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PERSONAL

Proving the Value of a Charitable Donation May Be the Least of Your Problems

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The Service is becoming more and more creative in its attacks on charitable contribution deductions claimed for various types of easements, and the Tax Court has upheld the technical requirements and refused to entertain taxpayer arguments that there was substantial compliance. The new focus is on appraisers and appraisals.

Imagine you have advised a client on deduction of a sizeable charitable donation of property. A reputable appraiser has prepared a thick appraisal, and he seems to have his facts straight. You have made sure the technical requirements of the Regulations have been satisfied, and appropriate parties have completed Form 8283 ("Noncash Charitable Contributions"). You probably feel comfortable advising your client that his risk is essentially an IRS challenge of the value, something typically resolved in negotiations if audited. Well, think again. Like a black cat in the shadows on Halloween night, other issues are lurking. Proving the value of the property donation may be the least of your problems.

Several issues have recently sprung up, mostly in the conservation easement arena, that directly affect appraisals in *all* valuation cases. IRS is currently attacking appraisals as not being "qualified" (even while conceding the appraiser himself *is* qualified). It is liberally proposing taxpayer and appraiser penalties in large amounts. The Service is even trying to exclude apparently sound appraisals from being used in evidence in Tax Court trials under the principles of *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 US 579 , 125 L Ed 2d 469 (1993), which excluded opinions based on an insufficient foundation.

Even practitioners with tax controversy practices have never experienced the intensity and variety of scrutiny that is becoming standard practice within the IRS. Having tried and defended deductions for qualified conservation contributions, the authors have witnessed first hand these attacks on qualified appraisers and their work, and the impact of these attacks on taxpayers.¹ Taxpayers are having mixed success meeting the challenges. Also, these issues are not limited to conservation easement donations; they lap over into all valuation-based cases. What follows is an overview of the importance of having a "qualified appraisal," the attack on seemingly good appraisals by the IRS in audits and in court, and the imposition and consequences of very substantial taxpayer and appraiser penalties.

THE ATTACK ON THE QUALIFIED APPRAISAL AND EXPERT REPORTS

For a charitable contribution of property with a claimed value of more than \$5,000, a taxpayer must obtain a "qualified appraisal" of the property prepared by a "qualified appraiser."² Practically speaking, a qualified appraisal should be obtained for every substantial non-cash charitable contribution, considering that the value of such a donation is often, or might be found to be, in

excess of \$5,000. Although much of the recent IRS focus involves contributions of conservation easements, a qualified appraisal must be obtained for *any* contribution of property with a claimed value of more than \$5,000. The scope of this article is therefore relevant to appraisals of all types of donated property.

Definition of ‘Qualified Appraisal’

Section 170(f)(11)(E) defines both "qualified appraisal" and "qualified appraiser." A qualified appraisal is an appraisal prepared by a qualified appraiser and prepared in accordance with generally accepted appraisal standards³ and with Regulations prescribed by the Secretary. The Treasury Regulations extensively expand on the definition of a qualified appraisal. The definition consists of several technical requirements that must be met as a prerequisite before the determined value of the contributed property is even considered.

A qualified appraisal report must relate to an appraisal performed no earlier than 60 days before the contribution of the property, and no later than the due date of the taxpayer's return (including extensions), and be prepared, signed, and dated by the qualified appraiser.⁴ The Regulations also require certain information to be in the qualified appraisal, including:

- A description of the property in sufficient detail that a person not familiar with the property can ascertain the type of property being contributed.
- The physical condition of the property.
- The date or expected date of contribution.
- Any agreements entered into between the donor and donee (or reserved rights of the donor or third party) with respect to the property.⁵

Further information is required that is specifically aimed at the qualifications of the appraiser and the appraiser's methodology and approach to valuation. This information includes:

- The qualifications of the qualified appraiser⁶ (including background, general experience, experience evaluating the particular type of property, education, and membership in professional associations).
- A statement that the appraisal was prepared for income tax purposes.

- The date the property was appraised.
- The FMV of the property.
- The method of valuation.
- The specific basis for the valuation.⁷

Effect of Not Having a Qualified Appraisal

If the taxpayer does not obtain a qualified appraisal, generally no deduction for the charitable contribution of property is allowed.⁸ IRS is frequently alleging that the thick, impressive-looking appraisal obtained by the taxpayer and performed by a qualified appraiser was not a qualified appraisal. If a taxpayer cannot resolve her case with the IRS Appeals Office and ultimately takes it to the Tax Court, the Service may file a motion before trial, or argue during trial or in subsequent briefing, that the original appraisal report was not a qualified appraisal. If the judge agrees, the taxpayer has no qualified appraisal, no case, and therefore no deduction.

Based on recent cases, and motions filed in pending cases, it appears that judges are reluctant to rule on the issue of qualified appraisal before trial; the issue is too highly factual not to allow the parties to present evidence. Such judicial cautiousness, however, will only get the taxpayer into trial. If the judge is unconvinced after evidence has been presented that the *original* appraisal was "qualified," the taxpayer gets no deduction.

This is true *even if* the taxpayer has another appraiser prepared to testify whose appraisal is based on sound methodology and assumptions and avoids whatever deficiency was found in the original appraisal. If it is determined that the taxpayer lacked a qualified appraisal, the taxpayer never gets to the issue of value, which is what taxpayers and practitioners traditionally have expected cases to come down to.⁹

ATTACK OF APPRAISALS BY THE IRS AND IN TAX COURT

Two recent Tax Court cases exemplify the Service's current attack on appraisals and the Tax Court's approach to analyzing the quality and sound foundation of appraisals.

Recently, IRS has been keen on what it deems "sloppy" appraisals. These attacks have focused not on the technical aspects of the Regulations but rather on the appraiser's basic methodology

and assumptions—criteria selection usually governed by generally accepted appraisal standards under USPAP. Although the Regulations require that the qualified appraisal describe the methodology and specific basis of valuation used by the qualified appraiser,¹⁰ and require that USPAP principles be applied,¹¹ the Regulations do not provide exact guidelines to be used to perform the methodology or the specific basis of valuation.¹² The appraiser is still given the freedom of exercising the art of appraising property.

The *Scheidelman* Case

In *Scheidelman*, TC Memo 2010-151 , RIA TC Memo ¶2010-151 , the taxpayer was denied a deduction for the charitable contribution of a façade easement, because she lacked a *qualified* appraisal.

The taxpayer owned property in a registered historic district of New York City. After educating herself regarding the city's various conservation and preservation organizations, the taxpayer decided to donate a façade easement to the National Architectural Trust (NAT). The taxpayer was advised that an appraisal would be necessary for the contribution to qualify for a charitable deduction under the Code.

The taxpayer hired an appraiser having considerable experience in valuing façade easements. The appraiser prepared an appraisal that was the basis for the taxpayer's claimed charitable contribution deduction. In denying the deduction, the IRS alleged that several requirements of the Regulations defining a qualified appraisal had not been satisfied, including that the appraisal did not describe the property contributed, did not include the terms of the deed of easement, did not include a statement that it was prepared for income tax purposes, and did not provide the method and specific basis for valuing the easement.

Before beginning the analysis of its decision, the Tax Court observed, "Because we conclude that the [original appraisal] report is not a qualified appraisal, we do not discuss [conflicting expert testimony] or reach a conclusion as to the value of the easement." Although the IRS alleged several deficiencies in the taxpayer's appraisal, the court focused only on the appraiser's methodology and basis of valuation. Both of these components are required under the qualified appraisal Regulations.¹³ The court explained that the pertinent Regulation "provides that the qualified appraisal is to include the method of valuation used to determine fair market value, such

as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach. These methods are suggested, but not mandatory."

The *Scheidelman* appraisal purportedly used the before-and-after method, which is the most widely used method for valuing conservation easements.¹⁴ The court did not criticize the appraiser's approach to "before" value (i.e., the value before placing the façade easement).

The appraiser's approach to determining "after" value, however—the value of the property after the façade easement was placed, and ultimately the value of the easement—was lacking a recognized methodology and specific basis of valuation. To determine the value of the easement, the appraisal cited the appraiser's experience in appraising façade easements for income tax purposes. Specifically, the appraisal determined that the façade easement had an approximate value of "11-11.5% of the total value of the property. That figure is based on the appraiser's experience as to what the Internal Revenue Service has found acceptable (on prior appraisals)." Based on the cited value range, the appraiser concluded that the façade easement had an FMV of 11.33% of the total unencumbered FMV of the property.

The Tax Court criticized such an approach because it "applied mechanically a percentage with no demonstrated support as to its derivation, other than acceptance of similar percentages in prior [Tax Court cases]." Furthermore, the court determined that the appraiser failed to provide a specific basis for valuing the property because it was not explained "how the specific attributes of the subject property led to the value determined in the [appraisal]."

Applying a percentage reduction to the unencumbered FMV of the property was thought by many to be a recognized valuation methodology when valuing façade easements. Even IRS seemed to adopt the approach.¹⁵ The opinion indicated that had the appraisal expanded on certain reasoning contained in the appraisal, the court might have given more consideration to the appraisal. Although the appraisal explained that estimating the value of the subject property was akin to condemnation appraisal practice that includes attempts to define what rights have been lost and the value of such rights to establish damages, the Tax Court determined that the appraiser failed to conduct an analysis of such methodology.

The taxpayer argued that she had substantially complied with the substantiation requirements for qualified conservation contributions, and that she should nevertheless be entitled to the claimed

deduction (or at least some of the claimed deduction). The court concluded that it would not apply the substantial compliance doctrine, stating it had never applied the doctrine in the absence of a qualified appraisal.

The Tax Court declined to address the Service's alternative argument that the contribution failed to meet the Section 170(h) requirements because it was neither exclusively for conservation purposes nor protected in perpetuity. Thus, the lack of a qualified appraisal at the outset precluded the taxpayer from advocating the value of the easement and rendered moot the other issues raised by the IRS.

The *Boltar* Case

In *Boltar, L.L.C.*, 136 TC No 14 , Tax Ct Rep (CCH) 4038, Tax Ct Rep Dec (RIA) 136.14, 2011 WL 1314445 , a taxpayer lost its deduction when the Tax Court excluded the taxpayer's appraisal report from evidence at trial, as contrasted with determining the taxpayer's appraisal was not a "qualified appraisal."

The taxpayer claimed a charitable deduction for the donation of a land conservation easement. To establish the value of the easement (and thus the amount of the deduction) the taxpayer obtained a professional appraisal, which determined the value of the conservation easement by purportedly applying the before-and-after method.

The appraisers determined that the highest and best use of the property before being encumbered by the conservation easement was residential development (a condominium development), which would be worth \$3,340,000 (i.e., the "before" value). They concluded that a conservation easement which would preclude the assumed development would be valued at \$3,270,000. As an alternative, the appraisal considered the value of the property as "raw land," and concluded the property after the easement would be worth \$68,700. As the Tax Court noted, however, the appraisal never determined the highest and best use of the property after the easement (i.e., the "after" value).

The taxpayer used the appraisal (without any revisions) as its expert report, and the IRS moved before trial to exclude the taxpayer's report as unreliable and irrelevant under Federal Rules of Evidence (FRE) 702 and *Daubert*. The Tax Court held that the standards of reliability and

relevance apply in Tax Court trials, and because the taxpayer's appraisers failed to properly apply the before-and-after valuation method, the expert report was excluded from evidence under the principles of *Daubert*. Without any direct, affirmative evidence as to value, the court adopted the IRS expert's valuation in full and upheld the value determination in the statutory notice of deficiency.

The appraisers' development of the before-and-after method of valuation was determined to be deficient in several respects. For instance, with respect to the "before" value, the hypothetical development used by the taxpayer's appraisers to determine that value (i.e., the value of the property if developed) could not fit on the eight acres of easement property (the hypothetical development was plotted on ten acres).

The appraisers also failed to take into consideration the proper zoning laws affecting the easement property. The appraisers assumed that the property was within the city limits and zoned PUD (planned unit development). With respect to the purported "after" value, the appraisers failed to determine the highest and best use of the property after being encumbered by the easement.

The Tax Court pointed out that the taxpayer's appraisers acknowledged these deficiencies but still persisted in defending their "peculiar methodology" instead of making adjustments to the appraisal. In several parts of the opinion, the court suggested that had the taxpayer's appraisers made adjustments and corrections based on the alleged and admitted deficiencies, the court might have considered the appraisal in determining value.¹⁶

Accordingly, the court therefore found that the appraisers "failed to determine the value of the Eased Area before and after the grant of the easement." The court found that the IRS in its reply brief aptly summarized the deficiencies of the taxpayer's expert report as the failure "to properly apply the before and after methodology, to value all of petitioner's contiguous landholdings, to take into consideration zoning restraints and density limitations and to take into consideration the pre-existing conservation easements. As a result, the [taxpayer's experts] saw nothing wrong with a hypothetical development project that could not fit on the land they purportedly valued, was not economically feasible to construct and would not be legally permissible to be built in the foreseeable future."

In addition, the taxpayer's appraisers' approach to "after" value was determined to be unfounded and unsupported. The appraisers failed to determine a highest and best use of the property after the grant of the conservation easement.

Based on these deficiencies, the court then considered the application of *Daubert* to bench trials, and to Tax Court cases in particular. The court first determined that FRE 702, governing the use of expert testimony, was applicable to Tax Court cases. Therefore, the Supreme Court's directives in *Daubert* were equally applicable. The court then observed:

"We have long recognized that receipt of unreliable evidence is an imposition on the opposing party and on the trial process.... We have also frequently stated that an expert loses usefulness to the Court and loses credibility when giving testimony tainted by overzealous advocacy.... Expert opinions that disregard relevant facts affecting valuation or exaggerate value to incredible levels are rejected...." (Citations omitted.)

Whereas in *Scheidelman* the Tax Court determined that the appraisal was not a *qualified* appraisal under the Section 170 substantiation rules, in *Boltar* the court found the appraisal unreliable and excluded it from being used as an expert report under *Daubert* principles. This distinction leads to the conclusion that while an appraisal might be a qualified appraisal under the Regulations, the taxpayer still must survive a *Daubert* challenge should the case proceed to Tax Court.¹⁷ Otherwise, the taxpayer is only slightly better off than not having a qualified appraisal. The taxpayer is left without any affirmative evidence of value (although some evidence might still be gleaned from opposing experts or other witnesses).

Rarely is there an issue with the appraiser being a qualified appraiser. As the Tax Court in *Boltar* commented, "[i]n most cases, as in this one, there is no dispute about the qualifications of the appraisers. The problem is created by their willingness to use their resumes and their skills to advocate the position of the party who employs them without regard to objective and relevant facts, contrary to their professional obligations."

The Impact of *Daubert*

Daubert entailed a suit against a pharmaceutical company for birth defects allegedly caused by the mother's ingestion of a particular drug marketed by the company. On motion for summary

judgment by the defendant Merrell, the trial court considered the expert opinions of Merrell's expert and eight experts offered by the plaintiffs.

The trial court granted Merrell's motion, and in affirming the trial court the Ninth Circuit cited *Frye v. U.S.*, 293 F 1013 (D.C. Ct. App., 1923), as embodying the correct standard to apply to scientific evidence. This standard excludes expert testimony unless the expert's scientific technique in deriving conclusions is "generally accepted" as reliable in the relevant scientific community.

In reversing, the Supreme Court held in *Daubert* that FRE 702, as opposed to *Frye*, was controlling on the issue of relevant and reliable expert testimony. In its opinion, the Court clarified the standard for determining admissibility of novel scientific evidence and noted that *Frye* predated the Federal Rules. FRE 702 provides the limits of expert testimony, as follows:

"If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, [an expert] may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case."

The Court analyzed the particular phrases of Rule 702 to determine the limits prescribed by the conditions of the Rule. For instance, the Rule requires that testimony *assist* the trier of fact, which goes primarily to relevance. The Court also described how the Rule establishes the trial court's role as a *gatekeeper* with regard to relevant and irrelevant expert testimony. Another important limit established by the Rule concerns reliability. Elaborating on the application of the Rule, the Supreme Court's landmark opinion established what has come to be known as the *Daubert* factors.

Furthermore, the Supreme Court in *Kumho Tire Company, Ltd. v. Carmichael*, 526 US 137 , 143 L Ed 2d 238 (1999), clarified that the principles of *Daubert* apply to expert opinion testimony in addition to scrutinizing experts' scientific techniques. Specifically, *Kumho Tire* held that *Daubert* applies to *all* expert testimony, regardless of whether the expert is a scientist.

Application to appraisals. As exemplified in the Tax Court's decision in *Boltar*, *Daubert* challenges are becoming more relevant to attacks on the work of financial experts in court. The

attacks are not only made with respect to appraisers of property; empirical studies show that from 2000-2010, the number of *Daubert* challenges to financial experts increased from 253 in 2000 to 879 in 2010. In 2000, 121 of these challenges succeeded in having the expert witness evidence excluded at trial; in 2010 that number climbed to 431.¹⁸

The *Daubert* factors are not as workable in the context of examining the admissibility of appraisals and appraiser testimony. In *Boltar*, the Tax Court used the "gatekeeper" directive to analyze the reliability of the taxpayer's expert report. Tax Court Rule 143(g) requires an expert to submit a report before the expert is entitled to testify at trial. Therefore, if the report is excluded as unreliable, the expert cannot testify directly as to its contents.

The Tax Court in *Boltar* appeared to focus on variations of two *Daubert* factors: (1) the theory or technique used and (2) its acceptability in the relevant [appraisal] community. In excluding the report, the court criticized the "peculiar" valuation methodology used and the erroneous assumptions made by the appraiser. The court also inquired as to general principles of reliability under FRE 702 without trying to force its inquiry into any particular *Daubert* factor. In fact, the Tax Court never explicitly referred to any single *Daubert* factor; it instead simply determined that the *Daubert* principles apply to expert testimony in Tax Court.

The consequences of having a poor quality appraisal are apparent in both *Scheidelman* and *Boltar*. The taxpayer faces the prospects of the appraisal being deemed not a qualified appraisal; alternatively, if the appraisal is used as an expert report, the taxpayer faces the prospects of the appraisal (the expert report) being excluded at trial. As seen in both cases, either result kills or badly damages the taxpayer's charitable deduction. While not having a qualified appraisal defeats the deduction entirely, having expert testimony and evidence as to value excluded at trial may result in the taxpayer receiving little or no percentage of the claimed deduction.

Planning

There are lessons to learn from the Tax Court's recent *Scheidelman* and *Boltar* cases. When advising clients on non-cash contributions and other value issues, the practitioner must be sure that the appraiser has all the facts, uses sound methodology (e.g., proper application of the before-and-after method), and makes reasonable assumptions in employing the methodology

(e.g., takes into account zoning restrictions and property size limitations). Careful vetting of an appraisal is advised and a desk review by a second appraiser is sometimes appropriate.

When cases come to the practitioner after the fact, the front-end safeguards are no longer available to the practitioner. Nevertheless, the practitioner can create an anticipatory defense by securing a reputable appraiser to prepare a quality appraisal before trial. A vigorous defense of the original appraisal should be made and clear errors corrected. When the taxpayer lacks a qualified appraisal or a viable expert report at trial, the taxpayer faces valuation and understatement penalties.¹⁹

APPRAISER PENALTIES

As if worrying about keeping the client happy weren't enough: appraisers have always had to do a quality job to keep the doors open, but now they must watch their backs for penalties, suspension, and disbarment. Valuing the property may be the least of the appraiser's problems.

As noted above, a "qualified appraiser" must prepare the taxpayer's "qualified appraisal." Section 170(f)(11)(E)(ii)(I) provides that a qualified appraiser is an individual who has received an "appraisal designation from a recognized professional appraiser organization" (i.e., a licensed appraiser) and regularly performs appraisals for compensation. Section 170(f)(11)(E)(ii)(III) authorizes the Secretary to prescribe other requirements (in Regulations or other guidance) that an appraiser must meet to be deemed a "qualified appraiser."

Notice 2006-96, 2006-2 CB 902 , and Reg. 1.170A-13(c)(5) expound on the requirements of a qualified appraiser. The qualified appraiser, among other things, must include, in an appraisal summary, a declaration that the appraiser understands that an intentionally false or fraudulent overstatement of value may subject the appraiser to civil penalties under Section 6701 .

Reg. 1.170A-13(c)(3)(ii) requires several pieces of information to be included in the qualified appraisal, including the method of valuation used to determine FMV and the specific basis for the valuation, such as specific comparable sales transactions or statistical sampling (including a justification for using sampling and an explanation of the sampling procedure employed).

In addition, the Regulations require that the qualified appraisal be made no earlier than 60 days before the contribution and no later than the due date of the tax return.²⁰ The qualified appraiser

must sign and date the appraisal, and the appraiser must not have received a prohibited appraisal fee, which is a fee based on a percentage of the appraised value of the property.²¹

Technically, the absence of any of the requirements can cause the appraisal to not be a qualified appraisal. The requirements specifically relating to value, however, are the ones that lead to the imposition of appraiser penalties.

Section 6695A Penalties

Section 6695A is directly applicable to appraisers. This penalty was added by section 1219 of the Pension Protection Act of 2006 (PPA), and applies to all appraisals prepared for returns or submissions filed after 8/17/06. It imposes a penalty against an appraiser if:

"(1) a person prepares an appraisal of the value of property and such person knows, or reasonably should have known, that the appraisal would be used in connection with a return or a claim for refund, and

"(2) the claimed value of the property on a return or claim for refund which is based on such appraisal results in a substantial valuation misstatement ... (within the meaning of section 6662(e)), ... or a gross valuation misstatement (within the meaning of section 6662(h)), with respect to such property."

The penalty amount is the lesser of (1) the greater of 10% of the amount of the underpayment or \$1,000, or (2) 125% of the gross income received by the appraiser in exchange for preparing the appraisal.²² A "substantial valuation misstatement" generally occurs if the claimed value of property is 150% or more of the amount determined to be the correct value. A "gross valuation misstatement" occurs when the claimed value of the property is 200% or more of the correct amount of such value. If the Section 6695A penalty is assessed, the appraiser faces a lengthy administrative procedure before the penalty will be abated.

The Section 6695A penalty will not apply if the appraiser establishes that the value set forth in the appraisal "was more likely than not the proper value."²³ There is some doubt as to the workability of this relief provision. If the determined value is so far removed from the appraised value that the penalty has been asserted, how could the appraised value be "more likely than not" the proper value?²⁴

Section 6701 Penalties

Section 6701 imposes a penalty of \$1,000 on any person "(1) who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and (3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person."

In the context of appraisers, the first two requirements are typically satisfied. The appraisal is a "document" prepared by the appraiser, and because the appraiser must fill out the appraisal summary on the Form 8283 filed by the donor, the appraiser knows that the client will use the appraisal in connection with the valuation of a charitable gift, which is a material matter. Therefore, the element to be proved is in the third requirement, which is that the appraiser knows that such portion (if so used) would result in an understatement of the tax liability of another person.

The appraiser has many avenues to challenge the Section 6701 penalty, and CCA 200512016 elaborates on these avenues. Like the Section 6695A penalty, the appraiser has post-assessment Appeals rights. Unlike the Section 6695A penalty, however, Appeals rights are post-payment rights.

To successfully challenge the assessed Section 6701 penalty, the appraiser must show that there was a reasonable basis for the valuation. This is a more workable standard than the relief provision of Section 6695A(c) . *Internal Revenue Manual* 20.1.6.13.1(3) (09-17-2010) explains as follows:

"A tax advisor would not be subject to this penalty for suggesting to a client an aggressive but supportable filing position even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty. However, if the advisor suggested a position which he or she knew could not be supported on any reasonable basis under the law, the penalty would apply."

Consequences of the Appraiser Penalties

Appraisers are subject to oversight by the IRS Office of Professional Responsibility (OPR), which administers and enforces the Regulations governing practice before the IRS. These governing Regulations are found in title 31 of the Code of Federal Regulations, part 10, and are published as Circular 230.²⁵

Circular 230 authorizes OPR to disqualify appraisers who provide supporting valuations for internal revenue matters. As explained in CCA 200512016 , "[i]n 1985, the Service amended Circular 230 to conform to legislative changes requiring the disqualification of an appraiser who is assessed a penalty under section 6701 of the Internal Revenue Code for aiding and abetting the understatement of a tax liability."

Section 10.60(b) of Circular 230 provides that "the Director of the Office of Professional Responsibility may reprimand ... [or] institute a proceeding for disqualification of the appraiser" if the Director is advised or becomes aware that a Section 6701 penalty has been assessed against the appraiser. Whether or not such a proceeding is instituted, the Director may confer with the appraiser concerning allegations of misconduct.²⁶ The Director may institute proceedings to suspend the appraiser for a certain period.²⁷ Whether disqualification or suspension is sought, an administrative law judge presides over the proceeding,²⁸ and (yielding a small sigh of relief for the appraiser) the Director must prove any fact that is necessary for a finding of disqualification against an appraiser by clear and convincing evidence in the record.²⁹

If the ALJ decides in favor of the Director and thus suspends or disqualifies the appraiser, the Director also will give notice to the proper authorities of the state in which the suspended or disqualified person was licensed to practice.³⁰ Thus, the appraiser faces potential suspension by the appropriate state board of appraisers. The appraiser may petition the OPR for reinstatement after the expiration of five years following disqualification, and such reinstatement is at the discretion of the Director of OPR.³¹

Given the Circular 230 procedures and rules governing appraiser suspension and disqualification, the imposition or assessment of a penalty against an appraiser does not, by itself, affect the appraiser's ability to prepare an appraisal for use in connection with the filing of a tax return. The Director of OPR must file a complaint and pursue formal administrative proceedings against the appraiser before disqualification occurs.

If an appraiser is disqualified, the appraiser is barred from presenting evidence or testimony in any administrative proceeding before Treasury or the IRS, unless and until authorized to do so by the Director, regardless of whether the evidence or testimony would pertain to an appraisal made prior to or after the effective date of disqualification. Furthermore, any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before Treasury or the IRS. An appraisal otherwise barred from consideration pursuant to these provisions may be used solely for the purpose of determining the taxpayer's reliance in good faith on such appraisal.

Because the disqualified appraiser cannot present evidence or testimony in any administrative proceeding before the IRS, *regardless of whether the appraisal was performed before or after the effective date of the disqualification*, reliance on the appraisal by a taxpayer to establish value is effectively barred at that level.

No Tax Court Rule explicitly bars an appraiser from testifying at trial as an expert as a consequence of being suspended or disbarred from appearing before the IRS. It can be safely assumed, however, that a suspension or disqualification would heavily affect the appraiser's usefulness as an expert.

CONCLUSION

So where are we heading? The IRS appears to improvise new ways to attack qualified conservation contributions in rapid succession. First, conservation purpose and other technical requirements of the Regulations were the focus of the attack. Next, the Service particularly focused on the claimed value of the conservation easement.³² In addition to continuing to allege these failings, as well as contending in general that appraisals are not qualified appraisals, the IRS has fine-tuned its attack by focusing on the requirements of an appraiser conducting an appropriate valuation methodology. Taking it to the next level, the IRS is employing this attack to get appraisals and appraiser testimony excluded at trial under *Daubert*.

As empirical evidence shows, and with the recent IRS victory in *Boltar*, it appears that the use of *Daubert* to exclude appraiser testimony in Tax Court will become more commonplace in valuation cases generally. Nevertheless, we must keep in mind that a *Daubert* challenge works both ways. It can be used to disqualify IRS experts, too.

Practitioners have only recently seen the use of the "new" Section 6695A appraiser penalties. Defending against these penalties may prove to be extremely difficult, given the circular "relief" standard embodied in the statute. As with other valuation issues, defenses against these penalties will develop over time.

Practice Notes

If a practitioner determines an appraisal is deficient in material respects, the practitioner should not use the appraisal as an expert witness report at trial. Although the practitioner cannot retroactively cure a "qualified appraisal" problem, she can prevent a *Daubert* challenge by obtaining a new or substantially revised report.

1

See, e.g., Wooldridge, Levitt, and Rhodes, "*Kiva Dunes*—Making and Substantiating the Value of Conservation Easements," 111 JTAX 300 (November 2009) .

2

Section 170(f)(11)(C) .

3

Generally accepted appraisal standards are currently embodied in the Uniform Standards of Professional Appraisal Practice (USPAP).

4

Regs. 1.170A-13(c)(3)(i) and (iv)(B) . Recent examinations have challenged appraisals made 62 days prior, and even have resisted reports made within 60 days when identical to a prior report not made within 60 days.

5

Reg. 1.170A-13(c)(3)(ii) . The Regulations contain additional required information, but an exhaustive analysis of this information is beyond the scope this article.

6

Reg. 1.170A-13(c)(5) defines "qualified appraiser" and will be revisited during the discussion regarding appraiser penalties.

7

The distinction between the "method of valuation" and the "specific basis" for valuation will be discussed later in this article in connection with a recent Tax Court case.

8

See Scheidelman, TC Memo 2010-151 , RIA TC Memo ¶2010-151 .

9

See Levitt, Wooldridge, Rhodes, and Vinson, "Tax Court Analysis of Land Conservation Easement Values—Developments Since *Kiva Dunes*," 22 Tax'n of Exempts No. 6 (May/June 2011), page 31.

10

Regs. 1.170A-13(c)(3)(ii)(J) and (K) .

11

Although the Regulations do not refer to USPAP directly, Notice 2006-96, 2006-2 CB 902 , incorporates USPAP into the definition of generally accepted appraisal standards.

12

Id.; the Regulations do provide specific examples of methodologies and specific bases of valuation. See Scheidelman, *supra* note 8.

13

See note 10, *supra*.

14

Using the before-and-after method, the appraiser derives a value for the property before it is encumbered by the easement, and then finds a value for the property after it is encumbered by the easement. The difference between the two values represents the value of the easement. See Reg. 1.170A-14(h)(3)(i) .

15

The IRS had published a Market Segment Specialization Program Guide and a Topical Tax Brief which indicated a range that IRS believed a façade easement could be expected to reduce the value of property. These documents were posted on the IRS website, but have since been removed. See CCA 200738013 (addressed to IRS counsel involved in Scheidelman on 9/21/07, long after the appraisal was done).

16

Under Tax Court practice, an expert's report is identified and offered into evidence by counsel as the expert's direct testimony. Opposing counsel has an opportunity to examine the witness

about the sufficiency of the report, before the report can be admitted into evidence.

17

An interesting aspect of Boltar is that the IRS moved, pursuant to a preliminary motion, to exclude the expert report from evidence, as opposed to alleging the appraisal failed to constitute a qualified appraisal under the Regulations. Whether this was a tactical decision by the IRS or a failure to spot the "qualified appraisal" issue is unknown.

18

PricewaterhouseCoopers, "Daubert Challenges to Financial Experts: An 11-year study of trends and outcomes," February 2011, available at www.pwc.com/us/en/forensic-services/publications/daubert-study-2010.jhtml.

19

Sections 6662(d) , (e) , and (h) .

20

Regs. 1.170A-13(c)(3)(i) and (c)(3)(iv)(B) .

21

Reg. 1.170A-13(c)(6)(i) .

22

Section 6695A(b) .

23

Section 6695A(c) . Unlike a Section 6701 penalty, the Section 6695A penalty does not require that the appraiser have knowledge of any resulting understatement of tax.

24

This task becomes even more difficult if a taxpayer were to settle a case at the administrative level, accepting a value that would indicate a valuation misstatement. Such a decision might become evidence against an appraiser even if the taxpayer settled on grounds unrelated to valuation, e.g., technical issues or the desire to avoid litigation costs.

25

See generally Lipton, "New Circular 230 Guidance Is Broad—and May Prove to Be Controversial," 115 JTAX 61 (August 2011) .

26

Circular 230, section 10.61.

27

Id., section 10.62.

28

Id., section 10.72.

29

Id., section 10.76.

30

Id.

31

Id., section 10.81.

32

See Levitt et al., *supra* note 9.