

# Practical Guidance on Valuation Practices and Procedures from the *Estate of Mitchell* Decision

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*In the Estate of Mitchell, the Tax Court concluded the value of a decedent's estate that included unique real estate and artwork assets. What is particularly noteworthy about this judicial decision is the Tax Court's practical guidance (to both taxpayers and valuation analysts) with regard to tax-related valuation practices and procedures.*

## INTRODUCTION

The Tax Court decision in *Estate of Mitchell*<sup>1</sup> represents a taxpayer victory in a fairly complex estate tax valuation dispute. The dispute primarily involved the valuation of the decedent's real estate and artwork. The Tax Court upheld the valuation positions of the taxpayer.

In addition, this Tax Court decision provides several interesting observations about the characteristics that it looks for in valuations. For the most part, these judicial observations are as relevant to the valuation of businesses and securities as they are to the valuation of real estate and artwork.

## THE HISTORY OF THE *ESTATE OF MITCHELL* DISPUTE

The Internal Revenue Service (the "Service") examined the estate's federal estate tax return. And, the Service claimed that the estate underreported the fair market value of (1) certain paintings and (2) real estate fractional interests. In response, the executor of the estate filed a petition with the Tax Court. The executor contested the entire claimed estate tax deficiency.

The parties were able to resolve most of the valuation and other estate tax issues before trial.

However, the parties still disputed the fair market value of two categories of property:

1. Fractional leased-fee interests in two real estate properties
2. Two paintings

However, before trial, both the taxpayer and the Service agreed to apply valuation adjustments (i.e., discounts) ranging between 19 percent and 40 percent to the disputed real estate fee simple interest values for the subject real property fractional interests.

Asked to determine the fair market value of the estate's real property interests and paintings, the Tax Court noted that valuing these types of assets "can be an ambitious task."

This is because the Tax Court noted that such assets are "unique and infrequently exchange hands." In addition, the Tax Court noted that the value of art "often lies in the proverbial 'eye of the beholder.'"

At trial, both the estate and the Service discarded the initial valuations that were used on the estate tax return and in the notice of deficiency. Rather, both parties presented de novo valuations at trial.

The Tax Court stated that this case illustrated the difficulty associated with determining the fair market value of a decedent's property, the "quintessential fact question."

Nonetheless, the Tax Court concluded that the estate had properly determined the fair market value of both (1) the decedent's real property fractional interests and (2) the decedent's paintings.

## THE ESTATE OF MITCHELL VALUATION ISSUES

Under Section 2031, the fair market value of a decedent's gross estate is determined by including the value of all real estate and personal property—both tangible and intangible. Therefore, the estate includes all of the property held by the decedent at the time of his or her death.

Regulations Section 20.2031-1(b) indicates that the value to be applied in Section 2031 is the property's fair market value. The regulations define fair market value as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

In addition, the value of the decedent's tangible property should reflect its highest and best use as of the valuation date.<sup>2</sup> This conclusion is relevant since the disputed assets in the Mitchell estate were entirely tangible property.

As indicated in the *Mitchell* decision, the determination of fair market value is a question of fact that can cause controversy and litigation. This conclusion is particularly true when the subject assets are distinctive. In the *Mitchell* decision, both the artwork and the real estate were distinctive assets.

If a decedent's estate includes assets that have marked artistic or intrinsic value that totals more than \$3,000, then Regulations Section 20.2031-6(b) requires an appraisal, executed by the appraiser under oath, to be filed with the estate tax return.

The regulations also require that the estate should ensure that the appraiser is reputable and recognized as competent to appraise the subject artistic assets.

Due to the frequency of disagreements regarding the value of artwork, Revenue Procedure 96-15 instituted a procedure by which the taxpayer may, after transferring artwork valued at \$50,000 or more, obtain a statement of value from the Service. The taxpayer may then rely on that Service statement of value when filing the income gift, or estate tax return reporting the transfer.

According to Revenue Procedure 96-15, the taxpayer must attach to (and file with) the appropriate tax return a copy of the Service's statement of value. This procedure is required regardless of whether

or not the taxpayer agrees with the Service's statement of value.

If the taxpayer disagrees with the Service's statement of value, then the taxpayer may submit additional information with the tax return in order to support a different fair market value conclusion.

When the taxpayer and the Service do not agree on the fair market value of the artistic asset, then both parties may obtain appraisals from independent valuation experts.

In this instance regarding the valuation of artwork, the taxpayer technically has the burden of proving that the Service's valuation is incorrect. However, in such a valuation case, if the taxpayer submits an appraisal report to support its property valuation, then the dispute typically becomes a battle of the valuation experts.

While a federal court may hesitate to decide the value of the taxpayer's property, it will do so when it is required. Many times, a court will merely accept the better supported of the two parties' appraisals. In other instances, the court may weight—or even average—the value conclusions of the two parties' appraisals.

In estate tax disputes, the federal courts require qualified appraisers:

1. to use generally accepted valuation approaches and methods in their appraisals and
2. to thoroughly explain their valuation analyses in the appraisal report.

The federal courts will typically consider all of the relevant facts, weigh all relevant valuation evidence, and draw appropriate inferences and conclusions in their determination of the taxpayer property fair market value.

## THE DECEDENT'S ASSETS IN THE ESTATE

The Mitchell estate reported a \$17 million gross estate value. The two largest assets included in the decedent's estate were beach front property and a ranch.

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The beach front property was subject to a 20-year lease to an unrelated third party. That lease accomplished the decedent's announced goal of ultimately keeping the ownership of property in his family. The lease also transferred all of the costs of the property maintenance to the property lessees. And, the lease provided income to the decedent's family.

The ranch property was also subject to a long-term lease to commercial cattle ranchers. Leasing the ranch property accomplished the decedent's announced goal of maintaining the ranch property until it would be distributed to the decedent's two sons.

The decedent's revocable trust held all of his assets, including the beach front property and the ranch property. The trust provided that, after the decedent's death, both properties would be held for the benefit of the two sons. And, both properties would be distributed to the two sons once the younger of the sons attained the age of 45.

Shortly before the decedent's death, he gifted a five percent ownership interest in each of the two properties to a separate children's trust for the benefit of the two sons.

The estate also included several Western theme paintings by well-known American artists. The two Western theme paintings subject to the Tax Court's review were:

1. an oil painting named "Casuals on the Range," by artist Frederic Remington and
2. a watercolor painting named "Creased," by artist Charles M. Russell.

## THE RESPECTIVE PROPERTY APPRAISALS

In the appraisal of the real estate ownership interest, the Tax Court noted that the two parties already

agreed that 19 percent and 32 percent fractional ownership interest discounts applied to the beach front property 95 percent and the 5 percent leased-fee interests, respectively.

Also, both parties already agreed to apply 35 percent and 40 percent fractional ownership interest discounts to the appraisals of the ranch 95 percent and 5 percent leased-fee interests, respectively.

Accordingly, the Tax Court only had to determine the fair market value of a 100 percent ownership interest in each real estate property in order to determine the adjusted (i.e., discounted) fair market value of the decedent's ownership interest.

The estate's valuation analyst used the income capitalization method to estimate each property's ownership interest value. In contrast, the Service's valuation analysts used the so-called lease-buyout method to estimate the fair market value of the subject ownership interests.

The income capitalization method values an income-producing property by estimating the present value of its expected future cash flow. The Service's valuation analysts indicated that the so-called lease-buyout method equals:

1. the subject property's fee simple interest value minus
2. the amount of money that would be necessary in order to buy out the lessee's leasehold interest.

The Service's valuation experts also testified that appraisers generally use the income capitalization method only with respect to commercial property leases—and not with respect to residential property leases.

The Tax Court disagreed with this assertion made by the Service's appraisers. The Tax Court concluded that any property that generates rental income can be valued using the income approach and the income capitalization method.

The decedent had treated the beach front property as an investment, and the decedent had leased out the beach front property for a profit. Furthermore, the decedent did not intend to live in the beach front property or to use it as his personal residence. The Tax Court concluded that leasing the beach front property was an income-producing activity that put the land to its highest and best use.

The ranch, which the decedent had leased for 25 years, provided the decedent with annual income. In addition, the lease effectively re-allocated the property maintenance costs from the decedent to the third-party lessees.

The Tax Court ruled that the Service's so-called lease buyout method was "speculative at best." The Tax Court noted this so-called valuation "method":

1. had not been accepted by any court and
2. was not generally recognized by real estate appraisers.

Rejecting the Service's real estate valuation method, the Tax Court ruled that the estate appraiser's income capitalization method was the best method for determining the value of the 100 percent leased-fee interest of both of the decedent's properties.

To value the estate's artwork, the Tax Court concluded that art appraisal experts consider several different criteria or "art valuation factors." These various factors include thematic appeal, period of work, style, overall quality, provenance, condition of artwork, and market conditions.

The Tax Court received appraisals of the subject artwork from the estate, from the Service, and from the Service's Art Advisory Panel. The Tax Court specifically noted that the Service's appraisal experts did not have either expertise or an extensive background in American Western art.

All of the art appraisal experts in this case used the sales comparison (or market) approach to value both paintings.

The Tax Court concluded that one of the Service's appraisal experts relied on poorly documented private sales data to value one of the paintings. In contrast, the estate's appraisal expert relied on public auction comparable sale data.

The Tax Court concluded that the public auction price data provided a better indication of the fair market value of the first painting.

With respect to the second painting, the Tax Court found that the Service's appraisal experts failed to adjust their valuation for the subject painting's inferior status, poor paper quality, and poor back boarding.

The Tax Court concluded that the estate appraisal expert's appraisal reports provided the better indications of the artwork fair market value.

The Tax Court also noted that the estate expert's appraisal reports were more understandable, reasonable, and well supported.

## PRACTICAL VALUATION GUIDANCE FROM THE MITCHELL JUDICIAL DECISION

Both valuation analysts and taxpayers can benefit from the practical valuation guidance provided by

the Tax Court in the *Mitchell* decision. This practical guidance relates to the judicial considerations regarding both:

1. the quality of appraisers and
2. the quality of appraisals.

## The Judicial Determination of Fair Market Value

As demonstrated in the *Mitchell* decision, the judicial determination of value in the Tax Court often operates somewhat like an arbitration proceeding. The Tax Court will conclude which valuation best estimates the fair market value of the taxpayer's property.

Of course, it is the taxpayer's responsibility to conduct the appropriate valuation analyses in order to estimate a value conclusion. Without evidence that the taxpayer (or the taxpayer's expert) performed the appropriate valuation procedures, the Tax Court may conclude that the taxpayer failed to properly establish the property's fair market value.

## The Taxpayer's Responsibility and Tax Return Preparer's Responsibility

Under Section 6662, the taxpayer can be subject to substantial accuracy-related penalties that start at 20 percent of the amount of the understatement. These valuation-related penalties can be higher with a substantial understatement of tax.

In addition, the tax return preparer can also be subject to understatement penalties under Section 6694. Therefore, the tax return preparer should be concerned that the taxpayer's property valuations as disclosed on the tax return in fact have the appropriate support.

## Factors That May Trigger the Service's Examination of the Estate Valuation

Recently, the Service increased its audit scrutiny of high-income and high-net-worth taxpayers. According to the Service's *Fiscal Year 2011 Enforcement and Service Results* report, in 2011, the Service examined approximately 12 percent of all taxpayers earning at least \$1 million annually.

That 2011 12 percent audit rate represents an increase from the 8 percent audit rate in 2010 and the 6 percent audit rate in 2009.

In contrast, only about 1 percent of all taxpayers earning less than \$200,000 had their income tax returns examined in 2011. These statistics conclude

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that tax returns with large reportable income, taxable gifts, or taxable estates face an increased probability of audit by the Service.

It is noteworthy that the Service has also increased the number of experienced examination agents in the estate and gift tax discipline. The Service’s investment in manpower has resulted in an increased examination of federal estate and gift tax returns.

And, this increase in the number of examinations has resulted in a greater number of

notices of deficiency. Accordingly, it is possible that even an appropriately prepared tax return can result in an examination for no other reason than that the amount of the taxable gift or bequest is large.

### **The Service’s Approach to Valuation-Related Examinations**

As evidenced by the facts of the *Mitchell* case, the Service can be aggressive with respect to taxpayer valuation disputes. Many of the Service challenges related to estate tax returns have claimed valuations that are substantially larger than, and in some cases more than double, the valuation claimed by the estate.

The Tax Court’s valuation determinations in such matters are often influenced by which party presents the best data to support its proposed estate values. In circumstances where the taxpayer fails to adequately substantiate the fair market value of the decedent’s property, the additional tax costs can be substantial.

## **INTERNAL REVENUE SERVICE EXAMINATIONS OF ESTATE TAX VALUATIONS**

Certain estate tax return factors appear to increase the risk of a tax return examination. Some of these factors are unavoidable, such as related-party transaction. However, other factors possibly may be avoided through the use of effective tax planning.

### **Examination of the Related-Party Transactions**

Transactions between related parties (as defined in Section 267) appear to create an increased risk

of examination by the Service. This is because the Service often perceives an attempt on the part of a parent generation to pass value to the younger generation through an asset sale consummated at a discounted price.

The Service may likely attempt to prove that the parents’ related-party transaction passed a disproportionate benefit to the younger generation. In that case, the Service likely may assert that:

1. the younger generation received value above the amount paid for through the discounted sale transaction price and
2. the difference between the actual value of the transferred property and the related party transaction discounted sale price is a taxable gift.

In contrast, transactions between unrelated third parties have a rebuttable presumption of being fairly negotiated. Nonetheless, it is noteworthy that this presumption of fair negotiation is not absolute.

Some transactions between unrelated third parties can result in a review by the Service. That is, the Service can claim that there still can be “sweet-heart” transactions between unrelated parties similar to related-party transactions, such as those between common-law partners.

### **The Use of Formula Valuations to Value Property Transfers**

Many closely held company buy-sell agreements use accounting book value as the basis for the subject business equity sale. When attached as an exhibit to the taxpayer’s tax return, such formula approach buy-sell agreements often increase the risk of a Service examination.

Often, the question of whether book value appropriately represents fair market value is not relevant. This is because, upon review, the Service will simply assume that the book value formula analysis is arbitrary.

If the Service challenges this formula approach valuation and, in turn, supports its own valuation of the transferred ownership interest with a competent appraisal, then the taxpayer runs the risk of a larger tax liability.

### **The Use of Out-of-Date Taxpayer Valuations**

The taxpayer’s reliance on older property valuations or out-of-date subject property information may also create a problem. With regard to the

valuation of most types of taxpayer property, timing is everything.

Many taxpayers (and their tax advisers) may rely on a rule of thumb, such as the use of appraisals conducted within three months of the property transfer date transaction. However, this rule of thumb can be problematic to the taxpayer if the transferred property has large swings in value that can make the prior appraisal assumptions obsolete.

## PROCEDURE TO MITIGATE THE RISK OF A VALUATION EXAMINATION

### The Use of a Qualified Appraisal

A qualified appraisal (one that meets the requirements under Regulations Section 1.170A-13(c)(3) for certain charitable contributions) is not required to substantiate the transferred property fair market value for purposes of determining the size of the decedent's taxable estate.

However, the use of a qualified appraisal provides a strong foundation to establish the fair market value of the decedent's property.

The use of a qualified appraisal does not completely protect the taxpayer from an Internal Revenue Service examination. The Service challenges many taxpayers' qualified appraisals, sometimes based on issues that estates can usually avoid.

Some of these avoidable valuation-related issues are summarized below:

1. Is the appraiser qualified? Taxpayers should ensure that the estate's property appraiser meets the definition of "qualified" under Regulations Section 1.170A-13(c)(5).
2. Is the appraisal report objective? Disclosing the reason for the property appraisal in the appraisal report may provide the Service with reasons to challenge the subject appraisal report.

For example, if the appraisal report discloses that the appraisal relates to a related-party sale, then the Service may argue that the concluded value is not objective. The Service may claim that the taxpayer's goal is to conclude a lower value and not necessarily to conclude a reasonable fair market value.

3. Are multiple appraisals consistent? If more than one property appraiser provides an appraisal report, each appraiser may be using different assumptions in order to conclude the fair market value.

For example, the use of different capitalization rates used to calculate value under

the income capitalization method may create a concern on the part of the Service. When the estate uses different appraisers, the taxpayer should share information from prior appraisals with all of the appraisers. This procedure may allow the multiple appraisers to consider the application of a consistent valuation approach.

## Review of the Transaction Tax Planning Documents

The estate's tax advisers should review documents related to any buy-sell agreements, articles of incorporation, and voting trusts that have transaction provisions. Furthermore, any prior property transfer transactions, whether between related or unrelated parties, should also be reviewed by the estate's tax advisers.

The reason for this review is to resolve any inconsistencies that can lead the Service to assume that the estate has used either an arbitrary value or an inconsistent valuation procedure.

Property appraisals that meet the qualified appraisal requirements typically provide the taxpayer with greater protection during an Internal Revenue Service examination.

## SUMMARY AND CONCLUSION

The Mitchell decision provides practical guidance for taxpayers and for valuation analysts with regard to their assessment of the appropriate valuation practices and procedures. Proper valuation planning can help the taxpayer to mitigate the examination risk and to increase protection related to the transfer of tax returns.

Taxpayers with high income and high net worth should be particularly diligent regarding the valuation process. Such taxpayers should ensure that they rely on valuation analysts who apply generally accepted valuation approaches and methods.

When the taxpayer does not rely on a qualified appraisal prepared by a qualified appraiser, then an Internal Revenue Service valuation challenge may result in a large tax liability, along with interest and penalties.

### Notes:

1. Estate of Mitchell, T.C. Memo 2011-94.
2. See Estate of Kahn, 125 T.C. 227 (2005).

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