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HEADLINE: IRS DEFINES FAIR MARKET VALUE OF ART;
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The Internal Revenue Service recently ruled that for estate tax purposes, the fair market value of artwork sold at public auction is the sales price plus the 10 percent premium paid by the buyer to the auction house.¹

The IRS further considered the extent to which the buyer's premium is a deductible administration expense. This article analyzes this recent ruling, Technical Advice Memorandum 9235005 (the TAM), and offers guidance to estate planning practitioners representing clients with valuable works of art or other collectibles.

The TAM involved the estate of a New York decedent. She was survived by one daughter and one granddaughter. Her gross estate consisted almost entirely of valuable works of art and real property.

The decedent authorized her daughter to select works of art, within six months of the issuance of letters testamentary, subject to a cap of one-half the value of the residuary estate computed as if no works of art were selected. The will directs the executors to sell any works of art not selected by the decedent's daughter and to add the proceeds of sale to the general estate. The will divides the residuary estate, computed as though the decedent's daughter did not select any works of art, into two equal shares.

One share (less the value of any works of art selected by the daughter) is to pass outright to the decedent's daughter and the other share is to be held in trust. The decedent's daughter is the sole income beneficiary of the residuary trust.

The decedent's daughter did not select any works of art as permitted under the will. The executors consigned the artwork to a world renowned auction house. Like other major auction houses, the consignee generally is compensated in two ways.

The auction house seeks a seller's commission, which equals an agreed percentage (usually 10 percent) of the sales price. In addition, the auction house will charge the buyer a premium imposed on the hammer price.

The amount of the buyer's premium, which is nonnegotiable, varies from country to country. In the U.S., it generally is 10 percent, but for works with a value of \$50,000 or less, it recently was increased to 15 percent.

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In this case, the executors and the auction house agreed that there would be no seller's commission payable by the estate. Accordingly, the auction house's only remuneration for its services was the 10 percent premium paid by the buyer.

On the federal estate tax return, the executors reported the proceeds received, that is the aggregate hammer price, as the fair market value of the artwork. At audit, the IRS claimed that the fair market value should be increased by the 10 percent premium paid by the buyers. The matter thereafter was submitted to the National Office of the IRS for technical advice.

Fair Market Value

The value of property includible in a decedent's gross estate is its fair market value at the time of the decedent's death, or as of the alternate valuation date.² The regulations define fair market value as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.³ The fair market value is to be determined by reference to the market in which the item is most commonly sold.⁴

The taxpayer in the TAM placed considerable weight on the U.S. Supreme Court decision of **United States v. Cartwright**.⁵ In **Cartwright**, the decedent owned shares in three open-end mutual funds at the time of her death. Shares in such mutual funds could be sold by the shareholder only back to the fund and only at a set redemption price, or bid price. In contrast, the asked price, or the price at which the fund offers shares to the public, sometimes includes a fixed sales charge assessed by the fund's principal underwriter.

The question in **Cartwright** was whether the fair market value of the shares in an open-end mutual fund is the bid price, that is the amount which the shareholder would receive upon redemption, or the asked price, which includes the sales charge.

At the time the Supreme Court considered this question, the regulations promulgated under the predecessor to 2031⁶ expressly provided that the shares in an open-end mutual fund were to be valued at the public offering price, including the sales load.⁷ The Supreme Court concluded that the regulation was invalid and held that the fair market value is the amount that the shareholder can realize.

The Supreme Court considered the imposition of an estate tax on the asked price to be unrealistic and unreasonable.⁸ The only price that a shareholder may realize is the redemption price, nothing more. In the teeth of this fact, Regulation 20.2031-8(b) purports to assign a value to mutual fund shares that the estate could not hope to obtain and that the fund could not offer.⁹ Under **Cartwright**, therefore, the point of reference is the maximum amount that the seller can receive in the appropriate retail market.¹⁰

The IRS, however, distinguished **Cartwright** by stating that valuable works of art, unlike mutual fund shares, are not sold in a restricted market.¹¹ While **Cartwright** is distinguishable on several grounds, the Supreme Court decision is relevant to the issue at hand.¹²

Under the regulations,¹³ the bell-wether is the retail market in which the item is most commonly sold to the public. In the TAM, the IRS declined to recognize that, for estates holding valuable works of art, the dominant market place is the public auction. Executors select the auction market in the overwhelming number of cases in order to raise cash efficiently to reach the greatest number of potential purchasers and to minimize the inherent difficulties associated with judging the market. This is certainly the practice of professional executors, such as banks. In short, driven by their fiduciary duty to act prudently and perhaps conservatively, executors most commonly select the public auction market.

Cartwright and the issue at hand therefore are more similar than the IRS was ready to acknowledge. As a practical matter, the art market is a restricted market for executors, albeit not by legislative act.

Excise Tax

In reaching its conclusion that the fair market value of artwork sold at auction includes the 10 percent buyer's premium, the IRS relied principally on a series of cases involving the federal excise tax.

For example, the IRS cited **Publicker v. Comm'r**,¹⁴ a gift tax case. There, the taxpayer purchased two items of jewelry and as part of the purchase, was required to pay a federal excise tax (computed as a percentage of the purchase price). She thereafter gave the jewelry to her daughter. The court concluded that, for gift tax purposes, the fair market value included the excise tax. A similar result was reached in **Duke v. Comm'r**¹⁵ and **Estate of Gould v. Comm'r**.¹⁶

These cases, however, are easily distinguishable. It is clear that the federal excise tax is considered part of the purchase price. For example, when individuals purchase airline tickets, cigarettes or other items subject to an excise tax, they never are quoted the price without the excise tax. They probably would not even know the price exclusive of tax.¹⁷ As the court in **Estate of Gould v. Comm'r** observed, the man on the street, to the extent he considers the excise taxes at all, regards them as an integral part of the purchase price.¹⁸ Simply put, as far as the public is concerned, there is one price for the article, which includes the excise tax.

In complete contrast, the bids of prospective purchasers at a public auction do **not** include the buyer's premium. After the final bid is accepted, the buyer's premium is an added expense, just like other expenses of the purchaser, such as local sales tax. Furthermore, when the seller considers the choice of an auction house, the seller and the auction house staff focus on the pre-sale estimates and reserves, which are quoted without the buyer's premium.

The IRS dismissed these important distinctions:

Buyer's premiums paid on the purchase of art work at auction are a standard practice in the auction industry. Thus, every buyer is given notice that, if an item is purchased at an auction, he or she will have to pay a premium in addition to the hammer price. Indeed, the auction houses, in publishing the sales results of each auction, list, as the sales price, the aggregate of the hammer price plus premium. Thus, the buyer's premium is recognized in the industry as a component of the sales price of the artwork, and appraisals using comparable sales are routinely based on the listed sales prices. Accordingly, in the instant case, as was the case in **Publicker**, the premium paid by the buyer is commonly recognized as part of the cost of purchasing the art work, and therefore is properly included in determining the fair market value of the property.¹⁹

The taxpayer in the TAM challenged the accuracy of these statements. In its submission to the IRS, the taxpayer established that the major auction houses, in performing fair market appraisals and providing pre-sale auction estimates, generally do **not** consider the buyer's premium or other costs of the buyer. Unlike the excise tax, the buyer's premium is listed separately from the hammer price in publications available to appraisers.

The taxpayer further argued that the practice of the auction houses in reporting the sales inclusive of the buyer's premium is not determinative of the fair market value of works of art which are sold. When the buyer's premium is included in their reports, the auction houses clearly advance their own business objectives by maximizing the reporting of the transaction. The taxpayer further pointed out that the reporting practices vary, as some publications do not include the buyer's premium in their reporting of auction prices.

Buyer's Premium

Having concluded that the buyer's premium is to be added to the hammer price in order to arrive at fair market value, the IRS next considered the extent to which the buyer's premium is a deductible administration expense.

Section 2053(a)(2) provides that administration expenses are deductible, if allowable by the laws of the jurisdiction under which the estate is being administered. The regulations purport to impose an additional requirement: the expenses, according to the regulations, must be necessarily incurred in the administration of the estate.²⁰

More specifically, [e]xpenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration or taxes, to preserve the estate, or to effect distribution.²¹ The term expenses for selling property is defined to include brokerage fees and other expenses attending the sale, such as the fees of an auctioneer if it is necessary to employ one.²²

After concluding that the buyer's premium is an expense allowable under local law,²³ the IRS examined whether the sales were necessary. Prior to the sale of the artwork, the estate at issue in the TAM lacked sufficient liquidity with which to satisfy its cash obligations. The National Office of the IRS acknowledged that the buyer's premium, to the extent sales were required to raise funds to pay taxes, debts and administration expenses, would constitute a deductible administration expense.²⁴

The taxpayer argued that the deduction should not be limited to the expenses of sale necessary to raise cash solely for those purposes. Due to the provisions of the will, the taxpayer argued, the sales were necessary to effect distribution.

Private letter ruling 8119002²⁵ supports this view. There, the will directed the executor to sell certain tangible personal property at a public auction. The IRS concluded that the auctioneer's commissions were deductible as administration expenses because such expenses were necessary to effect the distribution of the estate. The executor had a duty to sell the tangible personal property as directed in the will. Similarly, under the facts of the TAM, the executors were

directed to sell those works of art not selected by the daughter. Thus, the taxpayer argued, in order to carry out the duty imposed upon them to distribute estate assets in accordance with the will, the executors were required to sell the works of art.

The taxpayer further argued that, even without the direction in the will, a portion of the sale was necessary to effect distribution to the residuary trust. In *Estate of Vatter*,²⁶ the executor, pursuant to discretionary authority, sold three parcels of improved real estate to satisfy the wishes of the trustee of the testamentary trust that liquid assets be distributed to the trust. The Tax Court concluded that the sales were necessary to effect distribution of the residuary estate.

In the TAM, the IRS rejected the argument that the sales were necessary to effect distribution to the decedent's daughter. Because she had the right to select works of art, the IRS concluded that the sale of the artwork that otherwise could have passed outright to the daughter was primarily for the daughter's benefit.²⁷ The National Office of the IRS, however, neglected to consider whether the sale of artwork otherwise deemed earmarked for the daughter was necessary for a different reason: to raise sufficient funds to meet the estate's cash obligations, such as taxes, expenses and debts.

After the issuance of the TAM, the taxpayer established to the satisfaction of the IRS that the estate's cash shortfall was so significant that the sale of **all** of the artwork was necessary to satisfy the estate's cash obligations. Thus, the eventual result for the taxpayer in the TAM was that the buyer's premium, in its entirety, was deductible as an expense necessary to pay debts, expenses of administration and taxes and to effect distribution to the residuary trust. In this case, the IRS's efforts to increase the gross estate by the buyer's premium were negated by the offsetting deduction.

Planning

The official position of the IRS is that, for estate tax purposes, the fair market value of artwork sold at auction includes the 10 percent buyer's premium.²⁸ If the TAM is followed, it is possible that an estate will be forced to pay federal and state estate taxes, which in New York could have a combined marginal rate of as much as 65 percent, on an item which can never be realized by the executor and never passes through the executor's hands. Estate planning practitioners representing clients with valuable works of art should anticipate this problem and consider how to minimize the adverse consequences. A close examination of the TAM offers some possible solutions.

The TAM may encourage clients to direct their executors to sell the artwork. An absolute direction in the will should help the estate in its efforts to procure a deduction for the buyer's premium.²⁹ Similarly, if the residuary estate passes to a trust, the sale may be considered necessary to effect distribution,³⁰ especially when coupled with a direction to sell. However, there is no guarantee that the IRS will continue to allow testators to create deductible expenses by directing a sale or creating a residuary trust.³¹ Furthermore, a direction to sell and/or the creation of a residuary trust may not conform with the client's testamentary wishes.

If the estate sells the artwork and is not entitled to deduct the buyer's premium, the estate should claim a capital loss for income tax purposes. Once the collector of the works of art has died, those works in the executor's hands cease to be personal assets and are no different from other assets that are held for investment.³²

Assuming the fair market value of the artwork equals the hammer price plus the 10 percent buyer's premium, the cost basis of the property likewise includes the premium.³³ The amount realized upon the sale is the hammer price, less any applicable seller's commission.³⁴ The difference between the cost basis and the amount realized represents the estate's income tax loss.³⁵

However, under 1211(b), the amount of the loss that may be recognized is limited to the amount of capital gains plus \$3,000, assuming there is at least that amount of other income. The unused capital loss is carried forward under 1212. In the final year of the estate, the carryover loss will pass to the beneficiaries succeeding to the property of the estate.³⁶

The ability partially to offset the increased estate taxes by the income tax loss somewhat softens the adverse impact of the TAM. However, if the estate or eventual beneficiaries do not have capital gains against which to apply the loss, the capital loss may be of little utility.

The TAM also will affect estates owning works of art which are not sold. An executor, in carrying out his or her fiduciary duty, generally will have works of art appraised for federal estate tax purposes. The appraisal usually is based on an analysis of so-called comparable sales. Under the IRS's rationale in the TAM, the comparable sales utilized in the appraisal should include the buyer's premium. Where there is no sale, there is no possibility of an offsetting deduction or capital loss.

The TAM, if followed, therefore has far-reaching implications. Estate planning practitioners representing individuals with valuable works of art or other collectibles should study the IRS's current position and advise their clients as to possible ways of dealing with the adverse consequences which flow from the TAM, at least until such time as it may be overruled by court decision, legislation or IRS reconsideration.

a **Alan Halperinis an associate at Stroock & Stroock & Lavan, the attorneys representing the taxpayer in the TAM ruling. This article was reviewed by Stroock partner Jerome A. Manning, who presented the case to the IRS.**

1 Tech. Adv. Memo. 9235005 (May 27, 1992).

2 Treas. Reg. 20.2031-1(b).

3 Id.

4 Id.

5 **United States v. Cartwright**, 411 U.S. 546 (1973).

6 All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

7 Former Treas. Reg. 20.2031-8(b).

8 **United States v. Cartwright**, 411 U.S. at 550.

9 Id. at 553.

10 In reaching this conclusion, the Supreme Court cited Judge Tannenwald's dissenting opinion in **Estate of Wells**, 50 T.C. 871 (1968). See **United States v. Cartwright**, 411 U.S. at 553. In that case, Judge Tannenwald stated: The touchstone of fair market value has always been the price which a willing seller would reasonably be expected to be able to obtain from a disposition of the property in question. **Estate of Wells**, 50 T.C. at 878 (Tannenwald J., dissenting).

11 Tech. Adv. Memo. 9235005, at 7.

12 Congress has not legislatively restricted the art market as it has done with respect to the mutual fund industry. Under the Investment Company Act of 1940, any sale of mutual fund shares in **Cartwright** could have been made only to the fund. In contrast, executors theoretically are free to sell the artwork through private dealers or directly to purchasers. Furthermore, in **Cartwright**, the government attempted to equate fair market value with the price at which a hypothetical purchaser would pay another seller, that is the fund. In the TAM, by comparison, the IRS was able to point to an actual transaction involving the estate asset whose value was at issue.

13 Treas. Reg. 20.2031-1(b).

14 **Publicker v. Comm'r**, 206 F2d 250 (3d Cir. 1953).

15 **Duke v. Comm'r**, 200 F2d 82 (2d Cir. 1952) (fair market value of jewelry for gift tax purposes includes federal excise tax paid by the purchaser-donor).

16 **Estate of Gould v. Comm'r**, 14 T.C. 414 (1950) (fair market value of ring for gift tax purposes includes the federal excise tax paid by the purchaser-donor).

17 Id. at 416.

18 Id.; see also **Publicker v. Comm'r** 205 F2d at 255.

19 Tech. Adv. Memo. 9235005, at 4-5.

20 See Treas. Reg. 20.2053-3(a).

21 Treas. Reg. 20.2053-3(d)(2).

22 Id.

23 New York law provides that, absent a contrary or limiting provision in a court order or in the governing instrument, every fiduciary is authorized to sell at public or private sale any property that is not specifically disposed of, on such terms as in the opinion of the fiduciary will be most advantageous. N.Y. EPTL 11-1.1(b)(5)(B) (McKinney Supp.

1992). Furthermore, New York law expressly authorizes every fiduciary to pay all reasonable and proper expenses of administration from the property of the estate. N.Y. EPTL 11-1.1(b)(22) (McKinney Supp. 1992).

24 Tech. Adv. Memo. 9235005, at 15. According to the National Office, the District Director of the IRS has jurisdiction to determine whether the sales were necessary to raise funds to pay debts, expenses and taxes. *Id.* at 15-16.

25 Priv. Ltr. Rul. 8119002 (Jan. 16, 1981).

26 **Estate of Vatter v. Com'r**, 65 T.C. 633 (1975), *aff'd*, 556 F2d 563 (2d Cir. 1976).

27 Tech. Adv. Memo. 9235005, at 14-15.

28 The author is aware of three other pending cases in the New York area in which the IRS is advocating this position.

29 See Priv. Ltr. Rul. 8119002 (Jan. 16, 1981).

30 See **Estate of Vatter v. Comm'r**, 65 T.C. 633 (1975), *aff'd*, 556 F2d 563 (2d Cir. 1976).

31 At the conference with the taxpayer's representatives at the National Office, the IRS questioned whether it is appropriate for a testator to be able to create deductions through specific will provisions.

32 See **Waterman's Estate v. Comm'r**, 195 F2d 244 (2d Cir. 1952); **Reynolds v. Comm'r**, 4 T.C.M. (CCH) 837 (1945), *aff'd*, 155 F2d 620 (1st Cir. 1946); **Carnick v. Comm'r**, 9 T.C. 756 (1974); **Watkins v. Comm'r**, 32 T.C.M. (CCH) 809, T.C. Memo 1973-167 (1973).

33 See IRC 1014.

34 See IRC 1001(b).

35 See IRC 1001(a). 165(c), which limits the allowability of losses, permits a deduction for losses incurred in any transaction entered into for profit, though not connected with a trade or business. IRC 165(c)(2).

36 IRC 642(h).

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