



Fine Arts

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Cheaper By The Dozen?: Blockage Discounts in Art Valuation

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The concept of blockage discount is important to understand in valuing large collections of artwork by a single artist, particularly for estate and gift tax purposes. The David Smith case involved 425 pieces which were mostly very large, abstract sculptures. In determining the fair market value of these pieces the estate claimed a 75 percent discount; it valued the pieces at 25 percent of their “one-at-a-time” value, while the IRS decided that this “blockage” discount was not permitted and valued the pieces at a total of their one-at-a-time values.

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When taxpayers and the IRS can't agree, the matter is often resolved by the United States Tax Court. The 1972 Tannenwald decision concludes that “the impact of such simultaneous availability of an extremely large number of items of the same general category is a significant circumstance which should be taken into account.”

The court determined a 37 percent discount – pieces with an aggregate one-at-a-time value of \$4,284,000 were valued by the court at \$2,700,000. This “Solomonic” approach split the discount in half, between the estate's assertion that it should be 75 percent, and the IRS's assertion that it should be nothing.

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The David Smith case is extremely important in that it gave official court approval to the concept of blockage discount in valuing art. But it provides no guidance on how to determine the discount. For such guidance, one has to travel a number of years downstream. One must swim past the

1985 Louisa J. Calder Tax Court case, which

allowed about a 46 percent blockage discount for a large collection of Alexander Calder's works, but in doing so, used the Government's annuity tables – the rates published monthly by the Government under Internal Revenue Code Section 7520. These tables are normally used to determine the present value of a definite stream of payments which will be made over a period of time (an annuity). It is a method for valuing a very conservative investment, does not make much sense to us as a measure of the risk for disposing of an art collection over a period of time, and has not found wide usage.

What was established by these cases is that time is the key factor. Whether used to do a formal discounted cash flow analysis, or simply used as a gauge of risk assumed by the purchaser, the longer it will take to sell a piece of art the greater the costs (for example, storage, insurance, promoting it for sale) and the greater the risks in a fluctuating art market; thus the greater the appropriate blockage discount.

Georgia O'Keeffe, whose best-known works were large paintings and prints of sensual flowers, died owning many of her own works. Again resolving a dispute between the estate and the IRS, the Tax Court in a 1992 memorandum decision determined a 50 percent blockage discount. Unlike its predecessors, this decision sets forth a rational, mechanical way to compute the discount.

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Taking all factors into account (quality, uniqueness, salability, etc.), one determines how much time it is likely to take for the works in this group to sell. In the Estate of Georgia T. O'Keeffe, the Tax Court determined that works that can be sold in less than 7 years are entitled to a 25 percent discount and those which will take more than 10 years to sell receive a 75 percent discount. Since the collection owned by the artist at her death had, the court determined, approximately equal numbers of each, an overall discount of 50 percent was determined.

"The Tax Court determined that works that can be sold in less than 7 years are entitled to a 25 percent discount and those which will take more than 10 years to sell receive a 75 Now let's take a look at some fairly recent and unpublished applications of the O'Keeffe approach. An American artist whose draftsmanship was particularly well-respected and whose paintings and drawings are widely collected died owning a large number

percent discount."

of the artist's own works. An appraisal was prepared including a complete biography of the artist along with auction comparables, prices that the gallery representing the artist was able to provide, and a history of the sale of the artist's works over a number of years.

The appraisal was very detailed, voluminous and answered every question the IRS could ask. The dealer representing the artist also wrote a memo as to why the works were hard to sell. As the best works of this artist were on the secondary market (private or auction), they competed with the estate collection held by the dealer. In addition, although some individual pieces sold from time to time, there were no active collectors interested in forming a large collection. The basic approach set forth in the O'Keeffe case was followed: dividing the works into those that would sell in less than 7 years and those that would require more than 10 years to dispose of, with 25 percent and 75 percent discounts taken respectively. The appraisal was accepted by the IRS and by the State estate tax bureau in the state where the artist died.

A similar approach was used in appraising the estate of a well known sculptor. There were large collections of sculptures in both New York and Italy and it was at first a consideration that the appraisal in Italy would be done by photos. This decision was changed and the appraiser went to Italy, much to the benefit of the clients. In photos, the stone sculptures appeared to be in acceptable condition. In fact, almost all had been kept outside and were in poor condition caused by either the weather or vandalism. After seeing these sculptures the appraiser was able to make several different groupings varying from a 25 percent to a 75 percent discount. Some of the pieces were in such bad condition that they had become not sellable and this group was appraised for no value. Again, the valuation was accepted by the IRS and the applicable state auditors.

So it seems pretty clear at this point that the IRS accepts, as it should, the approach taken in the O'Keeffe case. But there is a wrinkle, which is best explained in the context of the audit of an estate which owned a large number of works by a well-known American painter. As often seems to be the case in recent audits, the IRS and the estate agreed upon the one-at-a-time values. Beyond that, the IRS and the estate agreed upon the basic O'Keeffe approach taken by the estate in establishing the blockage discount. Where the IRS and the estate parted company was on the effect, if any, of inflation or the general increase in the art market over time.

In estate, gift, or income tax matters, where the value of a work of art reported on a return exceeds \$20,000, the IRS Art Advisory Panel becomes involved. The Art Advisory Panel is an ever-changing group of volunteers, experts in the art market (nationally prominent

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value works of art.

them."

In audits of estate or gift tax returns, IRS agents give great weight to the valuation opinion of the Panel. In several recent audits, including the audit of the estate of the well-known American painter referred to above, the head of the Panel has taken the position that, after the blockage discount is established, it needs to be adjusted to take into account the potential increase in value of the works of art over the years it will take to dispose of them. The estate replied, employing the opinion of a professor at an Ivy League School of Business Management, that no such increase is assured. Take, for example the major drop in the art market, particularly the modern art market, in 1990. The IRS and the estate ultimately agreed upon the value of the art, including blockage discount, and agreed upon certain other issues in contention in such a way that the precise effect of this inflation factor, if any, was impossible to determine. Thus, in determining blockage discounts, one should be prepared to negate a potential IRS assertion of an inflation factor.

Because the current estate and gift tax rates top out at about 50 percent (more in some states with state estate tax added), the blockage discount can have a huge effect upon the tax ultimately paid. Appraisers, attorneys, trust officers, art dealers, and others involved in the valuation of art should be aware of this important aspect of art valuation.

J. Lee Drexler, President of Esquire Appraisals (www.esquireappraisals.com) has been an appraiser of fine arts, furniture, antiques and jewelry for over 37 years. She has been President of the Hudson Valley Chapter of the American Society of Appraisers (ASA), Vice President of the Manhattan Chapter and is a member of the Programming Committee of the Appraisers Association of America. She appraises a wide variety of fine arts, furniture, antiques and jewelry. James R. Cohen heads the Estates and Tax Group at Kleinberg, Kaplan, Wolff & Cohen, P.C., a law firm in Manhattan which he co-founded in 1971. His focus is estate planning and tax advice to private clients, hedge fund, and other asset managers and artists. Jim has represented the estates of a number of artists in which blockage discount was an issue. He has written and lectured widely on tax, estate, and business succession planning, investment fund and hedge fund life insurance issues. Jim was named a New York Super Lawyer in 2006.

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