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FEATURE: PHILANTHROPY

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Elkins: A Double-Edged Sword?

The ruling may result in a lower charitable tax deduction for contributions of fractional interests in art

In September 2014, the U.S. Court of Appeals for the Fifth Circuit held, in *Estate of Elkins v. Commissioner,*[1] that the estate of a prominent Texas art collector was entitled to substantial valuation discounts for owning fractional interests in artwork. In this landmark decision, the Fifth Circuit rejected the Internal Revenue Service's argument that fractional ownership discounts don't apply to art as a matter of law and reversed a nominal 10 percent discount permitted by the Tax Court.

The *Elkins* case paves the road for art collectors and their advisors to implement attractive tax and estate-planning techniques using valuable artwork. Prior to this decision, taxpayers could expect only a modest 5 percent discount when planning with fractional interests in art. The *Elkins* court granted the taxpayer discounts of more than 50 percent.

While the taxpayer's victory in *Elkins* creates opportunities for collectors who want to leave their artwork to family members, it may present a new obstacle for owners who wish to donate fractional interests in art to charity during their lives. Based on *Elkins*, the IRS may now assert that such gifts are entitled to a lower income tax charitable deduction, even if the donor complies with the onerous rules for gifts of partial interests in tangible personal property (including art) under Internal Revenue Code Section 170.

IRS Position

The IRS has long taken the position for all tax purposes (income, gift and estate) that fractional interests in art don't qualify for any valuation discounts. For example, in Revenue Ruling 57-293, the IRS analyzed the income tax consequences of a charitable donation of an undivided partial interest in a work of art. The revenue ruling concluded that the value of the fractional interest gift was equal to a proportionate share of the value of the entire piece.

The Tax Court's opinion in *Elkins* discusses the government's rationale for this position. Essentially, the IRS' argument is based on a narrow reading of the regulatory standard for valuing property.[2] Under the regulations, the fair market value (FMV) of property that's generally obtained in the retail market is the price at which that (or a comparable) item would be sold at retail.

Specifically, the IRS argues that because there's no established market for undivided fractional interests in works of art, the relevant market is the retail market where all co-owners agree to sell the entire interest in the artwork. In such a sale, each seller receives the full, undiscounted value for her partial interest. As a result, no fractional interest discount can ever be available as a matter of law.

The IRS' position in the revenue ruling is favorable to charitably inclined taxpayers because it allows donors to take a full charitable deduction for gifts of fractional interests in artwork without regard to any valuation discounts. It's markedly less favorable, however, to taxpayers who seek valuation discounts in the context of intra-family estate planning, as illustrated by the few litigated cases in this area.

Case Law Before *Elkins*

The Tax Court first addressed the issue of valuation discounts for partial interests in artwork in 1994. In *Estate of Scull,*[3] a leading collector of pop and minimalist art died owning a 65 percent undivided interest in a collection of artwork. The remaining 35 percent was

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owned by his ex-wife, who sought to increase her share of the collection to 50 percent after his death. In the absence of proof that a higher discount was warranted, the Tax Court allowed a nominal 5 percent discount in valuing the decedent's share of the collection.

In 2007, a federal district court in the Ninth Circuit analyzed valuation discounts for artwork. In *Stone v. United States*,[4] the decedent owned an undivided 50 percent interest in several paintings. The estate claimed a 44 percent fractional interest discount, which the IRS disallowed. The court held that the estate's 44 percent discount was too high and allowed a 5 percent discount, which the IRS conceded, "in a spirit of compromise," only after a court order to attempt a settlement. The Ninth Circuit affirmed the 5 percent discount.

The *Elkins* Case

Elkins is significant for at least two reasons:

(1) It represents the first clear statement that taxpayers are entitled to valuation discounts for fractional interests in art as a matter of law. The only question going forward will be the magnitude of the discounts.

(2) It opens the door to leasing the gifted interests back from the recipient. Under a lease-back structure, a donor can make discounted gifts of fractional interests in art, reducing the value of the remaining interests in her estate, while still enjoying the art on her wall.

In *Elkins*, James Elkins and his wife owned 64 works of art valued at over $35 million. During their lives, the spouses transferred partial interests in the art to their children. James' wife died first, and following her death, James continued to own the partial interests with the children. At the time of James' later death, his ownership interests in each piece of art ranged from 50 percent to 73.055 percent.

The artwork was subject to two agreements governing its use and sale. James leased two pieces back from his children. (Interestingly, the rental amount was left blank and wasn't determined until after James' death six years later.) The agreement also prevented the parties from selling their separate percentage interests in the leased art without the joinder of the other parties.

The remaining art pieces were subject to a cotenants' agreement between James and his children. The agreement provided that each cotenant had the right to physical possession of the art based on her ownership interest and that the artwork could be sold only with the consent of all of the owners. The court's opinion doesn't discuss whether the family actually shared possession, as contemplated in the cotenants' agreement.

> The Tax Court rejected both sides' positions and made its own determination of the appropriate discount.

James died in 2006. On the estate tax return, his executors claimed a combined fractional interest discount in the artwork of 44.75 percent, which was determined by an independent appraiser. The IRS disallowed the discount in its entirety and asserted a deficiency of over $9 million.

The estate filed a petition in the Tax Court contesting the deficiency. The dispute centered primarily on the issue of valuation.[5]

The IRS argued that the valuation discount for fractional ownership claimed by the estate should be disallowed as a matter of law, for the reasons described above. Relying solely on that argument, the government's lawyers chose not to introduce any evidence regarding the magnitude of the appropriate discount. This litigation strategy was relatively successful in the Tax Court, but it proved to be a major tactical mistake on appeal.

In response, the estate offered testimony from three valuation experts, which supported even higher discounts than the 44.75 percent discount claimed on the estate tax return. The experts' discounts, calculated

separately for each work of art, were substantially over 50 percent.

The Tax Court rejected both sides' positions and made its own determination of the appropriate discount. The court disagreed with the IRS' legal argument and held that the estate tax regulations don't require valuing fractional interests in art solely on the basis of a retail market for entire works of art. The Tax Court also pointed out that *Scull* and *Stone* indicated that some fractional interest discount for art was permitted, as long as there was adequate proof of the discount.

The Tax Court also disagreed with the estate's valuation experts. In applying the "willing buyer, willing seller" standard, the court reasoned that the Elkins children (who already owned a portion of the artwork) would be highly motivated to acquire the decedent's fractional interests to consolidate 100 percent of the ownership in their hands. For that reason, the court held that a nominal discount of 10 percent was appropriate.

If renting gifted artwork can withstand IRS scrutiny, donors may be able to remove valuable pieces of art from their taxable estates at discounted values, while retaining possession and enjoyment of the gifted pieces during life.

The estate appealed the Tax Court's decision to the Fifth Circuit, which sided with the taxpayer. Like the Tax Court, the Fifth Circuit rejected the IRS' position that fractional interests in artwork aren't entitled to valuation discounts as a matter of law.

Importantly, the Fifth Circuit also reversed the Tax Court's award of a nominal 10 percent discount and held that the estate could claim the full discounts determined by its appraisers. This ruling was based primarily on the government's failure to introduce any contrary evidence regarding the magnitude of the discount. Because the estate submitted all of the evidence on that issue, the Fifth Circuit held that the IRS was barred from challenging the sufficiency or weight of that evidence on appeal.

Intra-Family Planning Opportunities

The *Elkins* decision offers three key insights for art collectors who wish to pass their collections to the next generation of owners in a tax-efficient manner.

First, the decision gives taxpayers a strong basis for claiming fractional interest discounts for artwork in excess of the nominal 5 percent discount established by pre-*Elkins* case law. In the estate tax context, this shift means that executors of estates that own partial interests in art may now have a fiduciary duty to seek more substantial valuation discounts.

Second, *Elkins* suggests a roadmap for more advanced estate-planning opportunities with artwork. For example, the facts of *Elkins* indicate that the IRS may be willing to respect an art lease between a donor and a donee of a work of art without causing inclusion of the gifted interest in the donor's estate.

If renting gifted artwork can withstand IRS scrutiny, donors may be able to remove valuable pieces of art from their taxable estates at discounted values, while retaining possession and enjoyment of the gifted pieces during life. To avoid an IRS argument that the art lease isn't an arm's-length transaction, the lease should provide for fair market rent supported by an appraisal.

The lease-back technique creates some potential income tax issues, however. If the ownership structure of the gifted art is similar to the facts of *Elkins*, in which the art passed to the donor's children outright, the donor's rental payments will generate taxable income to the recipient. A client can mitigate this tax inefficiency by making the gift (or installment sale) to a grantor trust for the benefit of the donor's family members. In that case, the rent payments will be income-tax free and will help transfer additional wealth out of the donor's taxable estate in a tax-favorable manner.

The third insight offered by *Elkins* is the importance of reliable appraisals to support both the valuation discount and the rental amount for the art lease. The IRS is

unlikely to repeat its tactical mistake in *Elkins* and will begin to engage its own appraisers to establish lower fractional interest discounts. Fortunately, art appraisers are increasingly comfortable providing discount opinions for partial interests in artwork and for fair market rentals of art, which should make it easier for taxpayers to resist valuation challenges by the IRS.

Charitable Giving Opportunities

The taxpayer's success in *Elkins* may, however, prove to be a double-edged sword for art collectors who are interested in donating fractional interests in artwork to charity during their lives. Historically, partial interest gifts to charity were attractive to stretch the income tax deduction over a longer period than the standard 5-year carryforward would allow.

The Tax Court's and Fifth Circuit's respective decisions are squarely at odds with the IRS' 1957 revenue ruling that allowed donors a full income tax charitable deduction for gifts of partial interests in art without regard to any valuation discounts. To remain consistent, the IRS will now need to allow or disallow valuation discounts for all tax purposes, including estate and gift tax planning (where discounts are desirable) and charitable gift planning (where discounts result in a lower deduction and are harmful to the taxpayer-donor).

On balance, the new transfer tax planning opportunities created by *Elkins* should outweigh the additional hurdles it may raise for charitable planning. After 2006, donors who want to make charitable gifts of partial interests in artwork are already required to navigate a web of complicated rules that significantly restrict the usefulness of this charitable giving technique.

Specifically, IRC Section 170(o) imposes the following requirements:

- **Ownership:** A gift of an undivided interest in tangible personal property is eligible for the charitable deduction only if, immediately before the gift, all interests in the property are held either by the donor alone or by the donor and the donee. This requirement means, for example, that an owner who inherited a partial interest in a work of art (like the Elkins children) won't derive any tax benefit from giving that partial interest to charity.
- **Timing:** To avoid recapture of the charitable deduction (plus interest and an additional 10 percent tax), the donor must contribute all of the remaining interests in the donated work of art to the same donee within 10 years of the initial fractional contribution (or the donor's death, if earlier).
- **Related use:** Recapture of the charitable deduction can also be imposed if, within the same period described above, the recipient charity doesn't have substantial physical possession of the artwork or doesn't use the property in a manner related to its exempt purposes.
- **Valuation ceiling:** The FMV of the additional contributions of fractional interests (and, therefore, the income tax deduction) will be calculated based on the lesser of the value of the property at the time of the initial contribution and of the additional gift. In effect, this rule places a ceiling on the value of the contributed artwork for income tax purposes and prevents the donor from benefiting from any future appreciation in value, while exposing the donor to the risk of depreciation.

The rules of Section 170(o) are sufficiently onerous to discourage all but the most determined donors from making charitable gifts of partial interests in artwork. If the IRS adopts the holding of *Elkins* for income tax purposes and begins to impose valuation discounts for fractional interests in art, this planned giving technique may become even less attractive.

Endnotes

1. *Estate of Elkins, Jr. v. Commissioner,* 140 T.C. 86 (2013); *Estate of Elkins, Jr. v. Comm'r*, 767 F.3d 443 (5th Cir. 2014).
2. Treasury Regulations Section 20.2031-1(b) (estate tax); Treas. Reg. Section 25.2512-1 (gift tax); *see also* Treas. Regs. Section 1.170A-1(c) (income tax charitable deduction).
3. *Estate of Scull*, T.C. Memo. 1994-211.
4. *Stone v. United States*, 99 A.F.T.R.2d 2007-2992 (N.D. Cal. 2007); *Stone v. U.S.,* 100 A.F.T.R.2d 2007-5512 (N.D. Cal. 2007) (supplemental decision); *Stone v. U.S.*, 103 A.F.T.R.2d 2009-1379 (9th Cir. 2009) (unpublished opinion).
5. The Tax Court also discussed whether the sale restrictions in the lease and the cotenants' agreement should be disregarded under Internal Revenue Code Section 2703. While the Tax Court sided with the Internal Revenue Service on that issue, the IRS' victory was moot because it didn't affect the court's ultimate holding regarding the discounted value of the artwork.