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Art is Long, Life is Short :

Estate Planning For the Artist and the Art Collector

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Art is Long, Life is Short[1]:

Estate Planning For the Artist and the Art Collector

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I. NON-CHARITABLE TRANSFERS DURING LIFE

Art is particularly well-suited for charitable transfers if the circumstances fit, but not all collectors or artists want to leave their art to a charitable organization. In order to understand the different ramifications of transfers of art during life and why it may be preferable to wait for death to make the transfer, it is important to first understand the income tax rules particular to art.

A. Income Tax Issues

1. **Capital Gains versus Ordinary Income Property.** In most cases, a work of art is "capital gain collectible property" as opposed to "ordinary income property".

   - The work of art is long-term "capital gain collectible property" if:

[1] Proverb originating with Hippocrates.

- It is a capital asset under Section 1221;
- It has appreciated in value;
- It is a collectible under Section 408(m); AND
- It has been held by the donor for more than one year.

- Sales of capital gain collectible property are taxed at a maximum rate of 28%, whereas sales of ordinary income property (including short-term capital gain) are taxed at a maximum rate of 35%.
  - Despite reductions over the years in the capital gains rate, the rate on gain from the sale of long-term collectible property has remained constant at 28%.[2]
  - The Taxpayer Relief Act of 1997 added Section 1(h)(5)(B) of the Code to prevent taxpayers from converting the 28% rate to the current 15% capital gains rate by creating a partnership, corporation or trust to hold the collectibles.
- A work of art is "ordinary income property" if:
  - It was created by the donor;
  - It was received by the donor as a gift from the creator;
  - It is held in inventory by a dealer; OR
  - It has been owned for one year or less at the time of transfer.

2. Basis Issues

- When the artist sells his or her art, the artist receives ordinary income, and the artist's basis is the cost of the materials used to create the work.
- Likewise, when the donee of a work of art received as a gift directly from the artist who created the piece later sells the work, the donee is subject to ordinary income tax and shares the artist's basis.[3]

[2] IRC Section 1(h)(5).
[3] IRC Section 1221(a)(3)(C). Note, that if gift tax is paid at the time of transfer, the donee's basis is increased by the gift tax paid. IRC Section 1015(a).

- This ordinary income tax "taint" stays with the art until it is in the hands of a buyer after a purchase or until the owner dies and the art gets a step up in basis.

- When art is received as a testamentary bequest, the donee receives art with a stepped up basis and is able to sell the work as a capital asset under Section 1221(a)(3)(C).

B. Transferring Art During Life versus at Death

- Generally, it is preferable to wait until death to make non-charitable transfers of art for the following reasons:
    - Receive a step up in basis to fair market value.
        - If an artist is married, the surviving spouse can then gift or sell the art to third parties, or donate the art to a public charity and receive a charitable deduction equal to the full fair market value.
    - May also be able to get a blockage discount or qualify for Section 6166 relief if wait until death.
- There are some circumstances where it is advantageous to make lifetime transfers of art:
    - If portability is no longer in effect or you still want to take advantage of funding a credit shelter trust at the first spouse's death but one spouse lacks sufficient assets, art can be transferred to the less wealthy spouse.
        - Marital deduction applies, and this is often less controversial than transferring business assets or liquid assets.
        - If less wealthy spouse dies first, the art gets a step up in basis and can be sold to the surviving spouse or a third party to fund the credit shelter trust with cash and securities.
    - If it becomes apparent that one spouse is going to predecease the other, transfer all of the art to the ill spouse so that it gets a step-up in basis at death.
        - This is helpful when the art will be used to fund a credit shelter trust or will be bequeathed to someone other than the spouse.

        - If the art is to come back to the spouse within one year of the transfer, the step-up in basis will not apply unless the art comes back in the form of a QTIP trust that is considered a different taxpayer from the surviving spouse.[4]

    - If the artist is not yet well-established, but it becomes apparent that his or her works are about to start selling at higher prices, a gift can be made while values are still low.

        - If an artist has had even a smattering of success – one or two high-priced sales amid a lifetime of struggling to make ends meet, those high-priced sales could cause the Service to place a similar value on the artist's unsold works at the time of his or her death.

    - If there is a piece that has sentimental value to a child, and the child would likely hold the work until his or her death, a gift could be made to take advantage of the current $5M lifetime gift tax exemption.

    - If the artist or collector is in a committed same-sex or heterosexual relationship, the client may want to consider a grantor retained income trust (GRIT), which can reduce the gift tax cost of a transfer to a non-family member.

- Process of making non-charitable gifts[5]:

    - Donor should sign a Deed of Gift with a signed acceptance;

    - File a gift tax return if the value exceeds the annual exclusion amount;

    - Change the insurance policy to the new owner;

    - Effect delivery to avoid the Section 2036 argument of retained use and enjoyment.

- Beware of the "Empty Hook" strategy.

    - This term refers to the appraiser or IRS agent arriving at the decedent's residence to find bare walls, except for empty hooks showing where art once hung.

[4] Section 1014(e).
[5] Ralph E. Lerner, "The Last Picture Show: What Should Be Done With Artwork", Heckerling Institute, January 2012.

- Planners should strongly caution clients against placing art in children's homes with no gift or estate tax reporting.

- There is no statute of limitations for estate tax fraud.

- Heirs miss out on opportunity to get step-up in basis.

II. LIFETIME CHARITABLE GIFTS

A lifetime transfer of a work of art to charity saves the donor income taxes where the charitable contribution deduction is available, it eliminates the expense and worry connected with the maintenance of valuable art and, where the donor is also the artist, it can increase the artist's popularity with art critics, collectors and the general public.

A. Income Tax Rules

1. For the Artist.

- Creative property is ordinary income property in the hands of the creator, and the artist's basis in a work is limited to the cost of his or her materials.[6]

- The artist's charitable contribution deduction will be limited to his or her basis in the ordinary income property.

  - The artist has very little tax incentive to donate his or her art to a charity during life.

  - Nevertheless, there may be substantial non-tax reasons, primarily that the gift might increase the artist's profile and sales.

- Same rule applies to donee of a lifetime gift of art from the creator. If the donee tries to donate the work to charity, the donee's charitable contribution deduction will be limited to the creator's basis in the work.

  - In contrast, the property is not ordinary income property under section 1221(a)(3)(C) in the hands of the person who inherits art from the artist at the artist's death.

[6] Section 170(e)(1)(A). Regs 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, a manuscript prepared 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).

- In that case, the donor of the art likely will receive a charitable contribution deduction equal to the stepped-up basis of the property.

  - For this reason, an artist with charitable inclinations may wish to leave the property to his or her spouse, and allow the surviving spouse to donate the works to charity to take advantage of a higher charitable income tax deduction.

- Note, the limitation imposed by Section 170(e)(1)(A) on charitable contributions of ordinary income property may not be avoided by transferring the art to a corporation and then gifting shares of the corporation to charity if the corporation was created for the sole purpose of tax avoidance.[7]

2. **For the Art Collector.** The Collector's contribution of art to charity is also limited to his or her basis in the property if:

   - The charity's use of the work of art is unrelated to its exempt purpose[8]; OR

   - The charity is a private foundation.[9]

   Stated another way, in order to obtain a charitable contribution deduction equal to the fair market value of the work of art, the work must be donated to a public charity or private operating foundation, and the charity's use of the work must be related to its exempt purpose. Each of these requirements will be discussed below.

3. **Related Use**

   The charitable contribution deduction of a donor of capital gain collectible property will be limited to the donor's basis in the property if the donee's use is unrelated to its exempt purpose.

   - The Treasury Regulations[10] provide that contributed property is treated as having been put to a related use if:

     - The donor establishes that the property is

[7] Ford v. Comm'r, TC Memo 1983-556.
[8] IRC Section 170(e)(1)(B)(i).
[9] IRC Section 170(e)(1)(B)(ii).
[10] Regs. 1.170A-4(b)(3)(ii).

not in fact being put to an unrelated use the by donee; or,

- 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.

- Double negatives aside, this means that 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 the donor has actual knowledge to the contrary) that the work of art will be put to a related use, whether or not the museum later sells or exchanges the object.[11]

- As part of the Pension Protection Act of 2006, a donor now must file Form 8283 for each item of donated property with a value in excess of $500. On the Form, the charity certifies whether the property will be put to a related use.

  - If so, the donor should ask the charity to agree to make a "certification" to the IRS if the property is later sold (see below).

- The charity should also sign the Taxpayer's Form 8283, which 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 Return) with the IRS and give the donor a copy of that form."

- If the charity in fact sells the work of art within 3 years of the date of contribution, it must file a Form 8282, and the donor's charitable contribution deduction is subject to recapture.[12]

  - Recapture is avoided if the donee charity makes a certification in accordance with Section 170(e)(7)(D).

  - A "certification"[13] 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

[11] Regs. 1.170A-4(b)(3)(ii)(b)
[12] IRC Section 170(e)(7)(A) and 170(e)(7)(B)(ii).
[13] IRC Section 170(e)(7)(D).

related use at the time of the contribution but that the intended use has become impossible or infeasible to implement.

- If the IRS asserts that the property was not in fact used for a related purpose, the charity may also make a certification stating that the use of the property by the charity was related to the purpose of the charity's exemption and describing exactly how the property was used and how the use furthered the charity's exempt purpose.

- *Related Use Penalty*.[14] Any person who identifies applicable 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 is subject to a $10,000 penalty.

- There have been few litigated cases regarding related use, but several Private Letter Rulings show the IRS is somewhat lenient when interpreting whether a use is related:

  - 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.

  - PLR 8009027. Related use rule was not satisfied where donor gave an antique car to a university, since the university did not offer a course in antique car restoration.

  - PLR 8143029. Related use requirement met when donor gave his collection of porcelain art objects to a public charity operating a retirement center, since the display of art was related to the charity's purpose of creating a comfortable living environment for its residents.

  - PLR 9833011. Related use rule was satisfied when donor gave paintings to a Jewish community center that had an arts wing and library.

4. Type of Charitable Organization

[14] IRC Section 6720B.

The type of charitable organization that receives the donated art will have bearing on the amount of the donor's charitable deduction.

- Public Charities. Public charities generally receive part of their support from the general public. IRC Section 509(a).
  - Typically, public charities include churches, schools, hospitals and museums.
  - A charity's status can be verified by checking IRS Publication 78.
- Private Operating Foundations are described in Sections 170(b)(1)(F)(i) and 4942(j)(3). A private operating foundation is typically funded by one donor or family. Unlike private foundations, it uses its assets and directly makes expenditures for the active conduct of activities related to its exempt purpose.
  - The donation of a residence and all of the donor's works of art contained therein to be used as a museum that is open to the public could be a private operating foundation.[15]
- Private Foundations do not typically use their assets to directly further an exempt purpose; instead, they make grants to public charities or private operating foundations.

5. Percentage Limitations

- For contributions of cash and ordinary income property to a public charity or private operating foundation, the charitable deduction is limited to 50% of the taxpayer's contribution base. Section 170(b)(1)(A).
- For contributions of cash and ordinary income property to a private foundation, the charitable deduction generally is limited to 30% of the taxpayer's contribution base. Section 170(b)(1)(B).
  - "Contribution base" means adjusted gross income computed without regard to any net operating loss carryback to the taxable year under Section 172.
  - The amount of the charitable deduction for

[15] See Regs. 53.4942(b)-1(d), Example 1.

ordinary income property is limited to the basis of the property in the hands of the donor (taking into account the percentage limitations discussed above).

- For contributions of capital gain property to a public charity or private operating foundation where the related use test is met, the charitable deduction is permitted to the full extent of the fair market value of the property, but not in excess of 30% of the taxpayer's contribution base. Section 170(b)(1)(C)(i).

- If the related use rule is satisfied, the taxpayer may elect to increase the 30% limitation to 50% of his or her contribution base, but the election limits the deduction to the donor's cost basis.[16]

    - Thus, the election should only be made when there is very little appreciation in the property, such as when the capital gain property is received from a testamentary disposition.

- For contributions of capital gain property to a private foundation, the deduction is generally limited to 20% of the taxpayer's contribution base, and the deductible amount is the donor's basis in the property contributed.

- Any amount of charitable contribution in excess of the 50%, 30% or 20% limitations may be carried forward for 5 years.

B. Gifts of Partial Interests

1. Section 170(f)

Generally, a charitable contribution deduction is disallowed for a gift of a partial interest in property not in trust. Section 170(f)(2) and (3). A partial interest is defined as an interest that is less than the donor's entire interest unless the property falls within a specific statutory exception.

- A contribution of the right to use the property for a period of time is considered a partial interest.

    - For example, a donor cannot retain a life estate and contribute the remainder interest in a work of art to charity and receive a current charitable contribution

[16] IRC Section 170(b)(1)(C)(iii).

deduction.

- Section 170(f)(3)(B)(ii) provides an exception for the outright contribution of an undivided portion of the donor's entire interest in the property.
    - This exception is of great significance to collectors and heirs of artists who own fractional undivided interests in artwork.
    - Allows for contribution of vertical divisions (i.e., a 40% tenant in common interest in a painting), but not horizontal divisions (i.e., a retained life estate with remainder to charity, or a donation of the work of art with retained rights to the copyright) of art to charity.
- *Winokur v. Comm'r*, 90 TC 733 (1988), acq. 1989-2 C.B. 1. In *Winokur*, the taxpayer gave the Carnegie Institute a 10% undivided interest in 44 works of art by Scandinavian artists, and another 10% undivided interest the next year. The Carnegie Institute did not exercise its right to take physical possession of paintings for its share of the year.
    - The IRS argued that the museum's right amounted to a future interest in the art, which is not deductible under Section 170(f).
    - The Tax Court held the taxpayer is entitled to a charitable contribution deduction equal to 10% of the fair market value of the contributed art. It was sufficient that the museum had the right to claim possession for its proportionate share of the year.
- As a result of *Winokur*, taxpayers could have their deduction and keep their art too.
    - In addition, having the art partially owned by a renowned museum often provided an added bonus of increasing the value of the art between the year of the first gift and the year of the second gift.

2. Pension Protection Act of 2006

The Pension Protection Act of 2006 effectively shut down the *Winokur* party by adding Section 170(o), which generally disallows a charitable deduction for an undivided portion of a donor's entire interest in art (or any tangible personal property) unless:

- The donor or the donor and the donee held all interests in the property immediately before the contribution.

- Section 170(o)(3) imposes recapture of the charitable contribution deduction if:

    - (1) the donor does not contribute all the remaining interest in the property to the donee (or, if the donee no longer exists, to another public charity) before the earlier of the donor's death or 10 years from the date of the initial contribution, or

    - (2) 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 during the period beginning on the date of the initial fractional contribution and ending on the date described in (1).

- In addition to recapture, a 10% penalty is imposed in the year of recapture.

- The contributor'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 an interest in the same work of art, the value is limited to the lesser of:

    - The value used for determining the charitable deduction for the initial fractional contribution or,

    - The fair market value at the time of the subsequent fractional contribution.[17]

- Because of the timing limitation, the donor should update his or her Will or Revocable Trust to leave the donor's remaining interest in the work to the charitable donee at death.

    - Generally, before a museum will accept a fractional interest gift, it will want assurances that it will receive the balance of the undivided interest when the donor dies, so that it does not have to negotiate with the heirs over the fractional interests.

    - Discuss fractional interest gifts with the

[17] IRC Section 170(o)(2).

museum before making them.

- Although the Pension Protection Act of 2006 greatly reduced the desirability of fractional interest gifts, the technique may still be useful for a collector who owns a very valuable work of art and wants to spread the contribution deduction over a period in excess of 6 years (year of donation plus the 5-year carry forward). The fractional interest technique allows the gift to be deducted over as many as 12 years.

3. Contributions of Copyrighted Property

Copyright ownership is treated differently for income and estate tax purposes.

- Under income tax rules, a work of art and a copyright are treated as two interests in the same property, rather than two separate property interests.

- Thus, a donor who owns both the work of art and the copyright to the work must donate both the art and the copyright to receive an income tax charitable contribution deduction.

- Failure to donate both items is treated as donating only a partial interest in the property under Section 170(f)(3) and no charitable contribution deduction is permitted.

- Typically, only artists own copyrights in their works. Because the charitable contribution deduction of the creator of a work of art is already limited to his or her cost to produce the work, this rule has little practical effect for the artist.

    - It still may be desirable to donate the artwork with no charitable deduction and retain the copyright in the work.

- This rule does not apply for gift and estate tax purposes, where the work and the copyright are treated as two distinct properties. Section 2522(c)(3) and 2055(e)(4).

C. Split Interest Charitable Trusts

1. Selling Art to Fund Annuity Interest

Generally, a charitable remainder trust ("CRT") can be funded with art only if it is also funded with sufficient cash or marketable securities to make the annuity or unitrust

payments, OR, if the Trustee is instructed to sell the donated property.

If the collector or artist wants to sell a work of art without incurring a capital gains or ordinary income tax hit, he or she should consider funding a CRT with the artwork. As a charitable organization, the trust will not be taxed when the work is sold (unless there is UBTI), and the collector or artist or his or her designated beneficiary will receive a stream of annuity payments in exchange, together with a possible charitable income tax deduction.

- The CRT can sell the artwork upon receipt, and the gains will not be taxable to the charity or the donor, except to the extent the gains are paid out to the donor or non-charitable beneficiary as unitrust or annuity payments under Section 664(b).

- While contributions of art to a CRT are eligible for the gift tax charitable contribution deduction, no deduction is allowed to the donor for income tax purposes until all intervening non-charitable interests expire or are no longer held by the donor or a related person. Section 170(a)(3).

    - Accordingly, when a collector transfers a painting to a charitable remainder trust, if the donor or a related person is the non-charitable annuitant of the trust, the charitable income tax deduction is postponed until the art is sold by the Trustee to an unrelated third party. See PLR 9452026.

    - The donor's income tax charitable contribution deduction will be the value of the remainder interest at the time of the sale.

- The charitable remainder beneficiary may purchase the art, but this should not be agreed upon in advance. If the trust is legally bound or can be compelled to complete a sale, the IRS will treat such sale as income to the donor.[18]

- The CRT's sale of the art is an unrelated use, so the income tax charitable deduction will be limited to the donor's cost basis allocable to the remainder

[18] See *Palmer v. Comm'r*, 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.

interest.[19]

2. Flip CRUT

A Flip CRUT could be particularly useful, especially if you are not sure how long it will take to sell the artwork after it is transferred to the Trust.

- A Flip CRUT is a NIMCRUT that "flips" to a fixed percentage trust after a triggering event.
    - A NIMCRUT is a type of CRUT that sets the unitrust payment as the lesser of the trust's net income (which would be zero if it only owned art that was producing no royalties) or the unitrust amount, and that allows the trust to "make-up" for the difference between the net income paid (i.e., nothing) and the unitrust amount in later years when the net income exceeds the unitrust amount.
- So, you can allow the trust to make no distributions to the non-charitable annuitant until the work of art is sold, and the sale can be the triggering event that "flips" the NIMCRUT into an "old-fashioned" unitrust, which, in today's market, is likely to give the noncharitable beneficiary a greater payment than would net income alone.
- If there is no anticipated sale of the work at the time of contribution, then it is a good idea to do either a Flip CRUT or fund the trust with cash and/or securities that can be used to pay the income interest.
- Caution in funding a NIMCRUT or a Flip CRUT: For income-only CRTs, the special valuation rules of Section 2702 will apply unless (1) there are two consecutive noncharitable beneficial interests and the transferor holds the second interest or (2) the only permissible recipients of the unitrust amount are the donor, the donor's U.S. spouse or both the donor and the donor's U.S. spouse.

3. Traps for Unwary

- *Domestic Charity*. While the gift tax rules permit a gift and estate tax charitable contribution deduction for gifts made to foreign charities, Section 664 split interest trusts must name a domestic charity in order to qualify for the income tax charitable contribution deduction.

[19] PLR 9452026. See also Regs. 1.170A-4(b)(3)(i): "The use by a trust of tangible personal property contributed to it for the benefit of a charitable organization is an unrelated use if the use by the trust is one which would have been unrelated if made by the charitable organization."

- *Independent Trustee*. Typically, a grantor may serve as the Trustee of his or her own charitable remainder trust, but where the trust 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.[20]

- *Accidental Creation of UBTI*. The CRT allows the artist to sell his or her works without incurring income tax, so long as the trust does not have UBTI.[21]

    - Section 512(b)(5) excludes from UBTI all gains and losses from the sale of property, other than properly includible in inventory and property primarily for sale to customers in the ordinary course of a trade or business.

    - Art is properly included in inventory when it has been offered for sale to customers. So, it is important for the artist to fund the trust with a work or works of art that have never been offered for sale.

D. Charitable Gift Annuities

A charitable gift annuity is a simple contract in which a donor and/or his designated beneficiary is provided with a stream of fixed payments for life in exchange for his or her donated gift. They are sanctioned by IRC Section 501(m)(3) and (m)(5), and are further described in IRC Section 514(c)(5).

- Many public U.S. charities offer a charitable gift annuity in exchange for contributed property, such as works of art.

    - Note, however, that some states, such as New York, do not permit gift annuities to be funded with tangible personal property.

- The annuity must be payable to the donor or his or her designated beneficiary over life, as Section 514(c)(5)(C) requires that the annuity contract cannot guarantee a minimum or specify a maximum amount of payments.

- The value of the annuity must be less than 90% of the value of the property received by the charity.

- The annuity can be paid over one or two lives in being, such as the donor and the donor's spouse.

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[20] Regs. 1.664-1(a)(7).

[21] Regs. 1.664-2(d) and 1.664-3(d) contemplate the contribution of ordinary income property to CRTs by referencing Section 170(e)(1)(A) and the regulations thereunder for the applicable rules. LOOK UP.

- Income and gift tax charitable deductions are permitted for the difference between the value of the annuity and the value of the contributed property.

- A charitable gift annuity is a form of bargain sale – part gift and part sale to the charity.

- A portion of each annuity payment may not be subject to income tax for a number of years, and a portion may generate income for the annuitant, the character of which depends on whether capital gains or ordinary income property is contributed.

III. TESTAMENTARY CHARITABLE GIFTS

A testamentary transfer of art to a tax exempt organization saves the decedent's estate a great deal in estate taxes and headaches by removing an illiquid, difficult to value, and often unwanted (from the heirs' perspective) asset from the estate.

A. Formation of Charitable Foundation

The artist or collector may want to form a foundation during life or at death. The benefit of establishing the foundation during life is that the client can play an active role in its administration, and then additional works may be contributed at death. The client may want to form a private, grant-making foundation or a private operating foundation.

1. Operating Foundation

If the client wants to open his house up as a museum (preferably after death), this may qualify as a private operating foundation.

- If the donor turns his house into a museum while living, the donor would have to move to a new residence, as any personal use of the contributed assets after the donation has been made can result in denial of tax-exempt status.[22]

- Could convert a vacation home into a museum at death or while living, so long as the home is no longer used as a residence after the contribution is made.

- May require re-zoning of the property.

2. Private Foundation

There is no 20% limitation on gifts of art to a private foundation at death. The estate tax charitable

[22] See, e.g., Rev. Rul. 74-600.

contribution deduction generally covers the full fair market value of the property contributed to a private foundation at death.

- In addition, there is no requirement that the art be used in a manner related to the foundation's purpose.

- An outright testamentary transfer of the artist's or collector's art to a private foundation allows the art to be kept together as a unit and eliminates the problem of raising money to pay the estate taxes attributable to the inclusion of illiquid art in the gross estate.

B. Bequests to Existing Charities

- Before making a charitable bequest of art in a Will, make sure the charity will accept the work.

- If the donor wants to remain private and not reach out to the charity, then give the Executor the power to make alternate dispositions to other charities if the named charity will not accept it.

IV. SPECIAL RULES FOR COPYRIGHTS

A. Related Use and Testamentary Transfers

Often, an artist will transfer ownership of an artwork to a charity at death, but give his or her family the interest in the copyright.

- The US Copyright laws treat a work of art and the copyright as two separate property interests, but the tax regulations have always treated works of art and copyrights therein as two interests in the same property.

- 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 bequeathed to the charity, due to the inability to receive a charitable deduction for split interest gifts.

- While the income tax rules are unchanged, the estate and gift tax rules were changed in 1981 to treat the work of art and the copyright as two separate property interests, but only in certain cases.

- 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 "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.[23]

- If the contribution is qualified, the estate will be entitled to a charitable deduction for the value of the art, and the value of the copyright will be included in the artist's estate.

- Unrelated use will cause the painting and its copyright to fall outside Section 2055(e)(4) and be treated as one property for which the estate tax charitable contribution deduction will be denied under the partial interest rules.

- This is a huge trap, and is best illustrated by the following example:

  - The Will of an artist bequeaths "my painting entitled 'XYZ' to the ABC Church. All the rest and residue of my property of any kind I bequeath to my son."

    - The artist owned the copyright at the time of his death (copyrights come into existence when the original work is created).

    - Under state law,[24] the copyright probably passes with the residue.

    - If the ABC Church cannot satisfy the related use rules, the estate tax charitable contribution deduction is denied.

  - A provision that bequeaths "all my right title and interest in and to" the work of art may not be sufficient to transfer the copyright to the charity.

  - The best course of action is to specifically include the copyright with the bequest of the art, unless the testator is certain that the charity's use of the art will be related to its exempt purpose.

[23] IRC Section 2055(e)(4)(C).

[24] Regs. 20.2055-2(e)(1)(ii)(e), Ex. 1. makes clear that the IRS looks to state law to determine whether the copyright was transferred with the art.

- The collector typically purchases art without the copyright, since the artist retains the copyright unless it is specifically transferred in writing.

- If the collector does not own the copyright to the work of art, he or she does not have to be concerned with the related use requirement of Section 2055(e)(4).

B. Right of Termination

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.[25]

- Under the Copyright Act of 1976, the artist has a right to terminate any inter vivos (but not testamentary) transfer or license of a copyright or of any of the separate rights therein.[26]

- If the artist exercises the termination right, he or she can terminate the transfer and get back the copyright.

- 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.[27]

    - The artist must give notice of termination, and the notice must specify a termination date that falls within the 5 year window.

    - 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).

- If the artist dies before exercising the termination right (that is, 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.[28]

    - 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.[29]

[25] 17 USC Section 302(a). Works created prior to 1978 are subject to different copyright rules and are beyond the scope of this outline.
[26] 17 USC Section 203(a).
[27] 17 USC Section 203(a)(3).
[28] 17 USC Section 203(b)(2).
[29] 17 USC Section 203(a)(2)

- Only those individuals who hold a majority of the termination rights can exercise the notice of termination (i.e., spouse plus one child).

- The artist has no ability or right to change this statutory design by estate planning documents.

- Techniques exist to avoid the forced heirship of the termination right.

  - If the artist is able to give notice before he or she dies, the termination will continue to take place on the notified date and the forced heirship rules will not come into effect.[30]

  - If the planning is being done before the notice period arises, the artist can include an *in terrorem* clause in the will to provide that a beneficiary who attempts to exercise a termination right (or who fails to exercise a termination right, depending on the artist's wishes) will have no right to receive further distributions from the estate.

V. VALUATION ISSUES

Valuing works of art is difficult, given the subjective aesthetic judgments involved and the fickle favor of critics, collectors and the general public. Knowing the value of a collector's or artist's work of art is imperative in the following situations[31]:

- For income tax purposes if the art is transferred during life to a charitable donee;

- For gift tax purposes if the art is transferred during life to a non-charitable donee;

- For estate tax purposes if the art is owned at death; and

- For property insurance purposes (appraisal is required to determine premiums for coverage).

A. Appraisal Requirements and Penalties

1. Income Tax Valuations

- For the deduction of an item with a value in excess of $5,000, the Regulations require a qualified appraisal, made not more than 60 days before the date of contribution, to be attached to the income

[30] 17 USC Section 203(b)(2).

[31] Lerner, "The Last Picture Show: What Should Be Done With Artwork", Heckerling Institute, January 2012.

tax return.[32]

- The $5,000 amount applies to a single item of property or to a collection of similar items of property donated in one calendar year, such as a set of coins, stamps, lithographs or books.

- The aggregation rule applies whether all the items are donated to one charity or to two or more charities.

- *Important*: The appraisal is required even if the donor is the artist contributing ordinary income property, or if the donor is contributing capital gains property to a private foundation, where the charitable contribution deduction is limited to basis.

    - This is likely because the deduction is measured by the fair market value of the property, reduced by the amount that would be ordinary income, short term or long-term capital gain (as the case may be) if the property were sold.

- A "qualified appraiser"[33] is an individual who holds himself or herself out to the public as an appraiser and who is an expert as to the particular type of property being valued, who understands that he or she will be subject to civil penalties under Section 6701 for fraudulent misstatements of value, and penalties under Section 6695A for gross misstatements of value, and who is completely independent of the donor.

    - The dealer who sold the donor the artwork cannot be the appraiser, nor can any employee of that dealer.

    - Often times, auction houses offer appraisal services. Do not use the auction house that sold the donor the artwork as the appraiser.

    - The Pension Protection Act of 2006 also requires the qualified appraiser:

        - to have earned an appraisal designation from a recognized

[32] Regs. 1.170A-13(c).
[33] Regs. 1.170A-13(c)(5)(i).

professional appraiser organization;

- to have verifiable education and experience in valuing the type of property subject to the appraisal; and

- to have not been prohibited from practicing before the IRS at any time during the three-year period ending on the appraisal date.[34]

▪ The donor must now check the credentials of the appraiser to ensure the appraiser is an expert in the item being appraised. The donor may need different appraisers for donations of an Impressionist painting and a contemporary sculpture.

▪ 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.

o Completion of Form 8283 will satisfy the appraisal summary requirements.

▪ The Instructions to the Form no longer require that an 8" x 10" color photograph (or a transparency no smaller than 4" x 5") be attached, but the photograph must be made available to the IRS upon request.

▪ The Form 8283 must be signed by the appraiser and the charitable donee.

▪ The Instructions also provide that the donor must provide the charitable donee with a copy of the qualified appraisal.

o The charitable donee must also file Form 8282, Donee Information Return (Sale, Exchange or other Disposition of Donated Property), notifying the IRS of any sale or exchange of the gifted property within three years of the date of the gift.

o *Penalties*. Thresholds were made more strict under the Pension Protection Act of 2006:

▪ A "substantial valuation misstatement" occurs if the value is overstated by 150% or

[34] IRC Section 170(f)(11)(E)(ii).

more, in which case a penalty of 20% of the underpayment of tax is added to the tax, but only if the underpayment exceeds $5,000[35] (formerly, the threshold was a 200% overstatement).

- 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[36] (formerly, the threshold was a 400% overstatement).

- The "substantial valuation misstatement" penalty can be waived if there is reasonable cause for the underpayment and the taxpayer shows he or she acted in good faith.[37]

    - The "reasonable cause" requirement can be satisfied if the claimed value was based on a qualified appraisal by a qualified appraiser.[38]

    - To satisfy the "good faith" requirement, the taxpayer should keep a diary or write a memorandum about his or her personal investigation into the value of the property.

- The "gross valuation misstatement" penalty cannot be waived.[39]

2. Estate and Gift Tax Valuations

If a decedent's estate includes household and personal effects articles having "marked artistic or intrinsic value of a total in excess of $3,000", an appraisal of an expert, under oath, must be submitted with the return.[40]

- The appraiser must be reputable and of recognized competency to appraise the particular class of property involved.

    - Unlike income tax rules, estate and gift tax rules do not require a qualified appraisal by a qualified appraiser.

[35] IRC Section 6662(e)(1).
[36] IRC Section 6662(h)(1).
[37] IRC Section 6664(c)(3).
[38] IRC Section 6664(c)(3)(A) and (B).
[39] IRC Section 6664(c)(3).
[40] Reg. 20.2031-6(b).

- For appraisals of paintings, the size, subject and artist's name must be stated.

- *Penalties*[41]:

  - If the value claimed on the return is 50% or less of the value determined to be the correct value, a penalty of 20% of the underpayment of the tax is imposed, but only if the underpayment of tax exceeds $5,000.

  - If the value claimed on the return is 25% or less of the value determined to be the correct value, a penalty of 40% of the underpayment of the tax is imposed.

  - The IRS has discretionary authority to waive all or part of the Section 6662 penalty if the taxpayer establishes a reasonable basis for the claimed value and the claim was made in good faith.

3. Art Advisory Panel

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.[42]

- In 2011, the IRS changed the threshold for works of art that are subject to review by the Art Advisory Panel from $20,000 to $50,000. Not all of the IRS publications have been updated to reflect this change.

- The Panel consists of 25 nationally prominent art museum directors, curators, scholars, art dealers, auction representatives, and appraisers.

- The Panel meets once or twice a year for one day, and reviews hundreds of works per session.

- To ensure objectivity, the Panel is not told whether the appraisal was for an income tax charitable contribution deduction or for estate or gift tax purposes.

- The Office of Art Appraisal Services provides staff support and coordination of the Panel's functions.

[41] IRC Section 6662(g)(1)
[42] See IRM 4.48.2 and IRM 8.18.1.3.

- The Panel members, after reviewing photographs or color transparencies, along with relevant documentation provided by the taxpayers and research by the staff appraisers, make recommendations on the acceptability of the claimed values. If unacceptable, the Panelists make alternate value recommendations. Such recommendations are advisory only; however, after review by the Office of Art Appraisal Services, these recommendations generally become the position of the Service.

    - But see, *Mitchell Estate v. Comm'r*, TC Memo 2011-94. The Estate of James J. Mitchell (son of the co-founder of United Airlines) distributed a Frederic Remington painting and a Charles Russell painting to non-charitable beneficiaries. The IRS discounted the evidentiary value of appraisals made by the Art Advisory Panel and asserted appraised values nearly double what the Art Advisory Panel and estate's attorney claimed. The Court sided with the estate's values, which were within the range of the Art Advisory Panel's recommendations.

- *Reconsideration of Value Determinations*. If agreement cannot be reached with the taxpayer, further assistance may be requested of the Panel and the Office of Art Appraisal Services.

    - The taxpayer may request reconsideration of an adjusted claimed value only if the taxpayer provides additional evidence such as comparable sales data or other relevant facts to support the fair market value opinion.

    - The taxpayer's request must respond specifically to the report issued by the Art Appraisal Services Office.

    - The taxpayer's request for reconsideration is rarely successful.

B. Special Valuation Issues

1. Deductions for Expenses of Sale

Fair market value ("FMV") is the price paid by the buyer to the seller, not the amount ultimately received by the seller.

- Thus, deductions for selling expenses (including the expense of auctioneer) are permitted only to the extent the sales are necessary to pay the decedent's debts, expenses of administration or taxes, or to preserve the estate or "effect distribution".[43]

    - If the sale is necessary and is made to a dealer at a price below fair market value, the estate can deduct the difference between the sales proceeds and the FMV as of the relevant valuation date, or the difference between the sales proceeds and the FMV as of the date of sale, whichever results in a lower deduction.

- *Publicker v. Comm'r*, 206 F.2d 250 (3rd Cir. 1953), cert. denied, 346 U.S. 924 (1954) is the most often cited case in this field for the principal that the sale price establishes fair market value, not the proceeds received by the seller.

    - In *Publicker,* the FMV of a gift of jewelry included the excise tax paid by the seller on the sale of the jewelry.

- *Smith Est. v. Commissioner*. 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.

    - "The measure of value… is what could be received on, not what is retained from, a hypothetical sale".

- *Scull Estate v. Commissioner*, TC Memo 1994-211. 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, and not the estate, receives the buyer's premium.

- TAM 9235005. 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.

[43] Regs. 20.2053-3(d)(2).

- Art Advisory Panel apparently routinely adds equivalent of a buyer's premium to items that are retained by the estate or specifically bequeathed.[44]

Planning Tip. If the artist's or collector's Will directs the sale of the art and bequeaths the proceeds to a beneficiary or the residue, the auctioneer's commissions and other selling expenses should be deductible under Section 2053(a)(2) as expenses necessary to "effect distributions".[45]

2. Fractional Interest Discounts/Cost to Partition

Fractional interest discounts may be limited to cost to partition:

- *Stone v. U.S.*[46] The case of Robert G. Stone was the first to consider whether or not discounts based on lack of control and minority ownership are permitted for undivided partial interests in art.
  - The estate claimed a 44% discount for its undivided 50% interest in 19 paintings that were left to family members. The state court reasoned that a hypothetical seller would seek to sell the entire work of art and split the proceeds or, if consent by the other owner was not granted, would bring a legal action to partition the property.
  - The 9th Circuit agreed that the discount was limited to the cost to partition, and the discount granted was only 5%.
  - The *Stone* case is a warning that art is treated differently from real estate or closely held business interests when it comes to applying discounts.
  - The planner should not assume that discounts usually available for a non-controlling interest in property will be available for gifts of art.
- The IRS interpretation of fractional gifts of art is to take the full fair market value of the work of art, multiplied by the percentage transferred.[47]

3. Relevant Market

[44] See Wolf, "Appraisals and the IRS Art Review Panel: Recent Issues," 20 Tax Mgmt. Est., Gifts, & Tr. J., 138 (May-June 1995).
[45] Regs. 20.2053-3(d)(2).
[46] Stone v. U.S., 103 AFTR 2d 2009-1379 (9th Cir. 2009).
[47] See, e.g., Rev. Rul. 57-293, PLR 9303007, PLR 200223013, PLR 200418002.

Regs. 20.2031-1(b) and 25.2512-1 require the FMV of artwork and collectibles to be determined by the sale price in the market in which the article is most commonly sold. If normally acquired at retail, the retail price would be the FMV. If normally acquired at wholesale, the wholesale (or, auction) price would be the FMV.

- The value should not be a forced sale price.
- The relevant market for most items of tangible personal property is retail and not wholesale, but the relevant market for art is somewhat blurred, and depends on the type of art, demand and supply, and whether such art is typically purchased at retail or wholesale.
    - In *Ferrari v. Comm'r*, TC Memo 1989-521, the taxpayer sought a charitable income tax deduction for his contributions of pre-Columbian art to Duke University. The Court agreed that, while auction sale prices are readily available and gallery sale prices are not made public, the relevant market is what collectors will pay to galleries specializing in the type of art at issue (thus, retail instead of wholesale).[48]
    - *Jennings v. Comm'r*, TC Memo 1988-521. Tax Court valued original Asian artwork by unknown artists for charitable contribution purposes based on their price on the secondary auction market, finding that the work could not be sold in the broad public market where works of well-known artists are sold or the primary market where dealers and individuals sell to galleries.
    - *Isaacs v. Comm'r*, TC Memo 1991-473. Taxpayer received multiple tapestries designed by Alexander Calder directly from the wholesaler and later donated them to Yale University and to another charity. The bulk purchase and bulk donation shifted the relevant market from retail to wholesale, resulting in a lower charitable contribution deduction.

4. Forgeries and Stolen Art

Even if it seems a work of art should have no value because it was stolen or is a forgery, that assumption is often

[48] See also, *Biagiotti v. Comm'r*, TC Memo 1986-460 (In another case involving contributions of Mayan art to Duke University, the Tax Court agreed that the relevant market was what collectors paid to private dealers, not sales at auction).

incorrect, unless the forgery is clear or there is no market for the stolen goods.

- *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 and 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, as did the poor quality of the painting and materials and settled on a value of $30,000.

- *Quendlinburg Treasures*. PLR 9152005. While serving in the U.S. Army during World War II, decedent was charged with guarding a medieval town in Germany. He stole several artifacts from a church there 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. His siblings were aware of the artifacts, but did not include them on the estate inventory, and did not file an estate tax return for the otherwise modest estate. When the siblings tried to sell a manuscript, they received offers ranging from $500,000 to $9M. The medieval church learned of the sale and sued.

    - The Service ruled the artifacts were included in the decedent's estate under Section 2033 and that no deduction is allowable under Section 2053(a)(3) for the claims of the theft victims, as the victims did not bring their claims against the estate during the one-year period following the issuance of letters testamentary.

    - As is the case with drug dealers who die owning massive amounts of drugs, no distinction is drawn between lawfully and unlawfully received property for estate tax purposes.

    - Fair market value for the stolen goods is still based on the price a hypothetical willing buyer would pay a willing seller, even if the market is illicit.

C. Blockage Discount

An artist or collector may have built up a very large inventory of works. In this situation, the courts have sometimes allowed a "blockage discount" from the aggregate retail value of the

individual works. The blockage theory for works of art is based on the same theory for the value of stocks – that a large number of similar works of art coming on the market at one time will depress the value of all the items. Regs. 20.2031-2(e) and 25.2512-2(e).

- Courts have recognized that the art collection would need to be sold over considerable time to obtain what would be fair market value prices in the relevant market.

- *Smith Estate v. Comm'r,* 57 TC 650 (1972) was the first case that applied the blockage discount to art.

  - David Smith died with an inventory of 425 abstract sculptures. He 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 had known how many were available for sale, the price would have dropped significantly.

  - 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.

  - 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 the 10-year period envisioned by the estate as necessary to liquidate Smith's works.

  - The Court agreed that if all 425 works of art were offered to the market at the same time, there would be an impact on the sales price of the works. It applied a blockage discount of 37%.

- *Calder v. Comm'r*, 85 TC 713 (1985) presented issues unique to gift taxes.

  - The widow of Alexander Calder made gifts of gouaches to what was essentially six separate trusts, one for each of her two daughters, and one for each of her four grandchildren. The trusts for the daughters

received approximately 300 gouaches each, and the trusts for the grandchildren received approximately 150 gouaches each.

- At Calder's death, his estate reported the value of 1,292 gouaches with a blockage discount of 60% and the Service accepted this position.

- Calder's widow used the same discount on the gift tax return, but the Service argued that each of the six gifts should be viewed independently of the other, so rather than placing over 1,200 paintings on the market at once, it was now only 300 or 150.

- The Court agreed, citing the gift tax regulations for blockage discounts of stock,[49] which state: "if the donor can show that the block of stock to be valued, *with reference to each separate gift*, is so large …".

- Court considered how many years it would take to sell each work, and reduced the future proceeds to present value to determine fair market value.

- *O'Keeffe Estate v. Comm'r*, TC Memo 1992-210.

  - In *O'Keeffe*, the experts agreed on the fair market value of the artwork but disagreed on the appropriate blockage discount.

  - At Georgia O'Keeffe's death, her estate owned approximately 400 of her works of art, of which 80 pieces were the subject of specific bequests, and the rest were part of the residuary of O'Keeffe's estate.

  - The IRS argued that the blockage discounts did not apply to the bequeathed art, as there was no need to sell these paintings.

  - The Court affirmed that fair market value 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.

  - The Court reasoned that O'Keefe's works should be divided into two categories and

[49] Regs. 25.2512-2(e).

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.

- *In re Warhol Estate*, No. 824/87, (Sur. Ct. NY Co. 1994)
  - Surrogate Court of New York rejected the proposed discounts of Christe's, which averaged 60%. Instead, the court applied an average discount of 25%.
  - The court failed to articulate the specific rationale for its determination, but did state that Warhol was more famous than Smith & O'Keeffe.
  - The court's application of an average discount of 25% has been criticized because it ignored the necessary time it would take to sell 90,000 pieces of art.
- Income Tax Rules: The IRS Valuation Guide[50] 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.
  - This should sit well with the taxpayer, who seeks the highest possible value for income tax deductions.

D. Advance Valuation Ruling

Rev Proc. 96-15[51] instituted a procedure where a taxpayer may, 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, gift or estate tax return.

- A taxpayer may rely on the Statement of Value if it is issued to that taxpayer and the representations on which the Statement was based are accurate statements of the material facts.

[50] IRS Valuation Training for Appeals Officers, Coursebook (1997). Lesson 5, Valuation of Art Objects and Collectibles, 5-12 and excerpt in worksheets. UPDATE?.
[51] 1996-1 C.B. 627.

        - If the taxpayer disagrees with the Statement of Value, the taxpayer may submit with his or her return additional information in support of a different value.

    - To request a Statement of Value, the taxpayer submits a user fee of $2,500 for the first 3 items ($250 for each additional item) to the IRS along with an appraisal that was prepared no earlier than 60 days prior to the valuation date. The appraisal must state the specific basis for the valuation, include a professional quality photograph of a size and quality fully showing the item, preferably an 8" x 10" color photograph or a color transparency not smaller than 4" x 5" inches, and give a complete description of the item of art, including:

        - Name of the artist
        - Title or subject matter
        - Medium, such as oil on canvas, or watercolor on paper
        - Date created
        - Size
        - Any marks, signatures, or labels on the item of art, on the back of the item of art, or affixed to the frame
        - History (provenance) of the item including proof of authenticity, if such information is available,
        - Record of any exhibitions at which the item was displayed
        - Any reference source citing the item
        - Physical condition of the item.

    - For estate and gift tax purposes, the request must be accompanied by a statement that the appraisal was prepared for estate tax purposes or gift tax purposes, the date on which the item of art was appraised, and the appraised FMV.

    - For income tax purposes, the requested must be accompanied by a completed appraisal summary that meets the requirements of Regs. 1.170A-13(c)(4).

VI. PLANNING FOR DEATH

A. Inventory of Works

It is imperative for both artists and collectors to keep a running inventory of their works and files with information about each work. This information is invaluable with respect to the registration of copyrights, challenging fakes, and reporting lost or stolen works.

- Inventory should list the name of each work and the date it was created and fixed in a tangible medium.
- Note the medium, dimensions, and give a narrative of the artist's process in creating the work, any special meaning or symbolism attributable to the work, etc., as this type of historical information aids the sale process later.
- Record the expenses incurred in creating the work in order to determine the artist's income tax basis.
- Keep a price list with suggested retail and wholesale prices of unsold works.
- 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 thereon), pledged, gifted, or otherwise transferred and, if so, when, where, and to or with whom.
- 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, etc. and all licenses.
- 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.
- If the work is stolen, note the circumstances of the theft.
- If a work was produced in a limited edition of multiple copies, the inventory should state how many copies were produced and whether the plate or cast was destroyed.
- Include appraised values for insurance purposes.
- 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.

Collectors should keep detailed records of purchases, including the name of the seller, the date and place of the purchase, and the consideration paid.

- Prior to a purchase, the collector should ascertain the work's provenance and make reasonably diligent inquiries as to whether the work has been reported as lost or stolen, whether it was lawfully imported and exported, and whether it is genuine.

B. Provisions for Estate Planning Documents

- Financial Power of Attorney: Should expressly authorize the attorney-in-fact to deal with all copyright matters and the works themselves, including the negotiation of contracts, arrangements with dealers, etc.
    - If the artist intends to exercise the termination interest in a copyright so that it will pass through his or her estate, the attorney in fact 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 of the work.
- Will or Revocable Trust:
    - If art is extremely valuable, separate it from the standard distribution of tangible personal property outright to children.
        - Have the art added to the residuary estate, bequeath it to a trust, or mandate that it be sold and the proceeds added to the residuary.
    - If art is to be sold at death, state so, and indicate that the commissions and fees for selling the works will be deductible for estate tax purposes.
        - Consider giving children or other heirs a right of first refusal or option to buy items of art from the estate.
        - An option is particularly important if the art or the proceeds is bequeathed to a private foundation 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.[52]

- If art is bequeathed to one beneficiary and an equalizing payment of cash is made to another, specify whether the blockage discount or partial interest discount should be applied in valuing the art.

- Tax Apportionment Clause: if an artist or collector specifically bequeaths a valuable work of art to a non-charitable beneficiary, specify who will bear the burden of the estate tax attributable to such bequest.

- Specifically address copyrights, and whether the copyrights should pass with any art that is specifically bequeathed.

    - 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 the spouse and descendants to provide notice and terminate the rights or risk application of an *in terrorem* clause.

C. *Appointing an Art Executor*

Often, the artist's or collector's spouse or children don't have the requisite knowledge, experience or interest to plan for the disposition of the decedent's art at death. In this case, the client should consider appointing an Art Executor who will assemble the works, develop, sell, exhibit, market or otherwise promote the works as appropriate, determine which could be sold for a reasonable price in the short term, which should be held to generate interest, and which should be discarded.

- The Art Executor should also be given authority over all copyright matters.

- The Will or trust should state who bears the expense of the art executor's work (residuary beneficiaries, etc.)

- See *In re Warhol Estate*, 629 N.Y.S.2d 621 (N.Y. Sur. Ct. 1995). Duties of art executor included:

    - Sale and transfer of all art;

    - Consider the effect of sales on the overall

[52] Regs. 53.4941(d)-1(b)(3).

value of the estate and the value of the other assets (which consisted of 75,000 pieces of his art, his personal art collection of 10,000 pieces, diaries, films, trademark and licensing rights);

- The authentication, appraisal, securing and insuring of art;
- Negotiations for a retrospective of Warhol's art at the Museum of Modern Art, later shown around the world, which would be critical to insuring Warhol's status in the fickle and fluctuating art market;
- Negotiations for the auction of his works;
- Negotiations for contracts for publication of Warhol's diaries and the right to exploit his images;
- Forming the Andy Warhol Foundation and a museum devoted to Warhol;
- Opposing substantial claims of ownership of Warhol art;
- Collecting insurance for art lost by Museum of Modern Art.

- The Trust or Will should make clear whether or not the art executor is simply an advisor or an actual executor. If the Art Executor is to be an actual executor, make it clear that the fiduciary has the power to act in his or her sole and absolute discretion with respect to the property at issue, even if over the objections of the other fiduciaries.
- Determine whether the Art Executor should be entitled to commissions.
    - Because the commissions from sales of art typically are not netted from the value of the art for estate tax purposes, an Art Executor could be particularly helpful in this regard.
    - If the decedent's art dealer is the Art Executor, the estate may pay the Art Executor a commission that is reasonable or permissible under state law in lieu of a standard commission agreement between the dealer and the seller.

- In the estate planning process, the attorney should review existing agreements with the dealers, agents and galleries, with a special focus on whether those contracts will terminate or continue after death.

- If an art dealer or fellow artist is to be appointed as Executor or Trustee, the document should excuse possible conflicts of interest (but only if the artist trusts the conflicted fiduciary).

  - The case *In re Rothko*[53] is a cautionary tale for artists or collectors and their fiduciaries.

  - Mark Rothko's will appointed three executors: One was his dealer and the owner of the prominent Marlborough Gallery, one was a struggling artist friend of Rothko's, and one was a friend and professor of anthropology at Fordham. The dealer acted quickly and within one month had contracted to sell 798 works of art by Rothko to a corporation controlled by him. For going along with the plan, the struggling artist was offered a show of his work and representation by Marlborough Gallery. The professor orally objected to the proposed sales and hired his own attorney.

  - All three were fined and removed as executors. 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."

VIII. ESTATE ADMINISTRATION

A. Initial Steps

- Executor should make sure all works are insured and inventoried.

  - The executor should obtain a rider to any existing insurance policy covering the interests of the estate and the beneficiaries.

- Ensure art is securely stored.

[53] 43 N.Y.2d 305, 372 N.E.2d 291, 140 N.Y.S.2d 449 (1977).

- The court in *In re Warhol Est.*, 629 N.Y.S.2d 621, 627 (N.Y. Surr. 1995) commended the Executor for securing Warhol's home on the day of his death and not losing a single object to theft or misplacement, noting that the home contained over $100 million of valuable objects and people were seeking entry to claim ownership of objects from the day of Warhol's death forward.

- Copyright Records. Any records regarding copyrights, transfer of copyrights, licenses, registration, renewals, and exercise of termination rights should be obtained, reviewed and logged.
    - A log should be kept of when future termination rights can be exercised and by whom.
    - Termination rights generally should be exercised at the earliest possible date.
    - An agency or attorney may be retained to protect, manage and exploit the copyright and other intangible interests of the artist, such as his or her trade name and any rights of publicity.

- Marshaling Assets. If works of art are on loan to a museum or other location, the executor should notify the borrower of the estate's intent to preserve its interest in the works and, if appropriate, demand return of the works.
    - Otherwise, an "old loan" statute in the state may pass title in the loaned object to the borrower on a deemed gift, abandonment, or statute of limitations theory.
    - These statutes generally apply to an indefinite loan, or a loan with a defined term that has expired.

- Ownership of Artwork. The Executor should ascertain whether anyone besides the decedent owned an interest in the works, whether the works are owned by an LLC, partnership or other entity, and whether the decedent gave fractional interests in the works to children, friends or museums.
    - If the artist had contracted to sell but had not yet delivered a work of art, the proceeds received by the executor upon delivery of the work to the buyer will be income in respect of a decedent ("IRD") to the estate.

- For sales made after the artist's date of death, the artwork is treated as capital gain property and not ordinary income property.[54]

- Sale of Art Through an Auction House: If the works are to be auctioned, the executor may be able to negotiate the terms of the sale with the auction house. If the works are valuable or prestigious, some of these terms may be negotiable:

  - Percentage of Seller's commission.

  - The auction house may guarantee a minimum price.

  - The auction house may be willing to cover all costs of transportation, insurance, photography for the auction catalog, etc.

  - The auction house could arrange for a high-profile, single-owner sale.

B. Stolen Art

- If a work of art was stolen prior to the artist's death or in the course of administration of the estate, the executor should take steps to locate it.

  - The theft should be reported to the police, the Federal Bureau of Investigation, and Interpol.

  - It should also be reported to stolen art archives such as the Art Loss Register, which has offices in London and New York.

  - Assistance should be sought from experts who deal with the type of art involved.

- Efforts to locate the works should be continuous, even though they may seem futile. If the work is located, the cause of action to recover it could be time-barred in states that apply a discovery rule, or extinguished by laches in states that apply the demand and refusal rule.

  - See, e.g., *O'Keefe v. Snyder*, 416 A.2d. 862 (N.J. 1980). The "discovery rule" permits the artist who uses reasonable efforts to report, investigate and recover a painting to preserve the rights of title and possession. Some of the factors to consider are:

    - Whether the artist used due diligence to recover the paintings at the time of the alleged theft and thereafter;

[54] See, e.g., PLR 9043068.

- Whether at the time of the alleged theft steps were taken to alert the art world of the theft;

- Whether registering the stolen works with the Art Dealers Association of America or other organizations would put a reasonably prudent purchaser of art on constructive notice that someone other than the possessor was the true owner.

- If more than four years have passed from the date a bona fide purchaser buys stolen art that is later reclaimed by the owner, the bona fide purchaser's claim against the dealer from whom the art was purchased may be time barred under the Uniform Commercial Code.

    - Purchaser should require the dealer in the agreement of sale to give a written guarantee of quiet possession of the purchased work.

C. Forgeries

- There are essentially three varieties of art forger. The person who actually creates the fraudulent piece, the person who discovers a piece and attempts to pass it off as something it is not, in order to increase the piece's value, and the third who discovers that a work is a fake, but sells it as an original anyway.

- What is the responsibility of an Executor who determines a work of art included in the estate is a forgery?

    - The Executor could be liable criminally or civilly at the Federal or state level for selling a known forgery as an original.

    - The work of art may still be sold, but the Executor should provide written notice to the buyer that the work either is a forgery or that there are legitimate questions as to the art's authenticity.

D. Paying Estate Taxes

- The artist or collector should consider whether life insurance is necessary to provide liquidity for estate taxes.

- Section 6161 may enable the artist's or collector's estate to extend the time for payment of the estate tax for up to 10 years if the estate can show that a forced sale of the art would be necessary to generate liquidity to pay the tax. [55]

[55] IRC Section 6161(a)(2).

- If the artist characterizes his or her unsold art as inventory in a business, the unsold art may qualify for the family-owned business treatment under Section 6166 or 2057.
    - In order to be eligible for Section 6166 estate tax deferral (which allows the estate tax to be paid in installments over a period of up to fourteen years), the artist must have been actively engaged in the trade or business of being an artist and producing the works of art that are part of the estate.
        - Being "actively engaged" means the taxpayer is involved in producing art with continuity and regularity, and the taxpayer's primary purpose for the activity is for income or profit, rather than a hobby or diversion.
        - The value of the works of art must exceed 35% of the total value of the taxpayer's adjusted gross estate.
    - Section 2057 entitles the estate to an extra deduction for the family-owned business interests of the decedent.
        - This deduction typically won't be helpful for the artist because the estate tax will be recaptured if the artist's heirs fail to continue the family business for at least 5 years after the date of death or sell the business within 10 years after the artist's death.[56]
- Some states, such as Connecticut and New Mexico,[57] may accept works of art from the estates of artists in payment of death taxes.
    - This is something for the U.S. government to consider.
    - Internationally, France has been forerunner in accepting payment of its inheritance taxes through the transfer of works of art to the state under a practice known as "dation". The French Foreign ministry accepted works by Picasso, Chagall, Matisse and Monet in lieu of inheritance taxes.

[56] IRC Section 2057(f)(1)(A) and (B).
[57] Conn. Gen. Stat. §12-376d (2003); N.M. Stat. Ann. §7-7-20 (2004).

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