

# VALUATION – MORE ART THAN SCIENCE

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## Tags

Artwork  
Code §2031  
Estate and Gift Tax

## INTRODUCTION

A recent Tax Court Memorandum decision,<sup>1</sup> involves the valuation of two Old Masters paintings for estate tax purposes. An expert at a famous auction house was retained by the estate. His reasoned opinion as to the value was dismissed by the court when one of the works was actually sold by the estate several years later for more than four times the amount determined in the expert valuation report. While subsequent events generally are not considered in determining valuation at a specific date, they can be relevant and were indeed relevant here. In sum, the case provides an example of what not to do when a decedent owns valuable art.

## FACTS

In *Kollsman*, the decedent was a U.S. citizen who owned two 17th-century paintings at the conclusion of life. The paintings needed to be valued for estate tax purposes, and Sotheby's was retained to perform the valuation. Sotheby's also held exclusive rights to sell the paintings for the estate. The fee for the valuation was subsumed in the general fees that Sotheby's would receive as a result of the sale. The valuation report was prepared by the co-chair of Sotheby's Old Master Paintings Worldwide. He stated that the values of the paintings were impaired as they were in such an unclean condition that cleaning might cause irreparable harm. Accordingly, the paintings were valued at \$500,000 and \$100,000, and this was the valuation that the estate recorded on the decedent's estate tax return. Several months later, the paintings were cleaned and one painting was sold 34 months later for a hammer price of \$2,100,000 and a total price \$2,434,500, taking account a buyer's premium fee to Sotheby. The I.R.S. asserted that the actual value of the paintings was \$2,100,000 and \$500,000, and adjusted the decedent's U.S. estate tax liability accordingly.

## IN GENERAL

U.S. citizens and non-citizen individuals that are domiciled in the U.S. ("U.S. individuals") are subject to the U.S. estate tax on global assets held at the conclusion of their lifetimes.<sup>2</sup> U.S. tax law allows a credit that is the equivalent of a lifetime gift tax and estate tax exemption U.S. individuals. The nominal amount of the exclusion is U.S. \$5,000,000,<sup>3</sup> which is indexed for inflation beginning in 2011.<sup>4</sup> For 2017, the

<sup>1</sup> *Estate of Eva F. Kollsman, et al. v. Commr.*, T.C. Memo 2017-40.

<sup>2</sup> Code §2033.

<sup>3</sup> Code §2010(c)(3)(A).

<sup>4</sup> Code §2010(c)(3)(B).

exemption amount is U.S. \$5.49 million.<sup>5</sup>

The U.S. estate tax base (the “gross estate”) of a U.S. citizen includes all property, no matter where located.<sup>6</sup> This includes tangible property, personal property, and real property, including artwork. The gross estate tax value is reduced by deductions.<sup>7</sup> The value of a property is determined based on “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.”<sup>8</sup>

The estate bears the burden of proving the values that the I.R.S. determines in a statutory deficiency notice are incorrect.<sup>9</sup> The I.R.S. bears the burden to prove the values it asserts in a deficiency notice.<sup>10</sup>



## COURT HOLDING

The Tax Court noted that a valuation expert is obligated to present his or her case in an objective fashion, with detached neutrality and without bias.<sup>11</sup> Further, experts lose credibility if they become advocates for a party’s position.<sup>12</sup> The Sotheby’s expert indicated that his valuation was based on the grimy nature of the paintings and that the difference in his date of death valuation and the sales price valuation was due to a combination of the paintings being cleaned and an increased interest from Russian buyers.

Since the paintings were later cleaned by another party without incurring damage, the court believed that the expert exaggerated the delicate nature of the paintings to reduce their valuation for U.S. estate tax purposes. Instead, the court discounted the expert’s valuation for the following reasons:

- A willing buyer and seller would investigate and find that the paintings could be cleaned without incurring damage.
- The expert did not provide a valuation list of comparable paintings, so the court could not compare whether the estimated value provided by the expert was appropriate.
- The expert was possibly incentivized to provide a low valuation to obtain the auctioneering business from the sale of the paintings. The expert’s firm had a financial interest in obtaining the paintings for auction.

To some extent, the court disagreed with the I.R.S. valuation expert and held that the unclean nature of one of the paintings justified a 5% discount from the value

<sup>5</sup> Rev. Proc. 2016-55.

<sup>6</sup> Code §2031(a).

<sup>7</sup> Code §2053(a). This includes the lifetime exemption, funeral and administrative expenses, indebtedness, and claims against the estate.

<sup>8</sup> Treas. Regs. §20.2031-1(b).

<sup>9</sup> *Welch v. Helvering*, 290 U.S. 111, 1933.

<sup>10</sup> Code §142(a).

<sup>11</sup> *Kollman*, at 16.

<sup>12</sup> *Id.*

determined by the I.R.S. The court allowed a further discount for the second painting, as the estate's expert and the I.R.S. expert disagreed as to the actual identity of the painter of the painting.

## CONCLUSION

There are several takeaways from the *Kollsman* case. Practitioners should note that post-valuation events may cause a court to change a date of death valuation. Accordingly, a plan that relies on a low valuation to reduce U.S. estate tax liability may not be feasible if later results demonstrate that the actual value is much higher than the valuation price. For the valuation to be valid, estate planners should only employ valuers who do not have an interest in the items they are evaluating. Finally, valuers must have data to defend their decision making. This evidence should include comparable values of similar items. In sum, the pedigree of the evaluator is less important than the preparation of a credible and complete report.

*“A plan that relies on a low valuation to reduce U.S. estate tax liability may not be feasible if later results demonstrate that the actual value is much higher.”*