

ESTATE OF ELKINS v. COMMISSIONER OF INTERNAL REVENUE:

Cautionary Tale and Gem

In the eternal game of cat and mouse between the taxpayer and the Internal Revenue Service (the "Service"), the case of *Estate of James A. Elkins, Jr. v. Commissioner of Internal Revenue*, 767 F3d 443 (2014), represents a "cautionary tale" for the Service and a "gem" for the taxpayer.

I. The Facts

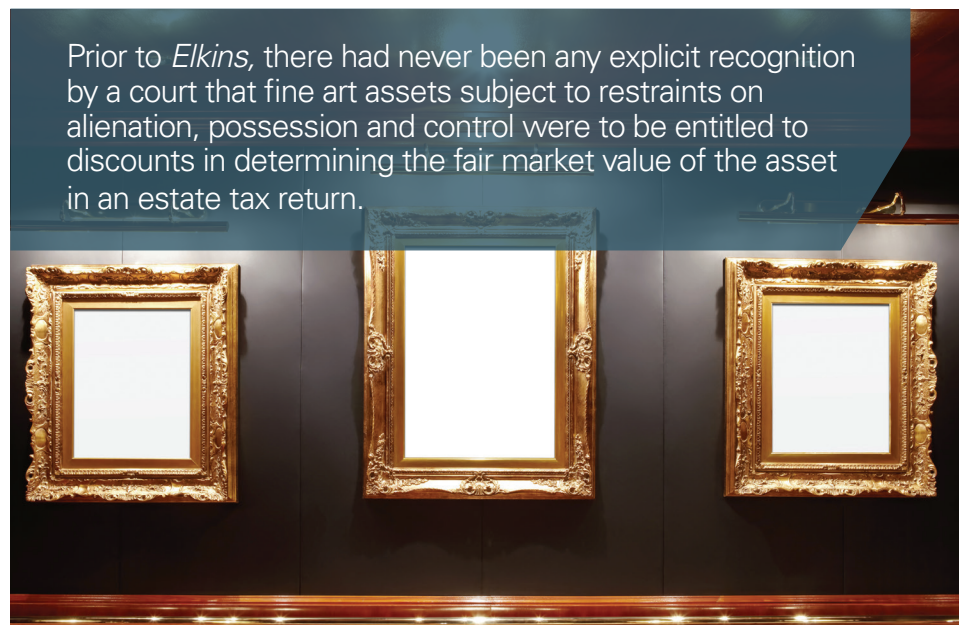
Over the course of a lifetime, James A. Elkins, Jr., the son of the founding member of the venerable Houston based law firm of Vinson & Elkins, and his wife amassed a significant and very valuable art collection consisting of works by many of the giants of modern art. Commencing in the 1990s, Mr.



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Elkins and his wife, focusing on 64 of the more valuable works from their collection (hereafter the "Collection"), began to consider the manner in which the Collection could be most efficiently transferred to their children to meet their testamentary wishes as well as to minimize the value of their estate. Presciently guided by counsel at his father's law

firm, Mr. Elkins and his wife set out to fractionalize the ownership of the Collection in a manner which met family objectives as to the management of the Collection and would result in favorable valuation treatment under the estate tax by allowing the estate to claim a discount from fair market value based on the fact that the Collection was owned as a fractional interest. Inasmuch as all family members deeply cared about the Collection and wanted to share ownership of it, Mr. and Mrs. Elkins, and after Mrs. Elkins' death, Mr. Elkins, engaged in a series of transactions, described in *Elkins*, which resulted in the Collection being jointly



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owned in fractional interests by Mr. Elkins and his children after the death of Mrs. Elkins. After the death of Mrs. Elkins, the family voluntarily put a number of controls in their fractional ownership interests in the Collection as indicated by this excerpt from *Elkins*:

From time to time following the death of his wife, Decedent and his children voluntarily subjected their respective interests in the works of art to various restraints on possession, partition, and alienation. For example, Decedent's three children leased their combined 50 percent interests in two

items of [the Collection] to Decedent thereby ensuring his uninterrupted possession of those two works. That lease, which was still in effect at Decedent's death, specified, *inter alia*, that no

co-owner could dispose of his or her interest in a leased work unless joined by all co-owners. The lease also provided that none could transfer or assign his or her "rights, duties and obligations" under the lease without the prior consent of all.

Similarly, Decedent and his children encumbered 61 items of [the Collection] with a "Cotenants Agreement." Among other things, it spelled out each co-owner's right of possession for a specific number of days during any 12 month period. More pertinent to this appeal, that agreement prohibited the sale of an interest in any work by a co-owner without the prior consent of all. The one piece in [the Collection] that had not been subjected to the children's lease to Decedent was eventually added to the list of works covered by the Cotenants Agreement.

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Several key factors should be noted in the above described sequence of events: (a) the fractionalization of ownership of the Collection took place well before the death of either Mr. or Mrs. Elkins; (b) great care was taken to impose legally binding restrictions on the alienation, possession, and control of the fractional interests, and no evidence was adduced that the family had failed to abide by the agreement; (c) the fractionalization was driven by "natural causes" and necessity, i.e. the grim reality that eventually loved ones pass away and the control and possession of fractional interests in property that they leave must be

rationalized among an entire family. The estate planning insight was to take a plain vanilla tenancy in common of the fractional interests and layer it with numerous restraints on alienation, possession, and control.

Upon filing Mr. Elkins' estate tax, the estate valued Mr. Elkins' fractional interest in the Collection as approximately \$12.2 million, which reflected a 44.75% fractional discount from fair market value. The appraisal of the Collection was performed by Sotheby's and the discount valuation was calculated by Deloitte, LLP. (*Id.* at 445, fn. 1.)

After review of Mr. Elkins' estate tax return, the Service denied the estate's discount valuation of 44.75% and assessed an estate tax deficiency of \$9,068,266.00, which was based on the undiscounted fair market value of the Collection, which was \$18,500,000.00. (*Id.* at 447.) This is where the Service's cautionary tale begins. It is my contention that, in *Elkins*, the Service mismanaged its strategy as to how to protect its position that fine art assets were not entitled to fractional interest discounts as well as its tactics with respect to the most effective way to try the deficiency case.

II. Before The Tax Court "A Cautionary Tale"

A. Strategy

Prior to *Elkins*, there had never been any explicit recognition by a court that fine art assets subject to restraints on alienation, possession and control were to be entitled to discounts in determining the fair market value of the asset in an estate tax return. At most, cases like *Estate of Scull v. Commissioner of Internal Revenue*, 67 T.C.M. (CCH) 2953 (1994) had awarded minimal discounts to take into account an extraneous factor, such as pending divorce litigation. A potential interpretation of *Scull* was that

art assets were never sold in partial interests and thus had to be valued at par regardless of how they were held. See *Estate of Scull v. Commissioner of Internal Revenue*, 67 T.C.M. (CCH) 2953, at *19-*21 (1994); see also, *Stone v. United States*, 100 A.F.T.R. 2d 2007-5512 (2007). This was a major strategic advantage for the Service, but it should have been loath to test it in court. The argument that fine art must always be valued at par was suspect to begin with, as there is nothing in the law of estate taxation that would lead one to believe that fine art should be treated differently from any other tangible asset. Further, the notion that fine art is an asset that is never bought or sold in fractional interests is losing currency given the development of fine art as an "asset class" and the evolution of this concept in the art market. Strategically, then, there was a significant risk that a court today might not go along with the Service's "no discount" position. Thus, the strategic advantage held by the Service was the lack of clear cut legal authority and this uncertainty should have been used by the Service to enhance its bargaining position to negotiate a suitable discount. So long as the uncertainty in the law persisted and *Scull* remained unchallenged, the Service could presumably have a stronger negotiating position with respect to "fine arts" valuation issues. Once the service could no longer rely on *Scull* as precedent, its negotiating position would be diminished. Thus, it was poor strategy to let this case go to trial. Compounding the strategic risk was the fact that the Service's opponent in this case, the Elkins Estate (the "Elkins Estate"), had deep pockets and sophisticated counsel. Even if the Service was looking for a test case to solidify its "no discount" position, this was not the right case. Notwithstanding the foregoing, the case went to trial, which leads us to the tactics employed at the trial.

B. Tactics

The mantra of the effective trial lawyer corresponds to the Boy Scout motto: “Be Prepared.” Actually, a better exposition of this mantra is “Be Over-Prepared.” The trial lawyer should be prepared for every possible contingency and should protect his record on appeal. Once the Service was put to trial, it inexplicably failed to aggressively litigate the issue of valuation or protect the record for appeal with respect to the value of the Collection by presenting its own evidence of valuation. Quite possibly, the Service was intractably invested in the notion that there was no market for fractional interests of fine art. Also, the Service may have felt that the “control” provisions of the Cotenants Agreement and lease prepared by Mr. Elkins was invalidated by the provisions of Section 2703(a)(2) of the Internal Revenue Code (“IRC”), which under certain circumstances, ignores “control” provisions imposed on estate assets. Whatever the reasoning, the Service waged everything on the argument that as a matter of law, the Elkins Estate was not entitled to a discount on the fair market value of the Collection.

At trial, the Elkins Estate presented extensive expert testimony as to what the discounted value of the Collection should be. *See Estate of James A. Elkins, Jr.*, 767 F.3d at 451–52. The testimony was presented in terms of specific economic analysis of the value of fine art assets, analysis of the art market, and legal analysis of the law of partition. *See id.* It was a substantial showing.

Against this evidentiary showing, the Service merely argued that as a matter of law, there was no market for fractional interests in fine arts and that the proper measure of such fractional interests is the fair market value after all fractional owners agree

to sell. Additionally, the Service raised technical arguments based on Section 2703 of the IRC, which are beyond the scope of this paper. Incredibly, the Service presented no evidence of valuation other than the fair market value of the fine arts in question, relying solely on its legal theory. The sole expert presented by the Service stated that sales of fractional interests of fine arts were rare, but could not rule out that such sales never occurred. *See id.* at 448–49. There was equivocal testimony produced regarding the personal motivation of the children of Mr. Elkins who were cotenants with the deceased father. The testimony indicated the children were emotionally attached to the art and

would not sell it, but would only pay a “fair” price for any minority interest. *See id.* at 451. The relevancy of this testimony regarding motivation could be questioned since the fair market value test used to value assets for purposes of determining the value of a decedent’s estate is not supposed to factor personal motivation but consider the value that a hypothetical buyer and seller would assign to an asset.

The tactics used by the Elkins Estate to defend its estate tax return were overwhelming analysis and proof of fair market value. The tactics used by the Service to defend its assessment were to rely on a legal argument and focus on the motivation of the Elkins children. In my view, the



tactics used by the Elkins Estate were consistent with the best practices of a trial attorney-focused, extensive and thorough with overwhelming proof and attention to preserving an excellent appellate record. The tactics used by the Service were inexplicably lacking with no consideration to protecting the appellate record on the factual issue of the value of the Collection. As a result, on appeal the only evidence of valuation was that presented by the Elkins Estate.

The flawed tactics of the Service did not result in an adverse outcome for it at the Tax Court level. *See Estate of Elkins v. C.I.R.*, 140 T.C. 86 (2013) *aff'd in part, rev'd in part*, No. 13-60472, 2014 WL 4548527 (5th Cir. Sept. 15, 2014). The Tax Court, stressing that Mr. Elkins' children were motivated to protect their fractional interest in the Collection held that the value of the Collection merited a nominal discount from fair market value of 10%. *See id.* at 135. The Tax Court ruling, however, presented the Service with a significant strategic defeat which would prove its undoing on appeal. The Tax Court held that there was no prohibition in the tax code which would prevent a discount from fair market value for fine art owned in fractional interests. *See id.* at 126. The inevitable appeal which followed would prove the strength of the Elkins Estate's strategic and tactical choices and, conversely, of the Service's poor judgment.

III. Before the Fifth Circuit Court of Appeals

The Gem

In the inevitable appeal to the Fifth Circuit Court of Appeals (the "Fifth Circuit") by the Elkins Estate of the Tax Court's decision, the poor strategic and tactical choices made by the Service produced a gem for the taxpayers.

Before the Fifth Circuit, the strategic and tactical weaknesses in the Service's case were exposed as the Court made short shrift of the Services arguments as follows:

1. The Court clearly held that there was absolutely no prohibition in the law against discounting the value of fractional interests in fine art provided that adequate evidence of economic analysis justifying the discount was presented. The *Scull* and *Stone* cases were distinguished as being merely cases where the taxpayer had failed to submit sufficient economic analysis to justify value discounts for fractional interests in art and not cases holding that discounts for fractional interests in art were forbidden. *See Estate of James A. Elkins, Jr.*, 767 F.3d at 450.

2. The Court held that its review of the value of the Collection for estate tax purposes was a mixed question of fact and law which the Court could review *de novo* on appeal. *See id.* at 449. This was not good news for the Service because it had failed to present any valuation evidence at trial. The Court then held that the very detailed evidentiary showing of the Elkins Estate, which consisted of legal analysis of partition of jointly held assets as well as specific economic analysis of the value of fractional interests of fine art, justified value discounts in excess of the 44% originally propounded by the Elkins Estate and that the trial court clearly erred in ignoring this evidence which the Court found credible and sufficient. *See id.* at 452-453. The Court further held that the trial court had improperly focused on the personal motivations of the heirs of Mr. Elkins arriving at its 10% discount valuation, stating that such reasoning departed from the classic definition of fair market value, which is based on a hypothetical buyer and seller.

Id. Finally, the Court held that since the evidentiary showing of the Elkins Estate was adequate and the Service had failed to present any evidence of value, it would accept the value presented by Elkins Estate, which justified discounts ranging from 50% to 80% of fair market value. *Id.* Since this issue was a mixed question of fact and law, according to the Court, there was no need to remand to the trial court. Thus, the failure of the Service to present any evidence of value was fatal to its case. 767 F.3d at 450-452.

3. Significantly, for purposes of future cases, which may rely on the precedent of *Elkins*, one of the experts utilized by the Elkins Estate was an economic analyst who had never previously appraised fine art. However, the analysis of this expert was specifically geared to the characteristics of a fine art asset. The Court accepted this without comment. This implies that fine art is to be treated just like any asset, which may sometimes be valued at par or at discount depending on the circumstances. Also, the fact that the agreements relating to the fine arts assets were between family members did not affect the valuation discounts. This implies that so long as there is a sound purpose for the transaction, family planning goals relating to fine art assets will be accepted.

IV. Conclusion

The Service's mishandling of its case in *Elkins* has now resulted in a clear precedent by a Federal Circuit Court of Appeals allowing substantial discounts from fair market value for fractional interests in fine arts assets for purposes of calculating a decedent's gross estate. *Elkins* is a diamond in the rough, which savvy taxpayers can polish to create discounts in fractional interests of fine arts assets in the valuing of a decedent's estate. The planning involved to justify such a

discount is not a slam dunk. Careful attention must be devoted to the agreements creating the fractional structures, which agreements must be complied with, and there must be a substantive economic justification for the discount in value. There should also appear to be a planning motivation for the fractional structure other than obtaining a discounted value.

Had the Service negotiated with the Elkins Estate prior to or during litigation and relented on its inflexible position of zero discount, it could have avoided the damaging precedent established by *Elkins* and could have continued to rely on the *Scull* and *Stone* cases to assert that fine arts assets were entitled to little or no discount from fair market when valuing a decedent's estate. No more, this train has left the station.

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