

## MEMORANDUM

TO: Attendees, Advanced BV Conference, Boston

FROM: Jay Fishman and Peter Barash

DATE: October 6, 2009

SUBJECT: With The Issuance of Interim Guidance For Imposing Civil Money Penalties On Appraisers For Valuation Misstatements, IRS Moves One Step Closer To Completing Its Implementation of The Pension Protection Act's Appraisal Provisions – But, The Guidance Fails To Provide Appraisers With Due Process Safeguards Adequate To Prevent Inappropriate Misstatement Penalty Proceedings

### Executive Summary

A recently issued IRS Memorandum and accompanying Tool Kit for the guidance of Examiners, detail the process under which the Service will (1) determine whether an individual providing a tax-related valuation for Income, Estate or Gift tax purposes has committed a substantial or gross valuation misstatement under section 6695A of the IRC and (2) seek to assess a civil money penalty against an individual for such misstatements. The processes prescribed, which are in full force and effect, represent a key element in IRS' implementation of the valuation provisions of the Pension Protection Act of 2006 (the PPA). Regrettably, they do not appear to provide valuation practitioners with adequate due process safeguards; and, absent significant changes, are likely to lead to inappropriate and costly penalty assessment proceedings against them.

One particularly serious problem is that under the processes outlined in the Memorandum, it appears that a penalty assessment letter (Letter 4477) will be sent to the appraiser without first advising him or her that issuance of a penalty letter is under consideration; and allowing an explanation of the basis of the appraised value before the Letter goes forward. The 4477 letter states that the Service is “proposing a penalty under IRC section 6695A...based on our review of the appraisal(s) relating to a federal tax matter that you prepared on behalf of the taxpayer(s) named above.” While the IRS guidance states that a penalty assessment letter “generally...will not be proposed until the related tax examination is completed at the group level”; and, while receipt of the letter does not constitute a final judgment that a punishable valuation misstatement has, in fact, occurred, it does represent an official, written IRS pronouncement that a misstatement exists and it triggers a penalty assessment process – all before the appraiser has an opportunity to contest the allegation.

It's possible, of course, that the valuer will have had some discussion about the appraisal with a revenue agent during examination of the relevant tax return. But, such discussion is not inevitable and does not appear to be required prior to the issuance of a 4477 Letter. Moreover, even if such a discussion happens to happen, it would not be equivalent to or an appropriate substitute for, an appraiser's right to defend the valuation prior to facing a penalty assessment proceeding.

A subordinate but serious problem involves whether and under what circumstances the existence of a 4477 penalty assessment Letter would have to be disclosed by the valuation practitioner. Would disclosure be required, for example, if, after receipt of the letter, the appraiser is testifying as an expert witness in unrelated litigation and is asked whether there are any proceedings pending against him or her relating to valuation competency? Would a state licensed or certified real estate appraiser be obligated to affirmatively disclose his or her receipt of a 4477 penalty assessment letter to their state appraiser licensing agency? Would the ethics requirements of nationally recognized professional appraisal organizations obligate a designated member to disclose the Letter's existence? In addition to the fact that the interim guidelines appear to permit the sending of 4477 penalty assessment letters without notice to and a response from the valuation practitioner, there is no clarity on these important disclosure questions.

A third area of concern is that the contents of the Memorandum fail to include a definition of and protocols related to a "safe harbor" provision in the PPA – a provision which allows the appraiser to avoid a valuation misstatement penalty. Section 6695A of the PPA states that "no [valuation misstatement] penalty shall be imposed...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." But, the meaning of the phrase, "more likely than not the proper value" and guidance on how an appraiser would assert that defense do not currently exist. Absent such a definition and protocols, how can a valuation misstatement be found and how can a 6695A penalty assessment proceeding take place?

### **Background**

IRS is in various stages of implementing the important appraisal provisions of the Pension Protection Act of 2006 (the PPA). Those provisions – and the manner in which IRS implements them – are important not just to the thousands of practitioners whose valuations are used for tax purposes; but also because they may well set a precedent for government agencies and private sector entities which seek to ensure investors of the credibility of financial reports, including the valuation of the tangible and intangible assets of companies.

The Pension Protection Act's appraisal provisions are designed to improve the integrity and reliability of tax related appraisals and to hold those who perform them to a high degree of accountability. The law seeks to achieve these objectives in several interrelated ways: First, by reforming IRS' outmoded definitions of who is "Qualified Appraiser" and what constitutes a "Qualified Appraisal" for valuations of noncash charitable contributions (on August 7, 2008, the Service proposed and sought stakeholder comment on, interim rules defining these terms. Final rules are expected to be issued soon); Second, by tightening the percentage tolerances used to define a "substantial" or "gross" valuation misstatement for all Income, Estate and Gift tax purposes, thereby making it "easier" for the Service to allege such misstatements; and, Third, by (1) imposing a new civil money penalty on those found to have engaged in a valuation misstatement and (2) by referring to the Office of Professional Responsibility, for possible suspension or debarment action, those valuation practitioners who are believed to have committed Circular 230 infractions for violating professional standards of care or due diligence.

On August 18, 2009, IRS issued an internal "Memorandum For All Examiners, Estate and Gift Attorneys And Appellate Officers" establishing interim guidance to ensure that the Service's examiners are aware of the procedures for assertion of the Internal Revenue Code section 6695A penalties for substantial and gross valuation misstatements. The Memo was issued jointly by the IRS Commissioners for the Small Business and Self-Employed Division; Large and Mid-Size Business Division; Tax Exempt and Government Entities Division; and by the Chief of IRS Appeals. Also issued was a "Tool Kit" or "Checklist" to aid examiners in identifying valuation misstatements and a new form letter (Letter 4477) advising an individual who has performed a valuation, that the Service is proposing a section 6695A penalty.

The procedures outline in the valuation misstatement Memo and Tool Kit apply to all tax-related valuations whether for Income, Estate or Gift Tax purposes and are currently in effect. But, they are scheduled to expire on August 18, 2010 – presumably because by that time they will be supplanted by regulations. Indeed, the Memo states that "forthcoming regulations will provide...guidance on the standard" established by the PPA in new section 6695A that the valuation misstatement penalty does not apply if the appraiser can establish that it is "more likely than not" that their appraisal value was correct.

IRS has not yet issued any interim guidance or proposed regulations on another key feature of the PPA appraisal provisions: referrals to the Office of Professional Responsibility alleging Circular 230 infractions by appraisers for violating professional standards of care or due diligence.

## Highlights Of Statements In Penalty Assessment Memo

### **IN GENERAL:**

- IRS has the authority to assert penalties AND to seek enjoinder of appraisers. [Although the term “enjoinder” is not explicitly addressed in the relevant documents, a reasonable assumption is that it has reference to referrals to IRS’ Office of Professional Responsibility for suspension or debarment action];
- The amount of the 6695A penalty is the lesser of (i) the greater of 10% of the amount of the tax underpayment attributable to the misstatement or \$1,000 or (ii) 125% of the gross income received by the appraiser from preparation of the appraisal;
- The penalty does not apply if the appraiser can establish that his/her appraised value was “more likely than not” correct. Forthcoming regulations will provide further guidance on this standard;
- The new penalty applies to appraisals prepared for “returns or submissions” filed after August 17, 2006. However, if the appraisal relates to a façade easement donation, the penalty applies to returns filed after July 25, 2006.

### **PROCESS FOR ASSERTING PENALTY:**

- The 6695A civil money penalty is to be asserted by “revenue agents, Estate and Gift attorneys and Tax Compliance Officers”;
- Examiners are encouraged to submit referrals to LMSB’s Field Specialists Engineers for assistance or consultation. Additional Engineer support may be warranted to fully develop the penalty case particularly if the Engineers were not involved during the related tax examination;
- An IRC section 6695A appraiser penalty case will be conducted as a separate and distinct case from the related tax examination. During the tax examination, examiners will inquire, as warranted, to develop facts and circumstances to determine whether or not a 6695A appraiser penalty case should be opened. This determination will be documented in the examination workpapers;
- Penalties under 6695A will not be proposed in the presence of the taxpayer. All discussions related to appraiser penalties with either the taxpayer, return preparer or designated Power-of-Attorney will be limited to the development of facts to determine the applicability of a penalty (emphasis added);
- If a review of the appraiser’s value as reported on the tax return results in a substantial or gross valuation misstatement, “the examiner should open an IRC section 6695A penalty case to determine if sanctions against the appraiser are warranted.” Generally, an IRC section 6695A appraiser penalty will not be proposed until the related tax examination is completed at the group level;
- Generally, “there is a substantial valuation misstatement under chapter 1 if the value of property is 150 percent or more of the amount determined to be the correct amount of such valuation. A gross valuation misstatement under chapter 1

- occurs when the claimed value of the property is 200 percent or more of the correct amount of such valuation”;
- “There is a substantial estate or gift tax valuation understatement if the value of the property claimed is 65% or less of the amount determined to be the correct amount of such valuation. There is a gross estate or gift tax valuation understatement if the value of the property claimed is 40 % or less of the amount determined to be the correct amount of such valuation”;
  - The statute of limitations for assessing a 6695A penalty “generally expires three years from the later of the due date of the related return or the date the return was filed.” The statute on the appraiser penalty case under 6695A can be extended using Form 871-AP (“Consent to Extend the Time on Assessment of an Appraiser Penalty”). Consent should be obtained when the statute of limitations will expire within 180 days;

### **FIELD EXAMINATION PROCEDURES FOR ASSESSING A 6695A**

**APPRAISER PENALTY:** The memo sets out the field examination procedures which are reflected in Form 5345, including the following -

- Project Tracking Codes: If the appraiser penalty case is related to a project, enter appropriate project code;
- Group managers will indicate approval for the appraiser penalty case by signing and dating THE 5345 form;
- After securing the approval, the examiner will contact the appraiser using Letter 4477, IRC section 6695A *Appraiser Penalty Appointment Letter*.<sup>1</sup> The purpose of this meeting with the appraiser “will be to gather sufficient facts to determine whether the appraiser can establish that the value established in their appraisal meets the ‘more likely than not’ exception as provided in IRC section 6695A(c). If the appraiser cannot establish that the ‘more likely than not’ exception applies, the examiner must propose an IRC section 6695A penalty.” (emphasis added). **[NOTE THAT IRS’ CONTACT WITH THE APPRAISER APPEARS TO TAKE PLACE AFTER A 4477 LETTER HAS ALREADY BEEN SENT TO HIM OR HER. ALTHOUGH THE APPRAISER MAY HAVE HAD CONTACT WITH THE REVENUE AGENT DURING EXAMINATION OF THE RETURN, SUCH CONTACT IS NOT INEVITABLE AND DOES NOT APPEAR TO BE REQUIRED. MOREOVER, EVEN IF THERE WAS DISCUSSION WITH IRS ABOUT THE BASIS OF THE APPRAISAL DURING THE EXAMINATION PROCESS, THAT DISCUSSION WOULD NOT BE**

---

<sup>1</sup> The letter states: “Dear \_\_\_\_\_: We are proposing a penalty under Internal Revenue Code section 6695A, Substantial and Gross Valuation Misstatement Attributable to Incorrect Appraisals. This penalty is based on our review of the appraisal(s) relating to a federal tax matter that you prepared on behalf of the taxpayer(s) named above. We have scheduled a meeting to give you an opportunity to discuss the facts or legal arguments you or your representative may present to the Service in considering the appropriateness of the penalty. Appointment Information: \_\_\_\_\_. Please contact me at the telephone number shown above if you have any questions. Thank you for your cooperation. Sincerely, Internal Revenue Agent.”

**EQUIVALENT TO OR AN APPROPRIATE SUBSTITUTE FOR, A RIGHT TO DEFEND THE APPRAISAL WHEN FACED WITH A PENALTY ASSESSEMENT PROCEEDING];**

- If the examiner determines no penalty is warranted, Letter 4478, IRC section 6695A *Appraiser Penalty No-Change Letter*, “will be prepared at the group level and left undated in the file. Technical Support will date and issue the letter if the case is selected for sample review, otherwise, the letter will be issued according to area policy”;
- After consideration of all facts and circumstances, if the examiner determines an IRC section 6695A penalty does apply, the examiner will prepare Form 8278, *Assessment and Abatement of Miscellaneous Civil Penalties*, and Form 886A, *Explanation of Items*, or its equivalent;
- Form 886A, *Explanation of Items*, should include the following information:
  - a. The basis for assertion of the penalty;
  - b. Why the “more likely than not” statutory exception does not apply, and
  - c. The appraiser’s position regarding the penalty.
- The examiner will prepare Letter 4485, *IRC section 6695A Appraiser Penalty Assessment Notification Letter*. This letter will advise of the proposed penalty, solicit payment, offer a supervisory conference, and provide an explanation of the dispute process. A copy of the Form 886A and other pertinent documents or workpapers should be included with this correspondence;
- If an IRC section 6695A penalty is assessed against an appraiser, “an information referral to the Office of Professional Responsibility should be considered where willful conduct is involved.” (emphasis added) A referral to the SBSE Lead Development Center is mandatory. If a penalty case is “no-changed, a copy of the no-change letter will be sent to the SBSE Lead Development Center to update their database.”
- The following information should be included in the penalty case file:
  - a. First two pages of the related tax return and any schedules related to the understatement;
  - b. A copy of the original appraisal prepared by the appraiser;
  - c. A copy of the IRS Field Specialist Engineer’s and/or outside fee appraiser’s appraisal or appraisal review report;
  - d. A copy of the Revenue Agency report;
  - e. Any documents, interview notes, or affidavits pertinent to the determination of the appraiser penalty.

**IRS VALUATION PENALTY JOB AID CHECKLIST FOR IRC SECTION 6695A, 6700 & 6701:**

In addition to the internal guidance summarized above and the Letter 4477 (the text of which is footnoted), the IRS package also includes a checklist of items and issues

that are intended “as a guide to assist Engineering and Examination in evaluating whether a civil penalty may be appropriate with respect to a specific appraiser, appraisal firm, or other persons/entities identified during the course of an examination with a valuation issue. It is recommended that the assigned Engineer/Appraiser complete this job aid and forward to the Revenue Agent or Estate & Gift Attorney.” The “Instructions” sheet asks for –

- The appraiser’s name and TIN;
- The identity of the appraiser’s firm, if any;
- The identity of the IRS “Engineer” and/or the Revenue Agent/E&G Attorney;
- A description of the type of property valued and it includes a number of boxes (to be checked off), including: “Conservation Easement”; “Business Valuation”; “Stock”; “Artwork”; “Other - Describe”.

The “Valuation Penalty Job Aid” contains 5 pages of guidance to the Revenue Agent or Examiner as to whether an IRC Section 6695A, 6700 or 6701 appraiser violation has occurred. Also important to review is IRS Form 886-A which requires detailed information on the alleged appraiser infraction.