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PROPOSED CHANGES TO ENSURE APPROPRIATE SAFEGUARDS FOR IMPOSITION OF APPRAISER PENALTIES UNDER IRC § 6695A

This proposal was prepared by Avram Salkin, Robert S. Horwitz and Gary Markarian.[1] The authors wish to thank the members of the California Lawyers Association Taxation Section Executive Committee whose exceptional efforts allow for this opportunity and Michael Desmond and Robin Klomparens for their valuable insights and comments.[2]

Contact Persons: Robert S. Horwitz
rhorwitz@taxlitigator.com
Gary Markarian
markarian@taxlitigator.com
Avram Salkin
salkin@taxlitigator.com

Hochman Salkin Toscher Perez, P.C.
9100 Wilshire Blvd., Suite 900W
Beverly Hills, CA 90212
310-281-3200

[1] The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the California Lawyers Association.

[2] Although the authors, presenters and/or reviewers of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

EXECUTIVE SUMMARY

Section 6695A of the Code[3] imposes a monetary penalty on an appraiser who knows or reasonably should know that an appraisal they prepared would be used in connection with a return or refund claim if the value claimed on the return or refund claim is based on that appraisal and results in a substantial valuation understatement as defined in Section 6662(e), a substantial estate or gift tax valuation understatement as defined in Section 6662(g), or a gross valuation misstatement as defined in Section 6662(h). Under Section 6695A(c), no penalty is imposed if the appraiser "establishes to the satisfaction of the Secretary that the value established in the appraisal was more likely than not the proper value." The penalty is "assessable," meaning that an appraiser has no right to pre-payment judicial review.

The sole defense to an asserted penalty (other than that the appraiser did not know and had no reason to know the appraisal would be used in connection with a tax return or refund claim) is to prove to the Secretary's satisfaction that the value in the appraisal "was more likely than not the proper value." Accordingly, Section 6695A imposes liability on an appraiser regardless of whether the appraisal was a reasonable determination of value or whether proper methodologies were used.

Additionally, the statute does not state when the determination of whether there has been a substantial or gross valuation misstatement is to be made by the Internal Revenue Service ("Service"). However, the Internal Revenue Manual para. 20.1.12.3 states that the penalty against an appraiser will not be proposed until the examination of the return or claim for refund to which it relates (the "related tax examination") is completed at the group level and that the appraiser penalty case can proceed when the related tax examination case is closed agreed, closed no response after default, is in Appeals or is in Tax Court. Normally, the penalty will not be assessed if the related tax examination case is in Appeals or in Tax Court unless no more than 180 days is left on the Section 6695A statute of limitations. Thus, the penalty can be assessed against an appraiser even if there has been no final resolution of the related tax examination case.

We propose that Section 6695A be amended to provide that the penalty will not be imposed if the appraiser can establish either a) that there was no substantial or gross valuation misstatement on the return or claim for refund to which it relates or b) that there was reasonable cause for the valuation in the appraisal. We further propose that Section 6695A be amended to provide that the determination with respect to a return or claim for refund will be deemed made when a deficiency is assessed against the taxpayer with respect to the return and, with respect to a refund claim, after there is final action on the claim (including a decision by a court of competent jurisdiction). We finally propose that the statute of limitations on assessment of the penalty be the later of three years after the underlying return or claim for

[3] References to "Section" are to the Internal Revenue Code of 1986, as amended (the "Code").

refund was filed or six months after the determination with respect to the related tax examination return is final.

DISCUSSION

I. BACKGROUND

A. Introduction

Approximately 200 sections of the Code require a determination of fair market value and approximately 400 additional Code sections use the term "value."[4] As a result, the valuation of property and property interests plays an integral role in determining the correct liability of a taxpayer for income tax, estate and gift tax, employment tax and various excise taxes. Disputes between the Service and taxpayers over the correct value of property have been a consistent feature of our tax system.[5] What Judge Laro wrote over twenty years ago remains true today:

> Disputes over valuation fill our dockets, and for good reason. We approximate that 243 sections of the Code require fair market value estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue. It is no mystery, therefore, why valuation cases are ubiquitous. Today, valuation is a highly sophisticated process. We cannot realistically expect that litigants will, will be able to, or will want to, settle, rather than litigate, their valuation controversies if the law relating to valuation is vague or unclear. [6]

By the late 1970s, the use of inflated valuations to support tax deductions was a feature of a number of abusive tax avoidance schemes. One such scheme involved donating works of art to Section 501(c)(3) charitable organizations and claiming charitable contribution deductions based on valuations the Service considered grossly inflated.[7] As part of the Deficit

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[4] Based on a Checkpoint search of the Code using the terms "fair market value" and "value."

[5] See, e.g., *Appeal of the Hotel de France, Co*., 1 B.T.A. 28 (1924) (value of a leasehold interest for purposes of determining the "deduction for the annual exhaustion of a leasehold" for the years 1918, 1919, 1920 and 1921); *Appeal of Campbell,* 1 B.T.A. 441 (1925) (determining that the value of goodwill received by the taxpayer upon his withdrawal from a partnership was a return of capital and not income); *Appeal of the Surviving Executors of the Estate of Jacob Fish*, *Deceased*, 1 B.T.A. 882 (1925) (correct method of valuing stock of a closely held corporation for estate tax purposes; the Board determined the value was $10 per share more than the amount determined by the Commissioner).

[6] *Estate of Auker v. Commissioner*, TC Memo 1998-185.

[7] See *United States v Brigham Young University*, 679 F.2d 1345 (10th Cir. 1982) (reversing district court order denying enforcement of John Doe summons issued to Brigham Young University for the names of donors who gave gifts in kind other than securities); see also *United States v. Philatelic Leasing, Inc.*, 794 F.2d 781 (2d Cir. 1986) (injunction granted

Reduction Act of 1984 (the "DRA"),[8] Congress authorized the Secretary to issue regulations requiring taxpayers to obtain qualified appraisals if they claimed a deduction under Section 170 exceeding $5,000 for in-kind contributions of property, other than publicly traded securities.[9] The DRA also amended 31 U.S.C. sec. 330 to allow the Secretary to determine that appraisals by an appraiser against whom a Section 6701 penalty (aiding and abetting understatement of tax liability) has been assessed would have no probative value before the Service and to bar such appraisers from presenting evidence or testifying in any federal tax proceeding.[10]

In response to the legislative change to 31 U.S.C sec. 330, in 1985 the Service revised Circular 230, which was retitled "Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service." Section 10.77 of the revised Circular 230 included rules for disqualifying an appraiser against whom a Section 6701 penalty had been assessed.[11] It has been reported that in the subsequent twenty years, the Office of Professional Responsibility did not bar any appraiser from practicing before the IRS.[12] We could find no reported decisions involving the assessment of a Section 6701 penalty against an appraiser and, prior to 2019, no reported decisions involving an action under Section 7408 to enjoin an appraiser.[13]

B. The Pension Protection Act of 2006 Adds Sec. 6695A to the Code

On August 17, 2006, President George W. Bush signed into law H.R. 4., The Pension Protection Act of 2006 ("the PPA").[14] Title XII of the PPA, entitled "Provisions Relating to Exempt Organizations," included provisions relating to appraisers and the substantial or gross overstatement of property valuations.[15] The PPA lowered the threshold for imposing accuracy

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against shelter promoters who used grossly inflated valuations to support deductions claimed for leasing philatelic plates).

[8] Pub. L. No. 98-369, 98 Stat. 494.

[9] Pub. L. No. 98-369, §155.

[10] Pub. L. No. 98-369, §156.

[11] The 1994 revision of Circular 230 is available online at https://www.irs.gov/pub/irs-prior/pcir230--1994.pdf.

[12] Woolbert, "IRS Turns the Heat on Bad Appraisals and Appraisers," 2007 *J. Bus. Valuation* 193, 195.

[13] We could find only two reported decisions involving an action to enjoin an appraiser involved in an abuse shelter: *United States v. Tarpey*, 124 AFTR2d 2019-6574, prior proceedings at 123 AFTR 3d 2019-1138 (D. Mont. 2019) and *United States v. Zak*, 124 AFTR2d 2019-6993 (ND Ga. 2019). Neither decision has been officially reported.

[14] Pub. L. No. 109-280,

[15] *Id.* §1219.

related penalties on a taxpayer due to a substantial[16] or gross valuation understatement[17] for estate and gift tax and for a substantial[18] or gross valuation misstatement[19] for income tax. It also eliminated the reasonable cause defense to accuracy-related penalties under Section 6662 if there is a gross valuation misstatement.[20]

Under the DRA amendment to 31 U.S.C. sec. 330, disciplinary action could not be taken against an appraiser by the IRS Office of Professional Responsibility absent the assessment of a penalty under Section 6701. The PPA eliminated the need for that assessment before disciplinary action under Circular 230 could be taken. Under the amendment, disciplinary action can be taken after notice and a hearing.[21]

The PPA also enacted the Section 6695A penalty applicable to persons who prepare appraisals used in connection with a tax return or claim for refund.[22] Section 6695A provides for the imposition of a 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)), a substantial estate or gift tax valuation misstatement (within the meaning of section 6662(g)), or a gross valuation misstatement (within the meaning of section 6662(h)), with respect to such property. [23]

The amount of the appraiser penalty under Section 6695A is computed by reference to

[16] Section §1219(a)(1)(B) of the PPA changed the threshold for a substantial estate and gift tax understatement under IRC §6662(g) from 50% or less of the amount determined to be correct to 65% or less.
[17] Section 1219(a)(2)(B) of the PPA changed the threshold for a gross estate and gift tax understatement under §6662(h) from 25% or less of the amount determined to be correct to 40% or less.
[18] Section 1219(a)(1)(A) of the PPA changed the threshold for a substantial income tax misstatement under §6662(e) from 200% or more of the amount determined to be correct to 150% or more.
[19]Section 1219(a)(2)(A) of the PPA changed the threshold for a gross valuation misstatement under Section 6662(h) from 400% or more of the amount determined to be correct to 200% or more.
[20]Section 1219(a)(3) of the PPA amended Section 6664(c)(3) to eliminate the reasonable cause defense for gross valuation misstatements.
[21] Pub. L No. 109-280, §1219(e)(2).
[22] Pub. L. No. 109-280, §1219(b)(1).
[23] 26 U.S.C. § 6695A(a).

the valuation misstatement on the relevant return or claim for refund and is equal to the lesser of (1) the greater of: (A) 10% of the underpayment attributable to the misstatement, or (B) $1,000, or (2) 125% of the gross income received by the person who prepared the appraisal.[24] The only exception to imposition of the penalty is 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."[25] The PPA also amended the procedural rules applicable to penalties under Sections 6694 and 6695 to make them applicable to Section 6695A penalties as well.[26]

C. IRS Formal Guidance on the Sec. 6695A Penalty

On October 19, 2006, the IRS issued Notice 2006-96, "Guidance Regarding Appraisal Requirements for Noncash Charitable Contributions."[27] The preamble to the Notice states that it "also provides guidance on complying with new section 6695A" and that it "provides transitional guidance relating to … new section 6695A of the Code regarding substantial or gross valuation misstatements…."[28] The Notice provides transitional guidance on the meaning of "qualified appraiser" and "qualified appraisal" under Section 170(f)(11).[29] The sole reference in the Notice to Section 6695A concerns the reporting and substantiation requirements of Treas. Reg. sec. 1.170A-13(c) and states:

> For returns filed after February 16, 2007, the declaration required under §1.170A-13(c)(5)(i) must include an additional statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund, may subject the appraiser to a civil penalty under §6695A. See also §1.170A-13(c)(3)(iii).[30]

Several comments submitted on the Notice addressed concerns with the Section 6695A penalty. One comment stated that the "historic" percentage test set forth in the accuracy-

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[24] 26 U.S.C. § 6695A(b).
[25] 26 U.S.C. § 6695A(c).
[26] 26 U.S.C. §6696(a)-(e). At the time the PPA was enacted, Section 6696 defined return and claim for refund to mean returns and refund claims with respect to a tax imposed under subtitle I. The IRS therefore took the position that there was no period of limitation for assessing a Section 6695A penalty with respect to an estate or gift tax return or refund claim. See IRS AM 2007-017 (Nov. 9, 2007). The 2007 Small Business and Work Opportunity Tax Act, Pub. L. No. 110-28, codified at 26 U.S.C. §8246(a)(2)(H) amended the definition of return and claim for refund in Section 6696 to include returns and refund claims for any tax imposed under the Internal Revenue Code.
[27] 2006-2 C.B. 902.
[28] *Id.*
[29] Notice 2006-96, §3.01-3.03.
[30] Notice 2006-96, §3.01-3.04(a).

related penalty provisions of Section 6662 for determining whether there has been a valuation misstatement may well be appropriate for real property appraisals (where market data on comparable properties are generally available and, where the facts, circumstances and assumptions about the nature and value of real property are finite and well understood). However, this type of certitude rarely applies to many types of business appraisals.[31]

This comment further noted that the "more likely than not" exception to the penalty is ambiguous and that there is no guidance on what the term means or how an appraiser would prove that the appraisal falls within the exception.[32] The comment recommended that Treasury and the Service recognize that percentage differentials may not be appropriate for all appraisals and provide relief through the exception provision. It further recommended that the phrase "more likely than not the proper value" should be "premised on the approaches to value established in the Uniform Standards of Professional Appraisal Practice" and its interpretation.[33]

A second comment submitted in response to Notice 2006-96 discussed the "false precision" of the term "valuation misstatement," noting that commercial real estate has "a narrower valuation variance than hard to value assets, such as closely held stock or certain stock options."[34] The comment recommended that the reasonable cause exception of Section 6664(c) apply to the Section 6695A penalty and that the penalty only be imposed after the appraiser "fails to establish that the appraisal in his or her reasonable belief was more likely than not a proper value."[35] The comment also discussed, among other things, the impact that the timing of a penalty determination by the Service could have upon the appraiser's livelihood and recommended that the penalty only be imposed after final resolution of any proposed adjustment to the underlying tax return or final action on the underlying refund claim, including expiration of all appeal rights."[36]

A third comment submitted in response to the Notice noted that values of certain types of property can fluctuate frequently. At auctions it is not uncommon for the final bid price to be more than two times the pre-sale estimate. To illustrate this, the comment noted that the sale of the replica of the Starship Enterprise used in the motion picture "Star Trek: The Next Generation." Pre-sale estimates ranged between $25,000 and $35,000 while the winning bid

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[31] "Comments Submitted by American Society of Appraisers, Leslie Miles President, Jay Fishman, Chair, January 11, 2007" at p. 9 (referred to hereafter as "Miles and Fishman").
[32] Miles and Fishman at 9.
[33] Miles and Fishman at 9, 10.
[34] American Bar Association Section of Real Property, Probate and Trust Law, "Comments on Internal Revenue Code Sec. 6695A," February 14, 2007, at 5 (hereafter "ABA Comments").
[35] ABA Comments at 6.
[36] ABA Comments at 6.

was $576,000.[37] The comment recommended that either the statutory exception be amended to provide that it applies if it is established that the appraisal "was determined in good faith by the appraiser on the date of the appraisal."[38] Alternately, the comment suggested that the Service should create a safe-harbor exception for art objects and collectibles where the appraiser could establish that they acted in good faith and that in making the valuation judgment, they exercised due diligence, examined comparable sales records, the provenance of the object, its quality and rarity, and the frequency with which items of the type come to market.[39]

Although the comments on the Notice indicated the need for guidance from the Service on the applicability of the penalty and the interpretation of the phrase "more likely than not the proper value," no regulations have been proposed and no other guidance has been published in the Internal Revenue Bulletin concerning the application of the Section 6695A penalty.

D. Informal Guidance

Aside from a handful of Chief Counsel Advice Memoranda,[40] the only guidance on how the Service will interpret and administer the Section 6695A penalty is the Internal Revenue Manual ("IRM").[41]

The IRM states that if the value claimed on the return or refund claim results in a substantial or gross valuation misstatement or understatement, "the examiner or attorney

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[37] "Comments on Notice 2006-96 Guidance Regarding Appraisal Requirements for Noncash Charitable Contributions and Requested Technical Corrections to the Pension Protection Act of 2006" submitted by Bjorkland on behalf of Christie's Appraisals, Inc., 2007 WL 2729957 at *7-10 (hereafter "CAI Comments").
[38] CAI Comments at 8.
[39] CAI Comments at 10.
[40] To date, eight Chief Counsel Advice Memoranda have been issued that mention the Section 6695A penalty: two note that an Appeals' Power Point presentation has a slide on the penalty (CCA 20102038, CCA 200950037); three note that the penalty can be assessed against a person who prepares an appraisal that substantially or grossly misstates the value of a façade easement (CCA 200947053, CCA 200943033, CCA 200738013); one states that AM 2007-17 is no longer correct in light of the amendment making the three year statute of limitations applicable to appraisals prepared in connection with all returns and refund claims (CCA 201123034); one notes that information gathered in an estate tax examination can be disclosed to a person under examination for a Section 6695A penalty, "but only if the estate tax return information directly relates to a determination under section 6695A" (CCA201214025); and one refers to Section 6695A only in passing (CCA201514008).
[41] Chief Counsel Advice cannot be used or cited as precedent. See, https://www.irs.gov/privacy-disclosure/legal-advice-issued-by-associate-chief-counsel. Similarly, the "Internal Revenue Manual does not have the force of law and does not confer rights on taxpayers." *Fargo v. Commissioner*, 447 F.3d 796, 713 (9th Cir. 2006).

should open an IRC 6695A penalty case."[42] The Service appraiser or valuation specialist who assists in the examination is to recommend the penalty to the examiner or attorney if the valuation issues meet the threshold of a substantial or gross misstatement.[43] The assertion of the penalty is the responsibility of the examiner or attorney, who is to conduct the penalty examination as a separate and distinct case from the related tax examination.[44] The penalty normally should not be proposed until the related tax examination is completed at the group level.[45] If the statute of limitations for asserting the appraiser penalty will expire within 180 days and the examination of the underlying return is not complete, the penalty case file should be worked, or a statute extension should be obtained so a protective assessment can be made if needed.[46]

During the penalty exam, the examiner or attorney should contact the appraiser to schedule an audit appointment.[47] The purpose of this meeting is to "gather sufficient facts to determine whether the appraiser can establish the value in the appraisal meets the 'more likely than not' exception."[48] If the appraiser cannot establish that the "more likely than not" exception applies, "the examiner or attorney must propose an IRC 6695A penalty."[49]

While the focus of a Section 6695A penalty examination is on whether the more likely than not exception applies, the IRM provisions do not discuss how to apply the exception or what factors are to be considered in making the determination. The examiner is directed to consult with IRS Counsel on the "more likely than not" determination.[50]

Examining agents and attorneys are advised to exercise discretion in referring persons to the Office of Professional Responsibility against whom an appraisal penalty is asserted and that such a referral should be made only if there is a "pattern of conduct that is subject to IRC 6695A penalty" or a "willful violation of IRC 6695A."[51]

Prior to January 22, 2020, the IRM provided for a "primary review appraiser" to review the work of the examination appraiser if a Section 6695A penalty was recommended. If the primary review appraiser determined that the penalty should not be asserted, and the manager disagreed with the primary review appraiser, a secondary review appraiser would review the

[42] IRM 20.1.12.3 (Oct. 6, 2021).
[43] IRM 20.1.12.7 (Oct. 6, 2021).
[44] IRM 20.1.12.3 (Oct. 6, 2021).
[45] *Id*.
[46] *Id*.
[47] IRM 20.1.12.6(6) (Oct. 6, 2021).
[48] *Id*.
[49] IRM 20.1.12.6(8) (Oct. 6, 2021).
[50] IRM 20.1.12.3 (Oct. 6, 2021).
[51] IRM 20.1.12.7 (1) (Oct. 6, 2021).

work of the examination appraiser.[52] A memorandum issued January 22, 2020, by the Commissioner, Large Business and International Division, and the Commissioner, Small Business and Self-Employed Division, and effective that date, eliminated the provision for multi-tiered review of a proposed Section 6695A penalty.[53] Whether the penalty will be proposed is now solely left up to the examiner and the examination appraiser/valuation specialist, subject to managerial approval.[54]

E. Court Decisions

A person against whom a Section 6695A penalty has been assessed has no pre-assessment right to judicial review. Generally, the Service has exercised its discretion to provide an opportunity for Independent Office of Appeals review post-assessment but prepayment.[55] Aside from filing for bankruptcy, an appraiser can only obtain judicial review by paying the penalty, filing a claim for refund and, if the claim is denied or not acted upon within six months, filing a suit for refund in District Court or the Court of Federal Claims.

We have not found any reported court decisions involving the Section 6695A penalty, but there are 3 unreported decisions. In *United States v. Zak*,[56] the Government brought an action to enjoin defendants who it alleged participated in a "highly structured – and abusive – tax scheme involving the syndication of conservation easement donations." The complaint alleged that one of the defendants, Ms. Zak, "assisted in appraising the conservation easements" by helping make the highest and best use determination. Count II sought to enjoin Ms. Zak and another defendant on the ground that they engaged in conduct violative of Sec. 6695A. Ms. Zak moved to dismiss Count II, asserting that Sec. 6695A applies only to a person who prepares an appraisal, not to a person who merely assists in the preparation. Reading the complaint as a whole, the district court noted that it contained detailed allegations about another defendant's appraisal activities, including that he was an appraiser who knowingly provided appraisals that overvalued the easements, while similar allegations were not made against Ms. Zak, whose role was described as "a conservation manager, consultant, and project manager" whose duties included hiring an appraiser and assisting in the highest and best use determination and who sometimes "reviewed" the statements provided by appraisers. The district court granted Ms. Zak's motion to dismiss Count II, finding that the complaint "fails to

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[52] IRM 20.1.12.7.4 (Dec. 18, 2017).
[53] Interim Guidance Memorandum LB&I-20-0120-001, available online at https://www.irs.gov/pub/foia/ig/lmsb/lbi-20-0120-0001.pdf.
[54] As a penalty under the Internal Revenue Code, Section 6751(b) requires the initial determination of a Section 6695A penalty to be personally approved in writing by the immediate supervisor of the individual making such determination. See, *Roth v. Commissioner,* 922 F.3d 1126, 1133 (10th Cir. 2019).
[55] IRM 20.1.12.10 (Dec. 18, 2017).
[56] 124 AFTR3d 2019-6993 (N.D. Ga 2019).

state adequate specific factual allegations to support its conclusory claim that Zak is an 'appraiser' per 26 U.S.C. § 6695A."

In *Benson v. Internal Revenue Service*, [57] a group of appraisers filed a proposed class action complaint involving the Service's investigation of syndicated conservation easement transactions. The plaintiffs, who represented themselves and the proposed class, were comprised of appraisers who had received letters regarding Section 6695A penalties. They argued that the Service improperly used Section 6695A to "effectually eliminate § 170(h) donations by intimidating those qualified appraisers who work in the nexus of the donation valuation into no longer doing appraisals which might be used for § 170(h) deductions." They further argued that the penalties would put "almost any appraiser out of business."

The government filed a motion to dismiss on six grounds, but the Court focused on the final ground that "Plaintiffs failed to timely serve the defendants and failed to properly serve one of the individually named defendants." The Court did not consider the plaintiff's legal arguments and dismissed the case for failure to properly serve all defendants.

Excelsior Aggregates, LLC v. Commissioner,[58] focuses on the requirement of supervisory approval for Section 6662(h) penalties in a conservation easement case. The case does not focus on Section 6695A penalties, but the court does mention that the appraiser involved in the case had overvalued the easement at issue and 11 other easements in cases involving the same Tax Matters Partner. The Service asserted Section 6695A penalties for all 12 of the appraisals for a total of $150,000.

II. SECTION 6695A FAILS TO PROVIDE APPROPRIATE SAFEGUARDS FOR PERSONS WHO PREPARE APPRAISALS

A. Current State of the Law

Unlike many other civil penalty provisions, there is no scienter requirement for the Section 6695A penalty to apply beyond knowing or having reason to know that the appraisal would be used in connection with a tax return or refund claim. There is no requirement that the person acted fraudulently, as with the Section 6663 penalty, willfully, as with the Section 6672 trust fund recovery penalty, or acted negligently or without reasonable cause, as required by the failure to pay, failure to file, accuracy-related and fraud penalties, among others.[59] A person who is the subject of a Section 6695A investigation will be assessed a penalty if the

[57] Case No. 2:21-CV-00074-SCJ, 2022 WL 2347366 (N.D. Ga. June 6, 2022).
[58] T.C. Memo. 2021-125.
[59] See, 26 U.S.C. §6651(a)(1) (failure to file return penalty) 26 U.S.C. §6651(a)(2), (3) (failure to pay tax penalties); 26 U.S.C. §6664(c) (reasonable cause exception to accuracy-related and fraud penalties).

Service determines that there was a substantial or gross valuation misstatement that resulted from the use of an appraisal the person prepared. The person's only defense is to demonstrate that the valuation set forth in the appraisal was "more likely than not" the "proper value." Because the statute of limitations on assessing the Section 6695A penalty is three years from the date of the filing of the return or refund claim with respect to which the appraisal was used, absent the person who prepared the appraisal agreeing to an extension of the statute of limitations on assessment, the Service may be required to assess the penalty before the completion of Appeals Office review or judicial proceedings or even the examination of the underlying tax return or claim for refund, if any of these is ongoing immediately prior to the expiration of the penalty statute of limitations.[60]

B. The Failure to Provide a Reasonable Cause Defense Works an Injustice

Many penalties contained in the Code provide an exception where the taxpayer had reasonable cause. These include, among others, (a) foreign information reporting penalties under Sections 6038A, 6038B, 6038C, 6038D, 6039F, 6039G, and 6677; (a) failure to file or pay penalties under Sections 6651, 6652, 6656, 6657, 6679, 6686, and 6698; (b) accuracy-related and fraud penalties under Sections 6662 and 6663; penalties for filing an erroneous claim for refund or credit (Section 6676); penalties with respect to excise tax liabilities (Section 6684); and return preparer penalties under Sections 6694 and 6695.

Reasonable cause, for purposes of penalties, is defined as the exercise of "ordinary business care and prudence."[61] Whether there was reasonable cause is based upon all pertinent facts and circumstances in the case.[62] A return preparer generally will not be liable for a return preparer penalty if he relied "in good faith without verification upon information furnished by the taxpayer."[63] That an appraiser had reasonable cause and acted in good faith is not, however, a defense to a Section 6695A penalty.

The Section 6695A penalty was enacted in response to concerns that taxpayers were claiming excessive tax deductions for in-kind donations of property to charities. It was meant to combat perceived abuses by appraisers. The appraisal process is not, however, an exact science but merely an opinion of value. It requires the appraiser to use his or her best informed

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[60] IRM 20.1.12.3(4) (Dec. 18, 2017) states that generally the appraiser penalty will not be proposed prior to completion of the related tax examination at the group level, but cautions: "If the statute of limitation on the IRC 6695A penalty will expire within 180 days, then the penalty case file should be worked, or a statute extension should be obtained so that a protective assessment can be made if needed."
[61] Treas. Reg. Section 301.6651-1(c)(1).
[62] *Id.*; Treas. Reg. Section 1.6664-4(b); Treas. Reg. Section 1.6694-2(e) (listing factors to be considered in determining if a return preparer had reasonable cause).
[63] Treas. Reg. Section 1.6694-1(e).

judgment and apply accepted methodologies to arrive at an opinion of value. The failure to allow the person against whom the Section 6695A penalty is assessed to avoid the penalty upon a showing of reasonable cause is an injustice and can result in appraisers fearing to provide their honest professional opinion if they believe that the IRS may challenge the value reached in the appraisal. This will, in turn, limit the pool of qualified appraisers whose work is a critical component of hundreds of different Code provisions, putting proper administration of those provisions at risk and driving up compliance costs.

A determination by the Service that an appraiser is subject to the Section 6695A penalty has repercussions that go far beyond the amount assessed. First, it can result in disciplinary proceedings before the Office of Professional Responsibility that can lead to the appraiser not being able to provide appraisals or present testimony in any proceeding before the Service. Even where the appraiser is not disciplined, the fact that he or she has been assessed an appraisal penalty can adversely impact the appraiser's ability to obtain clients and could lead to an appraiser who is employed by a third-party, such as a valuation company, losing his or her employment.

Below are seven scenarios where an appraiser could be liable for a Section 6695A penalty even though the appraiser performed appropriate due diligence, use accepted appraisal methodology and reached an informed opinion as to value.

- In scenario one, for estate tax purposes, an appraiser values a piece of commercial real estate subject to non-recourse debt. The amount of the debt on the decedent's date of death is $43 million. The appraiser uses the cost, market and income approaches to value and arrives at an opinion that the fair market value of the property is $50 million. The Service's appraiser values the property at $55 million. The difference in the values is only 10%. The instructions for the estate tax return (Form 706) state that where property of the estate is subject to debt for which the decedent's estate is not liable "include in the gross estate only the value of redemption (or the value of the property less the amount of the debt)." The estate tax return therefore reports the value of the property as $7 million (the amount by which the appraised value of $50 million exceeds the debt) while the Service determines it is $12 million. Because the value of the property reported on the estate tax return is 58 1/3% of the value determined by the Service, the Service could arguably assert that the appraiser is subject to a sec. 6695A penalty.

- In scenario two, an appraiser is retained to value the decedent's minority interest in a closely held business. The appraiser, applying proper methodology, arrives at a going concern value for the business of $50 million ($120 million of assets minus $70 million of debt) and the value of the decedent's 10% fractional interest, without discount, of $5 million. Applying total discounts of 30% for lack of control and lack of marketability,

the appraiser opines that the date of death value of the decedent's interest was $3.5 million ($5 million x 0.7). The Service's appraiser valued the assets of the business at $140 million, or 16% more than the estate's appraiser, and arrives at a going concern value of the business of $70 million, or 40% more than the estate's appraiser. Applying total discounts of 15%, the Service's appraiser determines that the value of the decedent's fractional interest is $5.95 million, or 70% more than the value arrived at by the estate's appraiser. Even though the Service's appraiser believes that the estate's appraiser used standard methodologies and that the estate's appraiser arrived at a reasonable albeit erroneous conclusion, the estate's appraiser is subject to the Section 6695A penalty.

- Scenario three involves an appraiser's use of tax affecting. Many business valuation specialist believe that tax-affecting is an appropriate way to value a business conducted through a pass-through entity, such as an S corporation or a partnership.[64] The Service, in a Job Aid for its valuation specialists,[65] stated that entity level taxes should not be applied in valuing an S corporation absent "compelling evidence" that a third-party in negotiating the purchase of an S corporation would take entity level tax into account.

  In this scenario, a taxpayer gifts a 10% fractional interest in a pass-through entity. The taxpayer's appraiser uses tax affecting to determine the value under the discounted cash flow method. The Service's valuation specialist does not tax affect. Both the taxpayer's appraiser and the Service's valuation specialist give most weight to the income approach, using the discounted cash flow method. The taxpayer's expert concludes the value of the interest on the date of the gift was $3.8 million; the Service's valuation specialist concludes it was worth $6.25 million. The main reason for the difference in valuations is the use of tax affecting. The Service determines that the value reported on the taxpayer's gift tax return is a substantial estate and gift tax valuation understatement, subjecting the appraiser to the Section 6695A penalty.

- In scenario four, a venture capitalist has made a multi-million loan to a high-tech start-up. Start-ups are highly speculative and often difficult to value. Fearful that the startup

[64] Sellers and Fanon, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle,* Business Valuation Resources, April 2015; see also *Estate of Jackson v. Commissioner*, T.C. Memo 2021-48 (rejecting the use of tax affecting to value the decedent's interest in pass-through entities); *Estate of Jones v. Commissioner*, T.C. Memo 2019-101 (discussing tax affecting in the valuation of an S corporation and adopting the valuation of petitioner's expert, who tax affected).

[65] *Valuation of Non-Controlling Interests in Electing S Corporations--A Job Aid for IRS Valuation Analysts*, available online at https://www.irs.gov/pub/irs-utl/S%20Corporation%20Valuation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf.

might not be able to repay the loan in full, a business valuation specialist with extensive experience in valuing high tech startups is retained to value the start-up so the venture capitalist can determine whether he can write off the debt on his tax return. The valuation specialist determines that while the start-up had value at the beginning of the tax year, it became worthless during the year. The venture capitalist writes off part of the loan on her tax return. The Service's valuation specialist, with only limited experience in valuing start-ups, determines that the start-up became worthless several years prior to the year in which the bad debt deduction was taken. Although the taxpayer's business valuation specialist used accepted methodology and is a recognized expert in valuing high-tech start-ups, he is subject to the Section 6695A penalty.

Art works are often difficult to value with any degree of accuracy and there is great volatility in valuing works of art, as is seen by the fact that the sales price at auction can be several times greater, or only a fraction of, the amount that the auction house anticipated the work would sell for.

- In scenario five, the taxpayer owns a painting widely attributed to Ferdinand Leger, an early cubist and forerunner of pop art. A painting of Leger's, Study for "La Femme en Blue," sold at auction for $39,241,000.[66] The taxpayer's painting is smaller than the Study for "La Femme en Blue." The taxpayer hires a highly respected art appraiser who specializes in early twentieth century French art to appraise the painting for purposes of the taxpayer's donation of the work to the Los Angeles County Museum of Art. The appraiser does due diligence, including investigating the prices at which works by Leger and his contemporaries have recently sold, determines that the canvas is a genuine Leger, and concludes that the fair market value of the painting is $11 million. The appraiser signs a Form 8283, which the taxpayer attaches to his return. Because there had been several art experts who questioned whether the work was a genuine Leger, an IRS appraiser determines that, due to the questions, the work is worth $1 million. The taxpayer's appraiser is subject to a penalty under Section 6695A.

- In scenario six, the same taxpayer gifts the same Leger painting to a museum and claims an $11 million charitable contribution deduction based on the appraisal discussed in scenario five. There is no question as to the work being a genuine Leger. Eight months after the donation, a Leger painting of comparable size and from the same period in the artist's life, comes up for auction. While pre-auction estimates of value ranged from $10 million to $13 million, the painting sells for $7 million. The IRS appraiser determines that the value of the painting donated by the taxpayer was $7.5

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[66] See https://www.sothebys.com/en/auctions/ecatalogue/2008/impressionist-modern-art-evening-sale-n08437/lot.16.html.

million on the date of donation. The appraiser is subject to a Section 6695A penalty.

- In scenario seven, an appraiser is retained to value a commercial property that is subject to a twenty-year lease with options to renew to a retail store. The lease is triple net and calls for base rent plus a percentage. A management company managed the property for the decedent. The appraiser relies on financial information from the management company in his income approach to value. Since the property is commercial rental property subject to a twenty-year lease with renewal options, the appraiser gives most weight to the income approach. The estate uses the value arrived at by the appraiser on its estate tax return. During the audit, the estate discovers that the management company had been skimming part of the percentage rent, which led to the estate tax return undervaluing the property. The IRS arrives at its value based on the rents actually paid, not those reported by the management company. Had the estate's appraiser used the actual rent paid by the tenant, his value would have been within 5% of that arrived at by the IRS. Instead, his appraisal results in a substantial valuation misstatement. He is therefore subject to a Section 6695A penalty.

C. Persons Subject to the Sec. 6695A Penalty Should Have the Right to Challenge the Service's Underlying Determination of a Substantial or Gross Valuation Misstatement

There is only one statutory defense to a Section 6695A penalty: the person against whom the penalty is proposed or assessed is not liable if he or she can establish "to the satisfaction of the Secretary that the value established in the appraisal was more likely than not the proper value." Since this determination is left to the Secretary, the Secretary's determination can only be reviewed for abuse of discretion. Section 6695A does not provide for the person to defend against the penalty by establishing that any valuation misstatement on the underlying return was not substantial or gross.

While it may be rational to deprive the person of the right to challenge whether there was a substantial or gross valuation misstatement where there has been a final judicial determination in a deficiency or refund proceeding brought by the taxpayer, in many instances a taxpayer may decide not to seek judicial review of the IRS's deficiency determination or decision to deny a refund claim. A taxpayer may consent to assessment of the deficiency determined by Exam. A taxpayer may negotiate a settlement with the Independent Office of Appeals. A taxpayer may default the notice of deficiency. In each of these cases, there will be no judicial determination that the appraisal resulted in a substantial or gross valuation misstatement.

Unlike Section 6694(d), which provides that a return preparer penalty will be abated and any payment toward the penalty refunded if there is a final administrative or judicial

determination that there was no understatement, Section 6695A does not provide for the abatement and refund of a penalty if there is a final administrative or judicial determination that there was no substantial or gross valuation misstatement.

A review of recent Tax Court decisions shows that the Service's determinations of value are frequently off the mark.[67] To deprive the person against whom a Section 6695A penalty is asserted or assessed of the right to challenge the Secretary's determination that there was a substantial or gross valuation misstatement deprives that person of appropriate procedural safeguards and could have unintended consequences that undermine effective tax administration. We therefore propose that Section 6695A be amended to add that a person will not be liable for a penalty if he or she can establish (1) that there the value determined in the appraisal was not a substantial or gross misstatement of value or (2) in reaching the valuation, he or she exercised due diligence, applied accepted appraisal methodologies, and had reasonable cause for the valuation. We also propose that Section 6695A be amended to provide for the abatement of any penalty, and the refund of any amount paid toward such a penalty, if there is a final administrative or judicial determination that there was no gross or substantial valuation misstatement.

D. The Service Should Be Prohibited from Assessing a Section 6695A Penalty Until the Underlying Valuation Determination Becomes Final

Currently, the Service can assess a Section 6695A at any time within three years of the filing of the return or refund claim. While the Service will normally not make the determination until the examination of the taxpayer's return is completed at the group level, it may do so if 180 days or less remain on the statute of limitations for assessing the Section 6695A penalty. As a result, a person who is assessed the penalty can have his or her professional reputation damaged prior to a final determination being made. We therefore propose that the Service be prohibited from assessing the Section 6695A penalty until there is a final determination as to whether there was a substantial or gross valuation misstatement and that the time for assessment be extended until 6 months after the final determination.

III. PROPOSED CHANGE TO SECTIONS 6695A AND 6696

To accord appropriate safeguards for persons whom the Service asserts are liable for a

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[67] See *Estate of Jackson v. Commissioner*, T.C. Memo 2021-48 (the IRS's initial valuation expert valued Michael Jackson's image and likeness at $434,261,895, its trial expert valued image and likeness at $161,307,045; the Tax Court determined the value as $4,153,912); *Estate of Jones v. Commissioner*, T.C. Memo 2019-101 (IRS expert valued units of partnership gifted by the decedent at $2,530 per unit and the value of a noncontrolling interest in a corporation gifted by decedent at $140,398,000; the taxpayer's expert valued the same assets at $380 per unit and $21,000,000; the Tax Court adopted the valuations of the estate's expert).

Section 6695A penalty, we propose that Section 6695A be amended so that subsection (c) reads as follows:

No penalty shall be imposed under subsection (a) if the person:

1) Establishes that, in preparing the appraisal, the person acted in good faith and exercised ordinary business care and prudence;
2) Establishes that the determination of the Secretary that there was a substantial valuation misstatement, a substantial estate or gift tax valuation understatement or a gross valuation misstatement was erroneous; or
3) Establishes to the satisfaction of the Secretary that the value established in the appraisal was more likely than not the proper value.

We also propose that new subsections (d) and (e) be added to Section 6695A as follows:

(d) Time of Assessment:

1) No penalty may be imposed under subsection (a) until there is a final determination with respect to the claimed value of the property on a return or claim for refund that there was a substantial valuation misstatement, a substantial estate or gift tax valuation understatement or a gross valuation misstatement.
2) For purposes of this section, a final determination is made when an assessment of a deficiency is made against a taxpayer attributable to a substantial valuation misstatement, a substantial estate or gift tax valuation understatement or a gross valuation misstatement on a return.

(e) Abatement of Penalty Where No Substantial or Gross Valuation Misstatement. If at any time there is a final administrative determination or a final judicial decision that there was no substantial or gross valuation misstatement in the case of any return or claim for refund with respect to which a penalty under subsections (a) and (b) has been assessed, such assessment shall be abated, and if any portion of such penalty has been paid the amount so paid shall be refunded to the person who made such payment as an overpayment of tax without regard to any period of limitations which, but for this subsection, would apply to the making of such refund.

Finally, we propose that Section 6696(d)(1) be amended to allow the IRS to assess the penalty until the later of 6 months after a final determination or three years after the filing of the return or refund claim. As amended Section 6696(c) would read as follows:

(1) Assessment

The amount of any penalty under section 6694(a), or 6695 shall be assessed within

3 years after the return or claim for refund with respect to which the penalty is assessed was filed; no penalty may be assessed under 6695A until the later of within 3 years after the return with respect to which the penalty is assessed was filed or 6 months after a final determination (as defined in section 6695A(d)), and with respect to a substantial or gross valuation misstatement on a claim for refund, within 3 years after the return with respect to which the penalty is assessed was filed. No proceeding in court without assessment for the collection of a penalty under section 6694(a), 6695 or 6695A shall be begun after the expiration of such period. In the case of any penalty under section 6694(b), the penalty may be assessed, or a proceeding in court for the collection of the penalty may be begun without assessment, at any time.