



Planning for the Art Collector

May 1, 2019

9:00 a.m. – 10:30 a.m.

**CBA Law Center
New Britain, CT**

CT Bar Institute Inc.

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Lawyers' Principles of Professionalism

As a lawyer I must strive to make our system of justice work fairly and efficiently. In order to carry out that responsibility, not only will I comply with the letter and spirit of the disciplinary standards applicable to all lawyers, but I will also conduct myself in accordance with the following Principles of Professionalism when dealing with my client, opposing parties, their counsel, the courts and the general public.

Civility and courtesy are the hallmarks of professionalism and should not be equated with weakness;

I will endeavor to be courteous and civil, both in oral and in written communications;

I will not knowingly make statements of fact or of law that are untrue;

I will agree to reasonable requests for extensions of time or for waiver of procedural formalities when the legitimate interests of my client will not be adversely affected;

I will refrain from causing unreasonable delays;

I will endeavor to consult with opposing counsel before scheduling depositions and meetings and before rescheduling hearings, and I will cooperate with opposing counsel when scheduling changes are requested;

When scheduled hearings or depositions have to be canceled, I will notify opposing counsel, and if appropriate, the court (or other tribunal) as early as possible;

Before dates for hearings or trials are set, or if that is not feasible, immediately after such dates have been set, I will attempt to verify the availability of key participants and witnesses so that I can promptly notify the court (or other tribunal) and opposing counsel of any likely problem in that regard;

I will refrain from utilizing litigation or any other course of conduct to harass the opposing party;

I will refrain from engaging in excessive and abusive discovery, and I will comply with all reasonable discovery requests;

In depositions and other proceedings, and in negotiations, I will conduct myself with dignity, avoid making groundless objections and refrain from engaging in acts of rudeness or disrespect;

I will not serve motions and pleadings on the other party or counsel at such time or in such manner as will unfairly limit the other party's opportunity to respond;

In business transactions I will not quarrel over matters of form or style, but will concentrate on matters of substance and content;

I will be a vigorous and zealous advocate on behalf of my client, while recognizing, as an officer of the court, that excessive zeal may be detrimental to my client's interests as well as to the proper functioning of our system of justice;

While I must consider my client's decision concerning the objectives of the representation, I nevertheless will counsel my client that a willingness to initiate or engage in settlement discussions is consistent with zealous and effective representation;

Where consistent with my client's interests, I will communicate with opposing counsel in an effort to avoid litigation and to resolve litigation that has actually commenced;

I will withdraw voluntarily claims or defense when it becomes apparent that they do not have merit or are superfluous;

I will not file frivolous motions;

I will make every effort to agree with other counsel, as early as possible, on a voluntary exchange of information and on a plan for discovery;

I will attempt to resolve, by agreement, my objections to matters contained in my opponent's pleadings and discovery requests;

In civil matters, I will stipulate to facts as to which there is no genuine dispute;

I will endeavor to be punctual in attending court hearings, conferences, meetings and depositions;

I will at all times be candid with the court and its personnel;

I will remember that, in addition to commitment to my client's cause, my responsibilities as a lawyer include a devotion to the public good;

I will endeavor to keep myself current in the areas in which I practice and when necessary, will associate with, or refer my client to, counsel knowledgeable in another field of practice;

I will be mindful of the fact that, as a member of a self-regulating profession, it is incumbent on me to report violations by fellow lawyers as required by the Rules of Professional Conduct;

I will be mindful of the need to protect the image of the legal profession in the eyes of the public and will be so guided when considering methods and content of advertising;

I will be mindful that the law is a learned profession and that among its desirable goals are devotion to public service, improvement of administration of justice, and the contribution of uncompensated time and civic influence on behalf of those persons who cannot afford adequate legal assistance;

I will endeavor to ensure that all persons, regardless of race, age, gender, disability, national origin, religion, sexual orientation, color, or creed receive fair and equal treatment under the law, and will always conduct myself in such a way as to promote equality and justice for all.

It is understood that nothing in these Principles shall be deemed to supersede, supplement or in any way amend the Rules of Professional Conduct, alter existing standards of conduct against which lawyer conduct might be judged or become a basis for the imposition of civil liability of any kind.

--Adopted by the Connecticut Bar Association House of Delegates on June 6, 1994



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RELATED SERVICES

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OVERVIEW

Alexis Gettier assists high net-worth individuals, including same-sex married and unmarried couples, with tax and estate planning. She also counsels them on the structuring of gifts and planning for business succession. Alexis also advises families and fiduciaries in the administration of complex estates and trusts. In addition, she handles estate planning and administration for individuals with substantial art portfolios, including collectors, investors and artists.

Alexis serves on the Planned Giving Subcommittee of the Board of Trustees of Ability Beyond. Alexis lives in Darien, Connecticut, with her husband, Jake, and her two children, Ted and Eloise.

INSIGHTS

- Speaker, "The Art of Estate Planning," Art to the Avenue, BNY Mellon, Greenwich, CT, May 24, 2018
- Co-author, "'The 'ART' of Estate Planning: Assisted Reproductive Technology Issues to Consider," *Bloomberg BNA's Tax Management, Estates, Gifts and Trusts Journal*, May 10, 2018
- Speaker, "Estate Taxes II: The Marital Deduction, Credit Shelter Planning and Portability," NYU Summer Institute in Taxation, July 24, 2017
- Speaker, "Estate Administration from Start to Finish: Complex Issues in Estate Administration," National Business Institute, May 18, 2017
- Speaker, "Avoid Art Ache: Planning & Communication, Considerations For Collections," Bruce Museum, Greenwich, CT, November 16, 2016
- Co-author, "The Charitably Inclined Collector," *Trusts & Estates Magazine*, August 2, 2016
- Co-author, "A Corporate Trustee and a Trust Lawyer Walk Into a Bar," *The American Law Institute*, July 5, 2016
- Co-author, "Using Family Entities for Planning With Artwork," *Trusts & Estates Magazine*, May 18, 2016
- Speaker, "Estate Planning for LGBT Families," LeGal and FSIX CLE, September 24, 2012
- Co-author, "New York Governance Principles," *Law for Change*, January 2012

NEWS

- Featured, "Day Pitney Congratulates Our New Partners," *Day Pitney Announcement*, January 31, 2019
- Quoted, "We're Calling It: 2019 Is Year of Female Law Partner in Connecticut," *Connecticut Law Tribune*, January 23, 2019
- Featured, "Day Pitney Promotes Six New Partners," *Day Pitney Press Release*, January 2, 2019

EDUCATION AND CREDENTIALS**EDUCATION**

- New York University, LL.M., 2009
- Temple University, J.D., *cum laude*, 2008
- Wake Forest University, B.A., 2004

ADMISSIONS

- State of Connecticut, 2011
- State of New York, 2016
- State of New Jersey, 2008
- Commonwealth of Pennsylvania, 2008

AFFILIATIONS

- Connecticut Bar Association, Estate and Probate Section, Executive Committee
- Fairfield County Bar Association
- Pennsylvania Bar Association, Probate Section, Real Property & Trusts
- Estate Planning Council of Lower Fairfield County

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PLANNING FOR THE ART COLLECTOR

**Alexis S. Gettier, Esq.
Day Pitney LLP**

In this presentation, we will explore some of the most unique aspects of planning for art collectors. Specifically, we will discuss exactly why art is such a unique asset. We will also cover advising your collector clients with respect to thoughtful collecting and stewardship. Finally, we will explore some common techniques for deaccessioning works from a collection – both within a family (during life and at death) and to benefit charitable institutions.

I. Defining “Collector”

There are two primary categories of people who buy art – collectors and investors. The line can sometimes be blurred, but a collector is typically someone who buys art for the love of it, while an investor buys art because of its potential for future returns.

These materials and this presentation will focus on planning for the collector (as opposed to the investor), but it is important to understand the distinction. As the art market becomes ever more dynamic and auction sales continue to make headlines on a regular basis, investing in art has become not just a mounting trend, but also a lucrative form of investing for return for many. Art funds are gaining in popularity and investors who are otherwise undiversified are increasingly employing specialized art consultants to enable them to gain exposure to a different class of asset. On the other hand, a collector is unlikely to be motivated to purchase based on expected appreciation or deterred from a desired purchase based upon the expected lack thereof.

II. Why is Art so Unique?

Art is often referred to as a “unique” asset – but why?

A. Different Tax Treatment.

Unlike other capital assets, art and collectibles are treated differently by the Internal Revenue Code – they are subject to different depreciation rules¹ and capital gains rates,² among other things. This presentation will not focus on the tax aspects of planning for collectors, although it is important to be aware of these differences.

B. Emotional Significance.

As it turns out, there is no asset – tangible or intangible, that is quite as emotional as art. Family art collections can symbolize generational status and wealth, and can bear significant memories. It is not atypical for the child or grandchild of a significant collector to remark after

¹ In 1968, the IRS released Revenue Ruling 68-232, which stated – in its entirety – that “a valuable and treasured art piece does not have a determinable useful life. While the actual physical condition of the property may influence the value placed on the object, it will not ordinarily limit or determine the useful life. Accordingly, depreciation of works of art is generally not allowable.” This reading was consistent with I.R.C. §167 as it existed at the time, which permitted depreciation of tangible personal property if the taxpayer could establish that the property has a “useful life” – more difficult the task if the work is not purchased new or, in some cases, already many decades or hundreds of years old.

I.R.C. §§167 and 168 now apply to depreciation of property used in a trade or business or held for the production of income. It must still be established that the property to be depreciated is subject to wear and tear, exhaustion or obsolescence. It is unlikely that a taxpayer can establish that artwork can be exhausted in the ordinary situation; it is also difficult to prove that art can become “obsolete” since the evaluation of artwork is so often subjective. Accordingly, unless the taxpayer can prove that a work is subject to wear and tear, it probably cannot be depreciated. [It is noted that depending on the display conditions, it might be provable that artwork displayed at a place of business is subject to significant wear and tear. But the more expensive and important the work, the less likely the depreciation deduction will be allowed since it will be practically more difficult to establish that it is being subject to wear and tear.]

² Art held as inventory (i.e. by dealers and artists) is subject to ordinary tax rates when sold. Art held by investors and collectors is considered a capital asset, but ordinary income tax rates still apply, although there is a special cap of 28% on the tax levied on gains in connection with sales of these assets.

the collector's passing on the memory of a particular work occupying a special location in the collector's home, "in the foyer"/ "over the mantle"/ "in grandma's sitting room."

Often, a favorite work can symbolize love. Children may argue over a painting, even if it is not the most valuable one, if they believe that it was the favored work of a parent or grandparent. In other circumstances, children who are disinterested in a collection can resent that collection for the emotional and financial place it enjoyed in the life of that parent.

The art community is an eclectic, international and dynamic group of people -- artists, collectors, investors, dealers, gallery owners, art brokers, consultants, taste-makers and others. It attracts wealthy collectors and patrons and is often associated with a certain prestige. An individual's collection, therefore -- very unlike other assets, can be her connection to a certain lifestyle or to preferred social circles.

III. Thoughtful Collecting & Stewardship

Art collectors often do not think of themselves as "owners" of works of art in the traditional sense. Although they may use that phrase, a conversation with a thoughtful collector implies that the sense of obligation towards the work goes deeper. An important work lasts for generations, so the collector is responsible for its care and maintenance, but only until it is time for the next person to enjoy it. However, even for a collector, art is an investment and not just one of monetary outlay. For the informed collector, even before a piece is purchased, experts are retained, works are carefully researched and studied, provenance is confirmed, insurance is obtained, and a location for its repose is selected and secured.

A. Knowing What You Have.

Establishing the provenance of a work of art is essential. Important works are typically accompanied by pristinely catalogued literature, deeds of sale, receipts, and published

references to the work. Developing the history of a piece of art can be essential to being able to sell it. But knowing what you have is as important as knowing what you don't have.

Consider, for example, the case of Wolfgang Beltracci, an infamous German forger. Beltracci purportedly astonished people when, as a young teen, he began producing works that passed as those of famous artists. In his later years, Beltracci and his wife Helene moved to a new town, where they were able to pass off his vast number of forgeries as an inherited family collection. Beltracci went so far as to create old photographs (including at least one in which Helene posed as her own grandmother) that included the works, to create and support the work's provenance.

An iron-clad provenance is essential, as even experts can be fooled by a work's authenticity. In 2011, Sotheby's sold a painting to an anonymous United States buyer known as *An Unknown Man*. When the work was discovered to be a forgery, Sotheby's rescinded the sale and provided a refund to the buyer.

On the other hand, da Vinci's *Salvator Mundi* sold in 2017 for more than \$450,000,000. *Salvator Mundi* is first recorded in the collection of King Charles I of England in the mid-seventeenth century. In the 1950s, the same painting was attributed to one of da Vinci's students and sold at auction for only £45. It is worth noting that the attribution of this painting to da Vinci is still heavily debated by some art scholars, but the overwhelming consensus after careful study was that the painting was, in fact, produced by the master painter.

B. Research What You Buy & Retain Appropriate Experts.

Art scholars and experts in a particular artist's oeuvre should be retained to confirm a work's authenticity and attribution. Experts should scrutinize the paper trail and will bolster the provenance by finding published references to the works, such as in books and magazines. Other

experts should inspect the work itself to determine that the condition of the work is appropriate to its age, that the materials used are appropriate for the time period and that the style is authentic. It should also be confirmed that a work can be found in the artist's catalogue raisonné.

Authentication by an artist's authenticating body, typically the artist's foundation, is the gold standard for authenticating a work. However, it should be noted that authentication is becoming harder to come by. If unable to authenticate, foundations were often sued for monetary loss by destroying a work's fair market value. Uninterested in paying out its assets in such situations, many of these foundations have simply stopped authenticating. Those that will often ask that the owner permit destruction of the work by the authenticating body if it is unable to authenticate a work (typically even if it cannot confirm that it is a forgery). The purpose of this is understandable – the authenticating body's mission is to preserve the integrity of an artist's legacy and to rid the marketplace of any and all potential fakes. The fallout for an owner can be catastrophic, however.

The collector must also be aware of the risks of purchasing the works of a living artist. Cady Noland is an example of this risk. Cady is a sculptor who, in 2014, disavowed one of her own works after it was restored. The work, *Log Cabin Blank with Screw Eyes and Café Door*, was displayed outside in the elements for a decade before being purchased by another owner who restored the work. Upon finding out that the work had been altered without her consent, Cady Noland disavowed her authorship of the work. Prior to that, she had also disavowed ownership of her *Cowboys Milking*, which at the time was consigned to Sotheby's and slated for auction. Upon viewing the work before the sale, she determined that it had been bent during restoration, disavowed her authorship of the work and demanded it be removed from the auction, which it was.

C. Maintain and Secure What You Have.

Once the prospective buyer becomes the owner of a work, he also becomes its protector. The scaffolding of this protection is simple – security, insurance, and proper care.

- 1. Security.** A security system, including alarms, video monitoring, and appropriate lighting must encompass each work.
- 2. Location.** Art should be hung on the walls instead of stored out of view, since it is much harder to steal works in full view. Furthermore, art consultants should be retained to advise on a work's location. For example, works on paper must be stored with UV protection or completely out of the light.
- 3. Insurance.** Each work must be appropriately insured for its retail replacement value (i.e. the cost of replacing the work) and not for its fair market value (i.e. the price a willing buyer would pay a willing seller). The items must be revalued regularly; depending on the type of art, fluctuations in the popularity of a particular artist or genre, re-valuations may be appropriate as frequently as annually. An itemized rider should be prepared for insurance purposes, which includes full-size color pictures with high quality digital images.
- 4. Transportation.** Transportation must be undertaken only with the greatest of care, as art is most vulnerable to damage and theft when it is being moved from one place to another. Only specific art transportation companies should be used. These companies use appropriate care to package art, to keep it climate controlled during the transportation process, and to insure it during transport.

IV. Valuation and Valuation Difficulties

Unlike more liquid assets, artwork is inherently difficult to value. The one-of-a-kind nature of art means that its valuation is more closely aligned with that of real property than other assets. However, unlike real property, which has a value derived from objective factors (i.e. proximity, presence of water features, buildable space, zoning restrictions), the value of art is largely derived from subjective factors. Further, those objective factors that impact a work's value (i.e. authenticity, period, provenance, an artist's death) are not always readily apparent to the buyer or seller at the time a transaction takes place or a valuation is required.

For transfers of art by gift to others (during life or at death) or to charities, it is essential that the taxpayer obtain well-supported qualified appraisal of the works.

A. Contributors to Valuation Uncertainties.

Of course, there is technically a public market for collectible works of art at most times. However, that market is subject to periods of concentrated decline and intense appreciation, both of which are impossible to predict. Save for an actual auction sale of the work to be valued, no set of factors can predict with certainty the value of a particular work.

Accordingly, if you ask five different well-credentialed and well-regarded experts for their opinion of value for a particular work, you will get five different numbers. The reason for this is that, while there are comparable sales, no two original works are identical. In addition, art is subjective – whether someone likes or appreciates a work of art can differ from person to person. And general tastes change through the years. Aside from subjective preference, however, many factors can contribute to valuation uncertainty:

- 1. Fakes and forgeries.** It is impossible to guarantee with absolute certainty that a particular work is authentic. Even authentication is not fool proof and,

as noted above, it is not always possible to have a work authenticated. If a work is determined to be a fake through scientific testing or otherwise, its value goes to zero. Certain artists (for example, Alexander Calder) are the victims of relentless and repeated forgeries.

2. **Incomplete provenance.** As noted above, a work should have a complete provenance. Of course, the older a piece of art is, the less likely it is to have a complete file to accompany it.
3. **Artist deaths.** An artist's death can impact the value of his art in a positive way. Of course, an artist's death is not typically something the collector can predict. Further, as noted above, live artists can pose particular difficulties if they have a predilection towards disavowing their own works.
4. **General popularity.** The value of a particular genre of art, even a specific artist or a particular period of an artist's works, can wax and wane with changing tastes. Whether a work is likely to benefit from a rising public opinion or to fall victim to a declining one is something that cannot be perfectly predicted. In addition, unexpected auction results (both positive and negative) can have a significant impact on the values of related works (for example, works by the same artist, done in the same period, and/or of similar subject matter).

V. Sales of Artwork

Sales of artwork during life are often discouraged by estate planners due to the unfavorable capital gains treatment of any realized gains. So even for collectors' whose children do not wish to receive a collection, the general best practice from a tax perspective is to retain

the collection until death, get the income tax basis step-up and liquidate it immediately thereafter. General estate administration wisdom would embrace the fact that a federal estate tax return reporting the sale price of an asset shortly after death as its date-of-death fair market value ought to be free from attack by the IRS (assuming, of course, that the sale is made to a truly unrelated third party). However, the general rules are not as cleanly-applied with respect to works of art.

A. Auction Sales/ Establishing Value.

Courts tend to prefer sales over any other method of valuation and for sales of art, auction has consistently been determined to be the appropriate method of sale.³ In fact, for sales of assets other than art, courts have consistently confirmed that sales of assets even two years after the date of a taxpayer's death are highly probative of the asset's value on the date of death.⁴ However, where artwork is concerned, the IRS could successfully assert that meaningful market fluctuations occurred so close in time to an individual's death that any lapse of time between the death and the sale of a work ought to disqualify the auction sale price as conclusive proof of the work's date-of-death value. Note, for example, that the IRS has successfully argued that a work of art sold at auction nearly a year after a decedent's date of death should be the date-of-death value, when that auction price was substantially higher than the value claimed on the estate tax return as of the decedent's date of death.⁵

It is important to note that the IRS has the benefit of hindsight. In the case of an estate, the estate has until the filing deadline to establish a value for a work of art. The IRS, on

³ *Estate of Scull v. Commissioner*, T.C. Memo 1994-211; *Estate of Smith v. Commissioner*, 57 T.C. 650, 658 (1972), *aff'd* 510 F.2d 479 (2d Cir. 1975).

⁴ *Estate of Kaplin v. Commissioner*, 748 F.2d 1109, 1111 (6th Cir. 1984).

⁵ *Estate of Scull v. Commissioner*, T.C. Memo 1994-211.

the other hand, has additional time – even years – to examine a tax return and dispute the value based on facts that transpired after the filing deadline.

Another issue of which the executor of an estate must be aware is the fact that buyers' premiums and sales commissions are typically not deductible on an estate tax return. A buyer's premium is an additional amount, calculated based on the auction sale price, that the buyer must pay to the auction house. A buyer's premium is typically around 25% of the auction sale price. A sales commission, also based upon the sales price, is a percentage of the auction sale price that is payable to the auction house by the seller. Depending on the seller's relationship with the auction house and/or the extent of a commission or importance of a work, sellers may be able to negotiate a 0% sales commission. An exception to this general rule may apply where the estate is able to establish that the expense was necessarily and actually incurred in order to administer the estate (i.e. where a sale of the works is specifically directed by the will or revocable trust, or where liquidation is actually necessary to pay estate taxes). However, a preference for liquidating art over using other assets to pay estate taxes does not render the sale of the art necessary to the estate's administration.

It is worth noting that there are reasons why a private sale might be preferred by an individual or estate. Generally, sales at auction are published. For reasons of personal privacy or privacy surrounding the art itself, a sale at auction could be sub-optimal. For example, repeated appearances at auction can drive down the value of a work – it may be perceived as less distinctive or, it may be that the work was purchased so recently as to be its own best comparable sales price.

B. Liquidity Generation.

Liquidity needs can drive art sales after a collector's death – specifically the need to pay estate taxes. Art is inherently illiquid. As noted above, although there is technically a market for collectible works of art at all times, that market may be particularly disfavorable at particular times or may exist only during certain seasons. Annual sales for particular types of art are heavily advertised, marketed and anticipated by collectors. In fact, the market for certain works of art can be so specific that works by certain artists may achieve the best prices on certain continents or in a particular city. Consigned works are researched in advance by prospective buyers; teams of experts are hired to do the legwork on behalf of collectors. Accordingly, although a particular work could be worth millions in theory, forced sales that do not take advantage of the best possible market conditions are unlikely to derive the best results.

- 1. Life Insurance.** Adequate life insurance, evaluated annually and based upon a collection that is also annually appraised, is the gold standard for ensuring that sufficient liquidity is available upon a collector's death to pay estate taxes – even for the wealthiest collectors.
- 2. Secured Loans.** Secured loans may be available to an estate to generate the liquidity necessary to pay estate taxes. Most large lending institutions are now providing art loans based upon a 50% loan-to-value ratio. As recently as several years ago, many of the institutions that were lending on art portfolios would only do so if they could take possession of the works. Now, most institutions will lend on works without taking possession as long as proper storage, insurance, lighting, and security can be guaranteed. In addition, most lenders will require the

consignment of several pieces to safeguard against total loss in the case of catastrophe.

- 3. Bridge Loans.** If the sale of works is contemplated, many large auction houses will provide bridge loans to an estate based on 50% of the auction house's low auction estimate for consigned works. These bridge loans typically bear relatively low interest rates to induce consignment and are repayable from the proceeds of sale.

VI. Family Entities

A. Benefits of Family Entities.

When making transfers of works of art within a family, there are many objectives. Equality among children tends to be the primary objective – in other words, safeguarding against one child receiving a windfall (which might occur as a result of an unexpected auction result or an artist's death) while another suffers total loss (for example, in the case of an established forgery, refused authentication, theft loss or casualty loss).

A family entity – typically in the form of a limited liability company, can achieve these objectives and can also provide its members with the ability to bargain collectively with respect to insurance, transportation, security and other costs, and an effective structure for resolving disputes. An LLC achieves equality among its members, in proportion to their ownership interests, while avoiding actual fractionalized ownership of the works owned within the entity. Further, an LLC should have a manager who can evaluate and appropriately time sales of particular works, who can determine the equitable enjoyment of those works by its members, and who can determine fair market rental values for those works.

Individuals making gifts during life may also wish to retain some access to the works. While the donor of the works may retain rights equal to the other members (proportionate to her interest in the LLC), she must not retain the right to possession of the works without payment of appropriate rent. In addition, she must not retain a priority of possession over other members and the ability of the original donor to enjoy the works must be determined by the manager.

B. Fractional Interest Discounts.

Family entities can often avail themselves of fractional interest discounts for gift tax and estate tax purposes. These discounts are based upon lack of control and marketability restrictions. However, a taxpayer is unlikely to be successful advancing this position with respect to entities primarily owning artwork. Unlike an operating business or real estate that can be enjoyed simultaneously by multiple individuals, multiple members cannot enjoy artwork at the same time, unless they are living together. Practically speaking, it is even difficult for members to enjoy works of art directly in proportion to their interests in the LLC.

Based upon the premise that there is no actual market for fractional interests in art, the IRS appears unwilling to condone fractional interest discounts for artwork or for entities owning artwork.⁶

⁶ It is worth understanding the result in *Estate of Elkins v. Commissioner* (767 F.3d 443 (5th Cir.)), in which fractional interest discounts were found to be available for this type of planning. However, the taxpayer invested heavily in this result and the IRS has not acquiesced to the result. The IRS appears to be poised to continue its opposition to fractional interest discounts for artwork and for entities owning art.

VII. Transfers to Charitable Organizations

From a tax standpoint, the simplest way to donate artwork to a charity is a bequest at death. These transfers produce no income tax consequences and produce a charitable deduction equal to the fair market value of the work as of the date of death.

Transfers during life, however, produce both a gift tax deduction and an income tax deduction that can offset ordinary income for the full fair market value of the work (generally speaking, up to 30 percent of the donor's gross income for the year).⁷

The primary limitation on the availability of these deductions is the "related use test," which allows the deduction in full if the contribution is made to an organization for which the use of the contributed art is related to its mission (for example, a museum or an art school).⁸ If works are contributed to a church, school or other charitable organization, however, with the expectation or reasonable anticipation that the entity will sell the work and use the proceeds to further its mission, the donor's income tax deduction is limited to his basis in the asset and a gift or estate tax deduction may be refused entirely.

A. Gifts to Public Museums.

Gifts to public museums can be accompanied by many non-monetary benefits for the taxpayer. Art is so intensely personal that donors often derive satisfaction from publicly sharing their collections. In addition, some collectors revel in the prestige associated with public attribution. Public museums may, under certain conditions, be amenable to the donor specifying certain conditions on the display of a donated work or collection. However, since the overhead cost of maintaining art is so high, absent contributions of extremely historically important works, museums are typically loathe to agree to any conditions on display unless accompanied by an

⁷ 26 U.S.C. Section 170(b)(1).

⁸ Treas. Regs. Section 1.170A-4(b)(2), (3)

endowment. In fact, the most well-known public museums are not only full, but they are sitting on troves of stored artwork that hasn't been displayed for many decades and may not be displayed for many more. Smaller, less prestigious or less well-known institutions are more likely to agree on display conditions since these concessions can allow them access to more impressive works.

B. Fractional Interest Gifts and Fractional Interest Discounts.

A consistently-applied policy that allowed fractional interest discounts for fractional ownership interests in art (or entities owning them) would have to cut the other way. In other words, an individual making a gift of a fractional interest in art to a charitable organization would have to reduce that gift by the amount of the discount. Lucky for the charitably-inclined collector, then, that these discounts are not favored by the IRS.

Fractional interest gifts of art are a good solution for collectors who are not quite ready to part with a work of art during life. If a taxpayer donates a one-half interest in a work of art, he is entitled to an income tax deduction equal to half of the fair market value of the work, as long as he has contributed a one-half interest in each and every right owned by the donor, including the right to possession and enjoyment.⁹ So if a taxpayer contributes a one-half interest in a work of art to a public museum, he can retain the right to possess and display the work for one-half of each year.

A restriction on fractional interest gifts is that the remaining interest in the contributed work must be transferred to the same institution within ten years or, if the taxpayer dies within that time, upon the taxpayer's death.¹⁰ If this transfer does not occur within the prescribed timeframe, the income tax deduction will be recouped by the IRS – in other words,

⁹ Treas. Regs. Section 1.170A-7(b)(1)(i).

¹⁰ 26 U.S.C. Section 170(o)(3)(A).

additional income tax will be owed. At the time the remaining interest is transferred to the charity, another income tax deduction is permitted based on half of the lesser of the fair market value on the date of transfer of the remaining interest or the fair market value on the date of transfer of the fractional interest.¹¹

As noted above, well-established institutions are basically full. The logistical complications inherent in “sharing” a work of art for a period of up to ten years include the costs of transportation multiple times each year between the joint owners and the additional cost of insurance since art is most vulnerable during transportation. In the right situation, however, this arrangement can be mutually beneficial. The estate planning practitioner might specifically recommend this type of arrangement in the case of important art housed in a vacation or seasonal residence. Local museums are particularly motivated to accept fractional interest gifts of art since they understand the inconvenient arrangement to be of limited duration and may be able to assemble a more impressive collection by virtue of their accommodation to the donor taxpayer.

C. Gifts to Private Museums.

For the prolific collector, a private museum may be a viable option. As noted above, public museums may be unwilling to accept certain art or they may be unwilling or unable to display it. Private museums, on the other hand, typically run by private operating foundations established by a collector donor, can accept and display any art under any conditions. Private museums have a long and storied history in the United States and many of the best known museums are private museums, including the Frick Collection in New York City, the embattled Barnes Foundation in Philadelphia, the Rubell Family Collection which is housed

¹¹ 26 U.S.C. Section 170(o)(2).

in a transformed Drug Enforcement Agency warehouse in Miami, and the Crystal Bridges Museum established by Wal-Mart heiress Alice Walton in Bentonville, Arkansas.

Private operating museums can be controlled by the donor. There are two primary requirements for a foundation to qualify as a private operating foundation. First, it must make “qualifying distributions” directly in pursuit of its purpose equal to the lesser of its adjusted net income or its minimum investment return.¹² Qualifying distributions are any amounts reasonably paid by the foundation to accomplish its purpose, so long as that purpose is charitable.¹³ In the case of a private foundation operating a private museum, this purpose is educational. The second requirement is that substantially more than half of the foundation’s assets are devoted to its primary activity (i.e. the operation of the museum).¹⁴ In the case of important artwork, the most valuable assets owned by the foundation are likely to be its art collection, the display of which is a use in furtherance of the foundation’s charitable purpose. The foundation must report its activities, income and disbursements annually on its information tax return, Form 990-PF.

There are obvious tax benefits to establishing a private museum, including:

- 1. Full Fair Market Value Income Tax Deduction.** The collector donor is able to take a full income tax deduction for the fair market value of all assets contributed to a private operating foundation, not only for the art contributed, but also for all property contributed on an ongoing basis to cover overhead and the purchase of additional art. Further, these deductions are only limited

¹² 26 U.S.C. 4942(j)(3)(A).

¹³ 26 U.S.C. 4942(g)(1); 26 U.S.C. Section 170(c)(2)(B).

¹⁴ 26 U.S.C. 4942(j)(3)(B)(i).

to the extent they exceed 50 percent of the taxpayer's gross income for the year.¹⁵

- 2. Sales Tax Benefits.** Assets contributed to a private foundation to purchase new art can be advantageous as well, because the foundation can avoid sales tax on the purchase. Alternatively, if the donor were to purchase the work and then contribute it, the individual would not avoid the sales tax on acquisition.

The taxpayer seeking to establish a private museum must be careful not to run afoul of the IRS guidance. The IRS is wary of private museums that do not serve their stated educational purposes. The publicly-subsidized tax benefit to the art collector depends upon an educational benefit actually bestowed upon the public. In other words, hanging paintings on the wall of the collector's home and inviting school children to view them will never suffice. While there is no bright line test, it is generally accepted that private museums should be situated away from a donor taxpayer's residence, should have regular operating hours, and should have signage inviting the public to visit. While some of these factors may be flexible in certain circumstances, the estate planning professional should be specific when advising taxpayers that the more it looks like a public museum in terms of public accessibility, the better.

¹⁵ 26 U.S.C. 170(b)(1)(A)(vii); 26 U.S.C. Section 170(b)(1)(F)(i).