Steep IRS Penalties Deter Valuation Misstatements

Are valuations merely a good guess? According to the Internal Revenue Service, they better not be. When it comes to estate and gift taxes, the value of what's being transferred is an integral part of the tax liability equation. To underscore the importance of using valid valuation numbers, the IRS has serious penalties and sanctions in place, which discourage significant overvaluation or undervaluation. And as of August 17, 2006, the IRS has tightened these restrictions even further.

When transferring cash or stocks, valuation is relatively straightforward. Gifts of property or a business are often more complicated. To withstand IRS scrutiny, a "qualified appraisal" by a "qualified appraiser" is required.

What's the Punishment?

If a taxpayer underpays taxes due to a significant valuation misstatement, the IRS can collect three types of penalties: the actual back taxes owed, interest on the amount owed, and penalties. If the IRS believes the underpayment was intentional or particularly egregious, the IRS has multiple penalties at its disposal, spelled out in the Internal Revenue Code sections 6662 through 6664.

If the value reported on a return is 65 percent or less than the IRS-determined "correct" value, the penalty is 20 percent of the difference in the tax. If the value reported is 40 percent or less of the "correct" value, the penalty increases to 40 percent of the difference in the tax. No penalties are imposed for overstating property values for income tax purposes unless the overstatement is 150 percent of the correct value.

How to Avoid Penalties

The IRS has a few “outs” for exceptional cases. For example, the IRS will not impose a penalty on taxpayers who can prove they either had a reasonable cause to believe that the value was correct or that they acted in good faith. However, proving either scenario is difficult, and the exception is not available in the case of a gross misstatement.

Another exception is available when the underpayment is due to items that are supported by “substantial authority,” or are “adequately disclosed” on the tax return. But neither is available when the misstatement is the result of investment in a tax shelter, which is the root of many valuation disputes.

Experts agree that the best way to avoid valuation problems is to engage an experienced business valuation professional to provide an appraisal. Not only is it more likely that his or her work will be accurate and supportable, it will also be easier to defend in court in the event that a problem arises. The reputation, training and experience of a business valuation professional is important to the IRS. A valid appraisal will help protect you from penalties. Relying on any other form of valuation is a risk.

If you have any questions about penalties and sanctions, please let us know.

Sanctions for Practitioners, Too

The government has many rules regulating the practice of attorneys, CPAs and other professionals who practice before the Internal Revenue Service. And just as the IRS can penalize taxpayers who misstate value, the IRS can also sanction practitioners who disregard the rules by acting in a negligent manner or engaging in fraud. Sanctions for “disreputable or incompetent” conduct range from censure to suspension to disbarment from practice before the IRS. Appraisers can also be fined up to 125 percent of the appraisal fee or 10 percent of the underpayment, for a minimum of $1,000.

For a CPA, these sanctions could mean a devastating loss of livelihood, which is why CPAs are typically extremely cautious and conscientious about their work.