Elkins Decision Overturned by the Fifth Circuit

In March 2013, the Tax Court rendered its opinion as to the fair market values of undivided fractional interests in 64 works of modern and contemporary art includable in the Estate of James A. Elkins, Jr. (the "Estate"). During trial, the Tax Court was presented with testimony offered by the Estate's experts that appropriate discounts for the fractional interests in art should range from approximately 50% to nearly 80%.[1] Such testimony was in stark contrast to the position taken by the Commissioner, who did not believe any fractional interest discount was appropriate. Confident in its position, the Commissioner called only rebuttal witnesses during trial.

The Tax Court ultimately disagreed with both positions and applied a 10% discount for fractional ownership, noting that such discount would "enable a hypothetical buyer to assure himself or herself of a reasonable profit on a resale of those interests to the Elkins children." Despite the use of the term "hypothetical willing buyer," this line of reasoning appears to depart from the spirit with which the term is used in the definition of "fair market value," an observation we first made last year. In rendering its opinion, the Court disregarded a cotenants agreement covering the artwork, citing Section 2703(a)(2).

On September 15, 2014, the Fifth Circuit issued an opinion reversing the decision of the Tax Court, finding "no viable factual or legal support for the court's own nominal 10 percent discount." The Fifth Circuit found reversible error in the Tax Court's interpretation and application of the hypothetical willing buyer/hypothetical willing seller test, stating "While continuing to advocate the willing buyer/willing seller test that controls this case, the Tax Court inexplicably veers off course, focusing almost exclusively on its perception of the role of 'the Elkins children' as owners of the remaining fractional interests in the works of art…Moreover, the Elkins heirs are neither hypothetical willing buyers nor hypothetical willing sellers, any more than the Estate is deemed to be the hypothetical willing seller." Ultimately, the Fifth Circuit concluded that the valuation opinions offered by the Estate's trial experts are appropriate and rendered a judgment in favor of the Estate for the refund of taxes over-paid of approximately $14 million.

[1] The original 706 filed by the Estate incorporated a 44.75% discount.

MPI Commentary:

The outcome of this case can only be described as a complete victory by the taxpayer. What it also affirms, however, is the need to properly apply the hypothetical willing buyer/ hypothetical willing seller test. As in other recent cases, the court has, at times, appeared to depart from the traditional application of this test and replace it with one that involves hypothetical scenarios based on some assumed and, oftentimes cooperative, actions of hypothetical parties.

Interestingly, the Fifth Circuit also addressed directly (and agreed wholeheartedly with) a premise long held in many prior court decisions and by many of us in the appraisal community - that a combination of (a) the lack of a recognized market for a private asset and (b) legal impediments to resale, have a decidedly negative impact on the value of an asset, noting "A potential willing buyer would undoubtedly insist that his potential willing seller further discount the sales price to account for the virtual impossibility of making an immediate 'flip' of the art.

Such a fully informed willing buyer would be well aware that, by virtue of becoming a co-owner with the sophisticated, determined, and financially independent Elkins heirs, he could not possibly make such a quick resale - absent a deep discount, that is." This contrasts with testimony offered by an expert for the Commissioner who implied that the absence of a recognized market for a fractional interest in art would somehow enhance the value of such an asset. As noted by the Fifth Circuit,[2] this position does not appear to align with economic reality.

Lastly, although not addressed specifically, the Fifth Circuit appears to have importantly considered the cotenants agreement when reaching its decision.

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[2] The Fifth Circuit noted, "The absence of an established market would be a factor that a willing buyer would consider as calling for a deeper discount of fractional interests in art."

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