



NAEPC

Journal of Estate & Tax Planning

[Click here to view Issue 24](#)



A Primer on Tax and Other Issues
Relevant to Art Collectors and Their Advisors

Paul N. Frimmer
Loeb & Loeb LLP

I. Sales of Art.

A. Income Tax: General Rules.

1. If the art has been held for more than one year, any gain on sale is long term capital gain¹ unless the seller is a dealer, in which case the gain is ordinary income.²
2. If the art has been held for one year or less, or if the seller is a dealer, the gain is short term capital gain or ordinary income.³
3. The federal long term capital gains rate for sales of art (and tangible personal property in general) is 28% plus 3.8% for the Medicare surtax.⁴ When combined with a California rate that can be as high as 13% (without any benefit of the California income tax deduction against the federal income tax if the taxpayer pays tax at the alternative minimum tax rate⁵), the total long term capital gains tax rate on art can approach 45%. If the gain is short term capital gain or ordinary income, the rate can be over 50%.
4. Based on the rules for valuing tangible personal property sold at auction, estates of deceased collectors may have what might be called an “artificial” tax loss that can be used against capital gain from the sale of other property. Tangible personal property sold at auction is valued for estate tax purposes at the selling price, which is the hammer price plus any buyer’s premium that is paid to the auction house. However, the seller may deduct the buyer’s premium paid to the auction house as a selling expense on the estate tax return or on its income tax return. If the deduction is taken on the estate tax return, an artificial loss is created. For example, assume a painting sells at auction for a hammer price of \$1,000, and the buyer pays the auction house \$120 as the buyer’s

¹ IRC §§ 1(h)(4) & (5); IRC § 1222.

² IRC § 1221(a)(3)(c).

³ IRC § 1221(a)(3)(c) & 1222.

⁴ IRC §§ 1(h)(4) & 1411.

⁵ IRC § 56(b)(1)(A)(ii).

premium. For estate tax purposes, the fair market value of the painting is \$1,120. If the estate deducts the \$120 as an administration expense, estate tax will be paid on \$1,000, which is the net amount that the estate received from the sale. For income tax purposes, the estate's basis is \$1,120, but the estate only received \$1,000. Therefore, there is a loss of \$120 that can be used against other gain. If instead of deducting the buyer's premium on the estate tax return, the buyer's premium is deducted on the income tax return as an expense of sale, there is a similar result. The estate received \$1,000, but its basis is \$1,120. Therefore, there is a \$120 capital loss and when the selling expense of \$120 is deducted, the loss increases to \$240. However, the estate paid an additional \$48 in estate tax because the full \$1,120 was includable in the gross estate. The estate can do the math to determine whether deducting the buyer's premium on the estate tax return or on the income tax return is more beneficial, but in either case, there is an artificial loss of \$120 as a result of the rules relating to the valuation of tangible personal property sold at auction.

B. Deferral of Income Tax: 1031 Exchange of Work of Art. It is possible to accomplish an IRC §1031 exchange of art in a manner similar to an exchange of real property.⁶ Contrary to popular opinion, a valid exchange is not accomplished by transferring a work of art to a dealer and having the dealer give the collector another work of art. The nuances of tax free exchanges are beyond the scope of this outline, but in general, the following factors must be present:

1. The taxpayer must be an investor and not a dealer or collector.⁷ A dealer is someone primarily engaged in the trade or business of selling works of art.⁸ In contrast, an investor is someone who buys and sells with the primary motive of making a profit, but does not hold himself out to be a dealer or engage in a sufficient number of transactions that he is deemed to be engaged in the business of selling art.⁹ For most collectors, the "investor" requirement is the biggest hurdle because most collectors buy art (and occasionally sell art) not necessarily to make a profit (although many do in an art world with exploding values), but rather for the personal

⁶ IRC § 1031(a).

⁷ In order to qualify for a like-kind exchange under section 1031, the property must be held for "productive use in a trade or business or for investment." In addition, a 1031 exchange is not available for property held primarily for sale. IRC § 1031(a)(1) & (2).

⁸ *Comm'r v. Groetzinger*, 480 US 23 (1978).

⁹ *Drummond v. Comm'r*, 155 F.3d 558 (4th Cir. 1998). Treasury Regulation § 1031-1(b) provides that unproductive real estate held by a person other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale. Treas. Reg. § 1031-1(b).

enjoyment of owning the art. A true investor is likely to keep the art in storage rather than hanging it on his walls.

2. Both the property exchanged and the property acquired in the exchange must be held for investment.¹⁰
3. The art that is exchanged must be “like kind” to the art being acquired. While there is very little law on the subject, the fact that a work of art is being exchanged for another work of art is not sufficient. For example, in the context of a 1033 exchange, the IRS ruled that destroyed lithographs could not be replaced with other artistic media.¹¹ Query whether a water color is like kind as to an acrylic, or a painting is like kind as to a collage or an assemblage in a frame?
4. The transaction must be accomplished through a qualified intermediary, which is usually an escrow company or other professional “accommodator” who is licensed to carry out exchanges.¹² Many of the accommodators who handle real estate exchanges also will handle exchanges of works of art.
5. All of the technical rules for exchanges must be followed, such as the filing of IRS Form 8824.

C. Sales Tax. A seller of art is liable for sales tax in California, unless an exemption applies.

1. A seller may elect to collect sales tax from the buyer, but the seller is ultimately liable for the sales tax in the event the buyer fails to pay.
2. A seller is not liable for the payment of sales tax if one of the following common exemptions applies:
 - (a) A sale to a dealer or someone else who has a valid resale number for resale.¹³
 - (b) Occasional sales, which in California means a sale of less than three works in a twelve month period.¹⁴

¹⁰ Treas. Reg. § 1031-1(b), (c).

¹¹ PLR 8127089.

¹² Treas. Reg. § 1031-1(k)-1(g)(4).

¹³ Cal. Rev. & Tax'n Code §§ 6091; 6092.

¹⁴ Cal. Rev. & Tax'n Code § 6006.5; Cal. Sales & Use Tax Regs. § 1595(a)(1).

(c) Shipments out of state pursuant to the contract of sale.¹⁵

D. California Resale Royalty Act.¹⁶

1. The California Resale Royalty Act provides that a 5% royalty must be paid to certain artists upon the sale of that artist's works of art. The royalty is payable if the seller is a California resident, or the sale occurs in California, unless the artist has been dead for more than 20 years.
2. At the present time, the legality of the Act is in limbo because there are several court cases making their way through the courts on the issue of whether the act is valid.¹⁷
3. Historically, the Act has been ignored more often than it has been honored, although some artists and their estates have been very aggressive in claiming the royalty. California is the only state in the United States that has a statute like the Act, although most of the European countries have laws similar to the Act and from which the act was patterned.

E. Federal Act. There is a federal resale royalty act making its way through Congress, but it is not yet the law.¹⁸

F. Dealing with Dealers – Consignment Agreements

1. Transparency is critical. Obligate the dealer to disclose the selling price, the dealer's commission, commissions received from or paid to anyone else, and include "audit" rights (redacted, if necessary, to protect the identity of a buyer).
2. Sellers should file for a security interest in the work while it is in the possession of the dealer. Title should pass upon payment to the seller, and not necessarily upon payment to the dealer.
3. Limit the time to sell and showings to select prospective purchasers to avoid "burning" the work.

¹⁵ Cal. Rev. & Tax'n Code § 6396.

¹⁶ Cal. Civil Code § 986.

¹⁷ The Act was found unconstitutional in 2012. That decision has been appealed. *Estate of Graham v. Sotheby's*, 860 F. Supp. 2d 1117 (C.D. Cal. 2012), appeal docketed, No. 12-56077 (9th Cir., June 8, 2012).

¹⁸ The most recent bill proposed by the House of Representatives is the American Royalties, Too (ART) Act of 2014, HR 4103.

4. Choose a favorable choice of law provision so that disputes are resolved at minimum cost to seller and maximum cost to dealer.
5. Limit warranties to title and authority to sell if possible.
6. Limit seller's liability to rescission and refund of the purchase price; no consequential damages.
7. Obligate dealer to pay all costs of packing, shipping (both ways if the work is not sold) and insurance at the high estimate of value.
8. Obligate dealer to collect sales tax, resale royalties (if applicable), export and import duties and other "costs" of sale.
9. Major auction houses are now in "competition" with dealers for private sales, which often gives the seller leverage.
10. For artists whose works are in high demand, be prepared for dealers to impose other conditions on the purchaser:
 - (a) If the purchaser wants to sell the work at a later date, the purchaser must allow the dealer to sell it.
 - (b) If the purchaser wants to sell the work at a later date, the dealer has first right of refusal, sometimes at fair market value and sometimes at the purchase price plus some artificial appreciation factor that has no relationship to the then current fair market value.
 - (c) The dealer or the artist imposes a "private" royalty arrangement under which if the work is sold by the purchaser, the artist and perhaps the dealer are entitled to a percentage of the selling price. If California's Resale Royalty Act continues to be unconstitutional, and whether or not the federal act is enacted, dealers and artists may be more or less aggressive in demanding some portion of the profit on the later sale of a work.

G. Sales at Auction –Consignment Agreements

1. Despite the "boilerplate" contract, most sellers of major works do not pay any costs of sale. The auction houses will pay for pick up, return, crating, conservation to a limited extent, insurance (at the highest estimate instead of the standard contract provision insuring at the lowest or the median between the high and the low estimate).
2. Limit representations to title, authority to sell, and seller's actual knowledge, with no duty to investigate, for representations such as

payment of import/export taxes or whether there has been restoration.

3. For major works or major sales in the aggregate, the auction houses will give seller part of the buyer's premium.
4. Unless there is a specific need for a certain amount of proceeds, guarantees usually are not a good economic deal for sellers because third-party guarantors want too much of the "upside." In effect, a guarantee is a willingness to sell for the guaranteed price, which is usually below even the low-end of market.
5. Include the right to cancel or postpone the sale of the work if there is an economic crisis immediately prior to the sale (the Dow falls by 20%, an emergency closes the markets, etc.).
6. Auction houses usually want the freedom to grant a purchaser terms without interest because they believe that many high-end purchasers expect interest-free terms. Six months is usually the maximum period, and if the auction house is given the ability to grant terms, there should be a substantial down payment.
7. The agreement should provide that if the auction house releases the work prior to payment (whether or not there are terms), the auction house is responsible for payment.
8. A seller is usually not allowed to withdraw the work from the auction without a financial penalty, but the criteria for the seller being able to withdraw should be narrowed to breaches of seller's obligations that are within seller's control. The criteria for an auction house being allowed to withdraw an item should be based on objective evidence and not upon the auction house's "belief" that something is wrong. Always have a provision allowing either party to "cure" within a reasonable time prior to the auction.
9. Check the auction house's "terms and conditions of sale" to make certain that the only remedy of a buyer is rescission and refund of the purchase price; no consequential damages.
10. The auction house's is seller's agent, and the normal rules of agency apply unless overruled in the agreement.
11. If a work is damaged while in possession of the auction house, the standard agreement provides that the auction house or its insurer will determine the extent of the damage and the amount to be paid. For significant works, this provision should be altered to interpose a neutral party to avoid a "one-sided" assessment of damage.

12. Most auction houses' standard agreements provide that the reserve, which is the lowest price that the work can be sold, is determined by the auction house. Modify this provision to provide for a joint determination or better yet, agree on the reserve in advance, subject to change with the seller's consent.
13. For sales of more expensive works or large sales in the aggregate, there may be "perks" other than a part of the buyer's commission. Some examples include putting the work on the front cover, the back cover or pages inside the covers of the auction catalogue; placing the work within the auction in a certain position (in the first third); having a senior member of the auction team "travel" with the work to venues where it will be shown (typically, London and Hong Kong); having a separate catalog with an extensive discussion of the seller, the artist, the work, the context of the work, etc.; an agreed upon marketing plan outlining the number of venues to which the work will travel, the size and frequency and location of ads for the auction; and paying for family members to fly to the auction site and for hotel rooms at the auction site.

II. Purchases of Art: Sales and Use Tax. In addition to the usual issues of condition, authenticity, etc., the purchaser should consider the impact of the sales tax and the use tax:

- A. All but three states (Oregon, Delaware and New Hampshire) have sales tax and use tax laws.
- B. Sales tax is payable when tangible property (e.g. art) is purchased within the state, and use tax is payable when it is purchased out of state with the intent to bring it into the state. The use tax is a compliment to the sales tax, and without the use tax, a person could purchase a car, for example, in a state that has no sales tax and bring the car into a state that has a sales tax without paying any sales tax.
- C. California has been very aggressive in tracking purchases of art to determine whether a use tax is payable. For example, California has a sales tax office in New York that tracks auction sales. Under New York's sales and use tax law, if a work is purchased and is shipped out of New York on a common carrier, there is no New York sales tax obligation.¹⁹ However, if the purchaser is a California resident, and the work is shipped to California for use in California, a California use tax is payable by the purchaser.²⁰ By checking auction records, bills of lading, export and import documents, etc., the California sales tax office in New York can determine whether works of art purchased in New York or coming into the

¹⁹ N.Y. Sales & Use Tax Regs. § 526.7(e)(2).

²⁰ Cal. Rev. & Tax'n Code § 6201.

United States from abroad are destined for California with a use tax obligation on the part of the purchaser. There is a question on the California income tax return that asks whether the taxpayer owes California use tax for the taxable year.²¹

- D. It may be possible to avoid all sales and use tax if the transaction is properly structured. For example, if a work of art is purchased in New York and shipped from New York on a common carrier, there is no New York sales or use tax obligation. If the purchaser is a California resident, but the work is shipped to a state that has no use tax for use within that state, there may be no California use tax obligation even if the work is ultimately brought back into California by the California purchaser. There is a presumption that if a work is first used outside of California for a period of at least 90 days, the work is not being purchased for use within California.²² Although the law has not been tested, it is common for purchasers of high end art to have the works sent to a museum in Oregon or New Hampshire on loan for more than 90 days. If lending art to a museum is a “first use” (the law is not clear, but storage out of state is not a “use”), then when the art is brought back into California at the expiration of the loan period, no California use tax should be due. Shipping the art to a state that has a use tax may avoid California sales and use tax if a loan to a museum in that state is a “use,” but the purchaser may be liable for the use tax in that state. Many states that have a use tax are not as aggressive as California in enforcing the tax, but the use tax obligation exists nonetheless.

III. Non-Charitable Gifts of Art. Lifetime gifts of art to family members (including trusts for family members) may prove beneficial if structured in the proper manner. In general, the rules relating to lifetime gifts of any property, including art, are as follows:

A. General Principles.

1. Each individual can give \$14,000 per year to each other individual, and in addition, an individual can give \$5,430,000 (as of January 1, 2015) over his or her lifetime. The \$14,000 and the \$5,430,000 are indexed for inflation, so they should continue to increase over time.
2. If gifts exceed the exclusions and exemption in Paragraph 1 above, the gift tax is 40% of the excess.

²¹ Cal. Form 540, Line 95.

²² Cal. Sales & Use Tax Regs. § 1620(b)(3).

3. The donor's tax basis carries over to the donee unless gift tax is paid, in which case a portion of the gift tax may be added to the donee's basis.

B. Lifetime Gifts v. Step-up in Basis.

1. In California, because the combined state and federal income tax rate for sales of art (see Section I above) can be greater than the 40% estate tax rate, gifts of art, even though appreciating, may not be as beneficial as they have been in the past when the estate tax rate was significantly higher than the income tax rate. Under the current rate structure, absent other considerations, it likely is better to pay estate tax at 40% on any appreciation (and receive a step-up in basis to the work's date of death value) than have the donee pay an income tax at 45% on any appreciation when the work is sold.²³
2. Because it is more expensive to pay income tax on the sale of art in high tax states such as California than it is to pay estate tax, transferring art to avoid estate taxes is most likely not tax efficient unless the art is "legacy" art (art that will not be sold for many years), in which case an immediate reduction in the estate tax at death is more than likely to be more than offset by the hypothetical payment of capital gains tax when the work is sold many years subsequent to the date of death. If generation-skipping transfer tax planning is appropriate, there may be some benefit in transferring work during lifetime or at death at a discounted value.

C. Discounts for Gift of Fractional Interest in Art Work.

1. The law with respect to whether discounts are available for transfers of fractional interests in works of art is in a state of flux. There are two court cases on the subject, one of which allowed a 5% discount based on the fact that neither the taxpayer nor the Internal Revenue Service could prove what the appropriate discount should be, but the court instinctively knew that some discount was appropriate.²⁴ The second case, which was a more recent appellate court decision, allowed discounts of over 65% (the lower court allowed a 10% discount) based on the hypothetical "willing buyer, willing seller" test.²⁵ In the latest case, neither the taxpayer nor the Internal Revenue Service could demonstrate what the discount should be in the "real world" because there are no

²³ This analysis is specific to California. For states like New York that impose a state estate tax, the tax benefits of lifetime transfers may continue to outweigh the income tax consequences.

²⁴ *Stone v. U.S.*, 99 AFTR 2d 2007-2992 (2007, DC CA).

²⁵ *Estate of Elkins v. Comm'r*, 140 TC 86 (2013), *aff'd in part, rev'd in part*, 2014-2 U.S. Tax Cas. (CCH) P60,683 (5th Cir., Sept. 15, 2014).

public instances of transactions involving fractional interests in art, but the Internal Revenue Service offered no evidence of value so the taxpayer's evidence, although not very persuasive, was accepted by default. Dealers often purchase fractional interests with other dealers and sometimes a dealer will sell his interest to another dealer, but usually those transactions are at "face value" with no discounts.

2. One alternative may be to place the works of art in an entity such as a limited liability company or partnership, and then make transfers of interests in the entity. Transfers of minority, non-marketable interests in entities are subject to discounts in the 35% to 50% range, but it is not clear whether a court would "look through" the entity and determine that the transfers were really transfers of works of art rather than transfers of interests in the entity (as the courts do in the family limited partnership context²⁶).

D. Gift/Sale Leaseback.

1. Many collectors would like to transfer works of art to their children, but want to retain possession of the works during their lifetimes. It is clear that a transfer with a retained right to use and possess the transferred item will not accomplish anything because the transferred item will be subject to estate tax in the transferor's estate.²⁷
2. One method of accomplishing the collector's goals of transferring the art and retaining its use is a sale (or gift) and leaseback to a grantor trust.
 - (a) To allow the donor to retain possession and enjoyment of the transferred art, the donor must pay fair rental value to the new owner.
 - (b) If the transfer is structured properly, and is made to a certain type of trust, called a "grantor" trust, the rent paid by the parent to the trust is not subject to income tax in the hands of the trust, and thus is a gift, estate and income tax free transfer of the rent from the parent to the children each year that the parent rents the art from the trust. Depending on how long the parent lives and continues to rent the art, the cumulative payment of rent may more than offset the "negative arbitrage" between the capital gains tax rate and the estate tax rate. (See Section III.A above).

²⁶ See, e.g., *Estate of Strangi v. Comm'r*, TC Memo 2003-145, *aff'd*, 417 F3d 468 (5th Cir. 2005)

²⁷ IRC § 2036(a)(1).

- (c) A gift/leaseback or sale/leaseback is a complex transaction with many risks, but if properly planned and the risks acknowledged, there can be a very substantial transfer of wealth at minimal tax costs. For example, determining the fair rental value for valuable works of art is virtually impossible at the present time because there is no market to prove what a reasonable rental rate is for valuable works of art.. If the rental value is too low, the value of the artwork is included in the donor's gross estate. If the rental value is too high, the donor is making an annual gift to the trust. To eliminate the gift tax risk, the rental value could be determined based on a formula valuation clause, although valuation clauses are subject to IRS scrutiny.²⁸

E. Charitable Remainder Trusts.

1. An owner of a work of art can avoid paying the income tax on the appreciation at the time of sale by utilizing a charitable remainder trust. While a complete discussion of charitable remainder trusts is beyond the scope of this outline, in general, a charitable remainder trust is a trust that pays either a fixed annuity or a fixed percentage of the annual fair market value of the trust assets to the creator of the trust (and the creator's spouse if desired) for life, and upon the death of the creator (and the creator's spouse), the assets pass to charity.
2. There are several advantages to the creation of a charitable remainder trust:
 - (a) The creator receives an income tax deduction in the year the work of art is sold, not in the year the work of art is transferred initially to the charitable remainder trust.²⁹ The taxpayer is not eligible for an immediate income tax deduction because the taxpayer has retained an income interest in the tangible personal property. The deduction is available only when the retained income interest terminates.

²⁸ Despite the IRS's continued challenges to valuation clauses, the taxpayer has enjoyed considerable success in recent years in withstanding such challenges. *Estate of Petter v. Comm'r*, 653 F.3d 1012 (9th Cir. 2011) (upholding formula clause where excess value passed to charity); *Hendrix v. Comm'r*, TC Memo 2011-133 (upholding formula clause where excess value passed to charity); *Wandry v. Comm'r*, TC Memo 2012-88 (court upheld gift of LLC units having a value, as finally determined for gift tax purposes, equal to a stated dollar amount).

²⁹ IRC § 170(a)(3); Treas. Reg. § 1.170A-5. The taxpayer is eligible for an income tax deduction only when the taxpayer's rights to possession and enjoyment of the artwork have expired. The Treasury Regulations under Internal Revenue section 664 suggest that this rule applies to gifts of tangible personal property to a charitable remainder trust. Treas. Regs. §§ 1.664-2(d), -3(d).

- (b) The amount of the deduction depends on whether the work of art is long term capital gain property, short term or ordinary income property. In addition, the amount of the deduction for capital gain property depends on the use to which the property will be put. If the donor establishes that the property will be reasonably expected to be put to a related use by the charity, the deduction will be based on fair market value.³⁰ It is almost impossible to demonstrate that the property will be put to a related use because the property is usually sold after contribution to the trust. Even if the property is intended to be retained by the trust, and the remainderman is a charity that will use the property in furtherance of its exempt function (a work of art given to a trust with a museum as the remainderman), the trust cannot restrict the trustee's ability to sell the property so there is no reasonable expectation that the work would ultimately be transferred to the charity.³¹ If the contributed property does not relate to the charity's exempt purpose or function, the deduction is limited to the cost basis.³² Of course, even if the deduction is based on fair market value, the deduction is never equal to the fair market value of the work because the right to receive payments during the creator's lifetime must be valued and subtracted from the value of the work because the charity only receives the work when the creator dies.
- (c) The charitable remainder trust does not pay any income tax when it sells the work of art, thus making more assets available to earn income with which to make the payments to the creator.³³ For example, if a person has a work of art that he purchased for \$10,000 that is now worth \$1,010,000, a sale of the art would generate approximately \$450,000 of capital gains tax, leaving the creator with \$560,000 on which to earn income. If the charitable remainder trust sells the work, no income tax is payable, and the trust has \$1,010,000 on which to earn income. In most cases, the income earned by the trust will be taxable

³⁰ IRC § 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4.

³¹ See Treas. Reg. § 1.664-1(a)(3).

³² *Id.*

³³ IRC § 664(c). Charitable remainder trusts are not subject to the 3.8% net investment income tax, which is generally applicable for tax years beginning after 2012, but special rules apply for determining whether items of income allocated to annuity or unitrust payments constitute net investment income to the recipient beneficiary. See T.D. 9644, 78 Fed. Reg. 72394 (12/2/13); Treas. Regs. § 1.1411-3(b), (d).

to the creator as it is received, but with the capital gains rate approaching 45%, the trust will have approximately double the assets to invest over what the creator would have if the creator sells the work outside of the trust.

3. There are several negative aspects to charitable remainder trusts:
 - (a) The creator cannot use the work after it has been given to the trust even if he is willing to pay the fair rental value. If it takes time to sell the work, the work must be placed in storage or lent to a museum during the period that the work is for sale.
 - (b) Upon the creator's death, the assets of the trust pass to charity so the assets are not available for the creator's family.
 - (c) Before a charitable remainder trust is created, there should be a financial analysis to see whether there is a reasonable possibility that the creator will be better off by creating the charitable remainder trust than he or she would have been by selling the work and paying the capital gains tax. Whether the creator is better off depends on many factors, such as the amount and availability of the charitable deduction, the capital gains rates in effect at the time of sale, the percentage payment that is made from the trust, the work's income tax basis and the creator's age.³⁴

F. Other Estate Planning Techniques. Certain other estate planning techniques have been suggested for the transfer of art, but either the techniques do not work as well with art as they do with other assets, or the facts of a particular case have to be "perfect" for the technique to have a chance of working. For example, a grantor retained annuity trust ("GRAT") is a useful technique for passing appreciation over an assumed rate of return from the creator of the trust to family members. Although a complete discussion of GRATs is beyond the scope of this outline, a GRAT requires an annual annuity payment for a fixed number of years to the creator of the trust based on the initial fair market value of the property contributed to the trust. In the case of works of art, the transfer back will be a percentage of the work of art because the trust usually will not have liquidity with which to pay the annuity to the creator. Determining the annual fair market value of a work of art is expensive and often not productive because the GRAT works best when the appreciation can be demonstrated each year during the term of the GRAT. Works of art

³⁴ See, William L. Hoisington, "The Truth About Charitable Remainder Trusts (How to Separate True Help From The Hype)," 45 Tax Law 293 (1992).

typically do not appreciate dramatically within a relatively short period of time, so within the term of a typical GRAT, it may not be possible to demonstrate what the appreciation is each year. Also, the GRAT and the creator of the GRAT are likely to own fractional interests in the work of art during the GRAT term, and usage of the art must be shared. While a GRAT may be an appropriate vehicle for transferring interests in works of art, the logistics and the inability to demonstrate increases in value over relatively short periods of time make the GRAT inappropriate for works of art in most cases.

IV. Charitable Gifts of Art.

- A. Deduction Limits. Gifts of art to charity during the donor's lifetime generally entitles the donor to an income tax deduction, the amount of which is determined as follows:
1. The amount of the deduction depends on the nature of the gain that would be realized upon sale and the use to which the charity puts the work.
 - (a) If the sale of the work would generate long term capital gain, the deduction is equal to the fair market value of the work on the date of the gift if the charitable donee uses the work for a "related use" in furtherance of its exempt purposes.³⁵ The donor must receive written acknowledgement from the charity that the work will be so used.³⁶ If, however, the work will be used for a use that is unrelated to the purpose of function of the charitable donee, the deduction is limited to the donor's tax basis.³⁷ For example, if a donor gives a work to a museum to be added to the museum's collection, the fair market value deduction is available. If the donor gives the work to a church to be sold in the annual fund raiser silent auction, the deduction will be limited to the donor's tax basis. However, if the donor gives the work to a church to be hung in the church offices, a fair market deduction will be allowed. The deduction is subject to recapture if the donated art is sold within three years of the contribution.³⁸
 - (b) If the sale of the work would generate short term capital gain or ordinary income, the deduction is limited to the

³⁵ IRC § 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4.

³⁶ IRC §§ 170(e)(1)(B)(II); 170(e)(7)(D).

³⁷ IRC § 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4.

³⁸ IRC § 170(e)(7).

donor's tax basis.³⁹ Works of art created by the donor or received by the donor as a gift from the creator are considered ordinary income property and therefore the deduction is limited to tax basis.⁴⁰

2. Further, the deduction available to the donor is subject to certain percentage limitations based on the type of charity receiving the work and the nature of the gain.
 - (a) If the work is contributed to a public charity or a private operating foundation, the deduction limits are as follows:
 - (1) If a sale of the art would generate long term capital gain, the deduction may be taken up to 30% of the donor's adjusted gross income (adjusted gross income is generally the same as taxable income).⁴¹ If the donor is willing to reduce the value of the contribution by the gain that would be realized upon sale, the reduced value may be deducted up to 50% of the donor's adjusted gross income.⁴²
 - (2) If the sale of the art would generate short term capital gain or ordinary income, the deduction may be used up to 50% of the donor's adjusted gross income.⁴³
 - (b) If the work is contributed to a private non-operating foundation, the deduction limits are as follows:
 - (1) For capital gains, the deduction is limited to 20% of the donor's adjusted gross income.⁴⁴
 - (2) For ordinary income, the deduction is limited to 30% of the donor's adjusted gross income.⁴⁵

B. Qualified Appraisal Requirement. If the work has a value of \$5,000 or more, no deduction will be allowed unless the donor obtains a qualified appraisal of value and certain other reporting requirements are complied

³⁹ IRC § 170(e)(1)(A).

⁴⁰ IRC § 1221(a)(3).

⁴¹ IRC § 170(b)(1)(C)(i).

⁴² IRC § 170(b)(1)(C)(iii).

⁴³ IRC § 170(b)(1).

⁴⁴ IRC § 170(b)(1)(C)(i), (e)(1)(B)(ii).

⁴⁵ IRC § 170(b)(1)(B).

with by the charity and by the donor.⁴⁶ The Pension Protection Act of 2006 created new definitions of “qualified appraisal” and “qualified appraiser.”⁴⁷ The IRS has issued guidance relating to these definitions.⁴⁸

1. A “qualified appraisal” means an appraisal that is (1) treated as a qualified appraisal under regulations or other guidance prescribed by the Secretary of the Treasury, and (2) conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or guidance prescribed by the Secretary of the Treasury. An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards if, for example, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice as developed by the Appraisal Standards Board of the Appraisal Foundation.⁴⁹
2. The term “qualified appraiser” means an individual who:
 - (a) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary of the Treasury;
 - (b) regularly performs appraisals for which the individual receives compensation; and
 - (c) meets such other requirements as may be prescribed by the Secretary of the Treasury in regulations or other guidance.⁵⁰
3. An individual will not be treated as a qualified appraiser unless that individual:
 - (a) has not been prohibited from practicing before the Internal Revenue Service by the Secretary of the Treasury at any time during the 3-year period ending on the date of the appraisal;⁵¹ and

⁴⁶ IRC § 170(f)(11).

⁴⁷ IRC § 170(f)(11)(E).

⁴⁸ Prop. Regs. §§ 1.170A-17; *see also*, Notice 2006-96, 2006-46 I.R.B. 902 (Nov. 13, 2006).

⁴⁹ IRC § 170(f)(11)(E)(i). See The Appraisal Foundation’s website, www.appraisalfoundation.org, for the uniform standards of professional appraisal practice.

⁵⁰ IRC § 170(f)(11)(E)(ii).

⁵¹ IRC § 170(f)(11)(E)(iii).

- (b) demonstrates verifiable education and experience in valuing the type of property subject to the appraisal.⁵² For returns filed after February 16, 2007, such education and experience requirements are satisfied if the appraiser has successfully completed college or professional level course work that is relevant to the property being valued; obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued; and fully described in the appraisal the appraiser's education and experience that qualify the appraiser to value the type of property being valued.⁵³
4. Certain persons can never be qualified appraisers:
- (a) the donor;
 - (b) a party to the transaction in which the donor acquired the property being appraised, unless the property is donated within two months of acquisition and its appraised value is no higher than its acquisition price;
 - (c) the charity/donee;
 - (d) anyone employed by any of the foregoing, or related to any of the foregoing; and
 - (e) anyone whose relationship to any of the foregoing individuals or entities would cause a reasonable person to question the appraiser's independence.⁵⁴
5. Failure to obtain a qualified appraisal will result in the loss of the deduction even though it is obvious that the value is as claimed.⁵⁵ Taxpayers consistently have lost this battle with the IRS.⁵⁶ For example, if a donor purchases a work of art for \$50,000 and gives the work to a museum for its collection the next day, no deduction will be allowed if the donor does not obtain a qualified appraisal

⁵² *Id.*

⁵³ Notice 2006-96, 2006-46 I.R.B. 902 (Nov. 13, 2006).

⁵⁴ Treas. Reg. § 1.170A-13(c)(5)(iv).

⁵⁵ IRC § 170(f)(11)(A)(i);

⁵⁶ See, e.g., *Gomez v. Comm'r*, T.C. Memo 1999-94; *Jones v. Comm'r*, T.C. Memo 1998-444; *Stephens v. Comm'r*, TC Memo 1997-204; *Novick v. Comm'r*, T.C. Memo 1996-564; *Hamman v. Comm'r*, T.C. Memo 1996-160; *Bradley v. Comm'r*, TC Memo 1996-461. Taxpayers may be subject to negligence penalties for failure to obtain an appraisal and, although less likely, fraud penalties. *Purnell v. Comm'r*, T.C. Memo 1993-593 (negligence penalty); *Manning v. Comm'r*, T.C. Memo 1993-377 (fraud penalty).

even though it is obvious and provable that the value of the work is \$50,000.

C. Filing Requirements: Form 8283 and Form 8282.

1. Form 8283

- (a) The donor is required to file Form 8283 if the donor's deduction in a given year for all noncash gifts is more than \$500.
- (b) The form must be filed with the donor's tax return for the year in which the property was contributed and the deduction is first claimed.
- (c) For art worth more than \$20,000, a copy of the appraisal must be attached to Form 8283 with an 8 x 10 color photograph of the work.⁵⁷
- (d) For gifts over \$500,000 the qualified appraisal also must be attached to the donor's income tax return.⁵⁸

2. Form 8282:

- (a) If the charity disposes of the contributed item within three years of receipt, it must report such disposition on Form 8282. Note that this was changed from two years by the Pension Protection Act of 2006.
- (b) This rule does not apply if the donor certifies that the item was worth \$500 or less.
- (c) The Form 8282 advises the IRS of the amount of proceeds received upon disposition.
- (d) A copy must be provided to the donor.
- (e) Consider a three-year holding commitment on the part of the charitable donee, but this condition must be disclosed as a condition of the gift on Form 8283 and may affect value. Many charities observe a "voluntary" three-year holding period.

⁵⁷ Announcement 90-25, 1990-8 I.R.B. 25.

⁵⁸ IRC § 170(f)(11)(d).

- (f) Just because property is held for three years, it is not necessarily “related use” property for purposes of obtaining the fair market value deduction.⁵⁹

D. IRS Statement of Value. Under certain circumstances, donors of art may request a Statement of Value from the IRS after making the gift, but before filing a tax return claiming the deduction.⁶⁰

1. A Statement of Value can be requested for any item that has been appraised at \$50,000 or more and has been transferred as a charitable gift. The IRS may issue a statement for lesser-valued items if at least one of the items has been appraised at \$50,000 and it determines that issuing a statement would be in the interest of efficient tax administration.
2. The request for an IRS statement must include:
 - (a) A copy of the qualified appraisal. Additionally, the appraisal must include a complete description of the artwork and a photograph.
 - (b) There is a \$2,500 fee for a statement for up to three items, plus \$250 for each additional item.
 - (c) A declaration under penalties of perjury that the information is accurate.
3. Requests received by January 15 will “ordinarily” result in a statement being issued by June 30. Requests received by July 15 will “ordinarily” result in a statement being issued by December 31.
4. If the IRS agrees with the donor’s appraisal, it will issue a statement approving the appraisal. The donor may rely on such approval. If the IRS disagrees, it will issue a statement indicating the basis of its disagreement and its own determination of value.
5. A copy of the IRS’s statement must be attached to and filed with the return on which the contribution is reported. If the return is filed before the statement is received, the return must indicate that a statement has been requested and attach a copy of the request.
6. The Statement of Value may be used for income tax, gift tax, or estate tax purposes.

⁵⁹ See Part IV.A.1 *supra*.

⁶⁰ Rev. Proc. 96-15, 1996-1 C.B. 627.

7. In the author's experience, this process is rarely used and is helpful only for planning purposes if the donor makes gifts early in the year and would like to determine with relative certainty the donor's remaining available charitable deduction for the balance of the year.

E. Audits of Valuations of Art Work: Art Advisory Panel. If a work of art has a value in excess of \$20,000, the donor should be prepared to have the work reviewed by the IRS Art Advisory Panel. The Panel is made up of volunteers who are active in the art community. Among its members are dealers, museum curators, and others who have significant experience in the art community. If the donor's income tax return is audited, the auditor will send photographs of the work (supplied by the taxpayer) and the qualified appraisal to the Panel. The Panel meets each April and October to review the values that taxpayers have placed on works of art.

(a) In theory, the Panel does not know whether the taxpayer wants a "high value" because the gift is a gift to charity, or a "low" value because the owner has died and estate tax is payable on the value. However, for major works of art, the Panel often knows the purpose of the review because the Panel members are experienced members of the art community who generally track major collections and works in the ordinary course of their business.

(b) After reviewing the work, the Panel will issue a report setting forth what it believes is the value of the work. While the Panel's report can be challenged, it usually does an excellent job of determining value, and it is difficult and expensive to challenge its determination of value.

F. Gift of Fractional Interest to Charity. Until recently, a popular method for donating art to charity, while retaining the use of the art, was a gift of a fractional interest. For example, a donor gives 20% of a work to a museum. The donor and the museum enter into an agreement that the donor will have the right of possession for 80% of the time and the museum will have the right of possession for 20% of the time. The donor usually kept the work initially, but was obligated to allow the museum to have possession 20% of the time. In most cases, the museum never exercised its right to possession except for perhaps a show of the artist's work. Thus, the donor received an income tax deduction for the 20% gift, but never actually gave up possession.⁶¹ The law was amended a few years ago to impose the following somewhat draconian rules for dealing

⁶¹ *Winokur v. Comm'r*, 90 T.C. 733 (1988), acq. 1989-1 C.B. 1.

with gifts of partial interests, and the effect of these rules has been to eliminate gifts of partial interests except in very limited circumstances:⁶²

1. The initial gift is valued at fair market value multiplied by the fractional interest given, with no discount for the fact that a fractional interest is given.⁶³
2. Subsequent gifts of interests in the work are valued at the lesser of the value at the time of the gift of the first interest and the fair market value at the time of the gift of the subsequent interest. Accordingly, the donor gets no deduction for any appreciation.⁶⁴
3. The entire work must be donated prior to the earlier of 10 years from the initial contribution and the date of the donor's death.⁶⁵
4. The charity must actually have possession and use of the work for the fractional period equal to the fractional interest given.⁶⁶
5. If the donor violates the 10 year requirement or the "possession" requirement, prior years' deductions are recaptured.⁶⁷

G. Gift of Partial Interests. A donor may impose restrictions on the use or disposition of works of art given to charity, especially gifts to museums. Because a gift of a partial interest is not eligible for the income tax charitable deduction unless it is structured to fall within a narrow group of exceptions,⁶⁸ the issue becomes whether the imposition of the restrictions cause the gift to be a gift of a partial interest. Typical restrictions include requiring a credit line indicating that the gift was a gift of the donor; a restriction on deaccessing the work, either in perpetuity or for a limited period of time; a requirement that the work be displayed for a minimum period of time within a certain period; and a requirement that the work be displayed in a specific location or with other specific works. The Service has been liberal in favor of the taxpayer in ruling that restrictions such as these do not cause the gift to be a gift of a partial interest, although in one Private Letter Ruling, the gift agreement was required to be amended to eliminate the prohibition against deaccession in perpetuity.⁶⁹

⁶² IRC § 170(o).

⁶³ IRC § 170(o)(2).

⁶⁴ IRC § 170(o)(2).

⁶⁵ IRC § 170(o)(3).

⁶⁶ IRC § 170(o)(3).

⁶⁷ IRC § 170(o)(3).

⁶⁸ IRC § 170(f)(3).

⁶⁹ See Priv. Ltr. Rul. 200202032; 200418002.

- H. Bargain Sale to Charity. A donor may sell a work to charity for less than the fair market value of the work. This is known as a “bargain sale.” For tax purposes, the bargain sale is treated as a part-gift part-sale.⁷⁰ A charitable contribution deduction is allowed for the excess of the fair market value of the work over the selling price. The donor must recognize gain to the extent of the excess of the selling price over the part of the donor’s basis that has been allocated to the sale portion of the gift. The bargain sale rules only apply if a deduction is allowable under Internal Revenue Code section 170. Therefore, if the donor sells a work to a charity for an unrelated use and the purchase price is equal to the donor’s tax basis in the work, there can be no bargain sale because the deduction allowable under Internal Revenue Code section 170(e)(1) is limited to the donor’s tax basis.⁷¹
- I. Promised Gifts to Charity. A promised gift to charity does not entitle the donor to an income tax deduction until the work is actually given.⁷² Therefore, there is usually no economic benefit to making a promised gift, although there may be intangible benefits such as current recognition, satisfaction of a moral commitment, etc. In addition, many artists have “attached” a promised gift requirement to the purchase of their work. For example, an artist may allow the collector to purchase two paintings if the purchaser agrees to donate one of the paintings to charity. A purchaser often will receive a discount on the purchase price if the purchaser agrees to a binding promised gift agreement. If the collector is obligated to give the work to charity as part of the purchase transaction, the collector will not get an income tax deduction when the work is given during lifetime. Promised gift agreements must be reviewed carefully to make certain that there are no hidden tax issues and that the donor’s rights and obligations with respect to the work prior to actually transferring title are carefully delineated in the agreement. To avoid any argument that the obligation to give the work to charity constitutes the gift of a partial interest that does not qualify for the gift tax charitable deduction, the pledge agreement could be structured so that the charity is entitled to the work or cash upon the death of the donor, at the donor’s option. The charity is given an option to purchase the work with the cash.
- J. Gifts to Foreign Charities. A donor does not get an income tax deduction for a gift to a foreign charity during lifetime,⁷³ but a decedent’s estate will get an estate tax deduction for a gift to a foreign charity at death.⁷⁴ Many

⁷⁰ IRC § 1011(b); Treas. Reg. § 1011-2.

⁷¹ Treas. Reg. § 1.1011-2(a)(1).

⁷² Treas. Reg. § 1.170A-1(a); Rev. Rul. 55-410, 1955-1 C.B. 297; Rev. Rul. 68-174, 1968-1 C.B. 81; *Petty v. Comm’r*, 40 T.C. 521 (1963); *Guren v. Comm’r*, 66 T.C. 118 (1976).

⁷³ IRC § 170(c)(2); Rev. Rul. 63-252.

⁷⁴ IRC § 2055(a)(2); Treas. Reg. § 20.2055-1(a).

foreign charities have U.S. “friends of” organizations to which deductible gifts can be made during lifetime.⁷⁵ For example, the Tate in London has a “feeder” organization called American Friends of the Tate. A gift to American Friends of the Tate will be deductible for income tax purposes. For estate tax purposes, the gift can be left directly to the Tate in London.

- K. No Deduction for Loans of Art Work to Charity. No deduction is available for allowing a charity to use art, nor is there a taxable gift.⁷⁶
- L. Transfer of Copyright to Charity. While it is unusual for a collector or an investor to own both a work and the copyright associated with the work, if he or she does own both interests, there are special rules relating to the deductibility of transfers to charity:
 - 1. For estate and gift tax purposes, the work itself and the copyright relating to the work are separate interests, and if someone owns both the work and the copyright, he or she can separate those interests for estate and gift tax purposes. However, only gifts that are made to charitable organizations other than private foundations (a private operating foundation is not considered a private foundation for this purpose) and for use by the charity in furtherance of its exempt purpose will qualify for the treatment of the work and the copyright associated with the work as separate interests.⁷⁷
 - 2. For income tax purposes, the work and the copyright associated with the work are considered to be one interest, and if the collector owns both, he will not receive an income tax deduction for a gift unless both the work and the copyright associated with the work are given at the same time.⁷⁸

V. Maintaining a Client’s Collection After Death.

- A. Many collectors think about donating all or part of their collections to recognized museums or other educational institutions. Historically, museums have been “judged” by the depth of their collections even though at any given time, a tiny fraction of the collection is exhibited, and for most works of art in the collections, the period of exhibition is almost non-existent over a long period of time. Collectors have begun to realize that if the collector wants his or her works shown to the public, giving the works to established museums or educational institutions is not likely to

⁷⁵ Rev. Rul. 75-65, 1975-1 C.B. 79; Rev. Rul. 66-79, 1966-1 C.B. 48.

⁷⁶ IRC § 170(f)(3)(A); Treas. Reg. § 1.170A-7(a); IRC § 2503(g).

⁷⁷ IRC §§ 2055(e)(4); 2522(c)(3).

⁷⁸ IRC § 170.

accomplish that goal unless the works are so significant that the donee museum or educational institution will agree to exhibit the work for a significant period of time during any period. Because of space limitations and the pressure to exhibit as many works as the museum thinks is appropriate, museums are reluctant to agree as part of the terms of a gift to exhibit donated works for any specific period of time. Usually, a museum will agree to exhibit a work for several months during a five-year period, but the structure of the gift must anticipate that the museum will breach the agreement (most of the time unintentionally due to lack of adequate record keeping or monitoring), and therefore, there should be a mechanism in the agreement for someone to monitor the museum's use and enforce the agreement if the agreement is being breached, whether intentionally or unintentionally.

- B. In recent years, collectors have tried to find alternative ways of insuring that their collections will be viewed. One common alternative is to create a private operating foundation which becomes a "lending library" of art work. The works are stored (they cannot be hung in the creator's home or business), and are lent to museums and educational institutions around the United States or around the world. The foundation usually needs a financial endowment to help defray expenses of storage, conservation, insurance, and other expenses that are associated with owning and lending art. Depending on the borrower, expenses of packing, shipping and insurance while on loan may be borne by the borrower, but if the borrower is a small museum or educational institution, the foundation may pay the expenses in order to make the work available for viewing. Usually, the creation of a lending foundation is only practical for individuals with substantial collections and the financial wherewithal to "endow" the foundation for operations, but the lending foundation is a viable alternative to just leaving the works to a museum.
- C. If the collection is donated to a lending foundation during lifetime, then the creator will receive an income tax deduction for the fair market value of the works, and if the lending foundation is created at death, the creator's estate will receive an estate tax deduction for the value of the works.

VI. Special Rules for Artists. Artists often are collectors of the works of other artists whose works they received as gifts or in exchange for their own works. Ignoring the income tax consequences of artists' exchanges of their own works for works of other artists, several issues arise when artists make gifts, sales or bequests of other artists' work:

- A. If the work was a gift from another artist, the donor artist's basis (which is most likely zero) carries over to the donee, and any sale will result in

100% gain, which will be ordinary income because the work is not a capital asset in the hands of the donee artist.⁷⁹

- B. A gift by the donee artist to charity results in a deduction for basis (again, most likely zero) because the donated work is deemed to have the same character (e.g., ordinary income property) in the hands of the donee artist.⁸⁰ Accordingly, most artists would be better off buying a work from another artist at fair market value if it is anticipated that the work will be sold or given to charity at a later date. However, if the selling price is below fair market value at the time of the sale, the rules set forth in paragraph 1 above will be applicable because the donee/purchaser artist's basis is determined in part by the donor artist's basis.⁸¹
- C. Although an artist's ordinary income "taint" disappears at death, and any recipient of the artist's work receives a new basis and capital gain status for the work, the death of the artist does not remove the taint for previously gifted works because previously gifted works are not includable in the deceased artist's estate. Unless the donee artist dies owning the work that was previously gifted to him or her, in which case the ordinary income taint is removed because the basis is stepped up, the ordinary income taint remains with the gifted work, even if the donor artist dies.

⁷⁹ IRC § 1221(a)(3).

⁸⁰ IRC § 1221(a)(3).

⁸¹ IRC § 1221(a)(3).