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Discounts for Co-ownership Interests At Death

-by Neil E. Harl*

Over the last 30 years, substantial changes have emerged over the taxation of co-owned assets (other than joint tenancy) at death.[1] Interests in real property held as community property have been eligible for a discount in value for unmarketability of the decedent's fractional interest, at least since 1982.[2] However, discounts for undivided interests in tenancy in common ownership of property otherwise were rejected until fairly recently.[3]

A major shift in discounting

That changed dramatically beginning in 1989 in a Tax Court decision from Illinois (which at the time had relatively "tough" rules for partition and sale).[4] In that 1989 Tax Court decision, the court allowed a discount of 12 ½ percent for tenancy in common ownership.[5] That opened the flood gates for discounting tenancy in common ownership interests with the percentage of discounting increasing rapidly to the 20 percent level with some discounts even higher.[6]

One court decision, *Bonner v. United States,*[7] went so far as to allow discounts of undivided interests at the husband's death of ranchland and other property held under a QTIP trust even though the post death ownership may be reunited in the same beneficiaries. While the Fifth Circuit found that acceptable, and followed *Estate of Bright v. United States*[8] which was followed by *Propstra v. United States*,[9] the Seventh Circuit Court of Appeals criticized *Estate of Bright* In *Citizens Bank and Trust Co. v. Commissioner*[10] which put the damper on the *Bonner* decision.

In all of this, the Internal Revenue Service has insisted that discounting should be limited to the cost of partitioning the property.[11] However, in 2005, the Fifth Circuit Court of Appeals awarded litigation costs to the taxpayer on the grounds that the IRS position of limiting co-ownership discounts to costs of partitioning was not justified.[12]

Avoiding plans to talk about selling the property if discounting is contemplated

A pair of court decisions, decided several days apart and within 50 miles of each other, illustrate the importance of advising the family that talk about the likelihood of selling the property can prove a barrier to discounting or at least reducing the discount. In the case of *Estate of Brocato v. Commissioner*[13] a 20 percent fractional share discount was allowed for apartment houses in the City of San Francisco. Two weeks later, in *Estate of Busch v. Commissioner,*[14] the Tax Court allowed a 10 percent discount in a decision involving two

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elderly family members who owned farmland within a city east of San Francisco. The court stated that a 10 percent discount was "more than adequate" to cover reasonable market costs for fractional interests of partitioning of it came to that. The estate had claimed a 40 percent discount which the Tax Court knocked down to 10 percent. The view of the court was obviously shaped by widespread talk about the likelihood of sale of the property inasmuch as it was surrounded by developed areas and was ripe itself for development. The lesson from that case is: if you anticipate trying to obtain a discount, my conclusion is do not utter a word about sale.

Discounts for art collections

Until recently, discounts for art collections were relatively modest, around five percent.[15] However, in a 2013 decision in the Fifth Circuit Court of Appeals, *Estate of Elkins v. Commissioner*,[16] the appellate court allowed a 44.75 percent discount for an undivided interest for a lengthy list of art works owned in co-ownership by the decedent, ostensibly because the decedent's children would likely purchase any fractional interest sold. The Internal Revenue Service had argued in that case that no discount should be allowed from the *pro rata* fair market value of the decedent's interest. However, the appellate court was impressed by the taxpayers' argument that there is no "recognized" market for fractional interests in art and the art in question had been voluntarily subjected to restraints on partition (and alienation) as well as restraints on possession.

Will the Fifth Circuit Court of Appeals in *Elkins v. Commissioner,*[17] chart the course for art collections going forward? The Fifth Circuit Court of Appeals has earned the distinction of being the "most taxpayer friendly" circuit court in the country. But it will require additional cases before it can be said that the *Elkins* view will prevail widely.

ENDNOTES

[1] See 5 Harl, *Agricultural Law* § 43[02[1][c] (2017).

[2] Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982).

[3] See Estate of Pudim v. Comm'r, T.C. Memo. 1982-606; Estate of Clapp v. Comm'r, T.C. Memo. 1983-721; Estate of McMullen v. Comm'r, T.C. Memo. 1988-500 (value of decedent's undivided interest in trust property could not be discounted as fractional share where trust property to be sold as entire fee simple interest).

[4] See Youle v. Comm'r, T.C. Memo. 1989-138.

[5] *Id*.

[6] E.g. Estate of Cervin, T.C. Memo. 1994-550, *reversed on another issue*, 111 F. 3d 1252, (5th Cir. 1997) (20 percent discount allowed for a 50 percent interest in farm and homestead). See Estate of Wildman v. Comm'r, T.C. Memo. 1989-667 (decedent's 20 percent interest in farmland discounted a total of 40 percent for a minority interest and for restrictions on transferability).

[7] 84 F.3d 196 (5th Cir. 1996).

[8] 658 F.2d 999 (5th Cir. 1981).

[9] 680 F.2d 1248 (9th Cir. 1982).

[10] 839 F.2d 1249 (7th Cir. 1988) (voting and non-voting stock placed in separate trusts).

[11] See Ltr Rul. 9336002, May 28, 1993); Ltr. Rul. 9943003, June 7, 1999 (discount is a matter of fact).

[12] Estate of Baird v. Comm'r, 416 F.3d 442 (5th Cir. 2005).

[13] T.C. Memo. 1999-424.

[14] T.C. Memo. 2000-3.

[15] E.g., Stone v. United States, 2007-2 U.S.Tax Cas. (CCH) ¶ 60,545 (N.D. Calif. 2007*), aff'd*, 2009-1 U.S. Tax Cas. (CCH) ¶ 60,572 (9th Cir. 2009).

[16] 2014-2 U.S.Tax Cas. (CCH) ¶ 60,683 (5th Cir. 2014).

[17] *Id*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

FEDERAL ESTATE AND GIFT TAXATION

ALLOCATION OF BASIS FOR DEATHS IN 2010. The decedent died in 2010 and the attorney hired by the executor failed to file a Form 8939, *Allocation of Increase in Basis for Property Acquired from a Decedent*, before January 17, 2012. The estate requested an extension of time pursuant to Treas. Reg. § 301.9100-3 to file the Form 8939 to make the I.R.C. § 1022 election and to allocate basis provided by I.R.C. § 1022 to eligible property transferred as a result of the decedent's death. *Notice 2011-66, 2011-2 C.B. 184 section I.D.1*, provides that the IRS will not grant extensions of time to file a Form 8939 and will not accept a Form 8939 filed after the due date except in four limited circumstances provided in section I.D.2: "Fourth, an executor may apply for relief under § 301.9100-3 in the form of an extension of the time in which to file the Form 8939 (thus, making the Section 1022 election and the allocation of basis increase), which relief may be granted if the requirements of § 301.9100-3 are satisfied. The IRS granted an extension of time to file the election. **Ltr. Rul. 201710016, Nov. 28, 2016.**

GENERATION-SKIPPING TRANSFERS. The decedent had created an inter vivos trust for the benefit of the decedent's children. The trust was intended to qualify as a GST trust under I.R.C. § 2632(c)(3)(B). The decedent and spouse had filed Form 709, *United States Gift (and Generation-Skipping Transfer) Tax*