

THE ERSKINE COMPANY LLC

# Planning for the Sale of Artwork

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# Planning for the Sale of Art

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It seems intuitive that artists, collectors, investors and dealers of artwork, very often celebrities in their own field, would have in place comprehensive planning to manage these unique assets, to minimize the tax effect of a transfer by sale, gift or bequest, and have in place contingency plans, and the people to execute those plans, in case of an unforeseen event, such as a sudden death. It is rarely the case. Here are a few cases:

- James Gandolfini died suddenly from a massive heart attack in 2013 leaving his estate, including his artwork and royalties, subject to a 55% estate tax.
- James Brown's bequest of cash to educate his grandchildren was so ambiguously worded that his girlfriend sued, costing years and millions in fees.
- Doris Duke left her \$1.2 billion fortune, including her extensive collection of art, collectibles and historic properties, to a foundation; however, she left her butler in charge of the foundation, resulting in law suits claiming mismanagement and costing millions in fees.

Anyone can make a mistake, but these and other cases rise to the level of a disaster. Not one person, but many people, made multiple mistakes. Broadly, these mistakes are 1) not learning from the past, 2) not adapting to the present, and 3) not anticipating the future. The first two topics, which involve having the right procedures and the right leadership in place, are important but not the subject of this work. The focus here is on anticipating the future: that is foreseeing the possible risks and opportunities that exist, when artwork and the associated intellectual property such as copyrights and royalties is sold during one's lifetime or at one's death.

Why is this necessary? Because you, or your fiduciary cannot lump the sale of artwork together with the liquidation of publicly traded stocks, bonds and cash. The direct ownership of a specific tangible asset, like a piece of art, has both rational and an irrational decision-making process based on financial, emotional and personal value ownership of the item represents. A fiduciary is not only your agent, but is also the agent of your beneficiaries, charitable and non-charitable alike. When a beneficiary realizes that they are to receive a benefit, they immediately feel a degree of ownership over the artwork, and with that, a desire to control that item. This desire will conflict with the fiduciary's duty both to you and to the other beneficiaries unless proper planning is in place. This is compounded by the difficulties in valuation of artwork for capital gains, estate, income and gift taxation and

the fact that, relative to the stock and bond markets, the art market is opaque, conflicted and subject to trends and fads.

Table of Contents

Preliminaries..... 6

    Information ..... 6

        The Market ..... 6

        Existing Relationships and Rights ..... 6

        Ownership Status..... 6

    Agree on the Common Goal ..... 7

Planning for the Sale:..... 7

Consignment Agreements..... 7

    Agency Relationship ..... 7

Auction Sales..... 8

    Advantages of Auction Sales..... 8

    Disadvantages of Auction Sales ..... 8

    Risks of Auction Sales ..... 8

    Dealer Agreements Effect on Auction Sales ..... 9

    Fees, reserves and other things to consider ..... 9

Private Treaty Sales..... 10

Private Sales through Dealer ..... 10

    Consignment ..... 10

    UCC-1..... 11

Bargain Sales to Museums ..... 11

Income Taxation on the Sale of Art ..... 11

    The Artist ..... 11

    Non-Creator Ownership of Art..... 12

        The Art Investor ..... 12

        The Art Collector/Hobbyist..... 13

        The Business Investment Collector..... 13

        The Art Dealer ..... 14

Like- Kind Exchanges ..... 14

Alternatives to 1031 Exchanges for Artwork ..... 14

Charitable Remainder Trusts..... 14

Charitable Lead Trusts ..... 15

Qualified Opportunity Zone Funds ..... 16

Deferred Sale Trust ..... 17

Trades involving Artwork ..... 17

Charitable Contributions of Art..... 19

    Limitation ..... 20

Valuation of Art for Tax Purposes..... 20

## Preliminaries

The first step in planning for the sale of art is the gathering and organizing information about each item and the overall collection. Next, is to gather information about artwork and collectibles, and the clear or clouded title to the property, has a dramatic difference in the value, or even the right to own, artwork. The final preliminary step is establishing a common goal agreed to by all of the stakeholders in the artwork. This includes not only the current owners, but also the prospective future owners, the creators of the art, dealers and auction houses and the professional advisors such as lawyers and accountants.

## Information

Information on the prior and current ownership of an item, sometimes called the provenance of the piece, will have a dramatic impact, both positive and negative, on the value of art. So, to begin, gather as much information about the individual items you own, and your overall collection, as possible. In its basic form, this is your inventory, but you should also include:

### The Market

- Your Analysis of the relevant sectors of the market,
- Your opinion as to which method of sale is best for each item,
- The estimated impact of commissions, taxes and fees on net proceeds
- The impact of a bulk sale of your entire collection on the net value of the collection, and
- How your fiduciary can avoid having the piece "shopped around"

### Existing Relationships and Rights

Include for each item:

- Any business relationships you have related to your collection (dealers, conservators, agents, collaborators, artists, etc.)
- Any copyrights you may own for reproduction of the item in books, online etc.

### Ownership Status

Determine if you hold the item as a collector, an investor, as inventory, or as a business investment; and, identify which items you may hold a questionable title to possess.

## **Agree on the Common Goal**

Although the collection may be an asset of the estate, it is critical to form a consensus among the current or future stakeholders as the common goal they share in the outcome of any transaction, be it a sale at an auction house, private treaty sale, consignment through a dealer, or a bargain sale to a charity. Once this common goal is agreed upon, usually based on the stakeholders seeing that their individual objectives are best met by this course of action, much of the resistance to the sale falls away.

## **Planning for the Sale:**

Once the preliminary steps are taken, hopefully before the date of death, consider the consignment agreement, which will vary depending on the type of sale you choose. This will also be affected by the income taxation of the sale, and whether the income tax can be mitigated.

## **Consignment Agreements**

Whether it is a sale through a dealer or a sale through an auction house, your consignment agreements define the relationship that exists between you, as the Seller, and the Consignee. This is especially true on how much can be decided by the auction house alone, and how much only with the Seller's permission. Any consignment agreement is, however, a contract and so open to negotiation, so key terms should be negotiated.

## **Agency Relationship**

When artwork is consigned, an agency relationship exists between the Seller (the principal) and the Consignor (the agent). Statutes and the common law impose certain duties on all agents, including a duty of undivided loyalty. These duties can be altered by the terms of the consignment agreement.

If the consignment agreement gives the agent broad (or even sole) discretion on matters effecting the consignment, this latitude effectively nullifies the duty of undivided loyalty of any objective standards of reasonableness in the sale of the artwork. The result is that the auction house is not liable if they put their own interest over (or even in conflict with) the interests of the Seller. In effect, this shifts the entire burden of risk from the agent to the Seller in the transaction.

It is possible, with higher price or more desirable items, to negotiate the terms of the consignment agreement to swing the duty pendulum a bit further towards the interests of the Seller. Waiver or reduction of fees and commissions charged is also an element.

## **Types of Sale:**

### **Auction Sales**

An auction sale is a public sale where there is competitive bidding and the item is sold to the highest bidder. The auctioneer is, legally, and agent of the Seller though the consignment agreement can significantly alter, if not reverse, the role of the auctioneer to the Seller.

#### **Advantages of Auction Sales**

An advantage of selling at auction is that the Seller may have the attention of several prospective buyers at one moment, which can fuel bidding and drive prices up. The auction cycle for major sales also allows for extensive marketing campaigns including ads and exhibitions which can stoke interest in the material. Finally, the auction marketplace is relatively transparent; Sellers know when their work will be sold and can even observe the sale.

#### **Disadvantages of Auction Sales**

The disadvantage of selling at auction is that the Seller must adhere to the auction calendar, which is not always convenient. A work consigned in the summer may not hit the auction block until November. (In the case of smaller, more regional auction houses, the process of selling is usually much more expedient since the production—catalogue, marketing, exhibition, etc.—is not so elaborate.) Payment is typically made 35 days after a sale, but there have been cases where the funds have not been forthcoming and the Seller has to follow up

#### **Risks of Auction Sales**

As auctions are public forums, some collectors fear exposure. If their piece is recognized, people may wonder why they are selling (have they fallen on hard times?). If a work fails to sell, that, too, is public; the bought-in work will be considered “burned” and will be difficult to sell—at least in the immediate future—at the anticipated price. In order to re-introduce



such a bought-in work back into the market, the Seller will need to “rehabilitate” it: keep it off the market for some time and lend it to respectable shows where possible. This takes time.

### **Dealer Agreements Effect on Auction Sales**

In certain circumstances, when weighing whether or not to sell a work through an auction house, collectors should consider any agreements they may have made with the dealer from whom they originally purchased the work. It’s important to note that, in the primary market, as dealers like to control the markets of the artists they represent, even if the collector did not grant an actual right of first refusal in writing, a dealer may harbor an expectation that a work will be later sold through the gallery. Ignoring this expectation may have consequences.

### **Fees, reserves and other things to consider**

In evaluation of competing auction house offers, consider:

- What is the estimate they place on the piece?
- What are the fees charged?
  - Seller's fees from 10% to 25% plus costs.
- How is the piece to be marketed?
- Are comparable works to be sold at the same time?
- Where will the piece be placed in the catalog?
- What is the reserve price?
- Will the auction house hold the piece until the purchase price is paid in full?
- Who is the expert in this genre at the auction house?
- What other fees are assessed?
  - Photography: Anywhere from \$10 to \$1,500 per image
  - Buyer's premium: from 25% (below \$200,000) to 5% (over \$3 MM) varying based on the consignment agreement.
  - Buyback fees: Some auction houses (Doyle's) charge a fee up to 5% of the reserve price if the item does not sell.
  - Insurance: Charges of insurance will be between 1% and 1.5% of the reserve price (which may be waived if your insurance covers the artwork when in the hands of the auction house.)

- **Storage:** If the piece is not picked up promptly, a fee of \$5 to \$10 per day is charged.
- **Advertising and promotion:** the costs of advertising and promotion of the piece is passed on to the Seller.
- **Appraisal:** Appraisals are usually done by the hour, varying from \$25 to \$300 per hour.
- **Shipping:** Shipping an item is covered by the buyer (or Seller if the item does not meet reserve).
- **Collection:** If a Buyer defaults, the auction house has no obligation to chase the buyer for the agreed price. The auction house can assign the Seller the contract and then the Seller must cover the costs of collection.
- **Performance fees:** A few auction houses charge a 2% "performance fee" if the sale price exceeds the estimated price.
- **"Claw-back":** If, after the sale, the title or authenticity of the artwork is voided, then the Buyer can demand that the proceeds be "clawed back" from the Seller, regardless of whether the sale occurred in good faith and regardless of the amount of time that has gone by since the transaction. The Seller is responsible for all attorneys' fees.

## **Private Treaty Sales**

Essentially, this is an auction house acting as a dealer. This is a private sale on the secondary market where the Seller receives a specified price.

## **Private Sales through Dealer**

Sale through a dealer or other art advisor offers the most control over the sale process to the Seller possible, especially on whether the Buyer is "suitable". The drawback is that such a sale through a dealer can take months, if not years, to complete. This is especially true when there is an institutional buyer, since the acquisition process can take a year by itself.

## **Consignment**

Commonly, a Seller will consign an item to a dealer. In this case, the dealer offers a set price for the art, if sold, and the net sale price goes to the Dealer. The amount of the mark-up of the item is not disclosed to the Seller, and can be 25%, 50%, 100% or more.

Alternatively, the amount the dealer receives can be capped or the Seller receives a fixed percentage of the sale price, with the dealer receiving the rest

This means that the consignment agreement is something to carefully consider and negotiate.

## **UCC-1**

A Consignor should file with the state a form UCC-1 to perfect a security interest in the item consigned. At a nominal fee, the Consignor gets priority payment position as a creditor if something goes wrong. Remember that UCC filings must be renewed at least every five years.

## **Bargain Sales to Museums**

Some items are worth more than a museum can afford, in which case the Seller and the museum can enter into a bargain sale. This is where the museum pays an amount that is less than the fair-market value of the work, and the Seller receives a charitable deduction for the balance. This provides both cash and charitable deductions for the same transaction.

## **Income Taxation on the Sale of Art**

Unlike other assets, the rate at which you are taxed on the sale of artwork depends on your role and relationship to the artwork: whether you are the artist who created the art, a dealer who holds the artwork in inventory or consignment, a collector, an investor or a business owning art.

### **The Artist**

The creative process of the artist is constantly expanding the definition of what is a piece of artwork. The medium through which an artist works is likewise expanding.

An artist's work, during their life and later, may sell numerous times and be seen in galleries more than once. The sales value can vary from a small sum to millions of dollars such as with the work of Picasso, Van Gogh, etc. An artist may achieve notoriety during their life or may never achieve it; however, their works are of no less importance.

An artist may conduct their craft as their occupation as a for-profit trade or business or as a not for profit activity. Income would be taxed as ordinary income and generally expenses would fall under IRC § 162, however for the activity deemed not-for-profit under IRC § 183, expense deductibility is limited to gross income.

### **Non-Creator Ownership of Art**

Once the artwork leaves the hands of the artist, it generally goes to one of four categories of persons, each of which have different tax considerations. They are the investor, hobbyist, business collector and dealer. Which category a taxpayer falls into would depend on the facts and circumstances of that taxpayer's case. The line between these categories of art owners for tax purposes is not always clear; therefore, there has been much litigation in the courts such as the distinction between investor and dealer or between an investor and a hobbyist. In addition, a taxpayer might hold art in different categories. For example, a dealer might hold specific pieces of art in their trade or business and other pieces of art as an individual investor. Additionally, various expenses and losses in each category may or may not be deductible and likewise depends on the facts and circumstances. A customized plan based on a piece-by-piece determination as well as the category of taxpayer you fall into is often required. For each purchase or sale, whether any expense or loss is deductible, and whether it is ordinary income or capital gains income, is determined by how you relate to each item – that is a combination of your intent and your actions. Following is a brief introduction to the four categories of taxpayer you may be.

#### **The Art Investor**

An investor is a person who buys sells and collects art solely as an investment with the hope the asset will appreciate to enable sale at a profit. For an investor, generally the art investment when sold is taxable as a capital gain unless it falls outside the definition of capital asset. IRC § 1221 defines capital asset to include all assets except:

- (1) Stock in trade or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business
- (2) Property used in a taxpayer's trade or business that is subject to the allowance for depreciation or
- (3) An artistic composition held by the creator or a person in whose hands the basis of such artistic composition is determined by reference to the basis of the creator. A gift

from an artist to anyone would fall under category (3) and be taxable as ordinary income property.

A capital loss is available to an investor under IRC § 165(c)(2) if the intent test of entering into the transaction for profit can be proved: the taxpayer must prove the purchase and the sale of the artwork was a transaction entered into for profit. Many factors are looked at based on the facts and circumstances of the taxpayer's case however, the taxpayer's personal use and enjoyment of the artwork will generally be a critical factor showing the intent was not entered into for profit.

The expenses of the investments fall under IRC § 212 with respect to deductibility, if an investor's primary intent was to hold the art for the production of income can be proved. The intent is established through facts and circumstances that various court cases have established. Like the loss issue, a critical factor is personal use and enjoyment. Not all expenses would be allowed under IRC § 212, such as expenses to prolong the life or increase the value of the work of art, selling expenses, etc. If IRC § 183(d) applies, the activity is presumed to be for profit if the gross income exceeds the deductions in 3 or more years in a 5-year period. If not, then IRC § 183 may apply limiting the deduction of expenses, if the activity is deemed not for profit activity.

An investor can be classified as a dealer or a hobbyist instead of an investor based on the facts and circumstances in their case. Sometimes investors want to be classified as dealers when they have losses, to be able to deduct the loss as ordinary income rather than as a capital loss.

### **The Art Collector/Hobbyist**

A hobbyist is a collector who buys art without considering whether it will ever be a profitable investment. The hobbyist rarely sells a work, which if sold generally is a capital asset in which gains are recognized but losses are not allowed (IRC §§ 1221 and 165(c) respectively). Expenses attributed to maintaining the collection are generally not deductible per IRC § 262. However, IRC § 183 may allow some deductions up to the amount of gross income generated by the activity following the ordering rules of the IRC § 183. Because of the tax disadvantage of being a hobbyist, the hobbyist tries to be classified as an investor.

### **The Business Investment Collector**

A business collector does not buy the art for resale but rather for purposes such as office display or decoration in the ordinary course of trade or business. Because the useful life of

Art is not determinable, it's generally not subject to depreciation. In addition, many businesses buy art for investment that can place them in the category of investor or hobbyist. The art investment can be of such a nature that they cross the line into being a dealer. Again, facts and circumstances need to be reviewed in each individual case to determine the categorization of the activity.

### **The Art Dealer**

The dealer is one who buys and sells art as a trade or business. An art gallery is one of the types of dealers. Art dealers are taxed in the same way as any other retail operation. As such, all income including income from the sale of art is taxed as ordinary income (IRC §§ 61, 64). Expenses, if ordinary and necessary, are deductible under IRC § 162. Dealers sometimes want to be classified as investors because of the favorable capital gains rates versus being taxed on said gains as ordinary income. Additionally, dealers including gallery owners, often wear the hat of both investors in art as well as dealers in art, keeping the two as separate activities. There are many court cases dealing with this issue such as *Williford v. Commissioner*, T.C. Memo. 1992-450.

An issue which many times create problems for all the categories is the charitable contributions of art which is discussed below.

### **Like- Kind Exchanges**

Under the Tax Cuts and Jobs Act, exchanges of personal property and intangible property do not qualify as tax-free under Code Sec. 1031 for exchanges completed after Dec. 31, 2017. Thus, exchanges of machinery, equipment, vehicles, patents and other intellectual property, artwork, collectibles, and other intangible business assets do not qualify for non-recognition of gain or loss as like-kind exchanges.

### **Alternatives to 1031 Exchanges for Artwork**

#### **Charitable Remainder Trusts**

*A Charitable Remainder Trust is the best way to defer paying capital gains tax on appreciated assets, if you can transfer those assets into the trust before they are sold, generating an income over time.*

When a charitable remainder annuity trust is established, your gift of cash or property is made to an irrevocable trust. The donor (or another charitable beneficiary) retains an annuity (fixed payments of principal and interest) from the trust for a specified number of

years (up to twenty years), or for the life or lives of the non-charitable beneficiaries. At the end of the term, a qualified charity you specify receives the balance of the trust property.

Gifts made to a charitable remainder annuity trust qualify for income and gift tax charitable deductions; and, in some cases an estate tax charitable deduction for the remainder interest gift only if the trust meets the legislative criteria. The annuity paid must either be a specified amount expressed in terms of a dollar amount (e.g., each non-charitable beneficiary receives \$500 a month) a fraction, or a percentage of the initial fair market value of the property contributed to the trust (e.g., beneficiary receives 5% each year for the rest of his life).

You will receive an income tax deduction for the present value of the remainder interest that will ultimately pass to the qualified charity. Government regulations determine this amount, which is essentially calculated by subtracting the present value of the annuity from the fair market value of the property and/or cash placed in the trust. The balance is the amount that the grantor can deduct when the grantor contributes the property to the trust.

A Charitable Remainder Unitrust is essentially the same as a Charitable Remainder Annuity Trust except that instead of a fixed dollar amount or percentage of the original gift amount, the annuity is a specific percentage of the balance of the trust assets as of the beginning of the year the payments are to be paid.

### **Charitable Lead Trusts**

*A Charitable Lead Annuity Trust is the best way to accelerate charitable deductions to both reduce the negative effects of the new limitations on itemized deductions and to offset up to 50% of your Adjusted Gross Income in any tax year. It can also be used as a way to eliminate gift or estate taxes on transfers to children or other beneficiaries.*

You create a CLAT by transferring cash or other assets to an irrevocable trust. A charity receives fixed annuity (principal and interest) payments from the trust for the number of years you specify. At the end of that term, assets in the trust are transferred to the non-charitable remainderman you specified when you set up the trust. This person can be anyone: yourself, a spouse, a child or grandchildren even someone who is not related to you.

You can set up a CLAT during your lifetime or at your death. Both corporations and individuals may establish lead trusts, which is useful when you need to take appreciated assets out of a business tax-free.

If you are the beneficiary, then you will receive an immediate and sizeable income tax deduction. In the second and following years, you must report the income earned by the trust, less the amounts actually paid to the charity, in the form of an annuity.

One advantage of the CLAT is the acceleration of the charitable deduction for gifts made over up to twenty years into the year you create the CLAT. For example, if you have sold a very highly appreciated asset in 2019 for a net gain of \$250,000 and you would like to take the entire \$250,000 as a charitable gift in 2019 by transferring the cash into the CLAT, you'd then pay out the annuity equal to \$250,000 in 2019 dollars, in equal payments over twenty years, or at about 6.85%. If the assets make the average return on the stock market of 8% over those twenty years, the estimated value of the CLAT that returns to you is approximately \$382,000.

Another advantage of the CLAT is that it allows a "discounted" gift to family members. Under present law, the value of a gift is determined at the time the gift is made. The family member remainderman must wait for the charity's term to expire; therefore, the value of that remainderman's interest is discounted for the "time cost" of waiting. In other words, the cost of making a gift is lowered because the value of the gift is decreased by the value of the annuity interest donated to charity.

When the assets in the trust are transferred to the remainderman, any appreciation on the value of the assets is free of either gift or estate taxation in your estate.

A Charitable Lead Unitrust is essentially the same as a Charitable Lead Annuity Trust except that the payout to charity is a percentage of the trust assets at the beginning of the year in which the annuity payments are to be made.

### **Qualified Opportunity Zone Funds**

*The Qualified Opportunity Zone Fund is new enough that the regulations are not yet complete, but it has the potential to be a powerful tool to both defer capital gains and get a tax-free return on investments.*

A new provision in the 2017 Tax Cuts and Jobs Act creates the Opportunity Zone Program, a program intended to drive long-term investment of capital to distressed communities by providing tax benefits on investments in QOFs. Originally introduced in the Investing in



Opportunity Act (IIOA) – this is the first new community development tax incentive program introduced since the Clinton Administration.

A QOF is a passive investment fund that invests 90% of its capital in new opportunities in Opportunity Zones. Treasury certified QOFs can pool and deploy investment capital in Opportunity Zones by investing in stock, partnership interests, and business properties. U.S. investors in the QOF receive a tax deferral, for a minimum of five and a maximum of seven years, and other tax benefits on unrealized capital gains invested in the Fund. Additionally, any appreciation on the investment that remains in the fund for more than ten years can be cashed out tax-free. The benefits of investing realized capital gains into a QOF include:

- The tax on realized capital gains reinvested in an Opportunity Fund is deferred until investment is disposed of or December 31, 2026, whichever is sooner.
- The basis for capital gains reinvested in an Opportunity Fund is increased by 10% if the investment in the Opportunity Fund is held by the taxpayer for at least 5 years; and, by an additional 5% if held for at least 7 years, thereby excluding up to 15% of the original gain from taxation, and
- A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in an Opportunity Fund, if the investment is held for at least 10 years. This exclusion only applies to gains accrued after an investment in an Opportunity Fund.

### **Deferred Sale Trust**

A Deferred Sale Trust is where you sell a highly appreciated asset to an irrevocable trust in return for an installment note. The Trust then sells the asset to a third party. Under IRC section 453, you only pay tax on the gains and the interest as they are paid out to you, and the Trust pays no tax on the sale of the assets to the third party because the trust received a new cost basis when the installment sale occurred. The trust can then reinvest the proceeds into other assets or a wealth replacement vehicle (such as life insurance), the death benefit being triggered at the same time the term of the note ends, such as your death.

### **Trades involving Artwork**

Trades are a common income issue. Trades occur when a gallery, dealer, or artist trades inventory with another gallery or individual. Trades are treated in one of three ways:

- Recorded on the books as non-taxable. The basis of the new item received is the same as the item given up, plus any boot (money or assets added to the transaction to reflect the fair market value of the item traded) received would be reported as income.

- Recorded as a taxable event. The basis of the new item is its fair market value, or cost.
- Hybrid method using parts of both methods.

For the following reasons, the proper treatment of trades is to record them as taxable events:

- Section 61 defines gross income as income from whatever source derived. The regulations state:

Treasury Regulation 1.61-1

Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in case.

- In *James A. Lewis Engineering, Inc. v. Commissioner*, 39 T.C. 482 (1962), aff'd. 339 F.2d 706 (5th Cir. 1964), the court ruled that income includes the fair market value of assets received.
- Section 1031 allows for the tax-free exchange of like-kind assets. However, I.R.C. § 1031(a)(2)(A) makes an exception for stock in trade held primarily for resale (therefore, it excludes inventory).
- Furthermore, under Treas. Reg. 1.1001-1(a), gain or loss is realized when property is exchanged for other property "differing materially in either kind or extent." In *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), the Supreme Court held that exchanged properties are "materially different" when "their respective possessors enjoy legal entitlements that are different in kind or extent." The owner of a work of art enjoys different legal entitlement than the owner of another work of art. Each owner has a pecuniary interest in and is entitled to sell a unique piece of property. Therefore, trading artwork for other artwork is an exchange of materially different property.

The law then clearly dictates that in the exchange of inventory, income must be recognized up to the amount of the fair market value of the asset received.

Despite clear law on the recognition of income from the exchange of inventory, trades are still often treated as non-taxable events, with the industry claiming they have always done it this way and/or that fair market value is hard to determine. Irrespective, an adjustment to a taxable event is required.

## **Charitable Contributions of Art**

The computation of the amount of a charitable contribution, limitations that affect the amount of the allowable deduction and other aspects of charitable contribution are beyond the scope of this brief introduction. However, there are issues involving charitable contributions of artwork that the private taxable collector should be aware of.

### **Charitable Donation of Artwork by Art Galleries, Dealers or the Artist who created the Artwork**

The charitable contribution deduction for artwork by Art Galleries, Dealers or the Artist who created the artwork, is generally limited to the smaller of fair market value on the date of contribution or its adjusted basis. In addition, an adjustment to cost of goods sold must be done to prevent a double deduction.

A charitable contribution deduction under IRC §170(a) is generally based upon the fair market value of the property at the time of the contribution (Treas. Reg. § 1.170A-1(c)(1)). If a sale of donated property would have generated ordinary income or a short-term capital gain, the amount otherwise deductible is reduced by the amount of ordinary income or short-term capital gain that would have been recognized (IRC § 170(e)(1)(A)). Treas. Reg. § 1.170A-4(b)(1) states: “The term ‘ordinary income property’ means property where any portion of the gain on which would not have been long term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization. Such term includes, 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 \*\*\*”. IRC § 1221(a)(3)(A) excludes from treatment as a capital asset certain property in the hands of the person who created it: for example, art created by an artist is ordinary income property in the artist's hands.

### **Charitable Donation of Artwork by Investor**

Generally, an investor is allowed a charitable contribution deduction for the donation of long-term capital gain property equal to the property's fair market value. Reductions and limitations to the allowable deduction may be required under IRC §170 under various situations. Treas. Reg. § 1.170A-1(c)(2) states that “fair market value” is “the price at which the property would change hands between a willing Buyer and a willing Seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.” Numerous issues arise in this arena.

Where artwork is donated to a charitable organization by an Art Gallery owner or a Dealer in artwork, a possible issue is whether the artwork being donated is actually held as an

investment or is it inventory of the owner? The charitable contribution deduction for the long-term capital gain property is generally its fair market value, while the deduction for a contribution of inventory is limited to the lower of cost or fair market value (see discussion of donations by Art Galleries, Dealers or Artists above).

The deduction for artwork that was gifted by the artist who created it to the investor is generally limited to the smaller of the gift basis or the fair market value on the date of the charitable contribution. Under IRC § 1221(a)(3)(C), the property retains its character of ordinary income property as it would to the artist who gave it. IRC § 1015 states that the basis of property acquired by gift is determined by the basis in the hands of the donor (the artist). IRC § 1221(a)(3)(C) excludes the artwork from being treated as a capital asset when the artwork held by “a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B).” Subparagraph (A) describes “A taxpayer whose personal efforts created such property” i.e. the artist.

The amount of the charitable contribution deduction follows the rules discussed above under artwork donated by the artist, except the basis is the gift tax basis (artist basis adjusted for any gift tax under IRC § 1015(d)). A taxpayer who donates art after obtaining the artwork by inheritance (regardless of whether it was part of the estate of the artist) is generally allowed a deduction for the fair market value of the artwork.

### **Limitation**

Contribution of artwork to retirement center can't exceed 30% of taxpayer's contribution base for tax year: its appreciated capital gain property. See IRS Letter Ruling 8143029.

### **Valuation of Art for Tax Purposes**

- 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. IRM 4.48.2 provides this mandate and the procedures and information needed to make the referral. Even if the value is under \$50,000, the Art Appraisal Services will assist the examiner upon request.
- A contemporaneous written acknowledgment from the donee is required for donations of \$250 or more. For claimed charitable contributions over \$500 for property donated, Form 8283 must be attached to the return and the taxpayer must maintain certain records. Other substantiation rules can be found in IRC 170(f)(11), Treas. Reg. §§ 1.170A-13(b) and (c), 1.170A-13(f), and Notice 2006-96, 2006-45 I.R.B. 902.

- For a charitable donation of property in excess of \$5,000, the donor has an additional requirement of obtaining a “qualified appraisal” (IRC 170(f)(11)). Form 8283 requires that the appraisal for donated art valued at \$20,000 or more must be attached to the return. For property valued at more than \$5,000, an appraisal summary must be attached to the return. IRC § 170(f)(11)(D) requires that all appraisals in excess of \$500,000 be attached to the return. The specifics of “qualified appraisal” requirements as well as “appraisal summary” and other related requirements can be found in IRC § 170(f)(11), Treas. Reg. § 1.170A-13(b) and (c), and Notice 2006-96, 2006-45 IRB 902.
- A charitable donee is required to file form 8282 if it sells, exchanges, or otherwise disposes of (with or without consideration) charitable deduction property (or any portion) within 3 years after the date the original donee received the property. The form is filed with the IRS and provided to the donor of the property. A third-party contact should be considered to determine if the form 8282 was required and not provided.
- In order for a taxpayer to claim a deduction for the full fair-market value of tangible property donated to charity, the property must be used by the charitable organization in a way that is related to its charitable purpose. See IRC §170(e)(1)(B)(i) and Treas. Reg. §1.170A-4(b)(3). Art is generally a related use property for an art museum, and perhaps a school, but probably not for a rescue organization. See IRC § 170(e)(7) for capture of the deduction on certain dispositions of exempt use property.
- It is possible to claim a deduction for a donation of a fractional interest in art, but immediately before the donation, the property must be wholly owned by the donor or shared by the donor and the charity. Special valuation rules apply to subsequent fractional gifts. The deduction may be recaptured if the gift is not completed within 10 years after the initial fractional gift or the date of the donor’s death, whichever occurs sooner. IRC § 170(o).
- Section 6695A imposes penalties on appraisers in certain circumstances. Section 6662 provides accuracy related penalties on the donor.

## Conclusion

Whether the sale of your artwork is just a remote contingency or it is an immediate need, planning ahead will help you, and your fiduciaries, anticipate the possible risks and opportunities that lie ahead. Hopefully, this introduction to some of these risks and opportunities will be helpful in defining your common goal, developing a plan, and executing the plan in the future.

## ART COLLECTION ESTATE PLANNING DATA

### INTRODUCTION

This form should be filled out as completely as possible and forwarded to **MATTHEW F. ERSKINE** for review prior to a personal conference. Although reasonable value approximations are acceptable, it is important to be certain of the identity of assets and how they are owned. The form provides for identification of assets as owned solely by husband, solely by wife, as community property, or in joint tenancy. However, please note where other conditions exist, such as tenancies in common or community property with rights of survival.

I/We understand that this questionnaire is designed to provide **ERSKINE & ERSKINE** with important information for estate planning purposes and that the firm's ability to advise clients with respect to lifetime and testamentary disposition of assets, with minimization of adverse tax consequences, depends on the accuracy of such information. I/We hereby confirm that such information is substantially correct.

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Dated: \_\_\_\_\_

## I. INVENTORY/VALUATION OF YOUR ARTWORK

Do you have a current written inventory of all the work you own? yes \_\_\_\_\_ no \_\_\_\_\_

Do you have a current written inventory of all work you have sold, gifted or bartered?

yes \_\_\_\_\_ no \_\_\_\_\_

Do you have a current written inventory of all original works in your collection by name of the artist? yes \_\_\_\_\_ no \_\_\_\_\_

*Because artists often work in many different media, it is often difficult to determine who created what artworks in the collection. Therefore, artists and collectors should maintain current written inventories of the works they have created as well as the works in their collections. Inventories should include:*

- i. List of works created by artist and/or in your possession, authors (including joint authors and collaborations and contact information), date of creation*
- ii. Contracts associated with any works such as licenses, assignments, etc.*
- iii. Where are the works located? Galleries, purchasers' names and contact information*
- iv. There are both software programs and old-fashioned card catalogs systems for tracking inventory.*

## II. SIGNIFICANT BUSINESS RELATIONSHIPS

Does a curator, dealer, agent or manager represent you for purchases or sales?

yes \_\_\_\_\_ no \_\_\_\_\_

If yes, who and what is your agreement with this individual?

Have you defined this relationship in a written contract? Do you have a copy of this contract?

Do you currently have a relationship with a gallery/dealer/publisher/record company/record publisher/film company/film producer, etc. who shows/distributes/produces/publishes or sells your artwork? yes \_\_\_\_\_ no \_\_\_\_\_

If yes, what works have you licensed/consigned/assigned/sold, and to whom and under what conditions? Do you have those agreements in writing?

Do you keep a list of the works that are on loan or on consignment? yes \_\_\_\_\_ no \_\_\_\_\_

If yes, could an executor easily locate it? yes \_\_\_\_\_ no \_\_\_\_\_

Are there other gallery/dealer/publisher/record company/record publisher/film company/film producer who have shown/distributed/produced/published or sold you your artwork in the past? yes \_\_\_\_\_ no \_\_\_\_\_

If yes, to whom and what work? What has subsequently happened to that artwork?

Have you ever had any of your artwork appraised by a professional?

yes \_\_\_\_\_ no \_\_\_\_\_ By whom? Do you still have copies of any such appraisals?

Has any of the artwork you owned ever been sold at auction? yes \_\_\_\_\_ no \_\_\_\_\_

What auction house did you use and who purchased the work?

Was it a charitable auction?

Do you have in your possession contracts such as loan agreements, location releases, image releases, synchronization licenses, image licenses, collaboration agreements, gallery consignment contracts, etc?

For which object(s) and with whom?

## II. COPYRIGHT ISSUES

Do you control the copyrights of works in your collection?

yes \_\_\_\_\_ no \_\_\_\_\_ If no, who has control of such copyrights?

Do you control the copyright for works that are now owned by third parties?

yes \_\_\_\_\_ no \_\_\_\_\_ If yes, who has ownership of those object(s)?



Do you have a current listing of the copyrights that you have registered? yes \_\_\_\_\_ no \_\_\_\_\_

Did you commission any art projects or works as a collaborator with the artist? Do you have an agreement governing the collaboration?

*Copyright (which includes the right to reproduce a replica or image of artwork) lasts for the life of the author plus an additional 70 years. In the case of anonymous works (or works made for hire), the copyright lasts for 95 years from publication or 120 years from the date of first creation.*

*If the collector is a joint author (on such as a catalogue of their collection) or collaborator in a joint work (such as a custom piece of furniture or a commission painting), the collector will need to determine how the work will be managed and how the copyright in the work will be administered in the event one or both “creators” have died.*

*Each “creator” controls 100% of the work, but need all signatories for an exclusive license. Was there a collaboration agreement defining how the work would be treated should either author die or become incapacitated?*

### III. DISPOSITION OF YOUR ARTWORK

#### A. Executor

Have you appointed an executor to manage your estate? yes \_\_\_\_\_ no \_\_\_\_\_

Would your executor readily know how to maintain and ultimately dispose of any artwork in your estate that is not specifically left to any person or organization in your Will?

yes \_\_\_\_\_ no \_\_\_\_\_

*Cultural Executor: In some circumstances a cultural executor such as a gallery or expert in the field may be better equipped to manage the disposition of artwork than family members. Additional funds should be allocated for administrative costs.*

Insurance policies or funds from the estate can help alleviate the burden of these additional costs.

*Insurance should be held in a specified Irrevocable Life Insurance Trust intended to provide liquidity to a collection, and should be drafted specifically to allow investments in, and loans collateralized by, artwork and collectables.*

Do you keep your purchase & sale inventory records (including the names of galleries/dealers/auction houses or other persons who might be interested in buying/selling your work and any prior appraisals) in a place where your agents or executor could readily find them in the event something happens to you? yes \_\_\_\_\_ no \_\_\_\_\_

*Provenance has become critically important in the art world in the last decade, especially art coming out of Europe before and after WWII, and art coming out of countries in economic and political turmoil such as Russia in the 1990's. All ephemera associated with the artwork, such as auction catalogues, notes etc., should be retained and catalogued for future reference.*

#### B. Disposition & Copyright Controls

Have you specifically addressed the disposition of any copyrights you own in your Will?  
yes \_\_\_\_\_ no \_\_\_\_\_

*Unless the collector is also an artist, it is unlikely that they will have copyrights over artwork made by others, but where there was collaboration with the collector, such rights may exist. Be aware that copyrights can be created of an image of an object (such as a piece of furniture), which might otherwise be in the public domain. Also, consider that in drafting a specific gift to charity of an object, that gift does not carry the copyrights to the object unless specifically mentioned in the specific gift, but a gift to a non-charitable beneficiary of the same object will*

carry such rights.

Could your executor find records of the copyrights you own? yes \_\_\_\_\_ no \_\_\_\_\_

Are you giving more than one person the copyright interest in individual works?  
yes \_\_\_\_\_ no \_\_\_\_\_

Have you addressed how unfinished works are to be treated? Can a third party finish your work?

Do you have specific instructions or restrictions on how your works may be used or licensed: e.g., cannot be sold, commissioned books in the same series, music performed at certain venues, etc?

*Copyright transfers by law must be in writing signed by the copyright owner. In addition to a signed writing, the transfer may need to be recorded with the US Copyright Office. To determine whether your client's transfer should be recorded, review the Copyright Circular 12.*

### **C. Storage & Maintenance**

Have you made arrangements for the maintenance and storage of your work pending its distribution? yes \_\_\_\_\_ no \_\_\_\_\_

Have you made arrangements for the maintenance, storage and distribution of your art-making equipment and supplies? yes \_\_\_\_\_ no \_\_\_\_\_

Have you estimated the total cost of your planned disposition of your art, equipment and supplies at your death (storage, distribution, conservation)? yes \_\_\_\_\_ no \_\_\_\_\_

Do you have an insurance policy or other specially designated funds in your Will to pay for any such artwork-related estate administration costs? yes \_\_\_\_\_ no \_\_\_\_\_

Visual art will need to be stored properly, as will photographs, film and digital files. Additionally, equipment will also need to be properly stored and maintained if not sold off.

Designated funds and/or an insurance policy can be helpful in alleviating these costs.

### **D. Gifts & Bequests**

Have you made specific bequests of your artwork to certain individuals in your Will?  
yes \_\_\_\_\_ no \_\_\_\_\_ If yes, to whom?

*Note issues re Copyrights above.*

If you are not leaving your artwork to family and/or friends, have you considered other means of ultimately distributing your artwork on your death, such as through a charitable organization?

yes \_\_\_\_\_ no \_\_\_\_\_

If yes, to which charitable organizations do you plan to donate any work?

*In respect to charitable donations, collectors and estates can deduct the full market value of the art work. Living artists may only deduct the cost of the materials.*

*IRS has separate art panel to verify valuations:*

1. <http://www.irs.gov/individuals/article/0,,id=96804,00.html>

*Depending upon the number of pieces and overall value of the donation, there are different appraisal requirements:*

2. <http://www.irs.gov/publications/p561/aro2.html#doe617>

*The recipient must accept the donation.*

Have you notified and received approval from the donee organization regarding your planned bequest(s)? yes \_\_\_\_\_ no \_\_\_\_\_

## V. TRUSTS & FOUNDATIONS

Have you considered a trust to manage your collection? yes \_\_\_\_\_ no \_\_\_\_\_

*Trusts and charitable foundations are helpful vehicles in which to manage art*

*Because the trust or foundation can retain the copyright in its entirety, manage licensing and administer royalty payment to number beneficiaries.*

*In addition to a management trust or foundation, you should also consider the use of split interest trusts such as CRT, CLT, GRIT, GRAT, and so forth for transferring collections between generations.*