NORTHERN TRUST

WEALTH MANAGEMENT

WEALTH PLANNING WITH ART

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Art inspires us. It intrigues us. We celebrate art and artists globally – from EXPO CHICAGO to Art Basel Miami and Art Basel Hong Kong. Whether you view art as a passion or an investment, or perhaps a bit of each, today's vibrant art market and the surge in private gifts of art touch many of our lives. Within the following pages, we explore considerations for those who have an affinity for art.

The art environment is diverse and constantly changing. Wealth planning with art offers many opportunities, but it is also quite nuanced. Acquiring, managing, valuing and transferring art require thoughtful planning and the advice from trusted experts and advisors to realize the full value of individual works or a collection. We encourage you to confer with your art, legal and tax advisors about your particular circumstances.

THE ART RELATIONSHIP

An individual may have different relationships with various artworks and may have a blended relationship with a single piece or collection. Increasingly, high-net-worth individuals acquire art, not only for personal satisfaction, but also for investment. It is estimated that individual art investors allocate approximately 6% of their portfolio assets to art and collectibles.[1] It is not surprising, therefore, that the majority of art collectors view their collections as both a passion and as an investment.

THE VALUE OF ART

Beyond aesthetics and headline auction sales, determining the value of art presents important challenges. Unlike publicly traded securities, art has no public, regulated, transparent, real-time marketplace. A variety of factors have an impact on the value of art, accompanied by associated risk and uncertainty. Determining a work's value may be difficult, especially if the piece is unique, rare or does not have an established retail market. Valuation may be especially difficult if a work is commissioned, part of a larger collection or by a lesser-known artist. Generally, supply and demand determine price in markets; however, other forces unique to the art market will have a material influence on a particular work or collection's value and the price obtainable in the market.

VALUE FACTORS

AUTHENTICITY	PROVENANCE	TITLE
RARITY	CONDITION	GOVERNMENT RESTRICTIONS

Relationships With Art Vary

- **Investors** buy, sell and collect art as an investment with the hope the art will appreciate, enabling a profitable sale
- **Hobbyists** collect art for personal pleasure rather than for a profitable investment
- **Dealers** buy and sell art as a trade or business
- **Business collectors** buy art for business use, such as displaying in a workplace

AUTHENTICITY

Authenticating an art collection is the starting point for determining its value. In most cases, goods that trade on a secondary market can be readily verified and relied upon. However, authenticity of art can, and does, change because it is a consensus opinion at a point in time rather than a permanent condition.[2] Concerns about authenticity typically arise from forgery, misattribution and modification. Forgery is intentional deception while misattribution is a seller's mistaken opinion an artwork is by the artist in question. Modification generally occurs when the owner restores the artwork, and in doing so, modifies it.[3]

A major risk of investing in art is that a work could turn out to be fake, forged, stolen or questionably obtained. For a collector, it is critical to establish an artwork's authenticity. A reputable, unbiased independent expert serves as a verification for buyers who want to feel confident that they are bidding on an authentic auction or private sale item.[4] Because of the risk a major acquisition could turn out to be worthless, buyers should conduct their own due diligence whenever possible before purchasing a piece. Buyers should be wary of accepting a piece as authentic simply because of supporting documentation. Remember, documents can be forged too.

PROVENANCE

Provenance refers to an artwork's ownership history, auction records, conservation records, certificates and bills of sale. Provenance is a clear determinant in a work's value and provides a verifiable, public certification of authenticity.[5] Ownership history can have a marked effect on valuation of a piece. For example, a ruby and diamond Cartier necklace given to Elizabeth Taylor by Richard Burton was appraised at $200,000-$300,000. But, at auction it sold for almost $3.8 million because of its special provenance.[6]

GOOD TITLE

In transferring a piece of artwork, whether by sale or gift, you must be able to defend its title. A piece of artwork might be subject to various liens, serve as security for a loan or be subject to a legal claim. Additionally, stolen art creates difficult legal issues for the unsuspecting collector. Artwork that crosses international borders may have more than one legal system at play as countries have different laws as they pertain to purchasing stolen artwork.

Why is Obtaining a Loan to Buy Art Riskier Than Other Loan Types?

- **Authenticity** – When borrowing to purchase a building, no one asks if the building is real. A lender might confirm forgery is not a possibility by requiring expert analysis and reviewing the work's provenance
- **Mobility** – Unlike a building, the borrower can physically move artwork. A lender may require comprehensive insurance and security
- **Repayment Ability** – A lender will make sure the borrower can repay the loan without having to first sell the art

War-looted artwork not only impairs good title, but could also be subject to future legal controversies. When dealing with artwork with WWII-era provenance, for example, you should be sure to collect as much information as possible to avoid purchasing war-looted art. Title issues involving war-looted art arise more frequently than one might expect. For example, a Picasso painting, "Portrait of Angel Fernandez de Soto," then owned by the Andrew Lloyd Webber Foundation, was estimated to fetch between $40 million and $60 million at auction. But, the painting was withdrawn from a 2006 Christie's auction sale because of a claim it had been transferred under duress by a Jewish owner in Germany to an art dealer in Switzerland in 1935.[7] The legal challenge was subsequently resolved, and in 2010, Christie's presented the piece at auction where it sold for more than $51 million.

RARITY

Rare art objects often translate into higher values. For example, if an artist has created a small number of works, and the artist is considered of major importance, each individual work will likely be highly sought after and consequently expensive. However, this is not always the case. Rarity can negatively impact value if the work does not reflect current market taste, which could make the piece less desirable.

CONDITION

Maintaining a work's condition is crucial to maintaining its value. This is simply effective asset management. Collectors should properly store artwork to help ensure preservation. Musty rooms, direct sunlight and display over fireplaces can compromise a work's condition over time, even though – to an untrained eye – the artwork appears flawless.

GOVERNMENT RESTRICTIONS

A number of countries, including the United States, restrict the trade of certain items, which may adversely affect U.S. collectors. The Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES) is an agreement among 181 countries, including the United States. The CITES agreement ensures trade of certain wild animals and plants does not threaten their survival. The United States faces harsher restrictions under the Endangered Species Act of 1973 (ESA), which prohibits or restricts movement of protected plants, animals, feathers, corals, ivories, tortoiseshell, walrus, seal and certain types of wood.

APPRAISING ART

You may assume you know the value of specific works in your collection or can estimate value based on observed prices in the art market, but this is seldom true. You will need the services of a qualified appraiser.

The purpose of an appraisal is to guide selection of an appraiser and the requirements of the appraisal itself. It is important to work with a qualified appraiser who understands the purpose of the appraisal and regularly deals with the type of property being appraised. Working with a qualified appraiser helps ensure required information is included in the appraisal, as requirements may vary depending on its use.

APPRAISALS FOR INSURANCE PURPOSES

Insurance appraisals are a risk management measure that protects art assets from theft, accidental damage, fire, flood or other unfortunate situation. Insurance appraisals are generally based on retail replacement value (RRV). The RRV is the amount it would cost to replace an item with one of similar quality in a retail venue in a reasonable period of time. The RRV will likely be higher than fair market value, which is used for tax purposes, because it is the price one would pay to replace the item at retail, such as a high-end gallery.

APPRAISALS FOR TAX PURPOSES

If an appraisal is for tax-related purposes, Treasury regulations are generally consistent in their approaches to the valuation of artwork for income, gift and estate tax purposes.[8] Unlike the retail replacement value used for insurance purposes, the value for tax purposes is the work's fair market value at the time of the contribution or transfer, either during life or at death.[9] Fair market value for tax purposes is "the price at which such 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."[10] This value is based on a hypothetical sale in the market in which the artwork is most commonly sold to the public – at auction. However, if the artwork is unique, rare or part of a larger collection, the regulations' contemplated "retail market" may not exist.

Knowing Your Artwork's Value is Important for Many Reasons

- Determining and maintaining appropriate types and levels of insurance
- Making gifts to charity and substantiating associated income tax deduction
- Making gifts to family and other individuals and complying with applicable gift tax requirements
- Settling an estate, including making distributions and determining estate taxes
- Engaging in art-based lending transactions
- Engaging in sales and exchanges and related tax reporting

Not surprisingly, taxpayers and the Internal Revenue Service (IRS) at times have different views about the value of a work of art. The Art Advisory Panel of the Commissioner of Internal Revenue (the Panel) provides advice to the Art Appraisal Service unit in the Office of Appeals of the IRS. The Panel's charge is to help the IRS evaluate tangible personal property appraisals submitted to the IRS for tax purposes. Objectivity and taxpayer privacy are priorities. Although the Panel's recommendations are advisory, the IRS adopted 67% of the Panel's recommendations, in full, in fiscal year 2017.[11]

Charitable Gifts – Appraisal requirements of art for income tax deduction purposes are somewhat more involved than for gift or estate tax purposes. The income tax regulations articulate clear requirements for an appraisal to be a "qualified appraisal." For any contributed work of art valued in excess of $5,000, you, as the donor, must obtain a qualified appraisal from a "qualified appraiser" within 60 days of the contribution date.[12] A qualified appraiser must be an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis and is qualified to make appraisals of the type of property being valued.[13] Thus, an appraiser who specializes in Chinese pottery from the 13th century may not be qualified to appraise a Monet watercolor under the guidance provided by the tax rules.[14]

ART ADVISORY PANEL FISCAL YEAR 2017 COMPREHENSIVE RECOMMENDATIONS REPORT

Type of Adjustment	Number of Items (% of Total Items Reviewed)	Taxpayer Claimed Value	Panel Recommendation	Net Change (Panel Less Claimed Value)
TOTAL ITEMS INCREASED	128 (35%)	$69,351,508	$120,679,749	$51,328,241
TOTAL ITEMS DECREASED	94 (26%)	$50,019,030	$32,927,000	($23,092,030)
TOTAL ITEMS ACCEPTED	143 (39%)	$80,062,600	$80,062,600	$0
TOTALS	365 (100%)	$205,433,138	$233,669,349	$28,236,211
AVERAGE CLAIMED VALUE PER ITEM	$562,831			

Further, a qualified appraiser must be fully independent. This means an appraiser cannot be you (the donor), a party to the transaction in which you acquired the artwork (e.g., a gallery employee who sold the artwork to you) or anyone related to you as defined by the regulations. Further, if you have information that leads you to believe the appraiser would falsely state the value of the contributed works, that appraiser is not qualified. A qualified appraiser must have a designation from a recognized appraiser organization, such as the Appraisers Association of America and must not have been banned from practicing before the IRS during the three-year period ending on the appraisal date.[15] Donors of artwork must conduct due diligence to select a legitimate, qualified appraiser. The consequences for failing to do so can be severe, including loss of the entire charitable deduction and/or fines.[17]

Non-Charitable Gifts and Bequests – Current valuations of art are important for gift tax purposes, if works are gifted during your life, and for estate tax purposes if works are owned at death.

The difficulty of valuing art for gift and estate taxes can be complicated by the fact that a work is often part of a collection.[18] For example, renowned artist Georgia O'Keeffe owned a collection of approximately 400 works of art when she died. The IRS agreed with the estate that at the time of O'Keeffe's death in 1986, individual fair market values of the works totaled $72 million. Disputed, however, was the estate's claimed blockage discount attributed to the fact that so many of the works in the collection could not be sold in bulk for the price that individual pieces could sell for, if sold over an extended period of time.[19] The blockage discount recognizes, for transfer tax purposes, the disruption of supply and demand when a large number of artwork comes on the market at the same time. The tax court did apply a blockage discount in the O'Keeffe case.

Although the blockage discount in *O'Keeffe* was applied for estate tax valuation purposes, the discount would also be appropriate for valuing for gift tax purposes a lifetime gift of a collection of art. Other valuation discounts, such as the discounts for lack of marketability or control, may be applied in order to determine the fair market value of a transfer of art for gift and estate tax purposes in cases where, for example, the transfer is of an interest in an entity owning the artwork or where a collection is transferred subject to various restrictions on partition, alienation or possession.[20]

Unlike income tax rules that require a qualified appraisal by a qualified appraiser, estate tax rules require only a sworn statement from the executor of the estate to accompany the appraisal. The sworn statement must contain an itemized list of appraised artworks and a declaration of the appraiser's qualifications and disinterested character.[21]

No similar appraisal regulation applies to gifts of art under the federal gift tax. Nonetheless, if you want to begin the running of statute of limitations on the gift to prevent an IRS revaluation at a later date, the gift must be "adequately disclosed." Adequate disclosure is made by providing a description of the method used to

For Charitable Giving, a Qualified Appraisal Should Include:[16]

- A description of the artwork
- Expected donation date
- Identifying information about the appraiser, including name and address
- Appraisal date
- The appraised fair market value of the artwork and the related tax reporting

determine the fair market value of the gifted property, or by submitting an appraisal that meets requirements set forth in the regulations.[22] These requirements are similar to the qualified appraisal requirements for charitable income tax deduction purposes.

Advance Valuation Ruling Procedure – To help avoid the time and expense involved in disputing art valuations, taxpayers can obtain an advance ruling from the IRS, for a fee, as to the value of art for income, gift or estate tax purposes.[23] For a transfer of artwork appraised at $50,000 or more, a Statement of Value may be obtained from the IRS prior to filing the tax return that first reports the transfer.[24] Working with a reputable appraiser will ensure all requirements are met prior to submitting a request for advance ruling. Once the IRS issues a determination, it must be attached to the applicable tax return, and it is binding on the IRS. If the taxpayer disagrees with the IRS's determination, additional information to support an alternate valuation may be submitted with the appropriate return. This procedure is advantageous for a taxpayer who desires certainty when filing his or her return.

TRANSFERRING ART

At some point, an art collector's ownership of a work or collection will end. And, of course, "you can't take it with you." In planning for the eventual disposition of an art collection, the very first thing you should do is determine if your family is interested in the art collection – not just its financial value. It may be disheartening at first, but oftentimes family members will not share your level of interest in the collection, or in art generally. After determining your family's interest in the collection, the planning may begin.

Collectors commonly incorporate multiple strategies into their wealth transfer and tax plans to achieve a desired outcome. As part of a plan for disposition of an art collection, consider whether to:

- Transfer part or all of the collection to family or other non-charitable beneficiaries
- Transfer part or all of the collection to charity
- Sell or exchange part or all of the collection

You must also determine if the disposition will take place during your life or at death. The default "do nothing" alternative can be a financial and emotional burden on beneficiaries and very expensive when settling your estate.

PLANNING OPPORTUNITIES

DURING LIFE	SALES AT AUCTION
Transfer to family as a gift or via family entity	Transfer to family as a bequest or in a trust
Transfer to charity	Transfer to charity
Sale or exchange	

In addition to the $15,000 (in 2018) annual gift tax exclusion allowed every individual ($30,000 for married couples in the U.S.), you can transfer up to the applicable exclusion amount of $11.18 million in 2018 ($22.36 million for U.S. married couples), during life or at death, without federal transfer tax consequences

TRANSFERS TO FAMILY

Transferring art to next-generation beneficiaries truly is a gift of both value and values. Now that you have determined who will benefit, the questions are when (during life or at death) and how (outright or otherwise). Many advantages are associated with lifetime gifts and testamentary bequests. But regardless of whether the transfers are made during life or at death, they will be subject to federal transfer taxes: gift tax if made during life, and estate tax if made at death.

Gifts

You can gift significant amounts of art during life free of transfer taxes. In addition to the $15,000 annual gift tax exclusion allowed every individual ($30,000 per married couple), you can transfer up to the applicable exclusion amount of $11.18 million in 2018 ($22.36 million for U.S. married couples), during life or at death, without federal transfer tax consequences. Transfers exceeding the exclusion amount incur a maximum 40% federal transfer tax. When considering transfer opportunities, it is important to assess options and the most tax-efficient transfer strategy, taking into account income tax, gift tax and estate tax consequences.

A lifetime gift of art to family may be advantageous for a few reasons. First, the artwork will no longer be included in your estate, which reduces your estate's value, and thus, the federal estate taxes that may be due upon death. Second, any post-transfer appreciation in the collection's value occurs outside the estate and inures to the benefit of recipients free of additional gift tax. However, there are associated income tax considerations, as illustrated in *Case Study: Transferring by Gift vs. Bequest.*

CASE STUDY: TRANSFERRING BY GIFT VERSUS BEQUEST

Donald owns a sculpture with a current fair market value of $1 million. The sculpture's value is expected to appreciate at a rate of 6% per year. Donald has already used his annual gift tax exclusion in 2018 and his applicable exclusion of $11.18 million. He wants his daughter to have the sculpture, but considers whether to transfer the sculpture today as a gift or wait to transfer it upon his death. Assume Donald lives for another 10 years, with gift and estate taxes and exclusions the same as in 2018. If Donald makes the transfer now, he would owe approximately $400,000 in federal gift tax (based on $1 million fair market value in 2018). If he transfers the sculpture by bequest at his death, he would owe approximately $716,339 in federal estate tax (based on $1.79 million fair market value in 2028, an increase of 6% per year). Thus, Donald could save about $316,339 in gift and estate taxes by making the transfer now. However, as discussed below, Donald's daughter will receive his basis in the art in a lifetime transfer.

	TRANSFER BY GIFT (2018)	TRANSFER BY BEQUEST (2028)
Fair Market Value	$1,000,000	$1,790,848
Transfer Tax Rate	40%	40%
Transfer Tax Due	$400,000	$716,339
Transfer Tax Benefit	$316,339	($316,339)

Apart from potential tax benefits, gifting part or all of a collection during life will allow you to witness the enjoyment your prized art collection brings to your beneficiaries. It will also enable you to have conversations with the next-generation owners about the qualities that make the collection personally and financially valuable. Such a gift is truly one of both value and values. You may have to give up possession and control of the art to make a completed gift for tax purposes, which reinforces the importance of discussing the art collection with your beneficiaries.[25]

As the saying goes, "there's no such thing as a free lunch." Your tax benefit comes at a cost to the recipient: the recipient must use your tax basis (the purchase price or fair market value, whichever is lower) upon future disposition to compute gain or loss for federal income taxes.[26] As a result, when a recipient sells appreciated art, she must pay federal (and perhaps state) capital gains tax on all the appreciation in the art's value, not just the post-transfer appreciation. This additional "gift" of built-in tax liability may come as an unexpected and unwelcome surprise. If you were to wait to transfer the art at death, the recipient could receive a new fair market value basis in the art. This is why it is important to determine, first and foremost, if your beneficiaries want the art itself and not just the art's value.

Bequests

One of the major tax advantages of holding appreciated assets until death is the ability to obtain a fair market value income tax basis adjustment at no tax cost. When included in your taxable estate, the collection's tax basis is generally the fair market value at the date of your death or alternate valuation date. Depending on your family's goals for the collection, holding the collection until death and having your executor or trustee provide for disposition may be a workable option.

Trusts

As with other assets, transfers of art can be made in trust for chosen beneficiaries. A transfer of art to a trust assumes your beneficiaries desire the art collection itself and not just its value. Although using trusts for art succession planning may provide advantages over outright gifts, it presents a number of practical challenges.

If you intend to transfer art into trust, you should work with an experienced attorney to draft the trust document and be very thoughtful about selecting a trustee with experience in managing art. Once the art is held in trust, the trust document will dictate how the art is managed and ultimately transferred. In the trust provisions you can name specific individuals to receive certain trust assets (such as works of art) or direct the trustee to choose which beneficiaries use the works of art. Indeed, by transferring a collection to a trust, it can be used and enjoyed by beneficiaries without facing claims by creditors or divorcing spouses, as it would if transferred to beneficiaries outright.

Be mindful when selecting a trustee, as managing an art collection can be quite complex. Depending on the size or extent of the collection, consider naming an "art trustee." An art trustee is someone who is qualified and authorized to make decisions regarding control of the art collection, based on the collector's wishes or intent. The art trustee's duties can begin during the collector's life or upon death and may extend beyond the settlement of the estate. In some instances, therefore, it may be wise to select a corporate or institutional trustee to manage art transferred to trust. Keep in mind, however, that because the trust holds and owns the art, it will require additional funds to pay for owning, maintaining, storing, securing, valuing and insuring the art. Additionally, trust administration will also be more complex than, for example, a trust holding securities. This is due to the complexity of art ownership and significant ongoing care and maintenance.

Checklist for Non-Charitable Art Transfers:

- Obtain a qualified appraisal before making the transfer
- Provide all documentation pertaining to provenance, if applicable
- Transfer the title to the new owner
- File gift tax return and pay applicable gift taxes

Depending on the size or extent of the collection, consider naming an art trustee

Trust with Leaseback

If you are not yet ready for beneficiaries to take possession of your art collection, but you want to safeguard it for future generations, consider a leaseback arrangement. The structure of a leaseback arrangement is rather straightforward. The collector makes an irrevocable, taxable gift of the art collection (or a fractional interest in the collection) to an irrevocable trust. After the gift, the collector leases the art back from the trustee for fair market rental payments determined by an independent, qualified appraiser.

The fair market value rental payments can be distributed to beneficiaries, per the terms of the trust, to pay for expenses or for investment by the trustee. The trust can be structured as a "defective" grantor trust for income tax purposes, which means the collector pays the trust's income taxes. Any income generated by the leased art (or other investments) can be used by the trust beneficiaries undiminished by taxes.

In drafting the trust instrument and in executing the leaseback, it is important to work with an experienced attorney to avoid the unintended inclusion of the trust assets in your gross estate for federal estate tax purposes.[27] It is very important that the transaction between the collector and the trust and the trustee and the collector be properly structured as a bona fide transaction. You should not be the trustee of the trust or make decisions regarding the execution of the lease or regarding the amount due under it.

Thoroughly consider and address the following questions in a trust agreement.

- What are the trust assets and their value? It is very important to accurately document the works in the collection and the fair market value of each piece, as determined by a qualified appraisal. Additionally, the rental payment amount should be determined by an independent appraiser and/or an independent trustee.
- If the ultimate recipient of the collection is a charitable beneficiary, such as a museum, consider provisions governing use of the collection. For example, must the museum agree to display the collection from time to time? Can the museum sell the collection? If you want to impose conditions, be sure to include them in the trust instrument.
- What are the duties of the trustee? Must the trustee have custody of the collection? If not, who will have custody? If not, who will be liable if an item is damaged, lost or stolen?
- What are the powers of the trustee? May the trustee display the collection? Loan or rent it to family or non-family? Sell or exchange part or all of the collection?
- What powers, if any, do you wish to retain? Do you want the ability to reacquire the trust property and swap it for property of equal value? Are you willing and able to be responsible for the trust's income tax liability?

Family Entities

Family owned entities can be part of a wealth transfer plan, often used to manage and control family assets. If you and next-generation owners want to keep a collection intact rather than transfer individual works to beneficiaries, it may make sense to transfer the collection to a family limited partnership (FLP) or family limited liability company (FLLC). In exchange, you receive membership interests in the FLP or FLLC. These structures provide many benefits for art collectors and their families, including creditor protection and centralized management and ownership of the collection. Family entities also offer opportunities for efficient income and transfer tax planning.

CASE STUDY: FAMILY ENTITY IN ACTION

Carmen has an extensive art collection of 30 pieces. Carmen and her three children have decided to keep and maintain the collection for the foreseeable future. The collection is very valuable, but only if it remains a collection; the value of each individual piece ranges significantly. Rather than give each child 10 pieces, or cause a fight over who will receive certain pieces and their respective values, Carmen transfers her collection to Collector Family LLC in exchange for all membership interests. Instead of breaking up the collection among her children, Carmen is now able to make gifts of ownership interests in the LLC using her annual gift tax exclusion or her applicable exclusion. All in all, this helps avoid any conflict and leaves her and the children satisfied.

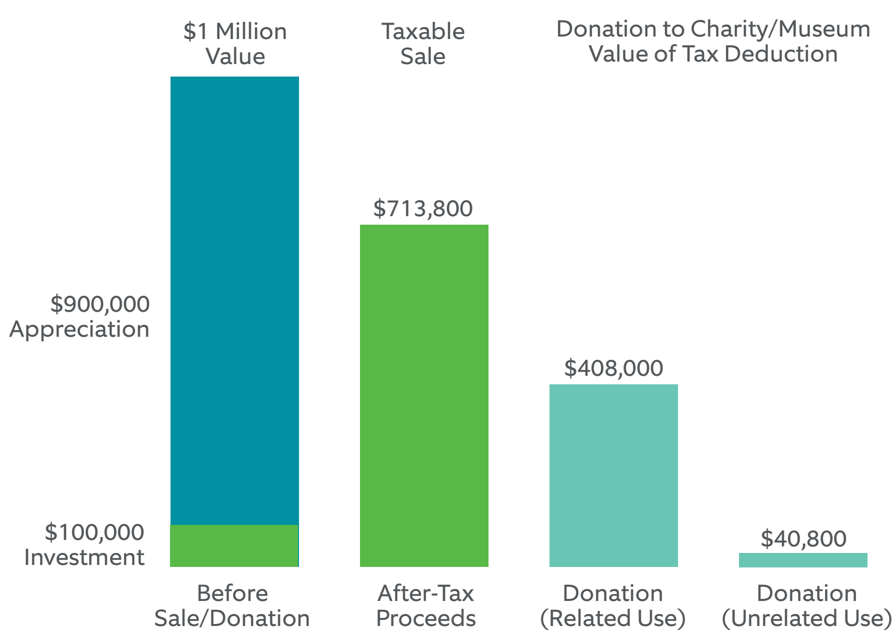
TRANSFERS TO CHARITY

Collectors often donate their prized art collections to charity because they have a desire to support specific organizations or make a positive impact on their communities. In addition, many donors are interested in obtaining a charitable deduction for income, gift or estate taxes. To optimize tax benefits, donors must consider many factors.

For federal income tax purposes, the charitable deduction amount depends on the type of property contributed, the type of recipient and how the recipient intends to use the property. Art held by collectors and investors for more than one year is generally considered long-term capital gain property. Income tax deduction for donating long-term capital gain property to public charities is generally based on fair market value of the property, and donors may deduct up to 30% of their adjusted gross income (AGI). By contrast, the income tax deduction for a donation of long-term capital gain property to a private charity is based on the tax basis (usually the cost) of the property and is deductible up to 20% of the donor’s AGI.

ADVANTAGES OF TRANSFERRING ART DURING LIFE	ADVANTAGES OF GIFTING ART AT DEATH
• Removes the value of the art from your estate, and therefore, any estate taxes that may be due upon death. Any appreciation in the art's value occurs outside of the estate. • Reduces the value of the taxable estate of the first-to-die and equalizes wealth between spouses; a spouse can make unlimited transfers during life, including art, to a U.S. citizen spouse without triggering federal gift taxes.	• In general, the recipient's basis in the art is equal to the art's value on the date of the owner's death. If, at death, the owner transfers art that has appreciated in value, the recipient may sell the art without realizing the built-in gain resulting from the step-up in basis. However, it is important to remember the value of appreciated art is still included in the value of the owner's gross estate. • Helps you to effectively achieve your charitable giving goals, depending on the goals and organizations you wish to support. • Allows you to enjoy the art in the comfort of your home until your final day.

ART SALE VERSUS ART DONATION



CASE STUDY: CHARITABLE TRANSFER TO MUSEUM

Darius is an avid art collector who owns many works by Claude Monet. Looking to collect works by Édouard Manet instead, Darius desires to contribute his Monet collection to a public museum that exclusively displays Monet. The fair market value of Darius' Monet collection is $1 million. He and his wife, Donna, have an AGI of $1 million and live in a state with no state or local income taxes. Darius may deduct $300,000 in the current year and the next two years. In the fourth year, he may deduct approximately $100,000 due to the 30% AGI limitations (assuming Darius and Donna's AGI remains the same).

	CURRENT YEAR	YEAR 2	YEAR 3	YEAR 4	TOTAL
Deductible Amount	$300,000	$300,000	$300,000	$100,000	$1,000,000

To obtain a deduction equal to the artwork's full fair market value, the work must be contributed to an organization that will use the artwork related to the organization's charitable mission. This is referred to as the related use test. A classic example of satisfying the related use test is a donation of a painting to a fine art museum. If a donation fails to meet the related use test, the deduction is limited to the property's tax basis.[28] Deductions exceeding the AGI limitation may be carried forward and deducted for up to five years, subject to the same AGI limitations.

Charitable transfers at death are not subject to the same extensive tax deduction requirements (such as AGI limitations and the related use test) as transfers during life. Instead, transfers at death are eligible for unlimited federal estate tax deductions. A charitable transfer at death allows you to benefit from full ownership of the collection during life, and may allow your estate to obtain an estate tax charitable deduction based on the fair market value of transferred items.

APPRAISAL OF THE CONTRIBUTED ART

While the old adage "beauty is in the eye of the beholder" reflects the subjective nature of art, a new adage of "value is in the eye of the appraiser" may be needed to reflect the importance of an objective, qualified appraisal for charitable gifts of art. As a reminder, donors looking to maximize their income tax charitable deduction must carefully follow complex IRS rules. Working with trusted advisors can make the process easier and help ensure your tax and philanthropic goals are aligned.

COMMUNICATION WITH THE DONEE

While charitable deductions may be an important consideration when donating charitable gifts of art, by no means is it the only consideration. Donors often have strong motivations for making charitable gifts such as safeguarding and preserving art for future generations to enjoy. But before making such gifts, you should work with potential donees to ensure both parties' goals and expectations are realistic and aligned.

If you are considering leaving art to a not-for-profit organization in your estate plan or will, it is a good idea to notify the organization while you are still alive. First and foremost, it is important to know if a museum or other not-for-profit is interested in receiving your art as a gift. If a cherished work of art does not fit into a museum's curatorial or accession plan, the organization may pass on the gift. That may not only thwart your philanthropic goals, but may also leave the executor of your estate with the task of figuring out a Plan B.

Work with an Advisor on a Gift Agreement

Communicating in advance with an intended donee allows you to express your wishes for how you would like the organization to manage your gift. For example, you may want a donated piece of art displayed for a certain period of time. Assuming you and the donee can come to an understanding around accepting an art donation, it is a good idea to document the transaction details in a written gift agreement.

Gift agreement templates may be easily accessible online, but it is worth the time and expense to work with an experienced attorney or philanthropic advisor to develop an agreement that accurately represents the goals and expectations of all parties.

Consider Making a Gift of Cash or Securities along with Gifts of Art

Along with art, you may also want to consider additional gifts of cash or marketable securities to help the recipient organization manage the donated art. Properly caring for and protecting art comes with associated expenses, such as insurance, storage, restoration and transportation. It would be wise to discuss these associated costs with potential donees. In certain circumstances, you may wish to make additional gifts of cash or appreciated securities to help offset some of the associated costs.

SELLING ART

Compared to other assets, art is expensive to sell regardless of whether it is sold during your lifetime or after your death. This is due to additional costs associated with the sale: auction house fees, sales commissions, insurance, taxes and shipping costs. Strategies to minimize tax costs associated with a sale or exchange of art depend on timing and the relationship between the taxpayer and the art.

Classifying a taxpayer as a collector or an investor is critical to determine income tax rules. This includes tax rates and permitted expense deductions. Art collectors are presumed to be engaged in a hobby – buying and selling art for personal pleasure rather than profitable investment.[29] On the other hand, investors buy, collect and sell art as an investment – they hope the art will appreciate in value to enable a profitable sale. Most individuals will be classified as collectors rather than investors. Nevertheless, collectors are increasingly looking to art as an investment to generate additional investment returns or for diversification purposes, blurring the line between collector and investor.

The key inquiry is whether you are engaged in an investment activity with a primary objective of making a profit. You have the burden of proving the art was primarily acquired and held for investment purposes.[30] To determine if you are engaged in collecting art for profit, consider:

- The manner in which you carry on the activity
- The time and effort you spend in carrying on the activity
- Your success in carrying on similar or dissimilar activities
- The amount of occasional profits, if any, you earned
- Your expertise or your advisor's expertise
- The expectation assets used in the activity may appreciate in value
- Your history of income or losses with respect to the activity
- Your financial status
- The elements of personal pleasure or recreation

All facts and circumstances are to be taken into account, and no single factor or group of factors is determinative.[31]

When considering sale options, it is important to realize the art market is comprised of many unique submarkets defined by artists and genres, each of which operates relatively independently. The upside is that a motivated seller will usually locate a willing buyer. The downside is many submarkets lack transparency, valuations are highly subjective and the obtainable price for a particular work depends, in part, on the collector or investor's taste or aesthetic.

LIFETIME SALE TO THIRD PARTY

Art sale gains held for one year or less are subject to ordinary federal income tax rates as high as 37%, plus 3.8% net investment income tax (NIIT), and applicable state and local income taxes. By contrast, gains held for more than one year are subject to the higher 28% tax rate instead of the 20% long-term capital gains tax that would ordinarily apply (plus 3.8% NIIT and applicable state and local income taxes).[32] As illustrated below, federal income tax consequences will greatly vary depending on whether the art is held for one year or less (ordinary income tax treatment) or more than one year (long-term capital gain treatment).

CASE STUDY: SELLING ART AFTER LONG-TERM OWNERSHIP VERSUS SHORT-TERM OWNERSHIP

Clara owns an impressive art collection of Impressionist works that has a $10 million fair market value. Clara has owned the collection for many years, which she originally purchased for $1 million. After discussing the collection with her children, she decides that selling the collection prior to her death would be the best option for her and her family. Clara lives in a state with no state income taxes. Her taxable gain is $9 million ($10 million fair market value, less $1 million tax basis), which is subject to 28% long-term capital gain tax plus 3.8% NIIT. Clara's total tax rate is 31.8%. She will owe approximately $2.86 million in federal income tax as a result of the sale.

With the same facts as above, assume Clara purchased the collection more recently, in August 2018, for $1 million. After a sudden high demand for Impressionist artwork, she decided to sell the collection now rather than risk a later reversal in the market. At a private sale in June 2019, Clara sold the collection for $10 million. Her taxable gain is $9 million ($10 million fair market value, less $1 million tax basis). She will incur the ordinary 37% federal income tax rate – plus 3.8% NIIT – because she has only held the collection for 10 months and does not qualify for long-term capital gain treatment. Clara's total tax rate is 40.8%. She will owe approximately $3.67 million in taxes as a result of the sale.

LEVERAGING VALUE FROM ART – USING ART AS COLLATERAL

Art can be aesthetically powerful, but some collectors have discovered another power you may not have considered: obtaining credit using art as collateral. Using the value of art without selling it can be a convenient way to leverage and monetize an illiquid asset to fulfill a financial need. Collectors can still enjoy viewing the artwork on their wall at home.

Depending on your need and the value of the art, a highly customized line of credit or term loan can be used for many purposes. Collectors can use funds for business and investment opportunities, personal trust and estate purposes (including solutions for estate taxes) and wealth diversification reasons. In some instances, individuals have leveraged their art to acquire more art.

Before discussing with your wealth advisor the pros and cons of leveraging value from art, consider and determine:

- **Purpose –** What will you use the proceeds for?
- **Timeframe and structure –** Depending on the purpose, does it make sense to schedule monthly principal payments (a term loan) or borrow for general liquidity purposes (a line of credit)?
- **Amount –** How much debt are you comfortable with?

As a rule of thumb, the loan-to-value is 50% and you should be prepared to demonstrate the ability to comfortably repay the loans without the need to sell the art.

Collectors Leverage Art for Many Reasons

- Collectors see a valuable, unused asset on their wall as an opportunity they can monetize
- In a relatively low interest rate environment, collectors don't mind incurring debt to take advantage of an opportunity to achieve a goal
- Leveraging art can be more cost effective than selling art, after factoring in taxes and selling costs; most importantly, collectors keep the art and continue enjoying it

CASE STUDY: LEVERAGING ART – MONETIZING AN ILLIQUID ASSET

Pablo owns a successful family owned business and has been an avid art collector for more than 30 years. He works closely with an art advisor to expand his vast collection of contemporary art. The current fair market value of his collection is estimated at $25 million. Pablo was recently presented with an attractive business investment proposal, one that requires initial capital investment of $8 million. Pablo wants to leverage his art, an otherwise illiquid, yet valuable, asset. He explored the possibility of using art as collateral to secure an $8 million loan on flexible terms that fits his existing personal cash flow. And, importantly, he wants to keep the art for his own aesthetic enjoyment. After working with his banking advisor, Pablo accepted the attractive business proposal after he determined with his business advisor that a four-year, fixed-rate term loan was the most fitting structure. The collateral was artwork with a fair market value of $16 million. The loan agreement also included an option for substituting specific pieces of art from the collateral pool after Pablo inquired about this possibility.

SALE BY ESTATE

If a lifetime sale is not desired, your estate or beneficiaries may want or need to sell part or all of the collection. One advantage of holding appreciated art until the collector's death, from an income tax standpoint, is obtaining a fair market value income tax basis adjustment at death. For example, if you purchased a particular work in your collection for $1 million, and at your death the work has a fair market value of $10 million, the $9 million appreciation is not subject to federal income tax. However, the tradeoff is the art will be includible in your estate for federal estate tax purposes. It may be subject to the 40% estate tax rate if the gross estate plus adjusted taxable gifts exceed the federal estate tax exclusion amount. In 2018, the federal estate tax exclusion amount is $11.18 million; for U.S. married couples with portability the 2018 exclusion amount is $20.36 million. Further, the estate or beneficiaries may not be able to realize the full value of the collection, or works therein, or must spend significant sums to do so. This would be especially problematic for your estate if no other assets can be easily liquidated to pay administrative fees for settling your estate or to pay federal estate taxes, if any.

LEASEBACK ARRANGEMENTS

Some collectors may wish to transfer works of art to children or grandchildren but hesitate to make an outright transfer. They may feel concerned subsequent generations are not able to properly care for the art, or their hesitation may arise from a desire to still enjoy and display the art. For collectors facing this dilemma, a potential solution may be a leaseback arrangement.

A leaseback arrangement can be rather straightforward. The collector transfers art to an irrevocable trust. The trust beneficiaries may be family members, friends or other loved ones. The collector then leases the art back from the trust for the fair market rental value, as determined by an independent, qualified appraiser. The collector makes fair market value lease payments to the trust that can be distributed to beneficiaries, per the terms of the trust, or for expenses such as insurance or taxes. The trust can be structured so the collector pays the trust's taxes, thereby allowing income generated by the leased art to be used for the trust beneficiaries. This technique has many potential benefits, including:

- Removing the value of art (and subsequent appreciation) from a collector's estate
- Safeguarding the art for future generations
- Generating an income stream to help maintain the art and benefit future generations
- Enabling the art to remain in the collector's home to enjoy and display

To take advantage of leaseback arrangements, it is critical collectors work with experienced attorneys and qualified appraisers. Many pitfalls can jeopardize the transaction, such as failing to pay fair market value for the leased art. A team of advisors who can structure the transaction can avoid these pitfalls.

When Selling All or Part of Your Art Collection, Be Sure To:

- Understand the tax consequences
- Be aware of selling costs and fees auction houses will deduct from the final sale price
- Follow all steps to properly execute a sale, including completing a final bill of sale, transferring title, changing applicable insurance policies and arranging for physically transferring the art

You should work with qualified art advisors who can assist in determining the appropriate sale venue in order to maximize sale proceeds and fulfill your intentions

AUCTION

An auction is a transparent process that exposes artwork to a bidding audience. The location of the market place is critical to a successful auction sale. Works sold at auction receive a free auction estimate, which is a price range of the artwork's value. Auction estimates can be an important marketing tool when presenting a work at auction. Most works also carry a reserve price, which is the minimum price a seller will accept. The reserve price is confidential and only known to the seller and auction house.

An appropriate time to start considering an auction is between three and four months before the scheduled sale season. During that time, sellers should have the artwork inspected by a qualified expert; obtain auction estimates; engage the auction house; pack the artwork; ship the artwork to the auction house; catalogue the artwork; create marketing materials; and, one week before the sale, schedule an exhibition.[33]

Should you, the seller, need funds before the sale, many options are available for raising that cash. The auction house might advance projected sale proceeds to you or guarantee the sale by offering you a minimum price, regardless of the sale's outcome. Or you can obtain a loan, secured by the artwork, from a financial institution.[34]

To ensure confidentiality of parties to an auction sale, auction houses will sometimes engage in a private treaty sale, which is not made publicly available.

PRIVATE OR GALLERY SALE

In some cases a private sale is preferred because the parties may want to remain anonymous or avoid publicity. In other cases, the auction cycle does not match the parties' required timeline, or a work can realize stronger prices through private sales than at auction. The latter example is particularly relevant for an artist who has a strong regional following.

Most data on artwork value comes from public auctions. Gallery sales and private auction sales are unreported; therefore, it is very difficult to obtain information about these transactions. Whether buyer or seller, parties to art transactions are well advised to conduct due diligence and carefully negotiate purchase and sale agreements, with advice of counsel, to protect themselves.

TRANSPORTING ART

Each country has its own rules for transporting artwork into or out of the country. Taxes must be considered, as well as customs duties, treaties and international agreements on transfer of cultural goods. Freeports, which are warehouses in tax friendly jurisdictions, such as Switzerland, have the potential to become important hubs for collectors and their advisors to hold artwork. With the increasingly global nature of the art market, the demand for storage facilities and duty-free zones is likely to increase.[35]

Inherent Market Risks

Monetizing an art collection is challenging because there is no fundamental pricing model for art. Each piece of artwork is unique. Measuring standards can vary, even for the same artist, depending on the medium or stage in the artist's career in which the work was created. The lack of a pricing model for art means that art is subject to fads, fashions and potential bubbles. For instance, is the current intense interest in contemporary art one of those market bubbles? Without an established pricing model, this question is difficult to answer. Collaborating with independent appraisers, reputable auction houses, dealers, art advisors, galleries, insurers and wealth advisors can help you identify your goals for art assets and better navigate the nuanced art market to achieve your goals.

AN AFFINITY FOR ART, AN APPRECIATION FOR PLANNING

We conclude where we began: an appreciation for art and artists, and a further appreciation for the many considerations when incorporating art into wealth planning and management.

Art collections are unique and very personal assets. Planning to build and maintain a collection and ensuring its future requires balancing special rules applied to collectibles and the personal and financial realities of individuals or families. Although transferring or disposing of a collection may be in the distant future, it requires planning well in advance. When collectors, their families and their trusted advisors engage in purposeful planning for art collections, they will be in the best position to preserve their collections and provide for a seamless, workable ownership succession.

For More Information

Northern Trust specializes in Goals Driven Wealth Management backed by innovative technology and a strong fiduciary heritage. Our Wealth Planning & Advisory Services teams leverage our collective experience to provide wealth transfer and tax strategies, financial planning and education, family governance, art advisory, business advisory and philanthropic advisory services to our clients.

It is our privilege to put our expertise and resources to work for you. If you would like to learn more, contact a Northern Trust professional at a location near you or visit northerntrust.com.

END NOTES

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These scenarios are intended to illustrate services available through Northern Trust and do not necessarily represent the experiences of our clients. Individual results may vary.

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