Keeping heirloom property (personal real property that is handed down from one generation to the next) in the family while minimizing estate taxes when the patriarch or matriarch dies is a particularly large challenge. One strategy is to use a generation-skipping trust, which could offer some relief from the estate tax as the property passes inter-generationally. Another approach—devilishly creative yet simple—involves combining long-term leases with undivided interests.

But then there’s a third strategy: doing both.

Such was the case in the 2011 Tax Court case Estate of Mitchell v. Commissioner, T.C. Memo 2011-94. Although the case was decided more than a decade ago, the strategies—which, when combined, might be called the “Mitchell Strategies”—have been overlooked in estate-planning literature.

Consider the following facts from the case:

Decedent died owning two valuable and unique real property assets—a beachfront property and a ranch. Both properties had special qualities that made them heirloom quality (i.e., properties to keep in the family for generations).

The beachfront property was strategically located with a generous amount of beach frontage and included a large residence. The ranch was large, had historical attributes, and was in a highly sought-after location. There were two residential structures on the ranch—a primary and secondary residence.

There was a significant difference in how IRS and estate appraisers in Mitchell valued the ranch property. The IRS valued the property at $20 million, and the estate at $3.5 million.

The estate used the income method for valuing the property, while the IRS tried a novel approach: a lease-buyout method. The Tax Court adopted the estate’s income
capitalization approach. Although income capitalization methods are not typically used by residential property, the long-term leases persuaded the court to adopt this valuation method. The court agreed with the estate’s appraisal and found the fee simple absolute value for the ranch to be $13 million. Using a 3.5 percent annual appreciation rate and a discount rate of 9.5 percent for comparable properties, the Tax Court found a property value of $2 million after discounting.

The beachfront property was also valued using the income approach. Applying the same factors used for the ranch property (namely, the 3.5 percent annual appreciation rate and a 9.5 percent discount rate for comparable properties) to the $14.5 million value for the fee simple estate, the ultimate value was determined to be $4.6 million after discounts.

The estate plan in Mitchell involved two critical valuation strategies that, used together, yielded significant estate tax savings.

**Strategy 1: Creating Undivided Interests**

An important factor in the Mitchell case was that the court applied an undivided ownership discount to the estate tax valuation. The decedent gave 5 percent minority interest in

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### The Basics: The Valuation Standard

Valuation of real estate in federal tax matters is one of the critical planning steps to a successful business or estate plan. The basic tax rules are well known. The Federal estate tax is a tax imposed on the transfer of property from a deceased property owner. The gross estate of a deceased property owner includes the fair market value of any interest the decedent held in property. The fair market value of property reflects the price at which the property would change hands between a willing buyer and a willing seller, neither having any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.

Determining fair market value requires judgment rather than mathematics. Even the U.S. Supreme Court observed long ago that “At best, evidence of value is largely a matter of opinion, especially as to real estate.” This statement has remained true through the years.

The value of tangible property must reflect its highest and best use as of the valuation date. An exception is made for special valuation rules for family farms under the provisions of IRC Section 2032A.

Estate tax regulations require that if a decedent’s estate contains assets that have marked artistic or intrinsic value totaling more than $3,000, an expert appraisal, executed under oath, must be filed with the estate tax return. The regulations also require that care be taken to ensure expert appraisers are reputable and recognized as competent to appraise the assets involved. As the subject matter expert, the real estate appraiser is the critical person in the process.

If the IRS disagrees with the property owner, both parties may obtain appraisals from valuation experts. The burden of proof falls on the property owner both to prove the asset’s value and to prove that the IRS’s valuation is wrong. Most commonly, however, when valuation of property is the principal issue in the case, the dispute to be resolved by a judge becomes a battle of the experts.

In this battle, the Tax Court and other courts evaluate expert testimony, considering each appraiser’s demonstrated qualifications and all other evidence in the record. When experts offer competing estimates of fair market value, courts will determine how to weigh those estimates by examining their underlying logic and the factors they considered in reaching their conclusions. Courts are free to ignore all expert opinions entirely or partly and reach their own determination of value.

Because all assets are unique, valuing property can be difficult. How judges decide a valuation varies. Many times, a court will use what it believes to be the better appraisal, though what qualities influence a judge to select one appraisal over another is one of the mysteries of the courtroom. In many instances, the court may take the middle ground and average the appraisals.

A review of cases in which the estate tax valuation is the critical issue shows judges are greatly influenced by qualified valuation experts who prepare and present a well-documented appraisal and clearly explain their appraisal opinions. Most judges will carefully consider all the facts and relevant evidence and draw appropriate inferences and conclusions to determine fair market value.

Trial lawyers often speak of the uncertainty of outcome in the courtroom, which is a comment directed at the fact that the judging process involves decision-making and is, therefore, somewhat unpredictable. Nevertheless, quality appraisers are an essential part of persuading a court of the fair market value of property, and their importance is indisputable.
the properties to trusts for his two sons, allowing the deces-
dent’s 95 percent retained, undivided interest to achieve a
significant discounted value:

<table>
<thead>
<tr>
<th></th>
<th>Beachfront</th>
<th>Ranch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fee simple 100%</td>
<td>$14 million</td>
<td>$13 million</td>
</tr>
<tr>
<td>Undivided interest discount</td>
<td>19%</td>
<td>35%</td>
</tr>
<tr>
<td>Discount value amount</td>
<td>$2.66 million</td>
<td>$4.55 million</td>
</tr>
</tbody>
</table>

For two properties with an aggregate fee simple value of
$27 million, assuming a 40 percent estate tax rate, these un-
divided property discounts alone yielded a value reduction
of $7.21 million and an estate tax savings of $2.88 million.
Hence, the power of the undivided interest discount. Some-
times the simplest strategy pays off.

**Strategy 2: Long-Term Leases**

Long-term leases enabled the properties to be maintained
and retained for future generations. The decedent did not
use one single long-term lease, but a series of four five-year
lease terms combined with the unilateral right of the lessee
to renew the terms.

The Tax Court made a critical finding when it was persuad-
ded that the four five-year lease terms should be combined
into a 20-year lease for valuation purposes. Whether or not
the lessee renews any or all of the renewal terms is beside
the point. The lease was treated as a 20-year lease for valu-
ation purposes. This reduced the present value of the rever-
sionary interest (the interest taking effect after the initial
lease term), resulting in dramatically lower tax values and,
consequently, higher tax savings.

For valuation purposes, the reversionary interest after
the long-term lease terms is a critical component of the
ultimate value conclusion. The present value of the lease
payments combined with the present value of the reversion-
ary interest results in the current property value. The longer
the lease, the smaller the reversionary interest and the lower
the appraised value.

The structuring of the long-term leases involves many
issues. In *Mitchell*, for example, the lease payments were
specifically structured to enable the property to be main-
tained and the property taxes to be paid. Annual rent in-
creases were reasonably modest. The lessees asked for and
received a right to relet the property, which was important
to them. They also extensively remodeled the residence on
the beachfront property. In short, the leases were structured
to create an incentive for the lessee to renew.

The genius of the Mitchell Strategies was the long game
that entailed combining two simple strategies into one
larger strategy and using traditional appraisal techniques
to achieve striking results. The estate tax savings were
extraordinary, and the heirloom properties were kept in the
family for generations to come.

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