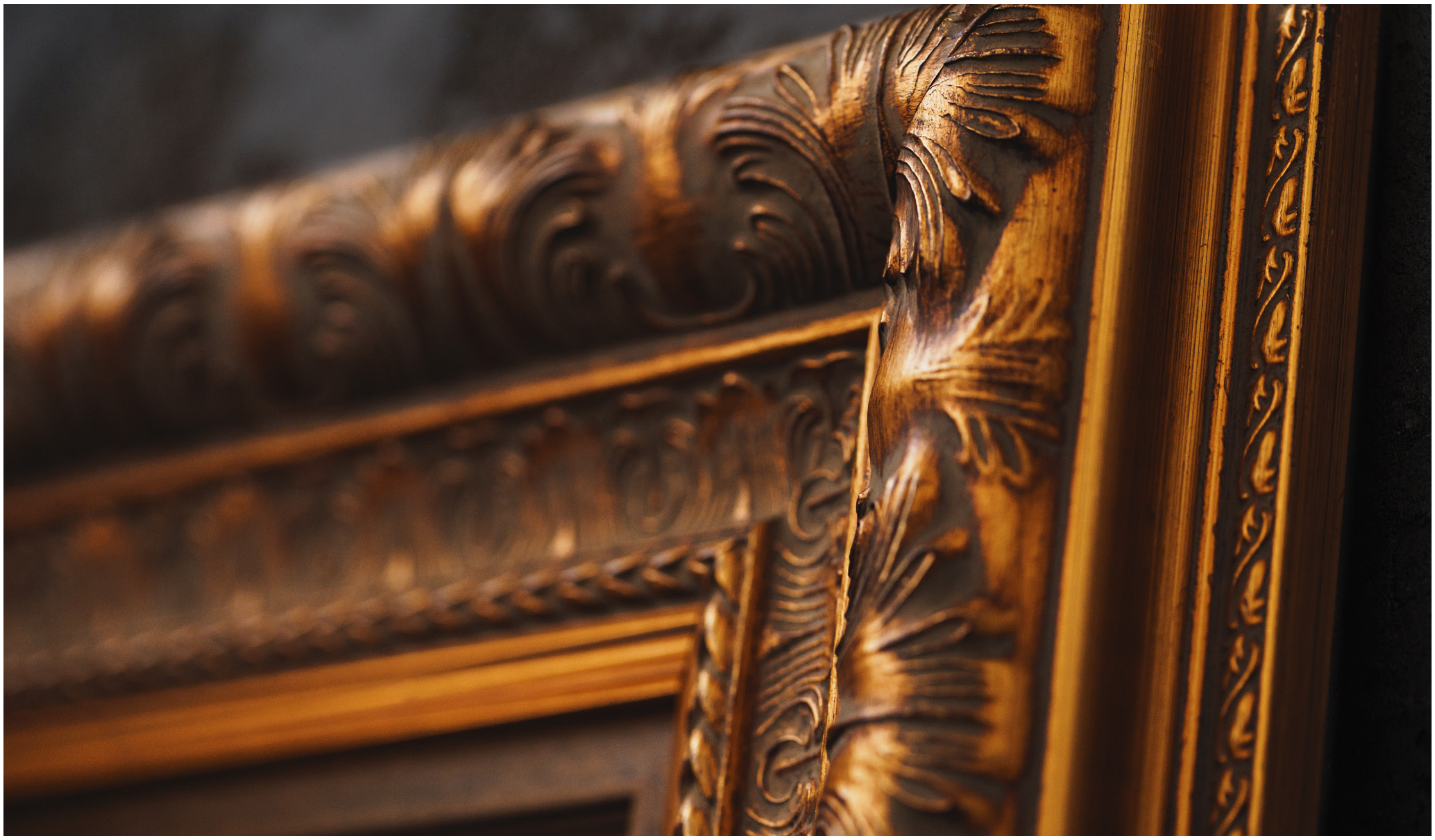
Taxation - Income, Estate, and Gift

Planning for art collections: Rules and tax considerations.

By Patricia M. Annino, Esquire



Years ago, in the process of probating a client's estate, I suggested to her son that he hire an appraiser to value the items in his mother's home as some of them, to a layman's eye, seemed valuable. He called me the following week in shock: the lamp in the hallway where he played football as a child turned out to be a real Tiffany worth more than $200,000.

Another client bought his wife a very famous Norman Rockwell painting at a New York auction. One month later Rockwell was the hottest game in town and the value of that painting had tripled. An untitled Jean-Michel Basquiat painting sold at a Christie's New York auction in 1984 for $19,000; it was sold in 2017 at a Sotheby's New York auction for $110,500,000.

The value of art is subjective and volatile. Sometimes clients think that the art they own is valuable when it isn't, and sometimes clients think the art they own is not valuable when it is. Those who choose to collect art may have a significant part of their investment portfolio in art, which can be a fickle and illiquid asset. Those who love art are very attached to it and can view its preservation and legacy as a very personal responsibility.

A recent Bank of America study reported that one in three high income earners currently collect art. Of those, 58% have not integrated their art collection with their overall wealth strategy and only 21% of current collectors and 18% of those interested in collecting art have discussed the impact on their financial and estate plan with their advisors.

Planning what to do with that one very valuable piece of art or the entire art collection requires careful thought and an understanding of the rules that apply to art.

Valuation of art

Valuation of art is an inexact science. The Internal Revenue Service established an Art Advisory Panel in 1968 to help the IRS review and evaluate appraisals of art. The panel consists of up to 25 art experts, who serve without compensation, and their recommendations are strictly advisory. The panel currently has two subcommittees: the fine arts panel (which reviews items such as paintings, sculptures, watercolors, prints, and drawings) and the decorative arts panel (which reviews items such as antique furniture, decorative art, ceramics, textiles, carpets, and silver).

If a tax return (income, gift, or estate) containing a work of art or cultural property with a claimed value of at least $50,000 is selected for audit, the case must be referred to the Art Advisory Panel for review. The panel meets twice a year for one day and reviews hundreds of works. All meetings are closed to the public, although the donor/taxpayer may see the panel's notes.

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In 2020, the Art Advisory Panel met once and reviewed 43 items with an aggregate taxpayer valuation of $57,672,000 on 14 taxpayer cases under consideration. The average claimed value of an item reviewed was $1,341,209. The panel recommended accepting the value of 12 items or 28% of the items submitted; it adjusted 31 items or 72% of the appraisals it reviewed and recommended total net adjustments of $12,372,565 to the appraised values – a 21.45% increase.

In addition to ascertaining an appropriate value, it is also important that the art be properly appraised and its provenance authenticated. IRS Publication 561 discusses the physical condition of the art (and restoration) and art appraisals. It defines qualified appraisals, qualified appraisers, and compliance—all of which are essential for tax reporting purposes.

Estate and gift tax consequences

Lifetime or death time gifting to family

A collector may wish to gift part of his collection to his children and wonder whether it makes sense to gift it now or at death.

Under the current law, it may be advisable to gift the art at death as the children or recipient will receive the stepped-up income tax basis in the art. This is particularly useful if the estate is under the federal exclusion threshold and is not taxable for federal estate tax purposes. However, the collector must always be cognizant of the changing value of art because when given at death, it is the date of death value that will be reported to the IRS and any state taxing authority.

It is also possible, if not likely, that more than the value of the art itself will be included in the taxpayer's taxable estate and the expenses of selling the artwork may not be deductible from the estate tax (unless the sale is necessary to pay the estate taxes or unless the will or trust specifically authorize the sale of the art at death).

In my experience, this is something many collectors do not know or pay attention to; one of the reasons for this is that they have not definitely decided whether to give it to a child and whether the child will want it. When that decision is not made and there is no specific direction to sell the art, it is important to understand that the estate tax can be significant.

It is also important, if giving a piece of art to one child, to review the tax clause in the will and trust and be sure that only the child who receives the art is responsible for paying the estate tax attributable to the art.

If a collector wishes to leave a Picasso to her daughter and apportion the estate tax so the daughter will be the only one of her children paying the estate tax, given the fluctuations in the value of the art, the collector should explore life insurance paid tax free to the daughter to cover that liability. Without proper planning the daughter may not be able to keep, insure, or enjoy the art.

If considering gifting art to a child at death, a collector should:

- Consider whether the child loves it as much as the collector does and has room in the home to show it.
- Consider if it makes economic sense for the child to tie up that much of an inheritance in an illiquid asset.
- Have an honest conversation with the child or children discussing these points.
- Review estate planning documents (will and trust) to ascertain if the child who will receive the art will be responsible for the payment of any estate taxes attributable to it or if the estate taxes will be paid by the estate (in essence, by all beneficiaries).
- Consider life insurance to cover the estate taxes due on the unique asset.

If, on the other hand, a collector gifts the art during his lifetime, the benefit is that any future appreciation will be removed from the collector's taxable estate (even though the basis may not step up).

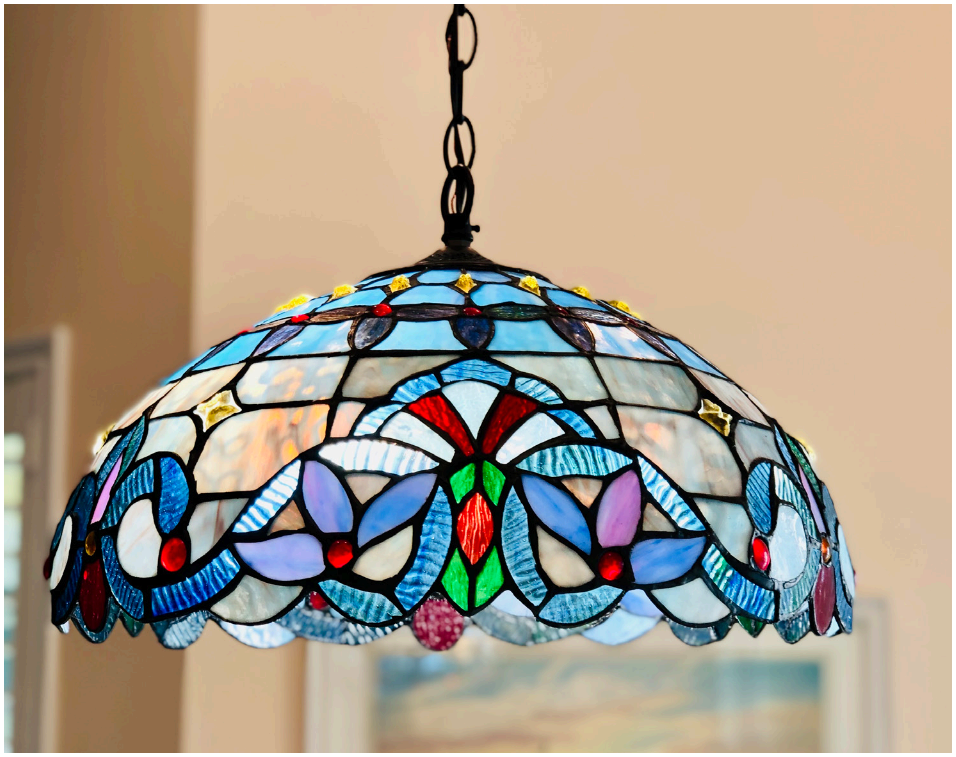
A key issue with a lifetime gift is that the collector must in fact give up the art, and the art must leave his home and his present enjoyment. If the collector claims to have gifted the art but continues to enjoy it as if he still owned the art, current tax rules will bring the art back into his taxable estate at the value as of the date of his death.

If a collector wants to keep the art in the family "forever," believes it will appreciate, and is willing to relinquish enjoyment of it now, it is important to take the following steps:

1. Sign a deed of gift.
2. Have a written acceptance by the donee.
3. Have the art appraised and file a gift tax return.
4. Change the property and casualty insurance policy to reflect ownership.
5. Deliver the artwork to the new owner.

The collector also may decide to make the gift not to a child directly, but to an irrevocable trust that will keep the art and its future appreciation out of the child's gross estate and subsequent estates. The irrevocable trust can hold title to the art, ensure its careful maintenance, and protect the collector's intentions for the art, all while keeping the art and its future appreciation out of the child's estate (and perhaps the estates of many subsequent generations).

If the art is very valuable and will be gifted to one child, the collector also should consider how to equalize that gift to other children. Sometimes life insurance can be an appropriate way to accomplish this equalization.



Death time gifting of art to charity

Unlike the income tax charitable deduction, the estate tax charitable deduction is unlimited. If the collector wishes to gift the art at his death to a museum, or some other qualifying charitable organization, it is important that the collector have a frank discussion with the museum first. The acquisition of that art may not fit in with the museum's strategic plan and they may decline the gift. The museum may only accept (or prefer to accept) gifts of art if cash is also included to cover the costs of storing it and maintaining it. Donating funds with the art for its maintenance and storage may be prudent. Today, very few museums will promise to never sell the art that is given to them or promise not to put the art in storage. To preserve the charitable deduction, the collector should consider including in his will and trust a provision that if the museum does not wish to accept it, the fiduciary must give it to a tax-exempt charitable institution.

Split interest gifting

It is also possible to split the gift between individuals and charitable organizations. A split interest trust is an irrevocable trust in which the beneficial interest in the trust is split between charitable and non-charitable beneficiaries. There are two types of split interests trusts: charitable remainder trusts and charitable lead trusts.

With a charitable remainder trust the non-charitable beneficiary (who could be the donor/collector) benefits now and the charitable beneficiary benefits when the trust ends. The trust can be established as either an annuity trust (in which a fixed dollar amount each year, regardless of the fluctuations in the value of the trust, is distributed to the non-charitable beneficiary each year), or a unitrust (in which annual payments are made at a variable rate to the non-charitable beneficiary each year). Regardless of whether the charitable remainder trust is an annuity trust or a unitrust, when the trust ends the remaining assets pass to the charity or charities.

Benefits of the charitable remainder trust include a distribution of income for a term of years and an income tax charitable deduction at funding. No capital gain tax is due when the underlying asset is sold and therefore the investable base should be higher. If art is contributed to a charitable remainder trust, the trust must be funded with enough cash to make the annual payments, or the trust must be directed or at least empowered to sell the art to make such payments.

When funded with art, there are special valuation rules. If the art was created by the donor, special rules also apply. It is very common to couple the technique of a charitable remainder trust with a funded irrevocable life insurance trust, the thought being that the insurance will replace (free of income and estate tax) the value of the asset that will pass outside of the family to the charity.

A charitable lead trust, on the other hand, provides the charitable beneficiary with benefits now and passes to the non-charitable beneficiaries (usually family members or a trust for family members) when the trust ends. As with the charitable remainder trust, the charitable lead trust may be either an annuity trust (in which annual payments are fixed each year regardless of fluctuations in the value of the trust) or a unitrust (in which annual payments to the charitable beneficiary fluctuate with the value of the trust).

Leverage occurs when there is a gift tax charitable deduction for the charity's right to the income stream, so the donor's taxable gift is reduced by that value, and depending on whether the trust is considered a grantor trust (the donor being considered as the owner of the trust assets for income tax purposes) or non-grantor trust (the donor is not considered the owner of the trust for income tax purposes), the donor may or may not be responsible for the income tax attributable to the trust income and able to benefit from an income tax charitable deduction.

The charitable lead trust is an especially valuable estate planning technique if the taxpayer has used most of his federal gift exclusion. The income, gift, and estate tax consequences should be carefully reviewed by the collector's advisors.

Conclusion

In summary, the decisions and choices as to how the collector can protect herself, her family, her artwork, and her charities require careful and thoughtful consideration. When deciding about art and the choices the collector has, the collector should communicate early and take the time to have a frank discussion with her intended family beneficiaries and any museum or charitable organization she is considering gifting the asset(s) to.

Planning for art has unique rules that should be integrated into the entire estate plan.

It is important that the collector work with all advisors (financial, legal, accounting, and life insurance professionals) to ensure that the goals are planned for and met, and the plan is integrated.

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