ROBERTS & HOLLAND LLP

NEW YORK
(212) 903-8700

WASHINGTON D.C.
(202) 293-3400

November 2014

ESTATE & GIFT TAX PLANNING NEWSLETTER

FRACTIONAL INTERESTS IN ART AND OTHER VALUATION CHALLENGES

By: Quincy Cotton, Stuart J. Gross and Mark David Rozen

Several recent valuation cases are of interest to our clients and friends. One fairly high-profile case involved the estate tax valuation of fractional interests in valuable works of art (the court accepted fractional interest valuation discounts between 51.69% and 79.74%!). Several other interesting cases involved the impact of intangible assets, including goodwill, on the valuation of an operating business. These cases illustrate the importance of the factual record and of determining the best litigation strategy if some of the important facts are in dispute. The cases also are instructive for planning purposes; in planning, we focus on what the facts will look like, and how to establish (and document) the record if, in the future, a judge examines the evidence to determine what happened.

Valuation of Fractional Interests in Art

James Elkins and his wife collected art. Over the course of their lives, they acquired works by Jackson Pollock, Henry Moore, Pablo Picasso, Paul Cezanne, and Jasper Johns, among others. As a result of some lifetime gifting transactions and transfers under the Will of Mrs. Elkins, Mr. Elkins and his children owned fractional interest in 64 works of art. At Mr. Elkins' death, he owned a 73.055% fractional interest in 61 works of art and a 50% interest in 3 works of art. In each case, the Elkins' children owned the balance of the interests. Most of the artwork was subject to a "Cotenants Agreement" that specified each co-owner's right of possession during each year and prohibited the sale of an interest in a work of art without the consent of all co-owners. A few pieces not covered by the Cotenants Agreement were subject to a lease that gave Mr. Elkins full possession and restricted the ability of the co-owners to dispose of their interests.

Mr. Elkins' fractional interests described above were included in his estate at his death and the estate hired appraisers to determine the value of such interests for estate tax purposes. First, an art appraiser determined the value of each work of art as a whole; then, a second appraiser determined the valuation discount appropriate to reflect the reduction in pro rata value attributable to owning a fractional interest subject to various restrictions. The values reported on the estate tax return reflected an overall discount of 44.75%. The IRS disallowed the discount and litigation ensued.

At trial in the Tax Court,[1] the estate contended that the discounts determined in the original appraisal (described above) were in fact too low. The estate produced new valuation experts at trial and asserted valuation discounts ranging from 51.69% to 79.74%

[1] Estate of Elkins, Jr. v. Comm., 140 TC 86 (2013).

(depending on the particular factors applicable to particular pieces). The government steadfastly maintained that no discount at all was appropriate and offered no evidence as to any level of discount (even as an alternative "back-up" position). The Tax Court rejected both the government's zero-discount position and the valuations presented by the estate. Rather, based on its own reasoning and without expert or other evidentiary support, the Tax Court concluded that the appropriate discount was 10%. The taxpayer appealed.

The Court of Appeals (5th Circuit)[2] agreed with the Tax Court's rejection of the government's zero-discount position. However, it also found no evidentiary support in the record for the Tax Court's 10% discount. Since the estate had produced extensive and credible evidence supporting its valuation discounts asserted at trial, and in the absence of any valuation discount evidence from the government, the Fifth Circuit determined that the estate's valuations should be accepted. The result was a major victory for the taxpayer, resulting in a large refund of estate tax.

Despite the favorable outcome, it is wise to be cautious reading too much into the Elkins case. The taxpayer's heavily discounted values were accepted by the court in the face of the complete lack of valuation evidence from the government. Certainly, the case stands for the proposition that a fractional interest in a work of art may be worth less (potentially significantly less) than its proportionate share of the value of the whole, but anyone attempting to prevail with discounted values must address a number of legal and practical issues. For one thing, the Cotenants Agreement described in the case is problematic under special estate and gift tax valuation rules. Indeed, the Tax Court ignored, probably correctly (for valuation purposes), certain restrictions imposed under that agreement. In addition, any agreement regarding shared possession and related matters would need to be diligently followed by any taxpayer who wants that arrangement to be respected by the tax authorities. The practicalities of moving around particular works of art among co-owners may make this difficult. The Elkins case does indicate, however, that with proper structuring and parties willing to put in the required effort, a fractional interest discount could likely be obtained.

[2] Estate of Elkins, Jr. v. Comm., 114 AFTR 2d 2014-5985 (CA5).

Goodwill Cases

Estate of Franklin Z. Adell, et al. v. Comm.

Franklin Adell owned (directly or indirectly) 100% of the shares of STN.Com, a cable uplinking company. STN.Com's sole purpose was to broadcast an "urban religious program" channel called The Word, which was owned and operated by World Religious Relief, a nonprofit entity. Ministers and other religious leaders paid The Word to broadcast their programs. This was accomplished by STN.Com's "uplinking" services. The Word paid a monthly programming fee for these services to STN.Com. Under the terms of the services agreement, the fee was to equal the lesser of the actual cost incurred by STN.Com or 95% of net programming revenue received by The Word. Franklin's son, Kevin Adell, solicited content and contributions for The Word. The facts of the case indicated that only Kevin (not his father) had the personal relationships necessary for The Word's (and thereby STN.Com's) business.

At Franklin's death, all of the shares of STN.Com were included in his estate for estate tax purposes. The estate hired an appraiser to determine the value of the shares and the appraiser concluded that, for valuation purposes, the company's operating expenses should be adjusted for a significant "economic charge" on account of Kevin's goodwill and his importance to the company. The IRS disagreed with the estate's appraisal. The biggest dispute related to the appropriate manner in which to take into account Kevin's contributions to the company's activities.

The Tax Court[3] determined that STN.Com did not own Kevin's personal goodwill, because the customers of The Word did not know that he worked for STN.Com. In addition, Kevin did not have a noncompete agreement with STN.Com and, therefore, could take his relationships elsewhere. Kevin's goodwill was personal to Kevin and had not been transferred to the company. On these facts, the value of STN.Com had to take into account the cost involved in keeping Kevin and his relationships at the company, which led to a significantly reduced valuation from that determined by the IRS. The case illustrates that relationships and goodwill developed by younger generations (and not

[3] Estate of Franklin Z. Adell, et al. v. Comm., TC Memo 2014-155.

transferred to a family business), can decrease the value of assets owned by the senior generation.

Interestingly, the somewhat unusual terms of the programming agreement between STN.Com and The Word had not originally been taken into account by the estate's appraisal. In a later appraisal, the appraiser opined that the value of STN.Com was zero, because under the terms of its agreement with The Word, its fee was limited to the lesser of its cost or 95% of The Word's revenue. This effectively prevents STN.Com from being able to make a profit. The Tax Court noted that, despite the contractual limitation on the programming fee, STN.Com had been profitable. The Word had, in fact, paid 95% of the net programing revenue, regardless of STN.Com's costs. The Tax Court found that a potential buyer of this going concern would not ignore the historical performance of STN.Com on account of the stated limitation in the programming agreement. This is likely incorrect as a matter of estate and gift tax valuation, but demonstrates a somewhat basic fact that where the parties to an agreement essentially ignore its terms, the government and courts are likely to do the same.[4]

Bross Trucking, Inc., et al. v. Comm.

Mr. Bross owned a trucking business, the principal customers of which were companies owned by family members. Mr. Bross had "close personal relationships" with the owners of these customers, but Bross Trucking, Inc. did not have formal written service agreements with the customers. Due to problems with safety investigations, Bross Trucking, Inc. was under heightened regulatory scrutiny, causing negative attention for the company.

Mr. Bross's three sons created a new company to engage in the trucking business. Bross Trucking, Inc.'s customers that were owned by family members moved their business to the new company. Because of the negative safety and regulatory associations of the "Bross" name, the new company had a different name. Mr. Bross was not involved in its ownership or management. The IRS thought that value had been transferred by Mr. Bross to his children as owners of the new trucking company, and asserted that Bross Trucking, Inc. had made a taxable distribution to Mr. Bross of intangible assets, including goodwill, enabling him to gift it to his sons. The Tax Court,[5] however, determined that whatever goodwill the company retained at the time was personal to Mr. Bross, due to his relationships with the customers, and therefore could not be distributed to Mr. Bross. Mr. Bross had not at any time transferred this personal goodwill to Bross Trucking in the form of an employment contract or noncompete agreement. Since the company did not own the goodwill, it could not have distributed it to Mr. Bross. The IRS addressed only the income tax consequences of the asserted distribution for the year in question, and did not otherwise assert a gift tax issue. It is interesting to note that the opportunities available to the next generation by virtue of their exposure to family business operations often fall outside the gift tax system.

William Cavallaro, et al. v. Comm.

The two family companies involved in this case did not fare so well in terms of gift tax consequences. Mr. and Mrs. Cavallaro owned a company that made tools and machine parts. Their sons owned a company that engaged in various related activities. The most successful part of the collective business was the development, manufacture and sale of a liquid-dispensing machine (CAM/ALOT), which had begun before the sons' company was created. In order to satisfy various regulatory requirements relating to CAM/ALOT, the two corporations were merged into one corporation, in which the parents and their three sons became shareholders. An appraiser valued the two companies in connection with the merger, in order to determine the appropriate allocation of its shares among the post-merger owners. In connection with this appraisal, it was assumed by the taxpayer's appraiser that the valuable technology developed for CAM/ALOT was owned by the sons' company. This resulted in a large allocation of value to the sons' company, relative to the parents' company, and the sons received a proportionately greater number of shares than their parents received in the post-merger company.

There was a significant factual issue regarding the ownership of the CAM/ALOT technology. During the discussions leading up to the merger, the taxpayers'

[4] STN.Com's dealings with The Word, a charitable organization, raise significant issues under the rules governing tax-exempt entities, but these issues were not raised in the case.

[5] Bross Trucking, Inc., et al. v. Comm., TC Memo 2014-107.

attorney suggested to them that Mr. Cavallaro had transferred the then nascent CAM/ALOT technology to the sons' new company at its formation. This was achieved (according to the theory of the attorney), when Mr. Cavallaro handed over the corporate "kit" (formation documents) to his son. Notwithstanding the subsequent course of conduct of the two companies -- i.e., the facts -- which were inconsistent with the attorney's theory, the taxpayers maintained, at trial, that the technology was owned by the sons' company and their evidence relating to valuation reflected that assumption.

The IRS determined, and the Court agreed, that there was no evidence of any prior transfer of the CAM/ALOT technology to the sons' company. Since the appraisal that allocated value between the two companies in connection with the merger assumed the CAM/ALOT technology was owned by the sons' company, the court rejected it. This left the taxpayers without any evidence of value of the sons' company and, on that basis, the court upheld the government's valuation. The result was a very significant gift by the parents to the sons as a result of the merger (the post-merger company had been sold within a year of the merger for $57 million).

The court was kinder to Mr. and Mrs. Cavallaro with respect to the penalties asserted by the IRS. The court found that they had reasonably relied on their advisors, including the well-known and well-respected attorney who had "concocted" a fiction of an earlier transfer of the technology to decrease the value of the Cavallaros' estates, and did not advise them that a gift tax return was required. The Court was also influenced by the fact that Mr. and Mrs. Cavallaro had limited education and, although they were successful in developing their company, were not sophisticated business people.

This case points to the importance of structuring ownership and employment relationships, even among family members, as early as possible in the building of a business, because you can't make up the facts! More generally, this case (and Elkins) point to the importance of introducing into the record evidence that may be necessary for the court to resolve the matters at issue, on one or more alternative theories of the case. A party who offers evidence to support only his preferred theory of the case – without offering support for any alternative resolution of the case -- does so at his peril. This happened to the taxpayers in Cavallaro: they did not offer valuation evidence other than evidence premised on the belief that their sons' company owned the technology. It also happened to the IRS in Elkins: the government steadfastly maintained its zero-discount position and did not offer its view of discount levels, in the event that the court found that some amount of discount was appropriate.

If you would like more information on estate planning generally or any of the specific items discussed herein, please contact any member of our Estate Tax Planning Practice Team.

Our Estate Tax Planning Practice Team

Stuart J. Gross	(212) 903-8723
Mark David Rozen	(212) 903-8743
Quincy Cotton	(212) 903-8739
Lionel Etra	(212) 903-8721
Debra G. Kosakoff	(212) 903-8735
Jessica. G. Weinberg	(212) 903-8750
Sanford H. Goldberg	(212) 903-8745