

**Statement of the American Society of Appraisers
Panel Discussion With IRS Regarding
The Process For Assessing Civil Money Penalties Against Appraisers For
Valuation Misstatements
February 18, 2010**

Presented By Jay Fishman, Chair, Government Relations Committee

I. Executive Summary

- **In General:** The American Society of Appraisers (ASA) respectfully objects to the procedures established by the Service for assessing civil money penalties against appraisers under section 6695A of the Internal Revenue Code. We object because the procedures lack due process safeguards and because IRS has failed to define a key provision of 6695A which provides appraisers with a safe harbor from valuation misstatement penalties. Absent fair and appropriate changes to the penalty assessment process and related actions by the Service, ASA urges that any civil money penalty actions against appraisers under the authority of section 6695A be held in abeyance;
- **Without Defining 6695A's Safe Harbor Provision, Appraisers Are Denied Protections Mandated By Statute:** Section 6695A(c) mandates that no valuation misstatement penalty shall be imposed if the appraiser establishes "to the satisfaction of the Secretary" that the appraised value "was more likely than not the proper value". Without a definition and guidance as to the meaning of the safe harbor phrase, individuals charged with a valuation misstatement have effectively been denied an opportunity to exercise it. What are the criteria appraisers must meet to pass the "satisfaction of the Secretary" test? What are the criteria and protocols appraisers must understand in order to demonstrate that the appraised value is "more likely than not the proper value"? Without answers to these questions, appraisers are being denied protections that Congress intended;
- **Letter 4477 Should Be Eliminated Or Its Contents Changed:** Letter 4477 – which states that IRS is proposing a penalty based on finding a valuation misstatement – should not be sent until the accused appraiser has been provided an opportunity to speak with the Service to explain the basis for his or her conclusion of value. The existing process is, we believe, not only unfair on its face, it denies appraisers the same right that appears to be available to tax return preparers to discuss a possible Code section 6694 infraction (Understatement of Taxpayer's Liability By Tax Return Preparer) before a penalty letter is issued. A serious and immediate negative consequence of the current penalty process is that mere receipt of a 4477 Letter, by itself, would have to be disclosed by the appraiser under circumstances that could be injurious to his or her professional standing and reputation.

I. Introduction And Background

The American Society of Appraisers (ASA)¹ is grateful to IRS and its Office of Servicewide Penalties (OSP) for convening today's important meeting. We are here to discuss our serious concerns about the process established by the Service for assessing civil money penalties against appraisers who it believes may be responsible for tax-related valuation misstatements.²

ASA has worked closely and constructively with IRS over many years to modernize its valuation-related policies, practices and procedures for the purpose of ensuring the reliability of appraisals performed for tax purposes and the valuation qualifications of those performing them. ASA also has worked with Congress on a variety of tax-related appraisal issues, including the valuation provisions of the Pension Protection Act of 2006 (Pub.L. No 109-280), which the Service correctly cites as its authority to impose civil money penalties for valuation misstatements. For the record, ASA strongly supported Congressional efforts to improve the education, training and experience requirements for those performing tax-related valuations; to mandate that valuations adhere to generally-accepted and uniform appraisal standards; and to establish greater accountability for those whose valuations fail to meet high standards of care.

As IRS knows – probably better than almost any other federal agency – Congress frequently changes existing law and often does so in rather broad-brush terms. Accordingly, it falls on the federal agencies with responsibility over the legislation's subject matter to implement changes through detailed rulemaking and guidance. How an agency interprets and implements new laws is as important to stakeholders as the words of legislation itself. That is clearly the case with respect to OSP's establishment of a penalty assessment process for appraisers.

II. Discussion - ASA's Conclusions & Recommendations

We sincerely appreciate the time and the attention required for the Service to develop the details of the penalty assessment process. Nevertheless, as expressed in the October 21, 2009, letter the professional appraisal organizations sent to IRS, we have concluded that key aspects of the process are unfair to and lack appropriate due process safeguards for those individuals believed by IRS to have committed valuation misstatements. ASA's

¹ ASA, which is the nation's oldest multidisciplinary appraisal organization, awards professional designations in business valuation, commercial and residential real property and in personal property valuation (including the valuation of fine art and machinery and technical specialties).

² "IRS SBSE Memorandum (SBSE-04-0809-015) on Penalty for Gross Valuation Misstatements Attributable to Incorrect Appraisals" issued on August 18, 2009, by the Commissioners of the Small Business/Self-Employed Division, the Large and Mid-Size Business Division, the Tax Exempt and Government Entities Division and the Chief of Appeals.

specific objections to the process and its recommendations for how to address them are summarized below:

(1) Penalty Assessment Letter 4477 – Which States That IRS Is Proposing A Penalty Based On Its Having Found A Valuation Misstatement – Is Sent To the Appraiser Before He or She Is Given An Opportunity To Discuss The Finding; And, In Some Cases, Before He or She May Even Know That The Service Is Questioning The Appraised Value. This Process Is Inherently Unfair. Moreover, it Denies Appraisers The Same Due Process Safeguards That the Service Appears To Accord Tax Return Preparers When Considering Civil Money Penalties Against Them:

Letter 4477 represents IRS' first official act in a process which seeks to impose a valuation misstatement penalty on an appraiser. Under the procedures outlined in the Memorandum, the Letter is sent to the appraiser without first advising that the Service is considering the initiation of a penalty assessment process, thereby denying him or her an opportunity to forestall the Letter by explaining the basis of the appraised value. 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 receipt of the letter does not constitute a final judgment that a punishable valuation misstatement has, in fact, occurred, it does represent the agency's official, written pronouncement that a misstatement exists and a penalty is being proposed – all before the appraiser has an opportunity to speak with the agency about the allegation. As explained in paragraph 3 below, mere receipt of this letter can have profound negative consequences for the appraiser.

We find this process is not only unfair on its face, it denies to appraisers under Code section 6695A the same due process rights that IRS appears to accord tax return preparers when it considers imposing a Code section 6694 penalty on them. Based on our review of available Internal IRS documents setting out the civil money penalty enforcement process against tax return preparers,³ we have concluded that preparers are permitted an opportunity to address, contest and otherwise discuss IRS' finding that a 6694 penalty is warranted prior to the Service sending the preparer an official written document announcing its conclusion.⁴ By contrast, appraisers are given an opportunity to rebut allegations of a misstatement only after a 4477 determination Letter has been sent.

It is important to point out that what we regard as IRS' disparate and disadvantageous treatment of appraisers as opposed to return preparers, is not dictated by

³ “IRS SB/SE Memorandum (SBSE-04-0509-009) Providing Interim Guidance On Return Preparer Penalty Procedures for Estate, Gift Tax Penalty Cases” May 8, 2009; “IRS SB/SE Memorandum (SBSE-04-0209-013) on Preparer Penalty Procedures for Employment Tax,” February 26, 2009. Also, “Memorandum For Excise Territory Managers and Program Managers,” 12/31/08

⁴ Those documents – Form 5816 (“Report of Tax Return Preparer Penalty Case” in situations calling for prompt assessment procedures) and Letter 1125 (Preparer Penalty 30-Day Letter – when prompt procedures are unnecessary) – explain the Service's conclusion that a penalty is warranted.

statute. Rather, it stems solely from IRS decisions about how to process penalty assessments against one stakeholder group versus the other.

RECOMMENDATION: Appraisers should receive reasonable due process safeguards (i.e., an opportunity to speak with the IRS about the appraisal) before the Service communicates that it has found a valuation misstatement and intends to assess a civil money penalty. ASA's strong preference is for the 4477 Letter to be eliminated entirely. If the Service has concerns about the reasonableness of the appraisal, the appraiser should be notified orally that the Service would like to discuss the basis of the conclusion of value. Oral notification appears to be the process followed when questions are raised about a possible 6694 violation by tax return preparers. If there is a compelling reason why IRS needs to send a letter, its contents should not state or imply that the Service has determined that a valuation misstatement has occurred and, therefore, is proposing a penalty.

We believe the revised process we recommend would benefit the IRS, as well as appraisers, because it would provide the agency with information which would demonstrate - certainly in some instances - that an actionable valuation misstatement has not occurred. A process requiring an opportunity for discussion between the appraiser and IRS prior to a proposed penalty notice would allow the Service to avoid initiating enforcement actions that are unjustified, of dubious merit or subject to the penalty exception provision of the statute. Enforcement actions are costly to appraisers and to the agency.

(2) We Are Deeply Troubled That The Penalty Assessment Memorandum Has Become Operative Even Though The Service Has Not Yet Defined A Crucial Safe Harbor Provision of the Pension Protection Act Permitting Appraisers To Avoid Valuation Misstatement Penalties If They Can Establish That the Appraised Value Is More Likely Than Not The Proper Value:

Section 6695A(c) of the PPA states –

“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.”

However, the phrase “more likely than not the proper value” has not been defined and guidance on how an appraiser would assert that defense does not currently exist. Absent such a definition and associated protocols, we question the propriety and the legality of any valuation misstatement enforcement actions being taken under the authority of Code section 6695A. We do not understand how a penalty assessment proceeding can take place absent an appraiser's opportunity to exercise his or her safe harbor rights; and, we wonder how that right is to be asserted without the ability to understand what it means. Indeed, OSP's August 18, 2009, penalty assessment

“Memorandum For All Examiners, Estate and Gift Attorneys and Appellate Officers,”⁵
IRS states –

“The [valuation misstatement] penalty does not apply if the appraiser can establish that it was ‘more likely than not’ that their appraisal value was correct. The statute does not define ‘more likely than not’ but forthcoming regulations will provide further guidance on this standard.” (Emphasis Added)

Of course, no such guidance has been proposed, let alone adopted. This lack of guidance effectively deprives appraisers of a crucial statutory protection. We respectfully question, therefore, whether it would be prudent for IRS to undertake enforcement actions under a statute whose safe harbor provision it acknowledges must be defined, yet has failed to do so.

While the absence of a definition and guidance on this safe harbor phrase is extremely damaging to appraisers of all disciplines who provide tax-related valuation services, I need to take a moment to point out why this is particularly devastating for business appraisers whose work involves the appraisal of closely held businesses and hard-to-value business assets.

Business Appraisers Have A Unique Interest In IRS Issuance Of Guidance On the Phrase “More Likely Than Not The Proper Value”:

Congress established a safe harbor from valuation misstatement penalties in the Pension Protection Act (PPA) because it recognized that while appraisals represent the expert opinions of highly trained professionals, they do not represent mathematical certitude. It created the penalty exception even though the percentage tests on which a valuation misstatement is based provide ranges within which an appraised value is acceptable.⁶

At its core, the PPA’s safe harbor provision represents recognition by Congress that IRS must have the authority – and must be accorded the latitude – to determine that an appraised value is the proper value **even in situations where it falls outside the statutory percentage tolerances.** This authority and latitude is nowhere more important than in certain categories of business appraisals, specifically the appraisal of hard-to-value assets, such as the stock of closely held businesses or illiquid assets. IRS Revenue Ruling 59-60, which is the Service’s seminal statement on the valuation of closely held companies where market quotations are not available, confirms the difficulties inherent in

⁵ Control # SBSE-04-0809-015.

⁶ A substantial valuation misstatement exists when the claimed value of property is 150 percent or more of the amount determined to be the correct value. A gross valuation misstatement occurs when the claimed value is 200 percent or more of the correct value. For estate or gift tax purposes, a substantial valuation misstatement exists when the claimed value of property is 65 percent or less of the amount determined to be the correct value. A gross misstatement exists when the claimed value is 40 percent or less of the amount determined to be correct.

performing these types of appraisals (but still requires a high degree of due diligence from the appraiser).

Revenue Ruling 59-60 outlines in considerable detail the general approach, methods and factors which appraisers must consider in valuing illiquid securities. But, it acknowledges that –

“No general formula may be given that is applicable to the many different valuation situations arising in the valuation of [closely held] stock.... Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.... Valuation of [closely held] securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal.”

ASA’s point is that without establishing a definition of and guidance concerning the “more likely than not the proper value” phrase; without a specific framework through which stakeholders and the IRS can reach common understanding as to the bases on which an appraised value is **excepted** from a penalty even though it may fall outside the valuation misstatement percentage tolerances, the penalty assessment process cannot work effectively and fairly.

ASA, and I’m certain the other stakeholder organizations, would be pleased to provide ideas to IRS on how the “more likely than not” phrase should be interpreted for tax-related appraisal services under 6695A. In this regard, we note that the Service has considerable experience in interpreting the meaning of that phrase in connection with Code section 6694 penalties pertaining to tax return preparers. On December 22, 2008, Treasury and IRS issued final regulations implementing amendments to the tax return preparer penalties under sections 6694 and 6695 of the Internal Revenue Code. The final regulations reflected amendments to the Code by section 8246 of the Small Business and Work Opportunity Tax Act of 2007. That section changed the standard of conduct return preparers must meet to avoid the imposition of penalties when the prepared return results in an understatement of tax. For undisclosed positions, the 2007 Act replaced the “realistic possibility” standard with a standard requiring the return preparer to demonstrate “reasonable belief that the position taken would more likely than not be sustained on the merits.” IRS’ December 2008 final regulations did, in fact, interpret and provide guidance for that phrase.⁷

⁷ The final regulations stated in part that if the position of the return preparer is for an undisclosed position “it is ‘reasonable to believe that a position would more likely than not be sustained on its merits’ if the return preparer analyzes the pertinent fact and authorities and, in reliance upon that analysis, reasonably

We are not suggesting that the Service’s interpretation of the “more likely than not phrase” for the undisclosed positions of return preparers would be appropriate in any meaningful sense for tax-related appraisals which are clearly disclosed on a return and which involve a process and considerations very different from those relating to positions taken by preparers on tax returns.⁸ We only cite this history to illustrate that the Service has carefully considered the “more likely than not” question in the recent past.

RECOMMENDATION: We respectfully recommend that 6695A civil money penalty enforcement actions against appraisers be held in abeyance until the Service has defined the “more likely than not proper value” safe harbor provision of Code section 6695A and provided guidance on how appraisers should assert this crucial penalty exception. ASA and I’m sure other stakeholders, would be pleased to participate in an expedited process leading to the adoption of such definition and guidance. We do not expect the Office of Servicewide Penalties to resolve this crucial concern by itself. Other IRS offices may well need to be involved. But, I can assure OSP that ASA and other stakeholders are anxious to work with the IRS, on an expedited basis, to define and provide guidance on the 6695A safe harbor provision. Until that is accomplished, we urge suspension of 6695A enforcement actions.

(3) We Believe that Under A Number of Likely Scenarios, Appraisers Will Be Required To Disclose Receipt of A 4477 Letter, Thereby Jeopardizing Their Professional Standing, Reputation And, Possibly, Ability To Practice: A serious unintended consequence of a process that denies appraisers an opportunity to address a preliminary Service finding of a misstatement before a 4477 Letter is sent, involves scenarios under which just the receipt of that Letter would have to be disclosed by the valuation practitioner. Examples of such scenarios follow:

- (a) **Testimony Of An Appraiser As An Expert Witness:** We believe that an appraiser who receives a 4477 Letter would have to disclose that fact if he or she was testifying as an expert valuation witness in unrelated federal or state court litigation and was asked by opposing counsel or by the court whether any proceedings are pending against them involving their valuation competency. We believe an affirmative reply would be required and that the consequences of that reply could result in a disqualification of the witness or undermine his or her valuation credibility;

concludes in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits.”

⁸ Indeed, Congress subsequently changed the standard of care for preparers in connection with undisclosed positions from “more likely than not” to the less onerous standard of “substantial authority for the position.”

- (b) **Applying For Or Renewing Errors & Omissions Liability Insurance:** Disclosure of a 4477 Letter would be required when the appraiser applies for Errors and Omissions Insurance or is trying to renew an existing policy. Most appraisers purchase E&O insurance . policies. Applications for these policies invariably ask whether any disciplinary proceeding has been undertaken by a regulatory or other governmental agency against the appraiser within a specified number of years preceding the date of the application. An application for a real estate appraiser E&O policy issued by the nation’s leading administrator of E&O insurance asks: “Within the last 10 years, [has the applicant] “been the subject of any disciplinary or corrective action by an appraisal organization, state licensing board or other regulatory body of a governmental entity as a result of their appraisal activities.”

Applications for policies issued by all appraiser insurance carriers contain similar questions. A “wrong” answer to these questions can result in a denial of E&O insurance or a large premium increase;

- (c) **Applying For Or Renewing A State Appraiser License:** We believe that the rules governing the real estate appraiser licensing laws of some states could require disclosure of a 4477 Letter when an individual applies for a license or renews a license. We are researching this issue to determine which state’s appraiser licensing laws would require disclosure of a 4477 Letter.

Based on these examples, we hope the Service will understand our concern over the damage that can be done to an appraiser’s reputation and livelihood from just the receipt of a 4477 Letter; and why we feel so strongly that the appraiser should be accorded an opportunity to address Service concerns about the validity of an appraisal, before a 4477 Letter is sent.

(4) Another Issue Of Concern: Some IRS Valuation Specialists Lack Professional Appraisal Credentials And The Service’s Valuation Policy Council Is Not Functioning

A related concern is that the penalty assessment process relies, to a significant extent, on the Service’s field specialist program – specifically its valuation specialists – to review taxpayers’ appraisals and determine whether a valuation misstatement has in fact occurred – leading, potentially, to a proposed penalty. Over the years ASA has had a great deal of interaction with members of the valuation specialist program. Some hold appraisal designations from ASA or from other professional organizations; and others have taken our coursework necessary to qualify in the future for a professional credential. We have great respect for the work the program performs.

We are troubled, however, that some of those called on to make judgments about the validity of taxpayers' appraisals have not earned an appraisal credential in the form of a state real estate appraiser license or a designation in other valuation disciplines from recognized professional appraisal organizations. Until about a year ago, the Field Specialists operated an aggressive program to get its valuation staff properly credentialed and assist them in doing so. That program faltered badly beginning about a year ago. As a consequence, highly credentialed private sector appraisers sometimes find themselves in a situation where their appraisals are being critiqued or disapproved by individuals working for the Service who lack the training, experience, education (including continuing education requirements) and professional credentials that private sector appraisers possess.

Also terminated about a year and a half ago was the IRS' Valuation Policy Council – an entity established by the Service many years ago which met from time-to-time and served as an important communications link between the appraisal profession and representatives of the IRS with responsibility for valuation issues. Had the Valuation Policy Council continued to operate as effectively as it did previously, the problems we are here to discuss today, might have been avoided.

RECOMMENDATION: We respectfully recommend that IRS' Field Specialist program reinstate its policy to encourage its valuation specialists without appropriate professional credentials to obtain them; and provide assistance to them in doing so. We recommend further, that the Valuation Policy Council be reactivated immediately.

If there are any questions I would be happy to answer them.