

## FCG VALUATION CASE E-FLASH

**Authored by John Walker and Chris D. Treharne, ASA, MCBA, BVAL  
of Gibraltar Business Appraisals, Inc. a member firm of FCG  
Issue 15:1**

*Estate of James A. Elkins, Jr., Deceased, Margaret Elise Joseph and Leslie Keith Sasser, Independent Executors, Petitioners v. Commissioner of Internal Revenue, Respondent*

140 T.C. No. 5, Docket No. 16597-10, Judge: James S. Halpern, Filing date March 11, 2013

In a case of great interest to appraisers of all stripes, James A. Elkins, along with his children, owned fractional interests in 64 pieces of art, some of which were from famous artists. Upon his death in 2006, his estate valued his fractional interests in the art with deep discounts. The IRS challenged the discounts, asserting no discounts were appropriate.

### TAKEAWAY

In a complex case, the Tax Court determined that discounts to fair market value for undivided interests in art were permissible. Specifically, "[t]here is no bar, as a matter of law, to an appropriate discount from pro rata fair market value in valuing, for estate tax purposes, decedent's undivided fractional interests in the art."

Experts for both sides testified that markets for undivided interests in art was very limited. Even though empirical data for discounts for lack of marketability (only, not control and marketability) for stock interests in more developed markets suggest greater discounts are appropriate, the court ultimately settled on a ten-percent total discount.

Importantly, the court rejected the IRS claim that discounts should be limited to the difference between the sale price and a seller's proceeds. Instead, it held "fair market value to be the gross amount paid by the buyer to the seller." Said in another way: Fair market value is consideration passed from buyer to seller, which should not be distorted by the seller's net proceeds.

### THE FACTS

During thirty years of marriage, James A. Elkins, Jr. ("Decedent" or "Mr. Elkins") and his wife collected 64 works of art, many of which are by famous artists. As a result of sophisticated estate planning, Mr. Elkins and his children each wound up with fractionalized interests in three of the pieces of art after Mrs. Elkins' death.

Mr. Elkins and his children signed an art lease for two of the three works, effectively giving the Decedent year-round enjoyment of the art in exchange for monthly payments.

Additionally, the Decedent disclaimed that portion of his late wife's interest in the other 61 works so that his interest in her estate's ownership of the art would pass, tax-free, to his children. Because of this transfer, the children and Mr. Elkins each acquired fractionalized interests in the remaining 61 works of art.

After the Decedent issued the disclaimer, he and his children executed a co-tenants' agreement, permitting each co-tenant possession and control of the sixty one pieces of art for the amount of the year equal to their respective ownership percentage in the art.

Upon Mr. Elkins' death, his estate filed a Form 706 indicating the fair market value of the art (as determined by Sotheby's, Inc.) and applying a combined 44.75% discount for both marketability and control (as determined by Deloitte LLP) to the pro rata share of the fair market value.

The IRS issued a notice of deficiency, claiming no discounts were appropriate.

## **DISCUSSION**

### *Estate's Position*

The estate's expert determined that discounts for fractional interests in art would be appropriate because auction houses do not deal in fractional interests, a fact which would negatively affect the marketability of the Decedent's fractional interests. He was unaware of any situation in which a museum had purchased a fractional interest in art without being assured of purchasing the entire work or purchasing a fractional interest with an entity other than a museum or institution. He believed this lack of a market for resale of fractional interests, combined with the logistical complications and potential for litigation, would make fractional interests in art extremely undesirable without significant discounts.

In his analysis, the estate's expert determined discounts in the fractional interests ranging from 50% to more than 95%, depending on the relative scarcity and importance of the works and their artists.

Another expert for estate testified regarding the time and duration of partition actions in Texas. He testified that partitioning works valued at more than \$650,000 (9 of the Elkins' 64 works) would take between 6 and nine and half years each. For those works valued below the \$650,000 threshold, partition actions would take three to four years each. Further, the expert opined that partition actions would incur more than \$25,000 in legal and other fees from trial through appeals for the least expensive works up to \$1.1 million for the most expensive.

The estate's final expert testified that art investors are more willing than financial asset speculators to incur additional costs and accept lower returns for the "psychic benefit" of owning the art. Further, the expert believed that the cotenants' agreement and the nature of a fractional interest in art (lack of control, limited use of the art as collateral, lengthy and expensive partition action time) justified substantial discounts. Finally, he stated that the absence of transaction data for undivided interests in art provided evidence "that there are very few willing buyers of such interests, not that there is a limited number of willing sellers."

Relying on the previous two experts' work, the final expert used a 10-year holding period and varying rates of return (14 to 22 percent, depending on the work and condition of the work) to determine the discount from net asset value a fractional interest owner would require. The final expert's concluded discounts ranged from 51.7 to 79.7 percent.

### *IRS Position:*

The IRS expert testified that there was "no established marketplace for the sale of a partial interest in a work of art." Her experience with sales of fractional interests in art primarily lies with co-owners who intend to sell or donate the art, which is not comparable to the subject interest.

Further the IRS argued that no discount is warranted for the interests for two reasons:

1. The restrictions contained in the cotenants' agreement and art lease agreement should be disregarded under [§ 2703\(a\)\(2\)](#), and
2. The proper market for partial interests is the retail market for whole works (i.e., all partial interests), where the work is sold for fair market value and the partial interest holder receives a pro rata share thereof.

The IRS believed that because no market for fractional interests exists, the only way to price fractional interests is sell the whole work and each party will receive a pro rata share of the proceeds. In such an instance, no discount from net asset value would be required.

Court's Analysis:

The Tax Court determined that the restrictions in the cotenants' agreement effectively cause the holder of an interest bound by the agreement to waive the right to partition. In so doing, the court disregarded any restriction on the right to partition. The court noted, however, that this impact on value was minimal.

The court further ruled that discounts for fractional interests in artwork were permissible, citing previous Tax Court rulings involving fractional real estate, art and business interests (e.g., *Estate of Baird*, *Estate of Lauder*, *Estate of Scull*, *Estate of Bonner*, *Estate of Bright*, and *Estate of Smith*, among others). Accordingly, the final issue for determination was the extent of permissible discounts.

While the court decided that discounts may be appropriate in the case, the discounts presented by the estate's experts did not give consideration to the ownership percentages' impact on negotiations between buyer and seller. The estate's concluded discounts also did not consider a hypothetical buyer's ability to drive a bargain with the Elkins' children (given their financial wherewithal and strong desire to continue to own and enjoy the art). According to the court, consideration of the Elkins family financial situation and attachment to the art constituted a relevant fact which would be considered by a knowledgeable buyer and seller under [§ 20.2031-1\(b\)](#).

Because the court determined that discounts were permissible but the estate's discounts were unreasonably high, it determined that a 10 percent discount from pro rata fair market value was appropriate

**CONCLUSION**

The Tax Court determined that undivided interests in artwork are likely subject to discounted values. However, due to non-existent transaction data and limited guidance from the estate's experts, the concluded discounts were much less than initially determined by those experts.

\*\*\*\*\*

**PERKINS VALUATION GROUP:**

Perkins' dedicated business valuation practice group can help both companies and individuals with their valuation needs. Our team can perform an objective analysis to determine the fair market value of your business and advise you on the next steps. Our team has performed valuations for closely-held companies, trust and partnership interests, restricted securities and other intangibles for the purposes of estate and gift planning, ESOP and Phantom Stock issues, merger and acquisition studies, divorce, buy-sell agreements and business succession planning. In addition, we can offer expert witness and litigation support.

**ABOUT FINANCIAL CONSULTING GROUP:**

Perkins & Co has chosen to join [Financial Consultants Group](#) (FCG), one of the largest valuation organizations in the country. This membership helps us stay current on valuation best practices and industry issues and give us a forum of other professionals for discussions, consultations, and second opinions. It also provides us with additional training opportunities and resources, including access to the nation's top experts in valuation and litigation support.

