Proving Value

Most of James Mitchell's fortune was held in his revocable living trust. Six days before his death in 2005, he transferred a 5% interest in two real estate properties to an irrevocable trust for his sons. The reason for the transfer was to keep the properties in the family at least until the sons reached age 45.

Mitchell had inherited a fortune from his father. After Mitchell's death his executor discovered that the father had a collection of paintings that had been crated and placed in storage. Whether Mitchell was even aware of the paintings was unknown.

Mitchell's estate filed a timely federal estate tax return, indicating a gross estate value of $17 million and a transfer tax of nearly $7 million. On audit the IRS sought to increase the value of estate assets substantially, resulting in a $10 million deficiency.

The value of two Western paintings, one by Frederic Remington and another by Charles Marion Russell, was one point of contention for the court to examine. The other was the value of the 5% gifted interest and the 95% retained interest in the real estate.

The real estate

The IRS did not challenge the transfer to the trust. Before trial the parties had agreed to stipulate the fractional interest discounts to apply to the gift and retained interests for each property. The disagreement was over the fundamental value of the properties, which were each unique. One was a single-family oceanfront property in a gated community in Montecito, California, near Santa Barbara. The other was a 4,065 acre ranch in Santa Ynez, California, one of the largest ranches in the area. One would be hard pressed to find comparable sales for either piece of real estate.

Fortunately, Mitchell had held both properties for their income value. Both were subject to long-term leases ($160,000 per year for the beachfront property). The estate used an income capitalization method to determine the value of the leases over their projected life and added the value of the reversionary interest expected at the end of the lease. The IRS argued that income capitalization is more appropriate for commercial property, not residential property. The Service instead offered a "lease buyout" valuation method, in which the estate would incur the expenses of breaking the lease to allow for a sale of the property.

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The Tax Court held that the income capitalization method was appropriate because the properties were generating income. The lease buyout analysis has not been accepted by any court, nor is it generally recognized by real property appraisers

The paintings

The estate's art appraisers offered a value of $1.2 million for the Remington painting and $750,000 for the Russell. The IRS believed that the value should be double those figures.

To assist in situations such as this, the IRS has an Art Advisory Panel of 25 volunteer art experts to assist with difficult valuations. The panelists are not told whether an item is being valued for purposes of a charitable deduction or for measuring an estate tax obligation, thus ensuring their objectivity. In this case, the panel believed that the Remington had a maximum value of $850,000, and the Russell could be worth from $300,000 to $1 million.

However, the Service in this case rejected the recommendation of the Panel in favor of its own appraisers' reports, believing that the Panel may have been inexperienced in Western art. However, the IRS experts didn't have the requisite expertise either. In fact, the Tax Court noted, only the estate's expert had credentials in that area.

The estate's expert relied only on public sales and looked at a large pool of sales of Western art. The IRS appraiser looked at a smaller number of transactions, including private sales. Those private sales are poorly documented and less reliable, the Tax Court held. Ultimately, the estate's position prevailed.

Do you have a question concerning wealth management or trusts? Send your inquiry to Suzanne at suzanne@secfedbank.com or to Jon-Myckle at jmp@secfedbank.com. You can also give us a call at 574-722-6261.