

# What Every Professional Advisor Should Know About Planning for Their Clients' Art Collection

September 2005

Michael L. Duffy<sup>1</sup>  
Mellon, Private Wealth Management  
Atlanta, Georgia

## I. Determining the Client's Status

### A. Artist

1. creator of work<sup>2</sup>

### B. Dealer

1. client must be regularly engaged in the activity
2. activity must be undertaken with an expectation of making a profit
3. client must hold out to others that he is engaged in the activity of buying and selling for profit.<sup>3</sup>

---

<sup>1</sup> Michael Duffy, is a Vice President and Senior Director of Mellon, Private Wealth Management. With more than 17 years of investment, tax, and legal experience, Mr. Duffy specializes in giving advise to affluent and ultra high-net worth families regarding wealth transfer, family governance, exempt organizations, business succession and executive compensation. Prior to joining Mellon in February of 2005, Mr. Duffy worked for the JP Morgan Private Bank for 7 years in the private bank's Wealth Advisory Group. He has also served as a tax attorney for the Palm Beach law firm of Alley, Maass, Rogers & Lindsay, PA; a tax associate for Coopers & Lybrand; a Financial Advisor for Shearson Lehman Hutton; and a Financial Officer for Florida National Bank.

Mr. Duffy received his B.A. from Flagler College in 1984, J.D. from Ohio Northern University College of Law in 1991, LL.M. in Taxation from Georgetown University Law Center in 1992. He is a member of the American Bar Association (Tax Section), Florida Bar Association, North Carolina Bar Association and South Carolina Bar Association.

The information contained herein is Mr. Duffy's understanding of the federal tax law as it pertains to certain transactions. Mellon or any of its affiliates does not guaranty or warrant the accuracy of his understanding or his conclusions. Mellon is not engaged in the practice of law.

<sup>2</sup> Sales treated as ordinary income. Expenses associated with the creation and storage off works are deductible under IRC Section 162.

<sup>3</sup> Sales treated as ordinary income. Expenses associated with maintaining art are allowed under IRC Section 162. Dealers are also liable for self-employment taxes. Dealer can enter into like-kind exchange transactions under IRC Section 1031.

### C. Investor

1. motive
2. purpose
3. frequency of sales
4. duration of ownership
5. business of client
6. use of proceeds
7. time and effort devoted to sales activity.<sup>4</sup>

### D. Collector

1. individual who collects for personal enjoyment.

## II. Outright Sales

A. Works of art (also known as "collectibles") not considered ordinary income property are subject to long-term capital gains at a tax rate of 28%.<sup>5</sup> While the term "collectibles" is not defined in Section 1 of the Code, IRC Section 408(m)(2) does provide the following useful guidance:

1. The term "collectible" means:
  - a. any work of art
  - b. any rug or antique
  - c. any metal or gem
  - d. any stamp or coin
  - e. any alcoholic beverage, or
  - f. any other tangible personal property specified by the Secretary for purposes of this subsection.
2. Ordinary income property is:
  - a. a work created and held by an artist<sup>6</sup>
  - b. a work received as a gift by the creator
  - c. a work received through a like-kind exchange from the creator
  - d. works held as inventory by a dealer
  - e. works sold within 12 months of acquisition

---

<sup>4</sup> Income from sales is generally capital gains. Expenses such as storage, insurance and maintenance are allowable under IRS Sections 212(1) and 212(2) but AGI limitations apply. Unused capital losses can be carried forward during the investor's lifetime. Collectors can enter into like-kind exchange transactions under IRC Section 1031.

<sup>5</sup> The Jobs and Growth Tax Relief Reconciliation Act of 2003, signed into law by President Bush on May 28, 2003, reduced the long-term capital gains tax rate from 20% to 15% for transactions that occur after May 5, 2003. The rate for collectibles remained unchanged at 28% as provided for in IRC Section 1(h)(5) and (6).

<sup>6</sup> IRC Section 1221(a)(3).

f. works if sold would create a capital loss.

B. Accordingly, when a collector sells a work of art held more than one year he will have 72% of the net proceeds to use for consumption or to re-deploy into an alternative investment.

### III. Outright Gifts

A. Taxpayer can make an outright gift of a work of art to a qualifying charity.

1. Donating art, antiquities and other types of collectibles can provide the donor with the following benefits:

- a. an immediate charitable income tax deduction
- b. avoidance of capital gains
- c. an estate and gift tax charitable deduction
- d. creation of a family legacy.

2. Generally, as long as the work:

- a. is contributed to a public charity<sup>7</sup>
- b. the work is considered long-term capital gain property<sup>8</sup>
- c. satisfies the related use test<sup>9</sup>

---

<sup>7</sup> The tax consequence for a donor of a work of art is, in general, the difference between a charitable deduction limited to tax basis if the transfer is to a private charity as opposed to a deduction of full fair market value if the transfer is to a public charity. IRC Sections 170(b)(1)(A)(i)-(viii), 170(b)(1)(B), (E)(i)-(iii), IRC Section 509(a); Treas. Reg. §1.170A-9. Generally it is wise for a donor to verify the status of the donee by obtaining a copy of a charity's exemption letter, verifying the donee's exempt status in IRS Publication 78, or requesting a letter from the donee charity's counsel as to the charity's "public" status.

<sup>8</sup> IRC Section 170(b)(1)(C)(iv) provides that the term "capital gain property" means, with respect to any contribution, any capital asset the sale of which at its fair market value at the time of contribution would have resulted in gain which would have been long-term capital gain. For purposes of the preceding sentence, any property which is property used in the trade or business (as defined in Section 1231 (b)) shall be treated as a capital asset. IRC Section 1221 specifically defines the term capital asset. IRC Section 1221(a)(3)(A) excludes an asset that was created by a taxpayer's personal efforts. Consequently, an artist's own work can never be a capital asset in that artist's hands. Treas. Reg. 1.170A-1(c)(4). This same rule applies to the donee of a work of art who acquired the property by *inter vivos* gift from the artist. IRC Sections 1015 and 1221(a)(3)(C).

<sup>9</sup> IRC Section 170(e)(1)(B)(i); Treas. Reg. 1.170A-4(b)(3) defines, in part, the term "unrelated use" as a use that is unrelated to the purpose or function constituting the basis of the charitable organization's exemption under IRC 501. Section 1.170A - 4(b)(3)(ii)(b) of the Regulations further explains, in part, that in the case of a contribution of tangible personal property to or for the use of a museum, the taxpayer may treat the property as not being put to an unrelated use by the donee if at the time of the contribution, it is reasonable to anticipate this. The donor's anticipation is reasonable if the object donated to the museum is of a general type normally retained by the museum or other museums for museum purposes, and the donor does not have actual knowledge that the object will not be put to an unrelated use by the donee, whether or not the object is later sold or exchanged by the donee. See also PLR 7751044; PLR 80009027; PLR 8143029; PLR 8208059.

- d. the donor obtains a qualified appraisal<sup>10</sup> of the work

the taxpayer will be eligible to claim an income tax charitable deduction<sup>11</sup> based upon the fair market value of the work.

### 3. U.S. Qualified Charity Required:

- a. IRC Section 170(c) provides that an income tax charitable deduction is permitted only if the donee organization was created or organized in the United States or any possession thereof, or under the law of the United States, any state, the District of Columbia or any U.S. possession. In the absence of an applicable treaty exception, if a U.S. individual donor wants a deduction against U.S. income for a gift to a foreign charity, the donation must be made to a U.S. tax-exempt organization that operates abroad or can make grants abroad.
- b. Treas. Reg. §1.170A-8(a)(1) provides that a deduction may be available even though all, or some portion, of the funds of the organization may be used in foreign countries for charitable or educational purposes.<sup>12</sup> IRC Section 170(c) further specifies that a donation to a U.S. charity is deductible only if it is to be used for purposes specified in IRC Section 170(c)(2)(B).<sup>13</sup>

---

<sup>10</sup>IRS Publication 561 sets forth the general requirements for a qualified appraisal. Such appraisals are needed for donations of property worth more than \$5,000. A qualified appraisal is an appraisal document that: (i) relates to an appraisal made not earlier than 60 days prior to the date of the contribution of the appraised property, (ii) does not involve a prohibited fee, (iii) includes certain information, and (iv) is prepared and signed by a qualified appraiser. The information that must be included is a description of the property, the physical condition, the date of the contribution, the terms of the agreement between the donee and donor, the name address and taxpayer identification number of the qualified appraiser, the qualifications of the appraiser, a statement that the appraisal was prepared for income tax purposes, the date the property was valued, the fair market value of the property, and the specific basis for the valuation (such as comparables). For art objects, Publication 561 sets forth the following examples of additional information: size, subject matter, medium, name of the artist, date of creation, cost, manner of acquisition, history of item including proof of authenticity, and a 10 x 12 photograph.

<sup>11</sup> Subject to the percentage limitation rules of IRC Section 170(b). Section 170(d)(1) provides that if there is excess charitable contribution deduction the excess may be carried forward up to five years.

<sup>12</sup> In November 2002 the Treasury Department released "Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities" (search at [www.treas.gov](http://www.treas.gov)). These guidelines were developed to help a charity reduce the risk that the charity's funds would be frozen in connection with any ongoing anti-terrorism investigation. See also Executive Order 13224 - Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten To Commit, or Support Terrorism. Section 2(a) provides: "[A]ny transaction or dealing by United States persons or within the United States in property or interests in property blocked pursuant to this order is prohibited, including but not limited to making or receiving of any contribution of funds, goods, or services to or for the benefit of those persons listed in the Annex to this order or determined to be subject to this order."

<sup>13</sup> Rev. Rul. 71-460, 1971-2 C.B. 231, provides that a domestic organization that conducts some or all of its activities outside the United States is not precluded from qualifying for exempt status under Section

## B. Donor Checklist:

1. determine donee status (public v private; domestic v foreign)
2. donate appreciated works
3. held more than one year
4. for a related use
5. obtain a qualified appraisal
6. prepare a Deed of Gift
7. attach IRS Form 8283 to donor's income tax return
8. consider the special election to increase deduction from 30 to 50 percent of AGI.<sup>14</sup>

## IV. Retained Life Estates

A. Before 1964 a remainder interest to charity was deductible. It was possible to reserve a life interest in a work of art, allowing the work to remain in the taxpayer's possession while enjoying an immediate income tax charitable deduction for the present value of the remainder to charity.

1. The Revenue Act of 1964 added IRC Section 170(f), now IRC Section 170(a)(3), which postpones any income tax deduction for a gift of a future interest in tangible personal property until there is no intervening interest in, right of possession of, or enjoyment of the property held by the donor.
  - a. Treas. Reg. §1.170A-5(a)(4) provides that the term "future interest" includes: reversions, remainders, and other interests or estates, whether vested or contingent. It further provides that it includes a situation where the donor purports to give an interest away in tangible personal property but has an understanding, arrangement, agreement, etc., whether written or oral, which has the effect of reserving to, or retaining in, such donor a right to use, possess or enjoy the property.

B. If a donor dies before relinquishing his right to use, possess or enjoy the work he will not be entitled a charitable income tax deduction.<sup>15</sup>

---

501(c)(3) of the Code. See also Rev. Rul. 68-117, 1968-1 C.B. 252, and Rev. Rul. 68-165, 1968-1 C.B. 253.

<sup>14</sup> Donor can elect to increase to the 30 percent AGI limitation to a 50 percent AGI limitation with a five-year carry forward if he: (i) reduces the amount contributed for all long-term property during the year by 100 percent of the appreciation, and (ii) reduces the deemed contribution for all long-term property gifts being carried forward from prior years. The result of which is to limit the deduction to cost basis. IRC 170(b)(1)(C)(iii); IRC 170(e)(1); Treas. Reg. 1.170A-8(d)(2).

<sup>15</sup> Treas. Reg. §1.170A-5(b), Example (3).

- C. TAX TRAP: If a donor relinquishes his right to use, possess or enjoy a work he may be making an unintended taxable gift. There is no gift tax charitable deduction for transfers of remainder interests in works of art.<sup>16</sup>

## V. Undivided Fractional Gifts

- A. IRC Section 170(f)(3) generally restricts deductions for partial interests in property, including tangible personal property.
- B. However, IRC Section 170(f)(3)(B)(ii) provides that the contribution, not in trust, of an "undivided portion" of the taxpayer's entire interest in property is deductible as an exception to that restriction.
- C. Under Section §1.170A-7(b)(1) of the Regulations, an "undivided portion" must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.
- D. A deduction is allowable under this exception if the charitable organization is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in the property.<sup>17</sup>

Example: A taxpayer can give away a 1/6 interest in a collection to a museum. Taxpayer could possess and enjoy the collection for 10 months out of the year and the museum could possess and display the collection 2 months out of the year. It is not necessary that the charity actually take possession of the art but the charity must have the full right and option to take possession for the appropriate fractional time. *See Winokur v. Commr.*, 90 TC 733 (21 Apr. 1988). The period of initial possession by the donee may not be for a period in time for than one year.

- E. In practice, when making gifts of fractional undivided interests the donee charity should require the donor to pledge the remaining undivided fractional interests to the charity upon her death. The promise to gift the remaining fractional interests owned at death should not constitute a taxable transfer.<sup>18</sup>
- F. Fractional interest gifts are useful when an outright donation would exceed the 30% AGI limitation for gifts made to public charities. In other words,

---

<sup>16</sup>IRC Section 2522(c)(2); Treas. Reg. §25.2522(c)-3(c)(1).

<sup>17</sup>Treas. Regs. §§1.170A-5(a)(2) and 1.170A-7(b)(1).

<sup>18</sup>PLR 9303007.

donors would not be limited to a five-year carry forward. Instead, they could time their contributions to best match their income tax liability for the year.<sup>19</sup>

- G. Fractional interests can be very useful when donating a work that is expected to appreciate. At each subsequent donation the work can be re-appraised. If the work has indeed appreciated so to the charitable income tax deduction.<sup>20</sup>
- H. Where the owner of an art object contributes an undivided present interest in such object to an organization described in Section 170(c) of the Code by delivery of a formally executed and acknowledged deed of gift, a deduction for the fair market value of such undivided present interest will be allowable under IRC Section 170(a), subject to the limitations of IRC Section 170(b), but only if the deed contains unequivocal language of a present gift and transfers to the organization rights to possession, dominion, and control of the art object consistent with the creation of a tenancy-in-common as between the donor and the organization. Revenue Ruling 57-293, C.B. 1957-2, 153.

## **VI. Loans**

- A. If the taxpayer intends to loan a work of art to a charity and intends to make future gift... there will be no charitable income tax deduction until the donor has actually irrevocable transferred the work of art to the charity.<sup>21</sup>

## **VII. Leaseback**

- A. Taxpayer can donate a work of art to a charity and then have the charity lease it back to the taxpayer for a term certain.
  - 1. asset out of taxable estate
  - 2. rent paid is not deductible
  - 3. rent probably UBIT to the charity.<sup>22</sup>

## **VIII. Bequests**

- A. Taxpayer can leave works to heirs.
  - 1. may cause estate liquidity issues<sup>23</sup>

---

<sup>19</sup> The Revenue Reconciliation Act of 1993 repealed the rule that made built-in-capital gains on donated property to charity a AMT tax preference item.

<sup>20</sup> "Donating Art, Good Works Great Works", *Art & Auction* (Investment Annual 2005); "Arranging for Joint Custody for your Monet", *WSJ* sect. D (July 6, 2005).

<sup>21</sup> Treas. Reg. §1.170-5(a)(1).

<sup>22</sup> Ralph E. Lerner & Judith Bresler, *Art Law: "The Guide for Collectors, Investors, Dealers and Artists"* 580 (1989).

2. fractional interests may qualify for a discount<sup>24</sup>

B. Taxpayer can leave a work of art to a charity using a Last Will and Testament.

1. no requirement that the objects be related and used for a purpose and function related to a charity's exemption under Section 501<sup>25</sup>
2. no requirement that the charity be US<sup>26</sup>
3. no percentage limitations under IRC Section 170
4. IRC Section 2033 will require any works of art that are owned by the decedent at the time of the decedent's death to be included in the gross estate
5. IRC Section 2055 generally provides that for purposes of determining the gross estate, the value shall be reduced by the fair market value of all charitable bequests.<sup>27</sup>

---

<sup>23</sup> Artist De Grazia, famous for creating the 1960 UNICEF Christmas card illustration, "Los Ninos" burned over 100 of his oil painting at Angel Springs in the Superstitious Mountains of Phoenix. De Grazia was outraged when he read that the heirs of another artist, Walt Kelly, faced bankruptcy as a result of the estate tax.

<sup>24</sup> Tax Court allowed a 5% discount. *Estate of Robert C. Scull v. Commissioner*, 67 T.C.M. (CCH) 2953 (1994).

<sup>25</sup> IRC Section 170(e)(1)(B)(i); Treas. Reg. §20.2055-1 (a)(4).

<sup>26</sup> Unlike the income tax charitable contribution deduction there is no requirement for estate tax purposes that the charity be organized within the United States. IRC Section 2005 provides, "For purposes of the tax imposed by Section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers - (1) to or for the use of the United States, any State, any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (2) to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, which is not disqualified for tax exemption under Section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." The Regulations state clearly that the deduction for gift and estate tax purposes is not limited to domestic corporations or associations, or to trustee for use within the United States, Treas. Reg. §§ 20.2055-1 (a) and 25.2522(a)-1 (a). The foreign organization must meet all of the requirements of IRC Section 501(c)(3).

<sup>27</sup> IRC Section 2005 provides, "For purposes of the tax imposed by IRC Section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers: (1) to or for the use of the United States, any State, any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (2) to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), and

- a. fair market value is based on a price that would be arrived at between a willing buyer and willing seller, neither being under a compulsion to buy or to sell and both having reasonable knowledge of the facts.<sup>28</sup>
- b. sample restrictions on gifts of art:
  - i. requirement that work be displayed on a permanent and continuous basis
  - ii. prohibition on the sale or exchange
  - iii. prohibition on lending the work
  - iv. requirement that the work be installed and displayed a certain way
  - v. requirement for certain publicity
  - vi. requirement for certain insurance.
- c. certain restrictions can cause the FMV to be diminished and therefore cause more estate tax<sup>29</sup>
- d. PLRs 200202032, 200203013, and 200203014 - Restrictions that were imposed by the collectors were ignored for purposes of IRC Section 2055 and the works were found to be of equal value to that which were includable under IRC Section 2033.<sup>30</sup>

---

the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, which is not disqualified for tax exemption under Section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

<sup>28</sup> Treas. Reg. 20.2031-1(b).

<sup>29</sup> Collectors Samuel and Norma Silverman contributed 148 paintings to various exempt organizations with the restriction that the paintings were not to be sold for three years. Court found said restriction diminished the fair market value of the donated paintings for estate tax purposes. *Silverman*, TCM 1968-126.

<sup>30</sup> The agreements essentially imposed the following restrictions: the museum was required to maintain the collection in a first-class condition, to maintain appropriate security, to exhibit the collection on a permanent and continuous basis, to exhibit the works together, to exhibit in a specified space which identified the name of the collection, to bear an appropriate plaque, to purchase similar works of art if a piece was sold out of the collection. The IRS ruled in favor of the taxpayers because the museum could not be divested of its ownership, the only restriction on sale was that the proceeds had to be used to acquire similar works, and the museum was not prohibited from loaning the works of art.

- C. In TAM 9152005 the Service concluded that when stolen assets are included in a gross estate, the estate remains liable for the tax on the asset but is not eligible for an estate tax deduction for the value of the property when it is recovered from the estate by the previous owner.

## IX. Bargain Sales

A. Taxpayer can sell a work of art to a charity below the work's fair market value.

1. Taxpayer will have to recognize income/capital gain on the difference between a portion of her tax basis and the sales proceeds received.<sup>31</sup>
  - a. IRC Section 1011(b) provides generally that there shall be allocated to the contribution portion of the property that portion of the adjusted basis of the entire property that bears the same ratio to the total adjusted basis as the fair market value of the contributed portion of the property bears to the fair market value of the property.

*Example:* Donor sells a work of art to a museum for \$400,000. The work had been part of the taxpayer's collection for longer than twelve months. Taxpayer's adjusted tax basis in the work was \$200,000. The fair market value of the art on the date of the sale was \$1 million dollars.

- i. allocation of tax basis is as follows: sales price/FMV times ' tax basis =  $400,000/\$1 \text{ million} \times \$200,000 = 80,000$
  - ii. long-term capital gain calculated as follows: \$400,000 minus 80,000 = \$320,000 times 28% = \$89,600
  - iii. balance of the basis \$120,000 (\$200,000 less \$80,000) is allocated to the gift portion of the transfer.
2. Taxpayer will be entitled to take a charitable income tax deduction based upon the difference between the sales price paid and the fair market value of the work of art.<sup>32</sup>

*Example:* Using the same facts as above, taxpayer's charitable income tax deduction is calculated as follows: \$1 million FMV less \$400,000 sales proceeds = \$600,000.

---

<sup>31</sup> Treas. Reg. §1.170A-4(c)(2).

<sup>32</sup> IRC Section 170(e)(2); *Magnolia Dev. Corp.*, 19 TCM 934; *Waller*, 39 TC 665 (Acq.); *Gladstein*, (DC) 68-1 USTC para. 9197; *Gamble*, (DC) 68-1 USTC para 9393.

## X. *Inter Vivos* Charitable Remainder Trusts

- A. IRC Section 170(f)(2)(A) provides that, "in the case of property transferred in trust, no deduction shall be allowed under this section for the value of a contribution of a remainder interest unless the trust is a charitable remainder annuity trust or a charitable remainder unitrust (described in IRC Section 664), or a pooled income fund (described in IRC Section 642(c)(5))."
- B. If the donor or a family member is a beneficiary of the CRT, IRC Section 170(a)(3) postpones the income tax deduction until the donor and his family no longer have an intervening interest.<sup>33</sup>
  - 1. IRC Section 170(a)(3) provides that payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in IRC Sections 267(b) or 707(b).
- C. IRC Section 170(e)(1)(B)(i) provides that the amount of charitable contribution of tangible personal property, if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under IRC Section 501, shall be reduced by the amount of gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).
- D. IRC Section 170(e)(1)(B)(i) imposes a "related use" rule for contributions of tangible personal property.
  - 1. PLR 9452026 provided that the donation of a violin to a CRT followed by the CRT's sale of the violin was considered as putting the musical instrument to an unrelated use for IRC Section 170(e)(1)(B)(i) purposes. Accordingly, taxpayer's deduction was reduced to that portion of taxpayer's tax basis that is allocable to the remainder interest in the musical instrument under IRC Section 170(e)(1)(B)(i).

---

<sup>33</sup> Treas. Reg. §1.170A-5(b), Example (6). If the CRT trustee sells the property and re-invests the proceeds into a diversified portfolio of marketable securities the sale of the art terminates any "interest" that the beneficiaries may have had in the property. CRTs are created for a number of reasons. One such reason is to diversify away from low basis assets with built-in capital gains and into a diversified portfolio of marketable securities thereby reducing a portfolio's overall risk profile. Because CRTs are exempt from paying income taxes such trusts can sell assets and re-deploy the sales proceeds into a diversified portfolio that is undiminished by capital gains tax.

## XI. Testamentary Charitable Remainder Trusts

- A. Since taxpayer's tax basis in all of her assets that she owns at death automatically receives a step-up in basis<sup>34</sup> ... testamentary CRTs lose some of their appeal since the assets will have no built-in-capital gains. Notwithstanding the forgoing, a taxpayer can indeed create a CRT at her death ... but like an *inter vivos* CRT ... the trustee will at some point be forced to sell the underlying assets in order to make the requisite annuity or unitrust payment.
- B. The executor of the decedent's estate can claim a charitable deduction for the fair market value of the remainder interest.<sup>35</sup>
- C. For purposes of IRC Section 2055, a testamentary charitable remainder trust is deemed created at the decedent's death even though the actual funding may be deferred. The funding can be delayed until the end of a reasonable period of administration. Treas. Reg. §1.664-1(a)(5)(i).
- D. Rev. Rul. 80-123 requires that the governing instrument of a testamentary CRT grant the trustee the authority to defer the payment of the annuity or unitrust payment until the end of the taxable year of the trust in which the trust is completely funded.

## XII. Like-Kind Exchange

- A. IRC Section 1031 is available for property held for investment or for business use. Taxpayer must establish that artwork is held for investment.<sup>36</sup> Therefore the taxpayer must be a "Dealer" or "Investor" ... not an "Artist" or "Collector".
- B. Works of art are like-kind based upon the definition in the Regulations.<sup>37</sup> The term "like-kind" refers to the kind or nature of the character of the property

---

<sup>34</sup> IRC Section 1014.

<sup>35</sup> IRC Section 2055(e)(2)(A).

<sup>36</sup> *Wrightman v. U.S.*, 492 F.2d 1316 (Ct. CL, 1970). Taxpayer acquired an extensive art collection concentrating in 18th Century French art. Taxpayer kept detailed records of the collection, including a comprehensive catalog containing purchase records and records of capital expenses associated with each piece. The taxpayer consulted with art experts, traveled, studied art, and became art experts in their own right. The taxpayer's fine art was displayed in their Palm Beach home. The tax dispute arose from the taxpayer's deduction of expenses related to their art collection, including insurance, travel and entertainment, subscriptions and services. Taxpayer claimed the expenses were deductible under IRC Section 212 as ordinary and necessary expenses incurred for the production of income or the maintenance of property held for the production of income. The U.S. Court of Claims, despite noting that the taxpayers produced significant evidence of their investment intent in acquiring the art collection, because their "principal" purpose in acquiring the art collection was for their personal pleasure and not for the production of income. No evidence was introduced of any sales of artwork for gain. Note: The *Wrightmans* were held to a higher standard than IRC Section 1031 requires. IRC Section 1031 requires the property to be held as an investment, which is broader than "held for the production of income".

<sup>37</sup> Treas. Reg. §1.1031(a)-2(c)(1).

and not its grade or quality.<sup>38</sup> There is surprisingly little guidance on like-kind exchange of tangible property:

1. copyright in a novel is not like-kind to a copyright of a song<sup>39</sup>
2. copyright in a novel is like-kind to a copyright of another novel<sup>40</sup>
3. gold bullion is not like-kind to silver bullion<sup>41</sup>
4. gold bullion is like-kind to gold bullion coins<sup>42</sup>
5. gold bullion coins are not like-kind to collectible gold coins.<sup>43</sup>

#### C. Involuntary conversion under IRC Section 1033.

1. The IRS has held that artwork in one medium was not similar or related in service or use to artwork in another medium.<sup>44</sup> The "similar or related in service or use" standard under IRC Section 1033 is more restrictive than the like-kind standard under IRC Section 1031.

#### D. Mechanics of a deferred exchange similar to other like-kind exchanges.

1. Sales contract should contain a like-kind cooperation clause permitting assignment of rights to a qualified intermediary.
2. Qualified Intermediary will be assigned all rights in the purchase agreement and notice will be given to all parties to the contract before the work is sold.
3. Net proceeds must be sent to Qualified Intermediary.
4. Taxpayer has 45 days to identify like-kind replacement property and 180 days to acquire the replacement property.

---

<sup>38</sup> Treas. Reg. Treas. Reg. §1.1031(a)-1(b).

<sup>39</sup> Treas. Reg. §1.1031(a)-2(c)(3).

<sup>40</sup> Id.

<sup>41</sup> Rev. Rul. 82-166,1982-2 C.B. 190.

<sup>42</sup> Rev. Rul. 82-96,1982-1 C.B. 113.

<sup>43</sup> Rev. Rul. 79-143,1979-1 C.B. 264.

<sup>44</sup> PLR 8127089. The IRS determined that a portfolio of artwork that was destroyed by fire was not similar or related in service or use to the replacement portfolio of artwork. The destroyed portfolio contained 99% lithographs and 1% other artwork. The replacement portfolio contained 63% lithographs and 37% other artwork.