different Valuation Variances?

The task force is concerned about the seemingly arbitrary nature of the penalty calculation. Code § 6695A imposes penalties based on valuation misstatements. A valuation misstatement is defined under Code § 6662 using fixed percentages (150% over the "correct amount," for example). Different classes of assets have different valuation variances. For example, 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 authors appreciate that the IRS can administer a percentage test with greater ease, it does not take into consideration the reality of valuation variances of different asset types.

This concern is equally valid for accuracy-related valuation penalties under Code § 6662(g), which effectively subject the taxpayer to strict liability for estate and gift tax valuation understatement in spite of the valuation variances. Unlike Code § 6695A, however, Code § 6664(c) provides a reasonable cause exception for all accuracy-related penalties under Code § 6662(g). Code § 6664(c)(1) states that no penalty is imposed on any portion of an underpayment for accuracy-related penalties under Code § 6662 (or under Code § 6663 relating to fraud penalties) if it is shown that the taxpayer has reasonable cause for such portion and acted in good faith for such portion. To be consistent, the reasonable cause exception under Code § 6664(c) also should apply to Code § 6695A penalties.

The task force recommends that the reasonable cause exception under Code § 6664(c) also should apply to Code § 6695A penalties. In the alternative, the IRS should impose Code § 6695A only after the appraiser fails to establish that the appraisal in his or her reasonable belief was more likely than not a proper value.

Would Penalties Imposed by Code § 6695A Be Imposed Only After Final Resolution of a Tax Controversy Case?

The timing of a penalty could have a profound effect on the livelihood of an appraiser. To illustrate this concern, consider the *McCord* case in which the Fifth Circuit Court of Appeals' decision ultimately found the taxpayer's appraisal reasonable. *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006). The initial *McCord* case involved gifts from 1996. Had a penalty been imposed at the outset of the controversy, the appraiser would have been burdened by the effects of the penalty

while the litigation process took years to complete.

Of course, timing concerns extend beyond the livelihood of the appraiser. One should consider the effect of disbarment on an appraiser's existing clientele. What are the protections for those who have engaged an appraiser before his disbarment?

The task force recommends that the IRS only impose the Code § 6695A penalties after a final resolution of the tax controversy case and only after all appeal rights have expired. Imposing penalties before such time puts an unreasonable financial burden on an appraiser and his or her clientele.

Do the Code § 6695A Penalty Provisions Apply Equally to the Appraisers Relied on by the Government in Tax Controversy Matters?

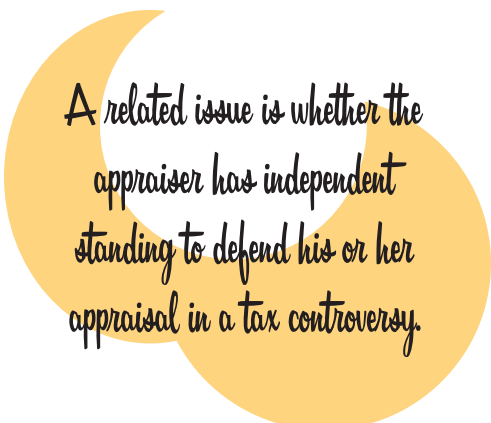
Often, taxpayers and the IRS use appraisers whose conclusions regarding value differ dramatically from each other. In fairness, an IRS appraiser who asserts an unreasonably high or low value should be subjected to penalties as well. The uneven playing field could encourage appraisers to appraise assets at a value higher or lower than what they truly believe, simply to provide some cushion in the event of an audit and an unreasonably high or low appraisal being asserted by the government. This undermines the well-established principles of Rev. Rul. 59-60. The task force recommends that the Code § 6695A penalties, however implemented and determined, should apply equally against government appraisers.

How Can the Exception to Code § 6695A Be Implemented When the Determination of Whether a Valuation Was More Likely Than Not a Proper Value Is Made After the IRS Has Already Determined a Penalty Should Be Imposed?

The exception set out in Code § 6695A appears completely ineffective. The task force had difficulty imagining a situation in which a person could establish to the IRS's satisfaction that the valuation in question "was more likely than not" a "proper value," after the IRS has already expressed its opin-

ion on the valuation by imposing a penalty. It is the authors' hope that guidance on Code § 6695A will clarify how appraisers actually avail themselves of the exception.

A related issue is whether the appraiser has independent standing to defend his or her appraisal in a tax controversy. A court may make a final



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determination of the "correct value," or the taxpayer may settle with the government for reasons of its own, without giving the appraiser the chance to make arguments in support of his or her conclusion. If so, must the government litigate the valuation issue a second time for the appraiser to have due process? Alternatively, will the court restrict the taxpayer's due process rights by requiring him or her to use the original appraiser in the subsequent litigation, just to bring the appraiser into the proceedings?

The task force recommends that the reasonable cause exception under Code § 6664(c) also should apply to Code § 6695A penalties. In the alternative, the IRS should impose Code § 6695A penalties only *after* the appraiser fails to establish that the appraisal in his or her reasonable belief was more likely than not a proper value.

Blacklisting Concerns

Another concern raised by new Code § 6695A is whether the IRS will use it proactively to "blacklist" appraisers under Circular 230. The complications and headaches of Circular 230 are apparently here to stay, as evidenced by the disclaimer language contained in almost every e-mail received by

every lawyer reading this article. Before the enactment of Code § 6695A, Circular 230 permitted blacklisting of appraisers, but only under certain more limited conditions—one being that the appraiser knew that the appraisal would result in an underpayment of tax. Section 10.50(b) of Circular 230 gives the Secretary of the Treasury the authority to "disqualify any appraiser with respect to whom a penalty has been assessed under section 6701(a)" of the Code.

The concern raised by Code § 6695A is that there is no reference to the penalty provisions under Code § 6701(a), thus begging the question whether an appraiser can now be blacklisted by the Secretary of the Treasury for even an unintentional error. Blacklisting has far-reaching business, professional, and practical implications for appraisers. If blacklisted, the appraiser may not present evidence or testimony in an administrative proceeding before the IRS until reinstated, which could possibly end the appraiser's career. The possibility will hang like a Damoclean sword above every valuation controversy.

Conclusion

New Code § 6695A raises a number of practical issues for appraisers, professionals, and others involved in the appraisal process. The IRS needs to issue significant guidance so that all involved have a better understanding of the scope and breadth of new Code § 6695A. Without clear guidance from the IRS, these new provisions will likely have a real negative affect on all those involved. Information-gathering may take longer, if the information is available at all. At the very least, appraisal costs could increase precipitously because of the real or perceived risk that the penalties will apply in every case. Without a clear and workable exception provision, the penalty provisions of new Code § 6695A will put the taxpayer at a real strategic disadvantage when interacting and negotiating with the IRS. The authors of this article encourage those appraisers and professionals who interact with the IRS on appraisal issues to independently raise their concerns with the IRS about new Code § 6695A. ■