

**HOW TO BLEND ART, COLLECTIBLES, AND NFTS INTO YOUR FINANCIAL
PLANNING STRATEGY**

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HOW TO BLEND ART, COLLECTIBLES, AND NFTS INTO YOUR FINANCIAL PLANNING STRATEGY

I. Introduction People of all walks of life collect things. “Humans have been collecting things ever since we developed the ability to gather more trinkets than were actually required for basic survival. While you might be able to theorize that the need to collect things has to do with our primal desire for security by accumulating items of personal interest, the psychological community is still at a loss for a more specific answer.”¹ Generally, the wealthier the client, the larger and more expensive the collection. The reasons people collect are varied: Some collect for relaxation, some just for the items’ physical beauty, and others because of the potential for appreciation or as an asset class as part of a diversified portfolio.² Some collect simply to acquire things to pass down to the next generation.³

Online auctions, eBay, 1stdibs, Craigslist, and countless other websites allow individuals of all lifestyles to become collectors. Clients may not consider what they own to be art, or recognize its value. Just as many are surprised to learn that what they have carefully and passionately collected has more sentimental than monetary value. Yet for many clients, art and collectibles can be significant assets in their portfolio. If the long-running PBS series *Antiques Roadshow* is a barometer of the vastness of America’s collective stash, it is worth noting that in any 12-hour day of filming, approximately 6,500 people bring their items to be appraised.⁴ The show visits six cities annually and has done so since 1997, with seemingly no end to the treasure trove it attracts. Yet, sometimes these assets are often overlooked by advisers when assisting clients with their tax, financial, and estate planning.

As advisers, unless we ask our clients the right questions to determine whether they are collectors (or the artists creating the items that others collect), or simply have what may be a valuable work of art or collection in the attic or basement, we can’t properly give advice on estate, income tax, and other types of planning for those unique assets. Attached as Exhibit A is a questionnaire that can be modified for clients to gather information about their collection and their goals. This can be a helpful starting point for planning for the disposition of the collection, and later helping the heirs understand their responsibilities as potential stewards of a collection.

¹ Daniel Faris, *The Problem with Using Psychology to Explain Collecting*, ZME Science (updated Sept. 5, 2017), <http://www.zmescience.com/other/feature-post/problem-using-psychology-explain-collecting/>.

² Art has surpassed gold as a way to store wealth according to recent statistics. *N.Y. Apartments, Art Top Gold As Stores of Wealth, BlackRock Chief Says*, Bloomberg News (Apr. 21, 2015), <https://www.bloomberg.com/news/articles/2015-04-21/new-york-apartments-art-top-gold-as-stores-of-wealth-says-fink>.

³ Barclays, *Profit or Pleasure? Exploring the Motivations Behind Treasure Trends*, Wealth Insights, [Profit ili zadovoljstvo - kompletan izvestaj.pdf \(enograf.com\)](#) (last visited Mar. 10, 2022).

⁴ Chris Morran, *10 Things We Learned About What Goes On At The Antiques Roadshow*, Consumerist (Mar. 25, 2014), <http://consumerist.com/2014/03/25/10-things-we-learned-about-what-goes-on-at-the-antiques-roadshow/>.

Valuable art and collectibles to one person can be a ball and chain to the next generation. This kind of inheritance can also create an unexpected and perhaps unaffordable estate tax liability for its heirs.

This outline is intended to provide guidance on (i) the type of appraisals necessary in connection with inter vivos and estate gifts of artwork and collectibles, both charitable and noncharitable; (ii) the gifting of artwork and collectibles; and (iii) advising the fiduciary in possession of a collection. Finally, this outline will examine unique issues that arise with art, collectibles, and cultural property (i.e., archaeological and ethnological material and antiquities) and related situations (i.e., stolen works, including transfers during the Holocaust era), which advisers need to understand so that they aren't caught by surprise when advising and representing the collector.

II. Relevant Background Information and “Terms of Art.”

A. What Is Art?

What is art? The IRS has defined art as “paintings, sculpture, watercolors, prints, drawings, ceramics, antique furniture, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia and other similar objects.”⁵ It defines collectibles to include “coins, stamps, books, gems, jewelry, sports memorabilia, dolls, etc., but not art.”⁶

B. Who Owns Art?

Once art leaves the hands of the artist, it generally goes to one of four categories of persons, each of which has different tax considerations: (i) the investor, (ii) the hobbyist, (iii) the collector, and (iv) the dealer. Which category a taxpayer falls into depends on the applicable facts and circumstances. There is no bright line between these categories of holders of art for tax purposes. In addition, a taxpayer might hold art in different categories. For example, a dealer might hold specific pieces of art in his or her trade or business and other pieces as an individual investor. Additionally, various expenses and losses in each category may or may not be deductible, and likewise depend on the facts and circumstances. The IRS’s publication entitled *2012 Art Galleries – Audit Technique Guide* can be quite useful in understanding the nuances and the distinctions the Service is looking for.⁷ The following is a brief introduction to the four categories.

1. Investors.

Investors are persons who buy and sell art solely as an investment with the hope the asset will appreciate to enable sale at a profit. For an art investor, generally the investment when sold is taxable as a capital gain unless it falls outside the definition of capital asset (discussed in more detail below). Expenses of art investments will generally be deductible under I.R.C. §212 if an

⁵ Rev. Proc. 96-15, 1996-1 C.B. 627; IRS Form 8283, Noncash Charitable Contributions (rev. Dec. 2021).

⁶ IRS Form 8283 at 1.

⁷ IRS, *Art Galleries – Audit Technique Guide* (Jan. 2012), <https://www.irs.gov/pub/irs-utl/artgalleries.pdf>.

investor's primary intent (based on facts and circumstances) was to hold the art for the production of income and the expenses were "ordinary and necessary" as described in I.R.C. §162.

If a taxpayer wants its artwork to be considered as investments, the taxpayer has the burden of proving investment intent. Whether an activity is an investment turns on whether the activity is engaged in for profit, after considering all applicable facts and circumstances.⁸ Treas. Reg. §1.183-2(b) sets out nine factors for determining whether an asset is held for investment, without any one factor being determinative:⁹

1. The manner in which the taxpayer carries out the activity
2. The taxpayer's expertise or that of the taxpayer's advisors
3. The time and effort expended to carry on the activity
4. The expectation that the assets used in the activity may appreciate in value
5. Success in carrying on other activities
6. History of income and losses with respect to the activity
7. Amount of occasional profits, if any
8. Financial status of the taxpayer
9. Elements of personal pleasure or recreation

If an activity produces a profit during three or more years out of a five-year period, the taxpayer is presumed to be in the activity for profit, unless the IRS proves otherwise.¹⁰

A capital loss is available to an investor under I.R.C. §165(c)(2) if the taxpayer can prove the purchase and the sale of the artwork was a transaction entered into for profit.

An investor may take a charitable income tax deduction for the fair market value of a donation, provided it is for a related use.

If I.R.C. §183(d), the Hobby Loss rule, applies, the activity is presumed to be for profit if the gross income exceeds the deductions in three or more years in a five-year period. If not, then I.R.C. §183 may limit the deduction of expenses if the activity is deemed a not-for-profit activity.

2. Hobbyists.

⁸ Treas. Reg. §1.183-2(a).

⁹ I.R.C. §183(d); Treas. Reg. §1.183-2(b).

¹⁰ I.R.C. §183(d).

A hobbyist is a collector who buys art for personal use and enjoyment, without considering whether it will ever be a profitable investment. Hobbyists rarely sell their collection, which if sold generally is a capital asset so gains are recognized but losses are not (I.R.C. §§1221 and 165(c) respectively). Expenses attributed to maintaining the collection are generally not deductible (I.R.C. §262); however, I.R.C. §183 may allow some deductions up to the amount of gross income generated by the activity following the ordering rules of the I.R.C. §183. Because of the tax disadvantages of being a hobbyist, the hobbyists try to be classified as investors.

3. Collectors.

Collectors are those who primarily accumulate art for personal use and enjoyment, but also consider their collection an investment. By definition, collectors are not engaged in a trade or business under I.R.C. §165(c)(1).

Art, if sold by a collector, generally is a capital asset in which gains are recognized at the same rate as other capital assets, but losses are not allowed, except to the I.R.C. §183 Hobby Loss rules.¹¹ Nor are expenses for acquiring and maintaining art deductible for collectors.¹² Note also that I.R.C. §165(c)(3) allows a limited casualty loss deduction to collectors.¹³ Nevertheless, favorable income tax treatment often can be taken advantage of when selling or donating a collection, as discussed below in Section V.

Collectors include a subset, referred to sometimes as business collectors. They do not buy art for resale but rather for purposes such as office display or decoration in the ordinary course of trade or business. Art owned by a business collector, because the useful life is not determinable, is generally not subject to depreciation. In addition, many businesses buy art for investment that can place them in the category of investor or hobbyist.

4. Dealers.

Dealers are persons in the business of selling art to customers primarily to derive a profit. Dealer classification is based on each person's unique facts and circumstances. Important factors to consider, among other things, are the type and effort of the person's sales activity and efforts and intentions of the person when a piece of art is acquired.

¹¹ I.R.C. §§1221, 165(c).

¹² I.R.C. §183 (denying most deductions attributable to activities not engaged in for profit); I.R.C. §262 (denying a deduction for personal losses and expenses).

¹³ 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 (deemed to be zero in the case of a theft) and (b) the property's adjusted basis. The deduction is further limited to the amount that exceeds 10% of the collector's adjusted gross income. I.R.C. §165(h)(2). However, for dealers and investors, if 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. Reg. §1.165-7(b). From the amount of loss, the taxpayer is also required to deduct \$100 for each casualty or theft. I.R.C. §165(h)(1); Treas. Reg. §1.165-1.

Art dealers are taxed in the same way as any other retail operation. All income, including income from the sale of art, is taxed as ordinary income.¹⁴ Expenses, if ordinary and necessary, are deductible under I.R.C. §162. Dealers are often also art investors. These dual roles will be respected for tax purposes as long as the separate activities are not commingled.¹⁵

As discussed below, a dealer realizes ordinary income on a sale that realizes a gain, and recognizes ordinary loss on a sale that realizes a loss.¹⁶ Nevertheless, there are other tax opportunities and obligations to keep in mind if artwork and collectibles are held by a dealer.¹⁷

A dealer may only take a charitable income tax deduction for the tax basis of a donation, but is not limited by the related use rule.

While beyond the scope of this outline, a few opportunities and obligations are described below:

- (a) I.R.C. §67, limitation on deductions to those exceeding 2% of a taxpayer's adjusted gross income.
- (b) I.R.C. §68, limitation on certain itemized deductions for taxpayers with adjusted gross income above certain indexed amounts.
- (c) I.R.C. §162, deduction for ordinary and necessary expenses incurred in conducting a trade or business.
- (d) I.R.C. §165, deduction for losses in a trade or business.
- (e) I.R.C. §212(1) and (2), deduction for expenses incurred in the production and collection of income.

For a useful discussion on succession planning for the art dealer, *see* Michael Duffy, *Art Dealers – Wealth Transfer Considerations*, 36 Prob. & Prop. 13 (Jan./Feb. 2022).

C. Capital Gain Collectible Property Versus Ordinary Income Property.

In most cases, a work of art is capital gain collectible property, not ordinary income property. A work of art is capital gain collectible property if it is a capital asset under I.R.C. §1221, has appreciated, is considered a collectible under I.R.C. §408(m), and has been held by the taxpayer for more than one year. On the other hand, a work of art may be ordinary income property if it was created by the taxpayer, was received by the taxpayer from the artist, is held as inventory by a dealer, or has been owned for a year or less at the time of transfer.

¹⁴ I.R.C. §§61, 64.

¹⁵ *Williford v. Comm'r*, T.C. Memo. 1992-450 (Aug. 10, 1992).

¹⁶ I.R.C. §165(c)(1).

¹⁷ *See* Michael Duffy, *For Auction Houses and Art Dealers Sales Tax Should Be a Science . . . Not an Art*, 35 Prob. & Prop. 15 (May/June 2021).

The sale by an artist of his or her own work generates ordinary income, and the artist's basis is the cost of the materials used.¹⁸ The recipient of a work from an artist continues to be ordinary income property under I.R.C. §1221(a)(3)(C), and receives a carryover basis. Once it is either received as a testamentary bequest or purchased it becomes a capital asset and is no longer treated as ordinary income property.

For a taxpayer who is not a creator or dealer but, instead, uses the work in its trade or business, there are many tax issues that need to be addressed, including rules under I.R.C. §1231 for property used in the taxpayers trade or business, so that gains might be capital and losses ordinary (in addition to I.R.C. §1231, other relevant rules include possible recapture under I.R.C. §1245, as well as the impact of I.R.C. §1245(b)(8) on intangibles under I.R.C. §197).

In the charitable deduction realm, Treas. Reg. §1.170A-4(b)(1) defines ordinary income property to include "property held by the donor primarily for sale to customers in the ordinary course of his trade or business, a work of art created by the donor."

Since 2012 the highest income tax rate on long-term capital gain property for taxpayers is 20%. However, the long-term capital gain rate for collectibles, which is applicable to investors and collectors, is even higher, at 28%.¹⁹ The Patient Protection and Affordable Care Act of 2010 enacted a 3.8% surtax on net investment income, which includes collectibles, and applies to many high-income investors and collectors. As a result, investors and collectors could pay a tax of up to 31.8% on the sale of collectibles. Works created by an artist, however, are generally taxed at rates of up to the highest ordinary income tax rate, which is currently 37%.

D. Charitable Donations: Recordkeeping and Reporting Requirements.

To take a deduction for a noncash donation, the IRS requires donors to carefully document the amount and type of their contributions and comply with certain strict requirements beyond the scope of this outline. But generally, the same documentation rules for gifts of \$250 or more, \$500 or more, \$5,000 or more, and \$500,000 or more have the same requirements as any other charitable noncash donation apply.²⁰ Donations of more than \$5,000 require the donor to complete IRS Form 8283, Section B, and to obtain a qualified appraisal that meets generally accepted appraisal standards. Donations of more than \$500,000 also require the donor to attach the qualified appraisal to the tax return.

III. Qualified Appraisals and Qualified Appraisers.

The lynchpin of planning for the collector is having accurate appraisals prepared by qualified appraisers. The burden of proof with respect to value is on the taxpayer: "While the Service is responsible for reviewing appraisals, it is not responsible for making appraisals; the burden of supporting the fair market value listed on a return is the taxpayer's. The IRS cannot accord recognition to any appraiser or group of appraisers from the standpoint of unquestioned acceptance

¹⁸ I.R.C. §§170(e)(1)(A), 1221(a)(3).

¹⁹ I.R.C. §1(h)(4)-(5).

²⁰ Charitable Contributions, IRS Pub. No. 1771 (rev. Mar. 2016).

of their appraisals.”²¹ Courts are not bound by the opinion of an expert witness, and may accept or reject expert testimony in the exercise of the court’s own judgment.²² Therefore, it is critical that the criteria for an appraiser as well as an appraisal be met. Ultimately, the IRS has concluded that the sale price is the best evidence of the fair market value of art, even if the sale occurs after (but not long after, the length of which is not defined) date of death.²³ The standards in the charitable realm versus the gift and estate tax realm are different. Both are discussed below.

A. Appraisals for Charitable Gifts.

Section 1219(c)(1) of the Pension Protection Act of 2006 (the “PPA”) added I.R.C. §170(f)(11)(E) to the Code, which provides statutory definitions of a “qualified appraiser” and a “qualified appraisal” for tax returns filed after August 17, 2006.²⁴

In general, for non-cash contributions exceeding \$5,000 (per item or collection of similar items donated in one calendar year),²⁵ a donor must obtain a “qualified appraisal”; attach a completed appraisal, prepared not more than 60 days before the date of the contribution, to the tax return on which the deduction is claimed; and maintain accurate records in connection with the donation.

1. Qualified Appraisal.

After the PPA modifications, a “qualified appraisal” is a document that meets the relevant requirements of Treas. Reg. §1.170A-17 and IRS Notice 2006-96, 2006-2 C.B. 902, including the following:

(a) Is prepared, signed, and dated in accordance with generally accepted appraisal standards. An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards within the meaning of I.R.C. §170(f)(11)(E)(i)(II) if 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.²⁶ The USPAP is the generally accepted standard for appraisers, including personal property appraisers.

²¹ Rev. Proc. 66-49, 1966-2 C.B. 1257.

²² *Estate of Elkins v. Comm’r*, 140 T.C. 86, 108-09 (2013) (citing *Helvering v. Nat’l Grocery Co.*, 304 U.S. 282, 295 (1938); *Estate of Newhouse v. Comm’r*, 94 T.C. 193, 217 (1990)), *aff’d in part, rev’d in part*, 767 F.3d 443 (5th Cir. 2014).

²³ *Estate of Newberger v. Comm’r*, T.C. Memo. 2015-246 (Dec. 22, 2015) (sales occurring after a decedent’s death but reasonably proximate in time are the best evidence of value and should be the starting point for a determination of value, but appropriate adjustments to take account of market conditions as of the valuation date may be justified).

²⁴ IRS Notice 2006-96, 2006-2 C.B. 902.

²⁵ Items may be aggregated even if the collection is broken up among charitable recipients when donated.

²⁶ IRS Notice 2006-96. Additional information about these standards is available at www.appraisalfoundation.org.

(b) Is received by the client before the due date, including extensions, of the tax return on which the charitable contribution deduction is first claimed for the donated property.²⁷ (If this deadline is not met, the client's entire charitable deduction is lost.)

(c) Does not involve a prohibited appraisal fee (generally, no part of the fee for a qualified appraisal can be based on a percentage of the appraised value of the property).²⁸

(d) Includes the following information:²⁹

- (1) A complete description of the object, and the facts on which the appraisal was based, such as: (a) the name of the artist or culture; (b) the title or subject matter; (c) the medium, such as oil on canvas, or watercolor on paper; (d) the date created; (e) the size; (f) any marks, signatures, or labels on the artwork, on the back or affixed to the frame; (g) the history of the item, including proof of authenticity, if such information is available, and the cost, date, and manner of acquisition; (h) a record of any exhibitions at which the item was displayed; (i) any reference source citing the item; and (j) the physical condition of the item;³⁰
- (2) The identity of, and relationship between, the transferor and each transferee;³¹
- (3) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;³²
- (4) The terms of any agreement relating to the use, sale, or other disposition of the property contributed, including the terms of any agreement or understanding that restricts or earmarks donated property for a particular use;
- (5) A statement that the appraisal was prepared for income tax purposes;

²⁷ Treas. Reg. §1.170A-13(c)(3)(iv)(B).

²⁸ Treas. Reg. §1.170A-13(c)(6)(ii).

²⁹ Determining the Value of Donated Property IRS Pub. 561 (rev. Apr. 2007), includes a list of the types of information that should, if relevant and available, be included in a description of donated works of art and collectibles. The IRS has also provided a preferred individual appraisal item format for works of art valued at over \$50,000. IRS, Preferred Object Identification Format for Art Valued Over \$50,000 (Mar. 2011), http://www.irs.gov/pub/irs-utl/appraisal_item_format.pdf.

³⁰ See generally Treas. Reg. §301.6501(c)-1(f)(3).

³¹ Treas. Reg. §301.6501(c)-1(f)(2)(ii).

³² Treas. Reg. §301.6501(c)-1(f)(2)(iii).

- (6) The appraised fair market value on the valuation date, which may not be more than 60 days prior to the date (or expected date) of the contribution (for gift tax purposes);
- (7) The method of valuation used to determine fair market value, such as the income approach, the comparable sales or market data approach, or the replacement cost less depreciation approach;
- (8) A professional quality image of the object;³³ and
- (9) The name, address, and identifying number of the qualified appraiser and of any entity or person who employs or engages the qualified appraiser, and the qualifications of the appraiser who signs the appraisal, including the appraiser's background, experience, education, and any membership in professional appraisal associations.

One appraisal for a group of similar items of property contributed in the same tax year may be provided. Otherwise, a separate appraisal is required for each item. An appraisal for a group of items must provide all of the required information for each item in the group. The appraiser, however, may provide a group description for selected items, the total value of which is not more than \$100.

2. Qualified Appraiser.

Art appraisers are not required by law to be regulated. But there are three main accrediting bodies in the United States for art appraisers: Appraisers Association of America (“AAA”),³⁴ American Society of Appraisers (“ASA”),³⁵ and International Society of Appraisers (“ISA”).³⁶ These three organizations provide training leading to certification for their accredited members. The IRS refers to a qualified appraiser as an individual meeting its criteria for performing art appraisals, as follows:³⁷

- (a) Regularly performs appraisals for compensation;
- (b) Is qualified to make appraisals of the type of property being valued, according to qualifications described in the appraisal, and demonstrates verifiable education and experience in valuing the type of property being appraised;

³³ See IRS Office of Art Appraisal Servs., Photographic Requirements for Art, Antiques, Decorative Arts & Other Cultural Properties, <https://www.irs.gov/pub/irs-pdf/p5497.pdf> (last visited Mar. 10, 2022) (allowing digital images).

³⁴ Appraisers Ass’n of Am., <http://www.appraisersassociation.org> (last visited Mar. 8, 2022).

³⁵ Am. Soc’y of Appraisers, <http://www.appraisers.org/> (last visited Mar. 8, 2022).

³⁶ Int’l Soc’y of Appraisers, <http://www.isa-appraisers.org/> (last visited Mar. 8, 2022).

³⁷ Treas. Reg. §1.170A-13(c)(5)(i).

(c) Signed IRS Form 8283, which contains the following declaration and sets forth additional requirements that must be met:

“I declare that I am not the donor, the donee, a party to the transaction in which the donor acquired the property, employed by, or related to any of the foregoing persons, or married to any person who is related to any of the foregoing persons.^[38] And, if regularly used by the donor, donee, or party to the transaction, I performed the majority of my appraisals during my tax year for other persons.”

“Also, I declare that I perform appraisals on a regular basis; and that because of my qualifications as described in the appraisal, I am qualified to make appraisals of the type of property being valued. I certify that the appraisal fees were not based on a percentage of the appraised property value. Furthermore, I understand that a false or fraudulent overstatement of the property value as described in the qualified appraisal or this Form 8283 may subject me to the penalty under section 6701(a) (aiding and abetting the understatement of tax liability). In addition, I understand that I may be subject to a penalty under section 6695A if I know, or reasonably should know, that my appraisal is to be used in connection with a return or claim for refund and a substantial or gross valuation misstatement results from my appraisal. I affirm that I have not been barred from presenting evidence or testimony by the Office of Professional Responsibility.”

(d) The PPA (as explained in IRS Notice 2006-96) added the following requirements:³⁹

- (1) Successfully completed college or professional-level coursework that is relevant to the property being valued, have at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued; and fully describe in the appraisal his or her qualifying education and experience.
- (2) Earned an appraisal designation from a recognized professional appraisal organization (such as the AAA (from the Appraisal Association of America), ASA (from the American Society of Appraisers) or ISA (from the International Society of Appraisers) for art and collectibles) or met certain minimum education and experience requirements.
- (3) Not been prohibited from practicing before the IRS under 31 U.S.C. §330(c) at any time during the three-year period ending on the date of the appraisal.

³⁸ Because of this declaration, the dealer or auction house that sold the donor the artwork may not also appraise the work.

³⁹ I.R.C. §170(f)(11)(E)(ii).

Fair market value for charitable gifts is defined as “The 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.”⁴⁰

B. Appraisals for Gifts and Estates.

Treas. Reg. §20.2031-1(b) is the starting point for the determination of fair market value in an estate valuation. Unlike the definition for charitable gift purposes, which is very general, it 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 to sell and both having reasonable knowledge of relevant facts.”⁴¹ It goes on to specify that fair market value is the value found in the market in which the item “is most commonly sold to the public.”⁴² Fair market value is established as of the date of death⁴³ or, where appropriate, the alternate valuation date.⁴⁴

Treas. Reg. §20.2031-6 elaborates on the rules applicable to appraisals of tangible personal property. Generally, “[a] room by room itemization of household and personal effects is desirable. All the articles should be named specifically, except that a number of articles contained in the same room, none of which has a value in excess of \$100, may be grouped. A separate value should be given for each article named. In lieu of an itemized list, the executor may furnish a written statement, containing a declaration that it is made under penalties of perjury, setting forth the aggregate value as appraised by a competent appraiser or appraisers of recognized standing and ability, or by a dealer or dealers in the class of personalty involved.”⁴⁵

If an estate includes items individually worth more than \$3,000 or a collection worth more than \$10,000, an appraisal must be submitted with the estate tax return.⁴⁶

Neither a qualified appraiser nor a qualified appraisal is required, but it is considered best practices to do so, to have the best evidence to defend a return in the event of an audit. Furthermore, Treas. Reg. §20.2031-6(d) advises the estate administrator to hire an appraiser who is “reputable and of recognized competency.” However, it appears that the IRS intends the concepts of “qualified appraisal” and “qualified appraisers” to apply to estate tax appraisers. Rev. Proc. 96-15, §8.04, 1996-1 C.B. 627, provides that the submitted estate tax appraisal must “(1) be prepared, signed, and dated by an appraiser, and contain a statement by the appraiser that: (a) the appraiser either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

⁴⁰ Treas. Reg. §1.170A-1(c)(2).

⁴¹ Treas. Reg. §20.2031-1(b).

⁴² *Id.*

⁴³ *Id.*

⁴⁴ The alternate valuation date is typically six months after the date of the decedent’s death. Treas. Reg. §20.2032-1(a)(2). However, if property is distributed, sold, exchanged, or otherwise disposed of within six months after the decedent’s death, the date of “dispos[al]” becomes the valuation date. Treas. Reg. §20.2032-1(a)(1).

⁴⁵ Treas. Reg. §20.2031-6(a).

⁴⁶ Treas. Reg. §20.2031-6(b).

[and] (b) the appraiser is *qualified* to make appraisals of the item of art; ... [and] (3) include the qualifications of the appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations." (Emphasis added.) This definition of an appraiser in the estate tax context found in Rev. Proc. 96-15, §8.04 is substantially similar to the one for income tax purposes set forth in PPA §1219(c)(1).

C. Appraisal Fees.

Most qualified appraisers base their fees on an hourly or daily basis. Some base their fees on a per-object basis. Billing based on a percentage of the appraised value is prohibited by all professional associations and the IRS.⁴⁷

D. Penalties.⁴⁸

1. Income Tax.

Appraisers and taxpayers are subject to severe penalties for certain overstated valuation statements. There are two types of valuation misstatements: "substantial ... valuation understatements" under I.R.C. §6662(g) and "gross valuation misstatements" under I.R.C. §6662(h).

A substantial valuation misstatement can trigger a penalty of 20% of the amount of the underpayment (but only if the adjustment exceeds the greater of \$5,000 or 10% of the tax owed).⁴⁹ For income tax purposes, a substantial misstatement is one where the donor values the donation at least 150% of the value as determined by the IRS or, if litigated, court.

A gross valuation misstatement can result in a penalty of 40% of the amount of the underpayment.⁵⁰ A gross misstatement occurs when the donor values the donation at least 200% of the value determined by the IRS or court.

Appraisers are also subject to penalties if they had knowledge of facts that would cause a reasonable person to expect the appraisal to be used in a substantial or gross valuation misstatement by the taxpayer. The penalties applicable to appraisers are the greater of (i) \$1,000 or (ii) 10% of the amount of an underpayment attributable to the misstatement, capped at 125% of the gross income received by the appraiser for preparing the appraisal.

In general, I.R.C. §6664(c)(1) permits relief from penalties where a taxpayer had "reasonable cause" for taking a reporting position. I.R.C. §6664(c)(3) modifies the reasonable cause exception for charitable deductions: When a charitable deduction is claimed, the reasonable cause exception is only available if the taxpayer can establish that the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and the taxpayer made a good-faith

⁴⁷ Treas. Reg. §1.170A-13(c)(6).

⁴⁸ For a thorough examination of penalties, see David M. Wooldridge et al., *Navigating the Defenses to Valuation Penalties in Charitable Deduction Cases*, J. of Tax'n (Dec. 2014), at 255.

⁴⁹ I.R.C. §6662(d)(1)(A).

⁵⁰ I.R.C. §6662(h)(1).

investigation of the value of the contributed property. Reasonable cause has been interpreted to mean that, in addition to obtaining a qualified appraisal from a qualified appraiser, a taxpayer may want to obtain an additional appraisal to verify the accuracy of the prior appraisal, have a tax advisor review the appraisal to determine whether it complies with the statutory requirements, and document any other independent investigations made regarding the value of the property.⁵¹ There is strict liability for the gross valuation penalty; it may not be waived.⁵²

E. Estate and Gift Tax.⁵³

If the value reported on an estate tax return is 50% or less of the final value as determined by the IRS, a penalty of 20% of the underpayment is applied, but only if the underpayment exceeds \$5,000. If the value reported is 25% or less of the final value as determined by the IRS, a penalty of 40% of the underpayment is applied. The Service has discretion to waive estate and gift tax penalties if the taxpayer can show a reasonable basis for the value reported, and that it was reported in good faith.⁵⁴

F. Issues Affecting Value.

An appraiser's determination of fair market value is generally based upon consideration of the following factors, if known and where applicable: subject matter, composition, palette, medium, size, orientation, date, condition, restoration, rarity, provenance, freshness to the market, significance of the item in relation to the artist's oeuvre, the economic state of the art market at the time of valuation, depth of interest, recent exhibitions, and prestige of the artist. An appraiser may also take into consideration the specific market conditions pertaining to the property and whether a blockage discount may apply. Some of these issues are discussed below.

1. Condition.

Condition is an important factor in the value of a work of art. Collectors pay a premium for art that is in its untouched, unrestored condition. If art has had restoration or conservation work done, or it has condition issues and needs to be restored, this can affect value. Overall impact on the composition is important. For example, if a painting has had its surface cleaned, which changes its appearance, that may have little impact on value. But if the art has been damaged and restored in more significant ways, value can be impacted substantially.

⁵¹ See *Whitehouse Hotel Ltd. P'ship v. Comm'r*, 755 F.3d 236 (5th Cir. 2014), *aff'g in part, vacating in part*, 139 T.C. 304 (2012). The Fifth Circuit expressed skepticism that the historic Maison Blanche had appreciated in value by approximately 970% in less than three years but ultimately concluded that obtaining a qualified appraisal, analyzing that appraisal, commissioning an additional appraisal, and submitting a professionally prepared tax return was sufficient to show the taxpayer engaged in a good-faith investigation sufficient to qualify for the reasonable cause exception and avoid the gross valuation misstatement penalty (under the pre-PPA rules).

⁵² I.R.C. §6664(c)(3).

⁵³ I.R.C. §6662(g)(1).

⁵⁴ I.R.C. §6664(c)(1).

In *Estate of Kollsman v. Commissioner*,⁵⁵ the Tax Court held that two old master paintings had been worth nearly \$1.8 million for estate tax purposes, but allowed discounts for the risks associated with cleaning the paintings (and the uncertain attribution of one of the paintings).

2. Blockage Discounts.

Value does not ensure liquidity. If a large collection, especially of one artist's work, is placed on the market all at once, there will be fewer collectors interested in purchasing the work, causing actual sales prices to be reduced.

Placing a large amount of any type of property on the market at once is recognized by the IRS to cause a blockage discount.⁵⁶ Blockage discounts apply in the art world.⁵⁷ While the value of the works for estate tax purposes may be reduced due to a blockage discount, flooding the market is also likely to depress the amount collected on the sale of the works.

The IRS does not permit blockage discounts for charitable contribution deductions, because the taxpayer, unlike a decedent, is able to control the rate at which the items enter the market.

3. Hammer Price Versus Buyer's Premium in Valuations.

An issue that is often overlooked when valuing artwork is the buyer's premium for works sold at auction. The general rule, stated in TAM 9235005 (Aug. 28, 1992), requires an estate that sells works of art at auction to use the hammer price plus the buyer's premium when reporting the fair market value of the item sold, even though the buyer's premium is not paid to the estate. The premium could be as much as 25%, with lower rates for larger sales. Because the premium is not received by the seller, it is part of the auction house's fee; it should be deductible under Treas. Reg. §20.2053-3(d)(2) as an expense of administration.

The Circuit Courts of Appeals and Tax Court have generally backed a strict approach to the Regulations, to deny sale expense as an administrative expense under I.R.C. §2053 for estate tax. The Seventh Circuit is more liberal than other Circuits on the point.⁵⁸

4. Fractional Interest Ownership.

Like airplanes and timeshares, art may be owned in fractional interests among individuals.⁵⁹ Until recently, the IRS took the position that a fractional interest in art was not entitled to a valuation discount. That changed when both the U.S. Tax Court and the Fifth Circuit Court of Appeals took a contrary position, allowing for discounts in *Estate of Elkins v. Commissioner*.⁶⁰ Elkins owned

⁵⁵ T.C. Memo. 2017-40 (Feb. 22, 2017).

⁵⁶ Treas. Reg. §§20.2031-2(e), 25.2512-2(e).

⁵⁷ *Calder v. Comm'r*, 85 T.C. 713 (1985); *Estate of O'Keefe v. Comm'r*, T.C. Memo. 1992-210 (Apr. 8, 1992).

⁵⁸ See *Estate of Jenner v. Comm'r*, 577 F.2d 1100 (7th Cir. 1978).

⁵⁹ Gifts of fractional interests to charity are discussed in Section V.D.2 below.

⁶⁰ 140 T.C. 86, 121 (2013), *aff'd in part, rev'd in part*, 767 F.3d 443, 449 (5th Cir. 2014).

fractional interests in 64 works of art, 61 of which were subject to a tenants-in-common agreement with his children that required unanimous consent to sell a piece from the collection. The Tax Court applied I.R.C. §2702(a)(2) and valued the property without regard to any restriction on the right to sell or use such property. It also based its opinion on the fact that the cotenants' agreement contained a waiver of partition. It did not, however, base its conclusion on the opinion of an expert. The Tax Court allowed a 10% valuation discount instead of the 44.75% discount claimed by the estate based on the conclusion that a hypothetical willing buyer and seller would agree to a price nearly equal to a pro rata share of the full fair market value when dealing with a fractional interest.⁶¹

On appeal to the Fifth Circuit, the court rejected the Service's expert, who claimed that there was no established market for fractional interests in art and therefore no discount was appropriate. The Fifth Circuit concluded that if there was truly no market a discount was appropriate, and upheld the value originally claimed by the estate.

Elkins is an unusual case because of the lack of expertise on the part of the Service's expert, among many other distinctive factors. Yet it has opened the door for significant valuation discounts when artwork and collectibles are owned among multiple individuals, and when subject to restrictive agreements. It is critical that any such agreement be scrupulously followed.

5. Restricted Gifts.

Donors often wish to impose restrictions or parameters on their gifts, not realizing that their well-intentioned restrictions may negatively impact the value of the gift.⁶² These restrictions may include requirements that a collection be maintained and/or displayed as a cohesive and permanent collection pursuant to certain specified terms and conditions. Other restrictions include maintaining the collection in perpetuity, and prohibitions on sale, exchange, or lending. Donors may also attempt to impose requirements regarding placement, credit for the donation, and publicity.

While the IRS has accepted gifts with restrictions,⁶³ the author is aware of instances where a charitable deduction has been reduced on audit of an estate tax return due to the extensive nature of the restrictions imposed by the donor. An onerous restriction may reduce the estate tax charitable deduction to an amount less than the fair market value of the donation, resulting in estate tax due on the difference.

6. Forged and Stolen Work.

While the topic of forged and stolen art and artifacts is beyond the scope of this outline,⁶⁴ it is important to keep in mind that even forged art has a value; it is just not the same value of the

⁶¹ *Id.*

⁶² See Alan F. Rothschild Jr., *Planning and Documenting Charitable Gifts*, 20 Prob. & Prop. 53 (July/Aug. 2006), for an examination of this topic.

⁶³ See PLR 200202032 (Jan. 11, 2002); PLR 200418002 (Apr. 30, 2004).

⁶⁴ See brief discussion in Section X.A below.

original piece, unless it can be shown that there is no market for the forged work.⁶⁵ The IRS has held that the fact that a market is illicit does not obviate the existence of that market for estate tax valuation purposes.⁶⁶

Similarly, stolen work is included in an estate under I.R.C. §2033, but no deduction is permitted due to the superior claims of rightful owners unless such claim is brought within a reasonable period based on state law, the date of filing of the estate tax return, and the facts and circumstances of the case.⁶⁷

IV. The Art Advisory Panel.

Artwork valuations submitted to the IRS are reviewed by the IRS's Office of Art Appraisal Services and may be referred to the "Art Advisory Panel." The panel consists of 25 volunteers drawn from a pool of nationally prominent art museum directors, curators, scholars, art dealers, auction representatives, and appraisers. The panel assists the Service in reviewing and evaluating appraisals submitted to support the fair market value claimed on income, gift, and estate tax returns.⁶⁸

A. Mandatory Review.

Transfers of artwork reported on a return with a claimed value of \$50,000 or more must be referred to Art Appraisal Services for possible review by the Commissioner's Art Advisory Panel.⁶⁹ The panel reviews appraisals that have been submitted and concludes either that the valuation is acceptable or arrives at its own conclusion of value. The panel's review is performed without knowing the taxpayer's identity or the purpose of the gift (which would affect whether the taxpayer would be motivated to claim a higher value – for charitable gifts – or a lower value – for noncharitable gifts).

⁶⁵ *Doherty v. Comm'r*, T.C. Memo. 1992-98 (Feb. 18, 1992) (a disagreement between two experts on a work's authenticity led the Tax Court to refer to the "shadow cast" by a question of authenticity and to hold that the fair market value of the work was "adversely affected" by their lack of agreement).

⁶⁶ *Jones v. Comm'r*, T.C. Memo. 1991-28 (Jan. 24, 1991) (the street market of illicit drugs was the relevant market for 42 kilograms of cocaine); *Browning v. Comm'r*, T.C. Memo. 1991-93 (Mar. 4, 1991) (the fair market value of marijuana based on the wholesale street market value).

⁶⁷ See TAM 9152005 (Aug. 30, 1991), in which the Service ruled that the claim of a medieval church asserted against two siblings for the return of stolen art objects was not a permitted deduction from the gross estate under I.R.C. §2053(a)(3) because (1) the claim, which was not asserted until after a reasonable period of administration expired, is not enforceable against the estate, and (2) the claim is regarded as arising by reason of the distributees' own business activities in marketing the art objects.

⁶⁸ See Art Advisory Panel of the Comm'r of Internal Revenue, Annual Summary Report for Fiscal Year 2017, <https://www.irs.gov/pub/irs-utl/annrep2017.pdf> (a summary of the panel's work in 2017). During its two meetings, it reviewed 365 works, with a taxpayer-claimed value of \$205.4 million and a panel recommended value of \$233.7 million, equaling an 18% increase.

⁶⁹ IRM §4.48.2.2, 8.18.1.3. The threshold was updated from \$20,000 in 2011, although not all publications have been updated to reflect this change.

B. Discretionary Review – Statements of Value.

At the request of a taxpayer, the IRS Art Advisory Panel (discussed below) will perform a review of certain appraisals prior to a return being filed and will issue what is called a “Statement of Value” that can be relied on when filing a return, to avoid substantial understatement penalties.

Rev. Proc. 96-15 provides procedures for taxpayers to request a Statement of Value for income, estate, and gift tax returns after the donation has been made but before filing the tax return reporting the donation (to avoid trial balloons).⁷⁰

Review is available for items of artwork that have been appraised at \$50,000 or more and have been transferred by reason of a decedent’s death, although the IRS may also consider an item valued under \$50,000 along with an item valued over \$50,000, if it believes that issuing a Statement of Value is in “the best interest of efficient tax administration.”⁷¹

The request must be accompanied by a previously prepared appraisal as well as the information set forth in IRM §8.18.1.1.1. The request must also be accompanied by the taxpayer’s signed declaration (the signature of a representative is not sufficient) containing the following: “*Under penalties of perjury, I declare that I have examined this request, including the accompanying documents, and to the best of my knowledge and belief, the facts presented in support of this request are true, correct, and complete.*”⁷² The Art Advisory Panel will not prepare an appraisal. If a taxpayer does not agree with the panel’s conclusion, it may request reconsideration but only if additional documentation is supplied. More information about the review process can be found here: IRS, Art Appraisal Services, (last updated Nov. 3, 2021), <http://www.irs.gov/Individuals/Art-Appraisal-Services>.

The current fees for a Statement of Value are \$6,500 for one to three items and \$300 for each additional item.⁷³

V. **Charitable Gifts of Artwork.**

Some families avoid the estate tax and lack of liquidity problems caused by a collection by simply giving it to charity. Giving a collection to charity opens up a whole world of options and tax ramifications. These are discussed below.

Again, without a basic knowledge of the tax rules concerning charitable gifts, it is hard to help a client choose the right options. The following are a few of the most important rules that a collector (or a collector’s advisor) should understand.

⁷⁰ Rev. Proc. 96-15, as modified by IRS Announcement 2001-22, 2001-1 C.B. 895 (changing the mailing address for such a request to IRS, POB 27720 McPherson Station, Washington, DC 20038).

⁷¹ Rev. Proc. 96-15 §3.02.

⁷² Rev. Proc. 96-15 §9.01 (emphasis added).

⁷³ These fees are adjusted periodically. See Rev. Proc. 2022-1, Appendix A, and Rev. Proc. 96-15 for procedures to request a statement of value

A. General Rules.

I.R.C. §170 governs income tax deductions for charitable contributions. It is important to consider the type of charitable recipient to anticipate the type of deduction that might be available: public charity, private operating foundation, or supporting organization.

In the case of an individual making an inter vivos cash gift to an I.R.C. §501(c)(3) organization classified as a “public charity” (such as churches, schools, hospitals, and governmental units), the gift is deductible for federal income tax purposes so long as the aggregate gifts do not exceed 60% of the taxpayer’s contribution base (the taxpayer’s adjusted gross income for the year without regard to net operating loss carrybacks, herein referred to as the taxpayer’s “AGI”).⁷⁴

The fair market value of appreciated property contributed to a public charity is deductible up to 30% of the taxpayer’s AGI.⁷⁵ The taxpayer may elect to increase the 30% limitation to 50% of the contribution base, but the deduction is then limited to the taxpayer’s basis.⁷⁶ Typically, this election would be made if the taxpayer’s basis in the property was very high or the deduction was so large that the taxpayer was not likely to use it in any case.⁷⁷

The rules are even more limited for gifts to nonpublic charities.

If a taxpayer contributes *cash* to a 501(c)(3) organization that is not a public charity, such as a private non-operating foundation, then the deduction for such contribution may not exceed the lesser of 30% of the taxpayer’s AGI or the excess of 50% of the taxpayer’s AGI for the year over the amount of cash contributions made to public charities.

If a taxpayer contributes *capital gain property* to an organization that is not a public charity, such as a private non-operating foundation, then the amount of the contribution allowed to be deducted may not exceed the lesser of 20% of the taxpayer’s AGI or the excess of 30% of the taxpayer’s AGI for the year, over the amount of the contributions of capital gain property to public charities. Contributions of capital gain property to which this 20% limit applies are taken into account after all other charitable contributions.

⁷⁴ I.R.C. §170(b)(1)(C)(i), (b)(1)(B). The value of capital gain assets contributed is taken into account after all other charitable contributions to public charities. Therefore, if the taxpayer contributes 30% of his or her AGI in cash and 30% of his or her AGI in capital gain assets, the cash gift will be counted first, then 20% of the capital gain property will be allowed, with the remaining 10% exceeding the taxpayer’s 50% limit held, to be deducted in future years.

⁷⁵ I.R.C. §170(b)(1)(C)(i).

⁷⁶ I.R.C. §170(b)(1)(C)(iii), (e)(1).

⁷⁷ 1 Frederick K. Hoops et al., *Family Estate Planning Guide* §11:8(d) (4th ed. 2005).

Contributions in excess of the limitations may be carried forward for each of the five succeeding tax years.⁷⁸ Any excess contributions will be treated as a charitable contribution of capital gain property in each of the five succeeding taxable years.⁷⁹

Deductions for inter vivos donations of ordinary income property are limited to the donor's *basis in the property*, not the full fair market value when donated.⁸⁰ This rule applies to works donated by the artist, donations of inventory by a dealer, and capital assets held one *year or less*.⁸¹

To the extent a donor receives anything other than personal gratification and recognition in return for the donation, that is considered *quid pro quo*, the value of which reduces the charitable deduction.⁸²

B. Related Use and Recapture.

To maximize a deduction, the donor should also confirm that the charity meets the “related use” test. The related use test requires that a donated object must be of a type normally retained *and* exhibited by that charitable organization as part of its nonprofit purpose.⁸³ If the donor fails to meet *either* requirement, the charitable deduction will be limited to the donor's basis. Just because a museum does not plan to hold a donation forever does not cause the donation to fail the related use test. A charitable recipient must demonstrate an intent to use the donated property for a period of time, to substantiate the related use requirement. But donations are often sold to raise funds for operations or to purchase other pieces.

To deter charities being used to churn donations to obtain a deduction, the PPA instituted a recapture rule. Now, charities must generally retain gifts of tangible personal property valued at more than \$5,000 for at least three years if the donor is to receive an income tax deduction for the fair market value. Property sold within three years may trigger a recapture of the excess of the deduction over the basis in the property.⁸⁴

Charities must report noncash donations on Schedule M of their Form 990. In addition, if they dispose of all or any portion of the donated property within three years after the date of receipt, they must file IRS Form 8282, Donee Information Return, to allow the Service to ferret out situations where the recapture tax may be applicable.⁸⁵ In addition, the IRS may impose a \$10,000

⁷⁸ I.R.C. §170(d)(1)(A), (b)(1)(C)(ii).

⁷⁹ I.R.C. §170(d)(1)(A)(ii).

⁸⁰ I.R.C. §170(e).

⁸¹ Charitable Contributions, IRS Pub. No. 526, at 11 (2014).

⁸² Rev. Rul. 68-432, 1968-2 C.B. 104.

⁸³ I.R.C. §170(c); Treas. Reg. §1.170A-4(b)(3)(ii).

⁸⁴ I.R.C. §170(e)(7)(A), (e)(7)(B)(ii).

⁸⁵ I.R.C. §170(e)(7)(D).

penalty where any person knowingly identifies property as having a related use when it is not intended for such use.⁸⁶

Even with this restriction, the PPA allows the recapture rule to be waived if a charity provides an affidavit stating that the charity used the property for its exempt purpose for a period of time, or that it became impractical to carry out this purpose.

C. The Appraisal Report and IRS Form 8283, Noncash Charitable Contributions.

Charitable contributions of art objects and other personal property for income tax purposes are reported on IRS Form 8283, with a copy to be provided to both the IRS and the recipient donee. Section A is for contributions of \$5,000 or less per item (but for items worth \$500 or less certain columns need not be completed). In lieu of an appraisal, an appraisal summary is accepted for items worth \$5,000 or less reported under this section.

An appraisal summary is a document that meets the following requirements:⁸⁷

- (A) The name and taxpayer identification number of the donor (social security number if the donor is an individual or employer identification number if the donor is a partnership or corporation);
- (B) A 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 contributed;
- (C) In the case of tangible property, a brief summary of the overall physical condition of the property at the time of the contribution;
- (D) The manner of acquisition (e.g., purchase, exchange, gift, or bequest) and the date of acquisition of the property by the donor, or, if the property was created, produced, or manufactured by or for the donor, a statement to that effect and the approximate date the property was substantially completed;
- (E) The cost or other basis of the property adjusted as provided by section 1016;
- (F) The name, address, and taxpayer identification number of the donee;
- (G) The date the donee received the property;
- (H) For charitable contributions . . . , a statement explaining whether or not the charitable contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution;

⁸⁶ I.R.C. §6720B.

⁸⁷ Treas. Reg. §1.170A-13(c)(4)(ii).

(I) The name, address, and (if a taxpayer identification number is otherwise required by section 6109 and the regulations thereunder) the identifying number of the qualified appraiser who signs the appraisal summary and of other persons as required by paragraph (c)(3)(ii)(E) of this section;

(J) The appraised fair market value of the property on the date of contribution;

(K) The declaration by the appraiser described in paragraph (c)(5)(i) of this section;

(L) A declaration by the appraiser stating that—

(1) The fee charged for the appraisal is not of a type prohibited by paragraph (c)(6) of this section; and

(2) Appraisals prepared by the appraiser are not being disregarded pursuant to 31 U.S.C. 330(c) on the date the appraisal summary is signed by the appraiser; and

(M) Such other information as may be specified by the form.

Form 8283, Section B must be completed for deductions of art objects and other personal property *over* \$5,000. This section requires that the donor obtain a qualified appraisal of the donated property from a qualified appraiser. The form must be signed by the donor, donee (acknowledging receipt of the gift), and appraiser (with a statement that he or she is qualified to perform this kind of appraisal).

For deductions of art objects and other personal property *over* \$20,000, Form 8283, Section B must include the signed appraisal (or qualified appraisal for income tax purposes), rather than an appraisal summary. A photograph must be available upon request.

D. Types of Charitable Gifts.

In addition to the gift or sale are part-gift, part-sale transactions. These are discussed only briefly below.

1. Bargain Sales.

A bargain sale of artwork to a qualified charitable organization (a sale for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange. The bargain sale results in both the receipt of cash and a charitable income tax deduction. The deduction would be the difference between the cash received and the fair market value.

The advantage of a bargain sale is that it partially monetizes the value of the art for the taxpayer who cannot afford to give the entire value to charity, and it produces an immediate charitable income tax deduction, which defrays some of the tax on the income received.

2. Fractional Gifts.

Rather than a gift of an entire work of art, a donor may wish to gift a partial interest (referred to as an “undivided fractional interest”). A donor may make a fractional gift of art if, immediately before the contribution, the art is owned entirely by the donor or by the donor and the recipient charity.⁸⁸

Prior to the PPA, a deduction was allowed under I.R.C. §170 for a fraction of the value of the entire interest equal to a ratio based on the size the donated fraction bore to the entire interest.⁸⁹ The PPA removed some of the appeal of fractional interest gifts, effective August 17, 2006. After the PPA, the value of any fractional gifts after the first is limited to the *lesser* of the initial fair market value or the later fair market value (except a gift of a fraction at death, which is valued at its then fair market value).⁹⁰ If the value declines, so does the deduction, but it may not increase even if the work appreciates.

There is no requirement that the museum be in possession *every* year. Instead, it must be in possession in the years a charitable deduction is recognized. In those years, the museum must take possession and use the piece of art the same way the donor would (have it on display, etc.). The regulations refine this requirement. The period of initial possession by donee may be deferred for up to one year (*thus, if an initial deduction is taken in 2022, the museum must be in possession of art in 2023*).⁹¹ However, the museum must take physical possession of the work before the gift is complete, which must be within the earlier of 10 years or the death of the donor.

I.R.C. §170(o)(3) imposes recapture of the charitable contribution deduction and a 10% penalty in the year of recapture if: (1) the donor does not contribute all the remaining interest in the art before the earlier of the donor’s death or 10 years from the date of the initial contribution, or (2) the donee has not had substantial physical possession of the property and has not used the property in a manner related to the donee’s exempt purpose during the period beginning on the date of the initial fractional contribution and ending on the date the entire interest is donated.

Because of the 10-year limitation, a donor should provide in his or her will or revocable trust that any fraction remaining in his or her estate be gifted at death.

3. Charitable Remainder Trusts.

⁸⁸ I.R.C. §170(e)(7).

⁸⁹ Rev. Rul. 57-293, 1957-2 C.B. 153. For example, a donor would give a museum the right to display a work of art for one month out of every 12. This would allow the donor to deduct 1/12th of the value of the work. The donation of each successive fraction resulted in a larger deduction if the value of the property increased.

⁹⁰ I.R.C. §170(o)(2).

⁹¹ Treas. Reg. §1.170A-5(a)(2). (“Section 170(a)(3) and this section have no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during 3 months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than 1 year.”).

A rarely used but powerful planning tool to generate a stream of income for art collectors is funding a charitable remainder trust (“CRT”) with art.⁹² Once funded, the trustee may sell the illiquid artwork and reinvest the proceeds into a portfolio that generates an income stream for a term of up to 20 years or for the lifetime of the grantor or grantors. The grantors receive a charitable deduction based upon the value of the art contributed, its age, current interest rates, and actuarial assumptions by the IRS.

A couple of rules make the CRT funded with art slightly less desirable than one funded initially with more conventional assets such as publicly traded securities. First, because the art is illiquid it is recommended to use a FLIP trust with the triggering event being the sale of the art. Until the art is sold the trust could be a net-income-only trust (unless the work is rented out prior to sale, generating income) if it is not likely to generate income, followed by a conventional unitrust beginning on January 1 of the year following the sale.

Second, the charitable donation is limited to the cost basis of the art contributed (multiplied by the remainder factor, which is based on the value received upon sale and the lower of the applicable federal rate in the month of sale or the two prior months).⁹³ If a big charitable deduction is driving a donor’s planning, this is probably not the right planning option.

Finally, the charitable deduction is delayed for a future interest in tangible property.⁹⁴ In other words, with a CRT a donor receives a tax deduction only in the year the trustee sells the art, not in the year that the art is contributed.⁹⁵ The art world is fickle and the donor may not get the deduction in the year he or she had hoped for. If the timing of the deduction is critical (for example, to mitigate a big income-generating event), it will be important to choose a highly marketable piece to fund the trust with, as early in the year as possible, to allow time for the sale to occur.

4. Charitable Lead Trusts.

Similar to the CRT is the charitable lead trust (“CLT”).⁹⁶ A CLT can be structured so that the present value of the CLT is equal to the fair market value of the art collection contributed, thereby

⁹² A charitable remainder makes distributions at least annually to a non-charitable beneficiary for a term specified in the trust instrument. At the end of the term, the assets of the CRT are distributed to a charitable beneficiary. I.R.C. §664(d)(1)(A), (2)(B). The grantor qualifies for an income tax and gift tax charitable deduction, or the gift qualifies for an estate tax charitable deduction for the present value of the remainder interest of the property given to the trust. I.R.C. §170(f)(2)(A); I.R.C. §2522(c)(2)(A); I.R.C. §2055(e)(2)(A); Treas. Reg. §1.664-2(c).

⁹³ I.R.C. §7520(a)(2).

⁹⁴ A deduction is allowed only after the “intervening interests” have expired. I.R.C. §170(a)(3).

⁹⁵ Treas. Reg. §1.170A-5(b), Example 7.

⁹⁶ A CLT provides annual distributions to a qualified charitable beneficiary for a term specified in the trust instrument with the remainder passing to a non-charitable beneficiary. The present value of the charitable income interest may qualify for an income and gift tax charitable deduction for the gift made by the grantor, or for an estate tax charitable deduction, or the gift qualifies for an estate tax charitable deduction in the grantor’s estate. I.R.C. §170(f)(2); I.R.C. §2522(c)(2); I.R.C. §2055(e)(2)(A); Treas. Reg. §1.170A-6(c)(3). While there is no upfront charitable deduction, if the trust provides for income to be paid to the charitable lead beneficiary, the income paid or set aside for charity will qualify for an income tax deduction. I.R.C. §642(c).

avoiding any estate tax. Once the artwork is sold and the proceeds of the sale invested, any income over the I.R.C. §7520 rate may pass to the non-charitable remainder beneficiaries free from federal transfer tax.

5. Testamentary Gifts.

An outright testamentary charitable gift will entitle the estate of the donor to an estate tax deduction at death.⁹⁷ Unlike the charitable income tax deduction, there are no percentage limitations on the estate tax charitable deduction, and no related/unrelated use or public charity/private foundation limitations.

6. Private Museums.

For a client who wants a charitable deduction but to retain a certain degree of control over his or her collection, the private museum is becoming a more popular option.⁹⁸ A collector may form a nonprofit private operating foundation and receive a federal income tax deduction for contributions to the museum. Artists too may wish to create their own private museum during life or at death.

A private operating foundation is a charitable entity that may be controlled by the family members and is exempt from income tax under I.R.C. §501(c)(3).⁹⁹ The foundation would need to be established and operated to use the contributed artwork exclusively for charitable or educational purposes that will confer a benefit upon the public and not the donors or their family members. The public must have access to the museum in order for it to qualify as a true charitable operation. Some foundations don't exhibit artwork; rather, they loan it to other art institutions for display.

Contributions to a private operating foundation are treated as if made to a public charity.¹⁰⁰ In contrast, the deduction to a non-operating private foundation is limited to the *lesser* of (1) 20% of the taxpayer's contribution base, or (2) the excess of 30% of the taxpayer's contribution base over the amount of charitable contributions allowable to public charities, determined without regard to the 30% limitation.¹⁰¹ Excess deductions may be carried forward for five years.

There are many compliance limitations that apply to private operating foundations and their donors. Unlike a private foundation, which is generally limited to passive grant-making to public charities, a private operating foundation directly operates a charitable activity or program, and dedicates its funds to operating that program, such as a museum. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt

⁹⁷ I.R.C. §2055(a).

⁹⁸ See Henry Neuendorf, *Art Demystified: What's Behind the Rise in Private Museums?*, Artnet (Aug. 25, 2016), <https://news.artnet.com/art-world/art-demystified-private-museums-593711>; Darren M. Wallace & Alexis Gettler, *The Charitably Inclined Collector*, 155 Tr. & Est. 13 (Aug. 2016).

⁹⁹ See Michael D. Martin & Mark B. Weinberg, *Private Operating Foundations: Helping Clients Explore "Hands-On Philanthropy"*, 14 Prob. & Prop. 18 (Sept./Oct. 2000).

¹⁰⁰ I.R.C. §4942(j)(3); Treas. Reg. §53.4942(b)-1.

¹⁰¹ I.R.C. §170(b)(1)(C)(i), (e)(1)(B)(ii).

purposes unless it serves a public rather than a private interest. It further states that “to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests.”

The donor family may not be permitted to use or have access to the donated property in any manner that is more advantageous than the public’s access to the property; such benefits must be incidental and tenuous. I.R.C. §4941(d) provides that self-dealing occurs when a private foundation transfers any of its income or assets to, or for the use or benefit of, a disqualified person, and Treas. Reg. §53.4941(d)-2(f) provides that incidental or tenuous benefits are not self-dealing. Determining whether a benefit qualifies as incidental or tenuous is not always clear, although the Service does provide some guidance. For example, the display of foundation-owned artwork in the private residence of a disqualified person may or may not qualify depending upon the facts and circumstances.

The IRS ruled in Rev. Rul. 74-600, 1974-2 C.B. 385 and TAM 8824001 (June 17, 1988) that if foundation-owned artwork is displayed at the private residence of a disqualified person, it will be considered self-dealing, if the general public is not able to tour the premises to view the artwork. In TAM 8824001, the donors permitted the public to tour the grounds, but not the house, upon request; most of the artwork was located near the personal use areas of the property rather than the property open to visitors, and there was no sign alerting the public to the museum’s location. The benefit to the disqualified persons was more than incidental and tenuous. But in PLR 8842045 (July 26, 1988), the IRS ruled that a disqualified person and a foundation may jointly own artwork and rotate its display between the foundation’s offices and the private residence of the disqualified person without running afoul of the self-dealing rules. The joint ownership of the artwork appears to account for the difference in treatment.

There are a number of advantages to creating a private museum during one’s lifetime. These include ensuring that the foundation actually carries out the founder’s wishes in the manner prescribed by the founder; the founder being eligible for a charitable income and gift tax deduction for the artwork and the funds required to establish the foundation; and the foundation being able to employ family members and other related parties to manage the foundation’s operations, so long as the foundation does not violate the self-dealing rules.¹⁰²

In spite of the many technical compliance requirements, in the appropriate situation the private operating foundation can provide a family with considerable flexibility in its charitable donation of an art collection. The family of the private foundation donor may control the management of the foundation. And, the foundation may use its funds to perpetuate the preservation of a collection rather than risk that it be sold off if donated to another institution.

E. Gifts Returned to the Donor.

¹⁰² I.R.C. §4941. Self-dealing restrictions apply to the grantor, substantial contributors, foundation managers, and family members of each of these individuals. Violation of the self-dealing rules can result in substantial excise taxes. I.R.C. §4941(d)(1)(E).

For various reasons, charitable gifts are sometimes returned: the donee is unable to carry out the donor's requirements; the donee is unable to properly store the collection; and facts related to the art are discovered that, had they been known at the time, the work would not have been accepted, among others.

If a charitable gift is returned to the donor, the donor must include the work on his or her income tax return at the value at the time it was returned, which may be substantially more than the value used for taking the original charitable deduction.¹⁰³

VI. Planning for the Transfer of a Particular Work or a Collection.

Once a collector knows the value of what he or she owns, he or she can begin to consider the planning options, both charitable and noncharitable. As an initial matter, a collector needs to think about whether he or she wants his or her collection to pass to individuals (outright or in trust), charity (with or without restrictions), or a combination of the two, or will it be sold? Will transfers take place during life, at death, or a combination of the two? Will the collector sell the collection or transfer it by gift? Before concluding that a gift to individuals is the ideal choice, it is important to determine whether they want it, whether they will understand its significance and have the means to preserve it, and whether there is a way to cover the estate taxes associated with the transfer.

Similarly, before gifting to charity, it is important to know whether the charity wants the gift, and if so, whether it plans to store, display, or simply sell the gift. Even a museum that would like the donation may not have the funds to maintain it.

A. Sell It Now or Transfer at Death?

Experienced collectors should not leave their fiduciaries and heirs to decide how best to dispose of a collection after they are gone. To the extent that the collector has specialized knowledge, it is always helpful to share that information with the planning attorney, the fiduciary, and the beneficiaries. Some items may sell better at auction; others through certain dealers who may even maintain waiting lists for particular artists. For items going to auction, would a local auction house (usually for less expensive works or local artists) or a national or international one (for more expensive works by artists with broader reputations) be better? Would the estate benefit from selling the works over time to avoid a blockage discount?¹⁰⁴

If a client wants the collection sold, a direction to do so should be included in the client's will or revocable trust. This will allow the expenses of sale to be deducted for estate tax purposes in a taxable estate.¹⁰⁵ Expenses of sale include appraisal fees, commissions, storage, and shipping. In

¹⁰³ PLR 8518033 (Feb. 1, 1985).

¹⁰⁴ Treas. Reg. §20.2031-2(e).

¹⁰⁵ I.R.C. §2053; Treas. Reg. §20.2053-3(d)(2).

a non-taxable estate, if there is a direction that the artwork be sold the expenses may be deductible on the estate's income tax return.¹⁰⁶

Websites can be used to value works based on past sales of similar items. These include WorthPoint, eBay, Prices4Antiques, askART, Artprice, and FindArtInfo (which provides samples of artists' signatures to help authenticate signed works). Some of these sites also facilitate sales.

Many families benefit from engaging a professional art advisor to provide market insight and act as a liaison with the art community, when determining the best way to dispose of or maintain a collection. One way to find such a professional is through the Association of Professional Art Advisors ("APAA").¹⁰⁷ The APAA is composed of independent art advisors, curators, and private collection managers. Members generally are expected to have an understanding of museum-quality methodology in registration, maintenance, conservation, art handling, and installation, as well as awareness of best practices for vendors and business partners—including support services such as framing, shipping, insurance, lighting, and security.

B. Is a Charitable Gift Appropriate?

If tax considerations are driving a client's choices with respect to a collection, a charitable gift may not always be appropriate. The following are a few issues that a client should consider before making a charitable contribution of artwork or collectibles to charity.

Based on the income tax rules outlined above, it is clear that a gift of appreciated property is preferable for lifetime gifts if a larger income tax deduction is desired. But it is important to avoid the income tax traps. Donations of artwork held as business inventory, works of art created by the donor, or capital assets held for less than one year will be denied long-term capital gain treatment. These may not be appropriate items for charitable giving.

A donation is not complete until the recipient organization accepts the contribution. This should be done in a written acceptance indicating the type of charity (public or private), whether it satisfies the related use rule, and whether anything was given to the donor in return. (Assuming nothing was given in return, a phrase substantially similar to the following must be included for substantiation purposes: "No goods or services, other than those describe herein, were provided to the donor in return for the gift.")

VII. Reporting and Paying Estate Tax.

Tangible personal property in an estate is reported on Schedule F (Other Miscellaneous Property Not Reportable Under Any Other Schedule) of Form 706. Schedule F requires appraisals to be attached for any items valued in excess of \$3,000 or any collection in excess of \$10,000. Items worth less than \$3,000 must be described, but a separate appraisal is not required.

¹⁰⁶ I.R.C. §67(e).

¹⁰⁷ APAA, <http://www.artadvisors.org/> (last visited Mar. 8, 2022).

A collection may often be the most valuable asset in an estate. When a family wants to retain a collection but lacks the liquidity to pay estate tax, there are planning opportunities to keep in mind. As discussed above, some families avoid facing the lack of liquidity issue by giving the collection to charity.

A. Life Insurance.

Many families use life insurance to cover the anticipated estate tax. This is also a good way to make one child whole, if another is to inherit a valuable collection.

B. Art Financing.

Instead of selling to raise funds to pay taxes, art can instead be used as collateral, so that the art need not be sold, or at least not immediately, to solve liquidity needs. Some financial institutions lend using art as collateral. Auction houses may offer loans at competitive rates so long as the owner has agreed to use the auction house to sell the collateral. For example, for consigned property, Christie's will lend up to 50% of the low range of the property's estimated return. After the consigned property is sold, the loan is paid off and the balance of the proceeds paid to the consignor. Longer-term loans are available to collectors willing to agree to the liquidation of their collection at a later date (typically from their estate). The advantage of selling post-death is that the owner may continue to enjoy the pledged work during his or her lifetime, and the pledged works obtain a stepped-up cost basis at the collector's death, eliminating capital gains tax (but not estate tax) on the sale. Other financial institutions offer a nonrecourse loan or even a line of credit secured by art.

Lenders vary from individual investors who specialize in all types of asset-based loans, such as Borro, to established investment banks that specialize in lending on fine art, such as Falcon Group in the United Kingdom, ArtAssure Ltd. in New York City, or Art Capital Group in New York City, which lends only on high-value artists with deep track records at auction.

Typically, the lender determines low/high estimates from auction houses and then lends between 40% to 60% of the estimated total low auction estimate of the property proposed as collateral. Interest rates can vary depending on the value of the artwork, whether it is simply being held as collateral or if it is being held for private sale or auction, and a number of other factors.

In many instances, the lender will accommodate requests by museums to exhibit the collateral during the term of the loan because of the potential positive impact a museum exhibition will have on its value.

VIII. Artistic Executors.

Like a literary executor for writers, it may make sense to name an artistic executor, who will handle the art collection in a fiduciary capacity. Or, where a client has a team of advisors, precatory wishes that the team be consulted should be included in the client's will or revocable trust. If a client has not assembled a team of advisors, there are plenty of art consultants, intermediaries, and advisors available for a fee. *In re Estate of Warhol*, is one of the earliest cases to examine the

duties of the artistic executor, the attorney for the literary executor, and the reasonableness of their fees.¹⁰⁸

Below is a nomination provision that identifies the property to be specially administered, appoints an individual separate from the formally appointed executor of the estate, to administer that property, gives that individual the necessary powers, which include marketing, sale, consignment, copyright, and licensing, and protects the artistic executor from liability.

In states that permit the use of a limited purpose executor, separate letters of administration are issued to artistic executors who have all the powers and duties of executors but only over the property that is to be specially administered.

Appointment of Artistic Executor

- (1) I direct my Artistic Executor to sell my remaining works of art, and I give the net proceeds of such sales to my issue.
- (2) I nominate _____, Artistic Executor to be responsible for the disposition of my works of art, but if he or she does not survive me, fails to qualify as Artistic Executor, or ceases to act prior to completing the disposition of my art, I nominate _____, Artistic Executor in his or her place or to succeed him or her, as the case may be. My Artistic Executor shall not be required to furnish a bond or other security in such capacity in any jurisdiction.
- (3) My Artistic Executor shall have exclusive authority and responsibility for the administration and disposition of artworks created by me/in my collection. My Artistic Executor shall oversee the selection of my works of art by my named individuals/trusts/charities. I direct that my Artistic Executor shall receive compensation for his or her services, which shall not exceed fifty percent (50%) of the selling prices of those works of art that are sold. Such compensation shall be paid from the sale proceeds.
- (4) I authorize my Artistic Executor to act as the dealer for any works of art to be sold and/or to engage such other art dealers as my Artistic Executor deems appropriate. If my Artistic Executor uses other dealers for the sale of artworks, the compensation or commissions due the other art dealer shall be paid from the compensation due my Artistic Executor. I recognize that my Artistic Executor may have a conflict of interest in determining how to sell works of my art. Nevertheless, I have complete confidence in the integrity and judgment of the two individuals whom I have designated as Artistic Executor and alternate, and I hereby relieve and release my Artistic Executor from any and all liability, which might otherwise be imposed because of a conflict of interest or perceived conflict of interest.

¹⁰⁸ 165 Misc. 2d 726, 629 N.Y.S.2d 621 (1995).

- (5) Upon the receipt by my Artistic Executor of the net proceeds of any sale, my Artistic Executor shall make an accounting to my Executors and shall deliver such net proceeds to my Executors for payment to my beneficiaries.

An additional duty to consider is whether the artistic executor will be responsible for protecting the trademark or publicity value of the artist's name and signature, and the artist's moral rights, if any, that survive the artist's death.

IX. Issues for the Fiduciary.

Fiduciaries are often burdened with the task of maintaining, safeguarding, and disposing of or distributing collections. Many may not ever know the value of the collection they have been entrusted with. An uninformed fiduciary may not ever discover what he or she has in his or her possession, and therefore fail to properly safeguard what has come into his or her possession, insure, appraise, or get the best value if items are sold. Collections to some may look like items to be donated or, even worse, dropped into a dumpster.

Fiduciaries need to be aware that heirs often remove items from the house not realizing that they are part of the estate, or *because* they know that they are part of the estate and think that by removing them they can avoid subjecting them to estate tax.

The fiduciary for an artist or art collector may need to take some or all of the following actions.

A. Secure the Collection.

Installing a security system is the first step to securing a collection, if one is not already in place. But that is only the beginning. For the more valuable collection, a security patrol service may be warranted. In some cases, an on-site security patrol may also be appropriate. In addition, individual works may be securely attached with their own alarms that are armed even when the security system for the site is turned off. Individual works can be monitored using wireless tracking devices, motion detectors, infrared beams, and closed-circuit television monitoring systems.

Collections need to be protected from damage. Art and valuable collectibles should be stored in a climate-controlled and secure environment. Changes in temperature, smoke, humidity, and any contact with water can ruin a collection. Even furniture is extremely susceptible to changes in humidity and temperature. Professional framing provides additional protection. Art that is displayed should be hung or mounted by professionals and the location should also be evaluated for risks, including the possibility of bursting pipes, flooding, sunlight, and any other relevant factors.

Before being moved, art should be inspected for condition before being professionally crated and inspected again when unpacked, to assess any damage in transit. It should be moved in a climate-controlled vehicle if possible, and consideration should be given to travelling with a security specialist or being followed by one when dealing with extremely valuable pieces.

B. Property and Casualty Insurance.

Determine whether appropriate insurance is in place. Some collectors choose to “self-insure.” If already insured, the insurance company should be notified of the death and should be asked to add as insureds the estate, its fiduciaries, and beneficiaries. If there is no insurance, determine whether obtaining it would be prohibitively expensive.

No amount of planning is useful if a collection is stolen or damaged. Clients often believe that their household property and casualty insurance covers their collections. This is usually not the case. They also may believe that they would be eligible for an income tax loss deduction if a loss were to occur. But, as discussed above, losses are not deductible for collectors.¹⁰⁹ Collections and individual items of any significant value need to be appraised and separately listed under most insurance policies.

Some collectors understand that their particular collection is irreplaceable if it were to be stolen or destroyed, and aren’t interested in financial reimbursement if it is, so they don’t insure at all and avoid the cost of insurance entirely.

Insurance is far from one size fits all. It could cover “all risks” or only “stated perils.” For some collections, only stated perils will be covered. It should never be assumed that art is covered by a homeowner’s policy, and even if a loss is covered, coverage under a homeowner’s policy alone likely will result in significant out-of-pocket expenses compared to a specialized art policy.

Not all risks can be covered. A fragile sculpture mounted next to a swimming pool simply can’t be covered for sun or water damage. Earthquake coverage is also difficult to obtain for most objects, especially on the West Coast. And most policies exclude coverage for lost or misplaced items, sometimes referred to as “mysterious disappearance” or “empty hook syndrome.”¹¹⁰ According to the Barron’s Insurance Dictionary, a “mysterious disappearance clause” excludes coverage for loss of property if the cause of the loss cannot be identified.

The majority of fine art losses occur while items are in transit.¹¹¹ Insurance should cover works while in transit and the insurance company should be able to recommend vetted companies to handle condition reports, crate building, rigging, packing, installation and deinstallation, permitting, transportation, and security, to name only a few of the issues that may be involved in moving a valuable collection.

It is important to know whether partial loss or total loss is covered. For example, glass objects by Dale Chihuly often come with many separate parts, where each individual piece would be valued on its own. If one piece is destroyed, leaving the remaining parts intact, some policies may not

¹⁰⁹ I.R.C. §183 (denying most deductions attributable to activities not engaged in for profit); I.R.C. §262 (denying a deduction for personal losses and expenses).

¹¹⁰ Michael Campbell, *Art and Antique Estates: A Guide to Planning for Life and Death*, 6 Est. Plan. & Cmty. Prop. L.J. 83, 86 (2013) (citing Michael Mendelsohn & Paige Stover Hague, *Life Is Short, Art Is Long: Maximizing Estate Planning Strategies for Collectors of Art, Antiques, and Collectables* 243 (Wealth Mgmt. Press ed. 2007)).

¹¹¹ Holly Hubbard Preston, *The Fine Art of Shipping Art – At Home Abroad – International Herald Tribune*, N.Y. Times (Apr. 28, 2006), <https://www.nytimes.com/2006/04/28/style/the-fine-art-of-shipping-art-at-home-abroad-international-herald.html>.

cover the partial loss. In a market where values are changing rapidly but insurance isn't adjusted regularly for that increase, a policy needs to have a special endorsement to cover increase in value. Some policies automatically increase coverage by a certain percent each year.

Once reimbursed for a loss, if a stolen object is recovered it belongs to the insurance company. The doctrine of "subrogation" allows an insurance company to stand in the place of the insured once it has paid proceeds to the insured.¹¹² Receipt of insurance proceeds in excess of the collector's basis will trigger taxable gain.¹¹³ Some policies allow a client to surrender the insurance proceeds back to the company in exchange for the object.

If there is an issue of ownership or authenticity, discussed below, and no other remedies or insurance policies apply, the Uniform Commercial Code ("UCC") may provide some protection. The warranties of good title and authenticity found in both express and implied terms under the UCC are intended to ensure that purchasers are entitled to the benefit of their bargains.¹¹⁴ Among its many limitations and shortfalls, the UCC does not allow the injured party to recover any attorney fees associated with the disputer; rather, each party must pay for its own fees.¹¹⁵ Furthermore, the UCC's entrustment provision, UCC §2-403(2), does not apply to art consigned for sale at auction, which is a method frequently used to obtain high-end artwork.¹¹⁶

C. Copyrights.

While copyrights are beyond the scope of this outline, a fiduciary may need to inventory copyrights, copyright assignments, licensing agreements, copyright renewals, and exercises of termination rights, and any similar arrangements, and engage competent advisors to deal with these matters. See <https://www.arsny.com/copyright-basics> for background concerning copyrights in the context of art of artists. Consideration should be given to the exercise of termination rights. Services can be engaged to manage and provide copyright clearances.¹¹⁷

D. Is the Collection Taxable? Obtain an Appraisal.

Most estates do not meet the federal or state (if any) filing thresholds. However, one valuable piece could push a nontaxable estate into being a taxable one. Therefore, as a preliminary matter,

¹¹² 16 Steven Plitt et al., *Couch on Insurance* § 222:5 (3d ed. 2005); see also 73 Am. Jur. 2d *Subrogation* § 1 (2001) ("'Subrogation' is broadly defined as the substitution of one person in the place of another with reference to a lawful claim or right.").

¹¹³ I.R.C. §1231(a). There is a limited exception if the proceeds are used to purchase similar replacement property within two years of the year in which the gain was realized. I.R.C. §1033(a)(2).

¹¹⁴ UCC §2-312.

¹¹⁵ See generally Leonard D. Duboff, *The Antique And Art Collector's Legal Guide: Your Handbook to Becoming a Savvy Buyer* (2003) (explaining the importance of determining authenticity and transferability before purchasing art).

¹¹⁶ See Steven E. Thomas, *Auction Consignment Agreements: Pitfalls and Planning Strategies*, 36 Est. Plan. 23 (Apr. 2009), for a thorough discussion concerning auction consignment agreements.

¹¹⁷ See Artists Rights Soc'y, <https://www.arsny.com/> (last visited Mar. 8, 2022), and Visual Artists & Galleries Ass'n, <http://vagarights.com/> (last visited Mar. 8, 2022).

an estate fiduciary who even suspects that an estate may contain items of significant value should have it reviewed by a qualified appraiser. The appraiser can identify any items that require further review to determine whether they meet the individual appraisal requirements for a taxable estate, and/or whether they would cause the otherwise nontaxable estate to be subject to tax.

Where warranted, obtain qualified appraisals from qualified appraisers to determine the date of death value and to establish the date of death on a stepped-up basis.

E. Prepare an Inventory.

If an inventory has not been completed during the collector's lifetime, this will be one of the first tasks of the collector's fiduciary after death. An accurate inventory is critical to substantiate and protect what a client owns. A lack of provenance (a historical record of ownership) makes it harder to legitimately dispose of items later on and may impact the rights of legitimate owners later in the chain of title.

When preparing an inventory, keep in mind that works may be on loan, out to be reframed or restored, consigned with a dealer, or even recently purchased and not yet delivered.

To document provenance, authenticity, and value, an inventory ideally would contain the following information:

1. Current owner;
2. Artist and biographical information on the artist;
3. Current and any former titles it may have been given;
4. Creation date as well as other important dates associated with the piece, such as the date the piece was commissioned, copyrighted, cast (often found next to the foundry's mark), or dedicated (often located on the pedestal of the sculpture);
5. Subject description (for abstract works, provide a description of the predominant forms, colors, shapes, sizes, or textures, for portraits provide biographical information);
6. Materials;
7. Dimensions;
8. Condition reports;
9. Purchase price, bill of sale, and date;
10. Photos;
11. Location of object;

12. Distinguishing features, inscriptions, and markings, and inventory numbers, artist's signature, and all other writing;
13. How it is framed, mounted, or secured;
14. Dates and description of repairs;
15. Previous owners (further investigation may be needed with antiquities and any work created before 1946 thought to have been in Europe after 1932);
16. Loan history: exhibition dates, venues, and the value placed on the work at the time of the loan (include notes about its condition before it leaves and when it arrives, and require a condition report from each location);¹¹⁸
17. Where published illustrations or descriptions may be found, whether it is included in the catalogue raisonné of the artist; and
18. Current appraisal and appraisal history.

There are companies that will inventory a collection as well as public databases for the do-it-yourself collector (such as the Getty Research Institute, <http://www.getty.edu/research/tools/> (last visited Mar. 8, 2022)) and database software designed specifically for art collections.¹¹⁹

Inventories of large and valuable collections should be updated periodically. Location of pieces should be confirmed and pieces should be evaluated for damage, and repaired if necessary.

X. Issues with Ownership.

Having clear title to artwork is more than just the right to enjoy looking at it. Title includes the unrestricted right to hold, use, sell, donate, exhibit, pledge as financial collateral, or otherwise enter into transactions with the work. Collectors typically assume that they have good title to assets they own and that they aren't subject to conflicting ownership claims. This is not always the case. But there are ways to protect clients and hedge against losses when ownership may be in doubt.

A. Stolen Property.

In the world of art and collectibles, unbeknownst to the purported owner, because of theft, looting, and war crimes, others may have superior claims, even in the most carefully acquired and curated collections. Often these claims only come to light when a family attempts to sell an important work of art at auction, to generate needed liquidity to pay estate tax. This not only creates an added expense and complexity to an estate, but it may subject the personal representative who signed an

¹¹⁸ Condition reports are critical in determining the time at which damage to the artwork occurred, which may be necessary when determining liability.

¹¹⁹ See Collectrium, www.collectrium.com (last visited Mar. 8, 2022), a subscription cloud-based service that provides a platform to integrate all collection data, management, market information, and maintenance in one place. Similar programs are reviewed at Gallery Software (last updated Jan. 2017), <http://www.gallerysoftware.com>.

auction agreement (which typically requires the signer to guarantee good title and to indemnify the auction house for liabilities due to lack of marketable title) to personal liability.

It is important that clients confirm that what they are purchasing or have purchased is neither stolen nor forged. For a fee, a client may obtain information on the title of a work. One such company, Art Title Advisors (www.arttitleadvisors.com), will prepare an Ownership Rights Protection Report that describes the results of their investigations into title using public and private databases.

There are a number of resources for doing due diligence. The International Foundation for Art Research, <https://www.ifar.org/authentication.php> (last visited Mar. 8, 2022), and The Art Loss Register, www.artloss.com (last visited Mar. 8, 2022) (a London-based organization), allow a potential purchaser to check that an item has not been registered as stolen, and to record items that have been stolen, to put others on notice.

The FBI also has an online database, the National Stolen Art File, <https://www.fbi.gov/investigate/violent-crime/art-theft/national-stolen-art-file> (last visited Mar. 8, 2022), that allows a potential purchaser to check whether an item has been stolen.

Art may also be subject to claims of cultural patrimony because it was plundered from an archaeological site or illegally confiscated by a government such as works seized by the Nazis. A number of statutes allow for seizure, recovery, and repatriation. Museum policies regarding the obligation to return works include provisions of the United Nations Educational, Scientific and Cultural Organization (“UNESCO”) Convention (discussed below); the Native American Graves Protection and Repatriation Act; and the Endangered Species Act (discussed below). They also include the ICOM Code of Ethics for Museums; and the following publications by the Association of Art Museum Directors (“AAMD”): the AAMD Art Museums and the Restitution of Works Stolen by the Nazis; the AAMD Guidelines on the Acquisition of Archeological Materials and Ancient Art; and the AAMD Report on the Acquisition and Stewardship of Sacred Objects.

1. The HEAR Act.

On December 16, 2016, President Obama signed into law the Holocaust Expropriated Art Recovery Act of 2016 (the “HEAR Act”), which establishes a uniform federal statute of limitations for claims seeking the recovery of artwork and certain other objects that were confiscated between January 1, 1933 and December 31, 1945 because of Nazi persecution.¹²⁰ The intent of the Act is to ensure that claims to artwork and other property stolen or misappropriated by the Nazis are not unfairly barred by statutes of limitations. In *Philipp v. Federal Republic of Germany*, 894 F.3d 406 (D.C. Cir. 2018), vacated and remanded by *Federal Republic of Germany v. Philipp*, 141 S.

¹²⁰ Holocaust Expropriated Art Recovery Act of 2016, Pub. L. No. 114-308, 130 Stat. 1524. See *Amelia K. Brankov & Lily Landsman-Roos, Congress Passes Important Law Governing Nazi-Looted Art Claims*, 156 Tr. & Est. 62 (Mar. 2017), for a thorough examination of this Act.

Ct. 703 (2021), the lower court held that under some circumstances, sales under duress are void and violate international law consistent with the policies of the HEAR Act.¹²¹

As a result of the HEAR Act, claims must be brought within six years of the claimant’s discovery of “(1) the identity and location of the artwork or other property; and (2) a possessory interest of the claimant in the artwork or other property,” giving rise to the claim.¹²² It is important to note that the statute does not preclude a laches defense.¹²³

The HEAR Act applies to all claims filed through 2026, and those pending at the time of enactment. In addition to artwork, the HEAR Act applies to books, archives, musical objects, manuscripts, sound, photographic, and cinematographic archives and media, and sacred and ceremonial objects and Judaica.¹²⁴ Claims filed after January 1, 2027 will be subject to the statutes of limitations then under effect and will not be afforded the enhanced statute of limitations of the HEAR Act.

2. The UNESCO Convention.

The 1970 UNESCO Convention on the Means of Prohibiting and Preventing the Illicit Import, Export and Transfer of Ownership of Cultural Property¹²⁵ (ratified by the U.S. by the 1983 Convention on Cultural Property Implementation Act¹²⁶) gave the signatories a mechanism to seek the return of illegally obtained cultural objects and antiquities, and a means for the signatories to cooperate to this end.¹²⁷

¹²¹ Cited by *Reif v. Nagy*, M-5280, 2019 NY Slip Op. 60524 (N.Y. App. Div. Jan. 10, 2019), in which the heirs of Viennese actor and Holocaust victim Franz Friedrich (Fritz) Grünbaum are entitled to the return of two Egon Schiele drawings, *Woman Hiding Her Face* (1912) and *Woman in a Black Pinafore* (1911). See also Simrit Hans, *The Unresolved Injustices of Nazi-Looted Art: A look at the 2016 HEAR Act*, Washington J. of Law, Technology & Arts, University of Washington School of Law (Feb. 12, 2020), <https://wjta.com/2020/02/12/the-unresolved-injustices-of-nazi-looted-art-a-look-at-the-2016-hear-act/>.

¹²² HEAR Act §5(a).

¹²³ In *Zuckerman v. Metropolitan Museum of Art*, 928 F.3d 186 (2d Cir. 2019), the Second Circuit held that the defendant museum was entitled to a laches defense in response to a HEAR Act claim. *Id.* at 190.

¹²⁴ HEAR Act §4(2).

¹²⁵ Adopted by UNESCO on Nov. 14, 1970, http://portal.unesco.org/en/ev.php-URL_ID=13039&URL_DO=DO_TOPIC&URL_SECTION=201.html.

¹²⁶ 19 U.S.C. §§2601-2613; see Bureau of Educational & Cultural Affairs, Background, <http://eca.state.gov/cultural-heritage-center/cultural-property-protection/process-and-purpose/background> (last visited Mar. 8, 2022).

¹²⁷ “Cultural Property” is defined in Article 1 of the Convention, <https://web.archive.org/web/20180601233603/http://www.unesco.org/new/en/culture/themes/illicit-trafficking-of-cultural-property/1970-convention/text-of-the-convention> as:

property which, on religious or secular grounds, is specifically designated by each [signatory country] as being of importance for archaeology, prehistory, history, literature, art or science and which belongs to the following categories:

(continued)

3. The National Stolen Property Act.

The National Stolen Property Act of 1934¹²⁸ is also used to combat and repatriate illegal cultural heritage looting. It applies within the U.S. to the trafficking of “goods, wares, merchandise, securities, or money” valued at \$5,000 or more, which have been “stolen, converted or taken by fraud” then transported, transmitted, or transferred in interstate or foreign commerce. The term “goods, wares, merchandise” is not defined but has been interpreted to include the “general and comprehensive designation of such personal property or chattels as are ordinarily a subject of commerce.”¹²⁹

4. Domestic Recovery Laws and Other Methods of Recovery.

-
- (a) [r]are collections and specimens of fauna, flora, minerals and anatomy, and objects of paleontological interest;
 - (b) property relating to history, including the history of science and technology and military and social history, to the life of national leaders, thinkers, scientists and artists and to events of national importance;
 - (c) products of archaeological excavations (including regular and clandestine) or of archaeological discoveries;
 - (d) elements of artistic or historical monuments or archaeological sites which have been dismembered;
 - (e) antiquities more than one hundred years old, such as inscriptions, coins and engraved seals;
 - (f) objects of ethnological interest;
 - (g) property of artistic interest, such as:
 - (i) pictures, paintings and drawings produced entirely by hand on any support and in any material (excluding industrial designs and manufactured articles decorated by hand);
 - (ii) original works of statuary art and sculpture in any material;
 - (iii) original engravings, prints and lithographs;
 - (iv) original artistic assemblages and montages in any material;
 - (h) rare manuscripts and incunabula, old books, documents and publications of special interest (historical, artistic, scientific, literary, etc.) singly or in collections;
 - (i) postage, revenue and similar stamps, singly or in collections;
 - (j) archives, including sound, photographic and cinematographic archives;
 - (k) articles of furniture more than one hundred years old and old musical instruments.

Each signatory country may define its own cultural property, under the condition that it must be of importance and within the categories defined above.

¹²⁸ 18 U.S.C. §2311, *et seq.*

¹²⁹ *United States v. Seagraves*, 265 F.2d 876, 880 (3d Cir. 1959).

There are a number of other ways that art and certain objects can be recovered, including replevin, forfeiture criminal prosecution, and domestic recovery laws.¹³⁰

Federally owned and controlled lands as well as tribal lands are subject to the Archeological Resources Protection Act (“ARPA”) and the Native American Graves Protection and Repatriation Act (“NAGPRA”).¹³¹ These are only two of the laws that prosecute archeological crimes, including vandalism, looting and theft of cultural property, human remains, antiquities, art, artifacts, and architecture.

The U.S. has also entered into a number of agreements with other countries recognizing a country’s right to control exports. There are also a number of other doctrines that apply to looted and stolen art, antiquities, and cultural property. UNESCO maintains a database of cultural heritage laws, available at <https://en.unesco.org/cultnatlaws>, that can be useful as a starting place to determine whether another country may have a right to claim ownership.

The U.S. also regulates the importation of antiques and endangered species under the Endangered Species Act (the “ESA”).¹³² Generally, the ESA allows “the importation and other activities without an ESA permit of an antique article (referred to as an ‘ESA antique’) that: A. Is not less than 100 years of age; B. Is composed in whole or in part of any endangered species or threatened species listed under section 1533 of the Act; C. Has not been repaired or modified with any part of any such species on or after December 28, 1973; and D. Is entered at a port designated for the import of ESA antiques.”¹³³ All importation must also meet the standards under the African Elephant Conservation Act, the Marine Mammal Protection Act, and the Wild Bird Conservation Act.¹³⁴ An appraisal submitted as documentary evidence of an article’s eligibility under the ESA antique exception must meet certain criteria, similar to those that apply to qualified art appraisers, which are available at <https://www.fws.gov/policy/do210A1.pdf>.

B. The Visual Artists Rights Act of 1990 (“VARA”).

Art collectors and their fiduciaries need to be keenly aware of the application of VARA.¹³⁵ VARA protects visual artists’ “moral rights” by prohibiting the destruction of “visual art,” including

¹³⁰ See U.S. Dep’t of Justice, Cultural Prop. L., Vol. 64 (Mar. 2016), for a thorough discussion of applicable laws and principles governing the prosecution of crimes involving archeological objects and cultural property.

¹³¹ Archaeological Resources Protection Act of 1979, Pub. L. No. 96-95, 93 Stat. 721 (Oct. 31, 1979), (codified at 16 U.S.C. §§470aa-470mm); The Native American Graves Protection and Repatriation Act, Pub. L. No. 101-601, 104 Stat. 3048 (codified at 25 U.S.C. §3001 *et seq.*).

¹³² See U.S. Fish & Wildlife Serv., Director’s Order 210, Appendix 1, Guidance on the Antique Exception Under the Endangered Species Act (ESA) (2014).

¹³³ *Id.* at 1 (footnote omitted).

¹³⁴ For an excellent explanation of the law applicable to ivory, see Jonathan Riedel (2016), *Understanding Ivory Law*, <https://www.arttrak.com/blog-content/2017/8/fitz-gibbon-law-source-for-ivory-update>. Note that some state laws regarding the ivory trade are more restrictive than federal law.

¹³⁵ Pub. L. No. 101-650, §§601-610, 104 Stat. 5089, 5128-33.

paintings, drawings, sculptures or photographs, models, and even unfinished works of “recognized stature.”¹³⁶ Only certain art is protected by VARA: works that fit a definition of “Works of Visual Art” in §101 of the Act. Multiples such as sculpture and prints and photographs are only protected if the work is a unique print or if it is in signed and numbered editions of 200 or fewer. Excluded items include posters, maps, models, applied art, motion pictures, or other audiovisual works, periodicals, databases, and art produced for primarily commercial purposes, such as advertising, packaging, or promotional material. Also excluded is any portion of a mixed-media work of art incorporating one of the specifically excluded items. By listing inclusive and exclusive works, the status of works in media not listed at all remains uncertain. For example, to what extent a mixed-media or craft work would be protected, or a piece of performance art “fixed” on digital media, has been left to the courts to decide.

Purchase of a piece of artwork does not cut off the rights of the creator of that work. In fact, as discussed below, how the purchaser treats that art could be subject to monetary penalties years after the date of purchase.

Art of “recognized stature” is art that “art experts, the art community, or society in general” views as possessing stature.¹³⁷ The creator of art covered by VARA will have the right to sue to prevent its destruction or, if the damage has already occurred, the artist may be entitled to damages ranging from \$750 to more than \$30,000, and increasing to \$150,000 for willful infringement (or limited to \$200 for innocent infringement).¹³⁸ VARA rights are non-transferrable, and are exercisable only by the artist.¹³⁹ And, VARA rights expire with the death of the artist (or if a joint work, at the end of the last surviving artist’s life.)¹⁴⁰

Building owners (and their fiduciaries) must recognize that VARA protects works of recognized stature that have been “incorporated in or made part of a building in such a way that removing the work from the building will cause the destruction, distortion, mutilation, or other modification of the work.”¹⁴¹ Examples include murals, frescoes, and sculptures that have been affixed or embedded into a building’s floors, walls, or ceilings.

There are limited exceptions to VARA liability, discussed below.

1. Explicit Waiver.

If artwork *cannot* be safely removed from the property, removal by the building’s owner would violate the artist’s VARA right unless the artist either (a) consented to the installation of the work

¹³⁶ *Id.* (codified at 17 U.S.C. §106A(a)(3)(B)).

¹³⁷ Christopher J. Robinson, *The “Recognized Stature” Standard in the Visual Artists Rights Act*, 68 Fordham L. Rev. 1935, 1950 (2000) (citation omitted).

¹³⁸ 17 U.S.C. §504(b)-(c).

¹³⁹ 17 U.S.C. §106A(e)(1).

¹⁴⁰ *Id.*

¹⁴¹ 17 U.S.C. §113(d)(1)(A).

into the building before VARA's effective date (June 1, 1991), or (b) the right was waived by the execution of a written agreement entered into by both the artist and the building owner.

A written agreement waiving VARA's application must, at a minimum, contain the following: (i) identification of the work and uses of that work to which the waiver applies; and (ii) specification that installation of the work may subject the work to destruction, distortion, mutilation, or other modification, by reason of its removal.¹⁴² For works prepared by multiple artists, a waiver made by one will waive the rights of all others.¹⁴³

2. De Facto Waiver.

For artwork incorporated into a building, which *may* be safely removed, VARA only requires that building owners make a "diligent, good faith" attempt to notify the artist of its intention to remove the work.¹⁴⁴ There is a presumption of such attempt if the building owner sends notice by registered mail to the artist at his or her most recent address as recorded by the Register of Copyrights.¹⁴⁵ No VARA claim may be made, even if the valid attempts were unsuccessful, or if the owner provides notice, but the artist fails to remove the work or to pay for its removal within 90 days after receiving notice.¹⁴⁶

If a building owner required that an installation be constructed in such a way that it may be safely removed without destruction of the work, a waiver would not be necessary.

3. Work for Hire.

VARA rights also do not apply to works "made for hire," which means either: a work prepared within the scope of an employee's employment; or a work commissioned as part of a collective work or a compilation, that has been agreed in writing, signed by both parties, to be work made for hire.¹⁴⁷

A fiduciary who comes into the possession of an art collection, especially one containing modern works, must consider whether VARA rights may have attached to any of the works, whether they have been waived, and if not, how violation can be avoided.

C. Title Insurance.

¹⁴² 17 U.S.C. §113(d)(1)(B).

¹⁴³ 17 U.S.C. §106A(e).

¹⁴⁴ 17 U.S.C. §113(d)(2).

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ 17 U.S.C. §101.

One way to hedge against the possibility of purchasing property subject to later title disputes is title insurance.¹⁴⁸ Provenance documents the history of a work's ownership, but it doesn't establish clear title. A work may have well-documented provenance, but anywhere along the chain of ownership someone may not have had clear title, putting subsequent individuals in the chain of ownership at risk of not having clear title.

In most sales of art, whether handled privately or through an auction house or a gallery, the seller must represent and warrant in the sales or consignment document that the seller (whether an individual or fiduciary) has clear legal title to the offered work. Similarly, the donor or lender to a charitable institution must provide such warranties. After the transaction, if an actual or alleged title defect or challenge arises, the trust, estate, and beneficiaries can be liable for indemnity to the buyer or recipient under the contractual guarantee of clear legal title to the art. Failure to possess good title could result in a sale or donation being unwound and sale proceeds disgorged. For example, Sotheby's provides a guaranty of good title to a purchaser for five years from the date an item is purchased at auction. A title policy can mitigate some of these inherent risks.

For example, ARIS Title Insurance Corporation (owned by Argo Group)¹⁴⁹ offers two types of policies: (i) an owner's policy for pending sales or existing collections, and (ii) a lender's policy for lenders facilitating clients borrowing against their art. Title insurance for art and collectibles typically covers four categories of risks: theft, import and export defects, liens and encumbrances, and illegal or unauthorized sales. A typical policy covers the legal costs of defending a title or dispute and compensates holders if they lose an ownership dispute.¹⁵⁰ ARIS charges a one-time premium based on the work covered, its provenance risk profile, and value.

Until recently unheard of, as collectors more frequently use their art as collateral, the use of title insurance is gaining popularity and becoming more common.

XI. NONFUNGIBLE TOKENS.

A. What Is an NFT?

A nonfungible token or "NFT" is a unique digital unit of data (often referred to simply as a "token") stored on a blockchain. (The blockchain is a peer-to-peer decentralized distributed ledger technology that makes the records of any digital asset transparent and unchangeable and works without involving any third-party intermediary.) It can be a representation of something (a work of art, a photo, video, online game, a tweet, or other types of digital files), or it can be an original creation that exists only in digital form. NFTs are typically purchased and sold using the type of cryptocurrency or token used or accepted on that particular blockchain.

¹⁴⁸ See Charles Danziger & Thomas Danziger, *An Ounce of Prevention*, 35 *Art + Auction* 73 (Dec. 2011), <http://www.danziger.com/brothersinlaw/2011-12.pdf>, for a discussion concerning art title insurance.

¹⁴⁹ ARIS, Art Title Protection Insurance, <https://www.argolimited.com/aris/product/art-title-protection-insurance/> (last visited Mar. 8, 2022).

¹⁵⁰ See <https://www.argolimited.com/aris/product/art-title-protection-insurance/> for a list of types of losses covered.

An NFT can be a representation of a single, one-of-a-kind asset, or one of multiples in a series. Once an NFT is created on a blockchain, all of its subsequent sales are tracked, time stamped, and recorded. Because each NFT is uniquely identified on the blockchain, its metadata cannot be duplicated or replicated, making it nonfungible and trackable. Even when multiple replicas are created using the same content, each NFT has unique metadata. No third-party authentication is necessary. Therefore, NFTs offer artists and other creative individuals the opportunity to control the digital content they have generated.

People who create NFTs are often referred to as “creators” and the process of initially recording the NFT on the blockchain is often referred to as “minting.” Creators include artists, musicians, celebrities, influencers, athletes, sports fans, collectors, and authors.

B. An NFT Is a Smart Contract.

NFTs are “smart contracts”; their metadata includes the contractual terms and conditions that govern their use. Purchasers only receive the rights granted to them in the NFT metadata, while creators can retain ownership of the content that is associated with the NFT.

The smart contract is linked to some form of intellectual property (an image or video, in the art world), which the content creator (an artist like Beeple) conceived and sold, but the NFT is not the intellectual property itself. The NFT does not contain a Beeple image. It is simply an address that links to the intellectual property.

Collectors need to understand that the NFT is initially linked to a physical server. Servers are not without risk. Therefore, it is important for collectors and clients to understand the types of storage for their NFTs, and the inherent risks associated with each type.¹⁵¹

There are both hardware wallets and software wallets. Popular software wallets include Coinbase, Metamask, and Trust Wallet. Software wallets can get hacked and their servers can go down or no longer be supported, losing the content stored on them. Then there are hardware wallets, which are physical devices that store the private keys for NFTs and allow that information to be sent or received and transactions executed from any device connected to the Internet. Hardware wallets can’t be hacked but they can be lost. Popular hardware wallets include Trezor and Ledger.

There is also the IPFS or “InterPlanetary File System,” which is a decentralized file storage system that uses peer-to-peer protocols to create distributed applications. It allows users to store files in an anonymous but permanent fashion, with no single point of failure.

C. Classification of NFTs for Tax Purposes: No Direct IRS Guidance.

¹⁵¹ See Fiverr Team, How to Securely Store Your NFTs: The Ultimate Guide, Fiverr Blog (Feb. 14, 2022), <https://blog.fiverr.com/post/how-to-securely-store-your-nfts-the-ultimate-guide>, for tips on storage, including the InterPlanetary File System (“IPFS”).

In IRS Notice 2014-21 (2014-16 I.R.B. 938) and FAQs (updated January 25, 2022), the IRS addressed the taxation of *convertible* cryptocurrency, which is cryptocurrency with an equivalent value in fiat currency (such as the U.S. dollar) that can be purchased for or exchanged into such currency or used to buy goods and services. Bitcoin, Dogecoin, Ethereum, Tether, and Cardano are a few popular convertible cryptocurrencies. According to the IRS, convertible cryptocurrency is property, not currency.

Notice 2014-21 does not address the tax character of non-convertible cryptocurrencies, which includes NFTs, but it is likely that NFTs are also property for tax purposes and for purposes of the Notice. But if we apply the general tax principles that apply to convertible cryptocurrency transactions to NFTs: the IRS treats the purchase or sale of an NFT like a stock sale with the short- and long-term gains based on the tax basis at acquisition.

D. Capital or Ordinary Assets; Collectibles.

Assuming Notice 2014-21 is authoritative, in the hands of creators of and dealers in NFTs, NFTs are ordinary assets. Such taxpayers have ordinary income and loss on their NFT transactions. For creators, an NFT is an ordinary income asset because it is created by the taxpayer's personal efforts or is property that was prepared or produced for the taxpayer.¹⁵² An NFT is also an ordinary asset in the hands of a dealer because the taxpayer is holding it as inventory or for sale to customers in the ordinary course of business.¹⁵³ An NFT dealer receives ordinary income and loss on sales of NFTs.

As discussed above in Section II.C, collectibles are a unique category of items subject to a special capital gain tax rate or 28%. Because each NFT is unique, those that are similar to works of art and other collectibles might be treated as collectibles. Those that are held for the long-term holding period are subject to the higher 28% capital gain rate. Taxpayers need to be aware of this higher rate so they properly report and pay estimated taxes. Short-term capital gains are subject to the same tax rates that generally apply to capital assets, without regard to whether they would be treated as collectibles. Losses on the sale of collectibles are subject to the limitations on losses that generally apply to capital assets.

It seems likely that those NFTs that qualify as works of art will be subject to the 28% maximum rate. Other types of NFTs, however, such as NFTs that represent ownership of actual assets or provide for experiences, might not be classified as collectibles, and would instead be subject to regular capital gain tax rates.

E. Estate Planning Tips.

Now that NFTs and cryptocurrency have gone mainstream, it is time to adjust our practices for the possibility that they may be part of a client's portfolio.

¹⁵² I.R.C. §1221(a)(3).

¹⁵³ I.R.C. §1221(a)(1).

At the client intake stage, when discussing digital assets, it is important to ask if they own any NFTs or online channels where content is monetized. When naming fiduciaries our clients need to consider whether that person will understand digital property and can be trusted to preserve its value.

At the drafting stage, fiduciaries should be given the authority to retain NFTs as part of the trust estate, even if such an investment doesn't comport with the prudent person standard. Or, given the volatility of convertible currency, they might want such property to be sold immediately. For excellent guidance for the fiduciary see Ivan Taback and Stephen L. Ham IV, *The Fiduciary's Guide to Cryptocurrency: Part I*, 160 Tr. & Est. 36 (May 2021), and Ivan Taback and Stephen L. Ham IV, *The Fiduciary's Guide to Cryptocurrency: Part II*, 160 Tr. & Est. 20 (July/Aug. 2021).

Clients are well-advised to create a system for tracking passwords and usernames. This is even more critical with convertible currency, where there is no help desk to call. A useful book to help clients develop a usable system to maintain their NFTs and other digital assets is by Pamela Morgan, *Cryptoasset Inheritance Planning: A Simple Guide for Owners* (2018).

F. Charitable Contributions of NFTs.

NFTs, as nonfungible assets, are not suitable for most direct charitable contributions. Typically, only those cryptocurrencies that are convertible into a fiat currency (such as the U.S. dollar) are of value to most charities. Like gifts of publicly traded securities, charities that accept cryptocurrency generally convert the asset to fiat currency as soon as possible. NFTs are not convertible into currency, so it is unlikely that a charity would be able to sell an NFT once it is received. NFT owners and creators have found ways to monetize NFTs for charity, discussed below.

1. Contributions by Creators.

To avoid valuation issues, creators who want to support charities are, instead, partnering with their favorite charities to auction off NFTs, where some or all of the proceeds benefit the charity.

2. Direct Charitable Contributions.

Theoretically, a donor holding an NFT can donate it directly to a charity if the charity is set up to accept such a donation. Although most charities would want to immediately convert an NFT to cash, an obvious exception is donating an NFT to an art museum that would make the NFT part of its collection.

Direct contributions of appreciated NFTs can provide donors that are not NFT creators with significant tax advantages. Donors who can meet IRS reporting requirements can avoid paying tax on the amount of gain they would otherwise incur if they had sold the appreciated NFT in the market and donated cash to the charity. Donors can receive a deduction for an appreciated NFT's full value up to the percentage cap of their adjusted gross income.

If cryptocurrency was not held by the donor for the long-term capital asset holding period prior to donation, the charitable deduction is limited to the *lesser* of the donor's tax basis or the

cryptocurrency's fair market value. For cryptocurrency that is an ordinary asset in the donor's hands (as would be the situation for most NFT creators and dealers), the charitable deduction is limited to the fair market value of the NFT less appreciation (*see also* Charitable Contributions, IRS Pub. No. 526 (rev. Apr. 2020)). Costs incurred to tokenize the NFT could be included in an NFT creator's tax basis.

If the taxpayer holds an NFT with a tax basis greater than its fair market value, the donor's deduction would be limited to the NFT's fair market value. In addition, the difference between the taxpayer's tax basis and the fair market value would not be a capital loss. Therefore, it is more tax efficient for a taxpayer with a loss in an NFT that is a capital asset to sell it in the market, report a capital loss for tax purposes, and donate fiat currency to charity to receive a charitable contribution equal to the amount of cash contributed.

3. Fair Market Value.

An NFT has no intrinsic value. Like other collectibles, its value is based on supply and demand. It is worth what a willing buyer is willing to pay a willing seller. As a result, NFTs are not appropriate for direct charitable donation unless they have a use related to the charity's mission, such as an art museum that might be interested in acquiring an NFT to be displayed as part of its art collection.

If a donor is not the creator of the NFT, the donor can deduct the fair-market value of the contribution with the amount of the contribution reduced by the amount of short-term capital gain that the donor would have reported if the donor had sold the NFT (I.R.C. §170(e)(1)(A)). Contributions of *tangible* personal property receive a fair-market value deduction only if the charity uses the tangible property in a way that relates to its charitable purpose (I.R.C. §170(e)(1)(B)). This requirement would not apply to NFTs because they are intangibles.

4. Qualified Appraisal.

A qualified appraisal for charitable purposes must meet the requirements of Treas. Reg. §1.170A-17 discussed in Section III.A.1 above, including the requirement that the appraisal be prepared by a qualified appraiser in accordance with generally accepted appraisal standards that meet the substance and principles of the Uniform Standards of Professional Appraisal Practice.

5. Qualified Appraiser.

As discussed in Section III.A.2 above, a qualified appraiser is defined for these purposes as someone who is a recognized appraiser with at least two years of experience in valuing the type of property that is being appraised. Because of the novelty of NFTs, it is likely that the requirements set out in the Treasury regulations for a qualified appraiser are difficult—if not impossible—for all but a handful to meet.

6. Fundraising with NFTs.

To overcome many of the issues raised when considering direct donations of NFTs, some charities are issuing NFTs directly or they are partnering with NFT creators to use NFTs to fundraise.

Rather than contributing NFTs directly to the charity, creators are selling or auctioning off NFTs, with all or a portion of the proceeds donated to the charity. Under this scenario, the NFT creator would report taxable income on the amount of taxable gain on the NFT (sales price minus adjusted tax basis), and the creator would report a charitable deduction for the amount of money or cryptocurrency donated to the charity from NFT sales.

Some charities are partnering with artists, celebrities, athletes, and other public figures to create NFTs. Other charities are creating their own NFTs and selling or auctioning them off to buyers, or providing NFTs to donors, similar to the Nature Conservancy bumper sticker or NPR mug. Often, the donor uses cryptocurrency, delivered to the charity's wallet, to pay for the NFT. This raises new challenges to charities, discussed below.

7. Challenges to Charities.

Charities must address several issues in accepting donations of NFTs or cryptocurrency received from sales of NFTs. They must determine the suitability of accepting such donations, the protocols for accepting NFTs and cryptocurrency, and the ways in which donated digital assets can be converted to U.S. dollars. In addition, a charity must also familiarize itself with the unique issues raised by accepting, storing, and displaying NFTs.

The donor use limitation, however, does not apply to contributions of intangible property. This means that the charity does not need to use or hold onto NFTs or cryptocurrency once donated.

As the wealthy are acquiring NFTs that appreciate, they will undoubtedly be looking for ways to donate them in return for a charitable deduction. Charities should start now to develop gift acceptance policies for cryptocurrency and NFTs, before the first donor comes knocking at the door with a short timeline for completing the desired transaction.

XII. Conclusion.

The subjective nature of art and collectibles presents many challenges to owners and their advisors. What is certain is that eventually collections will need to be valued. Clients need to understand how to protect the value of their collections, and know their options to divest themselves of the collections they may have spent a lifetime acquiring, whether during their lifetimes or as part of testamentary plans. Finally, fiduciaries need to understand the extent of their responsibilities when art and collectibles are involved.

Exhibit A
Collection and Collector Questionnaire

1. What do you actively collect?
2. Do you have other collections that you are no longer adding to or that you have acquired by gift or inheritance?
3. When did your interest in collecting begin and what was your inspiration?
4. Describe your first acquisition.
5. Are you drawn to a particular object, artist, or medium?
6. Do you have a favorite work?
7. What is your biggest regret with respect to your collection?
8. Has your vision of collecting remained the same? If not, how has it changed?
9. Do you share your collection with other collectors or the public?
10. Do you offer advice to existing or new collectors?
11. Are you a member of any collecting clubs, societies, or affinity groups?
12. What percentage of your total assets is devoted to art, collectibles, luxury collectibles, jewelry, gems, antiques, and other tangible personal property?
13. Has your collection been recently appraised?
14. Is your collection insured? If yes, by whom?
15. Have you maintained receipts, invoices, or a record of publications in which your work has been featured (provenance documentation)?
16. Do you have any recent condition reports?
17. Have you catalogued intellectual property rights retained by the artists?
18. Are any of your objects in storage? Where? Is it specifically designed for artwork?
19. Are any of your objects on loan? If yes, to whom?
20. Are any of your objects subject to partial interest gifts or promised gifts?
21. Have you considered how your collection fits into your estate plan?
22. On whom do you rely for independent advice for your collection?