Art and Income Taxes - The Changing Scene

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Abstract

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Almost every year brings about a new tax bill and new provisions that affect works of art. Most recently, the Tax Reform Act of 1986, the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988 have added new complexities. The purpose of this article is to generally acquaint the reader generally with some of the tax provisions pertaining to works of art.

Charitable Transfers

Generally

The lifetime transfer of a work of art to a charitable organization saves the donor income taxes because of the allowable income tax deduction. For example, a painting that cost the collector $1,000 some years ago may have a fair market value of $10,000 today. A contribution of the painting to a public charity (not a private foundation) that properly satisfies all the tax rules produces an allowable charitable deduction of $10,000. For someone in the twenty-eight percent tax bracket, such a contribution saves $2,800 in federal income taxes. Since the donor’s out-of-pocket cost was only $1,000, the taxpayer has made a $1,800 tax-free economic profit and has enjoyed the painting through its years of ownership.

* © Ralph E. Lerner, 1989. All rights reserved. Mr. Lerner is an attorney-at-law and a partner in the law firm of Sidley & Austin in New York City, N.Y. Mr. Lerner is the co-author of the recently published book, ART LAW—THE GUIDE FOR COLLECTORS, INVESTORS, DEALERS AND ARTISTS (1989), published by the Practising Law Institute.

1. All section references in this article are to the amended Internal Revenue Code of 1986, 26 U.S.C §§ 1-9602 (1988) unless otherwise indicated.
5. Id. at § 1, 63 (1988).
Reduction of Tax Rate

The Tax Reform Act of 1986 lowered the maximum ordinary income tax rate from fifty percent to 38.5 percent for 1987 and twenty-eight percent for 1988. The maximum tax rate on capital gains was increased from twenty percent for 1986 to twenty-eight percent for 1987 and years thereafter. A thirty-three percent ordinary income tax rate applies in 1988 and thereafter to specified ranges of income, e.g., between $71,900 and $149,250 for married individuals filing joint returns and for surviving spouses. Obviously, when the tax rate was at fifty percent there was a greater incentive for individual taxpayers to make charitable contributions since the taxes saved would be greater. For example, a contribution of a painting with a fair market value of $10,000 to a public charity would, under the old law, have produced a $10,000 deduction that saved $5,000 in taxes. Under the new twenty-eight percent rate, only $2,800 in taxes is owed. However, taxes are still saved, and, if properly done, there are still tax advantages to contributing appreciated works of art to a public charity.

Related Use Rule

The Tax Reform Act of 1986 amended section 170(e)(1)(B)(i) of the Internal Revenue Code of 1986 (henceforth the “Code”) to change the prior forty percent reduction rule to a one hundred percent reduction rule for failure to satisfy the related use rule. The related use rule applies to capital gain property that is “tangible personal property” contributed to a public charity. The term “capital gain property” means property which, if sold, would result in a long-term capital gain. The term “tangible personal property” includes paintings and art objects not produced by the donor. The related use rule requires that the use of the tangible personal property by the donee organization be related to the purpose or the function constituting the basis for the donee’s exemption under section 501. If the use of the work of art by the donee organization is unrelated to the purpose or the function constituting the basis for the donee’s exemption, the amount of the charitable deduction must be reduced by one hundred percent of the appreciation in value of the work of art contributed to the donee organization. In other words, failure to comply with the related use rule now results in limiting a taxpayer to his cost for appreciated works of art contributed to a public charity.

It is therefore helpful to review what the Internal Revenue Service expects in order to show compliance with the related use rule. The Regulations provide that a taxpayer may treat a contribution of a collection as meeting the related use rule if:

1. The taxpayer establishes that the collection is not in fact put to an unrelated use by the donee; or
2. At the time of contribution it is reasonable to anticipate that the collection will not be put to an unrelated use by the donee organization.

If a collector donates a collection to a museum and the collection is of a general type normally retained by museums for museum purposes, it is reasonable for the donor to anticipate, unless he or she has actual knowledge to the contrary, that the collection will not be put to an unrelated use by the donee. This is so whether or not the collection is later sold or exchanged by the donee. On the other hand, if an item is donated for the purpose of sale at an art auction to be run by the charity, that is an unrelated use, and one hundred percent of the appreciation in value is lost as a charitable deduction.

Example 1: The related use rule is satisfied when an art museum that is a charity, prominently and publicly displays a contributed painting. The contribution is deductible to the extent of the fair market value of the property up to thirty percent of the taxpayer’s contribution base. The contribution base is generally the taxpayer’s adjusted gross income.

Example 2: If the same painting is contributed to the Red Cross, which is a public charity and which from the outset intends to—and in fact promptly does—sell the painting, the deduction must be reduced.

6. Id. at § 1(g) (1988).
9. Id. at §§ 1221, 1222 (1988).
10. Id.
12. Id.
13. Id.
15. Id.
16. Id.
18. Id.
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15. Id.
16. Id.
18. Id.
by one hundred percent of the appreciation in value, with the balance deductible up to fifty percent of the taxpayer's contribution base.\textsuperscript{21}

The regulations also indicate that the related use rule is satisfied even if the donee sells or otherwise disposes of only an "insubstantial" portion of the collection.\textsuperscript{22}

To date there have been few litigated cases on the subject of related use. However, a number of Private Letter Rulings in this area do shed some light on what the IRS considers a related use.

In Private Letter Ruling 7751044, the IRS held that the related use rule was satisfied when lithographs were displayed in a camp and center devoted to handicapped and retarded children, since the lithographs were used in connection with an art appreciation program.\textsuperscript{23}

It was held in Private Letter Ruling 8009027 that the related use rule was not satisfied when a donor gave an antique car to a university, since the university did not offer a course in antique car restoration. However, in Private Letter Ruling 8143029, the IRS held that the related use rule was satisfied when a donor gave his porcelain art objects to a public charity operating a retirement center, since the display of the art was related to the charity's exempt purpose of creating a living environment for its residents.

Finally, in Private Letter Ruling 8208059, the IRS held that the related use rule was satisfied when a donor gave his stamp collection to a college, since it would be exhibited and since the college taught engraving as part of its curriculum. The donor included in the ruling request letters from the college, explaining in detail how it would use the collection.

It is important to make sure a proper paper trail shows that it was reasonable for the taxpayer to anticipate that the property would not be put to an unrelated use by the donee.\textsuperscript{24}

\begin{thebibliography}{9}
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property were taken into account at its adjusted basis." The statute uses the term "deduction allowable under section 170." This means that when the fair market value of the property contributed exceeds 30 percent of the taxpayer's contribution base, the amount above the 30 percent limitation is disregarded in determining the AMT. In other words, the amount of the tax preference is determined by disregarding any amount of the charitable contribution that is carried forward to another taxable year. When a portion of the charitable contribution is carried forward because it exceeds the applicable percentage limitation on contributions for the year, the portion so carried forward cannot increase the amount of the tax preference item until it is allowable as a deduction for regular tax purposes.

Example 1: Mr. Collector has a contribution base of $100,000. He contributes capital gain property with a fair market value of $50,000, in which he has a basis of $10,000, to a public charity. The related use rule is satisfied. Mr. Collector is allowed a deduction of $30,000 (thirty percent of 100,000) and a carryover of $20,000. His tax preference amount is $20,000 ($30,000 minus $10,000). In the next year, assuming no other contributions, his deduction is $20,000 and his tax preference is $20,000 ($20,000 carried over minus the remaining basis of zero).

Example 2: Assume the same facts as above, only the basis is now $40,000. Mr. Collector is allowed a deduction of $30,000 (thirty percent of $100,000) and a carryover of $20,000. His tax preference amount is zero since the deduction allowable does not exceed his cost basis. In the next year, assuming no other contributions, his deduction is $20,000 and his tax preference is $10,000 ($20,000 carried over minus the remaining basis of $10,000).

There is no substitute for making the mathematical calculations before making any contribution. It may come as a surprise to many taxpayers to learn that the AMT will not apply to them. My calculations indicate that the tax benefits of contributing appreciated property gradually disappear as the amount of AMT taxable income increases. Proper planning should ensure that the taxpayer does not cross over into the AMT area or, if that is unavoidable, that the amount of income subject to the AMT is at a minimum. A technique for avoiding

the AMT when a large charitable contribution is made is discussed below.

There are bills pending in the House (H.R. 173) and the Senate (S. 1577) that would repeal the appreciation in value on charitable contributions as a tax preference item subject to the alternative minimum tax. These bills are strongly supported by museums, universities and other charitable organizations. It is hoped that some action can be taken on these bills in the not too distant future.

Avoiding the AMT

The collector who wants to give away a collection and still enjoy its possession on a part-time basis should convey an undivided fractional interest in the property to a charity. The transfer of an undivided fractional interest is not a transfer of a future interest that would not be deductible under section 170(a)(3) or section 170(f). Therefore, an immediate charitable deduction is allowable for the value of the undivided fractional interest donated. However, the period of initial possession by the donee should not be deferred for more than one year, or the entire charitable deduction may be lost. In Winokur v. Commissioner, the court held that it is the right to entitlement or possession, not actual physical possession, that controls whether a purported present interest is to be regarded as a future interest.

Example: Ms. Collector transfers an undivided one-fourth present interest in a painting to an art museum by deed of gift. She is entitled to possession of the painting for nine months each year, and the museum is entitled to possession for three months each year. She can deduct one-fourth of the fair market value of the painting on the date of the gift, subject to the permissible maximum, as a charitable contribution.

The IRS position is to accept as the allowable charitable deduction the undivided percentage of the fair market value given to the charitable organization. Presumably, that is based on Revenue Rule 57-293.

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which gives a specific example covering that situation. The part of that
ruling dealing with a gift of a future interest is no longer applicable
because of section 170(f).

Of course, when the collector dies, the value of the undivided frac-
tional interest that was kept by the collector is includable in his es-
state. Because of Revenue Ruling 57-293, it would be difficult to argue
that, if the retained undivided interest is bequeathed to a noncharitable
beneficiary, there should be a discount for the minority undivided inter-
est retained. There is, however, no decided case on that point. If the
bequest is made to a person who does not own the other part, the tax-
payer should have a fair chance of convincing the IRS to allow some
discount for the fractional interest. If the bequest is made to the mu-
seum that already owns a partial interest in the painting, the estate tax
charitable deduction should be the percentage owned by the decedent
multiplied by the full fair market value of the painting on the dece-
dent's date of death. Generally, before a museum will accept a frac-
tional gift, it will want assurances that it will receive the balance of
the undivided interest when the collector dies. The museum does not want
to be left owning a fractional interest in a work of art with the donor's
heir's fighting over the remaining fractional interest. Therefore, always discuss a gift with the museum prior to making it.

It may be possible to increase the total charitable deduction
through the use of fractional gifts. In the example stated above, the
collector could deduct one-fourth of the fair market value of the paint-
ing on the date of the gift. A number of years later, the collector could
make an additional gift of a one-fourth interest in the same painting.
At that time, the painting may have increased in value not only be-
cause of the passage of time but also because it is now exhibited in a
museum. Therefore, one-fourth of the fair market value on the later
date may exceed the one-fourth value on the first date. If that process
was carried on until the entire painting was donated, the total charita-
bble deduction could exceed the total value of the painting on the date of
the first gift. Of course, an appraiser would have to verify the increases
in value each time an undivided fractional interest was donated to the
museum.

The technique of making charitable contributions of undivided frac-
tional interests has the added benefit of giving the taxpayer the
ability to avoid the alternative minimum tax (AMT) that might result

when appreciated property is contributed to charity. As discussed ear-
er, the appreciation in value of capital gain property is now a tax prefer-
ence item that would result in the total or partial loss of the ap-
preciation as a charitable deduction because of the application of the
AMT. The AMT can be avoided by controlling the amount of appreci-
ation in value (the tax preference) that is contributed to charity in any
one year. This can be accomplished by calculating the maximum
amount of appreciated property that can be contributed to charity in
the year without incurring the AMT, and then making an undivided
fractional interest gift within that limitation. Future undivided frac-
tional interest gifts could then be made in later years to use up the full
charitable deduction. At the same time, the donor can wind up over a
period of years with a charitable deduction that exceeds one-hundred
percent of the value of the work of art on the date the first part was
donated to the museum.

Exchanges

It is a common practice for collectors to exchange items, each in-
tending to improve his or her collection. Dealers often encourage collec-
tors to trade in works of art purchased from them in exchange for other
works of art. Section 1031(a) allows certain "like kind" exchanges to
be made tax-free. The statute limits such exchanges to property held
for productive use in a trade or business or for investment that is ex-
changed solely for property of a like kind to be held for productive use
in a trade or business or for investment.37

In the usual case, a collector is engaged in a hobby, not a business.
The collector may argue that he or she is an investor and held the
property for investment. The term "investment" is not defined in sec-
section 1031. Relying on Wrightsman v. United States38 and sections 162,
165, 212, and 183, the term most likely means property acquired and
held primarily for profit. The burden of proof for the collector who
wants to be an investor is difficult under section 1031(a) because of the
lack of authorities and the difference in terminology from sections 212,
165 and 183. Therefore, for the collector, the difference between the

37. I.R.C. § 1031(a) (1988); Treas. Reg. 1.1031(a)-1(b) (1988); see California
Fed. Life Ins. Co. v. Commissioner, 680 F.2d 83 (9th Cir. 1982), aff'd 76 T.C. 107
38. 428 F.2d 1316 (Cl. Cl. 1970).
which gives a specific example covering that situation. The part of that ruling dealing with a gift of a future interest is no longer applicable because of section 170(f).

Of course, when the collector dies, the value of the undivided fractional interest that was kept by the collector is includable in his estate.** Because of Revenue Ruling 57-293, it would be difficult to argue that, if the retained undivided interest is bequeathed to a noncharitable beneficiary, there should be a discount for the minority undivided interest retained. There is, however, no decided case on that point. If the bequest is made to a person who does not own the other part, the taxpayer should have a fair chance of convincing the IRS to allow some discount for the fractional interest. If the bequest is made to the museum that already owns a partial interest in the painting, the estate tax charitable deduction should be the percentage owned by the decedent multiplied by the full fair market value of the painting on the decedent’s date of death. Generally, before a museum will accept a fractional gift, it will want assurances that it will receive the balance of the undivided interest when the collector dies. The museum does not want to be left owning a fractional interest in a work of art with the donor's heir's fighting over the remaining fractional interest. Therefore, always discuss such a gift with the museum prior to making it.

It may be possible to increase the total charitable deduction through the use of fractional gifts. In the example stated above, the collector could deduct one-fourth of the fair market value of the painting on the date of the gift. A number of years later, the collector could make an additional gift of a one-fourth interest in the same painting. At that time, the painting may have increased in value not only because of the passage of time but also because it is now exhibited in a museum. Therefore, one-fourth of the fair market value on the later date may exceed the one-fourth value on the first date. If that process was carried on until the entire painting was donated, the total charitable deduction could exceed the total value of the painting on the date of the first gift. Of course, an appraiser would have to verify the increases in value each time an undivided fractional interest was donated to the museum.

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when appreciated property is contributed to charity. As discussed earlier, the appreciation in value of capital gain property is now a tax preference item that could result in the total or partial loss of the appreciation as a charitable deduction because of the application of the AMT. The AMT can be avoided by controlling the amount of appreciation in value (the tax preference) that is contributed to charity in any one year. This can be accomplished by calculating the maximum amount of appreciated property that can be contributed to charity in the year without incurring the AMT, and then making an undivided fractional interest gift within that limitation. Future undivided fractional interest gifts could then be made in later years to use up the full charitable deduction. At the same time, the donor can wind up over a period of years with a charitable deduction that exceeds one-hundred percent of the value of the work of art on the date the first part was donated to the museum.

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fair market value of the property received and the basis of the property given up results in a taxable gain. The investor, on the other hand, may be able to avoid any taxable gain under the umbrella of section 1031(a). Note, however, that even if an individual can carry the difficult burden of proof of being an investor, there may still be a problem on the exchange as to what constitutes “like-kind” property. In Private Letter Ruling 8127089, the IRS said that artwork in one medium (lithographs) exchanged for artwork in another medium (oil paintings) is not similar property.

The taxpayer who is considering an exchange must be familiar with section 1031, as discussed above, as well as the following provisions:

Section 67 generally limits miscellaneous deductions to those that exceed two percent of adjusted gross income.

Section 162 allows a taxpayer to deduct from gross income all ordinary and necessary expenses incurred in a trade or business.

Section 212(1)-(2) allows a taxpayer to deduct expenses incurred in the production or collection of income.

Section 165 allows a taxpayer to deduct losses sustained in a trade or business or in a transaction entered into for profit.

Section 183 qualifies the foregoing provisions by specifically disallowing, with certain exceptions, deductions attributable to activities not engaged in for profit.

Section 262 denies a deduction or loss for expenses that are personal in nature.

Investment intent can be shown by the factors listed in regulation section 1.183-2. These factors are as follows:

1. The manner in which the taxpayer carries on the activity. A businesslike manner with complete and accurate books and records is more likely than not to be profit-motivated.

2. The expertise of the taxpayer or the taxpayer’s advisors. Preparation for the activity by an extensive study of accepted business, economic, and scientific practices or by consultations with experts may indicate a profit motive.

3. The time and effort expended by the taxpayer in carrying on the activity. Spending a great deal of time and effort is more likely than not to indicate a profit motive.

4. The expectation that assets used in the activity may appreciate in value. The term “profit” does encompass appreciation in value of the assets, but unrealized appreciation alone is not sufficient. The taxpayer must show that his or her primary purpose is ultimately to realize appreciation.

5. The success of the taxpayer in carrying on other similar or dissimilar activities for a profit.

6. The taxpayer’s history of income or losses with respect to the activity. A series of realizations of income may indicate a profit motive.

7. The amount of occasional profits, if any, that are earned.

8. The financial status of the taxpayer. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that the activity is engaged in for profit.

9. Elements of personal pleasure or recreation. The regulations indicate that the greater the pleasure, the less likely it is that there is a profit motive. Although not required by the Internal Revenue Code or Wrightsman,40 a physical segregation of the art investment property out of the taxpayer’s personal residence or office will generally help the taxpayer prove his or her profit motive.

No one of the above factors is determinative, and the determination of a profit motive is not limited to the above factors. The test is based on “all the facts and circumstances,” is a profit motive present?

Regardless of whether an exchange is a taxable or nontaxable transaction for federal income tax purposes, it is treated as a sale, and a sales tax may be payable on the exchange. Generally, if the exchange is between a dealer and a collector, the dealer should collect and pay over the sales tax.41

Conclusion

Anyone involved in any aspect of dealing with valuable works of art must be aware of the tax implications of their actions. It is always best to think about the tax impact of contributing works of art to charity or exchanging works of art before taking such action rather than have any unhappy surprises later.42

39. 428 F.2d at 1316.
40. See N.Y. Comp. Codes R. & Regs. sections 526.5(f), 526.7(d).
41. This article only touches on some of the tax problems involved with valuable collectibles. For a detailed analysis of these and other tax issues see R. Lerner & J. Beisler, ART LAW—THE GUIDE FOR COLLECTORS, INVESTORS, DEALERS AND ARTISTS chs. 11-13 (1989).
fair market value of the property received and the basis of the property
given up results in a taxable gain. The investor, on the other hand, may
be able to avoid any taxable gain under the umbrella of section 1031(a). Note, however, that even if an individual can carry the diffi-
cult burden of proof of being an investor, there may still be a prob-
on the exchange as to what constitutes “like-kind” property. In Private
Letter Ruling 8127089, the IRS said that artwork in one medium
(lithographs) exchanged for artwork in another medium (oil paintings)
is not similar property.

The taxpayer who is considering an exchange must be familiar with
section 1031, as discussed above, as well as the following provisions:

Section 67 generally limits miscellaneous deductions to those that
exceed two percent of adjusted gross income.

Section 162 allows a taxpayer to deduct from gross income all or-
dinary and necessary expenses incurred in a trade or business.

Section 212(1)-(2) allows a taxpayer to deduct expenses incurred
in the production or collection of income.

Section 165 allows a taxpayer to deduct losses sustained in a trade
or business or in a transaction entered into for profit.

Section 183 qualifies the foregoing provisions by specifically disal-
lowing, with certain exceptions, deductions attributable to activities not
engaged in for profit.

Section 262 denies a deduction or loss for expenses that are per-
sonal in nature.

Investment intent can be shown by the factors listed in regulation
section 1.183-2. These factors are as follows:

1. The manner in which the taxpayer carries on the activity. A businesslike manner with complete and accurate books and records is
more likely than not to be profit-motivated.

2. The expertise of the taxpayer or the taxpayer’s advisers. Prepa-
ration for the activity by an extensive study of accepted business, eco-
nomic, and scientific practices or by consultations with experts may in-
dicate a profit motive.

3. The time and effort expended by the taxpayer in carrying on the
activity. Spending a great deal of time and effort is more likely than
not to indicate a profit motive.

4. The expectation that assets used in the activity may appreciate
in value. The term “profit” does encompass appreciation in value of
the assets, but unrealized appreciation alone is not sufficient. The taxpayer
must show that his or her primary purpose is ultimately to realize
appreciation.

5. The success of the taxpayer in carrying on other similar or dis-
similar activities for a profit.

6. The taxpayer’s history of income or losses with respect to the
activity. A series of realizations of income may indicate a profit motive.

7. The amount of occasional profits, if any, that are earned.

8. The financial status of the taxpayer. The fact that the taxpayer
does not have substantial income or capital from sources other than the
activity may indicate that the activity is engaged in for profit.

9. Elements of personal pleasure or recreation. The regulations in-
dicate that the greater the pleasure, the less likely it is that there is a
profit motive. Although not required by the Internal Revenue Code or
Wrightman, a physical segregation of the art investment property
out of the taxpayer’s personal residence or office will generally help the
taxpayer prove his or her profit motive.

No one of the above factors is determinative, and the determina-
tion of a profit motive is not limited to the above factors. The test is:
based on “all the facts and circumstances,” is a profit motive present?

Regardless of whether an exchange is a taxable or nontaxable
transaction for federal income tax purposes, it is treated as a sale, and
a sales tax may be payable on the exchange. Generally, if the exchange
is between a dealer and a collector, the dealer should collect and pay
over the sales tax.

Conclusion

Anyone involved in any aspect of dealing with valuable works of
art must be aware of the tax implications of their actions. It is always
best to think about the tax impact of contributing works of art to char-
ity or exchanging works of art before taking such action rather than
have any unhappy surprises later.

39. 428 F.2d at 1316.
40. See N.Y. Comp. Codes R. & Regs. sections 526.5(f), 526.7(d).
41. This article only touches on some of the tax problems involved with valuable
collectibles. For a detailed analysis of these and other tax issues see R. Lerner & J.
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