

COMMENTS ON
INTERNAL REVENUE CODE SEC. 6695A

The following comments are being submitted on behalf of the American Bar Association Section of Real Property, Probate and Trust Law. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Business Planning Group of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association. The principal responsibility was exercised by William S. Forsberg, of Parsinen, Kaplan, Rosberg & Gotlieb, P.A., Minneapolis, Minnesota, and by Hugh F. Drake, of Brown, Hay & Stephens, LLP, Springfield, Illinois. Also participating in the preparation of the comments were Brad Stevens, David Vines, Gary Marshall, George Schlagel, Paul Hood and Steven Gorin. Reviewing these comments on behalf of the Section's committee on Governmental Submissions was Edward F. Koren and Louis A. Mezzullo.

Although members of the Business Planning Group of the Real Property, Probate and Trust Law Section of the American Bar Association who participated in preparing these comments and recommendations have clients who are affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments, although these comments are not limited to Code Sec. 170(f)(11).

INTRODUCTION

The Pension Protection Act of 2006¹ provides new penalty provisions applicable to appraisers responsible for substantial or gross valuation misstatements through a new code provision under Code Sec. 6695A². These comments discuss concerns surrounding the implementation of Code Sec. 6695A, as requested by the Internal Revenue Service's (the "Service") Internal Revenue Bulletin 2006-96.

We appreciate the opportunity to comment on Code Sec. 6695A. Our goal is to work with the Service to address the uncertainty surrounding the manner in which Code Sec. 6695A will be implemented. Our hope is that the Service will provide guidance on the application of Code Sec. 6695A, resulting in a clear standard to guide tax professionals and appraisers.

Accordingly, we ask for guidance on the following questions:

¹ The Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) (the "PPA").

² References in these comments to Code Sections are to sections of the Internal Revenue Code of 1986 (the "Code"), as amended and, if preceded by "Treasury Regulations," to sections of the Treasury Regulations under the Code.

1. Will Code Sec. 6695A apply to estate and gift tax valuations or solely to income tax valuations?
2. What is the reach and scope of the “any person” language of Code Sec. 6695A?
3. What constitutes the preparation of an “appraisal” under Code Sec. 6695A?
4. Will Code Sec. 6695A apply only to individual appraisers, an appraisal firm as a whole, or both?
5. To what extent will Code Sec. 6695A come to bear on appraisers relying upon expert opinions establishing the nature of the property interest to be appraised?
6. Does the penalty calculation constitute false precision, particularly where different classes of assets have dramatically different valuation variances?
7. Would penalties imposed by Code Sec. 6695A be imposed only after final resolution of a tax controversy case?
8. Do the Code Sec. 6695A penalty provisions apply equally to the appraisers relied upon by the government in tax controversy matters?
9. How can the exception to Code Sec. 6695A be implemented when the determination of whether a valuation was more likely than not a proper value is made after the Service has already determined a penalty should be imposed?

COMMENTS

1. Will Code Sec. 6695A apply to estate and gift tax valuations or solely to income tax valuations?

Based upon the legislative background³, the genesis of new Code Sec. 6695A appears to have been the amendments to Code Sec. 170 under the Pension Protection Act of 2006. Code Sec. 170 relates to Chapter 1 income tax charitable contribution deductions. The amendments to Code Sec. 170 relate to, among other things, income tax charitable contributions of capital gain real property made for conservation purposes and income tax charitable contribution deductions for certain easements in registered historic districts. New Code Sec. 6695A appears to have been enacted primarily to alleviate the perceived concerns relating to appraisals of property for charitable contributions for income tax purposes under Code Sec. 170, and in particular certain difficult to appraise property, such as conservation easements, intangible assets, and possibly closely held stock. That said, Section 1219 of the Act states that it applies to income ***and*** (emphasis added) estate and gift tax valuations, including the elimination of the reasonable cause

³ Pension Protection Act of 2006, , PL 109-280, 8/17/2006, *Joint Committee on Taxation Report [JCX-38-06]*

exception for gross misstatements. The inconsistency between legislative intent (income tax valuations) and the provisions of the PPA (income, estate and gift tax valuations) needs clarification.

Task Force Recommendation: The task force recommends that the provisions of Code Sec. 6695A be limited to qualified appraisals of property prepared for charitable contributions for income tax purposes under Chapter 1 of the Code. The primary focus of the changes to Code Sections 170, 6662, 6664, 6696 and the enactment of new Code Sec. 6695A under the Pension Protection Act of 2006 appear to have been perceived abuses in the valuation of property for income tax purposes, not estate and gift tax purposes.

2. What is the reach and scope of the “any person” language of Code Sec. 6695A?

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

Task Force Recommendation: The task force recommends that the term “person” as used in Code Sec. 6695A be limited to “qualified appraisers” as defined under Code Sec. 6664 for the following reasons. The term “qualified appraisers” is a defined term and its meaning is certain, clear and unambiguous. The appraisal process involves the gathering of information and data from many sources and from many persons. By limiting the scope of Code Sec. 6695A to qualified appraisers it will facilitate the appraisal process and make enforcement easier. Third parties will not be reluctant to provide information or data to appraisers for fear of being subject to penalties under Code Sec. 6695A. As written, the scope and reach of the “any person” language in Code Sec. 6695A is unlimited and may unwittingly subject persons to liability who were only tangentially involved in the appraisal process.

3. What constitutes the preparation of an “appraisal” under Code Sec. 6695A?

For example, if a taxpayer simply reports a “best guess” value on a gift or estate tax return, or if a CPA uses a real estate property tax statement value and inserts that on a gift or estate tax return, or if the taxpayer’s attorney sends a letter to the CPA stating what he or she understands the value to be, have any of these people “prepared an appraisal” for purposes of Code Sec. 6695A?

Task Force Recommendation: The task force recommends that the term “appraisal” as used in Code Sec. 6695A be limited to “qualified appraisals” as defined under Code Sec. 170 for the same reasons as contained in question number 3 above. The term “qualified appraisal” is a defined term and its meaning is certain, clear and unambiguous. By limiting the scope of Code Sec. 6695A to qualified appraisals it will facilitate the appraisal process and make enforcement easier. Third parties will not be reluctant to provide information or data to appraisers for fear of being subject to penalties under Code Sec. 6695A. As written, the scope and reach of the “appraisal” language in Code Sec. 6695A is unlimited and may unwittingly subject persons to liability who were only tangentially involved in the appraisal process.

4. Will Code Sec. 6695A apply only to individual appraisers in a firm, the appraisal firm as a whole, or both?

Code Sec. 6695A does not indicate whether appraiser penalties will only befall individual appraisers, or whether the actions of an individual appraiser will be imputed to an appraiser’s entire firm. If the actions of an individual appraiser will be imputed to the appraisal firm will it be only under certain circumstances? And, if so, what are those circumstances? Finally, will the Code Sec. 6695A penalties apply to each appraiser in an appraisal firm who signs off on the appraisal (e.g. a review appraiser)?

Task Force Recommendation: The task force recommends that the provisions of Code Sec. 6695A be limited to the appraisal firm and the opining appraiser who signs the final appraisal report, whether that person is an individual appraiser, a managing partner, or a principal in an appraisal firm. The reach of Code Sec. 6695A should not extend to individual appraisers in the appraisal firm or agents or employees of the opining appraiser or appraisal firm who merely participate in the preparation of the final product, but do not take ultimate responsibility for the final product, and do not “sign off” on the final appraisal report.

5. To what extent will Code Sec. 6695A come to bear on appraisers relying upon expert opinions about the nature of the property interest to be appraised?

Very often appraisers will need to rely upon expert opinions about the nature of the property interest to be appraised and it is unclear whether such reliance would protect them from the penalties under Code Sec. 6695A. For example, if an appraiser (“Appraiser # 1”) is valuing an interest in an entity (“Entity Valuation”) that owns real estate, may Appraiser # 1 rely on the opinion of a qualified real estate appraiser (“Appraiser # 2) with respect to the value of the underlying real property (“Real Estate Valuation”)? If Appraiser #1 relies on Appraiser # 2’s Real Estate Valuation to prepare Appraiser # 1’s Entity Valuation, will both appraisers be subject to the penalties under Code Sec. 6695A? What if Appraiser # 1 limits the scope of his or her appraisal to the Entity Valuation, exclusive of the Real Estate Valuation? What if Appraiser # 2’s property appraisal is the “bad” appraisal that results in the imposition of penalties under Code Sec. 6695A? Will Appraiser # 1 be held equally liable, even though his or her report is solid? Also, if a lawyer opines that an interest to be appraised is an assignee interest in a family limited

partnership and not a limited partnership interest, may the appraiser rely on that advice and value the assignee interest accordingly? The concern is that the Service will challenge the characterization of the appraised interest as an assignee interest, and therefore challenge the overall appraisal of the interest. Would a valuation adjustment as a result of such a re-characterization of the interest by the Service subject an appraiser to Code Sec. 6695A penalties?

Task Force Recommendation: The task force recommends that the provisions of Code Sec. 6695A be imposed on a targeted but equitable basis, taking into account the realities of the appraisal process, which many times requires reliance by one appraiser on one or more ancillary appraisal reports before a final appraisal report can be issued. Only the appraisal firm and the opining appraiser who signs the final appraisal report should be held liable for penalties under Code Sec. 6695A. In addition, opinions or information obtained from third parties (e.g. lawyers, CPAs, realtors, etc.) who are not qualified appraisers but who provide information to qualified appraisers as to the nature or character of a property interest (e.g. partnership interest versus assignee interest) should not be held liable for penalties under Code Sec. 6695A. Also, the appraiser who obtained information from the third party should not be held liable for penalties under Code Sec. 6695A if the appraiser exercised reasonable diligence and good judgment in obtaining, verifying and using such information. Finally, it is the task force's view that each appraisal report should stand on its own and be judged independently from all other appraisal reports used or incorporated into any final appraisal report that is submitted to the Service for review. For example, in the above example, Appraiser # 1 should not be held liable by implication (assuming his or her report standing alone is accurate and would not otherwise be subject to the penalties under Code Sec. 6695A) simply because Appraiser # 2's appraisal report (standing on its own and reviewed independently) may be subject to penalties under Code Sec. 6695A. Put simply, there should be no automatic "piggybacking" or sharing of liability if multiple appraisals are involved. Such an approach would have a chilling effect on appraiser collaboration.

6. Does the penalty calculation constitute false precision, particularly where different assets have dramatically different valuation variances?

There is a concern about the seemingly arbitrary nature of the penalty calculation. Code Sec. 6695A imposes penalties based on valuation misstatements. A valuation misstatement is defined under Code Sec. 6662 using fixed percentages (e.g. 150% over the "correct amount"). Different classes of assets have different valuation variances. For example, commercial real estate has a narrower valuation variance than a hard to value asset, such as closely held stock or certain stock options. The percentage approach to the penalty calculation demands false precision. Although we appreciate that the percentage test is easier for the Service to administer, it does not take into consideration the reality of valuation variances of different asset types. This concern is equally valid with respect to accuracy-related valuation penalties under Code Sec. 6662(g) which effectively subject the taxpayer to strict liability for an estate and gift tax valuation understatement in spite of the valuation variances. However, unlike Code Sec. 6695A, Code Sec. 6664(c) provides a reasonable cause exception for all accuracy-related penalties under Code Sec. 6662(g). Code Sec. 6664(c)(1) states that no penalty is imposed with respect to any portion of an underpayment for accuracy related penalties under Code Sec. 6662 (or under Code Sec. 6663

relating to fraud penalties) if it is shown that there is reasonable cause for such portion and the taxpayer acted in good faith with respect to such portion. Therefore, to be consistent, it is suggested that the reasonable cause exception under Code Sec. 6664(c) should also apply to Code Sec. 6695A penalties.

Task Force Recommendation: The task force recommends that the reasonable cause exception under Code Sec. 6664(c) should also apply to Code Sec. 6695A penalties. In the alternative, Code Sec. 6695A penalties should only be imposed *after* (emphasis added) the appraiser fails to establish that the appraisal in his or her reasonable belief was more likely than not a proper value.

7. Would penalties imposed by Code Sec. 6695A be imposed only after final resolution of a tax controversy case?

The timing of a penalty could have a profound impact on the livelihood of an appraiser. To illustrate this concern, consider the McCord case⁴ in which the Fifth Circuit Court of Appeals' decision ultimately found the taxpayer's appraisal to be reasonable. Had a penalty been imposed at the outset of the controversy, the appraiser would have been burdened by the effects of the penalty while the litigation process took years to complete. In fairness, the imposition of Code Sec. 6695A penalties should be suspended until after all appeal rights have expired. Of course, timing concerns extend beyond the livelihood of the appraiser. The impact of disbarment upon an appraiser's existing clientele must be considered. What are the protections for those who have engaged an appraiser prior to his disbarment?

Task Force Recommendation: The task force recommends that the Code Sec. 6695A penalties should be imposed only after a final resolution of the tax controversy case and only after all appeal rights have expired. Imposing penalties before such time puts an unreasonable financial burden on appraisers and his or her clientele.

8. Do the Code Sec. 6695A penalty provisions apply equally to the appraisers relied upon by the government in tax controversy matters?

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

Task Force Recommendation: The task force recommends that the Code Sec. 6695A penalties, however implemented and determined, should be imposed equally against government appraisers.

⁴ *McCord v. Commissioner*, 461 F.3rd 614 (5th Cir. 2006)

9. How can the exception to Code Sec. 6695A be implemented when the determination of whether a valuation was more likely than not a proper value is made *after* (emphasis added) the Service has already determined a penalty should be imposed?

The exception set out in Code Sec. 6695A appears completely ineffective. It is difficult to imagine a situation where a person could establish to the satisfaction of the Service that the valuation in question “was more likely than not” a “proper value”, after the Service has already expressed its opinion on the valuation by imposing a penalty. It is our hope that guidance on Code Sec. 6695A will clarify how appraisers actually avail themselves of the exception.

A related issue is that a court may have made the final determination of the “correct value”, or the taxpayer may have settled with the government for reasons of their own, without the appraiser having had his or her chance to make arguments in support of their conclusion. If so, will the government be forced to litigate the valuation issue a second time in order for the appraiser to have due process? Alternatively, will the taxpayer’s due process be restricted by requiring him or her to use the original appraiser in the subsequent litigation, just to bring the appraiser into the proceedings?

Task Force Recommendation: The task force recommends that the reasonable cause exception under Code Sec. 6664(c) should also apply to Code Sec. 6695A penalties. In the alternative, Code Sec. 6695A penalties should only be imposed *after* (emphasis added) the appraiser fails to establish that the appraisal in his or her reasonable belief was more likely than not a proper value.

CONCLUSION

Our hope is that additional guidance on the application of Code Sec. 6695A will provide some clarity to guide tax professionals and appraisers. We appreciate your consideration of our comments and welcome the opportunity to discuss them further with you. If you would like to discuss these comments, please contact the following:

William S. Forsberg
Parsinen Kaplan Rosberg & Gotlieb, P.A.
Suite 1100
100 South Fifth Street
Minneapolis, MN 55402-1298
Phone: (612) 342-0371
Fax: (612) 333-6798
wforsberg@parlaw.com