TAX COURT CASE UPDATE

Citation:

Estate of James A. Elkins, Jr., et al. v. Commissioner, No. 13-60472 (5th Circuit), September 5, 2014.

Overview:

The Court of Appeals for the Fifth Circuit has reversed the Tax Court's finding that only a 10 percent fractional ownership discount applied to an estate's fractional share in artwork and instead ruled that the 45 percent discount argued by the taxpayer applied. The Fifth Circuit said the Tax Court erred because the IRS argued for no discount and presented no evidence as to the amount of any discount, whereas the taxpayer provided substantial discount evidence, so when the Tax Court rejected the IRS's no-discount position, the Tax Court should have accepted the taxpayer's uncontradicted evidence.

The Facts:

At the time of his death, James Elkins ("the decedent") owned a 50 percent undivided interest in three pieces of artwork that had previously been owned by a grantor retained income trust ("GRIT art"). His three adult children each owned one of the remaining 16.67 percent interests. At the time of his death, the decedent also owned a 73 percent interest in 61 other pieces of artwork ("disclaimer art"). His three children each owned one of the remaining 9 percent interests.

The children leased their combined 50 percent interests in two of the three pieces of GRIT art to the decedent. That lease, which was still in effect at the decedent's death, specified that no co-owner could dispose of his or her interest in a leased work unless joined by all co-owners.

Similarly, the decedent and his children encumbered all 61 items of disclaimer art and the remaining piece of GRIT art with a co-tenants' agreement. That agreement prohibited the sale of an interest in any work by a co-owner without the prior consent of all.

On the decedent's estate tax return, the estate took a 45 percent fractional ownership discount on all of the artwork. The IRS concluded that no fractional ownership discount applied. The estate sued in Tax Court.

Discussion:

The IRS made two arguments. First, it argued that no discount for the 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 lease were restrictions that had to be disregarded under Code Section 2703(a)(2). Then it argued that, because the proper market in which to determine the fair market value ("FMV") of fractional interests in works of art was the retail market in which the entire work was commonly sold at full FMV, a fractional interest holder (being entitled to a pro rata share of the sale proceeds from the entire work) was not entitled to any discount for his interest.

The estate argued that Code Section 2703(a)(2) did not apply to the co-tenants' agreement because that agreement only restricted the sale of any of the 62 works of art covered by that agreement. It did not restrict the sale of a co-tenants' fractional interest in the work; it was Elkins' fractional interests in the art, not the art itself, that had to be valued for estate tax purposes. The estate made no argument with respect to the art that was subject to the art lease.

The Tax Court rejected the IRS's second argument, but it accepted its first argument because, effectively the decedent waived his right to institute a partition action and in doing so relinquished an important use of his fractional interests in the art.

The Tax Court then applied a 10 percent discount to the art subject to the co-tenant's agreement. It arrived at the 10 percent amount based on the following reasoning: On the one hand, 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 FMV of those interests. But, on the other hand, a hypothetical seller and buyer could not be certain as to the decedent's children's intentions, in other words, 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 FMV for those interests.

The Fifth Circuit said that once the Tax Court rejected the IRS's no-discount argument, the Tax Court was required to judge the evidence as to what the discount should be. The Court noted that the IRS presented only one witness on the subject of the amount of discount, a rebuttal witness who was an art appraiser, whose testimony the court summarized as merely stating that there is no recognized market for partial interests in works of modern art and contemporary art within the secondary markets, with the galleries or with private dealers.

The court noted that the estate's witnesses which included one of the children and an art appraiser testified to the following, which the Court characterized as a realistic appraisal of the issue at hand:

(1) that the children would never be sellers of their interests;

(2) the children's financial astuteness and their high net worths;
(3) their hypothetical desire to acquire the decedent's fractional interests if a hypothetical willing buyer should acquire them first, but also their uncontradicted testimony that they would do so only for a "fair price," as determined by experts;
(4) their legal and financial ability to prevent any hypothetical willing buyer from quickly "flipping" his fractional interests in the art to third parties, particularly given the heirs' contractual restraints on alienation and partition; and
(5) their determination to rid themselves of unrelated co-owners regardless of how much time it might take.

At oral argument before the Fifth Circuit, the IRS argued that the Tax Court had rejected the estate's experts' testimony because that testimony did not assign sufficient weight to the children's strong emotional attachment to the family's works of art. The IRS claimed that the Tax Court faulted those experts for not concluding that the attachment would guarantee the hypothetical willing buyer a virtually undiscounted purchase price for the decedent's fractional interests. The Fifth Circuit concluded that the IRS was "cherry picking" the Tax Court's analysis, and therefore, disagreed with the IRS's conclusion. The Fifth Circuit also said that, even if the IRS's reading of the Tax Court's reasoning was correct, it would not absolve that court of clear error.

The Fifth Circuit concluded that the IRS had presented no evidence as to what the discount should be, the estate's evidence was substantial and convincing, and therefore, it held that the 45 percent discount argued by the estate applied.

Conclusion:

The Fifth Circuit reversed the Tax Court and found that the 45 percent discount that the estate argued for was appropriate.