One Tin Soldier: Estate Planning for Baby Boomers And Their Toys

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The Big Picture

A. Focus on Collectibles
    a. Many baby boomers are collectors or have collectibles
        i. According to one study, one-third of individuals with over $10 million in wealth are collectors of something.
        ii. According to the Wall Street Journal, auction houses Christie's and Sotheby's sold more than $9 billion in art in 2010, doubling their sales from the year before.
        iii. Value of art and collectibles in private hands in the US is put somewhere in the range of $4 trillion to $6 trillion.
        iv. Online sites to buy art and other collectibles are making it easier to become a collector.
        v. Some are treating collections as an "asset class" in investment portfolios and determining how collectibles perform vis-à-vis other asset classes. Investment advisors are being encouraged to consider their clients' collections as part of the mix of their clients' investments.
    b. Estate planners often don't ask detailed enough (or any) questions about client's collections.
        i. There may be no line on intake questionnaire for collections or collectibles.
        ii. Clients may not consider what they own as a "collection" or a "collectible."
        iii. Starting the conversation is a good way to create a connection with your client. You will know something more about them and what makes them tick. People who have collections or collectibles generally are passionate about them and will enjoy the opportunity to talk and share their knowledge.
    c. Why should client properly plan for collectibles
        i. The case of the disappearing artwork
            1. No statute of limitations on estate or gift tax fraud
            2. Decreases the value and marketability of the item
            3. Burdens future generations
            4. If estate tax return audited, IRS agent may ask for insurance policies and riders to verify that items owned by the decedent are reported on the return.
        ii. The case of the children who don't want (and have always resented mom and dad's focus on) the collection
        iii. The case of the unwitting or uninformed curator

1. Without proper planning, the executor or trustee may be burdened with the maintenance, safety and disposition of a collection or many collections about which they know nothing.
2. They are responsible for getting the best price for the items if they are to be sold and are probably unqualified to do so, without help. Selling collectibles for the maximum profit is a tricky business.

iv. More traditional issues necessitating prior planning

1. Liquidity to pay estate taxes
   a. A number of institutions will lend against art
   b. Life insurance may be a solution
2. Making the other children whole if one child is to receive a particularly valuable item

d. Why should attorneys properly plan for collectibles -- avoid confusion and lawsuits

i. Inadequate drafting

1. If decedent client owned a valuable gem cut to be fit in a setting, is the gem jewelry that passes under the will to the second wife, or is it an investment that passes under the residuary clause to the children of the first marriage?
2. *Estate of Rothko*, 77 Misc. 2d 168, 352 N.Y.S.2d 574 (Surr. Ct. 1974). Action to construe the will of famous painter, Mark Rothko, in which he left his residence at 118 E. 95th Street, New York, "together with all the contents thereof" to his wife and, aside from a few specific gifts, the residue of his estate to the Mark Rothko Foundation. The issue decided by the court was whether the bequest of the real estate and all the contents thereof included the more than forty Rothko paintings that were located in the house on 95th Street. Several were displayed, but most were stored on the fourth floor that Rothko claimed on his income tax returns was his part-time studio. Two of the three executors were also directors of the Foundation. The court held the paintings in the house were included in the bequest of the house's contents. Rothko, shortly after he executed his will and at the request of one of his executors, undertook to inventory his work. He inventoried all of his works, except those located at the house. The court interpreted this behavior to mean that Rothko thought of the paintings in his house differently. Interesting fact: Rothko's estate, which consisted mostly of 840 of his paintings, was valued at $5,000,000 in 1970 (approximately $6,000 per painting). Thirty-seven years later, in

2007, one Rothko painting sold for \$72.8 million at auction at Sotheby's New York.

ii. Disgruntled heirs or beneficiaries. There is a Rothko case for that too! See *Matter of Rothko*, 71 Misc. 2d 74, 335 N.Y.S.2d 666 (Surr. Ct. 1972).

B. Having the Conversation with Your Client

a. Cover the basics

i. Insurance coverage

1. Make sure the client has insurance that covers the items. Basic household property and casualty insurance policies are usually insufficient - there are companies that are very experienced in covering valuable tangible personal property.
    a. Some will even come in and remove items from home in the event of a flood to avoid damage.
    b. Insurance agents who write policies covering valuable artwork and collections can be good sources of information on companies that transport or conserve items.
2. Make sure the proper owner is listed (e.g., if the artwork is owned in an LLC, make sure that is properly reflected on the insurance policy).
3. Good questions to ask about the policy:
    a. "All risk" vs "stated perils"?
    b. Does it cover "change in value" resulting from a partial loss?
    c. Does it provide replacement cost protection in case of a full loss?
4. The general rule is that once the client takes the insurance claim for stolen art or collectible, the items belong to the insurance company if it is ever recovered. Make sure the policy allows the client to return the claim money in exchange for the recovered item.
5. What about "self-insurance"?
    a. This means taking the position that the benefit from taking the casualty-loss deduction on income tax return will exceed the cost of insurance. However, this may not necessarily be the case.
    b. Casualty-loss deduction (Code Section 165(c)(3)) for collector:
        i. Is limited to the amount that exceeds 10% of taxpayer's AGI. (Code Section 165(h)(2))

ii. The amount of the loss is the lower of (a) the difference between the fair market value of the item before the casualty and the fair market value of the item after the casualty (which will be deemed to be zero in the case of a theft) and (b) the property's adjusted basis. (However, if individual is a dealer or investor and the fair market value of the property before the casualty is less than its adjusted basis, the deductible amount is the adjusted basis, if the property is totally destroyed by casualty.) Treas. Regs. 1.165-7(b).

iii. From the amount of loss, the collector must subtract $100 for each casualty or theft (Code Section 165(h)(1)) and then apply the 10% of AGI limitation. (Code Section 165(h)(2)). Treas. Reg. 1.165-1.

ii. Inventory
1. Clients need to know what they own.
2. Encourage them to keep good records with pictures, word descriptions, date acquired, from whom.
3. Make sure they retain the bill of sale.
4. There are companies that will inventory a collection. There is also software available that will help the client create and maintain an inventory.
5. Proper records can greatly increase the value of the items

iii. Appraisal, Authentication and Provenance
1. Clients need to know what their collections are worth.
2. Clients also need to make sure what they own is real (and not a forgery) and that they have good title
   a. Stolen art isn't rare, especially in the US. According to the FBI, the US is the world's biggest market for stolen art.
      i. Can get title insurance to insure that client has good title
      ii. Check the Art Loss Register, a London-based organization to help recover stolen art (www.artloss.com). This organization allows you to report a theft, pre-register a valuable item and search to see if an item your client is intending to buy is registered with them as stolen.

iii. FBI has online tool that public can use to see if artwork has been reported as stolen. National Stolen Art File (http://www.fbi.gov/about-us/investigate/vc_majorthefts/arttheft/national-stolen-art-file).

b. A provenance is a history of the ownership of an item. A good provenance can improve the value of the item.

3. Boosting the provenance--collectibles as an investment
   a. Donating some pieces of collection may boost the value of the remaining pieces
   b. Lending works to museums may boost their provenance, but questions need to be asked first and loan agreements drafted.
      i. To avoid making a taxable gift of the value of the use of the work of art, borrowing entity must be a public charity or private operating foundation and loan must be of a "qualified work of art" for use in carrying on the borrower's charitable purpose. A "qualified work of art" is any archaeological, historic or creative tangible personal property. See Code Section 2503(g)
      ii. Make sure museum arranges and pays for insurance policy covering the items during shipping to and from the museum and during its display, but client should still keep own policy coverage.
      iii. May want to know about museum's policy on holding events to preclude damage to loaned items.
      iv. Make sure to use a qualified art shipper.

iv. Maintenance and proper conservation- can be very expensive, but may be necessary to maintain the value of the items.

b. Discuss planning options
   i. Four basic questions
      1. To whom will it pass -- family or charity or some combination or will it be sold?
      2. What part of it -- all or certain pieces?
      3. When-- during life or at death?
      4. How -- outright, in trust; to a family foundation, to a charity with restrictions?
   ii. Leave to family
      1. Do they want it?

2. What will they do with it?
3. Can they afford the estate taxes?
4. Will they understand its value and preserve it? Can they afford the maintenance?

iii. Donate to charity now or at death

1. Does a charity want it? There are companies that will help you find a museum that wants your client's collection or pieces of it
2. What will they do with it? Display it, store it, sell it?
3. Can they afford it? Will they want funds to maintain it as well?
4. Value of gift agreements negotiated in advance
5. Public charity vs. private operating foundation or supporting organization

iv. Sell it now or at death

1. Can be difficult to know if you are getting a fair price for an item and there are many questions to ask. Michael Mendelsohn, of Briddge Art Strategies, has posed some of the many questions the seller must ask when selling, especially at the collector's death.
    a. Is an auction sale the best way to dispose of the items?
    b. Would it be better to identify dealers with a network of potential buyers?
    c. If going with an auction house, should it be local or in another town?
    d. Should all the items be sold in one auction or in several specialty auctions?
    e. What should be the pre-sale estimate and reserve price, if using an auction house?
    f. Should the best items be authenticated or conserved and restored before selling, in order to obtain higher purchase price?
    g. Does the estate have good title; are the works authentic?
    h. Is borrowing against some of the items in the collection a good idea to enable the estate to retain some of the pieces?
2. Trying the DYI approach.
    a. Websites have sprung up to provide information on sales of similar items. WorthPoint, through a deal with eBay®, collects records of all transactions completed on eBay® and posts them on its website, which collectors can access for a fee. Prices4Antiques is another site that caters mostly to antique dealers. AskART.com and Artprice.com also

provide information on prior sales and ways to track market value.

b. Some of these websites, as well as others, like eBay® and ArtNet®, are available for selling or auctioning the collectible. However, online selling without professional help can be risky.

3. If sale will occur after death, ask client which dealers will know what their items are worth and best be able to dispose of them.
4. If selling through a dealer,
    a. Negotiate all the terms, including who is covering the insurance on the item while at the dealers, that you will be paid in cash within certain time after sold, that the items will be returned if not sold within a certain time frame
    b. Make sure person signing the consignment agreement has the authority to bind the dealer
    c. Dealers who run out of money can become desperate -- beware
5. Auction houses can be a good way to dispose of collectibles, but there are lots of costs and risks to avoid.
    a. Transportation to the auction house is generally the seller's cost.
    b. Transportation away from the auction house is generally the buyer's cost.
    c. Sellers pay a commission to the auction house; buyers pay a premium. Premium really affects the seller because buyers know they will be responsible for the premium when bidding on an item.
    d. Sellers can negotiate items in the consignment agreement such as the seller's commission, in what order the pieces will be offered in an auction, how the items are described in a catalogue, who provides and pays for insurance, the pre-sale estimate and the reserve.
6. The value of collectibles can change "with the wind."
7. 28% federal income tax rate on long term capital gains for sales by collectors or investors (Code Section 1(h)(4) and (5)); state taxes will be imposed as well.

v. Or combination thereof
    1. Bargain sales
    2. Charitable remainder or lead trusts
    3. Fractional gifts - not what they used to be

c. Industry of “art succession planners” and “art advisors” has arisen--do you need to build a team to help the client? Should the client name an “art advisor,” just like they would an “investment advisory” in their revocable trust or will?

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The views expressed herein are those of the author and not necessarily the views of the Smithsonian Institution.

I. Background

The Smithsonian Institution is comprised of 19 museums, the National Zoo, and several research centers. We have 137 million artifacts, works of art, and specimens in our collections -- 126 million of these specimens and artifacts are held by the National Museum of Natural History.

Many Smithsonian museums originated with gifts from private collectors. With Charles Freer's gift of 2,250 objects in 1906, the Smithsonian established the **Freer Gallery of Art**. Mr. Freer, who died in 1919, bequeathed the remainder of his estate to the Smithsonian. The Freer opened in 1923. The **Smithsonian American Art Museum**, grew from the contributions of three early collectors: John Varden, who opened a public gallery in Washington in 1836 consisting of "a mélange of historical, natural, and artistic curiosities altogether typical of the age," which was transferred to the Smithsonian in 1862; Harriet Lane Johnston, the niece of James Buchanan and his official hostess in the White House, who prompted the establishment of the first "national gallery of art" by leaving her small art collection to it; and John Gellatly of New York City, who gave his extensive art collection to the Smithsonian in June of 1929.

In more recent memory, Joseph H. Hirshhorn's gift of nearly 5,000 paintings and drawings, more than 1,500 pieces of sculpture, and $1 million for future acquisitions, established the **Hirshhorn Museum and Sculpture Garden.** The Hirshhorn opened to the public in 1974. In 1982, Dr. Arthur M. Sackler of New York donated 1,000 masterpieces of Asian art from his collection and $4 million to establish the **Arthur M. Sackler Gallery**, which opened in 1987. Additional examples of collections initially built by private collectors include the **Cooper-Hewitt, National Design Museum** (Amy, Eleanor, and Sarah Hewitt) the **National Museum of the American Indian** (George Gustav Heye), and the **National Museum of African Art** (Warren Robbins).

Private collectors continue to be an important source of the Smithsonian's collections. In 2010 donations and bequests made up 51% (106,414 of 209,926) of the Smithsonian Institution's acquisitions of museum items. Cumulatively for 2001-2005 and 2010, the number is 51% (1,260,654 of 2,454,882 museum items) Data are not readily available for 2006-2009.

These numbers do not include acquisitions of archival material, usually measured in cubic or linear feet, or library volumes. Most of the Smithsonian's non-gift acquisitions are acquired through such methods as purchase, field collecting, transfer, exchange, commission, and, in the case of the Zoo, birth.

II. The Best Planning Includes the Intended Donee/Beneficiary

Surprises can be wonderful – James Smithson's bequest to the United States was just that. But they may not always be welcome. It took the U.S. Congress eleven years to agree upon how to use Mr. Smithson's generous gift. (The bequest included his papers, personal effects, and mineral collection, which were destroyed in an 1865 fire in the castle building. Smithson's library survived.)

The bequest of Harriet Lane Johnston noted above also appears to have been a surprise. Mrs. Johnston left her artwork to the Corcoran Gallery of Art, with the stipulation that, if a national gallery of art should ever be established by the United States Government, the paintings would be turned over to it. The Corcoran declined the gift under these terms. Subsequently, in D. K. Este Fisher, vs. Harriet Lane Home for Invalid Children of Baltimore, (D.C. 1906), the D.C. Supreme Court ruled that the Smithsonian Institution was the "national gallery of art" for the purposes of the bequest. (A museum by that name did not exist at the time of Mrs. Johnston's death. It is now known as the Smithsonian American Art Museum.)

Numerous considerations go into accessioning a work or collection into a museum: The connection to the museum's collection plan (does the proposed gift complement or fill a gap in the existing collection?) the significance of the work(s), its size, its exhibit potential (including physical condition and the amount of work required to prepare it for display). In some cases board approval is required. Many private collectors serve as museum trustees, members of acquisition committees, or docents (or otherwise are in frequent contact with curators or museum directors), but for those who are not closely connected to the museum, a discussion about planned gifts can provide both donors and donees with valuable information to aid in decision making.

III. . . . . and the Donor's Family

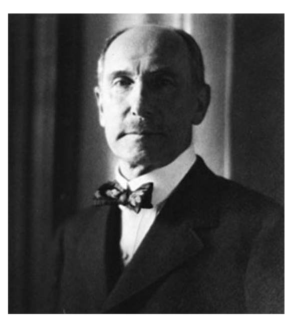
Museums do not relish litigating against other beneficiaries, but it happens. In Gellatly v. Wetmore, 177 F.2d 73 (D.C. Cir. 1949), the appeals court affirmed the decision of the district court granting the Smithsonian and its secretary Alexander Wetmore the Gellatly collection. The appellant was the widow of Mr. Gellatly, who filed the action because her late husband failed to inform her of his intended will.

IV. Restricted Gifts

It is generally the preference of museums that gifts have no restrictions. But there are exceptions. For example, Mr. Freer's deed of gift stated:

> No addition or deduction shall be made to the collections after my death, and nothing else shall ever be exhibited with them, or in the same building, nor shall the said collections, or any part thereof, be removed at any time from said building except when necessary for the purpose of making repairs or renovations to the building.

Mr. Freer modified these instructions in the codicil to his will, permitting purchases to be added to the collection after examination and approval of three named friends in consultation with the Fine Arts National Commission (which still plays a role in reviewing Freer acquisitions).



Charles Lang Freer

Perhaps the most notable cases regarding restrictions are those relating to the Barnes Foundation in Merion, Pennsylvania, the first of which took place in 1933. See Barnes Found. v. Keely,164 A. 117 (Pa. Super. Ct. 1933) (holding that reasonable regulations for admission to the public did not destroy the charitable nature of the gift). More recently, the Barnes Foundation sought and received the approval of the Orphans' Court of Montgomery County to make changes to its governing documents and move the collection to Philadelphia. In re Barnes Found., 2004 Pa. Dist. & Cnty. Dec. LEXIS 344, 56-57 (Pa. Cty. 2004). The court stated:

> By many interested observers, permitting the gallery to move to Philadelphia will be viewed as an outrageous violation of the donor's trust. However, some of the archival materials introduced at the hearings led us to think otherwise. Contained therein were signals that Dr. Barnes expected the collection to have much greater public exposure after his death. To the court's thinking, these clues make the decision -- that there is no viable alternative -- easily reconcilable with the law of charitable trusts. When we add this revelation to the foundation's absolute guarantee that Dr. Barnes' primary mission -- the formal education programs -- will be preserved and, indeed, enhanced as a result of these changes, we can sanction this bold new venture with a clear conscience.

The litigation concerning the Alfred Stieglitz collection at Fisk University in Nashville, Tennessee, also has received much publicity. This case involves 101 pieces of art collected by the photographer Alfred Stieglitz and donated after his death by his wife Georgia O'Keefe to Fisk. Under the terms of the gift, Fisk agreed never to sell the art and always to exhibit it together. Arguing that its precarious financial situation made it impossible to honor the terms of the gift, the university sought permission to sell an ownership interest to the Crystal Bridges Museum in Arkansas (founded by Alice Walton). The Chancery Court (after a reversal of its initial decision to return of the collection to the O'Keefe Foundation) permitted Fisk to sell the works on the condition that, of the $30 million paid to Fisk, only $10 million may be used by Fisk at its discretion. The remaining $20 million must be placed in an endowment fund for the exclusive benefit of the collection. According to Fisk, this amount is more than it needs to care for the collection. The Attorney General has appealed. In re Fisk University, No. 05-2994-III (Tenn. Chancery Court Nov. 3, 2010) (Mem. Op.) Selected pleadings available at http://tennessee.gov/attorneygeneral/cases/fisk/fisk.htm.

V. Partial Gifts and Pledges

Restrictions are not the only potential source of friction between donors and donees. Sometimes partial or promised gifts can lead to problems.

Take, for example, recent litigation concerning the de Young Museum's Jolika Collection. In agreements beginning in 2003 a pair of collectors promised a vast collection New Guinea tribal art (named for their three children) to the city-owned de Young Museum in San Francisco. The works were to be given over a number of years and, in the course of a larger re-building project, the museum constructed an 8,000 square foot gallery to house them. Contemporaneously, however, the donors used the works to secure loans from Sotheby's to acquire more pieces and also put the collection up as collateral in an inheritance dispute with family members. Litigation ensued in three states for a number of years, but the disputes were settled in 2010. Twenty-nine works will be sold to pay off the debt of the donors to Sotheby's. The museum paid an undisclosed amount to obtain clear title to 169 works that reside there. See http://deyoung.famsf.org/files/mfamsfbt104.pdf

Damage and theft are also concerns. Prior to the opening of the Hirshhorn Museum in 1974, six paintings that Mr. Hirshhorn had planned to donate to the Smithsonian were taken from his Greenwich estate. The stolen paintings included a self-portrait by Thomas Eakins, a portrait by Edward Hopper, two paintings by Winslow Homer, and two by Adolphe Monticelli. Three men were arrested and the paintings were eventually returned in a plea bargain agreement.

Thomas Eakins
Self-Portrait, (ca. 1902)
Hirshhorn Museum and Sculpture Garden

VI. Conclusion

Although this paper highlights issues that can arise with gifts of collections, the vast majority of gifts take place happily and without incident. Gifts of private collections are essential to museums. In many cases, they are transformative. With thoughtful planning donors and donees can achieve their mutual objectives to preserve and share with future generations the collections that individuals have built with care and dedication.

TAX MAN

WHAT SHOULD BE DONE WITH ARTWORK

AND COLLECTIBLES

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WHAT SHOULD BE DONE WITH ARTWORK AND COLLECTIBLES[1]

I. CHARITABLE TRANSFERS

United States tax laws provide an incentive for individuals to contribute during their lifetime or on their death works of art to United States tax exempt organizations, that is, museums, universities and other organizations that display and make use of works for art in furtherance of their tax exempt purposes.[2] The lifetime transfer of a work of art to a charitable organization saves the individual donor income taxes because of the allowable income tax deduction; at the same time, the lifetime transfer relieves the donor of the expense and the worry connected with the maintenance of a valuable work of art. For example, a painting that cost the donor $1,000 some years ago may have a fair market value of $10,000 today. A contribution today of the painting to charity that meets all the requirements discussed below produces an allowable charitable deduction of $10,000. For someone in the 35.0 percent tax bracket, such a contribution saves $3,500 in federal income taxes. Since the donor's out-of-pocket cost was only $1,000, the taxpayer has made a $2,500 tax-free economic profit and has enjoyed the use of the painting through its years of ownership at no cost. The problem is to make sure the contribution is correctly made, so that the tax benefit described is achieved.[3] Note that the tax benefit just described is available only for contributions to United States tax-exempt organizations and not for contributions to foreign tax-exempt organizations.

The National Endowment for the Arts and the National Endowment for the Humanities are constantly threatened by Congress to have its funding sharply reduced. Arts organizations, both big and small, must find a way to replace the grants they normally receive from the Endowments or will find themselves without the means to exist. By necessity arts organizations will turn increasingly to private individuals for funding, hopefully finding a sympathetic ear consistent with the purposes of the organization. Fund raising from individuals is somewhat easier when the individual can be made aware of the income tax benefits to be derived from the contribution.

A testamentary transfer of works of art to United States tax-exempt organizations saves the decedent's estate a great amount in estate taxes, because the full fair market value of the works of art on the date of death is an allowable estate tax deduction. At the same time, such a transfer relieves the estate of the problem of raising the cash necessary to pay the estate tax (maximum federal rate). Although such testamentary transfers are generally made to United States tax-exempt organizations, under certain limited circumstances the U.S. estate tax deduction is available for transfers to foreign governments or subdivisions if the items transferred are used exclusively for charitable purposes.

II. COMPLETE INTER VIVOS CHARITABLE TRANSFERS

Before making a lifetime donation of a work of art to a charitable organization, the donor must determine:

1. The status of the charitable organization,

2. The type of property being contributed,

3. Whether the collection satisfies the related use rule, and

4. Whether there is a qualified appraisal prepared by a qualified appraiser.

Each factor is considered below.

1. Status of the Organization

Charitable organizations are characterized as either public or private. Public charities generally receive part of their support from the general public. They include churches, schools, hospitals, museums, and other publicly supported organizations; private operating foundations; and certain organizations operated in connection with another public organization. They also include those private foundations that distribute all their receipts each year. Private charities include all other exempt organizations, and include the usual kinds of private foundations.[4]

It is important to verify the status of the charitable organization as either a public or a private charity. As will be seen below, there is a very different result when a taxpayer makes a contribution to a public charity as opposed to a private charity. Verification of a charity's status can be made by checking IRS Publication 78, Cumulative List of Exempt Organizations or by requesting the charitable organization to provide copies of letters from the IRS stating its status. It is, however, preferable to obtain copies of the letters from the IRS stating the organization's status. Note that there is a difference between the organization's exemption ruling under section 501(c)(3) and its ruling as a "public" organization under section 509(a). Generally, a taxpayer will only receive a deduction of his or her cost for a contribution of an appreciated work of art made to a private charity as opposed to the full fair market value for a contribution made to a public charity.

2. Type of Property

A. Capital Gain Property.

In most cases a work of art is "capital gain property." The term includes any property the sale of which at its fair market value at the time of the contribution would have resulted in long-term capital gain.[5] Any appreciation in value, no matter how small, makes the property capital gain property. The property is capital gain property if:

- o It is a capital asset under section 1221;
- o It has appreciated in value;
- o It is a collectible under section 408(m); and
- o It has been held by the donor for more than one year for contributions made after January 1, 1988.

As described below, a contribution of capital gain property receives favorable tax treatment.

The distinction between ordinary income (including short-term capital gain) and long-term capital gain for tax rate purposes is that ordinary income is taxed as high as 35.0

percent and long-term capital gain is taxed at a maximum of 28 percent. The Taxpayer Relief Act of 1997 reduced the long-term capital gain rate to 20 percent on the sales of securities and other capital assets held for more than eighteen months (changed to "more than twelve months" by the IRS Restructuring and Reform Act of 1998), but maintained the 28 percent rate on gain from the sale of collectibles held for more than one year. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (effective May 6, 2003) further reduced the long-term capital gain rate to 15 percent for sales of securities and other capital assets held for more than twelve months but once again maintained the 28 percent rate on gain from the sale of collectibles held for more than one year. The term "collectibles gain" is defined in section 1(h)(5)(A) to mean

> gain from the sale or exchange of a collectible (as defined in section 408(m) without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing taxable income.

Section 1(h)(5)(B) (added by the Taxpayer Relief Act of 1997) is designed to prevent taxpayers from converting the 28 percent rate to the 15 percent rate by creating a partnership, corporation or trust under rules similar to the rules of section 751.

The characterization of donated property as capital gain property or ordinary income property is particularly important regarding charitable contributions, and the proper characterization of contributed property as long-term capital gain property is crucial if the donor is to receive the full charitable deduction for appreciated tangible personal property. Although the IRS Restructuring and Reform Act of 1998 reduced the holding period for long-term transactions on the sale of capital assets to more than twelve months (the same rule that applies to collectibles), it kept the 28% tax rate rather than 20% tax rate for long-term transactions as it applies to collectibles. The Jobs and Growth Tax Relief Reconciliation Act of 2003 in reducing the long-term capital gain rate on the sale of most capital assets to 15% made no change to the 28% rate on the sale of collectibles. Since the maximum ordinary income tax rate was also lowered to 35% there is now a smaller difference between ordinary income treatment and capital gains treatment on the sale of collectibles. This may serve as increased incentive for individuals to make donations of collectibles rather than sell them. Taxpayers should note that section 1(h)(5) now clearly provides that losses from the sale of collectibles can be used to offset gains from the sale of collectibles.

Generally, if the four requirements for making a charitable donation are satisfied, a taxpayer will receive a deduction for the full fair market value for a donation of long-term capital gain property but will be limited to his or her cost for ordinary income property.

B. <u>Ordinary Income Property.</u>

The property is ordinary income property[6] if:

- o It was created by the donor;
- o It was received by the donor as a gift from the creator;
- o It is held in inventory by a dealer;

- o It would produce short-term capital gain if sold, that is, it is owned for one year or less before being contributed; or
- o It would produce a capital loss if sold.

All works of art created by the artist will be ordinary income property, since that property, by the definition contained in section 1221(a)(3), cannot be a capital asset. Hence, the artist may be surprised that contributions of his or her own work will not receive the favored capital gain property deduction treatment. Even more surprised may be the collector who accepted the artwork as a gift from the artist. Classification as ordinary income property greatly reduces any available charitable deduction.

A problem often encountered by a collector is the possibility of receiving a gift of a work of art from the artist who created it. In that connection, reference must be made to section 1221(a)(3) for the definition of the term "capital asset." Section 1221(a)(3)(C) states that the term capital asset "does not include property 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 in part by reference to the basis of such property in the hands" of the taxpayer whose personal efforts created the property. Under section 1015, covering the determination of basis for gifts, the basis of the property in the hands of the donee is determined by its basis in the hands of the donor. So, the collector who receives artwork as a gift from an artist has the same basis in the property as does the artist. Since artwork is ordinary income property in the artist's hands, it cannot be a capital asset in the donee collector's hands. Therefore, a taxpayer should be aware that a gift of a work of art from the creator retains its character as ordinary income property in the hands of the donee. If the property is purchased by the collector, it is converted into capital gain property, which results in an increased charitable deduction, since the collector can now claim a deduction for the fair market value of the artwork as opposed to only its basis, that is, its cost.

When advising a collector who is making a contribution, an attorney should find out how the collector acquired the property and what he or she did with it in order to determine if ordinary income property is present.

3. General Percentage Limitation.

For contributions of cash and ordinary income property to a public charity, the charitable deduction is limited to 50 percent of the taxpayer's contribution base.[7] For contributions to a private charity, the limit is the lesser of (a) 30 percent of the taxpayer's contribution base; or (b) the excess of 50 percent of the taxpayer's contribution base over the amount of charitable contributions allowable to public charities, determined without regard to the 30 percent limitation (discussed below).[8] The term "contribution base" means adjusted gross income computed without regard to any net operating loss carryback to the taxable year under section 172.[9]

A. Ordinary Income Property Percentage Limitation.

The amount of the charitable deduction for a contribution of ordinary income property is limited to the basis of the property in the hands of the donor (within the applicable general percentage limitation discussed above). That result is reached because the amount of the charitable deduction is determined by subtracting from the fair market value of the property the amount of gain that would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value.[10] Before making a contribution, the donor must be sure the property is capital gain property and not ordinary income property, since the available income tax deduction is substantially reduced for a contribution of ordinary income property.[11]

Any excess amount over the 50 percent or 30 percent limitations for a contribution of ordinary income property to either a public or private charity may be carried forward for five years, retaining its character as ordinary income property.[12] The carryover provision was extended to contributions made to a private charity by the Tax Reform Act of 1984, effective for contributions made in taxable years ending after October 16, 1984.

B. Capital Gain Property Percentage Limitation.

A contribution to a public charity of a work of art that is capital gain property and that meets the related use rule (discussed below) is allowable as a charitable deduction to the extent of the full fair market value of the property on the date of the contribution, but not in excess of 30 percent of the taxpayer's contribution base.[13] Any amount that exceeds the 30 percent limitation may be carried forward for five years, retaining its character as capital gain property.[14] If the contributed work of art satisfies the related use rule, the taxpayer may elect to increase the 30 percent limitation to 50 percent of his or her contribution base. However, if that election is made, the amount of the deduction must be reduced by 100 percent of the appreciation in value of the work of art;[15] in other words, the deduction will be limited to the donor's cost.

A contribution to a private charity of a work of art that is capital gain property is allowable as a charitable deduction to the extent of the fair market value of the work of art on the date of the contribution reduced (regardless of what use the charity makes of the work of art) by 100 percent of the appreciation in value. After the reduction the deduction is limited to the lesser of (1) 20 percent of the taxpayer's contribution base or (2) the excess of 30 percent of the taxpayer's contribution base over the amount of charitable contributions allowable to public charities, determined without regard to the 30 percent limitation.[16] The amount of the charitable deduction that exceeds the applicable percentage limitation may be carried forward for five years for contributions made in taxable years ending after July 18, 1984.[17] The percentage limitations on lifetime gifts to private foundations and the loss of 100 percent of any appreciation in value as a deduction make use of a private foundation to hold a work of art impractical, unless the foundation can qualify as a "private operating foundation."[18]

4. Related Use Rule

The related use rule applies to capital gain property that is "tangible personal property" contributed to a public charity. 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 100 percent of the appreciation in value of the work of art.[19] In that instance, after the 100 percent appreciation reduction, the remainder may be deducted up to 50 percent of the taxpayer's contribution base.[20]

One of the major changes made by the Tax Reform Act of 1986 was the amendment of section 170(e)(1) so that 100 percent of the appreciation in value is lost as a charitable deduction if the related use rule is not satisfied. The rule is effective for contributions made on or after January 1, 1987. Under the law in effect before January 1, 1987, only 40 percent of the appreciation in value was lost as a charitable deduction. Therefore, a taxpayer must be extremely careful to comply with the related use rule or else the charitable deduction for appreciated long-term capital gain property that is tangible personal property will be limited to his or her cost.

The regulations[21] provide that a taxpayer may treat a contribution of a collection as meeting the related use rule if:

1. The taxpayer establishes that the work of art 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 work of art will not be put to an unrelated use by the donee organization.

If a collector donates a work of art to a museum and the work of art 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 work of art will not be put to an unrelated use by the donee, whether or not the work of art 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 100 percent of the appreciation in value is lost as a charitable deduction.

<u>Example 1</u>: A painting contributed to an art museum that is a public charity and that can and, in fact, does from time to time display the painting prominently and publicly satisfies the related use rule. The contribution is deductible to the extent of the fair market value of the property within the 30 percent limitation.

<u>Example 2</u>: If the same painting is contributed to the Red Cross, which is a public charity and which from the outset intends to sell and in fact promptly does sell the painting, the deduction must be reduced by 100 percent of the appreciation in value, with the balance deductible within the 50 percent limitation.[22]

The regulations[23] also indicate that the related use rule is met even if the donee sells or otherwise disposes of only an "insubstantial" portion of a collection of works of art.

According to Representative Wilbur D. Mills, then chairman of the House Ways and Means Committee:

> . . . What we are trying to say is that we will allow you to give this appreciated property and take today's market value as a charitable deduction without any tax consequences to you whatsoever if you give it to a charitable organization that normally would use the property for its exempt purposes. Now, a clear case is a gift of a picture or work of sculpture, or anything of that sort, to a museum. The question does arise with respect to a college or university as to whether or not they are using

> this for their exempt purpose, whether it is used in their teaching. Of course, the college could have a course in art, and if the gift were to be used for that purpose it would probably qualify as such a gift.[24]

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.

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. (Private Letter Rulings 7911109 and 7934082 reach similar results in dealing with the exhibition of works of art.)

Private Letter Ruling 8009027: The IRS held 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.

Private Letter Ruling 8143029: The IRS held that the related use rule was satisfied when a donor gave his collection of 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.

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 the college had, as part of its curriculum, the teaching of engraving skills. 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 that 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.[25]

5. Appraisals — General Rules

Section 170(a)(1) expressly declares that a charitable contribution is deductible only if it is verified in the manner required by IRS regulations. Under prior law there was no specific statutory requirement that donors obtain appraisals to verify the fair market value of their donations. Rather than amend Code section 170(a)(1) to include the substantiation requirements, section 155(a) of the Tax Reform Act of 1984 requires the Treasury Department to issue regulations under section 170 that incorporate the charitable deduction substantiation requirements of section 155(a). Therefore, effective January 1, 1985, no income tax charitable deduction is allowed for any contribution of property for which an appraisal is required under the Tax Reform Act of 1984 unless the substantiation requirements of the regulations are met.

Final regulations encompassing the rules contained in section 155(a) of the Tax Reform Act of 1984 were issued on May 4, 1988.[26]

The rules apply to any charitable contribution made after December 31, 1984, by an individual, closely held corporation, personal service corporation, partnership, or S corporation of an item of property (other than money or publicly traded securities) the claimed value of which exceeds $5,000.[27] The $5,000 amount applies to a single item of property or to the aggregate of similar items of property donated during one calendar year, such as a set or number of stamps, coins, lithographs, or books. According to the General Explanation of the Tax Reform Act of 1984, similar items of donated property are aggregated whether all the items are donated to one donee or the items are donated to two or more donees. For example, the substantiation requirements apply if the taxpayer claims a deduction in one year of $2,000 for rare books given to College A, $2,500 for rare books given to Museum B, and $900 for rare books given to Public Library C,[28] a total of $5,400, which is $400 over the approved limit.

If the $5,000 limit is reached, the taxpayer must meet the following substantiation requirements:

1. Obtain a qualified appraisal for the property contributed;

2. Attach a fully completed appraisal summary to the tax return on which the donor first claims the deduction for the contribution; and

3. Maintain records containing certain specific information about the contribution.

It is crucial to keep in mind that if a taxpayer does not conform strictly to the substantiation requirements, no deduction is allowed under section 170.[29]

A. Qualified Appraisal.

The term "qualified appraisal" means an appraisal prepared by a qualified appraiser not earlier than sixty days before the date of the contribution of the appraised property.[30] The appraisal must be signed and dated by a qualified appraiser who charges an appraisal fee that is not based on a percentage of value and that contains the following information:

1. A detailed description of the property;

2. The physical condition of the property;

3. The date or expected date of the contribution;

4. The terms of any agreement or understanding entered into or expected to be entered into by or on behalf of the donor that relates to the use, sale, or other disposition of the property contributed;

5. The name, address, and taxpayer identification number of the appraiser;

6. A detailed description of the appraiser's background and qualifications;

7. A statement that the appraisal was prepared for income tax purposes;

8. The date on which the property was valued;

9. The appraised fair market value of the property;

10. The method of valuation used to determine the fair market value;

11. The specific basis for the valuation, such as any specific comparable sales transactions; and

12. A description of the fee arrangement between the donor and the appraiser.

Obviously, the cost to the taxpayer of having a qualified appraisal prepared is going to be high because of the detailed information required. A separate qualified appraisal is required for each item of property that is not included in a group of similar items of property. If the appraisal is for a group of similar items, the detailed information is required for each individual item other than items worth less than $100, for which a group description is allowed.

The qualified appraisal must be received by the donor before the due date (including extensions) of the taxpayer's return.[31] That deadline is extremely important, since the entire charitable deduction is lost if that provision is not complied with.

B. Qualified Appraiser.

The term "qualified appraiser" means[32] an individual who holds himself or herself out to the public as an appraiser who is an expert as to the particular type of property being appraised; who understands that, if he or she makes a false or fraudulent overstatement of value, he or she may be subject to a civil penalty under section 6701; and who is completely independent of the donor. To be independent of the donor, the qualified appraiser cannot be the donor or the donee, a party to the transaction in which the donor acquired the property,[33] a person employed by any of the foregoing, or a person related (within the meaning of section 267(b)) to any of the foregoing.

For example, if a person acquired a painting from an art dealer and later donated the painting to a museum, the donor, the dealer who sold the painting, the museum, any person employed by the donor or the dealer or the museum, or any person related to any of the foregoing is not a qualified appraiser. The regulations are so broad that they appear to disqualify an auction house from being a qualified appraiser if the donor had purchased the property at auction from that auction house.

The final regulations also disqualifies someone who regularly performs appraisals for a person who is not otherwise excluded from being a qualified appraiser and does not do a substantial number of appraisals for other persons,[34] for example, someone who performs appraisals for only one person. Also excluded as a qualified appraiser is any person who, if the donor had knowledge of the facts, would cause a reasonable person to expect that the appraiser would falsely overstate the value of the donated property. For example, the donor and the appraiser make an agreement concerning the amount at which the property will be valued, and the donor knows that the amount exceeds the fair market value of the property.

It is crucial that the appraiser selected be a "qualified appraiser," because if the donor chooses unwisely and the appraiser is later found to be disqualified, the entire charitable deduction is lost, since it is then too late to cure the defect.[35] In order to obtain the income tax deduction, a qualified appraisal prepared by a qualified appraiser must be attached to the income tax return.

C. Appraisal Summary.

Regulation section 1.170A-13(c)(4) sets forth the required information that must be on the "appraisal summary" that must be attached to the donor's income tax return. In February 1985 the IRS issued form 8283 (Noncash Charitable Contributions Appraisal Summary); the latest version of form 8283 was issued in December 2006. Completion of form 8283 will satisfy the appraisal summary requirements. The instructions for form 8283 no longer require that for works of art with an aggregate value of $20,000 or more that there be attached to form 8283 an 8" x 10" color photograph (or a color transparency no smaller than 4" x 5"). However, a signed copy of the full appraisal must be attached to form 8283 and a photograph must be made available to the Internal Revenue Service upon request. It is important to note that form 8283 must be signed and dated by both the appraiser and the donee charitable organization. The person signing on behalf of the donee must be an official authorized to sign the tax returns of the donee organization or a person designated by the donee organization to sign form 8283. The instructions also require that the donor must provide the donee with a copy of the qualified appraisal. On February 1, 2011 the IRS changed the threshold for works of art that are subject to review by the Art Panel from $20,000 to $50,000. To date there has not been a corresponding change in Form 8283 or the accompanying instructions.

If the taxpayer fails to attach the required appraisal summary to his or her tax return, the IRS can disallow the entire charitable deduction. However, regulation section 1.170A-13(c)(4)(iv)(H) does allow a taxpayer to submit the appraisal summary within ninety days after the IRS requests it, and the IRS will not disallow the charitable deduction if the taxpayer's failure to attach the appraisal summary was a good-faith omission.

D. Appraisal Fee.

The fee paid to the appraiser cannot be based on a percentage of the appraised value of the donated property.[36]

E. Guiding Principle.

The foregoing is only a brief summary of the new rules. In the future, the IRS may issue Revenue Rulings and other guidelines to clarify numerous unanswered questions. In the meantime, extreme care must be exercised in choosing the appraiser in order to make sure that he or she is an expert in the field and is not disqualified from preparing a "qualified appraisal" for the donor. It is also important to keep in mind that if the $5,000 claimed deduction amount is reached for a contribution of property, the new appraisal rules apply whether the donated property is capital-gain or ordinary-income property, whether the property has appreciated or depreciated in value since its acquisition by the donor, and whether the donee is a public charity, a private foundation, or some other donee eligible to receive contributions that may qualify for deduction under section 170.[37]

6. Examples

The following examples illustrate the foregoing rules.

Example 1: Ms. Collector received a painting as a gift from a little-known artist. The painting had a basis at the time of the gift of $100, representing the artist's cost for paint, canvas, and brushes. Twenty years later, after the artist had become famous, the painting has a fair market value of $10,000. If Ms. Collector now contributes the painting to an art museum, her maximum charitable deduction is $100, because the property contributed is ordinary income property. The entire $9,900 of appreciation in value is lost as a charitable deduction.

Example 2: 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. If the contribution satisfies the related use rule and there is a qualified appraisal by a qualified appraiser, Mr. Collector is allowed a deduction of $30,000 (30 percent of $100,000) and a carryover of $20,000. If the contribution does not satisfy the related use rule, Mr. Collector is allowed a deduction of $10,000 ($50,000 minus $40,000 appreciation equals $10,000), and there is no carryover. If there is not a qualified appraisal by a qualified appraiser, Mr. Collector would not be allowed any deduction.

Example 3: Mr. Collector has a contribution base of $100,000. He contributes capital gain property with a fair market value of $60,000 in which he has a basis of $40,000 to a public charity. If the contribution satisfies the related use rule and there is a qualified appraisal by a qualified appraiser, Mr. Collector is allowed a deduction of $30,000 (30 percent of $100,000) and a carryover of $30,000. If the contribution does not satisfy the related use rule or the election to increase the deduction is made, Mr. Collector is allowed a deduction of $40,000 ($60,000 minus $20,000 appreciation equals $40,000), and there is no carryover.

III. PENSION PROTECTION ACT OF 2006 - ART WORLD PROVISIONS

The Pension Protection Act of 2006[38] (hereafter the "PPA") added new section 170(e)(7)(A) that provides if a charitable organization receives appreciated tangible personal property as a charitable contribution and disposes of the property within three years of receiving it, the donor may not derive any tax benefit beyond a deduction in the amount of the property's basis.[39] However, this rule will not apply if the donee provides a "certification" from the donee charity that the property was intended to be used or was put to a use related to the donee's exempt purpose.[40]

1. Related Use Rule

The related use rule applies to capital gain property that is tangible personal property contributed to a public charity. 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 collection 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 100% of the appreciation in value of the collection.[41] In that instance, after the 100% appreciation reduction, the remainder may be deducted up to 50% of the taxpayer's contribution base.[42]

One of the major changes made by the Tax Reform Act of 1986 was the amendment of section 170(e)(1) so that 100% of the appreciation in value is lost as a charitable deduction if the related use rule is not satisfied. The new rule is effective for contributions made on or after January 1, 1987. Under the law in effect before January 1, 1987, only 40% of the appreciation in value was lost as a charitable deduction. Therefore, a taxpayer must be careful to comply with the related use rule; otherwise, the charitable deduction for appreciated long-term capital gain property that is tangible personal property will be limited to his cost.

The regulations[43] provide that a taxpayer may treat the 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 if,

2. At the time of the 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 has actual knowledge to the contrary, that the collection will not be put to an unrelated use by the donee, whether or not the collection is later sold or exchanged by the donee. However, 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 100% of the appreciation in value is lost as a charitable deduction.

Example 1: A painting contributed to an art museum that is a public charity and that can and, in fact, does from time to time display the painting prominently and publicly satisfies the related use rule. The contribution is deductible to the extent of the fair market value of the property within the 30% limitation.

Example 2: If the same painting is contributed to the Red Cross, which is a public charity and which from the outset intends to sell the painting and, in fact, promptly does sell it, the deduction must be reduced by 100% of the appreciation in value, with the balance deductible within the 50% limitation.

The regulations[44] also indicate that the related use rule is met even if the donee sells or otherwise disposes of only an "insubstantial" portion of the collection.

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.

Private Letter Ruling 77-51-044

The IRS held that the related use sale 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. (Private Letter Rulings 79-11-109 and 79-34-082 reach similar results in dealing with the exhibition of works of art.)

Private Letter Ruling 80-09-027

The IRS held 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.

Private Letter Ruling 81-43-029

The IRS held that the related use rule was satisfied when a donor gave his collection of 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.

Private Letter Ruling 82-08-059

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 the college had, as part of its curriculum, the teaching of engraving skills. In the ruling request the donor included letters from the college, explaining in detail how it would use the collection.

Private Letter Ruling 91-31-053

The IRS held that the related use rule was satisfied when a donor gave seeds, greenhouses, plants, livestock, animal semen, beds, desks, tilling equipment, and cafeteria equipment to a private school with exempt status under sections 501(c)(3) and 509(a)(1). The donated items of tangible personal property were to be used by the school in its plant science and animal science curriculum.

Private Letter Ruling 98-33-011

The IRS held that the related use rule was satisfied when a donor donated paintings to a Jewish community center that was not a museum but did have an arts wing and library. The community center proposed to solicit contribution of works of art that would be selected by a group of volunteers from the local community but would not be restricted to Jewish artists or to Jewish themes. The community center would accept only works of art that it expected to use in a manner related to the purpose or function constituting the basis for the community center's exemption under section 501(c)(3). The community center would display some of the works of art, and others would be put on loan with affiliated charitable organizations. The community center represented that it did not intend to sell the donated works of art except on a limited and infrequent basis when the collection exceeded the space available for display or an item was no longer relevant or it became too costly to provide maintenance and security for the work of art. The Private Letter Ruling held that so long as any loans to other charitable organizations further the community center's exempt purpose or function, then such activities will not be unrelated to the exempt purpose of the community center. However, the IRS pointed out that the community center may not rely on the exempt purpose or function of the charitable organization to which the works of art are loaned. The purpose of the loan must be to further the exempt purpose of the community center.

It is important to make sure that 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.[45]

A. Related Use Reporting

Prior to the PPA the IRS required the donee charity to file IRS form 8282 if the donee charity disposes of the property within two years of receipt. Presumably this would give the IRS the opportunity to audit the donor-taxpayer's income tax return if the price the donated item was sold for was less than the deduction claimed by the donor. Under the PPA the reporting requirement is increased to apply to dispositions made within three years after receipt by the donee charity[46]. Obviously, there is a new focus on the actual use the charity makes of the donated property. In addition, the information that must be reported now includes a description of the donee's use of the property and a statement indicating whether its use was related to its exempt purpose or function. If the donee charity does indicate a related use, it must include with the disclosure form the certification discussed below. Form 8282 was revised as of January 2007, a copy of which is attached.

Where there is no "certification" and a donee organization sells, exchanges, or otherwise disposes of the applicable property in the donor's tax year in which the contribution was made, the donor's deduction is limited to basis and not fair market value.[47] If the donated property is disposed of by a donee organization in a subsequent year within three years of the contribution, the donor must include as ordinary income for the year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.[48]

The limitation on the deduction in the first tax year or the recapture of the tax benefit in a subsequent year does not apply if the donee organization makes a "certification" to the IRS. A certification[49] is a written statement signed under penalty of perjury by an officer of the donee organization which either—

1. certifies that the property's use was related to the donee's exempt purpose or function and describes how the property was used and how such use furthered the exempt purpose of function; or

2. states the intended use of the property by the donee at the time of the contribution and certifies that such intended use became impossible or infeasible to implement.

In essence, the claim that donated property was put to an exempt use now triggers much more scrutiny if the donee organization does not retain that property at least until the end of the third year after the property was donated.

These new rules do not apply to any contribution of exempt use property with a claimed value of $5,000 or less.

B. Related Use Penalty

In conjunction with the new recapture rules discussed above, there is a new penalty for the fraudulent identification of exempt use property.[50] In addition to any criminal penalty, any person who identifies applicable property (as defined in section 170(e)(7)(C)) as having a use that is related to the donee's exempt purpose or function and who knows that the contributed property is not intended for such a use, is subject to a $10,000 penalty.

2. Qualified Appraisal

The PPA revised the definition of a "qualified appraisal"[51] to mean an appraisal of property which is:

1. treated as a qualified appraisal under the regulations or other guidance prescribed by the IRS; and

2. conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the IRS.

Effective for returns filed after February 16, 2007, the appraisal must contain a declaration that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund, may subject the appraiser to a civil penalty under section 6695A.[52] This statement is in addition to the requirement that the appraisal contain a statement that the appraiser understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalty under IRC § 6701 for aiding and abetting an understatement of tax liability.

The existing IRC regulations still apply requiring that the appraisal not be prepared more than sixty days before the date of the contribution of the appraised property and that the appraisal be signed and dated by a qualified appraiser who charges an appraisal fee that is not based on a percentage of the value of the appraised property.[53] The qualified appraisal must contain the following information:

1. A detailed description of the property

2. The physical condition of the property

3. The date or expected date of the contribution

4. The terms of any agreement or understanding entered into or expected to be entered into by or on behalf of the donor that relates to the use, sale, or other disposition of the property contributed

5. The name, address, and taxpayer identification number of the appraiser

6. A detailed description of the appraiser's background and qualifications

7. A statement that the appraisal was prepared for income tax purposes

8. The date on which the property was valued

9. The appraised fair market value of the property

10. The method of valuation used to determine the fair market value

11. The specific basis for the valuation, such as any specific comparable sales transactions

12. A description of the fee arrangement between the donor and the appraiser

Obviously, the cost to the taxpayer of having a qualified appraisal prepared is going to be high because of the detailed information required. A separate qualified appraisal is required for each item of property that is not included in a group of similar items of property. If the appraisal is for a group of similar items, the detailed information is required for each individual item other than items worth less than $100, for which a group description is allowed.

The qualified appraisal must be received by the donor before the due date (including extensions) of the taxpayer's income tax return.[54] That deadline is important, since the entire charitable deduction is lost if the taxpayer does not comply with that provision.

3. Qualified Appraiser

The PPA now includes in the Internal Revenue Code a definition of a "qualified appraiser"[55] to mean an individual who:

1. has earned an appraisal designation from a recognized professional appraiser organization, or has otherwise met minimum education and experience requirements set forth in regulations;

2. regularly performs appraisals for pay; and

3. meets other requirements that the IRS may prescribe in regulations or other guidance.

An individual cannot be a qualified appraiser with respect to any specific appraisal unless he:

1. demonstrates verifiable education and experience in valuing the property type being appraised; and

2. has not been prohibited from practicing before the IRS at any time over the past three year period ending on the appraisal date.

It is now imperative that the donor check the credentials of the appraiser in order to ensure that the appraiser is an expert in the item being appraised. In other words, an expert appraiser for Dutch 17th century drawing will not be the correct appraiser for a work of contemporary art.

The existing IRC regulations still apply regarding the independence of the appraiser. Under these IRC regulations[56] the term "qualified appraiser" means an individual who holds himself out to the public as an appraiser who is an expert as to the particular type of property being appraised; who understands that if he makes a false or fraudulent overstatement of value, he may be subject to a civil penalty under section 6701; and who is completely independent of the donor. To be independent of the donor, the qualified appraiser cannot be the donor or the donee, a party to the transaction in which the donor acquired the property, a person employed by any of the foregoing, or a person related (within the meaning of section 267(b)) to any of the foregoing.

For example, if a person acquired a painting from an art dealer and later donated the painting to a museum, the donor, the dealer who sold the painting, the museum, any person employed by the donor or the dealer or the museum, or any person related to any of the foregoing is not a qualified appraiser. The regulations are so broad that they appear to disqualify an auction house from being a qualified appraiser if the donor had purchased the property at auction from that auction house.

The final regulations adopted on May 4, 1988, did retain the provision that disqualifies someone who regularly performs appraisals for a person who is not otherwise excluded from being a qualified appraiser and does not do a substantial number of appraisals for other persons—for example, someone who performs appraisals for only one person. Also excluded as a qualified appraiser is any person who, if the donor had knowledge of the facts, would cause a reasonable person to expect that the appraiser would falsely overstate the value of the donated property. For example, the donor and the appraiser make an agreement concerning the amount at which the property will be valued, and the donor knows that the amount exceeds the fair market value of the property.

The appraiser selected must be a qualified appraiser because, if the donor chooses unwisely and the appraiser is later found not to be a qualified appraiser, the entire charitable deduction is lost, since it is then too late to correct the defect.[57] In order to obtain the income tax deduction, the taxpayer must attach to the income tax return a qualified appraisal prepared by a qualified appraiser.

There is a new penalty to be assessed against appraisers for certain types of valuation misstatements under section 6695 A. A person who prepares an appraisal of property must pay a penalty if: (1) he knows or reasonably should have known, that the appraisal would be used in connection with a federal tax return or refund claim; and (2) the claimed value of the appraised property results in a substantial valuation misstatement or a gross valuation misstatement related to income tax. The penalty is the lesser of: (l)the greater of $1,000 or 10 percent of the tax underpayment amount attributable to the misstatement; or (2) 125 percent of the gross income received by the appraiser for preparing the appraisal. However, no penalty is imposed if the appraiser establishes that the appraised value of the property was more likely than not the proper value for the property, section 6695 (A)(c).

A. Notice 2006-96-New Appraisal Requirements

Notice 2006-96 issued by the IRS in October 2006, offers some guidance as to the new appraisal rules introduced by the Pension Protection Act of 2006.[58]. According to the

Notice, an appraisal will be treated as a qualified appraisal under the new rules if the appraisal complies with all the requirements of the existing IRS regulations and is conducted by a qualified appraiser in accordance with generally accepted appraisal standards. An appraisal is treated as having been conducted in accordance with generally accepted appraisal standards if, according to the Notice, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice ("USPAP"), as developed by the Appraisal Standards Board of the Appraisal Foundation.[59]

An appraiser will be treated as having demonstrated verifiable education and experience in valuing the type of property subject to the appraisal if the appraiser makes a declaration in the appraisal that, because of the appraiser's background, experience, education and membership in professional association, the appraiser is qualified to make appraisals of the type of property being valued. For appraisals for returns filed after February 16, 2007, the appraiser will be treated as having met the minimum education and experience requirements if the appraiser has (i) successfully complete college or professional-level coursework that is relevant to the property being valued, (ii) obtained at least two years' experience in the trade or business of buying, selling, or valuing the type of property being valued, and (iii) the appraiser gives a full description of his educational background.[60]

IV. CHECKLIST FOR COLLECTORS

To maximize the charitable deduction, the donor should:

- o Make the contribution of appreciated tangible personal property to a public charity;
- o Be sure that the contribution satisfies the related use rule;
- o Make the contribution only with long-term capital gain property; and
- o Be sure that there is a qualified appraisal by a qualified appraiser of the contributed property.

A deed of gift should be used, and formal acceptance by the charitable organization should be indicated thereon, as set forth in form 2 attached. In addition, the deed of gift should be drafted in such a manner that it supports the taxpayer's compliance with the related use rule, and it should also require the donee organization to sign IRS form 8283. Before the gift is made there should be discussion and correspondence with the charitable organization to make sure that the related use rule is met. The correspondence should establish the proof necessary to meet the related use rule. Consideration should be given to the special election to increase the charitable deduction from 30 to 50 percent when the appreciation in the value of the property is relatively small. After the donor dies, there is no carryover of any remaining contribution deduction to his or her estate. See forms 1, 2, and 3 attached to this article.

Before making the contribution, the donor should do the following:

1. Check the type of organization — public charity or private charity;
2. Check the type of property — capital gain property or ordinary income property;

3. Check compliance with the related use rule;

4. Consider the special election to increase the deduction from 30 to 50 percent;

5. Prepare the deed of gift and have it signed by the donor and the donee organization;

6. Obtain a qualified appraisal by a qualified appraiser;

7. Make sure IRS form 8283 is completed by the donee organization and the appraiser and that it is attached to the taxpayer's income tax return;

8. Obtain the necessary photographs for property in excess of $20,000;

9. File the gift tax return if required — under the Taxpayer Relief Act of 1997 a gift tax return is no longer required for the outright charitable transfer of the donor's entire interest in the property transferred to a charitable organization; and

10. Maintain the documentation for the income tax return required by the income tax regulations.

If the $5,000 claimed deduction amount is reached, the new appraisal rules apply whether (1) the donated property is capital gain property or not, (2) the property has appreciated or depreciated in value since its acquisition by the donor, (3) the donee is a public charity or a private foundation, and (4) the related use rule is or is not satisfied.

V. PARTIAL INTER VIVOS CHARITABLE TRANSFERS

1. Fractional Gifts To Charitable Organizations

A. Fractional Gifts-Prior to August 2006

Prior to August 17, 2006 the collector who wanted to give away a collection and still enjoy its possessions on a part-time basis could convey an undivided fractional interest in the property to a charity. The transfer of an undivided fractional interest was not a transfer of a future interest than ran afoul of section 170(a)(3) or section 170(f).[61] Therefore, an immediate charitable deduction was allowable for the value of the undivided fractional interest donated. In the case *of James I. Winokur,*[62] 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.

For 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 the possession of the painting for nine months each year, and the museum is entitled to possession for three months each year. Ms. Collector can deduct one-fourth of the fair market value of the painting as a charitable contribution on the date of the gift, subject to the permissible maximum.

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 position is based on Revenue Ruling 57-293,[63] 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).

B. Fractional Gifts-After August 17,2006

The Internal Revenue Service was concerned that there was abuse of the fractional gift technique - that is, situations were discovered where a taxpayer claimed a deduction for a fractional interest in a work of art yet retained physical possession of the donated property for the full year. Under new section 170(o) introduced by the PPA, effective for contributions made after August 17, 2006, fractional gifts are no longer desirable.

C. Valuation Limitation.

Under section 170(o), the collector's initial contribution of a fractional interest in a work of art is determined as under current law and described above (full fair market value times the fractional interest donated). For purposes of determining the deductible amount of each additional contribution in the same work of art, the fair market value of the donated item is now limited to the **lesser** of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution.[64] For example, the collector who gives away a 50 percent interest in a painting when it is worth $1,000,000 would still be able to claim a $500,000 deduction. However, when the collector donates the remaining 50 percent interest 10 years later when the painting is work $2,000,000, the collector's donation would be limited to 50 percent of the initial fair market value of $1,000,000, that is $500,000, not 50 percent of the $2,000,000 current value.

D. Timing Limitation.

The collector must complete the donation of his entire interest in the work of art before the earlier of (1) ten years from the initial fractional contribution or (2) the donor's death.[65] If the donee charity is no longer in existence, the collector's remaining interest may be contributed to another section 170(c) organization.

E. Use Limitation.

Under the new provisions, the donee charity of a fractional interest in a work of art must (1) have substantial physical possession of the work of art during the donor allowed possession period (maximum of 10 years) and (2) use the work of art for an exempt use during such period - satisfy the related use rule.[66] The Joint Committee on Taxation Report[67] (the JCT Report) gives an example of an art museum described in section 501(c)(3) that is the donee of a fractional interest in a painting which includes the painting in an art exhibit sponsored by the museum, such use generally will be treated as satisfying the related-use requirement. However, the JCT Report contains no example as to the meaning of "substantial physical possession". For example, if a collector donates a 10 percent fractional interest in a painting to a museum and plans on donating the remaining 90 percent 10 years later, does the collector violate the substantial physical possession rule if the museum only has physical possession during the 10 year period for 10 percent of such period? The regulations will need to clarify this provision although, if the museum has physical possession for a period of time equal to the donated percentage interest, that should be sufficient to satisfy this requirement.

F. Recapture of Deduction.

If the collector violates the 10 year timing limitation or the use limitation (the substantial possession or related-use requirement), then the collector's charitable income and gift tax deductions for all previous contributions of interests in the work of art are recaptured plus interest.[68] In any case in which there is a recapture of a deduction, the statute also imposes an additional tax in an amount equal to 10 percent of the amount recaptured.

G. Denial of Deduction.

No income or gift tax deduction is allowed for a contribution of a fractional interest in a work of art unless immediately before such contribution all interests in the work of art are owned (1) by the collector or (2) by the collector and the donee organization.[69] The IRS is authorized to make exceptions to this rule in cases where all persons who hold an interest in the work of art make proportional contributions of undivided interests in their respective shares of such work of art to the donee organization. For example, if collector A owns an undivided 50 percent interest in a painting and his brother, collector B owns the other undivided 50 percent interest in the same painting, the IRS may under regulations to be issued, provide that A may take a deduction for a charitable contribution of less than the entire interest held by A, provided that both A and B make proportional contributions of undivided fractional interests in their respective shares of the painting to the same donee organization (e.g., if A contributes 25 percent of A's interest and B contributes 25 percent of B's interest).

H. Danger of Fractional Gifts and the Repeal.

The PPA contained similar limitations as described above for gift and estate tax purposes.[70] Like the income tax provision, the estate tax provision limited the estate tax charitable deduction to the **lesser** of: (1) the fair market value at the time of the initial fractional contribution; or (2) the fair market value at the time of the subsequent contribution.[71] In order to avoid the recapture of the income tax deduction, the transfer to the donee charity must be completed on the earlier often (10) years from the initial contribution or the donor's death. For example, the collector who gives away a 50 percent interest in a painting to a museum when it is worth $1,000,000 would receive a $500,000 income tax deduction. If the collector dies four years later when he still owns the remaining 50 percent interest and if the painting is then worth $2,000,000 his estate tax charitable deduction is limited to $500,000, that is, 50 percent of the initial value of $1,000,000 for the 50 percent interest. This would mean that the collector's estate would have a 50 percent interest in a painting going to a museum with a value of $1,000,000 (for the 50 percent interest) for which the estate was only entitled to a $500,000 deduction resulting in the estate having to pay an estate tax on the remaining $500,000. This is a trap for the uninformed and was not the result intended by the legislation. On December 29, 2007, President Bush signed the Tax Technical Corrections Act of 2007 (P.L. 110-172). The Act repealed the changes made to the estate tax and the gift tax that resulted in the tax trap described above in this paragraph. The net effect of this change is as if the special valuation limitation (value at time of initial gift) never existed for estate and gift tax purposes.

I. Future Planning.

If the valuation limitation described above is corrected, then fractional gifts may still be useful for a collector who owns a very valuable work of art and therefore needs to spread the deduction for the initial value over a 12 year period (year of donation plus 5 year carryover for two transfers). For example, assume a painting with a fair market value of $5,000,000 owned by an individual with an average yearly adjusted gross income (AGI) of $1,000,000. Since the maximum allowable charitable deduction is 30 percent of AGI, his maximum deduction if the entire painting was donated is $1,800,000 ($300,000 x 6, i.e. 30 percent of AGI and a 5 year carryover). If a one-half fractional interest in the painting is donated, the same $1,800,000 deduction over a six year period is allowable (50 percent of $5,000,000 is $2,500,000). hi year seven the individual can donate the remaining 50 percent interest in the painting and receive another $1,800,000 deduction spread over the following six years. Since the initial value of the painting is high, the individual would not be concerned with loss of the appreciation in value of the painting as a deduction. However, until there is a change in the tax code this type of fractional gift should not be made.

2. Retained Life Estate - The Future Interest Rule

Before 1964 a remainder interest was deductible: reserving a life interest in a work of art while enjoying an immediate deduction for the present gift of the remainder to charity was a widespread practice.[72] However, the Revenue Act of 1964 added section 170(f), now section 170(a)(3), to the Code, which postpones any income tax charitable deduction for a gift of a future interest in tangible personal property until there is no intervening interest in, right of possession of, or enjoyment of the property held by the donor, the donor's spouse, or any of the donor's brothers, sisters, ancestors, or lineal descendants. That amendment was generally applicable to contributions made after December 31, 1963, and the same rule currently applies.[73]

If an individual has made a gift of a future interest in property before January 1, 1964 and has taken a charitable deduction, he can now contribute his life interest and obtain a charitable deduction based on the gift's present value and calculated in accordance with the actuarial tables of the regulations under the Code.[74] Prior to April 30, 1989, the 10 percent actuarial tables under regulation section 20.203 l-7(f) were used to value such interests. Code section 7520, effective May 1, 1989, now sets forth the tables to be used.[75]

The term "future interest" includes situations in which a donor purports to give a work of art to a charitable organization, but has an understanding, arrangement, or agreement (whether written or oral) with the charitable organization that has the effect of reserving to or retaining in the donor a right to the use, possession, or enjoyment of the property.[76] In other words, there will be no present deduction allowed if a donor gives a work of art away with some sort of understanding or agreement through which the donor can borrow it back when he or she desires.

The contribution of a future interest does not necessarily mean that the charitable deduction is lost; it may only be postponed. Regulation section 1.170A-5(a)(5) provides that the other provisions of section 170 are applicable to a contribution until the contribution is treated as made under section 170(a)(3).

Example 1: In 1994 Mr. Collector transferred a painting to an art museum by deed of gift, but reserved to himself the right to the use, possession, and enjoyment of the painting during his lifetime. The value of the painting in 1994 was $90,000. Since the contribution consisted of a future interest, no deduction was allowed in 1994.

Example 2: Assume the same facts as in Example 1, except that in 1996 Mr. Collector relinquished all his rights to the use, possession, and enjoyment of the painting and delivered it to the museum. If the value was $100,000 in 1996, Mr. Collector was entitled to a deduction of $100,000 in 1996, subject to the applicable percentage limitations.

The above examples, which are similar to those in the regulations, can be a trap for the unwary. If a charitable transfer of a remainder interest in a work of art is made, the donor, as indicated above, does not receive a current charitable deduction. The danger is that he or she may incur a current gift tax liability. Under section 2522(c)(2) and regulation section 25.2522(c)-3(c)(l), there is no gift tax charitable deduction for a transfer of the remainder interest in a work of art. However, since a transfer of the remainder interest has taken place, there is a transfer subject to the gift tax.[77]

Revenue Ruling 77-225, 1977-2 C.B. 73: A taxpayer claimed a charitable contribution deduction for a donation of a rare book collection. However, the taxpayer retained for his life the right of full access to the collection and the right to deny access to others. The IRS ruled that the taxpayer was not entitled to a charitable deduction, since the rights the taxpayer retained were equivalent to the retention of substantial rights to actual possession and enjoyment of the collection. Therefore, the gift was a donation of a future interest in tangible personal property, which is not deductible under section 170(a)(3). Although the ruling did not cover the gift tax question, I believe that a taxable gift was made.[78]

The future interest rule of section 170(a)(3) must be read in conjunction with the partial interest rule of section 170(f)(3)(A), which denies a deduction for a partial interest in property with certain exceptions not applicable to tangible personal property unless that interest is in the form of an annuity trust or unitrust. However, if there is no intention to avoid the application of section 170(f)(3)(A) by the conveyance, it appears that the rule does not apply.[79]

Example 3: In 1994 Mr. Collector transferred to his sons a life interest in a painting and on the same date transferred the remainder interest to charity with the intention of avoiding section 170(f)(3)(A). No deduction would be allowed to Mr. Collector for his remainder interest. If there had been no intention of avoiding section 170(f)(3)(A), section 170(a)(3) would still have prevented any current deduction, and there would have been a gift tax on the present interest and the remainder interest.

Therefore, a remainder interest in a work of art should never be transferred outright to a charitable organization.

3. Inter Vivos Charitable Remainder Trust

A. Art Held For Trust Term

The foregoing discussion is applicable to outright transfers of a remainder interest in a work of art and the prevention of any deduction by section 170(a)(3). If, however, the transfer of the work of art is to be made in trust, then that type of transfer would first have to be examined under section 170(a)(3) and then be governed by section 170(f)(2)(A) which denies any income tax charitable deduction for the value of a remainder interest in trust unless the trust is a charitable remainder annuity trust, a charitable remainder unitrust or a pooled income fund as those terms are defined in sections 664 and 642(c)(5). With one exception discussed below, the effect of section 170(f)(2)(A) was to make a transfer of that type impractical, since non-income producing property, such as a work of art, cannot be put in the form of a guaranteed annuity, nor can it pay out a fixed percentage yearly of its fair market value. A charitable remainder unitrust is permitted to pay out only its income if that income is less than the stated percentage. However, if from the outset it is clear that the property put in trust will never produce any income, the charitable deduction may be denied on the ground that a valid charitable remainder unitrust was not created, since the trust cannot make an annual payment. The regulations[80] issued under section 664 indicate that a charitable remainder unitrust must make an annual payment to the noncharitable beneficiary. The regulations make no mention of a remainder interest in non-income producing property, such as a work of art. The only exceptions to the required unitrust form for a remainder interest in property given to a charity are contained in section 170(f)(3)(B)(i), which concerns a remainder interest in a personal residence or farm.

Further, the regulations state that a remainder trust will not qualify under section 664 if its governing instrument contains a "provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets."[81]

In Revenue Ruling 73-610, 1973-2 C.B. 213, the grantor of an irrevocable trust contributed a collection of antiques, in addition to income-producing assets, to a trust. The governing instrument of the trust provided that the grantor's spouse, who was the sole income beneficiary of the trust for her life, should have the use of the antique collection for her life. At her death, the antique collection and all the remaining assets in the trust were to be distributed to a charitable exempt organization. In all other respects the trust complied with the provisions of section 664 defining charitable remainder trusts. The IRS held that the retention of a life estate in the collection of antiques for the grantor's spouse restricted the trustee from investing all the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Therefore, the trust did not qualify as a charitable remainder trust. Similarly, in Revenue Ruling 76-165, 1976-1 C.B. 279, the IRS held that a remainder interest in household furnishings that were bequeathed to a surviving spouse for life and then to a charitable organization did not qualify as a deductible remainder interest.

Therefore, a work of art that is to be held for the trust term will probably disqualify the trust from being a charitable remainder unitrust or a charitable remainder annuity trust and there will be no income tax charitable deduction.

B. Art Sold Within First Year

One way to deal with Revenue Ruling 73-610 is specifically to direct and empower the trustee to sell any non-income-producing property (the work of art) at his or her discretion within the taxable year of its receipt by the trust. In such a case the trustee is not "restricted" from investing the assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. A recent Private Letter Ruling gives some support to this position.

In Private Letter Ruling 9452026 the taxpayer created an inter vivos charitable remainder annuity trust that was to be funded with publicly traded securities and an appreciated musical instrument. The taxpayer was not in the business of dealing in musical instruments, nor did he depreciate the instrument. In other words, the instrument was a capital asset.

The taxpayer requested a number of specific rulings, including the following:

1. That the Trust qualifies as a charitable remainder annuity trust under section 664(d)(1);

2. That the charitable contribution of the musical instrument contributed to the Trust is deductible to the extent of the charitable remainder interest;

3. That, in accordance with sections 170(b)(l)(C)(i), 2055(a)(2), and 2522(a)(2), provided there is no prearranged contract for the sale of the musical instrument, if the Trust sells the musical instrument before the end of the calendar year in which the musical instrument is contributed to the Trust, the charitable contribution is deductible up to 30 percent of the contribution base, and because the musical instrument has been sold, section 170(a)(3) does not apply; and

4. That, provided there are no prearranged contracts for the sale of the property contributed to the Trust, the taxpayer does not realize gain with respect to the property sold by the Trust and any gain is properly reportable by the Trust and the beneficiary includes in income only such amounts of income or gain distributed by the Trust.

The IRS refused to rule on whether the trust qualifies as a charitable remainder annuity trust. The Ruling relied on Rev. Proc. 94-3, 1994-1 IRB 79 that sets forth sample provisions for charitable remainder trusts, and stated that taxpayers relying on such provisions can be assured that the Service will recognize the trust as meeting all of the requirements to be a charitable remainder annuity trust.

The Ruling then discusses section 170(a)(3) and notes that it provides that payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or by those related to the taxpayer as described in section 267(b) or 707(b).[82] The Ruling than goes on to conclude that because the musical instrument is tangible personal property, section 170(a)(3) prevents any deduction for the remainder interest as long as the taxpayer retains an income interest in the musical instrument. The Ruling then adds the following important statement:

> However, an income tax deduction would be allowed under section 170(a)(3) when the trustee sells the musical instrument. When the musical instrument is sold, the taxpayer no longer retains an intervening interest in

> the tangible personal property as contemplated under section 170(a)(3), the taxpayer is only holding an income interest in the sale proceeds from the musical instrument. Accordingly, the taxpayer's intervening interest in the musical instrument is treated as terminated upon its sale.

The Ruling also concludes that the sale by the Trust would be considered as putting the musical instrument to an unrelated use for section 170(e)(l)B)(i) purposes. Accordingly, the taxpayer's deduction would be reduced to the portion of the taxpayer's basis which is allocable to the remainder interest in the musical instrument.

In discussing the capital gain issue, the Ruling relied on Palmer v. Commissioner.[83] In that case the donor had voting control of both a corporation and a tax-exempt private foundation. Pursuant to a single plan, the donor contributed shares of the corporation's stock to the foundation and then caused the corporation to redeem the stock from the foundation. The Tax Court held that the transfer of stock to the foundation was a valid gift and the capital gain was not attributable to the donor since the foundation was not bound to go through with the redemption at the time it received title to the shares. In the case of the musical instrument, the Ruling states that since there was no prearranged sale contract where the Trust was legally bound to sell the musical instrument, the taxpayer was not required to recognize any gain from the sale of the musical instrument.

Creating a charitable remainder unitrust or annuity trust to sell a work of art during the first year of the trust can be a useful planning technique. A work of art may have a very low cost and be worth a great deal of money. If the collector who is in need of income sells it he or she will have to pay approximately one-third of the gain in federal and state income taxes, leaving only the balance to be invested to produce income. Instead, if the collector contributes the work of art to a charitable remainder trust and the trust is the seller, that will result in allowing the work of art to be sold tax free, and preserve the one-third of the gain that would have gone in income taxes for future investment to produce a greater amount of income for the collector.[84] The collector could also claim a charitable deduction although the amount of the deduction will probably be limited to the collector's cost which is allocable to the remainder interest in the work of art since the contribution would not satisfy the related use rule. The trust instrument should direct the sale in the year of receipt of any non-income producing property to avoid any problem under sections 170(a)(3) and 170(f)(2)(A). A direction in the trust instrument to sell any non-income producing property should not run afoul of the so-called Pamona College problem in which appreciated securities were contributed to a tax exempt organization with a promise that the securities would be sold and invested in tax-exempt securities.[85] There would be no obligation for the trustee to invest in tax-exempt securities and the distributions out of the unitrust or annuity trust would carryout either taxable income or the capital gain realized by the trust.[86]

Even if the trustee sells the work of art in the first year of the trust, the amount of the allowable charitable deduction available for the collector will be limited to the collector's cost which is allocable to the remainder interest in the work of art since the transfer to the charitable remainder trust of a work of art that will be sold will not satisfy the related use rule of section 170(e)(l)(B)(i).[87] Regulation 1.170A-4(b)(3)(i) provides in part as follows:

> The use by a trust of tangible personal property contributed to it for the benefit of a charitable organization is an unrelated use if the use by the trust is one which would have been unrelated if made by the charitable organization.

Although the regulation is not entirely clear, it causes a problem because the trust is making no use of the property contributed to it since in order to qualify as a charitable remainder trust it can not hold non-income producing property. An argument for the full charitable deduction (the key is to satisfy the "related use rule") can be made as follows: that if the property was contributed directly to the remainderman charity (the organization that will receive the principal of the trust after the death of the noncharitable income beneficiary) and if it was reasonable to anticipate that the remainderman charity would not have put the property to an unrelated use, then the related use rule is satisfied and the charitable deduction should be allowable in full. The problem is convincing the IRS that it was reasonable to anticipate such use. The argument may be enhanced if the contributed property is sold to the designated remainderman charity by the trustee. There is, however, no authority for that position, and without a specific IRS ruling it is not recommended.

One commentator has suggested that if the charitable remainderman of the trust is a foundation described in section 170(b)(l)(A)(iv) whose function is to receive, hold, invest and administer property and make expenditures for the benefit of a college or university, that a sale by the trust of a work of art would satisfy the related use rule.[88] This appears to be a very aggressive position and although the trust might qualify as a charitable remainder trust the charitable deduction should be limited because the transfer does not satisfy the related use rule.

The Taxpayer Relief Act of 1997 added two new provisions that must be considered in the creation of a charitable remainder annuity trust or unitrust. There is now a prohibition against a provision that allows a distribution from the trust of more than 50 percent of the trust assets to the non-charitable beneficiary in any one year and a new requirement for both annuity trusts and unitrusts that the value (determined under the section 7520 valuation tables) of the remainder interest going to the charitable organization must be at least 10 percent of the initial net fair market value of the property placed in the trust. The new provisions are effective for transfers in trust after July 28, 1997.

Subject to certain limitations, a grantor may serve as the trustee of his or her own charitable remainder trust.[89] If a work of art is to be used to fund the charitable remainder trust, it is preferable to use an independent trustee, even if the work of art will be sold in the first year of the trust. The House Ways and Means Committee stated the following in its report on unitrusts:

It is contemplated that a charitable contribution deduction would be denied where assets which do not have an objective ascertainable market value, such as real estate or stock in a closely held corporation, are transferred in trust, unless an independent trustee is the sole party responsible for making the annual determination of value.[90]

That requirement was incorporated into the regulations on December 10, 1998 (see regulation 1.664-1(a)(7)), and it should serve as a warning for a grantor who wishes to be a trustee of his or her charitable remainder trust when it is funded with a work of art.

4. Testamentary Charitable Remainder/Lead Trusts

A collector is often reluctant to part with his works of art during lifetime. In certain situations, a testamentary charitable lead trust or a testamentary charitable remainder trust may be a useful estate planning tool.

A. Testamentary Charitable Remainder Trust

Since a charitable remainder trust is exempt from income tax[91] it is commonly used to sell highly appreciated assets during the lifetime of the grantor in order to avoid an immediate realization of income. This is not necessary on the death of an individual since the assets would receive a step up in basis equal to the fair market value of the assets at the date of death or six months later.[92] However, tax benefits still remain since the creation of a testamentary charitable remainder trust would entitle the testator's estate to an estate tax charitable deduction for the fair market value of the remainder interest.[93]

To qualify as a charitable remainder trust, the trust must satisfy the definition of a charitable remainder trust and function exclusively as a charitable remainder trust from the date of its creation.[94]

For purposes of section 2055, a testamentary charitable remainder trust is deemed created at the decedent's death even though the actual funding of the trust may be deferred. The regulations provide that the funding of a charitable remainder trust can be delayed until the end of a reasonable period of administration.[95] Rev. Rule 80-123[96] requires that the governing instrument of a testamentary charitable remainder trust grant the trustee the authority to defer the payment of the annuity or unitrust amount until the end of the taxable year of the trust in which the trust is completely funded. The obligation to pay the annuity or unitrust amount, however, begins at the decedent's death.[97]

> *Example:* G transfers property to a trust over which she retains an inter vivos power of revocation. Upon G's death the trust is required to pay the debts and administration expenses of G's estate. When the expenses are paid, the trust terminates and distributes all of its remaining assets to a separate trust T, which meets the definition of a charitable remainder trust. Trust T will qualify as a charitable remainder trust from the date of G's death because it will function exclusively as a charitable remainder trust from its creation. For purposes of § 2055, trust T will be deemed to be created at G's death, provided the governing instrument requires that the obligation to pay the annuity or unitrust amount begins on the date of G's death, even though the same instrument provides payment shall be deferred until the end of the taxable year in which the trust is funded.[98]

If payment is deferred, a correcting adjustment must be made within a reasonable period after the close of the trust's first taxable year in which it is completely funded.[99] In the event of an underpayment, the trust must pay the excess to the annuity or unitrust recipient, and in the case of an overpayment the recipient must repay the difference to the trust.[100] All payments must include interest. The applicable rate of interest depends on when the instrument was executed and whether it had been subsequently amended. The rate is the section 7520 rate for transfers made after April 30, 1989.

B. Testamentary Charitable Lead Trust

A testator can create a testamentary charitable lead annuity trust (CLAT) or a testamentary charitable lead unitrust (CLUT).[101] In a CLUT both the lead beneficiary and the remainder beneficiary share in any appreciation in value of the trust, whereas the charitable lead interest in a CLAT remains fixed. This makes a CLAT more advantageous to the noncharitable beneficiary since all appreciation in excess of that which the actuarial tables assumes will occur inures to the benefit of the noncharitable remainder beneficiary. The value of an annuity interest in a CLAT is determined under section 7520. This section requires the Treasury to prescribe valuation tables providing factors to value such an interest.[102] In conjunction with such factors, section 7520 also mandates the use of a defined interest rate.[103]

In valuing the interests in a testamentary charitable lead annuity trust, the appropriate valuation date in determining the annuity amount is the date of the decedent's death or the alternate valuation date.[104]

The key and most important element in a testamentary charitable lead trust is whether or not over the trust term the investment performance of the trust assets grow at a greater rate than the section 7520 rate used to value the trust assets for estate tax purposes. If an estate is permitted to claim a low valuation for assets going into a charitable lead annuity trust, the annuity amount is fixed at that value and the post-death appreciation in value will pass estate tax free to the noncharitable beneficiary at the end of the trust term.

The testamentary charitable lead trust will rarely be funded at the date of death or alternate valuation date. In addition, the exact value and nature of the assets to be transferred to the trust may not be ascertainable until settlement of the estate and inheritance tax account. Questions exist relating to the date the trust is actually created and the date when payment of the charitable income interest must commence. The regulations set forth extensive rules applicable to testamentary charitable remainder trusts.[105] Even though there is no comparable authority concerning testamentary charitable lead trusts, it would seem that the same rules should be applied to testamentary charitable lead trusts. Accordingly, the lead interest should become payable as of the date of death even though it may not be payable until a later date.

The governing instrument of the testamentary charitable lead trust should mandate that within a reasonable time after the funding of the trust, final adjustments as to the exact amount of annuity or unitrust installments should be determined.

Because the estate is subject to tax on its net taxable income during the period of administration, consideration should be given to making a current distribution to the charitable lead beneficiary in order to be able to obtain an income tax charitable deduction.[106]

Although interest is required to be paid with respect to any underpayment of the annuity or unitrust amount during estate administration for a testamentary charitable remainder trust,[107] interest is not required to be paid in the case of a lead trust. However, to avoid any question with respect to the estate tax deduction in the case of a lead trust, consideration should be given to providing for the payment of interest. Local law in some jurisdictions may require payment of interest on legacies.

C. Planning For the Collector

As indicated above, both a testamentary charitable remainder trust and a testamentary charitable lead trust have a period of time after the decedent's death (a period of reasonable administration) before the trust must be fully funded and start acting as a charitable remainder or charitable lead trust.

It is not necessary to name the specific charitable organization in a testamentary charitable remainder or lead trust. The governing instrument of a testamentary charitable remainder trust may permit the income beneficiary or the trustee to designate the charitable remainderman.[108]

Similarly, a testamentary charitable lead trust may permit the remainderman or the trustee to designate the charitable lead beneficiary.[109]

For the collector who desires to have his collection remain as a unit after his death but does not want to make an outright bequest of his entire collection to charity, the use of a testamentary charitable lead trust coupled with a testamentary charitable remainder trust may be useful. A charitable lead annuity trust for one-half of the collection and a charitable remainder unitrust for one-half of the collection would create an estate tax charitable deduction that would substantially reduce the estate taxes payable. Assume the entire collection is sold to a museum after the decedent's death as described below, there would be an annual cash flow (6% or 7% of the trust assets valued annually) from the charitable remainder unitrust to the decedent's child and an annual annuity payment from the charitable lead annuity trust to the museum with, at the end of the trust term, a substantial estate tax free payment to the decedent's child from the charitable remainder annuity trust of the post death appreciation in the value of the assets. This might be accomplished by taking the following steps:

1. The collection would be valued for federal estate tax purposes pursuant to the advanced ruling request procedure under Revenue Procedure 96-15.[110] This would fix the value of the collection for federal estate tax purposes and such determination is binding on the Internal Revenue Service.

2. Under the decedent's Will, the collection would be directed to be divided one-half into a charitable lead annuity trust and one-half into a charitable remainder unitrust. Each for six percent (6%) and each for a 20-year term.

3. The decedent's Will would not name a charitable remainderman for the charitable remainder trust and would not name a charitable beneficiary of the charitable lead annuity trust.

4. The Executor and Trustee of the Will would then discuss with various museums the sale of the collection. Efforts would be made to achieve a sales price for the collection to the museum in an amount in excess of the Revenue Procedure 96-15 amount by promising the purchasing museum that it will be named as the charitable remainderman of the charitable remainder

unitrust and as the charitable lead beneficiary of the charitable lead annuity trust. This should enable the museum to purchase the collection for an amount in excess of the federal estate tax fixed value since the museum would be receiving back most of its money over the 20-year term. In other words, in reality the museum would not be paying more than the fixed value as determined under Revenue Procedure 96-15, it would only be spreading out the payment over twenty years and, in fact, in present value terms the net cost to the museum will be substantially less than the purchase price. This should result in the charitable lead annuity trust being able to beat the section 7520 rate so that the non-charitable beneficiary would receive a substantial tax free benefit at the end of the 20-year term.[111]

5. The sale of one-half of the collection by the charitable remainder unitrust would be done immediately after that part of the collection is transferred to the trust.[112] Since a charitable remainder trust is a tax-exempt entity, there would be no capital gain on the sale. The non-charitable income beneficiary would be entitled to receive the unitrust amount calculated from the date of death plus interest at the section 7520 rate.

6. The sale of one-half of the collection by the charitable lead annuity trust would be done immediately after that part of the collection is transferred to the trust. Since a charitable lead annuity trust is not a tax-exempt entity,[113] a capital gains tax[114] would be payable on the sale on this part of the collection to the extent the sales price exceeds the Rev. Proc. 96-15 value. However, the annuity amount will be based on the Rev. Proc. 96-15 value and not on the sales price value. Although the annuity amount must be paid calculated from the date of death of the decedent, it appears that interest on such amount is not required to be paid.

This planning technique works best when there is a child of the taxpayer that has some assets of his or her own and the decedent, as well as the child, desire to keep the works of art together at one museum.

5. Private Operating Foundation

A private operating foundation falls somewhere between a private foundation and a public charity.[115] The major advantage of a private operating foundation is that, from the donor's point of view, he or she is treated in the same manner for tax purposes as if the contribution were made to a public charity. In other words, contributions of works of art to a private operating foundation can be deducted to the extent of their full fair market value so long as the specific donation requirements are satisfied.[116] Doing so includes satisfying the four requirements for obtaining the maximum charitable deduction: the property has been owned for more than one year and was not a gift from the artist, the property satisfies the related use rule (that is, the use of the art is related to the exempt purpose of the donee-charity), there is a qualified appraisal by a qualified appraiser, and the contribution is made to a public charity or a private operating foundation. If those requirements are met, the full fair market value donation of a collection is available for a donation to a private operating foundation.[117] Since the donor is the creator of the private operating foundation and can act as its president, the donor is afforded a degree of control over the collection and at the same time obtains a tax deduction for the full value of the donated property.

Private operating foundations are organizations that devote their assets or income to the active conduct of a charitable purpose, rather than making grants to other organizations. To qualify as a private operating foundation, the organization must satisfy the income test and either (i) the asset test, (ii) the endowment test, or (iii) the support test.[118]

A. <u>Income Test</u>

The income test, which must be satisfied by all private operating foundations, means that the foundation spends substantially all of the smaller of its adjusted net income or its minimum investment return (5 percent of its investment assets) directly for the active conduct of the activities constituting the purpose or function for which the foundation was organized and operated.[119] Therefore, the income generated in the foundation and the expenditures of funds must be for the direct activities of the foundation and not merely for the making of grants. Grants made to other organizations to assist them in conducting activities are considered an indirect, rather than a direct, means of carrying out activities constituting the charitable purpose of the foundation.[120] However, amounts paid to acquire or maintain assets that are used directly in the conduct of the foundation's exempt activities (the foundation's operating assets), such as works of art owned by a museum, are considered direct expenditures for the active conduct of the foundation's exempt activities. Those amounts also include administrative expenses. For example, if an individual was paid a fee to make sure that the foundation's works of art are properly insured, properly loaned to other organizations, properly stored when not on loan, and other related administrative activities, the fee is an expenditure directly for an exempt purpose.[121]

In addition to meeting the income test, a private operating foundation must meet one of three alternative tests: the assets test, the endowment test, or the support test.

B. <u>Asset Test</u>

The asset test means that the foundation must have substantially more than half of its assets devoted directly to the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose.[122] The IRS regulations give an example of satisfying the asset test in order to qualify for private operating foundation status as follows:

> Example (4). Z, an exempt organization described in section 501(c)(3), is devoted to improving the public's understanding of Renaissance art. Z's principal assets are a number of paintings of this period which it circulates on an active and continuing basis to museums and schools for public display. These paintings constitute 80 percent of Z's assets. Under these circumstances, although Z does not have a building in which it displays these paintings, such paintings are devoted directly to the active conduct of activities constituting Z's exempt purpose. Therefore, Z has satisfied the assets test described in this paragraph.[123]

Revenue Ruling 74-498,[124] specifically dealt with the qualification of a foundation that owns art as a private operating foundation. In that ruling the foundation was formed to further the arts, it owned a collection of well-known paintings, and the foundation had an endowment of stocks and bonds that produced income. Part of the income was used in a program of grants intended to further the arts, and the balance was used in a program of loaning paintings for display in museums, universities, and similar institutions. At any given time, all but a few of the paintings were in the hands of exhibiting institutions. Generally, when they were not on loan, the foundation's paintings were in transit, being reconditioned or restored, or being stored pending a schedule exhibit. In that ruling the IRS held that the foundation's collection of paintings was being used in an active loan program, and, therefore, it was being used directly to carry out its exempt purpose in the manner indicated in the IRS regulations.

A similar result was concluded by the Internal Revenue Service in Private Letter Ruling 9338042, dated June 29, 1993.[125] In that ruling the IRS made it clear that the artwork that was placed on loan to other institutions was *excluded* in determining the foundation's minimum investment return. The minimum investment return is 5 percent of a foundation's investment assets and is the amount that a foundation must use or expend each year for exempt purposes.[126]

Therefore, a donor can create a private operating foundation that can use the donor's name or any other name and to which the donor can contribute appreciated works of art and claim a deduction for the full market value. The donor, as president of the foundation, has to arrange to lend the items to other public tax-exempt organizations, so that the foundation can satisfy the asset test described above. The donor can contribute a cash amount to cover operating expenses. The donor and any other individuals can be members of the board of directors. When the works of art are not on loan or exhibition, they should be placed in temporary storage. The objective is to be absolutely sure that the donor has created a private operating foundation retroactive to the date of formation — that is, the year in which the foundation is created — with the result that a deduction for the full fair market value of the donated art is allowable.

In making use of a private operating foundation, the donor-president of the foundation must be aware that its exempt status will be lost if any personal benefit inures to the donor.[127] Therefore, it is crucial to understand what use can be made of the collection when it is not on exhibition at other institutions. A donor often wants to know about the possibility of exhibiting the collection in his or her home or on real estate that he or she owns. The question is whether any of the art can be stored or exhibited in the donor's home during the times it is not on exhibition.

In Revenue Ruling 74-600[128] the IRS was asked to rule on the question of whether the placing of paintings owned by a private foundation in the residence of a founder of the foundation constituted an act of self-dealing — that is, something that would disqualify the organization's tax-exempt status. The paintings were on exhibition in various museums for a number of years and then were returned to the residence of the founder, where they were displayed together with the founder's large private art collection in a part of his residence devoted to paintings and other works of art. Approximately 2,000 individuals visited the founder's private collection each year, and special tours were arranged for small groups and other individuals interested in the arts. The IRS ruled that the placement of the art in the founder's residence resulted in a direct use of the foundation's assets by or for the benefit of a private person, and, therefore, the foundation was not tax-exempt.

A similar result was reached in a 1987 technical advice memorandum[129] dealing with sculptures that were outside on a taxpayer's residential property, where the sculpture was open to exhibition to the public. The foregoing IRS position indicates how sensitive the government is to any personal use of art assets after the donation has been made.

If there is a separate structure on the donor's property, preferably a structure not attached to his or her residence, a ruling may be obtained that no personal use was made of the collection and that there was an exhibition space open to the public. Alternatively, the donor could build a storage space on his or her property and take the works of art out for conservation or for use in the storage space when scholars or other interested parties are in attendance.[130] The collection should never be used in the donor's personal residence. We strongly recommend that the items be placed in a storage facility, not on the donor's property, when the items are not on loan.

For a collector who wants the tax benefits of donating his or her art collection yet cannot cope with losing total control over the collection, the private operating foundation (by satisfying the income test and asset test) offers an alternative that should be given serious consideration.

C. Endowment Test

The endowment test requires direct distributions of at least two-thirds of the foundations minimum investment return — that is, 3 1/3 percent (2/3 times 5 percent) of its endowment.[131] The distributions must be made directly for the active conduct of the foundations exempt purpose. Most foundations that satisfy the income test will, as a practical matter, satisfy the endowment test in order to qualify as a private operation foundation.

D. Support Test

The support test requires that (1) at least 85 percent of the foundation's support, other than gross investment income, be from a combination of the general public and five or more exempt organizations, (2) not more than 25 percent of support, other than gross investment income, be from any one exempt organization, and (3) not more than 50 percent of support be from gross investment income.[132] The support test will rarely be used by a collector to qualify a foundation as a private operating foundation because of its fund raising aspects.

VI. COMPLETE TESTAMENTARY CHARITABLE TRANSFERS

An individual may desire to keep possession of a work of art during life and bequeath it to a charitable organization on death. Doing so results in an estate tax charitable deduction to the extent of the full fair market value of the property at the date of death.[133] In the case of a bequest at death there is no distinction between a public charity and a private foundation. Moreover, in general, the related use rule does not apply to testamentary transfers.[134] However, section 2055(e) introduced by the Economic Recovery Tax Act of 1981 (ERTA) contains a new related use rule for a testamentary charitable transfer when there is a retained copyright interest. That provision is discussed briefly later in this article.

Whenever a valuable work of art constitutes a substantial portion of the assets that a client wants to leave to charity on his or her death, consideration must be given to the extent of the charitable bequest. For example, an art collection left to charity at the time a will is drafted may constitute only 40 percent of a testator's estate. However, by the time of the testator's death, the art collection may have increased in value, and the testator's other assets may have decreased in value. That could result in the charitable bequest's constituting more than 50 percent of the testator's estate. If that situation causes a problem under local state law, provision must be made to avoid the problem by either drafting a clause with a percentage limitation or drafting the will so that it cannot be challenged.[135]

Generally, an estate tax charitable deduction for the full fair market value of the work of art is allowable for a bequest to either a public charity or a private foundation. Private foundations include all exempt organizations other than those described in section 509(a)(1), (2), (3), or (4). However, if the bequest is to a private foundation that has not complied with the requirement under the Tax Reform Act of 1969 of including certain amendments in its governing instrument or that has failed to notify the IRS of its status, the entire estate tax charitable deduction will be denied.[136]

]If the testator desires to bequeath a work of art to a private foundation, the drafter of the will should obtain a copy of the foundation's governing instrument to ascertain whether the instrument meets the Tax Reform Act of 1969 requirement mentioned above, and should also obtain a statement from the organization that it has notified the IRS of its status.

Outright testamentary charitable transfers allow the art collection to be kept together as a unit and eliminate the problem of raising the money necessary to pay the estate taxes attributable to the inclusion of a valuable art collection in the gross estate and eliminate any need for a forced sale of the art collection in order to pay the estate taxes.

A testator who wishes to bequeath a work of art to a charitable organization should make a specific bequest in his or her will. The bequest should be specific enough to identify clearly the property to be given. The bequest should always include "any copyright interest, if any" in order to avoid an inadvertent split interest transfer or other problem under section 2055(e)(4)(C). The testator should consider the possibility that a specific charitable organization may renounce the bequest. Therefore, the proposed gift and any conditions thereon should be discussed with the charitable organization. See form 5 attached to this article.

VII. RETAINED COPYRIGHT INTEREST

Section 423 of ERTA amended sections 2055(e) and 2522(c) to permit, under certain conditions, a charitable gift or estate tax deduction for the transfer by gift or bequest after December 31, 1981, of a work of art, but not its copyright, to a charitable organization.[137]

The tax regulations have always treated a work of art and the copyright as two interests in the same property. The United States Copyright law treats a work of art and the copyright as two separate property interests. The inconsistency made it impossible to obtain a charitable deduction for a work of art transferred to a charity if the decedent retained the copyright interest for his or her heirs since there was not a complete transfer of the property. Section 2055(e)(4) is an attempt by Congress to allow some flexibility in that area.

Section 2055(e)(4): Section 2055(e) was amended by ERTA by adding subsection (4), which provides for estate tax purposes that a work of art and its copyright are treated as separate properties in certain cases. The statute applies only to a "qualified contribution of a work of art"[138] and defines the term "work of art" as any tangible personal property with respect to which there is a copyright under federal law.[139] A federal statutory copyright for a work of art comes into existence at its creation

The term "qualified contribution" means "any transfer of property to a qualified organization if the use of the property by the organization is related to the purpose or function constituting the basis for its exemption under Section 501."[140] (That rule is similar to the related use rule under section 170(e)(l)(B)(i).) Therefore, a contribution is a "qualified contribution" for purposes of the retained copyright provision only if the related use rule is satisfied. If the contribution is not a "qualified contribution," the old split-interest rule applies, that is, the work of art and the copyright are treated as two interests in the same property, rather than as two separate property interests.

The statute applies only to qualified contributions made to a "qualified organization."[141] The term "qualified organization" means any organization described in section 501(c)(3) other than a private foundation under section 509. For that purpose a private operating foundation under section 4942(j)(3) is not treated as a private foundation.

Therefore, section 2055(e)(4) for the first time allows a decedent to make a transfer of a work of art to a charitable organization with his or her estate retaining the copyright interest so long as the transfer satisfies the estate tax related use rule of section 2055(e)(4)(C).[142]

In most cases when a collector purchases a work of art he or she is purchasing it without the copyright since the artist retains the copyright unless it is specifically transferred in writing. Therefore, when the will of a collector transfers a work of art to a charitable organization, the collector need not worry about satisfying the related use rule of section 2055(e)(4)(C) if he or she has never owned the copyright interest. If he or she does own the copyright interest, the charitable bequest should contain specific language to the effect that the copyright is included in the transfer in order to avoid any possibility of running afoul of the related use rule of section 2055(e)(4)(C).

An artist, on the other hand, who wants to bequeath a work of art under his or her will to a charitable organization must either (i) transfer the work of art and the copyright or (ii) transfer the work and retain the copyright interest if the related use rule of section 2055(e)(4)(C) is satisfied.

Section 2055(e)(4) is a benefit for the artist who wants to bequeath works of art to a charitable organization and retain the copyright for reproduction purposes for the artist's heirs. Before January 1, 1982, that could not be done. If the artist wants to bequeath a work of art to a charitable organization, but does not intend to retain the copyright interest, care must be taken to make sure that both the work of art and the copyright are specifically transferred to the charity. Otherwise, the statute is a trap for the unwary artist, whose estate tax charitable deduction may fail because of the related use rule of section 2055(e)(4)(C).

For collectors, the new provision presents no problem as long as the collector does not own the copyright. However, in preparing a will for a collector an attorney should take care to make sure that, if the collector does own any copyright interest, it is transferred to the charitable organization, along with the work of art.

VIII. VALUATION

Knowing the value or approximate value of a collector's work of art is of utmost importance:

- o For income tax purposes if the collection is transferred during life to a charitable donee;[143]

For gift tax purposes if the property is transferred during life to a noncharitable donee;[144]

- o For estate tax purposes if the property is owned at death;[145] and
- o For insurance purposes if the property is maintained during life (since insurance companies require an appraisal in order to determine the premiums for coverage).

As important as the concept of value is, there is no simple rule or answer. Although, as discussed below, the Internal Revenue Service (IRS) has by regulation attempted to create rules of valuation, those rules are not workable in all situations and are most difficult to apply when it comes to unique works of art.

1. IRS Valuation Regulations

The IRS regulations for estate tax, gift tax, and income tax contain certain parallel provisions, although they are not consistent in every respect.[146]

The estate tax regulation[147] defines fair market value as "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."

The gift tax and income tax regulations contain identical language.[148] The hypothetical sale must be in the market in which such property is most commonly sold to the public. When trying to place a value on a unique collection, those guidelines do not offer much help. The regulations contemplate a retail market that, when one is dealing with collectibles, may not exist. Regulation section 20.2031-1(b) gives the example of a used car to illustrate which market is to be considered retail. The regulation states that the market value is the market price at which the general public can buy the car-not the wholesale price the dealer can pay for the car. When dealing with an average automobile, there is no problem, since a market exists for its sale. However, if the automobile is a rare antique, such a market may not exist. The contemplated "retail market" rule of regulation section 20.2031-1(b) is an attempt by the IRS to formulate a simple rule where one does not fit. (The rule was injected into the estate tax regulations by T.D. 6826, 1965-2 C.B. 367. Similar language was inserted into the gift tax regulations by the same T.D. 6826, and is also contained in income tax regulation section 1.170A-1 (c)(2).

Neither the rule that value is the price at which an item can be sold at retail to the public nor the rule that value is the price that a member of the public can obtain on sale of the item is appropriate in every estate, gift, and income tax situation.

2. Determining Fair Market Value

The question of the fair market value of a work of art is difficult and must rest on expert appraisals. Resolving valuation disputes with the IRS, as demonstrated by the litigated cases, can be a time-consuming and expensive proposition.[149] The Tax Reform Act of 1976 recognized the plight of the taxpayer who is faced with a valuation issue and an IRS agent who supplies little or no information to support the Service's determination.

3. The IRS's Determination of Value

In 1968, the Service appointed an advisory panel of art experts to help determine whether taxpayers submit realistic appraisals of fair market value on donated works of art. The panel classifies the artwork valuation submitted as: clearly justified, questionable, or clearly unjustified. Generally, if a particular item has a value of more than $20,000, the local audit office sends the appraisal to the art panel in Washington, D.C. for consideration. Although the report issued by the art panel is supposed to be only advisory, the local audit offices consider the valuation reports to be mandatory and binding.

Unfortunately, because of the enormous volume of referred cases, having a request processed through the national office in Washington, D.C. often takes from six months to one year. The art panel only meets twice a year. The taxpayer's documentation, therefore, must be as complete as possible before submission. Attorneys who believe the art panel did not review the submitted items correctly can request resubmission to the art panel. Attorneys should provide the art panel with any additional documentation that indicates why the art panel may have been in error.

Section 7517 provides that the IRS must, on written request by a donor or executor, furnish a written statement explaining the basis on which the IRS has determined or proposes to determine a valuation of property that is different from the valuation submitted by the donor or the executor. That section applies to all valuation issues, whether the donation involves a lifetime transfer or a testamentary transfer to a charitable or a noncharitable transferee. The Conference Committee Report explains that the reason for the change is to encourage the resolution of valuation issues at the earliest possible time, and that can best be achieved if all parties have full information as to how the other arrived at the valuation. The IRS must furnish its statement within forty-five days of the date of the request or the date of its determination (or proposed determination), whichever is later. The IRS statement must (a) explain the basis on which the valuation was determined or proposed, (b) set forth any computation used, and (c) contain a copy of any expert appraisal made by or for the IRS. The statute specifically provides that the IRS statement is not intended to be a final or binding representation of the IRS position. Section 7517 is effective for transfers made after December 31, 1976.

4. Litigation on Valuation

Evidence of IRS willingness to litigate charitable contribution schemes that have no economic reality is found in Anselmo v. Commissioner,[150] involving the valuation of gems donated to the Smithsonian Institution. In Anselmo the taxpayer purchased colored gemstones and donated them nine months later, after the long-term capital gain holding period had been satisfied. The Tax Court found that members of the public did not generally purchase unset gems; rather, the usual consumers of unset gems were manufacturing and retail jewelers who used them to create jewelry. The Tax Court looked to the regulations and the definition of "retail market" to measure fair market value. The court found that the retail market in which to find comparable values for the donated gems was the market in which the jewelry stores made their purchases and not the market in which an individual member of the public made a purchase at the jewelry store. In effect, the Tax Court said there can be more than one "retail market," and the market that is closest to the taxpayer's activities is the market the court will look to for comparable values.[151] The court further held that a separate fair market value should be determined for each unit of property donated.

In Richard A. Skripak,[152] the Tax Court upheld the validity of a book contribution program, but substantially lowered the value of the books contributed. In Skripak, the taxpayer participated in a charitable contribution tax shelter promoted by Reprints, Inc. Reprints identified libraries to receive books and contributors who would contribute the books to the libraries. The contributors bought the books from Reprints at one-third of the normal price and, after holding them for longer than six months, contributed them to libraries at their retail price. The court held that the contributions were legitimately made and were not a sham, as alleged by the IRS. However, the court further held that the books had a value of only 20 percent of the retail price, less than the amount the contributors actually paid for them.

The Skripak case makes it clear that a taxpayer may participate in a tax shelter that is motivated solely by the goal of obtaining a charitable deduction without having the deduction disregarded on the ground that the shelter is a sham. However, taxpayers entering into such shelters risk having the amounts of their deductions reduced if the donated properties are not properly valued, and the taxpayers could lose money, since the donated properties could be found to have a value of less than they paid for them. In Skripak the court still looked to the "retail market" for the valuation of the books, but applied a "blockage discount," since the simultaneous marketing of all the books would substantially depress the market for the books.[153] A "blockage discount" is a reduction in market value based on the theory that a large number of similar items offered for sale at one time distorts the market value and results in a reduced market value.

The Samuel E. Hunter[154] case involved a taxpayer who purchased a group of high quality prints by prominent artists and donated them to various charities. The story began when Marlborough Gallery sold the prints in bulk to a middleman, who was able to buy them at one-sixth Marlborough's retail list price because Marlborough was disposing of excess inventory. The art was not unsalable, and, in fact, Marlborough retained a number of the prints for sale to the public at its normal retail price. The middleman then resold the prints to the taxpayer at one-third to one-fourth of Marlborough's list price. The taxpayer claimed a charitable deduction for the Marlborough list price of each print.

The Tax Court held that the transaction was not a sham and that it was not relevant that the taxpayer never took possession of the prints. It further dismissed the IRS contention that the blockage discount applied, since the number of prints was small.

The court concluded, however, that the deduction for the taxpayer was limited to what he paid for the prints. The court reasoned that the relevant "retail market" was the market in which the middleman had sold the prints to the taxpayer, that is, the market in which the taxpayer had made his purchase. Perhaps a different result might have been arrived at if the taxpayer had made his purchases directly from Marlborough Gallery, rather than through a middleman. The case indicates that whenever a purchase and a donation are close in time the IRS will give the charitable deduction careful examination.[155]

That does not mean that if someone finds a bargain he or she cannot make a donation of the property. In Bernard Lightman[156] the taxpayer made an advantageous bulk purchase of a number of works of art by one artist and donated the paintings to a museum shortly after one year of their purchase. The court recognized that the taxpayer had been given a price concession on the purchase and that their cost was not indicative of the values of the individual paintings. Instead, the court used auction prices of other paintings by that artist as the measure of market value for donation purposes. For a case involving the advantageous purchase of a gemstone followed by its contribution, see James H. Rhoades.[157]

Auction prices are not the absolute measure of fair market value. In Raymond Biagiotti,[158] involving the valuation of pre-Columbian and Mayan art, the Tax Court observed that Sotheby's auction sales did not represent a significant portion of the sales of such art in the United States and did not accurately represent the average sale prices of that art. The court found that a better measure of value was what collectors paid private dealers, since collectors rely on dealers' guarantees of authenticity, and auction houses do not guarantee authenticity.

Clifford M. Mast, Jr., Case

The case of Clifford M. Mast, Jr.[159] involved determining the fair market value of glass stereoscopic negatives, a photographic viewing technique popular between the mid-nineteenth century and the mid-twentieth century. The technique involves a pair of photographs that, when viewed in a special device called a stereoscope or a stereoscopic viewer, produce a three-dimensional image. The taxpayer had a large collection of glass stereoscopic negatives and donated them to the University of California, claiming an income tax deduction for the donation of $1,544,000. The Internal Revenue Service initially said that the value was zero.

The taxpayer based his original claimed value on an appraisal by an expert who had many years' experience as a collector of photographic equipment but who was not "a licensed appraiser." Apparently, the court did not realize that art appraisers are not licensed anywhere in the United States. In any event, the appraiser arrived at a per-unit value based on replacement costs and his knowledge of the market sales of comparable negatives and arrived at a price of $1,544,000. At trial the taxpayer called two additional experts, one a professional appraiser and a senior member of the Appraisers Association of America and of the American Society of Appraisers and the other expert a full-time dealer. The professional appraiser did a thorough analysis of the collection and clearly stated in her testimony, as reiterated by the court, that there are "a number of distinct approaches to valuation; the income approach, the cost estimated approach, the revenue approach and the market data comparison approach."[160] The appraiser estimated the value of the collection at $1,590,000, based on the market data comparison approach. That method of valuation is based on comparisons with reported sales, offers to sale by catalog, showroom and gallery pricing, and historic data. The court noted that the appraiser contacted leading galleries and received opinions about the collection's replacement value. She also contacted auction houses and obtained estimates of the collection's replacement value. Finally, the appraiser carried out a careful review of other available data, background knowledge, and experience as indicators of value.

The dealer gave his opinion on the basis of what he thought the items in the collection could be sold for. He arrived at a value of $ 1,200,000.

The Internal Revenue Service used a full-time professional appraiser but retained her only shortly before trial, so her analysis was less thorough than was the taxpayer's appraiser. Her valuation approach was to compare the donated collection with other, allegedly comparable, photographic collections that had been sold. She concluded that the collection had a value of $450,000.

The court, in reaching its conclusion,[161] first reiterated that most commonly used phrase from the IRS regulations, 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.

The court noted that fair market value is a question of fact to be determined from an examination of the entire record and that the market data comparison approach seems the most reasonable. The court stated that the IRS expert used a valuation method that differed substantially from that used by the taxpayer's experts.

Rather than use a market data comparison approach, the IRS expert determined fair market value on the basis of the sales of five allegedly comparable collections. The court found that, before that approach can be used, it must first be determined whether the five collections are, in fact, comparable.[162] The court decided that the IRS expert relied on collections that were not comparable, and the court gave little weight to the IRS expert's testimony. In reaching its holding that the fair market value of the glass stereoscopic negatives was $1,250,000, the court pointed out that questions of fair market value are properly resolved through settlement negotiations, rather than litigation. The court went on to state:[163]

> In the absence of settlement, we are left to adjudicate the validity of conflicting experts' opinions who are convinced that both their conclusions and methods are correct. The result is an over-zealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement. <u>Messing v. Commissioner</u> 48 T.C. 502, 512(1967).

The Internal Revenue Service in <u>Mast, Jr.</u> had originally held in its notice of deficiency that the value of the collection was zero. In a later appeal[164] the taxpayer was successful in his position that the IRS had acted unreasonably; the court found the IRS liable for $25,000 in legal fees, as provided for by section 7430, prior to its amendment by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. The court found that it was unreasonable of the Internal Revenue Service to determine, without the advice of an expert, that the collection had a zero value and then to stick with that determination throughout a trial, despite the facts that the IRS had no evidence to support such a position and that the taxpayer had provided the testimony of three qualified appraisers, who valued the collection near the same amount as that claimed by the taxpayer.

Other Valuation Cases

In Heriberto Ferrari[165] the issue involved the valuation of twenty-one pieces of pre-Columbian art donated to the Duke University Museum of Art and to the Mint Museum of Art. The case, which is similar to the Biagiotti case, discusses the proper marketplace for determining comparable sale prices of pre-Columbian art. The court correctly pointed out that the market to be looked at for comparable sales is the retail sales market at art galleries, not auction sales. When the time comes to purchase pre-Columbian art or antiquities, most buyers want to rely on the guarantee of authenticity and the connoisseurship of the art dealer; unless the buyers themselves are dealers or experts, they do not want to buy at auction, where the purchased antiquity may not be covered by any warranty of authenticity. The Heriberto Ferrari opinion includes an excellent discussion of what to look for in determining value. The court succinctly stated that value is determined by the condition, the uniqueness, or the rarity of the item, its authenticity, its size, and the market value of comparable objects.[166] In noting that retail gallery prices are the correct comparable marketplace to look at, the court found that different galleries price even the same or similar objects at different levels. Therefore, the court found that fair market value, as defined by the Internal Revenue Service regulations, is in this case not a single price but a range of prices, not necessarily the highest price at which an object would change hands between a willing buyer and a willing seller.[167] Any appraiser hired in a valuation case or for appraising property to be donated to charity must be fully familiar with the proper marketplace to be selected for finding comparable sale prices to support the valuation of the donated property.

The case of Jack C. Chou[168] involved the fair market value of a carved opal donated to a museum. In 1982 the taxpayer had purchased a rough opal for $19,500. The taxpayer returned the opal to the seller to be carved and then donated it thirteen months later to a museum. The seller recommended two appraisers to the taxpayer; they appraised the donated, now carved, opal at an average value of $300,000. The court, in holding that the value was $30,000, noted that the opal was purchased only a little more than a year before it was donated and that cost is important evidence of value when no intervening factors explain a substantial or unusual appreciation.[169] In reaching its conclusion, the court stated that it must determine the appropriate market for purposes of valuation and that the determination is a question of fact. Here the court seems to have gotten off the track and to have been misled by the IRS's valuation expert. The court stated that, in valuing gemstones, the market may be retail, wholesale, or a "collector's market."[170] The court first dismissed the wholesale market because the taxpayer was not a dealer in gemstones. The IRS expert testified that the appropriate marketplace is the collector's market because a knowledgeable buyer would not pay the higher retail prices, and, the IRS expert continued, the record indicated that the taxpayer was a knowledgeable, albeit amateur, collector. The court concluded that only values from the collector's market are appropriate.

It appears to me that the analysis in Jack C. Chou is incorrect to the extent it relies on a so-called collector's market. The court's opinion seems to imply that a knowledgeable taxpayer would get a lower income tax deduction for a donation than would a less intelligent taxpayer who did not know what he was doing. I do not believe that there is a defined collector's market that should be used for comparable values. Whether a taxpayer is knowledgeable or not should not be a determining factor in the amount of the available deduction for the donation. The amount of the deduction should depend on the value of the item, based on comparable sales in the most appropriate marketplace in which the item is most commonly purchased and sold. Since the case was such an obvious abuse of the donation process, the court seems to have gone overboard in rationalizing its decision.

Differences of opinion in valuation cases are illustrated in the case of Fuad S. Ashkar,[171] which involved the valuation of ancient biblical fragments donated to a university. The expert for the Internal Revenue Service valued the items at $25,000, and the expert for the taxpayer valued the items at $700,000. The court, in not following either expert, noted that the experts were academic scholars, rather than professional appraisers of ancient documents. The court relied on evidence of an offer that had been made for the collection; that offer of $337,500 was fairly close to the average of the prices given by the two experts. The court opinion also erroneously referred to a so-called collector's market.[172]

The Thomas G. Murphy[173] case involved the valuation of what was known as "the million-dollar rock", a sandstone rock sculpture that depicted the face of John Wayne. It was donated to Lubbock Christian College in Lubbock, Texas. The court correctly pointed out that the taxpayer's valuation of $500,000 was erroneously based on a faulty appraisal that failed to discuss the condition of the sculpture and failed to verify the accuracy of comparable prices. The IRS expert, who used the auction market as comparable prices, pointed out that, when the sculpture was viewed from the left side, the left temple was missing, the left eyebrow was missing, a large wedge-shaped area was missing below the left eye, the left cheek was missing, and part of the left chin was missing. Because of its extremely poor condition, the court upheld the IRS expert and valued the sculpture at $30,000. The case is also instructive in that the gift was donated on the condition that it not be sold or otherwise disposed of for a period of two years after its receipt and that the restriction, the court found, reduced the fair market value of the donated sculpture.[174]

In identifying the proper marketplace in order to find comparable sales, the case of Joseph Isaacs[175] is illustrative. The case involved a bulk purchase of Alexander Calder-designed tapestries that were handwoven by Guatemalan Indians. The tapestries were purchased for $900 each and were donated at a value of $10,000 each. The IRS argued that, in the most common marketplace in which a group of the tapestries would sell, the price would be deeply discounted, below the wholesale price. That was the same theory argued in the Samuel E. Hunter case, involving a donation in bulk of a group of lithographs. The court held that the tapestries were worth $3,000 each, based on the court's own determination of fair market value and comparable sale prices from the testimony of the various experts.

Frank P. Perdue, although best known for his chickens, was successful when the IRS challenged his donation of gold artifacts to the National Museum of American History.[176] The court pointed out that a premium could be added, when valuing the artifacts, for the excitement and the glamour associated with the fact that the items were recovered from a sunken Spanish ship. The court stated correctly that "neither section 170 nor the Treasury regulations thereunder specifies which market a taxpayer should use in calculating fair market value". The regulations that refer to a "retail market" are in the estate tax regulations[177] and technically do not apply to the income tax donation sections of the Internal Revenue Code, although it is our understanding that it is the policy of the Internal Revenue Service to treat the estate tax regulations as though they applied equally for estate tax and donation purposes. In determining the proper marketplace, the IRS expert said that the numismatic or precious metals market should be used and not the retail museum or gift shop market. The IRS expert also stated "that he has yet to meet a knowledgeable buyer in the glamour market." The IRS expert went on to state that the comparable auction prices that the taxpayer's expert used were not valid, since auctions attract only wealthy people without a lot of knowledge. That statement is an example of how an overzealous IRS expert can sink a case for the IRS with a clearly erroneous conclusion. The expert's testimony was discredited when the expert remarked that auction prices were not relevant, since only people without knowledge purchase in that market.

The George O. Doherty[178] case pitted against each other the two foremost authorities on the paintings of Charles M. Russell. The taxpayer had donated a painting to the Charles M. Russell Museum and had valued it at $200,000. The IRS said that the painting was a forgery and was worth only $100. The court noted that the credentials of the two experts were beyond question, yet they reached different conclusions. The court declined to rule on the authenticity of the painting in the light of the fact that the two experts could not agree on its authenticity. In reaching its conclusion that the painting had a value of $30,000, the court recognized that a dispute over the authenticity of a painting acts as a depressant on its value.

5. The Quedlinburg Treasures

An interesting twist to the identification of the proper market in which to value works of art was discussed in Technical Advice Memorandum 9152005 (Priv. Ltr. Rul. 9152005). The ruling closely follows the facts in what became known in the newspapers as the story of the Quedlinburg Treasures. In 1945 the decedent's United States Army unit was placed in charge of guarding some rare medieval art objects. The decedent stole and shipped the art objects to his home in Texas. When he died in 1980, his Texas inheritance tax return did not list any of the art objects. No federal estate tax return was filed, even though the art objects had a value of many millions of dollars.

First, the IRS ruled that under section 2033 the stolen art property was includable in the decedent's gross estate. Then the IRS had to decide how the art property should be valued. The decedent's attorney argued that the proper market to look at for valuation purposes was the illicit market in which stolen art objects are regularly sold and that, since there was no market for stolen medieval art objects, the value of the property must be zero. The IRS rejected that argument, analogizing, in part, to income tax cases in which the IRS had placed a value on cocaine and marijuana by referring to its street-market price. The IRS concluded that the fair market value of the art objects was the highest price that would have been paid, at the time of the decedent's death, either in the illicit stolen-art market or in the legitimate art market.

The decedent's attorney then argued that, if the objects were includable in the gross estate at their fair market value, the decedent should be entitled to claim a deduction under section 2053(a)(3) for claims against the estate by the legitimate owners of the art objects. The IRS rejected the deduction, noting that, in order to be enforceable under Texas law, a claim had to be submitted within a certain period of time, which had passed, and that section 2053(a)(3) provides that claims against an estate are allowable only to the extent that they are allowable by the laws of the jurisdiction under which the estate is administered.

6. Current Trend

The trend in valuation cases indicates that settlement is clearly the best course of action. Settlement is best achieved by being initially careful and thorough in the selection of the appraiser and by making sure that the appraisal complies with all the requirements of the IRS regulations. Most important, the appraisal should show comparable prices and identify the proper marketplace for valuing the donated property. Being thorough and complete at the time of a donation will most often be the best course of action and will best enable the taxpayer to sustain the value of the donated property and avoid expensive litigation.[179]

7. Advance Valuation Ruling Procedure

In what appeared to be an attempt to find a way to resolve charitable deduction valuation issues without litigation, the 1993 Tax Act contained provisions that requires the Internal Revenue Service to prepare a report on the development of a procedure enabling a taxpayer to receive an advance ruling from the IRS as to the value of tangible personal property for income tax purposes before the transfer of the property to a qualifying charitable organization. With this mandate, the IRS issued on December 28, 1995 Rev. Proc. 96-15, 1996-1 C.B. 627 that contain the procedure for an advance valuation determination. Under Rev. Proc. 96-15, the IRS stated that it would only issue an advance ruling for income tax purposes on the valuation of property (a) after the transfer of the property to a qualifying charitable organization, (b) if the taxpayer pays a user fee to the IRS of $2,500 for the first three items transferred and $250 for each additional item, and (c) if the taxpayer has already obtained a qualified appraisal by a qualified appraiser of each item of property and at least one of the items of property has a value of $50,000 or more. The procedure requires the taxpayer to attach a completed Form 8283 and a copy of the qualified appraisal to the ruling request.

Once the IRS issues a determination under Rev. Proc. 96-15 it must be attached to the taxpayer's income tax return and it is binding on the IRS. If the taxpayer disagrees with the IRS determination, the taxpayer may submit with his or her tax return additional information in support of a different value. The procedure should be appealing to those taxpayers interested in a high degree of certainty when they file their tax returns.

An interesting aspect of Rev. Proc. 96-15 is that it is also applicable to estate and gift tax returns, including items transferred to family members rather than charitable organizations. The same detailed appraisals are required to be prepared by the taxpayer and submitted to the IRS with a ruling request. This procedure may be useful to an estate containing valuable works of art in order to have an agreed on value early in the administration of an estate.

IX. FORMS

FORM 1

INFORMATION REQUIRED BEFORE CONTRIBUTION

XYZ Charity

Address

Gentlemen:

I am considering making a contribution to you of a work of art [described briefly]. Before doing so, I wish to have your counsel's opinion as to: (1) Whether your operations qualify you as a "public-type organization" within the meaning of Section 170(b)(l)(A)(i) through (viii) of the Internal Revenue Code; and (2) whether the use to which that work of art will be put by your organization is related to the purpose or function constituting the basis for your exemption under Section 501 of the Internal Revenue Code. I would also like to know the grounds for your counsel's opinion.

Very truly yours,

Art Collector Donor

FORM 2

DEED OF GIFT OF ENTIRE INTEREST

I, , residing at , being the absolute owner of the original oil painting called " ," painted by the artist , and dated , do hereby give, assign, and transfer over to the Museum of the City of and State of all of my right, title, and interest in and to said painting, including any copyright interest therein, if any, absolutely and forever. It is my intention that this transfer of the above-described painting shall constitute a gift of the same by me to said Museum, and that the oil painting called " " shall be displayed, from time to time, as part of the Museum's regular collection.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this day of 20 .

_______________________________ ss.

Donor

____

Notary Public

The above described gift is accepted by me on behalf of the ____________

Museum, of City and State, this day of 20 , and we agree to acknowledge our acceptance of the gift on IRS

Form 8283.

_______________________________ ss.

President

____

Notary Public

FORM 3

DEED OF GIFT OF ENTIRE INTEREST

WHEREAS, is the owner of the following paintings:

	Title	Description	Artist
1.			
2.			

and

WHEREAS, is desirous of giving said paintings to University upon the terms and conditions hereinafter set forth;

NOW, THEREFORE, the undersigned does give, grant, convey, and confirm unto the University all of his right, title, and interest in and to said paintings, including any copyright interest therein, if any, upon the condition that said paintings be made generally available by the University for inspection by the general public at such time and under such regulations and upon such conditions as the

University may reasonably impose and be utilized by the University as a part of its program for educating its students and upon the further condition that each painting be identified as being a part of the Collection by a suitable inscription or plaque.

IN WITNESS WHEREOF, the undersigned has hereunto set his hand and seal this day of , 20 .

_______________________________ ss.

Donor

____

Notary Public

The above described gift is accepted by me on behalf of the University this day of , 20 , and we agree to acknowledge our acceptance of the gift on IRS Form 8283.

________________________________ ss.

President

____

Notary Public

FORM 4

DEED OF GIFT OF ONE-FOURTH INTEREST

I, , of City, State, am the owner of the painting hereinafter described and I desire to give to the Museum, of City, State, an undivided one-fourth interest in said painting. To carry out my purpose and vest immediately in said Museum the title and ownership in an undivided one-fourth interest in said painting, I do hereby give, assign, transfer, and deliver to said Museum an undivided one-fourth interest in said painting, including any copyright interest therein, if any, which is described as follows" " by dated .

It is my purpose to vest in said Museum the absolute ownership of an undivided one-fourth interest in said painting at this time, it being understood that said Museum shall have rights of possession, dominion, and control of said painting for the number of months during and twelve-month period after the date hereof that the interest of said Museum bears to the entire interest, said Museum to have the sole discretion to decide the months during which it will exercise such rights.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this day of 20

_______________________________ ss.

Donor

____

Notary Public

The above described gift is accepted by me on behalf of the Museum, of City and State, this day of , 20 and we agree to acknowledge our acceptance of the gift on IRS Form 8283.

________________________________ ss.

President

____

Notary Public

FORM 5

SPECIFIC BEQUEST OF A WORK OF ART

TENTH: I give and bequeath to the Museum in the City of and the State of , the items described below, including any copyright interest therein, if any:

1. Oil painting entitled " " by dated .

2. Etc.

PROVIDED, HOWEVER, if at the time of my death the ________ Museum is not an organization described in section 2055(a) of the Internal Revenue Code of 1986, or corresponding provisions of any subsequent Federal tax laws, I give and bequeath said items to such other organization as is described in said section 2055(a) and is designated by my Executor.

FORM 6

QUALIFIED APPRAISAL

Information Required to be Contained in an
Appraisal of Tangible Personal Property being
Contributed to Charity for which a Deduction
will be Claimed for Federal Income Tax Purposes

The following information is required pursuant to Treas. Reg. Section 1.170A-13(b)(2)(h):

1. DESCRIPTION OF THE PROPERTY - in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was - or will be - contributed.

Description should include dimensions, color, materials used, and, if known, date of creation, maker, location of origin and whatever other factual details would be helpful.

2. PHYSICAL CONDITION of the property - the appraisal should note any repairs, defects, worn elements, fading, etc.

3. DATE - OR EXPECTED DATE - OF CONTRIBUTION TO Charity.

4. DATE OR DATES ON WHICH THE PROPERTY WAS VALUED by the appraiser - note that the appraisal can not be prepared more than 60 days prior to the actual date of contribution of the appraised property.

5. METHOD OF VALUATION used to determine the fair market value -such as comparable sales approach or replacement-cost-less-depreciation approach.

6. SPECIFIC BASIS FOR VALUATION, if any, such as specific comparable sales transactions

7. TERMS OF ANY AGREEMENT - or understanding between the donor and the donee charity relating to the use, sale or other disposition of the property. If none, the appraisal should so state, or if there are, the appraisal should explain.

8. FEE ARRANGEMENT between donor and appraiser - fees based on a percentage of the value will render the appraisal invalid for income tax contribution purposes.

9. QUALIFICATIONS of the APPRAISER including background, experience, education and membership, if any, in professional appraiser association. There should be included, in addition, specific examples of qualifications by way of experience or background to appraiser the particular items which are the subject of the appraisal.

10. FAIR MARKET VALUE - the appraised value of the property which is the subject of the appraisal as of the date (or expected date) of contribution.

11. PURPOSE OF APPRAISAL - a statement that the appraisal was prepared for federal income tax purposes.

12. SIGNATURE of appraiser on the appraisal. The name, address and taxpayer identification number of the appraiser must be on the appraisal.

X. ENDNOTES

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[1] Part of the material in this article appears in a similar manner in the book, Lerner & Bresler, "ART LAW: The Guide for Collectors, Investors, Dealers, and Artists" (Third Edition published by the Practicing Law Institute, 810 Seventh Avenue, New York, N.Y. 10019 in 2005).

[2] I.R.C. § 170(c).

[3] See generally Anthoine, Deductions for Charitable Contributions of Appreciated Property — The Art World, 35 Tax L. Rev. 239 (1980); Speiler, The Favored Tax Treatment of Purchasers of Art, 80 Colum. L. Rev. 214 (1980); Feld, Artists, Art Collectors and Income Tax, 60 B.U.L. Rev. 625 (1980); Symposium, Law and the Arts, 85 Dick. L. Rev. 182 (1981); Auten & Rudney, Tax Reform and the Price of Donating Appreciated Property, 33 Tax Notes 285 (1986); Sanders & Toolson, Planning for Charitable Giving After the Tax Reform Act of 1986, Taxes (June 1987); Wittenbach & Milani, A Flowchart Focusing on the Individual Charitable Contribution, Taxes (Apr. 1988); Anthoine, Charitable Contributions After the 1986 Tax Act and Problems in Valuation of Appreciated Property, 11 Colum. V.L.A. L. & Arts 283 (1987).

[4] I.R.C. §§ 170(b)(l)(A)(i)-(viii), (E)(i)-(iii), 509(a); Treas. Reg. § 1.170A-9; I.R.C. §§ 170(b)(1)(B), 509(a).

[5] I.R.C. §§ 170(b)(l)(C)(iv), 1221; Treas. Reg. §§ 1.170A-8(d)(3), 1.170A-4(b)(2).

[6] I.R.C. §§ 1221(d), 170(e)(1)(A); Treas. Reg. §§ 1.170A-8(d)(3), 1.170A-4(b)(2).

[7] I.R.C. § 170(b)(1)(A).

[8] I.R.C. § 170(b)(1)(B). The limitation was increased from 20 to 30 percent by the Tax Reform Act of 1984, effective for contributions made in taxable years ending after July 18, 1984.

[9] I.R.C. § 170(b)(1)(F).

[10] I.R.C. § 170(e)(1)(A); Treas. Reg. § 1.170A-4(a)(l); see Maniscalco v. Commissioner, 80-2 U.S. Tax Cas. (CCH) f 9717 (6th Cir. 1980), 632 F.2d 6 (1980), aff'g 37 T.C.M. (CCH) 1174 (1978); Beghe, The Artist, the Art Market and the Income Tax, 29 Tax L. Rev. 491 (1974); Anthoine, supra note 3; Bell, Changing IRC 170(e)(1)(A): For Art's Sake, 37 Case W. Res. L. Rev. 536 (1987).

[11] See Orchard v. Commissioner, 34 T.C.M. (CCH) 205 (1975) (opera tapes held less than six months not capital gain property). See also Glen v. Commissioner, 79 T.C. 208 (1982) (valuation of tape recordings of interviews with noted scientists); Ford v. Commissioner, 46 T.C.M. (CCH) 1353 (1983).

[12] I.R.C. § 170(d)(1)(A), (b)(1)(B) last sentence.

[13] I.R.C.§ 170(b)(l)(C)(i).

[14] I.R.C.§ 170(d)(1)(A), (b)(l)(C)(ii).

[15] I.R.C.§ 170(b)(l)(C)(iii), (e)(1).

[16] I.R.C.§ 170(b)(l)(C)(i), (e)(l)(B)(ii).

[17] I.R.C.§ 170(b)(l)(D)(ii).

[18] I.R.C. § 4942(j)(3). Contributions to a private operating foundation are treated like contributions to a public charity. See Treas. Reg. § 53.4942(b)-1.

[19] I.R.C. § 170(e)(l)(B)(i); Treas. Reg. § 1.170A-4(b)(3).

[20] I.R.C. §§ 170(b)(1)(A), (C)(1).

[21] Treas. Reg. § 1.170A-4(b)(3)(ii), (i).

[22] See Isbell v. Commissioner, 44 T.C.M. (CCH) 1143 (1982).

[23] Treas. Reg. § 1.170A-4(b)(3)(ii).

[24] 115 Cong. Rec. H40869 (bound ed. 1969); 115 Cong. Rec. HI3038 (daily ed. Dec. 23, 1969).

[25] See also Priv. Ltr. Rul. 8536022 (condominium to charity: unrelated use); Priv. Ltr. Rul. 8439005 (manuscripts to university: related use); Priv. Ltr. Rul. 8333019 (art collection to museum: related use). See Coleman v. Commissioner, 56 T.C.M. (CCH) 710 (1988) (horse to American Cancer Society: unrelated use); Jennings v. Commissioner, 56 T.C.M. (CCH) 595 (1988) (paintings to cancer society, hospital, and college: unrelated use); Priv. Ltr. Rul. 9452026 (violin to charitable remainder annuity trust: unrelated use); Priv. Ltr. Rul. 9833011 (paintings to Jewish Community Center: related use).

[26] Treas. Reg. § 1.170A-13.

[27] Tax Reform Act of 1984, § 155(a)(2); Treas. Reg. § 1.170A-13(c)(1).

[28] Joint Committee on Taxation Staff, General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, at 506 (1984).

[29] Treas. Reg. § 1.170A-13(c)(l). See Bond v. Commissioner, 100 T.C. 32 (1993); D'Arcangelo v. Commissioner, 68 T.C.M. (CCH) 1223 (1994); John L. Louderback v. Commissioner, 69 T.C.M. (CCH) 1675 (1995).

[30] Tax Reform Act of 1984, § 155(a)(2); Treas. Reg. § 1.170A-13(c)(3)(i).

[31] Treas. Reg. § 1.170A-13(c)(3)(iv)(B).

[32] Tax Reform Act of 1984, § 155(a)(2); Treas. Reg. § 1.170A-13(c)(5)(i).

[33] Treas. Reg. § 1.170A-13(c)(5)(iv)(B) does allow a party to the transaction to be a qualified appraiser if the property is donated within two months of the date of acquisition and its appraised value does not exceed its acquisition price.

34 Treas. Reg. § 1.170A-13(c)(5)(iv)(F).

35 If the appraiser is not a "qualified appraiser," he or she cannot prepare a "qualified appraisal," and, therefore, the donor cannot attach a qualified appraisal to his or her return when it is due. The question of who is a qualified appraiser is raised on audit, a time after the due date of the donor's tax return. See Treas. Reg. § 1.170A-13(c)(3)(i)(A). See cases cited in note 29, supra.

36 Treas. Reg. § 1.170A-13(c)(6)(i). There is one narrow exception for fees paid to an association that regulates appraisers.

37 General Explanation, supra note 28, at 506.

38 The Pension Protection Act of 2006 (PPA), P.L.109-280, August 17, 2006.

39 I.R.C. § 170(e)(7)(C).

40 I.R.C. § 170(e)(7)(B).

41 I.R.C. § 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4(b)(3).

42 I.R.C. §§ 170(b)(1)(A); (c)(1).

43 Treas. Reg. § 1.170A-4(b)(3)(ii), i.

44 Treas. Reg. § 1.170A-4(b)(3)(ii).

45 *See also* Priv. Ltr. Rul. 8536022 (condominium to charity: unrelated use); Priv. Ltr. Rul. 8439005 (manuscripts to university: related use); Priv. Ltr. Rul. 8333019 (art collection to museum: related use); Priv. Ltr. Rul. 9452026 (musical instrument to be sold: unrelated use); Priv. Ltr. Rul. 9303007 (paintings to museum: related use); Priv. Ltr. Rule. 7911109 (lithographs to numerous schools: related use); Priv. Ltr. Rul. 7934082 (fractional interest in painting to museum: related use); Priv. Ltr. Rul. 9303007 (fractional interest in painting to museum: related use); Priv. Ltr. Rul. 9452026 (violin to charitable remainder trust: no related use); *See* Coleman v. Commissioner, 56 T.C.M. (CCH) 710 (1988) (horse to American Cancer Society: unrelated use); Jennings v. Commissioner, 56 T.C.M. (CCH) 595 (1988) paintings to cancer society, hospital, and college: unrelated use); Priv. Ltr. Rul. 9833011 (paintings to Jewish Community Center: related use).

46 I.R.C. § 6050L(a)(l).

47 I.R.C. § 170(e)(7).

48 I.R.C. § 170(e)(7)(A); I.R.C. § 170(e)(l)(B)(i).

49 I.R.C. § 170(e)(7)(D).

50 I.R.C. § 6720B.

51 I.R.C. § 170(f)(ll)(E)(i).

52 Notice 2006-96, 2006-46 IRB 902, § 3.04(2).

[53] Treas. Reg. § 1.170A-13(c)(3).

[54] Treas. Reg. § 1.170A-13(c)(3)(iv)(B).

[55] I.R.C.§170(f)(ll)(E)(ii),(iii).

[56] Treas. Reg. § 1.170A-13(c)(5)(i).

[57] Treas. Reg. § 1.170A-13(c)(3)(i)(A); D'Arcangelo v. Commissioner, 68 T.C.M. (CCH) 1223 (1994); Louderback v. Commissioner, 69 T.C.M. (CCH) 1675 (1995); Bond v. Commissioner, 100 T.C. 32 (1993).

[58] Notice 2006-96,2006-46 IRB 902, 10/19/2006.

[59] *Id.* at § 3.02(2).

[60] *Id.* at § 3.03(3)(b).

[61] Treas. Reg. §§ 1.170A-5(a)(2); 1.170A-7(b)(l)(i); I.R.C. § 170(f)(3)(B)(ii).

[62] Winokur v. Commissioner, 90 T.C. 733 (1988). *See also* Priv. Ltr. Rul. 8333019; Priv. Ltr. Rul. 8535019.

[63] Rev. Rul. 57-293, 1957-2 C.B. 153. *See also* Priv. Ltr. Rul. 7728046; Priv. Ltr. Rul. 7934082; Priv. Ltr. Rul. 9303007; Priv. Ltr. Rul. 200223013.

[64] I.R.C. § 170(o)(2).

[65] I.R.C. § 170(o)(3)(A)(i).

[66] I.R.C. § 170(o)(3)(A)(ii).

[67] Staff of the Joint Committee on Taxation, "Technical Explanation of H.R.4, The Pension Protection Act of 2006".

[68] I.R.C. § 170(o)(3)(A).

[69] I.R.C. § 170(o)(l)(A).

[70] I.R.C. § 2055(g); I.R.C. § 2522(e).

[71] I.R.C. § 2055(g)(1).

[72] Rev. Rul. 57-293, 1957-2 C.B. 153; Rev. Rul. 58-455, 1958-2 C.B. 100.

[73] I.R.C. Sec. 170(f) was renumbered I.R.C. Sec. 170(a)(3) by Tax Reform Act of 1969, Sec. 201(a)(1), Pub. L. No. 91-172, 83 Stat. 487, 562 (1969). See Treas. Reg. Sees. 1.170-1(d)(2), 1.170A-5.

[74] Treas. Reg. Sees. 1.170A-5(b) example 5, 1.170A-7(a)(2)(i).

[75] See I.R.S. Notice 89-24 (Feb. 17, 1989), which provides guidance to taxpayers in determining the present value of an annuity, an interest for life or for a term of years, or a remainder or reversionary interest pursuant to methods established under section 7520. The provision, added by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, applies to gifts made after April 30, 1989, and to the estates of decedents who die after that date.

[76] Treas. Reg. Sec. 1.170A-5(a)(4). See also Treas. Reg. Sec. 1.170A-13(b)(2)(G), 1.170 A-13(c)(2)(D).

[77] Treas. Reg. Sec. 25.251 l-l(e). See also Rev. Rul. 77-300, 1977-2 C.B. 352, which deals with the gift tax question on split-interest gifts.

[78] Id.

[79] Treas. Reg. Secs. 1.170A-5(b) example 1, 1.170A-5(b) example 2, 1.170A-7.

[80] Treas. Reg. Sec. 1.664-3(a)(l).

[81] Treas. Reg. Sec. 1.664-1(a)(3). See also Treas. Reg. Sec. 1.170A-6(c)(3)(iii).

[82] The Ruling refers to Example (7) of Reg 1.170A-5(b) as an illustration of the application of Sec. 170(a)(3).

[83] Palmer v. Commissioner, 62 T.C. 684 (1974), aff'd on another issue, 523 F.2d 1308 (8th Cir. 1975), acq., Rev. Rul. 78-197, 1978-1 C.B. 83.

[84] Sec. 664(c).

[85] Rev. Rul. 60-370, 1960-2 C.B. 203.

[86] Sec. 664(b).

[87] Reg. 1.170A-4(b)(3)(i).

[88] Tidd, Charitable Remainder Trusts: Funding and Investment Considerations, 57 Taxes 577 (1979), footnote 7.

[89] Priv. Ltr. Rul. 7730015. But *see* Priv. Ltr. Rul. 9442017.

[90] H.R. Rep. No. 413 (Pt. 1), 91st Cong., 1st Sess., 50 (1969). *See also* Priv. Ltr. Rul. 9138024. Prop. Treas. Reg. § 1.664-l(a)(7) effective December 10, 1998, TD 8791, 63 Fed. Reg. 68,188, provides that if a charitable remainder trust holds unmarketable assets and if the trustee is either (a) the grantor of the trust, (b) a noncharitable beneficiary, or (c) a related or subordinate party to the grantor or noncharitable beneficiary (within the meaning of section 672(c) and regulations), then the trustee must use a current qualified appraisal from a qualified appraiser (as defined in regulation 1.170A-13(c)(3) and (c)(5), respectively) to value the unmarketable assets. A qualified appraisal from a qualified appraiser is not required if there is an independent trustee. The regulation was proposed on April 18, 1997 and became effective on December 10, 1998.

[91] Sec. 664(c); Reg. Sec. 1.664-1 (a)(l)(i). For an excellent discussion and background see Rosepink, 865 T.M, *Charitable Remainder Trusts and Pooled Income Funds*, A-13 (2002).

[92] Sec. 1014.

[93] Sec. 2055(e)(2)(A).

[94] Reg. Sec. 1.664-1(a)(4).

[95] Reg. Sec. 1.664-l(a)(5)(i).

[96] Rev. Rul. 80-123, 1980-1 C. B. 205.

[97] Reg. Sec. 1.664-l(a)(5)(i).

[98] Reg. Sec. 1.664-1(a)(6), Ex.(4).

[99] Reg. Sec. 1.664-l(a)(5)(i).

[100] *Id.*

[101] Sec. 2055(e)(2)(B). For an excellent discussion and background *see*, Etheridge, 866 T.M., *Charitable Income Trust*, A-35 (2002).

[102] Sec. 7520(a)(1).

[103] Sec. 7520(a)(1). The defined interest rate must equal 120% of the Federal midterm rate in effect under sec. 1274(d)(1) for the month in which the valuation date falls.

[104] Sees. 2033; 2032.

[105] Reg. Sec. 1.664-1(a)(5).

[106] Sec. 642(c).

[107] Reg. Sec. 1.664-1 (a)(5); Under Reg. Sec. 1.664-l(a)(5)(iv)(a), interest is payable at the section 7520 rate for transfers after April 30, 1989.

[108] Rev. Rul. 76-7, 1976-1 C.B. 179 and Rev. Rul. 76-8, 1976-1 C.B. 179. *See also* PLR 8919016 (trustee of charitable remainder unitrust may have the power to name a substitute charitable remainderman relying on Rev. Rul. 76-7); PLR 9445010 (income beneficiaries/trustees may have power to designate by majority vote which departments within a university will receive the

remainder, relying on Rev. Rul. 76-8); PLR 20034019 (grantor may retain inter vivos and testamentary powers to name charitable beneficiaries without disqualifying trust as section 664 charitable remainder unitrust, relying on Rev. Rul. 76-8).

[109] PLR 200043029 (IRS ruled that annuity interest in charitable lead annuity trust and unitrust interest in charitable lead unitrust would qualify under section 2055(e)(2) where trusts were to be created at death of surviving spouse and no specific charities were named as charitable income beneficiaries; trustees would have power to designate and change charitable income beneficiaries).

[110] Rev. Proc. 96-15, 1996-1 C.B. 627 contains the procedure for obtaining an advance valuation determination. Although designed for income tax charitable donations, it is equally applicable to noncharitable transfers. The IRS requires the payment of a user fee of $2,500 for the first three items to be valued and $250.00 for each additional item and generally applies only to items that have a value in excess of $50,000. The fees paid would be deductible on the federal estate tax return as an administrative expense.

[111] For a discussion of an attempt to use tangible personal property in a testamentary charitable lead annuity trust see Gopman, The Formula CLAT and the Super Formula CLAT: Estate Planning With Charitable Lead Annuity Trusts Established at Death - Part I, *23 Tax Mgmt. Est., Gifts and Tr. J.* 186, ft. note 51 (July-Aug. 1998), discussing the CLAT under the Will of Jacqueline Kennedy Onassis.

[112] Palmer v. Commissioner, 62 T.C. 684 (1974), aff'd on another issue, 523 F. 2d 1308 (8th Cir. 1975), acq.; Rev. Rul. 78-197, 1978-1 C.B. 83.

[113] A testamentary charitable lead annuity trust is not a tax exempt entity and is taxed in accordance with the provisions of Subchapter J of the Code. However, the trust should be entitled to an income tax deduction for the amount of the annuity paid to the museum each year during the trust term. Sec. 642(c)(1).

[114] The Jobs and Growth Tax Relief Reconciliation Act of 2003 (effective May 6, 2003) reduced the long-term capital gain rate to 15 percent for sales of securities and other capital assets held for more than twelve months but maintained the 28 percent rate on gain from the sale of collectibles held for more than one year. The term "collectibles gain" is defined in section 1(h)(6)(A) to mean gain from the sale or exchange of a collectible (as defined in section 408(m)

without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing taxable income.

115 I.R.C. § 4942(j)(3).

116 I.R.C. §§ 170(b)(l)(A)(vi)and 170(b)(l)(E)(i).

117 *Id.*

118 Treas. Reg. § 53.4942(b)-l(a)(l). *See* Cesare, 296-3rd BNA T.M. Portfolio, Private Foundations and Public Charities — Definition and Classification.

119 I.R.C. § 4942(j)(3)(A); Treas. Reg. § 153.4942(b)-(l)(a)(l)(ii).

120 Treas. Reg. § 53.4942(b)-l(b)(l).

121 Treas. Reg. §§ 53.4942(b)-1(b)(1); 53.4942(b)-l(b)(2)(i); 53.4942(b)-l(d)Ex.

122 I.R.C. § 4942(j)(3)(B)(i); Treas. Reg. § 53.4942(b)-2(a).

123 Treas. Reg. § 53.4942(b)-2(a)(6) Ex. 4.

124 Rev. Rul. 74-498, 1974-2 C.B. 387.

125 *See* Priv. Ltr. Rul. 8845059 where the IRS ruled that a railroad museum's collection was used in the active conduct of charitable activity; Priv. Ltr. Rul. 9236035 where the IRS ruled that the planned loan of works of art is a direct exempt activity and that the foundation qualified as a private operating foundation.

126 I.R.C. §§ 4942(a)(1); 4942(e)(1); Treas. Reg. § 53.4942(a)-2(c)(l).

127 I.R.C. § 501(c)(3).

128 Rev. Rul. 74-600, 1974-2 C.B. 385.

129 Priv. Ltr. Rul. 8824001.

130 *Supra* notes 77 and 78.

131 I.R.C. § 4942(j)(3)(B)(ii); Treas. Reg. § 53.4942(b)-2(b)(l).

132 I.R.C. § 4942(j)(3)(B)(iii); Treas. Reg. § 53.4942(b)-2(c)(l).

133 I.R.C. § 2055(a).

134 I.R.C. § 170(e)(l)(B)(i); Treas. Reg. § 20.2055-1 (a)(4).

135 N.Y. Est. Powers & Trusts Law § 5-3.3 (McKinney 1967); In re Cairo's Estate, 35 A.D.2d 76, 312 N.Y.S.2d 925 (2d Dep't 1970), aff'd without opinion, 29 N.Y.2d 527, 272 N.E.2d 574, 324 N.Y.S.2d 81 (1971). Section 5-3.3 was repealed, effective July 7, 1981. The memorandum in support of repeal points out that New York was one of only eight American jurisdictions that

imposed restrictions on testamentary dispositions to charity and that the New York provision could be easily circumvented.

[136] I.R.C. §§ 508(d)(2), (a), (e), 2055(e)(1); Treas. Reg. § 20.2055-5(b).

[137] Treas. Reg. §§ 20.2055-2(e)(l)(ii), 25.2522(c)-3(c)(l)(ii). See generally Lerner, Final Regulations Under Section 2055(e)(4), 62 J. Taxation 300 (1985).

[138] I.R.C. § 2055(e)(4)(A).

[139] I.R.C. § 2055(e)(4)(B).

[140] I.R.C. § 2055(e)(4)(C).

[141] I.R.C. § 2055(e)(4)(D).

[142] The House Committee Report on H.R. 4242 (ERTA) concluded that the rule allowing a deduction in such cases should apply only for estate and gift tax purposes and not for income tax purposes.

[143] Treas. Reg. §§ 1.170A-l(a)(2)(ii), (c), 1.170A-13.

[144] Treas. Reg. § 25.2512-1.

[145] Treas. Reg. § 20.2031-6.

[146] Treas. Reg. §§ 20.2031-6, 25.2512-1, 1.170A-1(c)(2).

[147] Treas. Reg. § 20.2031-6.

[148] Treas. Reg. §§ 25.2512-1, 1.170A-1(c)(2).

[149] Wehausen v. Commissioner, 56 T.C.M. (CCH) 299 (1988) (involves valuation of mathematical journals); Rhoades v. Commissioner, 55 T.C.M. (CCH) 1159 (1988) (opal); Williams v. Commissioner, 54 T.C.M. (CCH) 1471 (1988) (Indian artifacts); Goldstein v. Commissioner, 89 T.C. 535 (1987); Shein v. Commissioner, 53 T.C.M. (CCH) 1292 (1987) (paintings); Frates v. Commissioner, 53 T.C.M. (CCH) 96 (1987) (paintings and sculpture); Angell v. Commissioner, 52 T.C.M. (CCH) 939 (1986) (paintings; court upheld civil fraud penalties for gross overvaluation); Biagiotti v. Commissioner, 52 T.C.M. (CCH) 588 (1986) (pre-Columbian and Mayan art objects); Koftinow, 52 T.C.M. (CCH) 261 (1986) (statue valued using French Grid system; see Action on Decision 87-023, in which IRS said it would resist such an approach); Neely v. Commissioner, 85 T.C. 934 (1985) (African art; see Teitell, Deductions for African Art, N.Y.L.J., Mar. 17, 1986, at 1); Johnson v. Commissioner, 85 T.C. 469 (1985) (Indian artifacts); Lio v. Commissioner, 85 T.C. 56 (1985) (lithographs); Harken v. Commissioner, 50 T.C.M. (CCH) 994 (1985); Skala v. Commissioner, 49 T.C.M. (CCH) 419 (1985) (vintage aircraft); Krauskopf v. Commissioner, 48 T.C.M. (CCH) 620 (1984) (racing car); Glen v. Commissioner, 79 T.C. 208 (1982) (tape recordings of interviews with noted scientists and I.R.C. § 170(e)(1)); Isbell v. Commissioner, 44 T.C.M. (CCH) 1143 (1982) (Han Dynasty ceramic jar); Hawkins v. Commissioner, 44 T.C.M. (CCH) 715 (1982) (mosaic table purchased

from Vatican Studio); Peterson v. Commissioner, 44 T.C.M. (CCH) 650 (1982) (ivory carvings); Monaghan v. Commissioner, 42 T.C.M. (CCH) 27 (1981) (portrait); Reynolds v. Commissioner. 43 T.C.M. (CCH) 115 (1981) (water colors); Raznatovich v. Commissioner, 41 T.C.M. (CCH) 79 (1980) (unindexed negatives of aerial photography); Sylvester v. Commissioner, 37 T.C.M. (CCH) 1847-79 (1978); Vanderhook v. Commissioner, 36 T.C.M. (CCH) 1394 (1977); Furstenberg v. United States, 78-1 U.S. Tax Cas. (CCH) 9267 (Ct. CI. 1978), 79-1 U.S. Tax Cas. (CCH) 9280 (Ct. CI. 1979), 595 F.2d 603 (1979); Sevier v. Commissioner, 36 T.C.M. (CCH) 1392 (1977); Franklin v. Commissioner, 77-2 U.S. Tax Cas. (CCH) 9267 (W.D.N.C. 1977); Peters v. Commissioner, 36 T.C.M. (CCH) 552 (1977); Gordon v. Commissioner, 35 T.C.M. (CCH) 1227 (1976); Posner v. Commissioner, 35 T.C.M. (CCH) 943 (1976); Cupler v. Commissioner, 64 T.C. 946 (1975) (unique item of medical equipment); Jarre v. Commissioner, 64 T.C. 183 (1975); Farber v. Commissioner, 33 T.C.M. (CCH) 673 (1974), aff'd, 76-1 U.S. Tax Cas. (CCH) 9118 (2d Cir. 1974); Lee v. United States, 75-1 U.S. Tax Cas.(CCH) 9165 (C.D.Cal. 1975); Rupke v. Commissioner, 32 T.C.M. (CCH) 1098 (1973); Barcus v. Commissioner, 32 T.C.M. (CCH) 660 (1973); Winokur v. Commissioner, 90 T.C. 733 (1988) (paintings); Sammons v. Commissioner, 838 F.2d 330 (9th Cir. 1988) (Indian artifacts limited to cost); Mast v. Commissioner, 56 T.C.M. (CCH) 1522 (1989) (glass stereoscopic negatives); Saltzman v. United States, 89-2 U.S. Tax Cas. (CCH) 19391 (E.D.N.Y. 1989) (videotape of Bolshoi Ballet valued at cost); Engel v. Commissioner, 66 T.C.M. (CCH) 378 (1993) (wild game trophy mounts); Leibowitz v. Commissioner, 73 T.C.M. (CCH) 2858 (1997) (movie memorabilia); Korson v. Commissioner, 75 T.C.M. (CCH) 2115 (1998) (coin collection ledgers); Samuel Jacobson v. Commissioner, 78 T.C.M. (CCH) 930 (1999) (first day covers and religious books; the case also deals with the section 6662(h) penalty provisions).

[150] Anselmo v. Commissioner, 80 T.C. 872 (1983), aff d, 757 F.2d 1208 (11th Cir. 1985); see also cases cited note 28; Ford v. Commissioner, 46 T.C.M. (CCH) No. 556 (1983); Teitell, Charitable Donations of Art Works: The Special Considerations Involved, 51 J. Tax'n 326 (1979); Zobel & Shore, The IRS Crackdown on Valuation Abuses: How Far Does It Go; What Does It Portend?, 52 J. Tax'n 276 (1980); Melvin, Valuation of Charitable Contributions of Works of Art, 60 Taxes 756 (1982).

[151] See Dubin v. Commissioner, 52 T.C.M. (CCH) 456 (1986).

[152] Skripak v. Commissioner, 84 T.C. 285 (1985).

[153] See also Calder v. Commissioner, 85 T.C. 713 (1985).

[154] Hunter v. Commissioner, 51 T.C.M. (CCH) 1533 (1986).

[155] See also Jennings v. Commissioner, 56 T.C.M. (CCH) 595 (1988).

[156] Lightman v. Commissioner, 50 T.C.M. (CCH) 266 (1985). See also Herman v. United States, 99-2 U.S. Tax Cas. (CCH) U 50,899 (DC Term. 1999) (medical equipment purchased at a bankruptcy sale valued at 25 times the taxpayer's cost).

[157] Rhoades v. Commissioner, 55 T.C.M. (CCH) 1159 (1988).

[158] Biagiotti v. Commissioner, 52 T.C.M. (CCH) 588 (1986).

[159] Gifford M. Mast, Jr. and Judith A. Mast, et al. v. Commissioner, 56 T.C.M. (CCH) 1522(1989).

[160] Id at 1525.

[161] Treas. Reg. § 1.170A-l(c)(l).

[162] Mast, Jr., supra note 80 at 1529.

[163] Id. at 1529.

[164] Gifford M. Mast. Jr. and Judith A. Mast, et. al. v. Commissioner, 57 T.C.M. (CCH) 1355 (1989).

[165] Heriberto A. Ferrari and Noemi O. Ferrari v. Commissioner, 58 T.C.M. (CCH) 221 (1989).

[166] Id. at 222.

[167] Id. at 223. The court noted that it is astounding that these parties did not seek an arbitrated solution by an art expert rather than a litigation in the Tax Court.

[168] Jack C. Chou and Doris H. Chou v. Commissioner, 58 T.C.M. (CCH) 1496 (1990).

[169] Id. at 1499.

[170] Id. at 1498.

[171] Fuad S. and Theresa N. Ashkar v. Commissioner, 61 T.C.M. (CCH) 1657 (1991).

[172] Id. at 1662.

[173] Thomas G. Murphy v. Commissioner, 61 T.C.M. (CCH) 2935 (1991). The Court of Appeals subsequently held that the negligence penalty did not apply. See Thomas G. Murphy v. Commissioner, 1993 U.S. App. LEXIS 26485 (U.S. Ct. of Appeals 9th Cir. 1993).

[174] Id. at 2940. Tangible property (works of art) that are donated to a charity and disposed of by the charity within two years of receipt are required to be listed on IRS form 8282 revealing the name, address and social security number of the donor and the price at which the charity disposed of the property.

[175] Joseph M. Isaacs v. Commissioner, 62 T.C.M. (CCH) 827 (1991).

[176] Franklin P. Perdue v. Commissioner, 62 T.C.M. (CCH) 845 (1991).

[177] Treas. Reg. § 20.2031 -1(b).

[178] George O. Doherty and Emelia A. Doherty v. Commissioner, 63 T.C.M. (CCH) 2112 (1992), affirmed, 16 F.3d 338 (U.S. Ct. of Appeals 9th Cir. 1994).

[179] For other recent valuation cases see Robert A. Hall and Ann S. Hall v. Commissioner, 59 T.C.M. (CCH) 80 (1990) value of vintage football film collection; Thomas J. Baker and Patricia A. Baker v. Commissioner, 59 T.C.M. (CCH) 698 (1990) value of video tapes of surgeons' operations; Harry D. Mandelbaum v. Commissioner, 59 T.C.M. (CCH) 516 (1990) art master tax shelter; Robert L. Sanz and Irene R. Sanz, 60 T.C.M. (CCH) 1160 (1990) value of foreign language books; Daniel I. Rhode and Sally Rhode v. Commissioner, 60 T.C.M. (CCH) 1535 (1990) value of books; Alexander and Audrey Weintrob, 61 T.C.M. (CCH) 1947 (1991) value of grave sites; William E. and Elizabeth M. Straw v. Commissioner, 62 T.C.M. (CCH) 1056 (1991) value of a horse; Dorian M. Bennett v. Commissioner, 62 T.C.M. (CCH) 1400 (1991) value of piano and when gift is effective; Albert Victor Mills v. Commissioner, 62 T.C.M. (CCH) 1345 (1991) value of vintage car; Estate of Darwin A. Miller, deceased, and Virginia P. Miller v. Commissioner, 62 T.C.M. (CCH) 997 (1991) value of animal hunting trophies; The Chronicle Publishing Co. and Subsidiaries v. Commissioner, 97 T.C. 445 (1991), aff d, 983 F.2d 232 (5th Cir. 1993) value of newspaper clipping library, not a capital asset under section 170(e)(1)(A); Robert E. Bronson, HI v. Commissioner, 63 T.C.M. (CCH) 2225 (1992) art master tax shelter. See Karlen, Appraiser's Responsibility for Determining Fair Market Value, 13 Colum. J. L. & Arts 185 (1989). See Lerner, Valuing Works of Art For Tax Purposes, 28 Real Property, Probate and Trust J. 1 (1993).