



WEALTH PLANNING > ESTATE PLANNING

Appeals Court Finds Old Master Paintings Were Undervalued

Estate's reliance on expert was misplaced.

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In *Estate of Eva Franzen Kollsman v. Commissioner of Internal Revenue*, Case No. 18-70565 (June 21, 2019), the 9th Circuit U.S. Court of Appeals addressed in an unpublished opinion whether the Tax Court correctly determined the fair market value (FMV) of two Old Master paintings. Finding that the Tax Court's rejection of the opinion of the estate's expert witness and reliance on the Internal Revenue Service's expert witness wasn't in clear error, the 9th Circuit upheld the valuation of the paintings by the Tax Court.

Estate's Valuation of Paintings

Eva Franzen Kollsman (the decedent) died on Aug. 31, 2005, owning two 17th-century Old Master paintings, *Village Kermesse with Dance Around the Maypole* (*Maypole*) (depicting the revelry of a village festival) and *Orpheus Charming the Animals* (*Orpheus*) (depicting a Greek mythological musician playing the lyre surrounded by animals).

The estate's expert witness, a vice president of Sotheby's North America and South America and co-chairman of Sotheby's Old Master Paintings (Wachter) prepared a consignment agreement for the executor of the decedent's estate in which he valued *Maypole* between \$600,000 and \$800,000 and *Orpheus* between \$100,000 and \$150,000.

Simultaneously, Wachter sent the executor a letter in which he stated that the FMVs of the paintings "based on firsthand inspection of the property" were \$500,000 and \$100,000, respectively. The letter was attached to the timely filed Form 706 of the estate, and the FMVs reported on the return were \$500,000 for *Maypole* and \$100,000 for *Orpheus*.

The executor hired a "preeminent fine art services firm specializing in fine art restoration and framing" to reframe the paintings. On inspection of the paintings, a manager of the firm noted that the paintings were covered by a heavy layer of grime that could be removed with relative ease. The paintings were cleaned, at a price of \$4,500 and \$4,350, respectively, before being reframed.

In January 2009 (approximately three and a half years after the decedent's death), *Maypole* sold at Sotheby's for \$2,434,500. *Orpheus* remained in the possession of the executor at the time of the Tax Court trial.

IRS' Valuation of Paintings

The IRS issued a notice of deficiency to the estate, ultimately asserting that the FMVs of the paintings, as of the decedent's date of death, were \$2.1 million for *Maypole* and \$500,000 for *Orpheus*.

Tax Court Analysis

The Tax Court found Wachter "exaggerated" the dirtiness of the paintings and the risks inherent in cleaning them in arriving at his valuations. In applying the hypothetical willing buyer and seller test to determine the FMV of the paintings, the court emphasized that the hypothetical buyer is both informed and prudent and would have investigated the state of the painting and the cleansing process necessary before arriving at a purchase price.

In addition, the court found Wachter's omission of comparable sales to support his valuations to be "remarkable" as comparable sales are "quite important" in determining the value of art.

Finally, the Tax Court found the ultimate sale price of *Maypole* to be probative evidence of its value as of the decedent's date of death and was unpersuaded by Wachter's attribution of the disparity between his estimated valuation and the ultimate sale price of *Maypole* to its vastly improved condition post-cleaning and to a surge in demand for Old Master works after 2005. Based on its findings, the court gave "very little weight" to Wachter's opinion.

In contrast, the Tax Court found the detailed comparative market data approach used by the IRS' expert in valuing *Maypole* to be persuasive. The court accepted the valuation of the IRS' expert, with a 5% discount for the painting's dirty condition

and the minor risk involved in the cleansing process. Therefore, the court held that the relevant FMV of *Maypole* was \$1.995 million.

Similarly, the court found that the IRS' expert "supported his valuations of *Orpheus* with reasoned argument based on objective market data" in analyzing sales of comparable paintings and presented reasoned arguments for attributing the painting to one of two possible artists. The court accepted the valuation of the IRS' expert, with a 25% combined discount for the painting's dirty condition and the cleaning risk, possible bowing of the painting and possibility that the artist was the less prominent of the two options. Therefore, the court held that the relevant FMV of *Orpheus* was \$375,000.

Ruling Upheld on Appeal

On appeal, the 9th Circuit noted that the Tax Court correctly applied the law by concluding that the relevant value of the paintings was the FMV of the paintings as of the decedent's date of death, or the price at which a willing buyer and seller "both having reasonable knowledge of relevant facts" would exchange property.

The 9th Circuit upheld the Tax Court's findings of fact, including its:

(1) condemnation of Wachter's "exaggerate[ion]" of the paintings' dirtiness and the cleaning risks, his inadequate explanation of the disparity between his valuation and the ultimate sale price and his lack of comparable sales data; and

(2) acceptance of the valuation offered by the IRS' expert, based on the expert's "explain[ation of] his methodology, reliance on comparables, and research about the paintings' conditions."

Takeaways

Estate planning attorneys faced with compiling the relevant information for a 706 (or a 709) may well be tempted to outsource valuations and accept whatever report

is produced by the reputable expert involved. However, this case is notable for the highly critical language of both the Tax Court and the 9th Circuit in weighing the work of a seemingly highly qualified valuation expert. Here, the executor (and his counsel) was remiss in blindly relying on a knowledgeable expert in the relevant area rather than reviewing the basis for the valuation and seeking both comparables and a reasoned analysis.

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