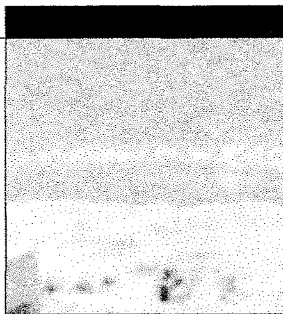

For Appraisers, New Tax Qualification Rules and Special Penalty

Appraisers who perform valuations for federal tax purposes must now operate under several significant professional responsibility constraints, including greater required professional credentials and potential application of monetary penalties.

JOHN A. BOGDANSKI, ATTORNEY

Distraught from watching corporate America thumb its nose at the U.S. tax system, Congress and the IRS have marked the start of the millennium with a number of initiatives seeking to compel taxpayers to clean up their acts. Among these is a battery of new rules and restrictions that seek to rein in the lawyers and accountants who give federal tax advice in the private sector. Tax practitioners now spend a good deal of their time and energy navigating through a maze of statutory and regulatory provisions that impose—on *them*, as distinguished from their clients—serious penalties for what has been branded as unprofessional or unethical conduct. With these rules comes an entire vocabulary: "listed transactions," "reportable transactions," "material advisors," "covered opinions," "reliance opinions," "marketed opinions," "potentially abusive tax shelters," and the like. And arcane rituals of disclosure and disclaimer now characterize even the most mundane communications between tax professionals and their clients.[1]

Recently, Congress decided that corporate transactions are not the only source of tax abuse worth targeting. Now the venerable charitable contribution deduction, claimed by tens of millions of individual taxpayers, has also been chosen for special scrutiny. The ability to deduct the fair market value ("FMV") of property given to charity inevitably leads some taxpayers into temptation to overvalue, and a series of recent statutory changes seeks to eliminate the potential for false claims in that arena. With donated intellectual property and used vehicles, the deductible amounts have essentially been changed to something other than FMV, at least as FMV has traditionally been known.[2] With used clothing and household items of modest value, Congress has invited the IRS to do away with the deduction altogether.[3]

It is not surprising that in this climate, lawmakers' attention has recently turned to the appraisers who opine for taxpayers about the values of property that they give to charity. In the same review, the tax-writing committees also apparently considered valuation advisors in estate and gift tax matters. As a result of this inquiry, in 2006 Congress enacted several measures imposing new requirements on valuation experts in federal tax contexts. Some of these are codifications or modifications of rules that were already in place, but they present several new wrinkles with which valuation experts now have to deal. And there are at least a few new statutory gaps that the legislators have left to the IRS to fill.

JOHN A. BOGDANSKI is a professor of law at Lewis & Clark Law School in Portland, Oregon; author of the treatise *Federal Tax Valuation* (Warren Gorham & Lamont 1996 & Supps.); and editor-in-chief of the bimonthly Warren Gorham & Lamont journal *Valuation Strategies*.

The recent legislative and agency developments on regulation of appraisers merit consideration by any professional engaged in tax planning that involves valuation. Given the ubiquity of issues of valuation in tax matters, that description may include virtually every tax professional in the country.

Appraisals for charitable contributions

Charitable contributions must be "verified," and in many cases "substantiated," to be deductible for income tax purposes.[4] Without proper documentation, the Tax Court has held, the deduction is either unavailable, or limited to the donated asset's tax basis.[5] For more than two decades, Regulations have required that most contributions of property leading to claimed deductions in excess of $5,000 must be accompanied by a "qualified appraisal," which (depending on the deduction's size) must be either summarized on, or attached to, the tax return on which the deduction is claimed.[6] One of the definitional elements of a "qualified appraisal" is that it be performed by a "qualified appraiser"—a term that the Regulations have also defined.[7]

Amendments to the Code in 2004 installed the "qualified appraisal" requirement in the statute, adding Section 170(f)(11). Changes made by the Pension Protection Act of 2006[8] both impose a new quality standard on the experts' work product and add new requirements to the definition of a "qualified appraiser."

Qualified appraisal. New Section 170(f)(11)(E) contains the definition of a "qualified appraisal." The two-part test requires that the appraisal (1) satisfy the tests found in Regulations and other IRS guidance for such documents, and (2) be "conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other [IRS] guidance...."

The reference to "generally accepted appraisal standards" is new, and it is not obvious what Congress intended. The phrase has a nice ring to it, but unlike "generally accepted accounting principles," it does not have a time-honored meaning.

Implementing Regulations have yet to be proposed at this writing, but in Notice 2006-96,[9] the IRS has issued temporary guidance while it seeks to develop more complete rules. According to the Notice, "[a]n appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards... if, for example, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice ('USPAP'), as developed by the Appraisal Standards Board of the Appraisal Foundation."[10] Thus, appraisals that fully comply with USPAP in every respect clearly qualify; those that do not fully comply but are "consistent with the substance and principles of" USPAP also appear to fit the bill. Taxpayers and their advisors are told that these are just examples of valuations that meet the congressional standards, but what might qualify beyond these is not known at present.

Qualified appraiser. To be a "qualified appraisal," a valuation must be performed by a "qualified appraiser."[11] The Code provides that a "qualified appraiser" is an individual who meets all of five requirements. He or she must:

- Have "earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations...."
- Regularly perform appraisals for pay.
- Demonstrate "verifiable education and experience in valuing the type of property subject to the appraisal."
- Not be included on the IRS's appraiser disqualification list

1 For an excellent summary of the current state of the law in this area, see Goldstein and Heuer, "Ethical Disclosure Requirements in Corporate Tax Representation," 33 J. Corp. Tax'n 19 (July/Aug. 2006) (Part I); 33 J. Corp. Tax'n 14 (Sept./Oct. 2006) (Part II); 33 J. Corp. Tax'n 3 (Nov./Dec. 2006) (Part III).

2 See Section 170(f)(12) (vehicles), Section 170(m) (intellectual property).

3 See Section 170(f)(16)(B).

4 See Section 170(a)(1) (second sentence) (verification), Section 170(f)(8)(A) (substantiation of gifts greater than $250 in value), Section 170(f)(11)(D) (substantiation of gifts greater than $500,000 in value), Section 170(f)(12)(A)(i) (substantiation of gifts of used vehicles greater than $500 in value), Section 170(n)(4) (substantiation of certain expenses of Alaskan Eskimo whaling captains); Reg. 1.170A-13(c)(2) (substantiation of gifts greater than $5,000 in value), Reg. 1.170A-13(f) (substantiation of gifts greater than $250 in value).

5 See Todd, 118 TC 334, 347 (2002) (alternative ground for holding that income tax deduction for charitable contribution of stock to private foundation was limited to stock's basis); Hewitt, 109 TC 258, 262 (1997), *aff'd without pub. op.*, 166 F.3d 332, op. at 82 AFTR2d 98-7164 (CA-4, 1998) (IRS conceded deduction up to basis); D'Arcangelo, TCM 1994-572 (held, deduction completely disallowed). Under the 2004 amendments to the Code, however, failure to obtain a required "qualified appraisal" may be excused if the taxpayer shows that the failure to comply "is due to reasonable cause and not to willful neglect." Section 170(f)(11)(A)(ii)(II), discussed *infra*.

6 Reg. 1.170A-13(c)(2). For purposes of applying the $5,000 threshold, "property and all similar items of property donated to 1 or more donees shall be treated as 1 property." Section 170(f)(11)(F); Reg. 1.170A-13(c)(1)(i) (final sentence). A qualified appraisal is now also required in the case of a single item of clothing or a household item with a claimed value greater than $500, if the item is not in good used condition or better. See Section 170(f)(16)(A) through Section 170(f)(16)(C). The appraisal requirement is inapplicable to donations of closely held stock with a claimed value less than $10,000, donations of publicly traded securities, and certain donations of inventory and equipment by widely held C corporations. See Reg. 1.170A-13(c)(2)(ii).

7 See Reg. 1.170A-13(c)(5).

8 Pub. L. No. 109-280, § 1219(c)(1) (8/17/06).

9 2006-46 IRB 902.

10 Notice 2006-96, at § 3.02(2).

11 Section 170(f)(11)(E)(i)(II).

(discussed later) at any time in the three years ending on the date of the appraisal.
- Meet any other requirements that the IRS prescribes in Regulations or other guidance.[12]

In contrast, the pre-existing Regulations required only that the appraiser declare on the appraisal the following:
- That he or she held himself or herself out to the public as an appraiser or regularly performed appraisals.
- That he or she was "qualified" to appraise the subject property by such factors as "background, experience, education, and membership, if any, in professional appraisal associations."
- That he or she did not have an impermissible conflict of interest under specific rules set forth elsewhere in the Regulations.
- That he or she understood the civil penalties and possible disqualification for aiding and abetting a tax understatement by means of "an intentionally false or fraudulent overstatement of the value" of the subject property.[13]

By incorporating the Regulations,[14] the new Code language picks up the requirements of the existing regime, including the required declaration relating to conflict of interest,[15] but it also adds new requirements. Most notably, the statute now requires that the appraiser either have an appraisal designation from a professional organization, or meet alternative education or experience requirements to be spelled out by the IRS.[16] Moreover, the Code now requires "verifiable" education and experience in valuing the specific type of property being appraised.[17]

Notice 2006-96 takes a few small steps toward fleshing out the new requirements. As for the requirement of a professional designation or education and experience, the Notice states that a designation must be "awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed."[18]

Absent the professional designation, the Notice says that the alternative education and experience requirements are met if, in the case of an appraisal of real estate, "the appraiser is licensed or certified for the type of property being appraised in the state in which the appraised real property is located."[19] Because there are no uniform standards for state licensing, this provision will likely result in differing levels of expertise being able to qualify, depending on the locale.

In the case of property other than real estate, the alternative requirements are met if the appraiser has done each of three things:
- Successfully completed "college or professional-level coursework that is relevant to the property being valued."
- Gained at least two years' experience "in the trade or business of buying, selling, or valuing the type of property being valued."
- Fully described his or her relevant education and experience in the appraisal.[20]

By treating buying or selling experience as the equivalent of valuation experience, and by focusing on education that relates merely to the property rather than to its valuation, the alternative test for personal property seems—in some respects—easier to satisfy than the professional designation requirement. The test does, however, specify minimum quantities of both education and experience that the Regulations did not contain. Hence, some respected valuation experts who have decades of experience but no classroom training will be unable to meet the alternative test. Indeed, query whether "coursework" is even available for some types of property, such as collectibles. Pending further guidance from the IRS, appraisers without such formal training must have a professional designation in order to be a "qualified appraiser."

Turning to the additional statutory requirement that the appraiser demonstrate verifiable education and experience in valuing the relevant type of property, the Notice takes a relaxed stance. It states that this requirement will be met if the appraiser merely "makes a declaration in the appraisal that, because of the appraiser's background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued."[21] Although Notice 2006-96 appears to set up a self-

[12] Section 170(f)(11)(E)(ii)-Section 170(f)(11)(E)(iii).

[13] Reg. 1.170A-13(c)(5).

[14] Section 170(f)(11)(E)(ii)(III). The IRS's transitional Notice confirms that appraisals made under the new rules must also comply with all the requirements of the pre-existing Regulations (except to the extent that they are inconsistent with Section 170(f)(11)). Notice 2006-96, at § 3.04(1).

[15] The conflict-of-interest rules provide that an appraiser is not qualified if he or she is the taxpayer, the donee, a related person to either of the foregoing, one of their employees, a captive appraiser of either, or a person from whom the donor acquired the property (unless the purchase was recent and the claimed value does not exceed the acquisition price). See Reg. 1.170A-13(c)(5)(iv). The Regulations also disqualify an appraisal if the donor had reason to expect that the appraiser would falsify it, such as where an inflated value is agreed to between the donor and the appraiser in advance. See Reg. 1.170A-13(c)(5)(ii). Further, the Regulations prohibit most appraisals in which the appraiser's fee is effectively based on a percentage of the value that the appraisal sets, or on a percentage of the value finally determined for tax purposes. See Reg. 1.170A-13(c)(6).

[16] Section 170(f)(11)(E)(ii)(I).

[17] Section 170(f)(11)(E)(iii)(I).

[18] Notice 2006-96, at § 3.03(1).

[19] *Id.* at § 3.03(3)(a)(ii).

[20] *Id.* at § 3.03(3)(b)(ii).

[21] *Id.* at § 3.03(2). The Notice also cross-references Reg. 1.170A-13(c)(5), the required appraiser's declaration under the pre-existing Regulations, discussed earlier.

certification system on this issue, it does use the conjunction "and" in describing the credentials that can lead to satisfying the requirement. Must the appraiser state that he or she has all the listed attributes, including formal education and association membership? Or will some lesser combination do, so long as it adds up to sufficient "qualification" to perform an adequate job? In another loose end, the Notice does not expressly state whether the declaration it describes is the only way in which the statutory requirement can be met.

The Notice further provides that in addition to the representations required in the pre-existing Regulations, the appraiser must declare that he or she understands that "a substantial or gross valuation misstatement" resulting from his or her appraisal may subject the appraiser to the new appraiser penalty under Section 6695A (discussed later).[22] This is similar to the declaration required under the pre-existing Regulations,[23] but it adds the new penalty to the old.

Exception. At least the new Code provision provides a possible escape hatch for taxpayers who fail to meet its rigorous requirements. The denial of the deduction is inapplicable "if it is shown that the failure to meet such requirements is due to reasonable cause and not to willful neglect."[24] Prior to 2004, no such exception appears to have been available.

Although a taxpayer fitting within this exception will not have his or her charitable contribution deduction automatically disqualified, query whether the taxpayer will succeed in having the claimed value of the property upheld. As an evidentiary matter, appraisals by qualified experts, prepared contemporaneously with the charitable transfers, are typically the best available evidence of the donated property. Without a timely, professional valuation, a taxpayer's case for his or her claimed value may be too weak to be sustained against an IRS challenge.

Analysis. The statutory revisions firm up the general principle that an appraiser valuing property for charitable deduction purposes must be trained and experienced. They specify that except to the extent that the IRS provides alternative methods of qualification, a professional designation from an appraisal association is a necessity. Moreover, the appraiser must have "verifiable education and experience" in valuing the type of asset at issue, and must regularly perform appraisals for financial compensation. No longer will a vague representation by the appraiser, that he or she is qualified, suffice.

One open issue in which some branches of the appraisal industry will be keenly interested is the question of how broadly a "type of property" is defined. For example, are all works of fine art of the same "type"? Are all collectibles? Can all art works and all collectibles be considered a single "type" of property? Are commercial buildings, residential properties, and vacant land all of the same "type"? Are ownership interests and lenders' interests alike? Interests in operating companies and interests in investment entities? Given the new rules' emphasis on professional designation, education, and experience in valuing the specific "type of property" at issue in a given appraisal,

[22] Notice 2006-96, at § 3.04(2).

[23] Reg. 1.170A-13(c)(5)(i)(D); see Section 6695A, discussed *infra*.

[24] Section 170(f)(11)(A)(ii)(II). Exceptions are also provided for donations of cash, publicly traded securities, inventory, intellectual property, and used vehicles where the taxpayer has complied with the special rules applicable to such donations. See Section 170(f)(11)(A)(ii)(I).

BEACo
Business Enterprise Appraisal Company, Inc.

Business & Real Property Valuations

Specializing in Valuations for Estate & Gift Tax

- FLP & LLC Interest Discounts
- Fractional Interest in Real Property
- Litigation Support
- Stockholder & Partnership Disagreements
- Corporate Planning
- Appraisals for Form 706 Filings
- Buy-Sell Agreements
- Profit Sharing Plans
- ESOPS

Robert M. Weinstock JD, CBA
Business Enterprise Appraisal Company, Inc.
23801 Calabasas Road, Suite 1016
Calabasas, CA 91302
(800) 928-7463
www.beaco.com

this will be a critical question in many cases.

Looking ahead. So far, the requirement of a "qualified appraisal" and the concept of a "qualified appraiser" are applicable only under the income tax, and only in certain contexts under that tax.[25] One wonders, though, how long these rules will remain confined to such a relatively narrow scope. If no major administrative problems arise under the new rules, one might look for Congress to extend their application to other tax settings in the future. Why, it might be asked, should a "qualified appraisal" not be required for valuation of significant items of property for other income tax purposes, or under the wealth transfer taxes?[26]

New appraiser penalty

For nearly 25 years now, any overly aggressive appraisers in the federal tax field have risked subjecting themselves to a civil penalty under Section 6701. This penalty applies to anyone "who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document,... who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and... who knows that such portion (if so used) would result in an understatement of the liability for tax of another person."[27] The penalty is $1,000, or $10,000 if the matter relates to the tax of a corporation.[28]

Finding this an insufficient disincentive for inflated appraisals, Congress (in the 2006 changes) has now added a tougher, appraiser-specific penalty in Section 6695A. Under this section, a civil penalty is imposed for preparing an appraisal that results in a sizable misstatement of the value of property for tax purposes. Specifically, the penalty applies to any person who "knows, or reasonably should have known" that an appraisal that he or she prepared would be used in connection with a tax return or refund claim, if the value claimed on the return or refund request in reliance on the appraisal results in either of two specified types of "valuation misstatements."[29] The amount of the new penalty may run much higher than that of the penalty under Section 6701, which also remains in effect. Section 6696 indicates that the two penalties may both be applied in the same case.[30]

Conduct subject to penalty. The categories of valuation errors that give rise to the new penalty are "substantial valuation misstatements" under the income tax, within the meaning of Section 6662(e); and "gross valuation misstatements" within the meaning of Section 6662(h).[31] A "substantial valuation misstatement" generally occurs under the income tax if the claimed value of the property is 150% or more of the value that is ultimately determined to be correct.[32] (Special rules apply in transfer pricing cases under Section 482.[33]) A "gross valuation misstatement," on the other hand, can occur under either the income tax or the wealth transfer taxes. In an income tax case, it occurs (transfer pricing cases aside) if the claimed value of the property is 200% or more of the value ultimately determined to be correct.[34] In a wealth transfer tax case, a gross valuation misstatement occurs if the claimed value is 40% or less of the value ultimately determined to be correct.[35]

Amount of penalty. The new appraiser penalty can be fairly steep. Its size depends in part on the tax owed on account of the faulty valuation, and in part on the fee charged for the appraisal. The penalty is the *lesser* of (1) 10% of the underpaid tax attributable to the valuation misstatement, or $1,000, whichever is greater; or (2) 125% of the gross income received by the appraiser for preparation of the appraisal.[36]

Example 1. Appraiser A prepares an appraisal that A knows will be used to support an income tax deduction for a charitable contribution of the subject property. A charges $6,000 for the appraisal. The appraisal values the property at $1 million, resulting in an income

[25] See Reg. 1.468B-3(b) ("qualified appraisal" required to support loss or deduction claimed with respect to transfer of specified types of property to a "qualified settlement fund," established to resolve tort litigation), Reg. 1.664-1(a)(7)(i) ("qualified appraisal" may help a trust to qualify as a charitable remainder trust).

[26] Of course, incorporation of a "qualified appraisal" requirement into the wealth transfer tax system is unlikely to occur while the future of those taxes remains in doubt. See Section 2210.

[27] Section 6701(a)(1)-Section 6701(a)(3).

[28] See Section 6701(b)(1)-Section 6701(b)(2). For general discussion, see Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 114.8.3 (2006). An appraiser might also be held liable for the penalty under Section 6700 for promoting an abusive tax shelter by making a "gross valuation overstatement as to any material matter." See Section 6700(a)(2)(B); Bittker and Lokken, at ¶ 114.8.2. Moreover, willfully aiding and abetting preparation of a fraudulent tax return is a felony. Section 7206(2); see Saltzman, *IRS Practice and Procedure* ¶ 7A.04 (2006).

[29] See Section 6695A(a).

[30] See Section 6696(a) (penalties under Section 6694-Section 6695A are "in addition to any other penalties provided by law").

[31] See Section 6695A(a)(2).

[32] See Section 6662(e)(1)(A). This threshold was lowered (from 200%) in the same round of Code changes that included the new appraiser penalty.

[33] See Section 6662(e)(1)(B).

[34] Section 6662(h)(2)(A). This threshold was lowered (from 400%) in the same round of Code changes that included the new appraiser penalty. As to income tax matters, there appears to be overlap between "substantial" and "gross" valuation misstatements, both of which trigger the appraiser penalty. In the estate and gift tax context, only "gross" misstatements can trigger the penalty.

[35] Section 6662(h)(2)(C). This standard was tightened (from 25%) in the same round of Code changes that included the new appraiser penalty.

[36] See Section 6695A(b).

tax benefit from the deduction of $300,000. The correct value is $600,000, resulting in an income tax benefit from the deduction of $180,000. The penalty applies because the claimed value of $1 million is more than 150% of the correct value of $600,000 (i.e., $900,000). The penalty against A is $7,500 (125% of the $6,000 fee), because this is less than 10% of the tax underpayment (10% of $120,000, or $12,000).

Example 2. The facts are the same as in Example 1, except that A charges $50,000 for the appraisal. The penalty against A is $12,000 (10% of the tax understatement of $120,000), because this amount is less than 125% of the $50,000 fee (i.e., $62,500).

Example 3. Appraiser B prepares an appraisal that B knows will be used to support an income tax deduction for a charitable contribution of the subject property. B charges $1,000 for the appraisal. The appraisal values the property at $10,000, resulting in an income tax benefit of $1,500. The correct value is $5,000, resulting in an income tax benefit of $750. The penalty applies because the claimed value of $10,000 is more than 150% of the correct value of $5,000 (i.e., $7,500). The penalty against B is $1,000, because this amount is (1) greater than 10% of the tax understatement of $750 (i.e., $75), and (2) less than 125% of the $1,000 fee (i.e., $1,250).

Analysis. Under the new penalty, it does not appear to matter whether the taxpayer who employed the appraiser is actually penalized under Section 6662. Indeed, it does not even appear to matter whether the taxpayer *could be* penalized. For example, in some cases, under Section 6664(c), the taxpayer penalty under Section 6662 is inapplicable "if it is shown that there was a reasonable cause for [the tax underpayment] and that the taxpayer acted in good faith with respect to" the matter in question.[37] Nothing in the new penalty under Section 6695A lets the appraiser off the hook simply because the taxpayer qualifies for this exception.

Nor does the appraiser's state of mind as to the correctness of his or her work appear to matter. In contrast to the aiding and abetting penalty of Section 6701, Section 6695A does not require that the appraiser know that the appraisal is incorrect. By its terms, the new penalty can apply where the appraiser was not even negligent. If the appraisal turns out to be wrong by the specified margins, and if the appraiser knows (or reasonably should have known) that it will be used to support a tax return or refund claim, the penalty appears to apply.

Interestingly, the penalty is a one-way street. It applies only to appraisers hired by taxpayers, and not to those who work on behalf of the IRS. Congress has taken steps to require taxpayers' valuation experts to avoid outlandish positions, but it seems to have left government experts free to adopt grossly erroneous positions with no exposure to monetary penalty. One wonders whether that imbalance will result in unfairness to taxpayers in valuation controversies with the IRS.

Exception. The only express exception, in Section 6695A(c), is that the penalty will not apply if the appraiser "establishes to the satisfaction of the [IRS] that the value established in the appraisal was more likely than not the proper value." Because the penalty applies only in the case of highly erroneous valuations—more than 150%, or less than 40%, of the correct values—it seems unlikely that appraisers will be able to demonstrate this exception to the government's satisfaction. How can a value that is so far from the correct amount have been "more likely than not" correct?

Open issues. It is not clear from the statute when the appraiser penalty might be asserted. Will the IRS wait until the underlying valuation issue is finally resolved as between the taxpayer and the government before proposing to penalize the appraiser? Until the final determination of the correct value of the property at issue, the applicability and amount of the penalty under Section 6695A cannot be known.

[37] Section 6664(c)(1). To fit within this exception in the case of certain charitable contribution deductions under the income tax, the taxpayer must show that the claimed value was based on a "qualified appraisal," as defined in the rules discussed earlier, and that the taxpayer additionally "made a good faith investigation of the value...." Section 6664(c)(2); Reg. 1.6664-4(h)(1).

OFFSHORE SPECIALISTS
LEGAL OFFSHORE SOLUTIONS
ASSET PROTECTION & WEALTH PRESERVATION
STRUCTURES FOR ESTATE PLANNERS
TRUSTS · TAX SHELTERS
FOUNDATIONS
COMPANY FORMATION
TRUST FORMATION & ADMINISTRATION
INTERNET ACCOUNT MANAGEMENT
WORLDWIDE INVESTING
GLOBAL BANKING
Custom planning, guidance & counsel from a trusted source. Our thorough knowledge of offshore practices & instruments, priceless.
"Call us to learn how the legal use of offshore wealth preservation strategies may be safely incorporated into almost all estate planning."
800.315.4269
RED SEA MANAGEMENT ltd.
San Jose, Costa Rica
THE MOST TRUSTED NAME IN OFFSHORE SERVICES
~ Members ~
ITPA—International Tax Planners Ass'n
APOI—Asia Pacific Offshore Institute
Costa Rican Chamber of Commerce
redseamanagement.com/EP

Unlike the penalty provisions applicable to tax return preparers, which generally give the IRS three years from the filing of the erroneous tax return or refund claim to assess the penalty, Section 6695A appears to be unbridled by any statute of limitations at all.[38] This could conceivably lead to an appraiser's receiving an unpleasant surprise with respect to a matter that he or she has forgotten. As tax practitioners know, federal tax valuation disputes can drag on for many years, particularly if the taxpayer agrees to extend the period of time for assessment of the tax. Picture an appraiser whom the taxpayer hired many years ago in connection with preparation of a tax return, but who did not participate in the taxpayer's lengthy valuation dispute with the IRS. If the IRS waits until after the underlying valuation issues are finally resolved before pursuing a penalty against the appraiser, or even notifying the appraiser of the potential for a penalty, the appraiser could be required to begin preparing his or her defense based on facts that occurred long ago.

Another question is to what extent, if any, a final determination of the value of property in a dispute between the taxpayer and the IRS will be binding on the appraiser for purposes of the Section 6695A penalty. Will the appraiser be given an opportunity, independent from that afforded the taxpayer, to contest the IRS's assertion of the correct value of the property? Will the answer depend on how active the appraiser was in the controversy between the taxpayer and the IRS? Will IRS appeals officers or courts be required to hear the valuation case twice—once for purposes of determining the proper underlying tax (and applicability of taxpayer penalties), and again for purposes of determining applicability of appraiser penalties? Should the two cases be joined? What if the taxpayer and the appraiser are no longer on good terms, or the taxpayer is unwilling to pay the appraiser for additional services beyond the original appraisal report? The dynamics of the assessment of the appraiser penalty in particular cases promise to be engrossing.

Expansion of appraiser disqualification

Although wearing of the scarlet letter "A" is not yet required by the federal tax laws, the IRS—at the urging of Congress—has for many years had on its books a formal disqualification process for wayward appraisers. As part of the statute giving the IRS the power to regulate practice before the agency, Congress in 1984 authorized the IRS to disqualify from federal tax administrative proceedings any appraiser against whom the civil penalty under Section 6701(a) had been assessed for knowingly aiding and abetting an understatement of tax.[39] The IRS acts in such matters through its Office of Professional Responsibility ("OPR"), which generally regulates representation of taxpayers before the agency under its Regulations, known as Circular 230.[40] However, to this author's knowledge, the IRS has never used its authority to disqualify an appraiser.

The 2006 changes to the Code have broadened the disqualification authority in one important respect: They have removed the requirement that a Section 6701(a) penalty be assessed against an appraiser before he or she is barred from appraising property for federal tax purposes.[41] Although the general thrust of the change is obvious—Congress is suggesting that the IRS toughen up—the deletion of the reference to the penalty leaves the statute curiously devoid of any description of the kinds of acts and omissions that should give rise to discipline by the IRS against an appraiser.

Perhaps Congress meant to say that the substantive grounds for disqualification should remain the same—knowingly aiding and abetting an understatement of tax—but that actual assessment of a civil penalty for such conduct should not be a prerequisite to discipline. On the other hand, perhaps Congress intended to open the door for the OPR to prescribe a new code of appraiser conduct, which could conceivably punish such matters as incompetence, disreputable conduct, or conflict of interest. Published reports have suggested that an interim notice is in the works that will require appraisers only to (1) follow standards similar to USPAP; (2) comply with all other laws, regulations, and procedures applicable to them; and (3) not tie their compensation to their appraisals' conclusions.[42]

Effects of disqualification. While the valuation communities await announcement of the proposed transitional criteria for discipline, a review of the overall regulatory scheme—long established under prior law—may be useful. The statute provides that disqualified appraisers are barred from pre-

[38] See Section 6696(d)(1) (three-year limitations period for penalties under Sections 6694 and 6695; no mention of Section 6695A). The appraiser penalty is not subject to the deficiency procedures of the Code; thus, it appears that appraisers may not contest it in Tax Court before paying it, but instead must pay it on the IRS's demand and seek a refund. See Section 6696(b).

[39] See 31 U.S.C. § 330(c).

[40] See 31 C.F.R. Part 10, § § 10.50-10.93. The OPR was formerly known as the Office of the Director of Practice. See IRS News Release IR-2003-3 (1/8/03).

[41] Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(d) (8/17/06).

[42] See Joyce, "OPR to Establish Standards for Appraisers; Interim Notice to Be Followed by Regulations," Daily Tax Report, p. G-13 (3/12/07).

senting evidence or testimony before the IRS or the Treasury Department in any administrative proceeding, and their appraisals have no probative effect in any such proceeding.[43] The Regulations stress that while disqualified, an appraiser may not testify or otherwise give evidence before the IRS, even if the testimony or other evidence relates to appraisals completed by the offender prior to the disqualification.[44]

Presumably, the disqualification would bar the appraiser from testifying even about appraisals that he or she performed prior to the behavior that gave rise to the disqualification, and even if the appraiser was disciplined in connection with work for an entirely different taxpayer from the one in the present proceeding. Moreover, any appraisal prepared after the date of the author's disqualification will have no probative effect in any administrative proceeding before the IRS or Treasury, nor will it satisfy the "qualified appraisal" requirement for large charitable contribution deductions under the income tax.[45] But it will be considered for the sole purpose of determining the taxpayer's reliance in good faith on the appraisal, presumably for purposes of determining whether penalties should apply to the taxpayer.[46]

These sanctions contain important lessons for appraisers, but they are also crucial for taxpayers and their advisors who employ appraisers in connection with planning transactions or preparing returns. Taxpayers and advisors in such settings should be careful to hire only an appraiser who is known to be so skilled and scrupulous as to avoid any violation of Section 6695A or Section 6701, or any other emerging ethical norm, in connection with that or any other taxpayer. For if the appraiser is later disqualified, he or she will be unavailable to defend his or her work in any examination of the taxpayer by, or appeal within, the IRS.[47]

Procedure. Before defrocking an appraiser, the enabling statute requires that the IRS provide "notice and an opportunity for a hearing."[48] The Regulations generally provide the same procedures for a disciplinary action against an appraiser as they do for a disciplinary action against a tax practitioner.[49] The OPR files a complaint against the appraiser, and the case is heard by an administrative law judge.[50] The Regulations do not enumerate which issues are relevant in such a proceeding. Under prior law, the only germane issue seemed to be whether the penalty was indeed assessed against the appraiser in question; a trial *de novo* on the issue of aiding and abetting did not seem called for. Under the new law, it may well turn out that factual inquiry into the appraiser's conduct and state of mind may be necessary; the scope of the procedures may depend largely on what the substantive criteria for disqualification turn out to be.

In any event, the decision of the administrative law judge is appealable by either the appraiser or the OPR to a delegate of the Secretary of the Treasury, who makes the final decision on the disqualification.[51] If the final decision is to disqualify, the OPR may reinstate the offending appraiser after five years following the date of the disqualification.[52] According to the Regulations, such reinstatement will not occur unless the OPR is "satisfied" that the appraiser is not likely to reoffend, "and that granting such reinstatement would not be contrary to the public interest."[53] And as was discussed earlier, an appraisal performed by an appraiser who was disqualified at any time in the three years ending on the date of the appraisal does not satisfy the "qualified appraisal" requirement for large charitable contribution deductions under the income tax.[54] Accordingly, even after reinstatement, an appraiser must wait three years before performing appraisals for that purpose.

To avoid a formal disqualification proceeding, an appraiser may, under the Regulations, consent to a "voluntary" disqualification, which the OPR may accept or reject.[55] Even before Congress explicitly authorized the appraiser disqualification list, the IRS apparently obtained at least one such "voluntary" disqualification, reported in a Tax Court case involving the disqualified appraiser's former client.[56] The appraisals done by the disqualified individual were not used in the Tax Court case. Because the taxpayer "had never heard anything derogatory about" the appraiser, however, the appraisals might have showed the

[43] See 31 U.S.C. § § 330(c)(1)-330(c)(2).

[44] 31 C.F.R. Part 10, § 10.50(b)(1).

[45] See Section 170(f)(11)(E)(iii)(II), discussed *supra*.

[46] 31 C.F.R. Part 10, § 10.50(b)(2) (second sentence).

[47] Whether a disqualified appraiser might be able to testify in the U.S. Tax Court is an interesting question. Cases before the Tax Court appear to constitute judicial, rather than administrative, proceedings. However, query whether a disqualified appraiser appearing on behalf of a taxpayer or the IRS could survive a challenge by the opposing party under Daubert v. Merrill Dow Pharmaceuticals, Inc., 509 U.S. 579 (S.Ct., 1993).

[48] 31 U.S.C. § 330(c).

[49] See 31 C.F.R. Part 10, § § 10.60-10.82.

[50] See 31 C.F.R. Part 10, § § 10.60(b), 10.62, 10.70.

[51] See 31 C.F.R. Part 10, § § 10.77-10.78. At last report, the appeal function was delegated to an official in the IRS Office of Chief Counsel. See Tandon, "Circular 230 Rewrite Planned, Says Korb," 111 Tax Notes 1206 (6/12/06).

[52] 31 C.F.R. Part 10, § 10.81.

[53] *Id.* (second sentence).

[54] See Section 170(f)(11)(E)(iii)(II).

[55] 31 C.F.R. Part 10, § 10.61(c).

[56] Biagiotti, TCM 1986-460, at 2117.

Practice Notes

It is not clear from the statute when the appraiser penalty might be asserted. Will the IRS wait until the underlying valuation issue is finally resolved as between the taxpayer and the government before proposing to penalize the appraiser?

taxpayer's good faith and reasonableness, if they had been at issue.[57]

Appraisers as tax 'practitioners,' or worse

While valuation professionals ponder the new world into which they have been thrust, some of them should be careful not to overlook the possibility that they may be covered by the main body of Circular 230, which much more heavily regulates tax "practitioners." Appraisers who are also certified public accountants could conceivably be covered by all of Circular 230, even if they do only appraisal work for their clients, as Circular 230 defines a "practitioner" to include all certified public accountants, and defines "practice before the IRS" to "comprehend... all matters connected with a presentation to the [IRS] or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under" the tax laws.[58]

There is even an outside chance that an appraiser could be a "material advisor" for purposes of the tax shelter disclosure and list maintenance rules. These Code provisions require that the details of "reportable transactions" (i.e., transactions of a type found by the IRS to have "a potential for tax avoidance or evasion"[59]) be reported to the IRS by any "material advisor" to the transactions.[60] Moreover, "material advisors" must maintain lists of their clients who engaged in the transactions, along with other information about the activity, for potential additional disclosure to the IRS.[61] The penalties for failure to comply with these rules are severe, with amounts running into hundreds of thousands of dollars.[62]

A "material advisor" is defined as anyone "who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out" the transaction.[63] This definition certainly seems broad enough to pick up some valuation professionals who participate in tax shelter activity. However, to fall into this group, an advisor must directly or indirectly earn a fee of more than $50,000 ($250,000 if substantially all the tax benefits are not enjoyed by individuals)[64] and make a "tax statement" to any of a large group of participants in the transaction, including taxpayers.[65] A "tax statement" is defined by the Regulations as "any statement, written or oral, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction...."[66]

Could an appraiser cross that line? Certainly it would be an unusual case, but stranger things have happened. Modern appraisal reports often contain summaries of various laws, including tax laws, on which the valuation expert is basing part of his or her opinion. It is not beyond the realm of possibility that some such summaries could be seen as "tax statements." If the valuation assignment is a highly lucrative one, the appraiser might then be seen as a "material advisor." Given the high stakes involved, this is a label that appraisers will wish to avoid at all costs.

Conclusion

Over the past three decades, large segments of the appraisal industry have evolved from an unstudied trade to a sophisticated profession. With the new polish and prestige, however, has come new responsibility.

Appraisers who labor in the federal tax vineyard must now operate under several significant professional responsibility constraints. They will not be permitted to value big-ticket items for purposes of charitable contribution deductions unless they can demonstrate a set of professional credentials, specific to the type of property being donated, greater than what may previously have been thought necessary. In many different types of federal tax matters, appraisals that are found to reach highly inaccurate conclusions will subject those who prepare them to substantial monetary penalties—in some cases, forfeiture of the appraiser's entire fee, and then some. And valuation professionals must now pay close attention to the pronouncements of the IRS disciplinary office, which has been given greatly enhanced authority to set standards of appraiser conduct, and to bar from appearing before the IRS those appraisers who fail to live up to such standards.

The new rules affecting appraisers are nowhere near as elaborate or restrictive as those that apply to traditional tax practitioners, such as lawyers and accountants. Nevertheless, if the experience of the latter groups is any indication of the likely trend, the appraisal community can expect the regulatory regime over valuation work to continue to expand. Rules of limited interest today may blossom into matters of greater importance a few years down the road. ■

[57] *Id.*
[58] 31 C.F.R. Part 10, § § 10.2(b)-10.2(e).
[59] See Section 6707A(c)(1); Reg. 1.6011-4(b).
[60] See Section 6111.
[61] See Section 6112.
[62] See Section 6707-Section 6708.
[63] See Section 6111(b)(1)(A)(i).
[64] See Section 6111(b)(1)(A)(ii), Section 6111(b)(1)(B).
[65] See Reg. 301.6112-1(c)(2).
[66] See Reg. 301.6112-1(c)(2)(iii)(A).