

# **The Internal Revenue Service and Treasury Turn Up the Enforcement Heat on Abusive Tax-related Appraisals and Those Who Prepare Them**

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The Internal Revenue Service is undertaking several new and significant enforcement initiatives that specifically target abusive tax-related appraisals and the individuals who prepare them. This conclusion is based on extensive discussions with the IRS and congressional sources, and on a review of internal IRS documents that have become publicly available. The *immediate* consequence for individuals and firms providing valuations for tax purposes is a three-pronged enforcement effort, as follows:

- First, the IRS is now singling out appraisals for special scrutiny. It has enhanced its traditional process of auditing appraisals of tangible and intangible property and has begun a Compliance Initiative Project that seeks a better understanding of patterns of appraisal usage in the tax system, including the use of valuation discounts. Finally, active discussions are ongoing inside the Service on what additional steps are necessary to increase appraiser accountability, including an easing of the current standard for taking enforcement action against appraisers. It is our understanding that the Service has hired additional appraisers to help accomplish these activities.
- Second, appraisers whose valuations improperly support an understatement of a taxpayer's tax liability will face Internal Revenue Code Section 6701 fines for knowingly aiding or assisting such understatement. We believe that a significant number of potential 6701 charges against appraisers are currently being studied.

- Third, when appraisers are found to have committed a 6701 violation, referrals will be made to IRS's Office of Professional Responsibility (OPR) for the purpose of initiating proceedings to disqualify them from practice before the Service. Procedures for making such referrals are not yet in place but are likely to be in the not-too-distant future.

What is noteworthy about Section 6701 and the OPR portions of the IRS's enforcement initiative is that although the authority to pursue each of them has existed for many years, we do not believe either has previously been exercised against any appraiser. This record of relative inaction is likely to change dramatically.

A related development, involving changes to Treasury Department Circular 230, could increase the likelihood that abusive appraisals will be detected in far greater numbers than ever before. These changes establish standards of practice for written advice that "tax practitioners" give their clients and were designed by the Treasury/IRS to rein in practitioners whose aggressive advice to clients has been blamed for an explosive growth in tax-avoidance schemes. While appraisers are not presently included in Circular 230's definition of a "tax practitioner," advice involving appraisals and material valuation issues are specifically covered by its provisions. This suggests that when the government enforces tax practitioner compliance with Circular 230 best-practice requirements, some of the tax advice at issue is likely to involve valuations. When that occurs, the IRS's attention will inevitably be drawn to the appraisers who prepared them.

The revisions to Circular 230 highlight an important fact about the underlying document that may be unknown to many appraisers and appraisal users. Circular 230, which has been in existence for many years and sets forth the responsibilities of practitioners before the IRS, was amended in 1985 to specifically allow for the disqualification of appraisers who are assessed an "aiding and abetting" fine. The inclusion of tax advice relating to valuations in the recent Circular 230 revisions make it likely that the enforcement focus on appraisers will increase. Still, the Circular's precise impact on valuers will not be clear for some years.

*A longer-term* consequence of the IRS's determination to curtail tax-related appraisal abuses-and a potentially crucial one-involves support inside the Service for easing the criteria

for taking debarment or suspension-type enforcement actions against appraisers. The likeliest direction for such a change is that the current and fairly stringent Section 6701 "aiding and abetting" test would give way to the much easier "incompetence" test, which now applies to accountants and other tax practitioners but not to appraisers. Such a change, if it were to occur, would almost certainly be accompanied by a sharp increase in Circular 230 sanctions against appraisers and could also lead to the establishment of other types of sanctions against appraisers.

The IRS's decision to "turn up the heat" on appraisers is a direct response to two interrelated realities. First, there is an increased recognition by senior IRS officials that the historic lack of proper attention to tax-related appraisal problems has contributed to ineffective tax administration and may well account for hundreds of millions of dollars annually in lost tax revenues. In fact, for millions of income, estate, and gift returns filed each year, determinations of the fair market value of tangible and intangible property are an important factor in establishing tax liability. The second reality comes in the form of sharply vocal criticisms from the tax-writing committees of the U.S. Congress over the reliability of tax related appraisals and the doubts, expressed by some, about the competency and/or integrity of the universe of individuals who prepare them. Indeed, some influential voices in Congress have even suggested that the concept of "fair market value" is ineffective as a public policy template for In many of the hundreds of Tax Code provisions that rely on it and that advocacy appraisals are too often used to improperly understate tax liability. That attitude was evident in the decisions of the tax-writing committees in the 108th Congress to prohibit fair market value tax deductions, in most cases, for charitable donations of intellectual property.

A very unwelcome, but not inconceivable, outcome for the community of professional appraisers could result from the mix of the two realities described above. One would be the enactment by the current 109th Congress of Tax Code changes that further reduce reliance on fair market value determinations (e.g., proposals of the Joint Taxation Committee [JTC] to eliminate fair market value tax deductions for charitable contributions on noncash property, including closely held stock) or that undermine the role of appraisers in our tax system (e.g., the JTC's recommended overturning of the existing practice of applying shareholder level

discounts for lack of control and marketability to inter generational transfers of interests in family limited partnerships). The second involves a more aggressive program of Treasury/IRS sanctions directed against appraisers. The American Society of Appraisers (ASA) has been working hard on Capitol Hill to convince legislators that professional appraisers, with meaningful valuation credentials, do possess the skills and independence necessary to perform tax-related appraisals in a fair, efficient, and reliable manner.

This article attempts to describe what appears to lie ahead for appraisers who provide tax-related services and sets forth our present understanding of how the IRS is likely to respond when it finds appraisals that it regards as problematic.

It also needs to be said at the outset that since the late 1990s, in anticipation of the difficult public policy climate that now exists for appraisers who practice in the tax area-ASA, through the Business Valuation and Government Relations Committees, has been advancing its own appraisal reform agenda with the Service. The centerpiece of that agenda calls for a major upgrading of the IRS's current and certainly inadequate definition of "qualified appraiser" and adoption, by the Service, of the Uniform Standards of Professional Appraisal Practice (USPAP) for those providing valuation services. To date, the Service has not upgraded its "qualified appraiser" definition (although it is considering doing so), and it has declined to require that appraisals for tax purposes adhere to USPAP. The IRS has, however, developed its own set of appraisal standards, which bear some resemblance to USPAP, for internal use by valuers who are employed by the Service. We strongly believe that adherence to the Uniform Standards is an essential indicator of competency for all appraisers providing tax valuations.

While not all valuers with a tax practice will welcome an enhanced enforcement focus on appraisers, the new regime is likely to produce some important public policy benefits, if it is accompanied by a significant upgrade in the definition of "qualified appraiser" and a requirement for adherence to uniform appraisal standards, as ASA has recommended.

## **Penalties for Aiding and Abetting Understatement of Tax Liability**

### ***Internal Revenue Code Section 6701***

Internal Revenue Code Section 6701 authorizes the imposition of financial penalties on "any person" providing aid, assistance, or advice with respect to a material tax matter and who knows that the result will be an understatement of tax liability. Earlier this year, the IRS's Office of Chief Counsel issued a memorandum on how Section 6701 should be applied against appraisers.<sup>1</sup> The February 8th memorandum responded to a request for guidance on this subject from the appraisal services unit of the IRS's Large & Mid-Size Business (LMSB) Division. That unit, which is a part of LMSB's Field Specialist Program, is responsible for reviewing those tax-related appraisals of tangible and intangible property referred to it (except for fine art items that are reviewed by the Service's Art Advisory Panel) for the purpose of establishing whether the elements of a 6701 infraction exist and, if so, referring the matter for final determination of liability.

Specifically, the Office of Chief Counsel's memorandum provides guidance concerning the criteria that Service personnel should consider to determine whether to impose a Section 6701 penalty, the administrative procedures necessary to impose one, and the due-process rights of a person who is the subject of the Section 6701 penalty assessment. In essence, it states that the first element of a 6701 infraction requires assistance in the preparation of a document for a return. A second element requires that a person "know, or have reason to believe," that the document will be used to establish a taxpayer's "gross income." The third element requires that the appraiser "have knowledge" that if so used, the document will result in an understatement of the tax liability of another person. The memorandum states that there is a split among courts as to the "level of proof" required to impose a penalty. Some courts have held that "a preponderance of evidence" is required, while one court has concluded that only "clear and convincing proof" is necessary.

As to administrative procedures for identifying and asserting a Section 6701 penalty, the February 8th memorandum states that it "will usually be identified by examiners through the

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<sup>1</sup> Internal Revenue Service, Office of Chief Counsel, Subject: "Section 6701 Appraisers," Memorandum no. 2005 120 16, UILC: 670 1.00-00, 8 February 2005.

examination process," and "as the government has the burden of proof...it can be assessed only by employees who have the requisite knowledge of the facts giving rise to the penalty." The memorandum cites "revenue agents and office auditors at a Service area office" as the appropriate assessing employees. Although the legal opinion does not specifically mention the "penalty examination" role of the LMSB appraisal specialists in identifying potential 6701 violations, that office would be part of a special examination team responsible for determining whether preparation of the valuation in question aided or assisted in an understatement of tax liability.

The IRS legal memorandum also addresses whether the Service could invoke its civil injunction authority under Section 7408 of the Internal Revenue Code to prevent an appraiser from engaging in prohibited conduct, "including conduct subject to the 6701 penalty." The Office of General Counsel states that this authority is available if the government can "show that injunctive relief is appropriate to prevent the recurrence of" prohibited conduct. It appears from the memorandum's discussion of the injunction authority that it might be available against an appraiser without the prior imposition of a 6701 fine (the conduct need be "subject to" a 6701 fine), while a Circular 230 debarment or suspension appears to require a prior actual finding of a 6701 infraction.

The memorandum discusses, at some length, the appraiser's due-process rights under a 6701 proceeding and the appraiser's right to challenge the imposition of the 6701 fine after the fact.

### ***The effect of "disclaimers"***

The Office of General Counsel memorandum does not specifically address two issues: first, the extent, if any, to which the appraisal itself (as opposed to the mindset of the appraiser) affects the question whether a Section 6701 infraction has occurred, and second, whether there is any way in which the appraiser, through use of some type of disclaimer language, can insulate himself or herself from the consequences of an appraisal that is used by a taxpayer to understate tax liability.

As to the first question, the memorandum leaves somewhat in doubt the precise elements of an appraisal engagement that would give rise to a Section 6701 "aiding and abetting" penalty. Does the issue only have to do with the mindset of the appraiser (i.e., knowing that the document will give rise to an understatement of tax liability), or can the penalty be triggered simply because the appraisal is incapable of being substantiated and, therefore, may be used for understatement purposes? Further, is there any circumstance under which an appraiser could be regarded as being in violation of 6701 even if the appraisal itself is capable of being substantiated?

With respect to the second issue, there has been some discussion among tax practitioners covered by the Circular 230 amendments about the use of disclaimer language in communications with clients or in conjunction with tax advice itself that is designed to protect the practitioner (and presumably the client) from violations of the tax laws. Appraisers who provide valuations for tax purposes have also raised this issue. If an appraiser produces, in good faith, an appraisal product for a taxpayer the conclusions of which cannot be substantiated, can the appraiser disclaim "aiding and abetting" responsibility if the appraisal is used by the taxpayer in connection with an understatement of tax liability? Some believe that disclaimers will not trump an otherwise abusive appraisal. We do not know and will not speculate. But additional guidance from the IRS on these questions is necessary and would be appreciated.

### **Amendments to Treasury Circular 230**

In late December of last year, the Treasury Department and Internal Revenue Service issued final regulations, effective 20 June 2005, amending Treasury Circular 230 "to promote ethical practice by tax professionals who practice before the IRS." Circular 230 governs practice before the Internal Revenue Service. The revisions provide standards of practice for written advice that tax professionals give to their clients. In the words of a Treasury Department press release, "The final regulations reflect current best practices and are intended to restore and maintain public confidence in tax professionals...The mandatory requirements for written advice that presents a greater potential for concern prohibit practitioners from providing advice

that, for example, relies on incorrect factual assumptions or representations, does not consider all relevant facts, or fails to analyze important legal issues."<sup>2</sup>

There are two aspects of Circular 230 that should be of particular interest to appraisers providing tax-related valuation services. First, while the terms and conditions of appraiser practice before the IRS clearly are within the authority of the Treasury Secretary (including suspension or debarment), appraisers do not appear to be covered, at least directly, by the Circular 230 amendments affecting "covered opinions" by practitioners." The term "practitioner" is defined to include "attorneys," "certified public accountants," "enrolled agents," and "enrolled actuaries" but not "appraisers." This brings us to the second point of interest, which is that the "best-practices" provisions of Circular 230 do appear to address valuation issues. The Treasury's explanation of its revised regulations states, as to requirements for "covered opinions" involving a "federal tax issue," that a practitioner providing a covered opinion "must not assume that a transaction has a business purpose...or make an assumption with respect to a material valuation issue." A "federal tax issue" is defined as including "the value of property for Federal tax purposes." The Treasury's explanation further states, as to factual matters, that "a practitioner must not base the opinion on any unreasonable factual assumptions... A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the...appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal."

Although the government expects tax professionals to comply with all its "best-practices" standards, it is not entirely clear which of the amended Circular 230 provisions are regarded by the Treasury and IRS as "aspirational" only and, therefore, not enforceable through disciplinary actions and which ones will be enforced through the use of sanctions. Nor is it clear how Circular 230's provisions relating to valuations will affect professional appraisers who are not also "tax practitioners," as well as those who are. And, given the IRS's extremely loose

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<sup>2</sup> IRS and the Treasury Department Amend Circular 230 to Promote Ethical Practice by Tax Professionals, IR-2004- 152, Dec. 17, 2004, <http://www.irs.gov/irs/Article/0,,id=132445,00.html>.

definition of what constitutes a "qualified appraiser," we are extremely interested in how it intends to apply the Circular's prohibition against basing a covered opinion on an appraisal if the practitioner knows or should know that it was prepared "by a person lacking the skills or qualifications necessary to prepare" it. Nevertheless, we do expect Circular 230 to have a significant impact on individuals and firms providing tax-related appraisal services, and it must be regarded as an important piece of the IRS's enforcement initiatives directed at appraisers.

## **Summary**

As a result of the greater focus of the Department and IRS on professional responsibility and their exasperation with tax-avoidance schemes, which could include the use of advocacy appraisals, those who provide tax-related valuation services will be facing an era of enhanced audits and enforcement sanctions. The new enforcement initiatives, recent changes to Circular 230 involving valuation-related tax advice, and the possibility (some would argue "probability") that appraisers practicing before the IRS in the future will be subject to penalties for incompetence will be the hallmarks of this new era. There is this additional consideration: If the congressional spotlight continues to shine on tax-related appraisal issues and the Service responds with the ramped-up enforcement initiatives we have described, then the federal government—in the form of the Treasury Department and the IRS—will become a major player in establishing appraiser qualifications and appraisal standards and in sanctioning wrongdoing by appraisers who provide any tax-related appraisal services.

We continue to believe that many of the ills involving tax-related appraisals, both real and perceived, would be greatly mitigated by a requirement that all higher-dollar value Tax Code valuations be performed by professional appraisers who have earned meaningful valuation credentials, who are subject to a code of ethics, and who adhere to the Uniform Standards of Professional Appraisal Practice. While these requirements would not entirely eliminate faulty appraisals, they would ensure a high level of professional responsibility and competence from appraisers who practice before the Service.

As the appraiser-enforcement developments discussed in this article unfold, it is imperative that all professional appraisers monitor them and help shape this changing landscape. We intend to.

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