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DISCOUNTED ART RESULTS IN A $14 MILLION ESTATE TAX REFUND

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The Elkins Case opens the door wide open to taking substantial discounts for undivided ownership positions in personal property, including art, for estate and gift tax purposes. In *Elkins I*, which was discussed in *ArtBanc Intelligence*, Issue 4, June 2013, the Tax Court made a small 10% adjustment to the $9.1 million (£5.2m) notice of deficiency. However, in *Elkins II*, the Fifth Circuit allowed 50% - 80% discounts to value for art, resulting in a $14.4 million (£8.6m) refund. With this result, estate planning for art and other personal property collections may be very valuable to the collector.

On February 21, 2006, a wealthy Texan, Mr. James A. Elkins, Jr., passed away.[1] Mr. Elkins and his family loved art. In their collection, the family owned 64 pieces by such well-known artists as Pablo Picasso, Henry Moore, Jackson Pollock, Jasper Johns and others. Due to community property laws in Texas, along with some creative estate planning, Mr. Elkins died owning undivided fractional interests in the art. In addition, the art was covered by a lease agreement and a co-tenancy agreement that effectively restricted the ability of the other co-owners (his three children) to force a sale of the art. As a result of not owning the art outright and the restrictions on the hypothetical willing buyer's ability to force a sale of the art, the Estate filed the estate tax return indicating a 44.75% discount from the full, undiscounted $23,257,393[2] (£13.3 million) pro rata value of the art.[3] The IRS issued a notice of deficiency rejecting any discounts and claiming an additional estate tax owed of $9,065,266 (£5.2 million).

"Estate planning for art and other personal property collections may be very valuable to the collector"

BATTLE IN THE TAX COURT

The Estate was determined to fight the IRS in Tax Court. In *Estate of Elkins*,[4] the Estate abandoned its 44.75% discount and used two valuation experts who applied valuation discounts ranging from 50% to 95% to the Estate's undivided interests. One expert arrived at a discounted pro rata value of $5,462,366 (£3.1 million) for the art (an aggregate 76.5% discount), and the other expert determined a discounted value of $7,658,645 (£4.4 million) (an aggregate 67.1% discount).

The IRS argued that no discount was applicable. The basis for such an argument rested on the assumption that (a) as there was no established market for undivided interests in art, the art must be sold in a retail market which assumes a sale of 100% of the art,[5] and (b) because the IRS does not require discounts for charitable contributions of undivided interests in

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art it would be inconsistent for the Tax Court to allow discounts for intra-family gifting and estate taxes. The Tax Court rejected both arguments and ruled that a discount is applicable to undivided interests in personal property and, in this case, specifically, art.

In determining an appropriate discount to apply, the Tax Court ruled that the resale restrictions contained within the lease agreement and the co-tenancy agreement cannot be considered. In rejecting these restrictions, the Tax Court relied on Section 2703(a)(2)[6] stating,

> In view of the irrefutable evidence that the only way to sell a fractional interest in artwork is by selling the entire art by agreement or through a partition action filed with the court, the only apparent reason for including the restriction on sale language in the Cotenants' Agreement and the Art Lease Agreement … was to reduce the value of Decedent's retained fractional interests in the Artwork as part of a plan to make a testamentary transfer of his remaining interests in the Artwork to his children at a reduced transfer tax rate - a purpose which section 2703 was specifically intended to prevent.[7]

As the discounts proffered by the Estate's experts were based upon the restrictions contained within the lease agreement and co-tenancy agreement, the Tax Court determined its own nominal 10% discount. The Tax Court's rationale for such a low discount was the fact that a daughter had testified that the family loved the art and wanted to keep the art in the family. Considering the immense wealth of the family and their desire to maintain ownership of the art, the Tax Court created a scenario whereby the "hypothetical willing buyer" would buy the Estate's undivided interest in the art at a 10% discount and turn around and sell the art back to the family at its full, undiscounted, value.

VICTORY IN THE FIFTH CIRCUIT

The Estate appealed the Tax Court's ruling and, on September 15, 2014, the Fifth Circuit overturned the Tax Court's ruling and granted the Estate a $14 million (£8.6 million) refund.[8] Not only did the Fifth Circuit reject the Tax Court's 10% discount, but mandated the use of the discounts presented at trial, which were substantially larger than the discounts used by the Estate in its tax return.

The simple reason that the Fifth Circuit overturned the Tax Court is that there was no expert testimony from the IRS regarding the value of the Estate's art interests. After ruling that the IRS's presumption of no discount was legally incorrect, it was the view of the Fifth Circuit that the Tax Court was left with only the testimony of the Estate's valuation experts.

> … given the total absence of substantive evidence from the Commissioner on the issue [of the discount], the Tax Court should have accepted and applied the uncontradicted quantums of the partial-ownership discounts that the Estate proved with much more than substantial evidence. … We repeat for emphasis that the Estate's uncontradicted, unimpeached, and eminently credible evidence in support of its proffered fractional-ownership discounts is not just a 'preponderance' of such evidence; it is the *only* such evidence. … we conclude that the discounts determined by the Estate's experts are not just the only ones proved in

court; *they are eminently correct*. [emphasis added][9]

The Fifth Circuit could have stopped there. However, it went on to comment regarding a number of assumptions made by the Tax Court. While not explicitly rejecting the Tax Court's application of Section 2703(a)(2), the Fifth Circuit clearly viewed the resale restrictions contained in the lease agreement and co-tenancy agreement as in force and having a negative effect on value. In rejecting the 10% discount concluded by the Tax Court, the Fifth Circuit stated, "the situation is only exacerbated by the effect of the various restrictions on partition, alienation, and possession that survived the death of the Decedent."

In addition, the Fifth Circuit was particularly harsh in its judgment regarding the assumption used by the Tax Court that the 'hypothetical willing buyer' could buy the fractional interests at a 10% discount and immediately sell those interests to the family for a full, undiscounted, pro rata value. According to the Fifth Circuit,

> …the Tax Court inexplicably veers off course, focusing almost exclusively on its perception of the role of "the Elkins children" as owners of the remaining fractional interests in the works of art and giving short shrift to the time and expense that a successful willing buyer would face in litigating the restraints on alienation and possession and otherwise outwaiting those particular co-owners. Moreover, the Elkins heirs are neither *hypothetical* willing buyers nor *hypothetical* willing sellers, any more that the Estate is deemed to be the hypothetical willing seller.[10]

In reaching its decision, the Fifth Circuit admonished the Tax Court stating

> We are never comfortable in disagreeing with, much less reversing, a jurist of the experience, reputation, and respect enjoyed by the Tax Court judge whose work product we are called on to review today. Yet our review of the court's extensive explication of this case and its ultimate conclusion that the proper discount is 10 percent, leaves us with the "definite and firm conviction that a mistake has been made." [11]

LESSONS LEARNED

The Fifth Circuit's decision in *Estate of Elkins* opens the door to the extensive use of fractional interests in art (and other personal property) in estate planning. The IRS is likely to abandon its contention that no discounts are applicable in valuing undivided interests in art. In fighting these undivided interest discounts, the IRS will now be required to retain experts to value such undivided interests. Moreover, the magnitude of the discounts (which the Fifth Circuit proclaimed "are eminently correct") will encourage the IRS to consider substantially larger discounts than previously allowed. Given the fact that the discounts accepted by the Fifth Circuit are substantially larger than those used by the Elkins' estate in its estate tax filing, the Fifth Circuit's decision is a clear and total victory for the taxpayer. ■

[1] Mr. Elkins' estate paid $102 million (£58.5 million) in estate taxes.

[2] See footnote #9 of the Tax Court's decision

[3] For estate tax purposes, the tax is imposed on the "fair market value" of the assets held by the Estate. Fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." §20.2031-1(b)

[4] Estate of James A. Elkins, Jr. - 140 T.C. No. 5 (March 11, 2013)

[5] In the Fifth Circuit's decision, footnote # 18, the Court states "In fact, the testimony [of the IRS's experts] that there is no recognized or established market for undivided interests in art lends support to a greater discount. The absence of an established market would be a factor that a willing buyer would consider as calling for a deeper discount of fractional interests in art. Such absence does not, however, mean that willing buyers and willing sellers of fractional interests in art do not exist and cannot find one another through means other than an established market…."

[6] Section 2703 (a)(2) requires that the valuator ignore "any restriction on the right to sell or use such property." However, if the restrictions can be shown to be (1) a bona fide business arrangement, (2) not a device to transfer assets to the junior generation at less than fair market value, and (3) comparable to other arms'-length transactions, the restrictions can be considered.

[7] Estate of James A. Elkins, Jr. v. Commissioner - No. 13-60472

[8] ibid. [9] ibid. [10] ibid. [11] ibid.