Estate & Succession Planning Corner

Tax Court Likened to Being a Deer in the Headlights

By Louis S. Harrison

Rely on the Appellate Courts to Understand the True Principles of Valuation

In one of its most important valuation decisions since the 1981 valuation opinion in *M.F. Bright Est.*,[1] the Fifth Circuit in *J.A. Elkins Est.*,[2] addressed the issue of whether a partial interest in artwork is entitled to a discount, and at what level. Along its way of holding in favor of the taxpayer's claimed discount, the Fifth Circuit was both critical of the Tax Court's reasoning and accepting of the taxpayer's claimed discount. By its opinion, the *Elkins* court paved the way for a taxpayer to develop acceptable arguments to claim discounts for partial interest ownership in artwork.

In its criticism of the Tax Court, the Fifth Circuit addressed a rather subtle issue. Over the last 20 years, practitioners in the estate and gift tax area have grown used to the Tax Court being its own appraiser. The IRS's expert will issue its discount opinion, and the taxpayer's experts their opinion, and then the Tax Court often analyzes both opinions and becomes its own appraiser, determining a level of discount that is somewhere between the two experts' opinions. In *Elkins,* the court was critical of the Tax Court operating in this fashion, being a Solomon-like appraiser, and rejected the Tax Court's attempt to modify the taxpayer's claimed 44.75-percent discount with what the appellate court regarded as an arbitrary 10-percent discount:

> The Tax Court concluded that a "nominal" fractional-ownership discount of 10 percent should apply across the board to Decedent's ratable share of the stipulated fair market value of each of the works of art; this, despite the absence of any record evidence whatsoever on which to base the quantum of its self-labeled nominal discount.

Further, the *Elkins* court set forth the rules for when the taxpayer satisfies its valuation burden of proof—if the taxpayer produces expert testimony that is

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quality, done in good faith and appears reasonable, the burden to void this valuation shifts to the IRS.

The Artwork Underpinnings of the Case

The case involved extremely valuable artwork, notably in excess of $35 million, included in decedent's estate. Prior to the decedent's death, a portion of the artwork had been gifted to the decedent's children, either through a failed grantor retained income trust (at the prior spouse's passing) or *via* a disclaimer (at the prior spouse's passing). The court does not address whether partial ownership was done in an attempt to claim a partial interest discount. But in the future, with this planning, this could be a key fact, and practitioners are encouraged not to set up partial-interest ownerships in a step-transaction kind of way (as a reference tool, see the fact pattern in the *Davidson* case, currently pending in the Tax Court, as a protocol to avoid).

Ownership of most of the art was 73.055 percent by the decedent and 26.945 percent by the children; a small amount of art was owned 50 percent by each of the decedent and his children as a group.

Although not emphasized, it appears that the formalities of partial interest ownership were followed. For example, leases were entered into between the parties to allow for the artwork to remain in the decedent's residence. There was also a co-tenants agreement.

[This opinion] imposes a good-faith standard on the IRS when it challenges taxpayers' experts in what could be regarded as a capricious (or at least callous) way.

The Numbers Do Not Lie

At decedent's passing, the artwork was valued at about $35,180,650 on an undiscounted basis. The estate then claimed a 44.75-percent discount from this value on its estate tax return for lack of control and lack of marketability.

The taxpayer had three different experts, one in the merchantability and valuation of art, an expert on the nature and costs of a partition proceeding that would be needed to force a sale of a partial interest, and an expert on the valuation of fractional interests in property. In the opinion of the appellate court, the IRS "adduced no expert testimony or other evidence to establish alternative quantums of fractional-ownership discounts," and instead argued for no discount.

Gist of the Tax Court's Opinion

The Tax Court rejected the IRS's multi-faceted attack that there should be a bar as a matter of law on obtaining a fractional interest discount in art. The IRS was looking for a zero discount. Extremes are always misleading, as demonstrated by both the Tax Court and appellate court opinions.

After a thorough analysis of the taxpayer's experts' opinions as to the level of discount, the Tax Court (through Judge Halpern) concluded that a 10-percent discount would meet the willing buyer/willing seller test as the level of reduction. The Judge offered substantial discussion as to how he arrived at that reduction; interestingly, the appellate court regarded the judge's conclusion on the 10-percent discount as "unsubstantiated."

The Appellate Court Agrees and Disagrees

The Fifth Circuit agreed without too much discussion that a discount is available for a partial ownership in artwork. It spent the majority of its opinion though on discussing why the 44.75-percent claimed taxpayer discount was acceptable, versus the 10 percent arrived at Judge Halpern/Tax Court discount. And in its reasoning, the appellate court was often hostile to the IRS's argument that no discount should apply:

> 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 zero.

The court was flabbergasted at the IRS's audacity of both not providing evidence fora low discount, and sticking to its zero-discount position. To let the IRS know that it will not tolerate this lack of effort (and attempt at governmental bullying), the court addressed who has the burden of proof in valuation cases, and what it means to satisfy that burden.

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