Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2247

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From: Steve Leimberg's Estate Planning Newsletter

Subject: Jeff Baskies: Discounts Permitted For Fractional Interests in Artworks - The Fascinating 5th Circuit Opinion in Estate of James A. Elkins, Jr. v. Commissioner

"Planners should be pleased with the taxpayer-friendly win in the Elkins case, but our enthusiasm should perhaps be tempered by the knowledge that much lower discounts may be offered in fractional ownership of artwork cases/audits/appeals matters. The lessons in this case are fairly simple.

First, fractional interests in artworks are entitled to some level of discounting. Second, lease agreements and co-tenancy agreements may be necessary to keep the fractional interests transferred out of our client's estates; however, they likely will not impact the discounting analysis - due to Section 2703(a)(2)'s application.

Third, if the IRS heeds the 5th Circuit's admonition, future court battles over proper discounting will likely pit experts arguing over the proper valuation level instead of 0% vs. 45%. Thus, the next round of cases may lead to very different conclusions as to the appropriate discounting level for fractional interests in artworks."

LISI has provided members with significant commentary on the Tax Court's decision in Estate of Elkins v. Commissioner. See Mitchell Gans and Jonathan Blattmachr in Estate Planning Newsletter #2079, Diana Wierbicki in Estate Planning Newsletter #2085, and Paul Hood in Estate Planning Newsletter #2087.

Now, we close the week with Jeff Baskies' analysis of the 5th Circuit's decision partially overturning the Tax Court's decision in Estate of Elkins v. Commissioner.

Jeffrey A. Baskies, a cum laude graduate of Harvard Law School, is a Florida Bar certified expert in Wills, Trusts, and Estates law. He practices at Katz Baskies LLC, a Boca Raton, FL, a boutique trusts & estates, tax & business law firm. In addition to over ten dozen published articles, he is the author of ESTATE, GIFT, TRUST, AND FIDUCIARY TAX RETURNS: PLANNING AND PREPARATION (West 2013). He can be reached at www.katzbaskies.com.

Before we get to Jeff's commentary, members should note that a new 60 Second Planner by Michelle Ward was just posted to the LISI homepage. In her commentary, Michelle reports on IRS Notice 2014-54, which provides rules for allocating pre-tax and after-tax amounts among disbursements that are made to multiple destinations from a qualified retirement plan. You don't need any special equipment - just click on this link.

Now, here is Jeff Baskies' commentary:

EXECUTIVE SUMMARY:

I've heard on several occasions, including, I believe, a few times at the Heckerling Institute (by John Porter and/or Stacey Eastland), that if a wealthy client is going to die, he is better off dying in Texas.

For example, a number of years ago in the Church case and then more recently in the Keller case (both cases from Texas) the 5th Circuit upheld valuation discounts for investment accounts not even funded into FLPs at the death of the client, because under Texas law partnerships can be funded impliedly based on the intent of the decedent prior to his death.

Recently, in the Estate of Elkins v. Commissioner (another Texas estate tax case), the 5th Circuit overruled the Tax Court (which awarded 10% valuation discounts for fractional interests in artworks) and issued a ruling with very taxpayer friendly 45% discounts for fractional interests in 64 pieces of art.

The good news is the Estate of Elkins ruling clearly concludes that some level of valuation discounting is appropriate for fractional interests in art, even though the court accepted the testimony of experts that there is virtually no market for fractional interests in artworks. Indeed, in its holding, the court asserts that the lack of a market maybe justifies higher discounts.

The bad news is the level of discounting afforded in this case may not be reliable for future cases. Further, the ruling provides a roadmap for the IRS, reminding the Commissioner of the Service's obligations to carry the burden of proof and the rather harsh consequences of failing to provide any evidence as to a reasonable discount – in essence punishing the Service for stubbornly sticking to a "no discount" approach. Assuredly, the advocates at the Service will learn this lesson and future fractional interest in artwork cases may not afford such significant discounts.

James A. Elkins, Jr. was a wealthy banker (his estate tax return reported a tax liability of $102,332,524) and son of the founding partner of the Vinson and Elkins firm. I assume it must have been particularly gratifying for the partners of that firm to have argued this case on behalf of the family of its founding partner and won. Anyway, Mr. Elkins was apparently an art collector, a philanthropist and generally a very well-regarded Houstonian.

The Executors of Mr. Elkins' estate fought an estate deficiency imposed by the Service, based on the Commissioner's disallowance of any fractional interest discounts in determining the value of the deceased's interests in 64 works of art – apparently a collection of modern and contemporary art. At death, the deceased owned fractional interests in the 64 works in question and his children owned the other fractional interests.

The Estate argued for 45% discounts. The Commissioner apparently steadfastly maintained that no fractional interest discount should be allowed.

At trial, the Tax Court rejected the Commissioner's no discount approach but also rejected the Estate's evidence supporting a 45% discount. Instead, Judge Halpern concluded that a "nominal" 10% fractional interest discount should be applied.

On appeal, the Commissioner continued arguing his no discount position. When the 5th Circuit rejected that position, they also found no evidence in the record to support the Tax Court's 10% discount. So with no evidence offered to contradict the Estate's experts and evidence, the 5th Circuit applied the 45% discounts argued by the Estate. The appeal resulted in a refund of $14,359,508.21 plus statutory interest.

While 45% discounts for fractional interest in artwork sound very appealing and might lead planners to advise all clients with valuable art to fractionalize their ownership (and maybe that's a good planning idea), there is one "hitch" with expecting to rely on the Elkins opinion.

The "hitch" is that while the 5th Circuit agreed with the Tax Court's rejection of the IRS's no-discount position (a holding the 5th Circuit expressly affirmed), it also made it very clear that it was adopting the 45% discount because there was no alternative evidence proffered, and it was rejecting the Tax Court's instinct to "make up" a 10% discount. But in future cases with the Service likely to offer some "quantum" of evidence, it seems relying on the Elkins decision and its 45% discounts might not be deemed reasonable.

FACTS:

In defining the issue on appeal the 5th Circuit wrote:

Despite the size and complexity of Decedent's estate and the millions of dollars of federal estate tax that it returned and paid, the single question presented in this appeal is narrow, straightforward, and easily posed:

Given the parties' stipulation of the FMV of each of the works of art in which Decedent owned fractional interests at his death, is the Estate taxable on Decedent's undiscounted pro rata share of those FMVs, as the Commissioner contended on audit and throughout the Tax Court proceedings, or is it taxable only on those values reduced by fractional-ownership discounts of either (1) a uniform 10 percent each, as held by the Tax Court, or (2) the various percentages that the Estate advanced through the testimony and reports of its expert witnesses?

This entire appeal thus begins and ends with the question of the taxable value of Decedent's fractional interests in those 64 items of non-business, tangible, personal property that were jointly owned in varying percentages by Decedent and his three adult children at the instant of his death. And, the answer to that one question begins and ends with the proper administration of the ubiquitous willing buyer/willing seller test for fair market value: "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 sell and both having reasonable knowledge of relevant facts.""

Background

The history/background facts were presented as follows.

Mr. Elkins and his wife each created inter vivos Grantor Retained Income Trusts ("GRITs") and then transferred each of their respective one-half interests in 3 of the 64 artworks to the GRITs (called the "GRIT Art" in the opinion). Apparently, Mrs. Elkins died during the term of her GRIT, and half of those 3 artworks passed outright to Mr. Elkins who owned the 50% interests until his death in February of 2006, and the other 50% in those 3 artworks passed to the Elkins' three children who owned the other 50% of those three works, 16.667 % each.

By virtue of a disclaimer by Mr. Elkins of part of his wife's 50% interest in 61 other artworks, 26.945% of those other 61 artworks was owned by the 3 children, and Mr. Elkins owned a 73.055% fractional interest in each of those 61 artworks (called the "Disclaimer Art" in the opinion). Thus each of the three children owned 8.98167% of the Disclaimer Art at the time of Mr. Elkins' death.

A few interesting facts came out in the opinion.

Retained Use and Art Lease

For example, apparently at least 2 of the 3 works of the GRIT Art remained in Mr. Elkins' home until his death. This would seem to implicate section 2036. However, either inclusion under section 2036 wasn't argued or it was just accepted that section 2036 did not apply because Mr. Elkins' children leased their 50% interest in those 2 works of GRIT Art to him. As a planning pointer, I can't imagine it is favorable to permit the uninterrupted possession of transferred works of art by the donor/parent/giver, but in the event it will happen, a written lease for the transferred artwork seems vitally important.

Also, apparently, the artwork lease, which was still in effect at Mr. Elkins' death, required that no co-owner could dispose of his interest in the leased artworks unless joined by all of the co-owners. It was noted in the opinion that the artwork lease also provided that the co-owners could not transfer or assign their "rights, duties and obligations" under the lease without the consent of the other co-owners.

Co-Tenancy Agreement

Next, the opinion states that Mr. Elkins and his children entered into a co-tenancy agreement regarding the other 61 artworks called the Disclaimer Art. Per the opinion, the co-tenancy agreement stipulated how the artworks would be shared among the co-owners, including how many days of possession each owner was entitled to each year. Plus, the co-tenancy agreement apparently prohibited the sale of an interest in any artwork by any co-owner without the prior consent of the other co-owners.

The exact terms of the co-tenancy agreement were reproduced in relevant part in the Tax Court opinion.

Tax Court Ruling

This case first came up to the Tax Court and Judge Halpern for trial in September 2011. The Tax Court issued an opinion in March of 2013 holding that the fractional interests in the artworks are subject to fractional interest discounts, but concluded only "nominal" discounts would be required for a willing buyer and willing seller and thus applied a "nominal" discount of 10%.

5th Circuit Ruling

The 5th Circuit noted that they review appeals from the Tax Court on issues of mixed questions of fact and law de novo. The court said it has long held that determination of fair market value is a mixed question of fact and law as there is a "pure question of law imbedded in the valuation calculus."

The 5th Circuit then went through a discussion of the burdens of proof under section 7491, and the quantums of fractional ownership discounts. The court concluded the IRS failed to meet its burden of proof by failing to offer any expert testimony as to the proper level of valuation discounts – perhaps based on a stubborn position taken that no discount should be afforded.

As stated in the opinion, "the Commissioner adduced no expert testimony or other evidence to establish alternative quantums of fractional-ownership discounts, sticking instead to his no-discount position." Which led to perhaps my favorite part of the decision; the following footnote: "The Commissioner appears to have ignored, or been unaware of, the venerable lesson of Judge Learned Hand's opinion in Cohan: In essence, make as close an approximation as you can, but never use a zero. See Cohan v. Comm'r , 39 F.2d 540, 543–44 [8 AFTR 10552] (2d Cir. 1930)." (emphasis added).

All of which led the 5th Circuit to conclude that the discount analysis offered by the Estate's experts was the only analysis offered at trial and that they are correct. The 5th Circuit explained:

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."

At bottom, we find nothing in this record or in the Tax Court's opinion that would justify any conclusion other than that the Estate is entitled to a final determination of the estate tax owed that produces a tax refund calculated on the basis of the fractional-ownership discounts and net taxable FMVs set forth on Exhibit B to the court's opinion. The record on appeal is sufficient for us to render a final judgment and dispose of the sole issue in this case without prolonging it by remand at the cost of more time and money to the parties. Accordingly, we (1) affirm the Tax Court's rejection of the Commissioner's insistence that no fractional-ownership discount may be applied in determining the taxable values of Decedent's undivided interests in the subject art work; (2) affirm the Tax Court's holding that the Estate is entitled to apply a fractional-ownership discount to the Decedent's ratable share of the stipulated FMV of each of the 64 works of art; (3) reverse the Tax Court's holding that the appropriate fractional-ownership discount is a nominal 10 percent, uniformly applied to each work of art, regardless of distinguishing features; (4) hold that the correct quantums of the fractional-ownership discounts applicable to the Decedent's pro rata share of the stipulated FMVs of the various works of art are those determined by the Estate's experts and itemized on Exhibit B to the Tax Court's opinion; and (5) render judgment in favor of the Estate for a refund of taxes overpaid in the amount of $14,359,508.21, plus statutory interest in a sum to be agreed on by the parties, based on the timing of the payment of that refund to the Estate, all as jointly stipulated to us by the parties.

COMMENT:

This case presents two very interesting rulings: the Tax Court opinion and the 5th Circuit Opinion.

Judge Halpern's Tax Court Opinion should not be ignored just because it was overruled in part. Remember: it was also affirmed in large part. And several key issues were addressed in the Tax Court opinion.

First, Judge Halpern ruled that Section 2703(a)(2) negated the restrictions in the co-tenancy agreement on sales of the co-tenant art, and thus neither the co-tenant agreement nor the art lease could be read as restricting the hypothetical seller's rights to sell Mr. Elkins' interests in the subject artworks. Because the hypothetical buyer would have to get the consent of the co-owners to sell the underlying artworks and to split the proceeds pro rata or would need to institute a partition action, the Tax Court acknowledged discounts of some level were still appropriate. While this issue wasn't addressed in the appeal, it was an important aspect of the Tax Court opinion.

Second, the 5th Circuit affirmed the Tax Court decision rejecting the IRS's no discount arguments. This holding should inform all future cases involving discounts for fractional interests in artworks.

Third, the Tax Court provided a detailed analysis of other fractional interest in art cases, and cited them for the proposition that some discount was proper and used them to distinguish the IRS's argument for no discount, but they all (including the Tax Court) only supported nominal discounts (5-10%).

For example, the Tax Court opinion notes that in the Estate of Stone v. US case, the district court rejected the proposed 44% fractional interest discounts for the estate's 50% interests in 19 paintings, holding that an undivided interest holder with the right to partition would not accept much less than liquidation value, although the Stone court did permit some "nominal" (5%) discounting for the uncertainties involved in waiting for a partition action to be resolved. Similarly, the Tax Court noted a 5% fractional interest discount was afforded to a fractional interest in artworks in the Estate of Scull decision.

And the 5th Circuit basically adopted all of the arguments of the Tax Court opinion and Judge Halpern's analysis, affirming in large part his holding, but veering in the conclusion as to the proper level of discounting.

The 5th Circuit opinion adopted much of Judge Halpern's holding; however, veering from the Tax Court's approach to apply a made-up 10% discount. Instead the 5th Circuit felt compel to apply the level of discounting proffered by the taxpayer's experts' opinions (45%) because the IRS offered no evidence at trial to contradict that level of discounting.

Had the IRS argued (at least alternatively) that if some discount is appropriate it should be closer to the 5% in Stone and Scull or maybe the 10% that Judge Halpern ruled was reasonable, or at least quantified the partition costs arguments, it seems distinctly possible the result in this case may have been different.

In fact, assuming the IRS will learn the lessons of this holding, it seems probable the next round of reported cases on valuation discounts for fractional interest in artworks may apply lower discounts (maybe much lower discounts).

Conclusion

The lessons in this case are fairly simple.

• Fractional interests in artworks are entitled to some level of discounting.

• Lease agreements and co-tenancy agreements may be necessary to keep the fractional interests transferred out of our client's estates; however, they likely will not impact the discounting analysis - due to Section 2703(a)(2)'s application.

• If the IRS heeds the 5th Circuit's admonition, future court battles over proper discounting will likely pit experts arguing over the proper valuation level instead of 0% vs. 45%. Thus, the next round of cases may lead to very different conclusions as to the appropriate discounting level for fractional interest in artworks.

Planners should be pleased with the taxpayer-friendly win in the Elkins case, but our enthusiasm should perhaps be tempered by the knowledge that much lower discounts may be offered in fractional ownership of artwork cases/audits/appeals matters.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Jeff Baskies

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CITES:

Estate of James A. Elkins, Jr. v. Comm., Cite as 114 AFTR 2d 2014-XXXX, (CA5), 09/15/2014; Estate of James A. Elkins, Jr., et al., 140 TC 86, Code Sec(s) 2031; 2703, 03/11/2013; The Church case, which was affirmed by the Fifth Circuit. 85 AFTR 2d 2000-804 (W.D. Tex. 2000), aff'd, 268 F.3d 1063 (5th Cir. 2001); Estate of Scull v. Commissioner, T.C. Memo. 1994-211 [1994 RIA TC Memo ¶94,211]; Stone v. United States, 99 A.F.T.R.2d (RIA) 2007-2992 (N.D. Cal. 2007), supplemented by 100 A.F.T.R.2d (RIA) 2007-5512 (N.D. Cal. 2007), aff'd, Stone ex rel. Stone Trust Agreement v. United States 103 A.F.T.R.2d , (RIA) 2009-1379 (9th Cir. 2009); Keller v. U.S., AFTR 2d 2012-XXXX (5th Cir. September 25, 2012).