TAX COURT CASE UPDATE

Citation:

Estate of James A. Elkins, Jr. v. Commissioner, 140 T.C. No. 5, March 11, 2013.

Overview:

The Tax Court concluded that, in valuing certain fractional interests in artwork, the decedent's agreement in which he waived his right to institute a partition action with respect to the artwork was disregarded under Code Section 2703(a)(2). However, The Court did apply a 10 percent discount to the artwork's pro rata fair market value to account for some uncertainties.

The Facts:

The decedent and his children owned interests of varying amounts in 64 pieces of artwork when the decedent passed away in 2006. The interests varied because of prior estate planning work that had been done, as well as additional elections that were made at the time that the decedent's wife passed away in 2000.

The decedent and his children had executed a cotenants' agreement in 2000 for 61 of the pieces of artwork. Each cotenant had the right of "possession, dominion and control of each of the works annually for an amount of time equal to their respective interests in the works." The cotenants shared the cost of maintaining and restoring the works of art to the extent of their percentage interests, and no work could be sold without the unanimous consent of all of the cotenants.

Upon the decedent's death, his undivided fractional ownership interests in the art passed to his children, and the balance of his estate passed to a family foundation, entitling the estate to a charitable contribution deduction. The estate applied a 44.75 percent fractional interest discount in valuing the artwork, which the IRS denied. The estate had used three experts to support the values of the artwork and the discount.

The reasoning behind the denial of the discount was as follows:

> As alternative bases for his using undiscounted values of decedent's fractional interests in the art in computing decedent's taxable estate, respondent determined that (1) the restrictions on the sale of art subject to the cotenants' agreement and fractional interests in art subject to the art lease constituted 'an option, agreement, or other right to acquire or use such artwork at a price less than the fair market value' and, alternatively, 'a restriction on the right to sell or use the decedent's interest in such artwork' so that, pursuant to section 2703(a)(1) and (2), respectively, decedent's interests in the art covered by those agreements "should be valued without regard to" those restrictions; (2) 'the discounts used in calculating the fair market value of Decedent's fractional interests in *** [the art] are overstated and no discount is appropriate.' In addition, because decedent's will provided that all estate taxes were to be paid out of his

residuary estate passing to the Elkins Foundation, the notice reduces the deduction for the charitable bequest to that foundation by the amount of the proposed estate tax deficiency, i.e., by the amount of additional estate tax payable by the estate.

Discussion:

The parties stipulated to the undiscounted fair market values of the artwork.

The estate argued that Code Section 2703(a)(2) did not apply to the co-tenants' agreement because paragraph seven only restricted the sale of any of the 62 works of art covered by that agreement (co-tenant art). It did not restrict the sale of a co-tenants' or co-owners' fractional interests in the work, and it is the decedent's fractional interests in the co-tenant art, not the art itself, that had to be valued for Federal estate tax purposes.

On the other hand, the IRS argued that no discount from the pro rata fair market value of decedent's interest in each of the 64 works of art was warranted because the restrictions on sale in the co-tenants' agreement and the art lease were restrictions that had to be disregarded under Code Section 2703(a)(2). The IRS also argued that because the proper market in which to determine the fair market values of fractional interests in works of art was the retail market in which the entire work (consisting of all fractional interests) was commonly sold at full fair market value, a fractional interest holder (being entitled to a pro rata share of the sale proceeds) was not entitled to any discount for his interest.

The Tax Court found that the decedent owned undivided fractional interests in the 64 works of contemporary art. The Court reasoned that whether paragraph seven of the co-tenants' agreement was a restriction on decedent's right to sell the co-tenant art or was a restriction on his right to use the cotenant art was not important. That was because it was clear that, under paragraph 7, decedent, in effect, waived his right to institute a partition action, and in doing so relinquished an important use of his fractional interests in the co-tenant art. In valuing those fractional interests, under Code Section 2703(a)(2), The Court disregarded the decedent's agreement in which he waived his right to institute a partition action with respect to some of the art works.

In determining the total fair market value of the decedents' interests in the art, The Court applied a 10 percent discount on the disclaimed art to account for certain uncertainties. The Court reasoned that a hypothetical willing buyer and seller of the decedent's interests in the art would agree upon a price at or fairly close to the pro rata fair market value of those interests. But a hypothetical seller and buyer could not be certain as to the decedent's children's intentions because a buyer or seller could not be certain that the decedent's children would seek to purchase the hypothetical buyer's interests in the art rather than be content with their existing fractional interests, or that, if the decedent's children did seek to repurchase the decedent's interests in the art, they would agree to pay the full pro rata fair market values for those interests.

Conclusion:

The Court concluded that the estate was entitled to a 10 percent discount from pro rata fair market value with respect to the decedent's interests in the art.