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New Penalties on Appraisers and Related Valuation Worries Spawned by the Pension Protection Act of 2006

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Background

The name of the game in estate planning has long been valuation. Virtually, all lifetime estate planning arrangements involve some aspect of valuation, including grantor retained annuity and income trusts, qualified personal residence trusts and so-called "freeze" techniques. The lower the value, the lower the estate, gift or generation-skipping transfer tax that is imposed, as a general rule. Valuation often also is a key element in income tax matters, from determining the value of non-cash compensation income to the value of property contributed to charity entitling the donor to a charitable income tax deduction.

As a general rule, property is valued for tax purposes at its "fair market value," meaning in general the price at which the asset would change hands between a willing buyer and a willing seller, neither acting under a compulsion and both having reasonable knowledge of factors relevant to that valuation.²

Except where an explicit valuation rule is prescribed (such as for marketable securities sold on an exchange or over-the-counter where it is the average of the high and low trading prices on the principal market for the date of transfer³), the determination of value may be a matter of opinion and opinions may vary widely even among recognized valuation experts.⁴

Valuation Penalties

Taxpayers, in some cases, essentially are required to obtain valuation appraisals from qualified appraisers or be denied tax benefits.⁵ In addition, penalties may be imposed under section 6662 for an underpayment of income, estate or gift tax attributable to the incorrect valuation of property for such tax purposes.⁶ Fortunately, section 6664(c) permitted a taxpayer to avoid valuation penalties if the taxpayer acted in good faith and with a reasonable basis. Relying on an independent appraiser generally serves as the grounds for avoiding the imposition of the valuation penalty.

The Pension Protection Act of 2006 (the "Act") changes the penalty provisions imposed by section 6662 and makes it more likely a taxpayer will face penalties. Prior to the Act, a taxpayer faced a penalty equal to 20% of the underpayment attributable to a substantial valuation misstatement.⁷ A substantial valuation misstatement was deemed to occur for income tax purposes if the value used (*e.g.*, the value claimed for a painting donated to charity) was 200% (or more) of the correct value. It was deemed to occur for estate or gift tax purposes if the value used was 50% (or less) of the correct value. And the taxpayer instead faced a penalty equal to 40% if the underpayment was attributable to a *gross* valuation misstatement. A gross valua-

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¹ Portions of this article are derived from D. Zeydel, M. Gans and J. Blattmachr, "What Estate Planners Need to Know about the New Pension Protection Act," *J. Tax'n* 199 (October 2006).

² See, *e.g.*, Treas. Reg. § 25.2512-1 (defining fair market value for gift tax purposes).

³ But even with respect to publicly traded securities, valuation issues arise such as whether the transfer of the stock is restricted by contract or government rule (such as SEC rule 144) or the block of securities transferred is so large that a discount from trading price must be taken into account in determining the fair market value of the block. See, *e.g.*, Treas. Reg. § 25.2512-2(e).

⁴ For example, in *Estate of Thompson v. Comm'r*, T.C. Memo 2004-174, the taxpayer's expert valued the stock owned by the decedent in a closely-held publication company at \$3.60 per share, while the IRS's expert valued the stock at \$72 per share. The court

determined the value to be \$28 per share.

⁵ Under section 170(f)(1)(A)(i) of the Internal Revenue Code of 1986 as amended ("IRC"), a taxpayer is denied any charitable contributions income tax deduction for certain non-cash contributions to charity unless the taxpayer obtains an appraisal from a qualified appraiser and attaches a valuation summary to the taxpayer's United States income tax return. See also IRS Notice 2006-96, 2006-46 I.R.B. 1.

⁶ A taxpayer may also be penalized under IRC § 6662 for disregarding rules and regulations. For example, Treas. Reg. § 20.2031-6(b) requires that a valuation report for certain property must be made part of a decedent's United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706). It seems that failing to attach the regulatory required appraisal could serve as the basis for any penalty if the underpayment of tax is attributable to an incorrect valuation of such property. See IRC § 6662(b).

⁷ IRC § 6662.

tion misstatement was deemed to occur for income tax purpose if the value used was 400% or more of the correct value. A gross valuation misstatement was deemed to occur for gift or estate tax purposes if the value used (e.g., the value of an asset includible in the taxable estate) was 25% or less of the correct value.

The Act changes these percentages so that the penalties will become applicable in a greater number of cases. A substantial valuation misstatement will be deemed to occur for income tax purposes if the value used is 150% (or more) of the correct value. And it will be deemed to occur for estate or gift tax purposes if the value used to determine the amount of such tax is 65% (or less) of the correct value. A gross valuation misstatement will be deemed to occur for income tax purposes if the value used is 200% (or more) of the correct value. A gross valuation misstatement will be deemed to occur for gift or estate tax purposes if the value used is 40% (or less) of the correct value.

As stated above, before the Act, taxpayers could avoid, under section 6664(c), the misstatement of value (and other) penalties imposed by section 6662 if the taxpayer acted in good faith and had a reasonable basis to use the value reported.⁸ The Act has eliminated the defense in the case of a gross valuation misstatement with respect to an income tax charitable deduction.⁹ (Perhaps Treasury Regulations will provide some other protection from the 40% penalty in the case of a charitable income tax deduction, such as where the taxpayer believed it was more likely than not that the value claimed as a charitable contribution was correct.) The defense was not, however, eliminated with respect to substantial valuation misstatements in the case of a charitable deduction for income tax purposes. Nor does the Act alter the defense in the case of an estate or gift tax underpayment or an income tax underpayment not attributable to a charitable deduction.

New Penalty on Tax Appraisers

In addition, the Act imposes what seems to be a nearly automatic penalty on appraisers in some situa-

tions under new section 6695A. The section, in the case of a substantial income tax valuation misstatement or a gross estate or gift tax valuation misstatement contained in an appraisal that the appraiser knows or has reason to know will be used "in connection with a tax return or claim for tax refund," imposes a penalty on the appraiser equal to the greater of \$1,000 or 10% of the amount of tax underpaid by reason of the incorrect valuation (but in no event more than 125% of the gross income received by the appraiser for preparing the appraisal). For example, an appraiser, who has been engaged to value property for estate tax purposes and that will be reported on an estate tax return and who values it at \$400,000, will be subject to the penalty if the correct value of the property is \$1 million or more. The only defense would be if the appraiser proves, to the satisfaction of the Treasury Department, that the appraised value was more likely than not the correct value.¹⁰

Although, as indicated, section 6695A by its terms imposes the appraiser penalty with respect to estate and gift incorrect valuations, and not just income tax incorrect valuations, another change made by the Act "confuses" that application. Section 6695A, by its terms, only applies to an appraiser who knew or reasonably should have known that the appraisal would be used in connection with a "return" or a "claim for refund." Section 6696, as amended by the Act, provides a definition of the terms "return" and "claim for refund" for purposes of sections 6694, 6695 and 6695A. Section 6696 defines these with reference exclusively to the income tax. Thus, based on this section, it is arguable that an appraisal secured for estate or gift tax purposes cannot trigger the section 6695A penalty.

It seems rather clear, however, that Congress intended to impose the section 6695A penalty in the estate and gift tax context. After all, the section specifically cross-references section 6662(h), which unequivocally applies in the case of an estate or gift tax incorrect valuation. It would seem that this specific provision in section 6695A will take precedence over the general definitional provision in section 6696.

⁸ In the case of a substantial or gross valuation overstatement for income tax purposes in the context of a charitable contribution, the section 6664 defense was not available unless the taxpayer had obtained an appraisal from a qualified appraiser, and, in addition, the taxpayer had made a good faith investigation concerning value. See IRC § 6664(c)(2) as in effect prior to the Act.

⁹ Although the Staff Report does not state that the good faith/reasonable cause defense for gross valuation misstatement is eliminated only for the income tax charitable deduction, the text of the Act only eliminates it in that case. See Staff Report, p. 309.

¹⁰ Some argue that the penalty is inapplicable in the estate and gift tax context because of the use of the words "under chapter 1" in IRC section 6695A(a)(2). However, the authors believe that a

more conservative interpretation of the statute would construe it to apply to gross valuation misstatements in both the income and the estate and gift tax contexts. This interpretation is supported not only by the placement of a comma after the cross-reference to section 6662(e), which relates only to chapter 1, but also by the cross-reference to section 6662(h) after the comma, which applies to gross valuation misstatements for both income and estate and gift tax purposes. In addition, the words "under chapter 1" follow, and do not precede, the words "substantial valuation misstatement" and are not repeated after the words "gross valuation misstatement" indicating that they modify only the former, and not the latter, phrase. A senior member of the Staff with whom the authors had an informal conversation agreed with the authors' interpretation.

In short, it appears that the conflict between sections 6696 and 6695A is not likely to be resolved by a reading that renders the specific provision in section 6695A meaningless. Presumably, this will be clarified by Treasury Regulation or other guidance provided by the Treasury or the IRS. In the meantime, it seems appropriate to act conservatively and take action on the basis that the penalty may be imposed for an incorrect estate or gift tax appraisal.

It is interesting to note that the determination of whether the appraised value was more likely than not the correct value is to be made by the Treasury (the IRS) and not a court. Presumably, if a court were to find that the IRS abused its discretion in refusing to grant a waiver, the court could direct the IRS to grant it.¹¹ Nonetheless, it will be difficult for appraisers to meet the burden where the court has made a determination on the merits that the appraised value was grossly understated (*i.e.*, equal to 40% or less of the correct value). An unfortunate aspect of the new provision is that an appraiser may feel coerced to “back off” during an audit in order to avoid the penalty—even if the appraiser sincerely believes that his or her appraisal accurately reflects value.

It should be noted that the penalty imposed by section 6695A may be imposed upon anyone who prepares an appraisal for tax purposes, whether or not the person who prepares the appraisal is a professional appraiser. For example, an executor who estimates value for use on the estate tax return could conceivably be subject to the penalty (although it would be difficult to apply given that the statute limits the penalty to 125% of the appraisal fee). The new appraisal penalty is applied only against, in essence, appraisers hired by taxpayers. Appraisers hired by the IRS apparently are not subject to the penalty. Whether that distinction was intentional or not, it is unfair and creates the opportunity for appraisers hired by the government to understate the value of property for which a deduction is claimed for income tax purposes and overstate it if it is taxable for estate and gift tax purposes with impunity.¹²

“Blacklisting” of Appraisers

The Act may also hand another critical weapon to the Treasury: the threat of “blacklisting” the appraiser. Circular 230, § 10.50(b) permits the Treasury, in essence, to blacklist appraisers—that is, to rule that the appraiser is barred from presenting evidence or testimony in any administrative proceeding before the

Treasury or the IRS and that any appraisal made by that appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before the Treasury or the IRS. Before the Act, the Treasury could effect a blacklisting only if the penalty under section 6701 of the Code had been imposed on the appraiser. That section permits a penalty to be imposed only if, among other conditions, the appraiser knew the appraisal would result in an underpayment of tax. The reference to section 6701 has been removed from the Circular by the Act—thus raising the question whether an appraiser could be disciplined or blacklisted on the basis of an unintentional error. And by section 6695A, the Act now provides for the imposition of a penalty on appraisers apparently even if the appraiser did not know at the time of the appraisal that it would result in an underpayment of tax. It is uncertain what effect the new penalty might have on the authority of the Treasury to blacklist appraisers under the Circular. The Act does not direct the Treasury to adopt regulations (by amendment to the Circular or otherwise) to specify a course of conduct that could result in such discipline.¹³ It may be, however, that being subjected to the new appraiser penalty under section 6695A will be used by the Treasury as a basis for blacklisting.

More on Appraiser Penalties and “Blacklisting”

As indicated above, an appraiser cannot avoid the new section 6695A penalty by limiting appraisals to claims for refund. It applies where the appraisal is prepared “in connection with” a return or a claim for refund, perhaps even after the fact. For example, assume a taxpayer files a claim for refund of gift tax without submitting any appraisal, contending that the value reflected on the return was overstated. If an appraiser submits a valuation report in the court proceeding to obtain the refund, it may be that the appraiser could be subject to the penalty, as the court proceeding may be deemed to be “in connection with” the refund claim.

It should be noted that the section 6695A penalty does not deal exclusively with the determination of minority, marketability or other discounts. For example, an appraiser might use a methodology that the court finds inappropriate in the circumstances (*e.g.*, the appraiser might use a “net asset value” approach and a court later determines the “discounted cash flow” approach was more appropriate). Thus, appraisers will not be able to assume that the penalty can be avoided through the sim-

¹¹ *Cf. Baldwin v. Commissioner*, T.C. Memo. 2002-162 (applying an abuse of discretion standard under an analogous provision that has since been repealed).

¹² *Cf. McCord v. Commissioner*,—F.3d — (5th Cir. 2006), n. 5 (“This exemplifies a practice of the IRS that we see with dis-

turbingly increased frequency, *e.g.*, a grossly exaggerated amount asserted in a notice of deficiency”).

¹³ See, generally, J. Blattmachr, M. Gans & D. Rios, *Circular 230 Deskbook* (PLI 2006).

ple expedient of taking limited discounts.

What if an appraiser includes in the valuation analysis minority and marketability discounts in determining the value of a decedent's limited partnership interest in a family limited partnership and the court disallows the discounts by invoking section 2036 to cause the underlying assets of the partnership to be included in the decedent's estate rather than the partnership units? In that case, the appraiser will have evaluated one asset, a limited partnership interest, but the assets ultimately included in the gross estate are the underlying partnership property. Since the applicability of section 2036 is a legal question, rather than a valuation question, the penalty presumably will not be applied in this context.

Whether the penalty will apply to an appraiser who relies on another appraisal is also unclear. For example, assume that one appraiser determines the value of an entity's real estate assets and that a second appraiser relies on that appraisal in determining the value of the decedent's interest in the entity. If the real estate appraisal proves to be grossly inaccurate, will the penalty apply to the appraiser who performed the second appraisal? Regulations will have to clarify how to apply the penalty in such a case. Until clarification is provided, appraisers will need to remain cautious.

Appraisers may consider contractual provisions that shift the burden of the penalty to the taxpayer. If the taxpayer agrees to hold the appraiser harmless in the event the IRS invokes the penalty, several issues arise. First, the agreement may not be valid as a matter of state law in that it may violate public policy to permit the burden of a penalty to be shifted from the person targeted by Congress.¹⁴ Second, assuming no public policy impediment—or, in the alternative, that the taxpayer voluntarily agrees to reimburse the appraiser in accordance with the hold-harmless obligation and that, as a consequence, there is no litigation about the public policy question—the appraiser would presumably be required to include the reimbursed amount in gross income.¹⁵ Third, the appraiser would not be entitled to deduct the cost of the penalty.¹⁶ Interestingly, the deduction would appear to be unavailable even though the client's reimbursement is included in the appraiser's gross income. Given the tax effects of a hold-harmless agreement, appraisers may insist that it be drafted to include a "gross up" (requiring the tax-

payer to pay not only the cost of the penalty but also any income tax cost that the appraiser incurs by reason of the indemnification). But a gross-up, like the hold-harmless for the penalty itself, may be unenforceable as a matter of public policy. It would not be surprising if, faced with these uncertainties, appraisers increase their fees in order to compensate for the increased risk.

The effective date of section 6695A also seems harsh. It applies to any appraisal that supports a tax position with respect to a return or submissions after August 17, 2006, even if the appraisal was completed before that date. For example, assume an estate tax return was due to be filed on October 1, 2006, and that the executor had obtained the appraisal to value property in the taxable estate in February of 2006. Because the estate tax return will be filed after August 17, the appraiser could be penalized under the section even though the appraiser did not foresee the risk of the penalty at the time the appraisal was provided. Similarly, the new blacklisting rules (no longer requiring the imposition of a penalty under section 6701) apply with respect to returns and submissions after August 17.

The expanded ability to blacklist an appraiser, as well as the new section 6695A penalty, promises radically to alter the settlement and litigation dynamic in valuation cases. With appraisers made to feel more vulnerable by these provisions, the taxpayer's ability to support his or her valuation position in settlement and in litigation will necessarily be undercut.

Summary and Conclusions

The Pension Protection Act reduces the threshold for imposition of penalties for reporting incorrect valuations for income, estate and gift tax purposes. It eliminates the "good faith/reasonable" basis defense to the imposition of a gross income tax misstatement of value for contribution to charity. It imposes a new penalty on tax appraisers who incorrectly value non-cash assets for income, estate or gift tax purposes, which may only be waived if the IRS determines that the appraisal was more likely than not correct. It also permits an appraiser to be blacklisted even if the appraiser was unaware that the appraisal was not correct. On account of the importance of valuation in estate planning, the Act may have far-reaching effects for estate planners and their clients.

¹⁴ See *Mortenson v. National Union Fire Ins. Co.*, 249 F.3d 667 (7th Cir. 2001) (indicating in dicta that a taxpayer subject to the penalty under section 6672 would, in all likelihood, be precluded as a matter of public policy from seeking reimbursement under an insurance policy); see also Kylie D. Logue, "Tax Law Uncertainty and the Role of Tax Insurance," 25 *Va. Tax Rev.* 339, 405 (2005). Surprisingly, as *Mortenson* suggests, the public-policy

question may turn on state law, rather than federal law.

¹⁵ See Priv. Ltr. Rul. 7749029 (requiring the taxpayer to include in gross income the estimated-tax penalty recovered from the accountant). Neither a private letter ruling (PLR) nor a national office technical advice memorandum may be cited or used as precedent. IRC § 6110(k)(3).

¹⁶ See Treas. Reg. § 1.162-21(b)(1)(ii).