

## Strategic Insights

### ACQUIRING, HOLDING, AND TRANSFERRING ART

For most people, artwork is a passion but it can also be an excellent investment.

Understanding the unique tax and gifting rules associated with this asset type may

- allow you to take advantage of tax laws
- provide an option for philanthropy
- help you have your cake and eat it too!

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# ACQUIRING, HOLDING, AND TRANSFERRING ART

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YOU HAVE MADE IT. CONGRATULATIONS! AFTER YEARS OF HARD WORK YOU HAVE REACHED A LEVEL OF FINANCIAL SUCCESS THAT NOW PERMITS YOU TO DEPLOY YOUR PERSONAL RESOURCES TOWARD CERTAIN PASSIONS THAT YOU ENJOY. IF PUTTING TOGETHER AN ART COLLECTION IS ONE OF THESE PASSIONS YOU SHOULD CONTINUE READING. CONSIDER THIS A PRIMER ON THE QUIRKY TAX RULES ASSOCIATED WITH ACQUIRING, HOLDING, AND TRANSFERRING ART.

## CAN I DEDUCT THAT?

There are many costs associated with buying art other than its initial cost. Purchasers will no doubt incur expenses associated with transportation, storage, display, and insurance. There can be expenses for appraisals, conservation, and restoration. These costs may be deductible on your federal income tax return depending upon how the Internal Revenue Service (IRS) classifies you. Generally, artists, dealers, and investors can claim these types of expenses if they are incurred as a normal and ordinary business expenses, or if they are incurred in the production of income. Collectors, on the other hand, are often severely

To be classified as a dealer you must demonstrate that you are generally engaged in the business of dealing art, with the expectation to make a profit, and you must represent yourself as an art dealer to the art community. The IRS will want to determine that your interest in art is not merely a hobby. As you might have guessed, expenses and losses associated with pursuing hobbies are disallowed under the tax laws.

To be classified as an investor an individual must show that he or she collects primarily for investment purposes. Investor status is based on

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limited as to these types of deductions. However, as we will see, depending upon your circumstances you may actually want to be classified as a collector to obtain other tax benefits.

Artists are the creators of a work of art, and the IRS has little difficulty determining who falls within this category. In fact, artists arguably are treated the harshest under the various tax rules.

each person's unique facts and circumstances. The IRS typically will take into consideration the purpose for which the piece was acquired, the length of time each piece was held, the investor's other business interests, and the use of the proceeds from the sale of each work. Implicit in this list is the notion that investors sell, or they are willing to sell, the art for a profit. The IRS has denied investor status on numerous occasions

because taxpayers could not document that they ever sold a piece from their collection.

Most purchasers fall under the category of collector. Collectors are those who appreciate art and accumulate it for personal enjoyment. While expenses for acquiring and maintaining art are not deductible for collectors, favorable tax treatment often can be received when selling or giving collections away, as more fully described below.

WHAT AM I GOING TO PAY?

When President Bush signed the 2003 Tax Reconciliation Act, he lowered the long-term capital gains tax rate from 20% to 15%. The effect of this reduction was to lower the long-term capital gains tax by 25%. Excluded from the Act, however, was the capital gains tax rate for collectibles, which include, among other things, art. The long-term capital gains tax rate for collectibles remained at 28%. Consequently, gains on sales by investors and collectors of art held for more than one year are taxed at 28%. The rationale behind this rule is that art in an individual's possession is said to be a capital asset. The art that artists and dealers sell, however, is considered inventory and, as such, is taxed generally at rates of up to the highest ordinary income tax rate, which is currently 35%.

ART. TAX TREATMENT

CATEGORY	EXPENSES	TYPE OF TAX
Artist	Deductible	Ordinary Income
Dealer	Deductible	Ordinary Income
Investor	Deductible	Capital Gains
Collector	Not Deductible	Capital Gains

YOU CAN'T TAKE IT WITH YOU!

A time will come in the wealth planning process when art owners will need to address whether or not to transfer their collection to their heirs or to charity. The decision is actually a two-step process because it also must be decided when to make these transfers (i.e., during lifetime or upon death). If an art patron decides to transfer art to charity during his lifetime, several rules should be kept in mind.

In order to claim a charitable income tax deduction for the fair market value of works of art that are transferred to charity during a donor's lifetime:

*the work must be contributed to a public charity that was formed within the U.S.;*

*the work must be considered long-term capital property;*

*the work must satisfy the "related use" test; and*

*the donor must obtain a qualified appraisal*

The IRS does not allow donors to take a charitable income tax deduction for transfers to non-U.S. charities. However, a deduction is available for donations to U.S. charities even if all or some portion of the funds are used in foreign countries. In order to make sure your charity is a U.S. charity you should ask for a copy of the entity's exemption letter from the IRS, or check IRS Publication 78, which is a cumulative list of exempt organizations published annually by the IRS (available online at irs.gov). Interestingly, there is no requirement that a charity be a U.S. charity to receive an estate tax deduction if art is transferred at death.

Most art collectors harbor the hope that their collections will appreciate in value over time. In order for a collector to claim the work's current fair market value as the value of the charitable deduction he or she must have held the property for longer than one year. Also, the art must be capital gains property as it relates to the donor.

All works of art created by the artist are categorized as ordinary income property under the Internal Revenue Code. In other words, such works will never be taxed as a capital gain asset. Thus, if an artist were to donate one work to a charity, the artist would only be able to deduct the adjusted tax basis. For example, a visual artist's charitable income tax deduction will be limited to the cost of paints, brushes, and canvases. This is true even if the work could be sold to someone for \$5 million dollars. Crafty artists have tried to circumvent this rule by exchanging their works of art with another artist's like-value works, and then donating the other artist's art to charity in order to claim the fair market value as the deduction amount. The IRS is aware of this strategy and will not permit the deduction above the original art's adjusted cost basis.

#### ART. INCOME TAX TREATMENT

CATEGORY	TYPE OF PROPERTY	CHARITABLE INCOME TAX DEDUCTION
Artist	Inventory	Adjusted Cost Basis
Dealer	Inventory	Adjusted Cost Basis
Investor	Capital Asset	Fair Market Value*
Collector	Capital Asset	Fair Market Value*

\* See related use description and chart.

Dealers cannot contribute art to charity and claim the fair market value as a charitable income tax deduction because, to them, the art is inventory which does not qualify under the definition of a capital asset.

Only collectors and investors hold art that is considered a capital asset. Accordingly, only they are able to claim a charitable income tax deduction based upon the work's current fair market value.

Stay tuned for new developments in this area. The Joint Committee on Taxation, a Congressional body, continues to encourage more restrictive regulations designed to curb abuses related to donations of tangible personal property. One of its recommendations is a proposal to limit the tax deduction for gifts of non-cash property to the lesser of the donor's tax basis or the fair market value. While Congress has not gone this far yet, the Pension Protection Act of 2006 has made significant steps in the direction of increased scrutiny and limited deductibility.

#### WHAT RULE?

Perhaps the rule that catches most art lovers by surprise is the related use rule. In order to claim a charitable income tax deduction equal to the work's current fair market value, the IRA requires that the donated work be used by the charity to perpetuate the entity's charitable charter. For example, art donated to a museum should be used in the museum's collection. The donation will not qualify under the related use test if the intent from the inception of the gift is for the museum to sell the work to raise funds to build another wing. Similarly, if a piece of art is given to a university, the work should be used to further the curriculum of the institution (e.g., displayed and used in art history lectures).

#### ART. THE RELATED USE RULE

TYPE OF TAX	IS PROPERTY USE RELATED TO CHARITY'S EXEMPT PURPOSE?	TAX DEDUCTION
Income	Yes	FMV
	No	Cost Basis
Gift	Yes	FMV
	No	FMV
Estate	Yes	FMV
	No	FMV

It is not necessary that a charity hold the donated art in its collection forever. Museums often sell works in order to raise funds to acquire other pieces. A charity's clear intent to use the gifted property to further its charitable charter for some period of time used to be sufficient to justify this related use requirement. However, to curb the "wink-winking and nod-nodding" between donors and charities, the Pension Protection Act of 2006 (PPA) created a recapture rule. Now, charities must retain gifts of tangible personal property valued at more than \$5,000 for at least three years if the donor is to receive an income tax deduction for the fair market value. Property sold before three years triggers a recapture of the excess of the deduction over the basis in the property.

To accommodate legitimate "emergencies," the PPA waives the recapture rule if the charity provides an affidavit, signed by an officer under penalty of perjury, stating that the charity did use the gifted property for its exempt purpose for a period of time, but that it became impractical to continue to carry out this purpose.

Form 8282 used to be due from charities if gifted property were sold within two years. The time frame for this information return has now been

Finally, in order to claim a charitable deduction, works valued at over \$5,000 need to be appraised by a "qualified appraiser" as defined by the PPA. To claim a deduction, a donor must attach IRS Form 8283 to his personal income tax return. Form 8283 includes a summary of the appraisal, the signature of the appraiser and a statement by the appraiser that he is qualified to perform this kind of appraisal. For works of art valued at more than \$20,000, the full appraisal report also must be submitted with this form. Again, the PPA elaborates on what is required in the appraisal reports. This Act also imposes stiff penalties on appraisers who provide reports with inflated values.

**I WANT MY CAKE AND I WANT TO EAT IT TOO!**

We all want the best of both worlds. Ideally, we would like to be able to give art away today, claim an immediate charitable income tax deduction, but continue to have the art hanging in our homes until some future time, preferably until we die.

Before 1964 taxpayers could do just that. They could reserve a life estate in a piece of art and continue to enjoy it in their homes throughout their lifetime, claim that they had made a current gift of the remainder interest in the art, and receive a

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## For many art lovers, it no longer makes sense to gift fractional interests in works of art.

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extended to include sales within three years. This will allow the IRS to more easily identify situations where the recapture tax may be applicable.

current charitable income tax deduction. The deduction was calculated by deducting the actuarial value of the taxpayer's life estate from the current fair market value of the art. Essentially, the older the taxpayer, the better the income tax deduction.

Unfortunately, the IRS no longer allows such arrangements (or similar arrangements that have the same effect) to create a current income tax deduction.

#### DIVIDE AND CONQUER

Gifts of undivided fractional interests in art to charities used to be another alternative that was very attractive for owners. For instance, a donor would allow a museum to possess and display a piece of art for two months out of the year, while retaining the right to hold and enjoy the art for the remaining ten months. This would result in a gift of a 1/6 interest in this art to the museum. For the donor to claim an income tax deduction for the value of 1/6 of the art, it previously wasn't necessary for the charity to actually display or even take possession of the piece. The charity's having the legal right to use it was sufficient. Clearly there was abuse in this area. Little prevents the taxpayers from giving away large fractional interests to charities with unspoken arrangements that the charities would never take possession during their lifetimes.

The PPA significantly curtailed this practice. Fractional interests of tangible personal property now are subject to complicated new rules. The charity now must take "substantial physical possession" of the property immediately, and use it for their charitable purpose. After the initial gift, the charity must receive the balance of the property within the shorter of 10 years or the donor's death. A final blow to donors is the new rule that their tax deductions for subsequent gifts will be limited to the lesser of the market value of the original fractional gift, or the market value at the date of the subsequent gift.

If the above rules are violated, donors are required to recapture any income and/or gift tax deductions they have taken. They may also have to pay a penalty of 10% of the recaptured value. Gifting fractional interests used to be very useful from a planning perspective, particularly for donors who had made more charitable gifts in a particular year than they could deduct on their income tax return. However, for many art lovers, it no longer makes sense to gift fractional interests in appreciating works of art. These new rules are already having a significant impact on museums.

#### I GET CASH AND A DEDUCTION?

Another transfer technique, which removes the art from the owner's immediate possession, but has the added benefit of putting some dollars in the owner's pocket, is for a taxpayer to sell art to a charity at a substantially reduced price. This transfer strategy is called a bargain sale and accomplishes two things: it partially monetizes the value of the art for the taxpayer, and produces an immediate charitable income tax deduction.

The best way to illustrate a bargain sale is by example. Let's assume that a collector sells a work of art that he has owned for longer than 12 months (i.e., long-term capital gains property) to a favorite museum for \$400,000. Further assume that the donor's adjusted tax basis in the art is \$200,000 and that the current fair market value of the work is \$1 million.

Every bargain sale has two elements: part sale and part gift. Let's take a look at the gift element first. If the fair market value of the art is \$1 million, but the donor is going to receive \$400,000 in the sale, his charitable transfer would be \$600,000 (\$1 million less \$400,000). Accordingly, the donor could claim a charitable deduction of \$600,000.

The part-sale element is a bit trickier to calculate. To calculate the taxable gain element of the transaction the taxpayer must reduce the tax basis to reflect the \$400,000 that was received in the sale. The reduction in tax basis is accomplished by multiplying the tax basis by a fraction: the sale price divided by the fair market value, which would equal \$80,000 ( $\$400,000 / \$1 \text{ million} \times \$200,000$ ). To determine the long-term capital gains, you take the amount realized (\$400,000) and subtract the donor's reduced tax basis (\$80,000) to calculate a long-term capital gain of \$320,000. Because the taxpayer sold a collectible with a long-term tax rate of 28% the taxes due would be \$89,600 ( $\$320,000 \times 28\%$ ). Most charities are very familiar with this technique and are quite willing to explore such purchases.

first blush. First, the transaction fails the related use test. Remember that the donated property must be used to perpetuate the charity's charitable charter. Selling the donated property and managing the proceeds is never a related use. What this means is that your deduction will be limited to your tax basis. If a big charitable deduction is driving your decision to make the transfer, this is probably not the transaction for you. Another problem that often is overlooked is the timing of the deduction. With a CRT a donor only receives a tax deduction in the year the CRT trustee sells the art, not in the year that the art is contributed to the CRT. It is quite possible to contribute art to a CRT at the end of the year and have the trustee sell the art at the beginning of the next year. Under this scenario, donor would have to wait until year two to claim a

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## Collectors need to understand the effect their art will have on their estates.

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### ...AND MORE CASH?

Another idea that is bantered about quite a bit is funding a charitable remainder trust (CRT) with art. The idea is to allow the trustee of the tax-exempt CRT to sell the art and redeploy the gross proceeds into a diversified portfolio of stocks and bonds. This portfolio can pay you, or you and your spouse, an income stream for a term of years or for your lifetimes. You would also receive a charitable deduction based upon your age, current interest rates, and actuarial assumptions by the IRS.

What could be better? You receive a charitable deduction, income stream for life and your charity gets the portfolio upon your death. Two things make this strategy more difficult than it appears at

charitable deduction. If the timing of the deduction is crucial to you, you will want to begin this transaction as early in the year as possible.

### WHAT ABOUT MY FAMILY?

Transferring works of art to family members tends to be much easier from a structuring standpoint than transferring works of art to charity. Most transfers are made at the death of the collector, or at the death of the surviving spouse so that the collectors can enjoy the art throughout their entire lifetimes. Collectors need to understand the effect their art will have on their estates. Valuable pieces might cause an estate tax which may in turn cause the estate to have a liquidity problem. If you have a taxable estate and art that is appraised at more

than \$20,000, you should know that the IRS has an Art Advisory Panel that will review your estate valuation to determine whether its value should be adjusted upwards, creating more estate tax. In 2004 the Panel increased 56% of all of the items that were reviewed for estate and gift tax purposes, causing an increase in value by more than \$73 million.

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