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Valuing Fractional Interests In Art for Estate Tax Purposes

By Wendy C. Gerzog



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It is difficult to value fractional interests in art because there is virtually no market in those interests. Nevertheless, the Tax Court in *Estate of Elkins* valued the decedent's fractional interests in multiple artworks that the decedent and his children highly cherished. The court first addressed the restricted agreements under section 2703 and then determined the value of the decedent's interests in the art.

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In *Estate of Elkins*,¹ the decedent owned a 50 percent community property interest in 64 works of contemporary art, ranging from the very valuable to the more ordinary. The collection was principally housed and exhibited in his homes and office. In 1990 he and his wife transferred their community interests in three of those pieces respectively to separate 10-year grantor retained income trusts (GRITs), which allowed them to retain the use of the collection for the term of the trust and to then distribute their interests equally to each of their three children. The decedent's wife, however, died within the 10-year term and, under the GRIT provisions, her interest in the trust passed to the decedent. Likewise, in her will she left him her community interest in the remaining artwork, which, however, the decedent partially disclaimed. The disclaimer left him holding a 23.055 percent interest in addition to his own 50 percent community interest in the 61 artworks, and it left the children each owning an 8.98167 percent interest in the disclaimed portion.

¹*Estate of Elkins v. Commissioner*, 140 T.C. No. 5 (2013).

On February 14, 2000, soon after the disclaimer, the decedent and his children contracted regarding the disclaimed interest, outlining their respective rights and responsibilities concerning the possession and control of the 61 artworks. Article 7 of the agreement provided that any sale would require unanimous consent of the parties, "their respective heirs, personal representatives, successors and assigns." The cotenants' agreement stated Texas law would apply.

Effective July 13, 2000, at the end of the decedent's GRIT term, the decedent and his children executed a lease regarding the use of two of the three artworks in the GRITs. The decedent's children allowed him to retain possession of the art on a yearly, renewable basis, in return for his payment of rent to them. The rental amount was left blank and was unpaid until approximately six years later when fair rental value was determined. On February 17, 2006, the cotenants' agreement between the decedent and his children was amended to include the remaining piece of GRIT artwork not subject to this lease.

The decedent died on February 21, 2006, and his will provided for his undivided fractional interests in the artwork to pass to his descendants.² On his estate tax return, his 73.055 percent interest in the 61 artworks was valued at \$9,497,650, and his 50 percent interest in the GRIT art was valued at \$2,652,000. Those computations included a 44.75 percent combined discount for lack of control and marketability. The parties agreed that undiscounted, the estate tax values for those interests were, respectively, \$24,580,650 and \$10,600,000, for a total of \$35,180,650.

The IRS's notice of estate tax deficiency determined that the decedent's art interests should be included in his estate at their undiscounted values. Its conclusion was based on two theories: (1) section 2703(a)(1) required that the restrictions in both the cotenants' agreement and in the lease be ignored for

²The decedent's residuary estate passed to his son and to a family foundation, for which the estate was entitled to a charitable deduction. However, because the residuary bore the burden of the taxes, that fact required reducing the charitable share and thereby the charitable deduction if the court determined an estate tax deficiency.

valuation purposes; and (2) the decedent's fractional interest discounts were inflated and inappropriate.³

At trial, the taxpayers called three expert witnesses: David Nash, an experienced appraiser and art dealer; William T. Miller, a Texas attorney experienced in partition actions and art liquidations; and Mark L. Mitchell, a director of an appraisal firm who had experience in valuing undivided interests in personal property but not undivided interests in art.

Nash met with the decedent's children and examined all the artwork. His evaluation was strongly influenced by the fact that the children were adamant about keeping the pieces until the last family owner died. He concluded that all potential buyers would demand heavy discounts because of the unlikelihood of acquiring the remaining fractional interests and because of the potential for litigation with the decedent's children over various matters such as possession. Museums would be uninterested in buying co-owned art that was not co-owned with another museum or entity.⁴ For the five "highly desirable" pieces, he assigned a 50 to 80 percent discount; for the 19 "good" artworks, an 80 to 90 percent discount; and for the remaining 40 holdings, a 95 percent discount, asserting that this last group would "have only a nominal value."⁵ Applying those discounts, Nash valued the aggregate collection at \$5,462,366.⁶

Miller said that while paragraph 7 of the cotenants' agreement was effectively a waiver of the children's right to partition, he believed that a Texas court would likely invalidate the next paragraph's statement extending that limitation to others. Miller also said a sale was more likely than a partition in kind, and he estimated that the litigation would on average take seven years for the more costly artwork (nine of the pieces) and three to four years for

the less expensive art. Finally, Miller approximated the litigation expenses to range from \$25,000 to more than \$1.1 million for the most valuable piece.

Mitchell said the cotenants' agreement and fractional interests validated the application of large discounts. He explained the need for discounts in terms of "the reduction of both the buyer's psychic and financial returns attributable to fractional ownership"⁷:

Mr. Mitchell assumes, on the basis of the Nash and Miller reports, that the other interest holders have no desire to sell the art so that, under option 1[8], the hypothetical buyer "faces the prospect of holding a non-marketable interest * * * [indefinitely], with no prospects for * * * [monetizing his interest] and no ability to control decisions regarding the underlying * * * Art," and, under option 2, he is, in effect, purchasing a "litigation claim."⁹

Thus, under option 1, applying Nash's three categories for the decedent's art, Mitchell concluded discounts ranging from 51.7 to 71.7 percent for Category I art, a 71.1 percent discount for the 19 works in Category II, and a 79.7 percent discount for the remaining Category III items. For option 2, Mitchell computed discounts of between 60 and 85 percent for Category I and five Category II works, 90 percent or more for the remaining Category II items, and 100 percent for Category III items (because litigation costs would exceed the purchase price for assets in that category). Mitchell's appraisal of the collection totaled \$7,658,645.

The government's experts included Karen Hanus-McManus, a modern and contemporary art appraiser who had performed "a study on secondary markets for fractional interests in art,"¹⁰ and John R. Cahill, an attorney whose practice included mostly art-related litigation and planning issues. Hanus-McManus testified that no established market exists for segmented interests in art. Although there had been sales of those interests by co-owners who had wanted to sell or donate the whole art itself, that data did not reflect the facts here. Cahill concluded that the cotenants' agreement and the

³Also, the notice reduced the charitable deduction. See *supra* note 2 for a discussion of that issue.

⁴The court said:

Mr. Nash summarizes the "key factors" making decedent's fractional interests in the art "unappealing" to potential buyers as follows: (1) the inability to sell the art at auction houses, (2) the lack of exclusive possession and the inability to force a sale of the art without litigation against the Elkins children as coowners, (3) possible litigation involving time of possession and proper care, storage or transportation of the art, and (4) the difficulty or impossibility of insuring the purchased interest or using it as collateral for a loan. Nonetheless, he concludes that speculators "would be willing to purchase * * * [decedent's] interests if appropriately discounted."

Estate of Elkins, slip op. at 16.

⁵*Id.* at 18.

⁶Category I art was valued at \$4,336,859; Category II at \$976,451; and Category III at \$149,366.

⁷*Estate of Elkins*, slip op. at 25.

⁸Option 1 referred to owners of a fractional interest in art who want to convert their interest into money by selling their interest. Thus, option 1 related to the non-marketability factor. Option 2 referred to those who seek the sale of the artwork itself, through a partition action, with the sale proceeds divided proportionately among the owners. Thus, option 2 used Miller's report on litigation costs.

⁹*Estate of Elkins*, slip op. at 26.

¹⁰*Id.* at 31.

lease were “not comparable to similar arrangements entered into by persons in arm’s-length art market transactions.”¹¹

The court first addressed the section 2703 issue: whether the transferability limitations in the cotenants’ agreement and the lease were restrictions covered by section 2703(a)(2). The government argued that the proper market to value the decedent’s art interests was the retail market of the artwork itself wherein, as a co-owner, he would have received his proportional part of the proceeds. It also maintained that the purpose of executing those documents was to discount valuation for estate tax purposes. To prevent that result, the government argued, section 2703(a)(2) required the court to disregard the restrictions in those documents when assessing the value of decedent’s interests in the artwork. According to the government, the children’s refusal to sell the artwork was immaterial under the regulations; there was no market for the sale of fractional interests in art; and what commonly occurs with co-owners is a sale and then division of the receipts. The government also asserted that the taxpayers’ discounts were unsupported by their experts’ testimony and that allowing discounts would contravene the government’s long-held stance that fractional interests in art are not discounted for charitable deduction purposes.¹²

The taxpayers contended that the cotenants’ agreement restricted only the sale of the artwork and not the sale of a fractional interest. They conceded, however, that section 2703(a)(2) applied to the lease of the two GRIT artworks. The taxpayers asserted that case law, particularly in the Fifth Circuit, requires discounts for partial interests in personal property, which encompassed the artwork in decedent’s estate, and that the discounts should also reflect the litigation costs associated with a partition action. Finally, they maintained that the artwork must be valued individually and not as a collection because the artwork was not an interconnected unit.

The court held for the government on the section 2703(a)(2) question. Although intent evidence was inconclusive, the court held that intent was not even relevant to the application of that code section. Moreover, although the court did not consider this issue determinative of the valuation of the decedent’s art, it held that it would disregard any restrictions imposed on the decedent’s right to partition in the cotenants’ agreement.

¹¹*Id.* at 34.

¹²The government cited to section 170, the income tax charitable deduction, as support of this contention.

Consistent with the court’s finding about the applicability of section 2703(a)(2), the court held that the restrictions in both the cotenants’ agreement and in the lease did not apply to the seller’s right to sell the decedent’s artworks. The court next addressed whether the estate tax fair market value regulation allowed any discount from the decedent’s pro rata share. The government argued that no discount was permissible because, based on *Scull*¹³ and *Stone*,¹⁴ the FMV was the decedent’s pro rata share of the full value of the artwork. The court, however, rejected the applicability of those cases because they each allowed discounts based on “various uncertainties that would confront a hypothetical buyer of art.”¹⁵

The court proceeded to emphasize that the facts underlined the children’s “strong sentimental and emotional ties to each of the 64 works of art” and that a hypothetical buyer would be dealing with owners who were unlikely to sell either an interest in the art or any complete artwork. Moreover, Nash based his values primarily on that fact. Therefore, the court found that some discount was appropriate to reflect the uncertainty of the buyer’s ability to monetize his investment.

The court rejected the government’s argument that applying the particular characteristics of the children undermines the requirement that the seller be a hypothetical seller and not the actual seller because the children were co-owners and not the seller of the decedent’s fractional interests. The court said the children’s antipathy to any sale was a relevant fact for valuation purposes. The court likewise rejected the government’s reliance on *Holman*,¹⁶ which requires that the hypothetical buyer and seller be rational economic beings who lack the emotional and unique qualities of actual human beings. The court said the children would view their position to be “in their best psychic interests; that is, they would be willing to forgo the financial gain from a sale of the art in order to keep the collection intact and continue to enjoy it.”¹⁷

The experts agreed that there was no market in fractional interests in art. According to the court, however, that conclusion did not mean that it had to apply the full value of the artwork without any discount to reflect the applicable relevant facts, as the government contended.¹⁸ Thus, the court held that there was no prohibition to allowing a discount

¹³*Estate of Scull v. Commissioner*, T.C. Memo. 1994-211.

¹⁴*Stone v. United States*, No. 3:06-cv-00259 (N.D. Cal. 2007), *aff’d*, No. 07-17068 (9th Cir. 2009).

¹⁵*Estate of Elkins*, slip op. at 55.

¹⁶*Holman v. Commissioner*, 601 F.3d 763, 775 (8th Cir. 2010).

¹⁷*Estate of Elkins*, slip op. at 60.

¹⁸The court also rejected the government’s other arguments.

from the decedent's pro rata FMV in determining the value of his interest for estate tax purposes.

Addressing the question of an appropriate discount, the court said the taxpayers' experts failed to consider the children's ownership position in relation to a hypothetical buyer of the decedent's fractional interests. That is, those experts did not assess the fact that a "hypothetical buyer would be in an excellent position to persuade the Elkins children, who, together, had the financial wherewithal to do so, to buy the buyer's interest in any or all of the works, thereby enabling them to continue to maintain absolute ownership and possession of the art."¹⁹

Thus, it was likely that because of the children's desire to retain the art for themselves, they would be inspired to pay the buyer an amount close to the decedent's pro rata share and thereby avoid litigation costs and achieve their aim of full family ownership of the art. Indeed, the court concluded that the children would pay more than a disinterested buyer to accomplish that result, a result that makes much more sense in this context than the assertion that the children's "staying power" would lead them to undergo years of litigation when this simple alternative would more logically appeal as a solution to the children.

The court concluded that the hypothetical buyer would be in an excellent position to sell his interests

¹⁹*Estate of Elkins*, slip op. at 69.

to the decedent's children and that that fact was relevant under the FMV regulation. In the small art world, a hypothetical buyer and seller would be aware of the children's strong feelings, and that would affect their negotiations. Moreover, the court rejected Nash's conclusion that a museum would not be willing to co-own artwork with an individual owner. Thus, the court rejected, as producing an unrealistically low value, the taxpayers' expert opinions that relied on the "dubious assumption that the Elkins children would mount an unrelenting defense of the status quo, ignoring the very high probability that, instead, the children would seek to purchase the hypothetical buyer's interests in the art."²⁰

The court, therefore, valued the decedent's interests in the artwork at their pro rata market value but allowed a 10 percent discount to reflect a small amount of uncertainty regarding the children's intentions.

Analysis and Conclusion

Sometimes the truth is revealed by standing back and viewing the facts from another perspective. In the somewhat unusual situation in which co-owners sorely want to retain artwork and would be hard-pressed to sell any of the pieces, a fractional interest is worth more than any of the taxpayers' experts had supposed.

²⁰*Id.* at 78.