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ESTATE PLANNING FOR ARTISTS AND COLLECTORS

I. Income Tax Considerations

- A. Generally, a work of art is “capital gain collectible property.” Capital gain collectible property has the following characteristics:
1. It is a capital asset under Section 1221¹
 2. It has appreciated in value
 3. It is a collectible under Section 408(m), and
 4. It has been held for more than a year.
- B. A sale of capital gain collectible property is taxed at a maximum rate of 28%
1. In contrast to the long term capital gain rate on most capital gain property of 20%
 2. Sales of ordinary income property (including short-term capital gain) are taxed at a maximum rate of 39.6%.
 3. Maximum rate is 35% for AGI under \$450,000 for joint filers, under \$425,000 for head of household filers, and under \$400,000 for single filers.
- C. Such a sale is also subject to the 3.8% “Medicare contribution tax” on unearned income imposed by the 2010 Health Care and Education Reconciliation Act of 2010. Section 1411(a)(1).
1. Imposed on the lesser of (a) net investment income or (b) excess of modified AGI over \$250,000 for joint filers and over \$200,000 for others including single filers.

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¹ All unadorned Section references are to the Internal Revenue Code of 1986 as amended.

2. So the maximum rate on capital gain collectible property is now 31.8% plus of course, applicable state and local income taxes.
- D. Section 1(h)(5)(B) prevents taxpayers from converting the 28% rate to the 20% capital gains rate by creating a partnership, corporation or trust to hold the collectibles.
- E. A work of art is “ordinary income property” if:
1. It was created by the owner; **or**
 2. It was received by the owner as a gift from the artist; **or**
 3. It is held in inventory by a dealer; **or**
 4. It has been owned by one year or less at the time of transfer
- F. Basis
1. When the artist sells a work of art, the artist recognizes ordinary income, with the cost basis being the cost of materials.
 2. Likewise, when a donee of a work of art received as a gift directly from the artist later sells the work, the donee recognizes ordinary income and shares the artist’s basis.²
 3. This ordinary income tax “taint” stays with the art until it is owned by a purchaser or until the owner dies and there is a step-up in basis.
 4. **Regardless of whether ordinary or collectible capital gain, art receives an adjustment of basis upon death.** Thereafter it is capital gain collectible property.
 5. Because of this, it is preferable to make non-charitable donative transfers only at death.

II. Techniques for Non-Charitable Lifetime Transfers

- A. Process³
1. Donor should sign an Assignment of Art or Deed of Gift with a signed acceptance;
 2. File gift tax return as appropriate.

² Section 1221(a)(3)(c). If gift tax is paid, the donee’s basis is increased by the gift tax paid. Section 1015(a).

³ Lerner, “The Last Picture Show: What Should be Done With Artwork”, Heckerling Institute, January 2012.

3. Make sure donee has appropriate casualty insurance.
 4. Consummate delivery to avoid Section 2036 arguments based on retained use and enjoyment.
- B. Beware of the “Empty Hook” problem
1. Referring to an appraiser or IRS agent arriving at a decedent’s residence to find bare walls, except for empty hooks where the art had once hung.
 2. Caution clients against placing art in children’s homes with no gift tax reporting.
- C. Like Kind Exchange
1. Section 1031 allows like-kind exchanges for works of art, so long as the transferor is an art “investor” with capital gain property, and not an art “collector”.
 2. In *Wrightsmen v. United States*, 26 AFTR 2d 70-5132 (1970), the Court of Claims established the following factors to determine whether the primary purpose for acquiring and holding works of art is for investment, rather than for personal pleasure and satisfaction:
 - a. Frequency and degree to which taxpayer obtains advice from art experts;
 - b. Expertise of taxpayer;
 - c. Frequency and degree of time the taxpayer devotes to his collection;
 - d. Degree of personal use;
 - e. Whether adequate records are maintained;
 - f. Whether the taxpayer has a reputation of being in the “trade or business” or as being an “investor” in art.
 3. The *Wrightsmen* court set a high bar for meeting the investment purpose. The Wrightsmen were utterly devoted to 18th century French art and furniture, with Jayne Wrightsmen being recognized as one of the world’s foremost experts on the topic, yet the court held they collected art primarily for pleasure and not for investment.
 4. Requirements:
 - a. The works exchanged must be of “like kind.” This likely means a painting must be exchanged for a painting, sculpture for sculpture,

etc.

- 1) In Rev. Rul. 82-166, 1982-2 CB 190 IRS ruled gold is not like-kind to silver, as the two are intrinsically different metals and used in different ways, with silver being an industrial commodity and gold primarily being used as store of value.
- 2) In PLR 8127089 (April 10, 1981) the taxpayer could not replace a lithograph that was destroyed in a fire with other artistic media such as oil paintings or sculptures under Section 1033, although the standard under Section 1033 is “similar or related in service or use” as opposed to the like-kind standard in Section 1031)

- b. Once the taxpayer’s work is relinquished, he has 45 days to identify the artwork intended to be acquired, and must acquire the new property within the earlier of 180 days or the due date of the transferor’s tax return including extensions.
- c. Reverse exchanges also work, meaning the taxpayer may make a purchase first, and then sell an item from his portfolio within 180 days.

D. Create an Art LLC for Gifts and Sales

1. Contribute art collection to an LLC or a partnership;
2. Gift LLC interests to trusts for family members;
3. Gifts should qualify for discounts for lack of control and lack of marketability, however, cost and inherent unreliability of appraisals is a factor in any gifting program;
4. If donors wish to continue to display the collection in their residence, the LLC should charge donor a “display fee”. This may be distributed to the members to provide them with current cash flow, but may be taxable income (this adverse result can be avoided by using intentionally defective grantor gift trusts, discussed below).
5. There is no consensus on how to determine a “display fee”. Some museums charge rental fees and this may provide a benchmark.

E. Gift/Sale to an Intentionally Defective Grantor Trust

1. Sell LLC interests to an intentionally defective grantor trust in exchange for a promissory note with an AFR rate.

2. This works well where the LLC is charging the grantor a display fee so the trust has cash flow with which to repay the promissory note to the grantor. Display fees in excess of the AFR will accumulate without gift tax consequence.
 3. Sale proceeds, interest on the promissory note and display fees are not recognized by the grantor because of the grantor trust status.
 4. Use GST exempt grantor trusts as well.
- F. Gift to a Grantor Retained Annuity Trust (GRAT)
1. Annuity comes back to grantor in form of display fee income, or if inadequate an, LLC interest having a value equal to the annuity. Valuation problems with this.
 2. Grantor must survive the term in order to take the Art LLC interests out of the taxable estate.

III. Techniques for Lifetime Charitable Gifts

A. Income Tax Rules

1. For the Artist

- a. Since basis for the artist is limited to cost of materials, the charitable contribution deduction will be limited to basis. Section 170(e)(1)(A).
- b. Accordingly, there is little tax incentive to donate other than not paying ordinary income tax on a sale.
- c. Treas. Reg. § 1.170A-4(b)(1) defines “ordinary income property” to include, for example, “property held by the donor primarily for sale to customers in the ordinary course of his trade or business, a work of art created by the donor, and letters and memorandums prepared by or for the donor.” This is consistent with the definition of property denied characterization as a capital asset under Section 1221(a)(3).
- d. There may well be substantial non-tax reasons, primarily that the gift can increase the artist’s popularity with art critics, collectors and the general public.
- e. The same rule applies to someone who acquired the art as a gift from the artist

2. For Donees/Devises from the Artist

- a. A donee who receives the artwork from the artist has carryover basis which limits the charitable contribution deduction.
- b. This limitation cannot be avoided by transferring the art to a corporation and gifting shares of the corporation to charity if the corporation was created for tax avoidance. *Ford v. Commissioner*, TC Memo 1983-556
- c. However, a **devisee**, that is to say someone who receives the property at death, receives a step-up in basis. Also the property is no longer ordinary income property under Section 1221(a)(3)(C).

3. For the Art Collector

- a. The collector's contribution of art to charity is also limited to basis if:
 - 1) The charity's use of the work of art is unrelated to its exempt purpose. Section 170(e)(1)(B)(i), or
 - 2) The charity is a private foundation. Section 170(e)(1)(B)(iii).
- b. Stated differently, in order to obtain a charitable contribution deduction equal to fair market value, the work must be donated to a public charity or private operating foundation, and the charity's use must be related to its exempt purpose.
- c. Related use: Treas. Reg. § 1.170A-4(b)(3)(ii) provides that contributed property is treated as having been put to a related use if:
 - A) The donor established that the property is not in fact being put to an unrelated use by the donee; or
 - B) If, at the time of the contribution, it is reasonable for the donor to assume that the property will not be put to an unrelated use.
- d. Generally speaking, if a donor contributes a work of art to a museum and the work of art is of a type generally displayed by the museum, it is reasonable for the donor to anticipate (unless having actual knowledge to the contrary) that the work of art will be put to a related use, whether or not the museum later disposes of the work.
- e. A donor must file Form 8283 for each item valued at more than \$500. The charity must certify whether the property will be put to

a related use.

- f. Charity’s certification states, “this organization affirms that in the event it sells, exchanges, or otherwise disposes of the [donated] property . . . within 3 years after the date of receipt, it will file Form 8282 (Donee Information Form) with the IRS and give the donor a copy of that form.”
- g. If the charity does sell the property within 3 years of the date of contribution, the donor’s charitable deduction is subject to recapture.
 - A) Recapture is avoided if charity makes a certification in accordance with Section 170(e)(7)(D)
 - B) A “certification” is a written statement signed under penalty of perjury by an officer of the charity that certifies that the property was intended to be used for a related use at the time of contribution but that the intended use has become impossible or infeasible to implement.
- h. Related use penalty of \$10,000 can be assessed against a person who identifies property as having a use related to the donee’s exempt purpose and who knows that the contributed property is not intended for such use.
- i. There are a few private letter rulings on the subject:
 - A) PLR 7751044—related use requirement met when lithographs were donated to and displayed by a camp and center devoted to physically and mentally disabled children, where the lithographs were used in connection with an art appreciation program.
 - B) PLR 8009027—related use rule not satisfied where donor gave an antique car to a university since the university did not offer a course in antique car restoration.
 - C) PLR 8143029—related use requirement met when donor gave his collection of porcelain art objects to a retirement center since the display of art was related to the charity’s purpose of creating a comfortable living environment for its residents.
 - D) PLR 9833011—related use satisfied when donor gave paintings to a Jewish community center that

had an arts wing and library.

4. Charitable Organizations

- a. Of course public charities described in Section 509(a) qualify.
- b. A private operating foundation is also an option.
 - A) Typically funded by a single donor or family
 - B) An operating foundation uses its assets and directly makes expenditures for the active conduct of activities related to its exempt purpose.
 - C) Donation of a residence and all of the donor's works of art for a museum open to the public would qualify. Treas. Reg. Section 53.4942(b)-1(d), Example 1.
 - D) The private operating foundation can lend works to museums and can continue to acquire and curate a collection.
 - E) Allows a collection to remain intact, whereas with a donation to a museum, the collection could be divested over time or placed in storage.
 - F) May be safest to create the private operating foundation at donor's death so the donor does not run violate the self-dealing rules. Section 4941(d)(1)(E).

B. Gifts of Partial Interests

1. Vertical Divisions (Fractional Interests)

- a. Section 170(f)(3) allows deduction for the outright contribution of an undivided portion of the donor's entire interest in the property.
- b. This allows for a contribution of a vertical division—e.g. a 40% tenant in common interest in a painting.
- c. In *Winokur v. Commissioner*, 90 T.C. 733 (1988), acq. 1989-2 C.B. 1, the taxpayer donated a 10% undivided interest in 44 works of art by Scandinavian artists one year and another 10% undivided interest the next year to the Carnegie Institute which did not exercise its right to take physical possession of the paintings for the year. Tax Court held the taxpayer was entitled to a charitable

contribution equal to 10% of the fair market value of the contributed art.

- d. Section 170(o) was added in 2006 and disallows a charitable deduction for an undivided portion of a donor's entire interest in tangible personal property unless the donor and the donee held all interests in the property immediately before the contribution.
 - 1) Furthermore the charitable contribution deduction to the donee is recaptured (along with a 10% penalty) if:
 - A) the donor does not contribute all the remaining interest in the property to the donee before the earlier of the donor's death or 10 years from the initial contribution; and
 - B) the donee has not had substantial physical possession of the property and has not used the property in a manner related to the donee's exempt purpose. Section 170(o)(3).
 - 2) The donor's initial contribution of a fractional interest is still determined by multiplying the fair market value of the work times the percentage interest but for subsequent contributions of a fractional interest, the value is limited to the lesser of the value used for determined for the initial fractional contribution or the fair market value at the time of the subsequent fractional contribution.
 - 3) So in other words, if the property goes up in value donor can't use that higher value for future contributions, while if it goes down donor has to use that value.
 - 4) Also necessary to update estate planning documents to make sure the remaining fractional interest goes to the charitable donee at death.
- e. Although the desirability of fractional gifts is greatly reduced, the technique is still useful for a collector who owns a very valuable work of art and wants to spread the contribution deduction over a period of 6 years (year of donation plus 5-year carry forward).

2. Horizontal Divisions (Split Interest Charitable Trusts)

- a. Charitable Remainder Trust funded with artwork
- 1) A means of selling a work of art without incurring capital gains or ordinary income on the sale.
 - 2) As a charitable entity, the trust is not taxed upon sale (unless there is unrelated business taxable income (UBTI)).
 - 3) Owner (or designated beneficiary) receives a stream of annuity or unitrust payments and some charitable deduction.
 - 4) No income tax deduction is allowed until all intervening non-charitable interests expire or are no longer held by the donor or a related person. Section 170(a)(3).
 - 5) But when the art is sold by a trustee to an related third party, then the charitable deduction may be claimed. See, PLR 9452026.
 - 6) The remainder beneficiary may purchase the art, but if the trust is legally bound or can be compelled to complete a sale, or the sale is otherwise pre-arranged, IRS will treat the sale as income to the donor. *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd on other grounds*, 523 F.2d 1308 (8th Cir. 1975), *acq.* Rev. Rul. 78-197, 1978-1 C.B. 83.
 - 7) The CRT's sale of the art is an unrelated use [to its exempt purpose], so the income tax charitable deduction will be limited to the donor's cost basis allocable to the remainder interest. See Treas. Reg. Section 1.170A-4(b)(3)(i).
 - 8) Best to use a "Flip CRUT" that "flips" to a unitrust (i.e., a fixed percentage) after a triggering event such as a sale. Prior to the flip, the CRUT is a lesser of net income or the unitrust amount (a NIMCRUT). There would be no net income if the trust owned only art that produced no royalties.
 - 9) Trust would provide for no distributions to the non-charitable beneficiary until the sale occurred.
 - 10) The trust would then "make-up" the unitrust payments in later years.
 - 11) Be careful of Section 2702 which could apply special valuation rules if there are non-charitable beneficiaries other than the donor and/or the donor's spouse.

- 12) Where the CRT is funded with art, the art must either be valued by an independent trustee or the grantor as trustee must obtain a qualified appraisal of the art. Treas. Reg. § 1.664-1(a)(7).
- 13) Accidental creation of UBTI.
 - A) The CRT allows the artist to sell his works without incurring income tax as long as there is no UBTI.
 - B) Section 512(b)(5) excludes from UBTI all gains and losses from the sale of property, other than property includible in inventory and property primarily for sale to customers in the ordinary course of a trade or business.
 - C) Art is property included in inventory when it has been offered for sale to customers. So it is important for the artist to fund the CRT with art that has never been offered for sale.

IV. Techniques for Testamentary Charitable Devises.

- A. A testamentary charitable devise is often an optimum method to deal with an illiquid and difficult to value asset from the estate.
- B. Premier planning mechanism for both the artist and the collector is a private foundation
 - a. If established during life, client can actively participate in administration, with additional works contributed at death.
 - b. There is no limitation on the estate tax charitable deduction or related use requirement, unlike with the income tax. Section 2055.
 - c. An outright testamentary transfer of the artist's or collector's art to a private foundation allows the art to be kept as a unit and gives the foundation the ability to market the art in an optimum way without the need for fire sales to pay estate taxes.
 - d. Also optimum where the individual beneficiaries do not want or cannot maintain the entire collection.
 - 1) If children want particular pieces of art, make specific devises, or give an option to purchase works of their choice at fair market value (to avoid self-dealing penalties)

- 2) There is an “estate administration exception” for such options. Treas. Reg. Section 53.4941(d)-1(b)(3).

C. Private Operating Foundation

- a. Operating residence and art collection as a museum after death may qualify as a private operating foundation.
- b. Doing so during lifetime is problematic because personal use can result in denial of tax-exempt status. See, Rev. Rul 74-600.

D. Devise to Existing Charity

- a. No related use requirement for purposes of the estate tax charitable deduction.
- b. Consult with the charity to see whether the charity will accept the gift. Often a museum will want an endowment to maintain the work or if it accepts it at all, will want to sell it immediately.

V. Special Rules for Copyrights owned by the Artist

A. Related Use and Testamentary Transfers

1. US copyright laws treat a work of art and the copyright as two separate property interests, but the income tax regulations treat works of art and related copyrights as two interests in the same property
2. This inconsistency made it impossible to obtain a charitable contribution deduction for a work of art transferred to charity if the copyright was not also specifically devised to charity because of the split interest restrictions discussed above.
3. The estate and gift tax rules were changed in 1981 to treat the work of art and the copyright as two separate property interests in certain cases.
4. Section 2055(e)(4) provides that for estate tax purposes, a work of art and its copyright are treated as separate properties where the decedent makes a “qualified contribution of a work of art.”
 - a. A “qualified contribution” is a transfer to a public charity or a private operating foundation if the use of the property by the organization is related to its exempt purpose. Section 2055(e)(4)(C).
 - b. If it is a “qualified contribution” the estate will be entitled to a

charitable deduction for the value of the art, but the copyright will be included in the artist's estate.

- c. Unrelated use will cause the painting and/or its copyright to fall outside Section 2055(e)(4) and be treated as one property under which the estate tax charitable deduction can be denied under the partial interest rules.
- d. This creates a major planning issue for the artist.
 - 1) For example, if the artist devises "my painting entitled Red Blob Extravaganza to the American Red Cross", and the residue of my estate to my children", the copyright could pass to the children.
 - 2) IRS will look to state law to determine whether the copyright was transferred with the art. Treas. Reg. Section 20.2055-2(e)(1)(ii)(e), Ex. 1.
 - 3) Unless the American Red Cross can satisfy the related use rules, the estate tax charitable deduction will be denied.
 - 4) Even a provision that devises "all my right, title and interest in and to" the work of art, may not be sufficient to transfer the copyright to the charity.
 - 5) Best practice is to specifically include the copyright with the devise unless the testator is certain that the charity's use of the art will be related to its exempt purpose.
- 5. The collector typically purchases art without the copyright since the artist retains the copyright unless it is specifically transferred in writing. Since the collector doesn't own the copyright he doesn't have to be concerned with the related use requirement of Section 2055(e)(4).

B. Artist's Right of Termination

- 1. Every original work of art created on or after January 1, 1978 has a copyright with a term that extends for the life of the creator plus 70 years. 17 U.S.C. Section 302(a). Works created prior to 1978 are subject to different copyright rules which are beyond the scope of this outline.
- 2. Under the Copyright Act of 1976, the artist has the right to terminate any inter vivos (but not testamentary) transfer or license of a copyright.
- 3. If the artist exercises the termination right, he can terminate the transfer and get back the copyright and perhaps renegotiate a license on more favorable terms.

4. The exercise must be made within certain narrow time periods: 35 years after the date of the grant or license, there is a five-year window during which the grant or license can be terminated.
 - a. The artist must give notice of termination, and the notice must specify a termination date that falls within the 5 year window.
 - b. The earliest the artist can give notice is the first day of the 25th year (to take effect on the first day of the 35th year); the latest notice is the last day of the 37th year (to take effect on the last day of the 39th year).
 - c. If the artist dies before exercising the termination right (*i.e.* before year 25) or dies between years 25 and 38 without having given notice of termination, the right to exercise the termination right passes by law.⁴
 - 1) The artist's surviving spouse has a 50% interest in the termination right (or 100% if there are no children), and the artist's descendants, per stirpes, have a combined 50% interest in the termination right.⁵
 - 2) A majority of the termination rights can exercise the notice of termination (e.g., spouse plus one child)
 - 3) These rules cannot be changed by estate planning documents, that is to say, there is forced heirship.
 - d. To avoid the forced heirship:
 - 1) If the artist is able to give notice (*i.e.*, in the 25th year), then the termination will continue to take place on the specified date and the forced heirship does not come into effect.
 - 2) It might be possible to use an *in terrorem* clause to provide for a beneficiary to either exercise or fail to exercise a termination right. *Quere*, how would this be enforced?

VI. Valuation Issues

- A. Four contexts in which valuation is particularly important:
 1. For income tax purposes when art is donated *inter vivos* to a charitable donee.

⁴⁴ 17 U.S.C. Section 203(b)(2)

⁵ 17 U.S.C. Section 203(a)(2)

2. For gift tax purposes when art is transferred *inter vivos* to a non-charitable donee.
3. For estate tax purposes when art is devised to a non-charitable beneficiary.
4. For property insurance purposes to determine amount of coverage.

B. Appraisal Requirements and Penalties

1. Income Tax Valuations

- a. When the donor claims a charitable deduction in excess of \$5000, a qualified appraisal is required.⁶

- 1) Appraisal must be made not more than 60 days before the date of the contribution and attached to the income tax return.
- 2) The \$5000 amount applies to a single item of property or to a collection of similar items of property donated in a single year such as a set of coins, stamps, or photographs (whether donated to one or more charities).
- 3) The appraisal requirement is tied to the amount claimed by the donor as a deduction. So if the artist is claiming only a \$150 deduction for her basis in the work, no appraisal is required regardless of the value of the work.

- b. A “qualified appraiser” is an individual who holds himself out to the public as an appraiser and who is an expert as to the particular type of property being valued, who understands he will be subject to penalties for gross or fraudulent misstatements of value, and is completely independent of the donor.⁷

- 1) The dealer, or an employee thereof, who sold the artwork cannot be the appraiser. Thus the auction house which sold the work cannot be the appraiser.
- 2) The appraiser must have earned an appraisal designation from a recognized professional appraiser organization.
- 3) The appraiser must have verifiable education and experience in valuing the type of property subject to the appraisal.

⁶ Treas. Reg. § 1.170A-13(c)

⁷ Treas. Reg. § 1.170-A-13(c)(5)(i).

- 4) The appraiser must not have been prohibited from practicing before the IRS at any time during the three-year period ending on the appraisal date.
 - 5) The donor is responsible for checking the credentials of the appraiser.
 - 6) Notice 2006-96 offers guidance and states that the appraiser must have at least two years' experience in the trade or business of buying, selling or valuing the type of property being valued.
- c. Completion of Form 8283 will satisfy the appraisal summary requirements.
- 1) The instructions no longer require that an 8" x 10" color photograph be attached, but the photograph must be made available to the IRS upon request.
 - 2) Form 8283 must be signed by the appraiser and the charitable donee.
 - 3) The donor must also provide the charitable donee with a copy of Section B of the Form.
- d. The charity must also file Form 8282, Donee Information Return (Sale, Exchange or other Disposition of Donated Property), notifying the IRS of any subsequent sale or exchange of the gifted property within three years of the date of the gift.
- e. Penalties
- 1) A "substantial valuation misstatement" occurs if the value is overstated by 150% or more, but only if the underpayment exceeds \$5000.⁸
 - 2) A "gross valuation misstatement" occurs if the value is overstated by 200% or more, in which case a penalty of 40% of the underpayment is imposed.⁹
 - 3) The substantial valuation misstatement penalty can be waived if there is reasonable cause for the understatement and the taxpayer shows he acted in good faith.¹⁰ The

⁸ Section 6662(e)(1)

⁹ Section 6662(h)(1)

¹⁰ Section 6662(c)(3)

“reasonable cause” requirement can be satisfied if the claimed value was based on a qualified appraisal by a qualified appraiser.

2. Estate and Gift Tax Valuations

- a. If a decedent’s estate includes household and personal effects consisting of articles having “marked artistic or intrinsic value of a total in excess of \$3000”, an expert appraisal must be submitted with the estate tax return.¹¹
- b. The appraiser must be reputable and of recognized competency to appraise the particular class of property involved.
- c. **Unlike income tax rules, estate and gift tax rules do not require an appraisal by a “qualified appraiser”.**
- d. For appraisals of paintings, the size, subject and artist’s name must be stated.
- e. Penalties¹²
 - 1) If the value claimed on the return is 50% or less of the value determined to be correct, a penalty of 20% of the tax underpayment is imposed if greater than \$5000.
 - 2) If the value claimed on the return is 25% or less of the value determined to be correct, a penalty of 40% of the tax underpayment is imposed.
 - 3) IRS has discretionary authority to waive the Section 6662 penalty if the taxpayer established a reasonable basis for the claimed value and the claim was made in good faith.

3. Art Advisory Panel

- a. All taxpayer cases selected for audit that contain artwork with a claimed value of \$50,000 or more per item must be referred to Art Appraisal Services for review by the Commissioner’s Art Advisory Panel.
 - 1) The Panel consists of 25 nationally prominent art museum directors, curators, scholars, art dealers, auction

¹¹ Treas. Reg. Section 20.2032-6(b)

¹² Section 6662(g)(1)

representatives, and appraisers.

- 2) The Panel meets once or twice a year for one day, and reviews hundreds of works per session.
- 3) To promote objectivity, the Panel is **allegedly** not told whether the appraisal was for an income tax charitable contribution deduction for for estate or gift tax purposes.
- 4) The Office of Art Appraisal Services provides staff support and coordination of the Panel's functions.
- 5) The Panel members, after reviewing photographs or color transparencies, along with relevant documentation provided by the taxpayer and research by the staff appraisers, make recommendations on the acceptability of the claimed values. If unacceptable the Panelists make alternate value recommendations. Although the recommendations are advisory, after review by the Office of Art Appraisal Services, these generally become the position of the IRS.
- 6) However, in *Mitchell Estate v. Comm'r*, TC Memo 2011-94, the Estate reported a Frederic Remington painting and a Charles Russell painting passing to non-charitable beneficiaries. The IRS rejected the valuation of the Art Advisory Panel (which was consistent with the estate's appraisals) and asserted its own appraisals which were nearly double. The Court sided with the Estate saying the IRS' expert valuations were "unreasonably high". Estate's expert had researched all comparable sales, had expertise in American Western art and provided the most understandable report.

b. Reconsideration of value determinations

- 1) Taxpayer may request consideration only if the taxpayer provides additional evidence.
- 2) Request must respond specifically to the report issued by the Art Appraisal Services Office.
- 3) A waste of time as rarely successful.

C. Special Valuation Issues

1. Deductions for Expenses of Sale

- a. Fair market value (“FMV”) is the price paid by the buyer to the seller, not the amount ultimately received by the seller, thus deduction for anticipated selling expenses (including auction expenses) are not used in determining FMV. *Publicker v. Comm’r*, 206 F.2d 250 (3rd Cir. 1953), cert. denied, 346 U.S. 924 (1954) (FMV of jewelry included excise tax paid by the seller on the sale of jewelry)
- b. In *Smith v. Comm’r*, 57 T.C. 650 (1972), aff’d 510 F.2d 479 (2nd Cir. 1975), IRS successfully argued the estate tax value of an artist’s work was not reduced by the 33% commissions the artist, and later his estate had agreed to pay an art dealer under a contract granting the dealer an exclusive right to sell the work. Court stated, “The measure of value . . . is what could be received on, not what is retained from, a hypothetical sale.”
- c. *Scull Estate v. Commissioner*, TC Memo 1994-211 found that the value of art sold at auction includes the auction sales price plus the buyer’s 10% premium paid to the auction house, despite the fact that the auction house, not the buyer, receives the buyer’s premium.
- d. In TAM 9235005 the IRS included the buyer’s premium in the FMV of artwork, noting that if the estate had marketed the art through a private art dealer, the seller would have had to pay a commission to the dealer.
- e. The Art Advisory Panel apparently routinely adds the equivalent of a buyer’s premium to items that are retained by the estate or specifically devised. Wolf, “Appraisals and the IRS Art Review Panel: Recent Issues,” 20 Tax Mgmt. Est., Gifts & Tr. J., 138 (May-June 1995).
- f. However, if the artwork is actually sold by the estate, the selling expenses are deductible if the sale was necessary to pay the decedent’s debts, expenses of administration or taxes, or to “effect distribution”. Reg. Section 20.2053-3(d)(2).
- g. Planning tip: if the artist or collector directs the sale of the art, the auctioneer’s commissions and other selling expenses should be deductible under Section 2053(a)(2) as expenses necessary to “effect distributions”.

2. Fractional Interest Discounts/Cost to Partition

- a. In *Stone v. U.S.*, 103 AFTR2d 2009-1379, (9th Cir. 2009, unpublished), the estate claimed a 44% discount for its undivided 50% interest in 19 paintings left to family members.

- 1) The state court reasoned that a hypothetical seller would seek to sell the entire work of art and split the proceeds, or if the other owner didn't cooperate with a sale, a partition action would result.
 - 2) The 9th Circuit agreed that the discount was limited to the cost to partition and allowed only a 5% discount.
 - 3) This case treats art differently from closely held businesses when it comes to applying discounts.
- b. In *Estate of Elkins v. Comm'r*, 767 F.3d 443 (5th Cir. 2014), reversing 140 TC 5 (2013), the decedent owned 73% interests in 61 works of art and 50% interests in 3 other works. The remaining fractional interest were owned equally by 3 children, and all the works were subject to a Cotenants's Agreement that prohibited the sale of a work without the unanimous consent of all co-tenants.
- 2) The Tax Court rejected the Commissioner's zero discount position but allowed only a 10% discount to account for the uncertainties a hypothetical buyer would face as a cotenant with the children.
 - 3) Amazingly the Tax Court effectively abandoned the hypothetical willing buyer concept and concluded based on the testimony of the Elkins children that the art was "part of the family" and would never be sold outside the family such that the children were the pool of potential buyers.
 - 3) The Fifth Circuit had no compunction about reversing the Tax Court and accepting the 40% discounts determined by the Estate's experts.

3. Relevant Market

- a. Treas. Reg. §§ 20.3031-1(b) and 25-2512-1 require FMV of artwork and collectibles to be determined by the sale price in the market in which the article is most commonly sold.
- b. The relevant market for most tangible personal property is retail and not wholesale, but the relevant market for art depends on the type of art, demand and supply, and whether the art is typically purchased at retail or wholesale.
- c. In *Ferrari v. Comm'r*, TC Memo 1989-521, involved a charitable income tax deduction for donations of pre-Columbian art to Duke University. The Court agreed that while auction sale prices are readily available and gallery sale prices are not public, the relevant

market is what collectors will pay to galleries specializing in the type of art at issue, essentially then the retail price. *Cf, Biagiotti v. Comm'r*, TC Memo 1986-460.

4. Forgeries and Stolen Art

- a. In *Doherty v. Comm'r*, TC Memo 1992-98, taxpayer donated a painting by Charles M. Russell to the Charles M. Russell Museum. Taxpayer's claimed value was \$350,000 but the Service's expert claimed the painting was a forgery with a value of \$100. The case pitted the two foremost authorities on Russell against one another. The Court agreed that the dispute over the painting's authenticity reduced the value to \$30,000.
- b. PLR 9152005 involved the Quendlinburg treasures. While serving the U.S. Army during World War II decedent stole several artifacts from a medieval church and sent them home to his mother. He kept the artifacts in his home upon his return to Texas and left his estate to his brother and sister when he died 35 years later. Although the brother and sister were aware of the artifacts, they were not included on the estate inventory and did not file an estate tax return for the otherwise modest estate. When the artifacts were attempted to be sold, they received offers ranging from \$500,000 to \$9,000,000. The medieval church learned of the sale and sued. The Service ruled the artifacts were includible in the decedent's gross estate and ruled that no deduction was allowable under Section 2053(a)(3) for the claims of the theft victims as they did not bring their claims within the one-year creditor period.
- c. Bottom line is that FMV for stolen goods is still based on the price a hypothetical willing buyer would pay a willing seller even if the market is illicit.
- d. Estate of Ileana Sonnabend involved a prominent dealer of modern American art who died in 2007 at the age of 92. Her collection was reported on the estate tax return as having a value of \$892M. However, a mixed media "combine" entitled "Canyon" by Robert Rauschenberg was reported at a zero value because it contained a stuffed bald eagle and thus could not be (legally) sold. Mrs. Sonnabend was able to possess the combine because the eagle had been stuffed prior to the 1940 Bald and Golden Eagle Protection Act and the 1918 Migratory Bird Treaty Act which makes it a crime to buy, sell, barter or possess a bald eagle, dead or alive.
 - 2) IRS valued the work at \$65M and assessed additional estate taxes of \$29.2 M and penalties of \$11.7M based upon their assertion of the "black market" value.

- 3) Taxes and penalties were waived in an IRS settlement wherein the work was donated to the Museum of Modern Art (MoMA) in New York City.
- 4) There is an excellent analysis of this case at Melbinger, “The Sonnabend Estate and Fair Market Valuation of Canyon, 163 U. PA. L. Rev. Online 239

D. Blockage Discount

1. A blockage discount is allowed where an artist or collector has built up a large inventory of works such that a large number of similar works of art coming on the market at one time will depress the value of all the items. Treas. Regs. Sections 20.2031-2(e) and 25.2512-2(e). This is in recognition that the collection would need to be sold over considerable time to obtain FMV in the relevant market.
2. In *Smith Estate v. Comm’r.*, 57 TC 650(1972), was the first major case involving a blockage discount.
 - a. Sculptor David Smith died with an inventory of 425 abstract sculptures. Smith was a pioneer of welded sculpture in the U.S. and had received acclaim toward the end of his life but his death catapulted his works to national prominence. The most prized of his works were those of the “Cubi” series, which consisted of 29 works of welded, polished steel cubes. The works were expensive to transport and store, and if the public knew how many were available for sale the price would have dropped significantly.
 - b. During his life, Smith had contracted with the prominent Marlborough Gallery to sell his work, with the Gallery entitled to a commission of 1/3 of the sales price.
 - c. The Gallery and the estate agreed it was important to hold back the most valuable of Smith’s works for sale at a future date in order to sustain interest in his work over a 10 year period necessary to liquidate the collection.
 - d. The Court agreed that if all 425 works were put on the market at the same time there would be an impact on the sales price of the works and applied a blockage discount of 37%.
3. *Calder v. Comm’r.*, 85 TC 713 (1985) involved gift taxes.
 - a. The widow of Alexander Calder made gift of gouaches to six separate trusts, one for each of her two daughter and one for each of her four grandchildren. The children’s trusts each received approximately 300 gouaches and the grandchildren’s trusts each

received approximately 150 gouaches each.

- b. At Calder's death, his estate had reported the value of 1,292 gouaches with a blockage discount of 60% and the Service accepted this position.
- c. Mrs. Calder reported the same discount on her gift tax return but the Service argued that each of the six gifts should be viewed independently of the other such that instead of 1,200 paintings being placed on the market at the same time, it was as if 150 or 300 were.
- d. The Court agreed citing the gift tax regulations for blockage discounts of stock which state, "If the donor can show that the block of stock to be valued, with reference to each separate gift, is so large. . .".
- e. The Court considered how many years it would take to sell each work, and reduced the future proceeds to present value to determine FMV.

4. *O'Keefe Estate v. Commr*, TC Memo 1992-210

- a. At Georgia O'Keefe's death, her estate owned approximately 400 of her works, of which 80 pieces were the subject of specific bequests, and the rest were residuary.
- b. The experts agreed on the FMV of the artwork but disagreed on the appropriate blockage discount.
- c. IRS argued that blockage discounts did not apply to the specific bequests because there was no need to sell those paintings.
- d. The Court affirmed that the FMV of a work is the price a hypothetical buyer would pay a hypothetical seller, and agreed that the blockage discount should be applied to the bequeathed art.
- e. The Court found that the works should be divided into two categories and applied differing blockage discounts to each category: for those works that are salable within a relatively short period of time at approximately their individual values the Court applied a 25% discount, and for those works that can only be marketed over a long period of years with substantial effort the Court applied a 75% discount.

5. This analysis is not seem to be relevant for income tax purposes. The IRS Valuation Guide states that blockage discounts are not applicable to charitable contribution deductions since the taxpayer (contributor) controls

the market by selecting how many items are contributed. Of course, in this context the taxpayer doesn't want a discount.

E. Advance Valuation Ruling

1. Rev. Proc. 96-15 instituted a procedure where after transferring artwork valued in excess of \$50,000 and before filing a return reporting the transfer, obtain an IRS Statement of Value on which the taxpayer may rely in filing the income tax return.
2. There is a user fee of \$2500 for the first 3 items and \$250 per item for additional items, with various appraisal and informational requirements.
3. This procedure is also available for estate and gift tax purposes.

VII. Planning Ideas

A. Inventory

1. It is advisable for artists and collectors to keep a running inventory of their works with information about each work. This information is helpful with respect to registration of copyrights, challenging forgery and reporting lost or stolen works
2. Inventory information
 - a. List the name of each work and date of creation
 - b. Note the medium, dimensions, and provide a narrative of the artist's process in creating the work, any special meaning or symbolism attributable to the work. This information will aid the sales process.
 - c. Record expenses incurred in creating the work in order to determine the artist's basis.
 - d. Keep a price list with suggested retail and wholesale prices of unsold works
 - e. Include when and where the work has been exhibited, whether it has been loaned, leased, sold (and, if sold, whether the sale included a sale of the copyright), pledged, gifted or otherwise transferred, with details thereof.
 - f. Include in a file, signed copies of all agreements of sale, loan agreements, deeds of gift, records of all copyright registrations, deposits, notices, exercises of termination rights, and all licenses.

- g. To assist resale at a later date, also include any publicity about a work, information about shows in which the art was displayed, any catalogs in which the work was published or offered for sale.
- h. If the work is stolen, the circumstances of the theft and all police reports and insurance claims.
- i. If a work was produced in a limited edition of multiple copies, how many copies were produced and whether the plate or cast was destroyed.
- j. Make sure the artist signs each of his or her works. If there is no signature, the estate must apply an “estate stamp” which decreases the value of the art.

B. Purchase Records

- 1. Prior to purchase, collector should ascertain work’s provenance and make diligent inquiries as to whether the work has been reported as lost or stolen, lawfully imported and exported, and not a forgery.
- 2. Consider title insurance

C. Provisions for Estate Planning Documents

- 1. Durable Power of Attorney
 - a. Authorize the agent to deal with the artwork including all copyright matters
 - b. If the artist intends to exercise the termination interest in a copyright so that it will pass through his estate, the agent should be expressly authorized and instructed to exercise the termination right and should provide notice in the 25th year and exercise the termination right upon the commencement of the 35th year after creation.
- 2. Will and Revocable Trust
 - a. If art is extremely valuable, separate it from the standard distribution of tangible personal property.
 - b. Direct if art is to be sold:
 - 1) Consider providing a right of first refusal or purchase option
 - 2) An option is particularly important if the art or proceeds are

devised to a private foundation in order to avoid self-dealing issues. The “estate administration exception” to the self-dealing rules provides a list of requirements that must be met for the option to work. Treas. Reg. Section 53.4941(d)-1(b)(3).

- c. Be careful with tax apportionment when valuable art is specifically devised.
- d. Specifically address copyrights and whether the copyrights should pass with any art that is specifically devised.
- e. If the artist has unexercised termination rights, determine whether the artist wishes to exercise the termination rights and provide notice during life, if possible, or instruct spouse and descendants to provide notice and terminate the rights.

D. Art Executor (or Art Trustee)

- 1. Client should consider appointing an Art Executor who will assemble the works, develop, sell, exhibit, market or otherwise promote the works as appropriate.
 - a. Art Executor would determine which works would be sold in the short term and which should be held for appreciation or orderly sale.
 - b. Art Executor should be given authority over all copyright matters.
- 2. *In re Warhol Estate*, 629 N.Y.S.2d 621 (N.Y. Sur. Ct. 1995) successfully implemented this approach. Duties of the art executor included:
 - a. Sale and transfer of all art
 - b. Consider the effect of sales on the overall value of the estate and the value of other assets, including 75,000 pieces of his art, his personal art collection of 10,000 pieces, diaries, films, trademark and licensing rights;
 - c. Authentication, appraisal securing and insuring of art;
 - d. Negotiations for a retrospective at the MoMA, later shown around the world, which would be critical to insuring Warhol’s status in the art market;
 - e. Negotiations for the auction of his works;
 - f. Negotiations for contracts for publication of Warhol’s diaries and

- the right to exploit his images;
- g. Forming the Andy Warhol Foundation and a museum;
 - h. Opposing substantial claims of ownership of Warhol art;
 - i. Collecting insurance for art lost by MoMA.
3. Make clear whether the art executor is merely an advisor or a fiduciary. If the Art Executor is a fiduciary, make clear his priority to act over other fiduciaries.
 4. Specify whether the Art Executor is entitled to compensation from the estate (deductible) or commissions from sales (may not be deductible).
 5. If the decedent's art dealer is the Art Executor, the estate may pay the Art Executor a commission that is reasonable under state law in lieu of a standard commission arrangement.
 6. In the estate planning process it is advisable to review existing agreements with the dealers, agents and galleries with a special focus on whether the contracts will terminate or continue after death.
 7. Beware of conflicts of interest. *In re Rothko*, 43 N.Y.2d 305, 372 N.E.2d 291 (1977) is instructive.
 - a. Mark Rothko's will appointed three executors: one was his dealer and owner of the prominent Marlborough Gallery, one was a struggling artist friend, and one was a friend and professor of anthropology at Fordham.
 - b. Within one month the dealer had contracted to sell 798 works of art by Rothko to a his own corporation.
 - c. For going along with the plan, the struggling artist was offered a show of work and representation by Marlborough Gallery.
 - d. Although hiring his own attorney, the professor merely orally objected to the proposed sales.
 - e. All three were fined and removed as executors.
 - f. The professor was fined \$6M because it was not enough to "close his eyes. . . in the fact of the obvious loss to be visited upon the estate . . . and then shelter himself behind the claimed counsel of an attorney."