PROTECTING AND MAINTAINING YOUR ART

Wealth and Tax Planning for Collectors

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Art and other collectibles are unique and very personal assets. Whether a collector views art as an investment, as a personal passion, or combination of both, the realities of owning artwork require special consideration. Planning to build, maintain or ensure the future of a collection also requires balancing the specialized rules applicable to “collectibles” and the personal and financial realities of individual or family circumstances. Additionally, art is often an illiquid asset and costs involved with ownership should be considered. Although transferring or disposing of a collection may be in the distant future, successfully preserving or transferring a collection requires active planning well in advance. Collectors should consider their collecting habits, as well as long term goals.

At the outset of planning there are many questions to consider, including:

- How were the works acquired? The tax implications, and therefore the planning, may differ depending on whether the artwork was purchased or received as a gift or inheritance from a friend, loved one or from the artist.
- Is the artwork part of a collector’s general personal property, just like other items in a household? Or, is artwork thought of as a collection, something separate and apart from other aspects of life, to be treated accordingly?
- Where is the collector in the collecting cycle? Is the collector a newer collector, recent inheritor or long-term collector starting to plan her legacy?
- For experienced collectors, what are their collecting habits or future plans? Do they actively collect, or are they maintaining an existing collection? Thinking ahead, do they want their family to inherit their art work or do they have charitable intentions for art?
- Even if a collector is not yet ready to think about transferring a collection, what should he or she be doing now to protect the collection?

After evaluating current realities, collectors should work with knowledgeable advisors to align their personal preferences with planning options.

DEFINING A COLLECTION

Active collectors in particular should be aware that specific rules apply to art and other “collectibles.” From an income tax perspective, gain from the sale of collectibles held for more than one year is taxed at a rate of 28%. Other items subject to the 28% collectibles gain rate include antiques, certain metals and gems, stamps, coins and wine. On the other hand, upon disposition, art may be subject to ordinary income tax at individual rates if the property has been held for one year or less, is owned by the artist, is received as a gift from the artist, is dealer inventory or would produce a capital loss if sold.

Although the following mainly pertains to collectors, it should be noted that, as a result of these differences in tax treatment, planning for collectors has many potential differences from planning for artists and their beneficiaries.

CONSIDERING TRANSFER OPTIONS

Successful planning to maintain or divide a collection involves evaluating tax implications, financial realities of ownership and personal considerations.

It is important for collectors to assess options and calculate the most tax efficient gifting strategy, taking income tax as well as gift and estate tax consequences into account. When considering the financial implications of transfers, it is important to weigh the tax cost of gifting during life as opposed to at death. The highest marginal income and net investment income tax rate and gift/estate tax rates are converging at 43.4% (the combination of 39.6% and 3.8%) and 40%, respectively. Due to the fact that giving during life transfers the donor's basis to the donee, whereas transferring assets at death could entail a basis adjustment for the beneficiary to the value at the decedent's death, for highly appreciated works basis considerations may be a deterrent to making lifetime gifts to family or friends. However, gifting artwork during life may allow collectors to see the works enjoyed by the new owners. When making lifetime gifts, collectors also have the opportunity to actively teach a loved one about art and being a collector.

Successful transfer planning presupposes that the new owner wants—or can afford to own—the artwork. Although a collector may view the transfer of a collection as a gift, as well as an honor, the recipient may view the responsibility as a burden or a bother. The intended recipient may have different aesthetic sensibilities, a lack of interest in ownership, or merely want to sell the art as soon as practicable. Therefore, collectors may wish to ask what benefit they are bestowing on the beneficiary. Engaging in frank conversations with family members during the early stages of the process will help ensure that a gift really is a gift. Also, to help offset financial burdens associated with ownership, collectors should consider making additional financial gifts to help cover costs the new owner will face.

Some collectors may wish to make charitable gifts of art. An unlimited charitable deduction may be available for estate tax purposes. For transfers during life, an additional income tax deduction may be available. A collector's charitable income tax deduction is based on both the type of property being gifted and the type of organization to which the property is being donated. For public charities, for gifts of art to be eligible for a charitable income tax deduction equal to fair market value the gift must be related to the purpose for which the organization is afforded tax exempt status, otherwise the donor's deduction may be limited to tax cost of the property. For taxpayers in higher income tax brackets, the charitable deduction may be subject to phaseout (the Pease limitation), which limits up to 80% of otherwise allowable deductions. However, the income tax limitation will not limit the non-tax charitable impact of the gift.

Ultimately, there are many subtleties involved in making charitable gifts of art, so working with qualified appraisers and coordinating with the intended recipient organization is strongly encouraged. Like transfers to friends and family, museums will have additional costs associated with ownership. Therefore, consider making a gift of cash or marketable securities to help the museum cover operating costs.

DRAFTING CONSIDERATIONS

For collectors wishing to maintain their collection throughout their lives, it is important to work through the realities and implications of transfers at death in advance. Consider the effect of leaving artwork "equally" to three children. What if there are ten paintings? How will they be divided? Or, if there are nine paintings to share equally among three children, yet the works all hold varying fair market values as well as emotional values, how will “equal” be determined, let alone be perceived by beneficiaries?

During the planning process, it is important to evaluate whether or not it is better to make specific bequests of artwork or make more general reference to a “collection” in documents. For collectors who have a few, easily identifiable treasured works, making specific reference to particular artwork will help add clarity to the administration process. Doing so may avoid issues stemming from more general references to “art” or “collection.” For example, during the planning process, a parent may discuss with the adult children that references to “art” or “collection” mean the four prized paintings and collection of photographs. Down the road, when the parent passes away and the children enter the home with those documents in hand, “art” or “collection” may be construed—or misconstrued—to also include certain antique furniture acquired at auction or jewelry from a particular artisan or designer.

On the other hand, when planning for a larger collection, generally referencing the collection in documents may be a more manageable administrative reference. This may be especially true if the collectors are very active, frequently buying and selling works, or interested in having greater flexibility to title and retitle artwork.

Art is often illiquid. Therefore, consider the associated expenses during planning. To avoid causing works to be sold to pay a tax bill, it is important to consider how taxes will be apportioned in estate planning documents. Additionally, when making a gift or bequest, consider giving additional funds to cover maintenance costs and potential art storage needs.

MAINTAINING WORKS OF ART

Some collectors may want to plan for the future of their collection but do not anticipate transferring works for some time. In the interim, they should revisit insurance needs and maintenance costs. Some collectors may need to determine what intellectual property rights they own, if any, in various works of art. Particularly active collectors may need to consider how their long-term investment strategy will fit with their collecting habits or intentions. For instance, experienced collectors who plan to more actively collect during their retirement should consider whether their investment strategy will allow them the liquidity and flexibility to make new acquisitions and support additional costs.

VALUATIONS

Planning presupposes that collectors are in possession of current, appropriate valuations. Oftentimes, collectors assume they know the value of their works or are able to gauge value based on prices they observe in the art market. It is important to obtain a professional valuation since obtaining a determination of value of artwork may be difficult, especially if the work is unique, rare or does not have an established retail market. There are different purposes, and associated requirements, when seeking an appraisal. Typical purposes include insurance, resale value at auction, a retail value at a gallery, income tax, gift tax and estate tax. Although there may be market data for a particular artist, an expert appraiser will be able to properly analyze the information.

If a valuation is for tax related purposes, Treasury Regulations supply guidance that, generally, fair market value is “the price which a willing buyer would pay to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”[i] A rare, incomparable work of art may not have an ascertainable retail market as would a used car. It is therefore important to work with a qualified appraiser who understands the purpose of the requested appraisal and regularly deals with the type of property being appraised. Working with a qualified appraiser will help ensure that certain required information is included in the appraisal since the requirements may vary depending on the type of appraisal.

VALUING INTEREST IN ART IN AN ESTATE

Valuing art in an estate can be particularly challenging, especially where an estate holds a fractional interest in a collection. A key issue is the valuation discount associated with a fractional interest. Whereas discounts are commonly recognized for estates of artists,[ii] which often largely consist of illiquid holdings of artwork, it is not uncommon for the Internal Revenue Service to challenge the extent of the discount claimed by an estate. In a recent case of particular note, *Estate of James Elkins Jr. v. Commissioner*, [iii] the Tax Court effectively reduced a claimed 44.75% fractional interest discount to a 10% fractional interest. The Elkins decision reflects the complexities associated with valuing art and the Service's continuing interest in art-related transactions.

CONCLUSION

Maintaining and planning to maintain a collection of artwork involves careful evaluation of the many subtleties and particularities associated with the unique nature of art and collectibles. Therefore, it is important to take into account all tax, legal and personal circumstances to help ensure successful outcomes.

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[i] Treas. Regs. §§ 20.2031-6, 1.170A-1(c)(2), and 25.2512-1.
[ii] See, for example, Estate of Georgia T. O'Keeffe v. Commissioner, 63 T.C.M. 2699 (1992).
[iii] Estate of James Elkins Jr. v. Commissioner, 140 T.C. No. 5 (2013).