Revisiting Subsequent Events for Gift, Estate and Charitable Contributions, and Increased Valuation Penalties Exposure

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The National Association of Certified Valuators and Analysts

When are "subsequent events" knowable, and what about IRC Sec. 6662(g)(2) penalties?

Trout Ranch, LLC v. Commissioner raises additional causes for concern, including subsequent events in appraisal documentation and failures to include them, which may create more valuation penalties on tax filings.

The Tenth Circuit decision in *Trout Ranch, LLC v. Commissioner*, 110 AFTR 2nd 2012-5621, raises significant concerns on when, for tax valuations, subsequent events must be considered and also whether the taxpayer (and valuator) have expanded exposure to valuation penalties. While this is a case that involves a partnership's claimed charitable deduction for a conservation easement, it may have broader implications.

Typically, the appropriate date for gift tax valuations is the date of the taxable transfer. For estate purposes, this date is either the date of death or the alternate valuation date, which is six months after the date of death.

While reviewing the valuation of the contributed easement in the reference case, the Tenth Circuit concluded that "data unavailable to a reasonable buyer may still tell us something about the price such a hypothetical buyer would have been willing to pay at the time of the contribution". In addition, the court observed that:

No authority supports the contention that land appraisals cannot take account of data released after the valuation. Trout relies on Treas. Reg. §1.170A-14(h)(3)(i), which provides, "[t]he value of the contribution under section 170 in the case of a charitable contribution of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution." But a regulation fixing the fair market value at the time of contribution does not necessarily restrict the evidence to be considered in determining fair market value. Section 1.170-14(h)(3)(i) is neutral on the question of relevant evidence; it sets no limitations on the information informing fair market value.

Trout Ranch questions how a reasonable buyer at the time of contribution could be expected to account for land sales that had yet to occur; but Trout Ranch reads the "reasonable buyer" language too literally. The reasonable buyer is a conceptual device meant to illustrate the objective nature of the inquiry, not a limitation on the evidence that can inform it.

The Tenth Circuit also added, "[t]he reasonable buyer is a conceptual device meant to illustrate the objective nature of the inquiry, not a limitation on the evidence that can inform it. The question for the real estate appraiser and ultimately for the tax court is not what a reasonable buyer could say about a particular sale, but what the particular sale could say about the reasonable buyer."

In short, "known or knowable" can be impacted by subsequent events, which occur within some undefined period of time after the valuation date. In the *Estate of Scanlan v Commissioner*, TC memo 1996-331, the Tax Court concluded an event two years after the valuation was relevant to the value.

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The impact on estate and gift may be tempered by the court's statement that "Directly applying Ithaca Trust, McMorris holds that events occurring after the decedent's death may not be considered in determining the value of a claim against the decedent's estate, id at 1261. For the same reasons we have addressed, the holding should not be understood to extend beyond the estate-tax setting." This conclusion leaves uncertainty on when subsequent events are relevant.

Consider this hypothetical scenario. You are asked to value a family limited partnership (FLP) with substantial real estate holdings. A few months after the death of the controlling partner, an investor group announced a new water district near the property that subsequently impacted land values. It was not known or knowable to a "hypothetical buyer" when the decedent died. Land values doubled within months, turning the property's best use from agricultural to available for housing development. A date of death value for the land, if accepted by the FLP valuator, would have been roughly half of the value after the announcement. How will the IRS view the increase in value? Will it trigger valuation penalties for estate and gift purposes? Was this subsequent event sufficient to "inform fair market value" and support a finding by the IRS of a date of death valuation increase? If yes, this approach could cause significant defense cost and taxpayer exposure.

The taxpayer can be assessed a penalty of up to 20 percent of the misstatement if the valuation is less than 65 percent of the value ultimately determined to be correct under IRC Sec. 6662(g)(2). The penalty is increased to 40 percent if the underpayment is because of a gross valuation misstatement under IRC Sec. 6662(h)(1).

IRC Section 6695(A) spells out the "imposition of penalty" for appraisers when they know their reports will be used "in connection with a return or a claim for refund" and 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."

The penalty imposed on the appraiser is the lesser of 125 percent of the fee received OR 10 percent of the misstatement, but not less than $ 1,000.

Most appraisers would tend to agree with an earlier case decision in the 7th Circuit, *First National Bank v. United States*, 763 F2d 891 (1985) in which the court concluded, "The property in the decedent's estate is evaluated by determining what a willing buyer would give for it on the date of death. Information that the hypothetical willing buyer could not have known is obviously irrelevant to this calculation."

USPAP does tell us that "In the absence of evidence in the market that data subsequent to the effective date was consistent with and confirmed market expectations as of the effective date, the effective date should be used as the cut-off date". USPAP, 2012-13 Edition, Statement 3, Page U-8, Lines 2777-2779.

For members subject to the AICPA, Statement of Standards for Valuation Services Number 1, Par 43 dealing with subsequent events stipulates that, "An event that could effect the value may occur subsequent to the valuation date, Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or conditions."

This presents us with a dilemma. Which subsequent events confirm market expectations as of the valuation date, and which simply occurred and changed market expectations? Beauty is in the eye of the beholder and leaves us with professional judgment. The IRS and courts may not accept professional judgment.

In the hypothetical case mentioned above, which if any "hypothetical buyers" expected a new water district to change valuations of the agricultural land? Was the creation of a new water district reasonably foreseeable? Will the IRS under exam conclude that subsequent events should have been considered and assess penalties for failure to consider subsequent events?

As a general rule, this author concludes that valuators should inform their clients of the valuation impact of subsequent events if the size impact is known by the report date. Moreover, valuators should at least alert their clients that a decision to exclude subsequent events may give rise to significant penalties and costs of defense regardless of our professional decision whether that subsequent data is relevant in view of the Tenth Circuit decision in *Trout Ranch v. U.S.* Standards require us to use sound professional judgment to arrive at the correct value regardless of penalty concerns, but taxpayers also have a right to understand associated risks.

The best defense for taxpayers and professionals is to objectively review subsequent events to determine which, if any would have impacted value as of the valuation date which were "known or knowable" as of that date and to document the basis of our conclusion.

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