

Volume 37 | Issue 3

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1987

# Changing I.R.C. 170(e)(1)(A): For Art's Sake

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## Recommended Citation

Douglas J. Bell, *Changing I.R.C. 170(e)(1)(A): For Art's Sake*, 37 Case W. Res. L. Rev. 536 (1987)

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## CHANGING I.R.C. § 170(e)(1)(A): FOR ART'S SAKE

*Under current tax law, artists making charitable donations of their work are allowed a deduction equal only to the cost of the materials used. Art collectors, however, may take a deduction equal to the fair market value of any piece donated. Exacerbating this inequitable situation is the fact that an artist's estate is taxed on the fair market value, rather than material cost, of artwork still in his possession at the time of his death. This Note examines the relevant federal income and estate tax provisions in light of their detrimental effect on the donation of original works of art, and concludes that the income tax laws should be modified.*

### INTRODUCTION

**A**RT IS EVERYWHERE. We are exposed to it in many forms, from literature to music to the visual arts. Means of financing it are equally diverse, encompassing both public and private backing. Depending on the country, the proportion of individual to government assistance varies, but art is generally considered beneficial to society and worthy of support.<sup>1</sup>

In this country, an avenue of support once available for the arts was the ability of artists<sup>2</sup> to deduct from their taxable income the full fair market value of any contribution of their artwork. The effect of allowing such a deduction was to provide an incentive for artists to donate their work to museums, enabling these institutions to develop their collections. In 1969, however, this incentive was virtually eliminated as a result of legislation passed partially in reaction to President Nixon's large federal tax deduction for the donation of his vice presidential papers.<sup>3</sup> Since the enactment of the Tax Reform Act of 1969<sup>4</sup> an artist can no longer deduct the fair market value of his own work upon its donation to a museum or other charitable organization. He is only permitted to deduct what amounts to his material costs.<sup>5</sup>

The effect of the Act on America's museums and other cultural institutions has been staggering. By allowing a charitable contribution tax deduction only for art materials such as paint and canvas, but not for the creative part of the artist's work, this law has re-

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1. See *Paying for the Arts*, ECONOMIST, Nov. 17, 1984.

2. The term "artist" in this paper will refer to the combined group of artists, composers, and authors.

3. See *infra* note 39.

4. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended in scattered sections of 20 U.S.C.).

5. See *infra* notes 22-26 and accompanying text.

sulted in a dearth of artist contributions.<sup>6</sup> The irony in the government's change of position is that only four years earlier, in 1965, when creating the National Endowment for the Arts, Congress' stance was that "it is necessary and appropriate for the Federal Government to help create and sustain not only a climate encouraging freedom of thought, imagination, and inquiry but also the material conditions facilitating the release of this creative talent . . ."<sup>7</sup>

In addition to its adverse effects on the contribution of art to museums, the Tax Reform Act of 1969 works unfairness by discriminating against the artist as a taxpayer. The inequities manifest themselves in two areas. First, the 1969 tax gives art collectors much more favorable treatment than it gives the artists themselves.<sup>8</sup> If an artist donates a self-created piece, he can only deduct material cost. The collector, however, is allowed to deduct the full fair market value of any art work donated to a qualified charitable organization.<sup>9</sup> Second, upon the artist's death, his estate will be taxed not at material cost, which would make the valuation procedure consistent, but upon the fair market value of the works of art still in his possession.<sup>10</sup>

Part I of this Note will examine how the federal income and estate tax laws treat the artist, illustrating how the Tax Reform Act of 1969 forces the artist to deduct a lower value for the donation of a self-created work than may a collector contributing the identical piece.<sup>11</sup> Parts II and III will discuss why the 1969 Act was passed and emphasize that the reasons for the enactment are no longer valid.<sup>12</sup>

Part IV of this Note will analyze the pros and cons of altering either the estate or income tax laws, concluding that modification of the latter is preferable.<sup>13</sup> Part V will focus on attempts by Congress to eliminate the inequities of the 1969 Act.<sup>14</sup> Included will be the

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6. See *infra* notes 72-86 and accompanying text.

7. National Foundation on the Arts and Humanities Act of 1965, 20 U.S.C. § 951(5) (1982).

8. See *infra* notes 31-34 and accompanying text.

9. The charitable contribution has existed in one form or another since 1917 when created by the War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300 (1917) (current version at I.R.C. § 170). The wartime tax rates were high, and out of fear that the increased rates would reduce charitable contributions, the deduction was enacted. See 55 CONG. REC. 6728-29 (1917).

10. See *infra* notes 35-37 and accompanying text.

11. See *infra* notes 17-38 and accompanying text.

12. See *infra* notes 39-96 and accompanying text.

13. See *infra* notes 97-179 and accompanying text.

14. See *infra* notes 180-87 and accompanying text.

author's proposals for changes that should accompany any legislation that is passed.<sup>15</sup> Finally, this Note will conclude that a change in the federal income tax laws to allow an artist a fair market value deduction for the contribution of his own artwork is necessary. Such a modification is required to effectuate the Internal Revenue Code's goal of horizontal equity,<sup>16</sup> and will also provide the necessary incentive for artists to make charitable donations, thereby reviving the flow of art into our nation's museums.

## I. TAX TREATMENT OF THE ARTIST

Artists, like other individuals, are subject to paying income taxes. The artist may realize income either through the sale of his work or as fees, salaries, wages, or commissions paid to him for his services.<sup>17</sup> The gross income realized by an artist after the creation and sale of his work will almost always be ordinary income.<sup>18</sup> Once the artist determines his ordinary income, it is taxed under the same progressive rate schedule applicable to other taxpayers, whereby the tax rate increases in correlation with the amount of income earned.<sup>19</sup>

Rather than selling his works, an artist may donate them to a museum. Since 1917, all taxpayers, including artists, have been able to reduce gross income by the amount of a gift made to qualified charitable organizations.<sup>20</sup> Thus, prior to the 1969 Act, an artist's charitable contribution of his work was thrice blessed:

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15. See *infra* notes 188-210 and accompanying text.

16. See *infra* note 32.

17. VOLUNTEER LAWYERS FOR THE ARTS, THE VISUAL ARTIST & THE LAW 42-43 (1974). See also W. Joseph, *Income Taxation, Record Keeping, Reporting, Forms of Doing Business and Estate Planning Consideration 2* (October 25, 1980) (unpublished speech before the Ohio Art Law Association's 1980 Art Law Conference) (a discussion of the different sources of income to the artist) [hereinafter Joseph Speech]. For an analysis of what constitutes income to an artist, see *Tobey v. Commissioner*, 60 T.C. 227 (1973). Although *Tobey* is concerned with the income earned abroad, the definition of earned income for domestic gains is the same. L. DUBOFF, *THE DESKBOOK OF ART LAW* 63 (1977).

18. I.R.C. § 64 (1982). The artist determines the amount of gain from the sale or exchange of his work by subtracting the cost of materials from the price received. See I.R.C. §§ 1001, 1011, 1012 (1982).

19. I.R.C. § 1 (1982). "Under a progressive tax system, the tax value of any deduction or exclusion increases as the marginal tax rates increase, so that preferences (that are not in the form of tax credits) are most valuable to those with the highest incomes." J. PECHMAN, *FEDERAL TAX POLICY* 74 (4th ed. 1983).

20. I.R.C. § 170 (1982). See Note, *Tax Treatment of Artists' Charitable Contributions*, 89 YALE L.J. 144, 145 (1979) [hereinafter Note, *Tax Treatment*]; Note, *Tax Incentives for Support of the Arts: In Defense of the Charitable Deduction*, 85 DICK. L. REV. 663, 666 n.3 (1981) [hereinafter Note, *Tax Incentives*].

He realized no income either on the contribution or a later disposition by the donee; he was entitled to a charitable deduction from ordinary income equal to the fair market value of the work transferred; and, if the work had been created in a prior taxable year, his charitable deduction was not reduced on account of the costs of production previously deducted as business expenses.<sup>21</sup>

The Tax Reform Act of 1969 ended this favorable situation by limiting the deduction for the donation of self-created work to its material costs.<sup>22</sup> The most critical change was the addition of section 170(e)(1)(A),<sup>23</sup> which provided that a charitable deduction must be decreased by the amount which would have been ordinary gain had the artist instead sold his creation.<sup>24</sup> Since artwork is ordinary income property,<sup>25</sup> and the artist's sale of his own work would give rise to ordinary gain, the artist may deduct only his adjusted basis in the item, which is essentially the cost of his material.<sup>26</sup>

Artists' creations have been accorded ordinary property treatment since Congress enacted section 1221(3)(A) in 1950.<sup>27</sup> Prior to that time, self-created works of art were treated as capital assets.<sup>28</sup> If that were presently the case, artists would still deduct fair market value. Today, however, because artists' works are not characterized as capital assets,<sup>29</sup> it is difficult for the artist to avoid the application of section 170(e)(1)(A) and thus garner any tax advantage from the

21. Beghe, *The Artist, the Art Market and the Income Tax*, 29 TAX L. REV. 491, 514 (1974).

22. See S. REP. NO. 552, 91st Cong., 1st Sess. 80-82, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2109-111; see also Beghe, *supra* note 21, at 515-16 (history of legislation leading up to the Tax Reform Act of 1969).

23. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a)(1)(B), 83 Stat. 487, 549 (codified at I.R.C. § 170(e)(1)(A) (1982)). This section provides that "[t]he amount of any charitable contribution of property . . . shall be reduced . . . by the amount of gain which would not 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) . . ." *Id.*

24. Feld, *Artists, Art Collectors and Income Tax*, 60 B.U.L. REV. 625, 656 (1980).

25. "The term 'ordinary income' includes any gain from the sale or exchange of property which is . . . [not] a capital asset . . ." I.R.C. § 64 (1982). Ordinary income property includes all assets which, if sold at the time of contribution to charity, would generate ordinary income and not long-term capital gains. Treas. Reg. § 1.170A-4(b)(1). Examples of ordinary income property include merchandise inventory, depreciable property, and a work of art held by the taxpayer who created it.

26. See *supra* note 18.

27. Revenue Act of 1950, ch. 994, § 210(a), 64 Stat. 906, 933 (codified as amended at I.R.C. § 1221(3)(A) (1982)). "[T]he term 'capital asset' means property held by the taxpayer . . ., but does not include . . . a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by . . . a taxpayer whose personal efforts created such property . . ." I.R.C. § 1221(3)(A) (1982).

28. For a history of I.R.C. § 1221(3), see 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 51-34 to 51-39 (1981); Feld, *supra* note 24, at 628 & n.24.

29. See *supra* note 27.

charitable donation of his work.<sup>30</sup>

The hardship generated by this characterization is magnified when one considers the treatment of an art collector's charitable contribution of a work. The collector is able to deduct the full fair market value of a work he donates,<sup>31</sup> even if it is identical to a piece for which the artist can deduct only material cost. Assuming the collector is not buying or selling art on a regular basis so as to warrant trade or business treatment, his art collection is treated as an investment and is properly given capital asset status.<sup>32</sup> Thus, a non-artist individual's charitable donation of appreciated property<sup>33</sup> held for over six months is not subject to the restrictions of section 170(e)(1)(A).<sup>34</sup> The art collector is allowed a full fair market value deduction, even for the amount of appreciation over his purchase price, which is never taxed.

Another major inconsistency inherent in the system becomes apparent when one compares the treatment of artists for estate tax versus income tax purposes. According to estate tax provisions, self-created works remaining in the artist's estate at the time of his

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30. See Feld, *supra* note 24, at 656-57. Two possibilities for avoiding ordinary property treatment are suggested. One is for the artist to sell his work to a spouse or relative in an arm's-length transaction. A family member would thus take the art as a capital asset, and any charitable donation of the item would be deductible at its fair market value.

Another possibility is through a like-kind exchange under I.R.C. § 1031. If the artist can prove that he exchanged his work for like-kind property and that he held both the work exchanged and the like-kind property received for investment purposes, he would qualify for § 1031 non-recognition of gain. See Treas. Reg. § 1.1031(a)-1(b) (1982). If the artist can meet these statutory requirements, not only is there deferral of tax on any gain, but the new work can have capital asset status as well. He then would be entitled to a fair market value deduction upon donation, if the work is held for six months or longer, thus resulting in permanent non-recognition of the realized gain. A court might easily rule against like-kind exchange treatment since it undercuts the purpose of I.R.C. § 1221(3), in that the increment representing the artist's services will never be taxed at ordinary income rates. Feld, *supra* note 24, at 657.

31. See Treas. Reg. § 1.170A-1(c)(1) (1982). There are, however, limitations on the aggregate of contribution deductions in a taxable year determined by a percentage of the taxpayer's contribution base. I.R.C. § 170(b) (1982). See Levun, *Charitable Contributions of Works of Art and Other Property: An Analysis of Federal Income Tax Considerations*, 68 ILL. B.J. 604, 608 & nn.19, 20 (1980).

32. If the collector is actively buying and selling art work, his collection could be characterized as "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." This is one of the exceptions to capital asset property. I.R.C. § 1221(1) (1982). Thus, the collector's contribution would be considered a donation of ordinary income property. See also Treas. Reg., *supra* note 25 (an example of ordinary property is property held by the donor primarily for sale to customers in the ordinary course of his business).

33. The term appreciated property refers to any tangible or intangible property that has a fair market value in excess of its cost. BLACK'S LAW DICTIONARY 92 (5th ed. 1979).

34. See Feld, *supra* note 24, at 650 n.131.

death are not valued at material cost, as tax symmetry would dictate, but rather are assessed at fair market value.<sup>35</sup> The federal estate tax provisions allow deductions for gifts to certain charitable organizations, at which point the estate may deduct the full fair market value,<sup>36</sup> but this seems to be an inefficient means of employing assets.<sup>37</sup> It seems ludicrous to require a museum or similar institution to wait until an artist has died before it receives the work that he wanted to donate while living but was unable to because of his inability to deduct more than a miniscule fraction of its value.

There are gross inequities in the deduction value allowed for a donation of artwork. Not only are different standards applied to artists and art collectors, but different valuations are used for income and estate tax purposes as well. While one of the Internal Revenue Code's goals is horizontal equity,<sup>38</sup> it fails to reach that objective in its treatment of the artist.

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35. I.R.C. § 2031 (1982). "The value of the gross estate of the decedent shall be determined by including . . . the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." *Id.* § 2031(a).

36. *See id.* §§ 2055, 2522 (1982). "For purposes of the [estate] 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 . . . to or for the use of any . . . charitable [purposes] . . ." *Id.* § 2055(a)(2).

For a more detailed discussion of estate charitable deductions under § 2055, see Bateman & Kligman, *Estate Charitable Deductions Under Section 2055*, 26 PRAC. LAW. 71 (1980).

37. This "lock-in" effect is caused by the provisions of I.R.C. § 1014, dealing with the basis of property acquired from a decedent. The basis of inherited property is generally its fair market value at the time of the owner's death. I.R.C. § 1014(a)(1) (1982). Thus, the basis of property left by an artist will be stepped up, and the amount of the step up will not be subject to income tax. As a result of § 1014, assets might not be used in the most effective manner. For example, an artist may hold on to the art he wants to donate to a museum and have his estate donate it at his death. Since the estate takes the painting with a stepped-up basis, it gets a fair market value deduction, whereas the artist would have received only a material cost deduction. Opponents, however, will argue that few artists fall into this category. They would contend that the artist sells or donates his works for reasons other than the transaction's tax consequence. *See infra* note 97.

Congress has taken an unfavorable view of the argument that § 1014 discourages the efficient use of assets. In 1976, after many years of urging by the Treasury, Congress attempted to change § 1014. Under newly enacted § 1023, property acquired by inheritance would no longer take a fair market value basis but would take a carryover basis. M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 58 (1971). Under this new provision, selective transfer of assets would no longer be necessary, and efficient use of assets would be encouraged.

Section 1023's life was short, however; indeed, it was never even born. Criticized for its technical defects, the effective date of the section was continually pushed back. Finally, in 1980, § 1023 was withdrawn completely and § 1014 was back in force. M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 60 (4th ed. 1985).

38. J. PECHMAN, *supra* note 19, at 5. "Horizontal equity encompasses the principle that taxpayers with equal [circumstances] . . . should pay the same tax." *Id.*

## II. REASONS FOR THE TAX REFORM ACT OF 1969

Congress's dissatisfaction in several areas led to the changes contained in the Tax Reform Act of 1969. President Nixon's substantial deduction for the donation of his vice presidential papers certainly was influential,<sup>39</sup> but two other factors also contributed significantly to the change. First, Congress was concerned with the abuses prevalent in the valuation of donated art items;<sup>40</sup> second, it was disturbed that an artist could benefit more by donating his creation than by selling it.<sup>41</sup>

Works of art are difficult to value, and Congress was ever fearful of fraudulent valuations and the subsequent loss of income to the government coffers.<sup>42</sup> In a committee hearing, Congressman Wilbur Mills testified that "Paintings and other art objects are very hard to value. As a result, very high values are placed on paintings which cost the person very little. Who is to say how much a painting is really worth?"<sup>43</sup>

The 1969 tax change was also responsive to congressional apprehension over providing a greater tax advantage for the donation of appreciated property than for its sale.<sup>44</sup> Prior to the 1969 change, if an artist created a work costing him \$100 for materials, paid in after-tax dollars, and donated it to a museum a year later when it was worth \$1100, he could deduct the full \$1100 as a charitable contribution. His tax bill would benefit by the \$1000 in realized gain that he was not required to recognize as income. Although the artist lost the opportunity to sell the painting and profit by the gain, he

39. See S. REP. NO. 768, 93d Cong., 2d Sess. 10; H.R. REP. NO. 966, 93d Cong., 2d Sess. 10.

40. H.R. REP. NO. 413, 91st Cong., 1st Sess. 55, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1701.

41. *Id.* at 53-55, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 1699-1701; S. REP. NO. 552, *supra* note 23, at 80-82, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 2109-10. A parallel concern of Congress was appreciation in value that escaped taxation upon donation of the item. See *infra* note 45 and accompanying text.

42. The higher the appraised value, the greater the deduction from the taxpayer's gross income. The resulting reduced tax bill lowers the individual's payment to the government.

43. 115 CONG. REC. 22,571 (1969) (statement of Rep. Mills). One confusing aspect of the valuation concern is that price appraisals are a problem with all art, whether donated by an artist or collector. The Tax Reform Act of 1969 changes, however, affect only the artist, by erasing the special tax advantages for gifts of creator-held property. "[I]dentical benefits for contributors of other types of appreciated property were either limited less severely—in the case of unrelated-use tangible personal property—or left intact—in the case of real, intangible personal, and related-use tangible personal property." Note, *Tax Treatment*, *supra* note 20, at 147 n.12.

44. H.R. REP. NO. 413, *supra* note 40, at 53-56; S. REP. NO. 552, *supra* note 22, at 80-82.



nevertheless had an advantage over the person who made a \$1100 cash donation totally from after-tax dollars.<sup>45</sup>

All of these factors fueled a congressional response which manifested itself in the Tax Reform Act of 1969.<sup>46</sup> Charitable contributions by an artist now generate a deduction equal only to the artist's adjusted basis.<sup>47</sup> Thus, as far as the artist is concerned, the effect of the 1969 tax change was to limit the amount of the available deduction to the cost of materials used to create the work.<sup>48</sup>

### III. WHY ACTION MUST BE TAKEN

#### A. *The Correction of Past Abuses*

While the deductions taken for donation of papers by public officials,<sup>49</sup> the problem of valuation abuses,<sup>50</sup> and the possibility of ben-

45. Note, *Tax Incentives*, *supra* note 20, at 667 & n.19.

In 1969, the highest tax bracket was 70 percent with a capital gains deduction of 50 percent. *Id.* Assuming the artist is in the highest bracket, he would garner \$1000 in long-term capital gains if he sold the work after a year. His tax would be \$500, and thus his tax benefit would also be \$500. If he contributed the identical piece, the artist would be able to deduct the full fair market value of \$1100. This donation would yield a tax benefit of \$770 (70 percent of \$1100), and thus an advantage of \$270. *See also* Note, *Tax Treatment*, *supra* note 20, at 145-46 & n.7 (detailed mathematical explanation of the above analysis).

46. *See supra* note 4.

47. Adjusted basis, from which the computation of gain or loss is determined upon disposition of the property, is equal to the cost of the property and any adjustments delineated in I.R.C. § 1016. *See* I.R.C. § 1012 (1982).

48. This limitation on deductions for contributions by artists of self-created works presents a genuine hardship since, typically, the ratio of cost to market value for creative compositions is very high.

A good example—although perhaps a somewhat exaggerated one only because of the excellence and the reputation of the artist— would be Jasper Johns. . . . If he were to sell a painting from say, \$25,000 anywhere up to a massive work which could cost \$250,000 to a collector [(recent Jasper Johns originals have gone for over one million dollars)] and the collector in turn, were to give that work to a museum, the collector could deduct, for income tax purposes, up to the fair market value of the work. . . .

However, if Jasper Johns, as creator of the work were to contribute the exact same painting to a museum, he could deduct only the cost of the materials involved in making the work, which would probably run somewhere around \$45.

*Public Hearings on General Tax Reform Before the House Committee on Ways and Means*, 93d Cong., 1st Sess. 6022 (1973) (statement of John B. Hightower, President, Associated Councils of the Arts) [hereinafter *1973 Hearings*].

*See also id.* at 6118 (statement of Elias Newman, President, Artists Equity Association of New York, estimating the cost of a Rembrandt ink drawing at four cents); *id.* at 6130 (testimony of Elias Newman stating that the manuscripts of composer Igor Stravinsky, worth \$3.5 million, would only yield a deduction equivalent to the cost of pen, paper, and ink if Mr. Stravinsky were to donate them).

49. The 1969 Act was enacted to deal with, among other things, the sizable and unpopular deductions taken for donations of papers by public officials. "Dear Colleague" Letter of

efiting more from a contribution than from an outright sale<sup>51</sup> were salient problems in the 1960's, measures have been and are being taken to alleviate them. New concerns, however, have arisen in their place, including the virtual cessation of artist contributions to museums<sup>52</sup> and the stagnation of government support of the arts.<sup>53</sup>

One of the driving forces behind the Tax Reform Act of 1969 was the excessive deductions taken by government officials for the donation of their papers.<sup>54</sup> Legislators are cognizant of these past abuses, however, and have proposed bills which would enable artists to receive full fair market deduction value, while explicitly prohibiting these deductions by public servants.<sup>55</sup>

Another motivation behind the 1969 changes was anxiety over the pervasive abuses in valuing art. That problems arise is not surprising, because assigning a value to a piece of art is inevitably a subjective process. The uniqueness of each work makes it extremely difficult to determine a true fair market value.<sup>56</sup> In the absence of a recent cash sale, experts are forced to determine an object's value using other, more judgmental techniques.<sup>57</sup> Difficulties are inherent

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Congressman Thomas J. Downey (N.Y.) to fellow Congressmen (Jan. 31, 1983) [hereinafter "Dear Colleague" Letter] (available from Congressman Downey's office).

50. See *supra* note 40; see also *Hilla Rebay v. Commissioner*, 22 T.C.M. (CCH) 181 (1963) This overvaluation case exemplifies the situation with which Congress seemed to be concerned when it revised the Code in 1969. In this case, the Commissioner disallowed, in whole or in part, deductions claimed for the donation of self-created works of art. The decision was based solely on disagreement with the fair market value figure used by the taxpayer at the time of his contribution.

51. See *supra* notes 44-45 and accompanying text.

52. See *infra* note 78. This consequence of the 1969 Act is not surprising. In fact, the Senate version of the bill deleted the House provisions reducing the allowable deduction for artists' contributions. The Senate justified the deletion by pointing to the provision's potentially "adverse impact on charitable giving to public charities . . ." The House provisions, however, were incorporated into the final version. S. REP. NO. 552, *supra* note 22, at 82, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 2111.

53. See *infra* notes 88-91 and accompanying text.

54. See *supra* note 49 and accompanying text.

55. See *infra* note 185-87 and accompanying text.

56. Fair market is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." Treas. Reg. § 1.170A-1(c)(2) (1982). For a good overview of valuation problems and questions, see Melevin, *Valuation of Charitable Contributions of Works of Art*, 60 TAXES 756 (1982); see also Note, *Tax Incentives*, *supra* note 20, at 670-77 (illustrating the acute difficulties in valuing unique pieces of art).

57. The IRS tries to provide some guidelines for determining fair market value. The factors it considers are cost of donated property, replacement cost, sale of similar property, and appraisal value by an expert. See INTERNAL REVENUE SERVICE, *Basis of Assets* 551 (1985); see also Feld, *supra* note 24, at 650 (detailing some of the difficulties involved in obtaining an accurate fair market value).

because the Internal Revenue Service (IRS) requires an objective measurement of the value of a piece of art.<sup>58</sup>

In order to counteract this problem and in response to the growing need for uniformity and fairness, the IRS created the Arts Advisory Panel in 1968.<sup>59</sup> The panel is comprised of art experts from major segments of the art world—museums, universities, and dealers—and its purpose is to determine the accuracy of privately obtained appraisals.<sup>60</sup> Since its inception, the panel has been increasingly successful in stemming valuation abuses and, arguably, may deter other potential abusers.<sup>61</sup>

In addition to establishing the Arts Advisory Panel, the IRS, on the recommendation of Congress,<sup>62</sup> has refined the valuation process. New Revenue Procedures list acceptable appraisal methods.<sup>63</sup>

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58. Melevin, *supra* note 56, at 756. Adding to this confusion, the courts have developed their own valuation methods. Judicial decisions emphasize the individual nature of each value determination. *See, e.g.,* Anselmo v. Commissioner, 757 F.2d 1208 (11th Cir. 1985) (loose gems donated by a taxpayer to a museum must be valued with reference to the marketplace in which jewelry manufacturers buy such gems in bulk, not retail jewelry stores); John W. Pearsall, 36 T.C.M. (CCH) 956 (1977) (Tax Court ruling on the valuation of houses donated by the taxpayer when no willing buyer existed).

59. *See* I.R.S. News Release, 7 Stand. Fed. Tax Rep. (CCH) § 6573 (Feb. 1, 1968). The panel will determine if the valuation is either clearly justified, questionable, or clearly unjustified. The panel will also recommend the names of appraisers. *Id.*

60. Generally, if a particular item has a value over \$5000 (this figure was recently lowered from \$20,000), the Art Panel will probably review the valuation. (This does not mean that objects under this amount will not be examined, but it will be done at the local I.R.S. office. If however, the office needs the Panel's expertise, the valuation can be sent for review.) The Panel's decision is technically only advisory, but I.R.S. district offices consider them binding. Lerner, *Valuation Issues Predominate when Clients Want To Keep Collections in the Family*, 11 EST. PLANNING 90, 91-92 (1984).

61. In 1978, the panel reviewed 702 works of art. Taxpayers' claimed values were adjusted by \$12 million. In ten years of operation, the panel has reviewed appraisals with a total claimed value of \$276 million and has made adjustments of \$75 million. 1978 I.R.S. ANN. REP. 49. *See also* 122 CONG. REC. 23, 359-360 (1976) (statement of Senator Javits, claiming that valuation is no longer a problem). *But see* Speiller, *The Favored Tax Treatment of Purchasers of Art*, 80 COLUM. L. REV. 214, 236 & n.87 (1980).

62.

[T]he [Finance] [C]ommittee believes that the serious problems of valuation of gifts of tangible personal property would still remain even if the appreciation were to be taken into account for tax purposes, and that a more desirable method of controlling overvaluations is for the Internal Revenue Service to strengthen its audit procedures for reviewing the value claimed on such gifts.

S. REP. NO. 552, *supra* note 22, at 82, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2111.

63. Rev. Proc. 66-49, 1966-2 C.B. 1257. When an appraiser tries to value a unique collection, a retail market might not exist. The I.R.S. procedures provide that an appraisal should include: a complete description of the object; its cost, date, and manner of acquisition; a history of the item, including authenticity; a photograph of the item; and a statement of the factors upon which the appraisal was based. The factors might include the following: any sales of other works by the same artist, especially if near the valuation date; prices quoted in

The IRS's primary attack centered on the appraisal's credibility and objectivity, as well as the ability of the appraisers themselves.<sup>64</sup> Appraisers must now be licensed, as are attorneys and accountants testifying before the IRS.<sup>65</sup> Additionally, the IRS can take action against the appraiser for inaccurate work; possible sanctions include disqualification from future appraisals<sup>66</sup> and assessment of monetary fines.<sup>67</sup> Thus, while donors previously were not required to obtain an appraisal to document the fair market value of their donated work,<sup>68</sup> strictly regulated substantiation requirements are now in force. With these appraisal regulations and the successful emergence of the Arts Advisory Panel, the IRS has made great strides in combating valuation abuse.<sup>69</sup>

The final concern precipitating the 1969 tax changes, the possibility of benefiting more from a contribution than sale of an item, has since become moot. Because the Tax Reform Act of 1986<sup>70</sup> eliminates the capital gains taxation rate, the possibility of profiting

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dealers' catalogs of the artist's works; a statement of market conditions; a record of any exhibition at which the particular artist was displayed; and a statement as to the standing of the artist in his profession. *Id.* For life-time gifts made to charity after 1984, even more detailed substantiation is required. *See* Temp. Treas. Reg. § 1.170A-13T (1984).

64. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 155(a)(3)-§ 155(a)(5), 98 Stat. 494, 691-92. The Act requires the Treasury to issue regulations describing the procedures for valuation and requiring qualified appraisals if the item is over \$5000 and is not publicly traded stock. *Id.* at 691. The IRS, however, is not required to accept appraisals merely because they were prepared by experts. Not all appraisers are experts on all forms of art. It is now necessary to have an expert qualified in evaluating the specific type of art one is donating. Wittenbach & Milani, *Charting the Current Rules on Charitable Contributions*, 63 TAXES 541, 550 (1985).

65. *Appraiser Sanctions Clarified in Prop. Regs.*, 62 J. TAX'N 305 (1985) [hereinafter *Appraiser Sanctions*].

66. Regulations which became effective February 20, 1985, (pursuant to Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 156, 98 Stat. 494, 695), bar any individual against whom a penalty has been assessed for aiding and abetting an understatement of tax from appearing before the IRS for purposes of offering evidence as an appraiser. Additionally, the IRS's Director of Practice may either reprimand the appraiser or disqualify him from participating in IRS proceedings. *Appraiser Sanctions*, *supra* note 65, at 305.

67. *See* Temp. Treas. Reg. § 1.170A-13T(c)(5)(i)(D) (1984).

68. Wittenbach & Milani, *supra* note 64, at 549.

69. It is not contended that taxpayers are submitting perfect evaluations, but the IRS now has an effective procedure to attack valuation abuses and to make adjustments. The Arts Advisory Panel reports that in 1983, nearly three quarters of the donors of expensive artwork who claimed deductions overvalued their deductions an average of 10.17 percent. *See* Non-Profit Organization Tax Letter 2 (Mar. 22, 1985). Contrast this figure with the 29 percent valuation discrepancy in the panel's first five years of operations. *See* 1978 I.R.S. ANN. REP. 18.

70. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. — 1986 (repealing I.R.C. § 1202).

through donations has disappeared.<sup>71</sup> Thus, Congress need no longer concern itself with this past unfair result.

## B. *The Emergence of New Concerns*

### 1. *Museums*

In addition to eliminating the prior justifications for the 1969 changes, the tax code should be altered to curb the undesirable effects it has on our cultural institutions. Since 1969, the tax law changes have severely limited the ability of museums to make vital acquisitions.<sup>72</sup> Instead, works of art are sold to private collectors who take them into their homes and often out of the country.<sup>73</sup>

Museums in America largely depend upon private support for their existence,<sup>74</sup> since their acquisition budgets cannot compete with private money. Larry Reiger, director of the American Association of Museums in Washington, D.C., estimates that 80 percent of all works acquired by museums are donated.<sup>75</sup> At present, the vast majority of a museum's funds are used to meet operating expenses.<sup>76</sup> Thus, growth potential is almost nonexistent unless these

71. While the preferential long-term capital gains exclusion has been repealed by the Tax Reform Act of 1986 and is now taxed as ordinary income, characterization of gain as capital or ordinary and long or short-term is still vital. Long-term capital gains or losses can be used to offset short-term capital gains or losses. Furthermore, a donation of capital gain property still yields a deduction at fair market value.

The one effect that the 1986 Act has on the donation of appreciated capital gain property is that the appreciation is now a tax preference subject to the alternative minimum tax. *See* I.R.C. § 57(a)(6) (1986). If the artist is forced to calculate taxes using this alternative, then his charitable deduction calculation will be similar to that of an artist donating his own works. In 1983, however, only "12.6 percent of the taxpayers with [adjusted gross income] of \$200,000 and over were subject to the alternative minimum tax. Under the new law it is expected that even fewer taxpayers will be subject to the alternative minimum tax." TAX NOTES, Oct. 20, 1986, at 288.

72. "Dear Colleague" Letter, *supra* note 49.

73. News release of Congressman Thomas J. Downey (N.Y.) (Mar. 2, 1983) (available from Congressman Downey's office). "European and Japanese collectors and museums are now outbidding one another for works by our American artists, paying fantastic prices for work by artists who just a few years ago were amongst those who gave their works as gifts to museums. . . ." 1973 Hearings, *supra* note 48, at 6120 (testimony of Elias Newman, President of the Artists Equity Association of New York and Chairman of the Conference of American Artists).

*See also* 1973 Hearings, *supra* note 48, at 6144 (letter of John I.H. Baur, Director, Whitney Museum of American Art) ("Already buyers in Europe and Japan, drawn by the preeminent position of contemporary American art, have bought many major works for their own museums and private collections.").

74. 115 CONG. REC. 22738 (1969) (letter of Dr. Sherman Lee, Director, Cleveland Museum of Art).

75. *Generosity Will Cost More, I.R.S. Tells Donors*, ARTNEWS, March 1985, at 25.

76. "Caught in an economic squeeze created by their very success and the unprece-

institutions can acquire their collections through donations.<sup>77</sup>

The 1969 changes in the tax law are clearly the major cause for the decline in artist donations. Since their enactment, donations of self-created artistic, literary, and musical works to museums and libraries have virtually ceased.<sup>78</sup> The only recourse available to artists to protest the changes was to stop donating their works,<sup>79</sup> a tactic they seem to have adopted enthusiastically. For example, in the three years immediately preceding the tax change, the Museum of Modern Art in New York received 321 paintings, sculptures, drawings, and prints donated by ninety-seven artists. In the three years following, donations dwindled to twenty-eight works from fifteen artists, and those works consisted primarily of prints.<sup>80</sup>

The largest library in the world, the Library of Congress, owes its preeminence to its ability to seek and acquire donations.<sup>81</sup> In fact, the growth of collections of American museums in general has directly resulted from tax incentives which stimulate contributions.<sup>82</sup> Under the present law, however, the incentives for donating have disappeared. Artists are instead motivated to sell to the highest bidder, even if they are thereby required to break up a col-

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lected demands of the public, museums like ours have been forced to spend all their unrestricted funds on keeping their doors open and their programs going—and even so are incurring operating deficits." 1973 Hearings, *supra* note 48, at 6144 (letter of John Baur).

77. 115 CONG. REC. 22,738 (1969) (letter of Thomas P.F. Hoving, Director, Metropolitan Museum of Art, New York).

See also 1973 Hearings, *supra* note 48, at 6144 (letter of John Baur) (If museums "are to succeed in their mission, gifts from artists are an absolutely vital source.").

78. Conversation with Dr. Evan Turner, Director, Cleveland Museum of Art (Feb. 15, 1986) [hereinafter Turner Interview]. Dr. Turner said that donations to the Cleveland Museum have dried up completely.

79. VOLUNTEER LAWYERS FOR THE ARTS, *supra* note 17, at 81 n.144 ("The only answer the artist can give to this demeaning law is to stop contributing works to all institutions!") (quoting Artist's Equity Newsletter (October 1970)) (emphasis in original).

80. 1973 Hearings, *supra* note 48, at 6143 (letter of Richard E. Oldenburg, Director, Museum of Modern Art, New York). The 1973 Hearings contain much testimony illustrating the dramatic effects of the 1969 tax changes in reducing donations of art to museums.

The Library of Congress' Music Division, which received 1200 original manuscripts from living composers between 1963 and 1970, has received only 30 since that time. The Library's Manuscript Division was receiving approximately 200,000 manuscript collections each year, but since 1969, it has received only one major gift of self-created material by a living author. *Additional Estate and Gift Tax Issues: Hearings Before the Subcommittee on Estate and Gift Taxation, Senate Committee on Finance, 97th Cong., 1st Sess. 316 (1981)* [hereinafter 1981 Hearings] (testimony of Daniel J. Boorstin, Librarian of Congress).

Another case in point is the Library's Prints and Photographs Division, which has also experienced a precipitous drop in donations since 1969. "Three *New Yorker* artists have stopped donating their drawings and cartoons as a direct result of the 1969 act." *Id.*

81. See 1981 Hearings, *supra* note 80, at 315.

82. See 1973 Hearings, *supra* note 48, at 6104.

lection and sell their works piecemeal. This policy has resulted in limited public access to the affected works.<sup>83</sup>

The decline impacts most severely on institutions which specialize in original works of contemporary literature, art and music.<sup>84</sup> Prior to 1969, many of these institutions had donors who gave on a continuing basis. Such an arrangement reduced the loss of tax revenue since most donations were made before the works increased in value.<sup>85</sup> It also ensured that works were preserved and made accessible to scholars and the viewing public. This availability is no longer assured. Now, if the institution is able to obtain any work, it is through the use of an "on deposit" system which does not actually transfer title to the institution.<sup>86</sup> This method of "donation" is highly unsuccessful because the distinct possibility of removal by the donor exists, and it is costly to museums to process and maintain the works.<sup>87</sup>

## 2. Government Support

In addition to the declining support from the private sector, government assistance for the arts has also dwindled. While the Tax Reform Act of 1969 withdrew contribution incentives from the private sector, the government at that time responded to the needs of our cultural institutions<sup>88</sup> and increased its support.<sup>89</sup> These government subsidies, however, are no longer prevalent; the Reagan

83. Literary, Musical, and Artistic Donations to Libraries, materials from Congressman Thomas J. Downey 2 (1983) [hereinafter Downey Material].

84. Those museums with large endowments, such as the J. Paul Getty Museum, or immense collections, such as the Metropolitan Museum of Art in New York, are not the ones most affected. It is the smaller, less established museums in those communities that previously did not have a museum that are being hurt. ARTNEWS, *supra* note 75, at 25. See also Interview with Joseph O'Sickey, professional artist and Professor of Art at Kent State University, in Cleveland, Ohio (Nov. 28, 1985) [hereinafter O'Sickey Interview] (reiterating that smaller museums depend solely on contributions for their existence since their budgets are not large enough to make these acquisitions).

85. Downey Material, *supra* note 83, at 1.

86. See 121 CONG. REC. 10,192 (1975).

87. Although institutions do accept works under this arrangement, the practice is unsatisfactory. Institutions accept the items hoping they will become outright gifts, but the donor has the option of withdrawing his work. Such removal of works leaves resources thin and students upset, and results in a tremendous waste of time and money spent in cataloging, maintaining, and promoting the collection. Institutions with limited resources can ill afford to waste money in this manner, yet unless a collection is processed, it is of little value since scholars will not be aware of its existence. Downey Material, *supra* note 83, at 1. See also 1981 Hearings, *supra* note 80, at 316 (withdrawal rights have been exercised, and there is a mounting threat of further withdrawals if the tax laws remain unchanged).

88.

As we reduce charitable contributions, by making it less attractive for people to

administration has curbed much of the financial help as well as a number of special programs.<sup>90</sup> In this manner, the government is forcing art institutions to once again seek help from the private sector.<sup>91</sup>

While the climate might have been right in 1969 to check charitable contribution abuses, Congress "swung too broad an axe" when it eliminated the beneficial tax treatment of artists.<sup>92</sup> The subsequent burden placed on artists is unjustified when compared to the problems created by their contributions. Since the rationale behind the 1969 Act is no longer valid,<sup>93</sup> the time is right for changes.

The present decline in donations will continue unabated unless incentives for giving are implemented. Change is needed to stimulate the flow of materials back into our museums, ensuring the preservation of our cultural heritage.<sup>94</sup> As one expert notes,

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give, we again force the recipients to turn to Washington—to get the Federal Government to solve our problems in education, health, and charity.

. . . .  
And so, once again, through changing valid incentives to charitable giving, we are moving toward reliance on Washington. . . .

We are unquestionably eliminating some tax inequities. But in doing so, we are forcing private charities and all educational institutions to turn more to the Federal Government.

115 CONG. REC. 22,450, 22,582-83 (1969) (statement of George Bush and Rogers Morton).

89. Government appropriations for the arts increased from \$7,756,875 in fiscal year 1969 to \$60,775,000 in fiscal year 1974. 1985 NAT'L ENDOWMENT ARTS ANN. REP. 238-39. See also 1973 Hearings, *supra* note 48, at 6032 (statement of Congressman Herman T. Schneebeli). Even amidst the deficit and reduction and elimination of programs, one of the few areas which showed an increase in the 1974 budget was in the area of the arts.

Centralized government funding for the arts is not an unfamiliar concept. The British government, for example, handles support for the arts in this manner. Instead of allowing the individual taxpayer to dictate the flow of money into institutions via the charitable deduction, full taxes are paid to the government, which then administers the flow of money to the arts either directly or through its Arts Council. Through central control, institutions are not left at the mercy of millions of individual taxpayers and much better control is exercised over dividing the total available funds. See *Paying for the Arts*, *supra* note 1.

90. Frank Hodsoll, Chairman of the National Endowment for the Arts, states that his department's budget remains constrained by current and projected federal deficits. In fact, the appropriations for this major arts funding arm of the government experienced a 4.3% reduction in funds for fiscal year 1986. 1985 NAT'L ENDOWMENT ARTS ANN. REP., *supra* note 89, at 307.

91. President Reagan has asked American corporations and individual citizens to increase their support of charitable organizations since federal programs are being dismantled or diminished. Wittenbach & Milani, *supra* note 64, at 541. Recently proposed Treasury regulations, however, would limit a collector's contribution deduction to the fair market value of the property or the original purchase price, whichever is smaller. ARTNEWS, *supra* note 75, at 25.

92. 119 CONG. REC. 9400 (1973) (statement of Senator Frank Church).

93. See *supra* notes 49-71 and accompanying text.

94. Museums fulfill three main functions: they are depositories whose function is to preserve items of cultural, historical, aesthetic, and educational value; they serve as centers of



"[r]etaining the flow of valuable objects from private ownership into the public forum, where they are well cared for and the education process can continue, is a very valuable and necessary process to maintain through the future."<sup>95</sup> If done properly, the costs to the government would be minimal and the benefits everlasting.<sup>96</sup>

#### IV. WHAT ACTION CAN BE TAKEN

Merely concluding that the tax laws must be changed to achieve consistency and to increase the flow of natural treasures into our museums is insufficient. Several possibilities exist to accomplish this goal, each having advantages and disadvantages. One option is to change the estate tax laws so that an artist's collection at his death is valued at material cost instead of fair market value, thus creating symmetry between the estate and income tax laws. Another alternative is to change the income tax laws to provide that an artist may deduct the fair market value for the donation of his works, the same value that would apply to a collector's contribution and one consistent with the level used for estate tax purposes.<sup>97</sup>

##### A. *Modification of Estate Tax Laws*

Presently, when an artist dies, self-created works in his possession are assessed at fair market value for estate tax purposes.<sup>98</sup> Some artists claim that this valuation procedure is where the hard-

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research, by encouraging scholars to take advantage of their resources; and they serve as educational agencies by offering to both interested classes and the general public the opportunity to observe their collections. See A.S. WITTLIN, MUSEUMS: IN SEARCH OF A USABLE FUTURE 1 (1970); Note, *Tax Incentives*, *supra* note 20, at 701-02.

95. 1973 Hearings, *supra* note 48, at 6053 (testimony of Kyran M. McGrath, Director, American Association of Museums).

96. 1973 Hearings, *supra* note 48, at 6053. Congressman Downey estimates a cost to the U.S. Treasury of only \$5 to 15 million if his legislation to restore deductions for artists' contributions to fair market value is passed. 131 CONG. REC. E3563 (daily ed. July 26, 1985).

97. Other methods are possible, such as eliminating the charitable contribution altogether, but that issue is beyond the scope of this Note. A thorough examination of this possibility is contained in McNulty, *Public Policy and Private Charity: A Tax Policy Perspective*, 3 VA. TAX REV. 229 (1984).

There is a debate over whether tax incentives are necessary at all to stimulate donations. Some believe that the tax deduction controls individual motives to give to charity. See *Charity Begins at the Movies*, N.Y. Times, Dec. 8, 1984, at 23, col. 6. Martin Feldstein and other economists believe, however, that only about 25 percent of giving is tax induced, while the rest are made for altruistic or other reasons. Leaders of the charitable community agree with this perspective, stating that "the tax incentive simply encourages donors to give more at the margin, so that donations are larger than they would be in the absence of the tax incentive. See *How to Have Donations and a Deductibility Limit*, N.Y. Times, Dec. 21, 1984, at 34, col. 6.

98. See *supra* note 35; see also VOLUNTEER LAWYERS FOR THE ARTS, *supra* note 17, at

ship lies and that Congress should concern itself with changing this area of tax law rather than changing the charitable deduction value.<sup>99</sup> The artists' grievance centers on a scenario such as the following: An artist creates a painting, which is valued at his material cost. The artist dies the next day, and the painting is then valued at the market level. Almost magically, the value of the work has increased substantially overnight. In fact, in protest of the estate tax laws, a New Mexican artist recently burned his entire collection, claiming it would be too expensive for him to die.<sup>100</sup>

One benefit of changing the estate tax law to a material cost valuation would be to ease the tax burdens on artists' beneficiaries. The hardship placed on the artist's estate under the present system can be tremendous, particularly if family members desire to keep the works. Unless they have the resources to pay the estate taxes, which are often quite substantial, the estate will be forced to sell all or part of the collection to pay off the debt.<sup>101</sup> Material cost valuation would enable the estate to decide, without the tax debt being a major consideration, whether to keep the collection.

Easing difficulties in appraisals is another benefit which could be realized through altering the tax treatment of an artist's estate.<sup>102</sup> An artist's collection may contain hundreds of works, perhaps including a number which are unfinished.<sup>103</sup> A market probably will not exist for most of the art, but the estate must nevertheless pay taxes based on the fair market value of the entire portfolio.<sup>104</sup>

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47 (discussion of what items are actually included in the estate since the statutory definition of ownership is imprecise).

99. O'Sickey Interview, *supra* note 84.

100. Artist Ted DeGrazia, in the early 1980's, burned 100 paintings which he had valued at \$1.5 million, and plans to burn more during his lifetime. See L. DUBOFF, *supra* note 17, at 660-61.

101. See, e.g., O'Sickey Interview, *supra* note 84; Joseph Speech, *supra* note 17, at 37-38; T. CRAWFORD, *LEGAL GUIDE FOR THE VISUAL ARTIST* 183 (1975) (discrepancy between the amount of estate taxes owed and available cash can plague estates composed largely of artworks).

102. Mr. O'Sickey has valued a number of artists' estates while acting as an expert appraiser. He confirms that the process is extremely difficult. Laymen erroneously suppose that if one work of a particular artist is sold for a certain price, then all his works go up in price accordingly. In fact, each piece must be individually appraised. Moreover, many other factors must also be taken into consideration before a fair market value is determined. O'Sickey Interview, *supra* note 84. See also Speiller, *supra* note 61, at 227-28 (discussing the difficulty of valuing works of art).

103. See O'Sickey Interview, *supra* note 84.

104. Another problem arises when market forces take over. An artist's death might initially trigger a rise in the value of his work, but once part of his collection is put on the market, or after a few of his works are sold, supply and demand factors may drive the market price down, making it impossible for the estate to realize in cash the fair market value previ-

Though the artist might have sold only a few works in his lifetime, an appraiser must determine the collection's value.<sup>105</sup> The appraiser's task would be significantly easier if he had only to determine the value of the canvas, paint, and frames.

Allowing material cost valuation for self-created works in an artist's estate would not only bring estate tax treatment into line with deductions artists receive for donating items while alive, but would also rid the estate of the above-mentioned valuation and tax burden problems. When one considers that even an artist's sketchbook must be included in the estate at fair market value,<sup>106</sup> it is possible to understand why this work might be destroyed,<sup>107</sup> resulting in the loss of materials valuable to art scholars.<sup>108</sup>

While artists might argue that the above changes are viable, reasons for retaining the present estate tax system abound. Artists' estates are presently treated no differently than those of any other individuals, and to argue for a system that would eliminate this system of horizontal equity would defeat the goal of the Internal Revenue Code.

Furthermore, several factors make the present estate tax system objectively tolerable for artists by allowing them to avoid the harsh consequences discussed above. Under the current system, an artist can draft a will which dictates the handling of his possessions at death. This document will effectuate unified management and con-

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ously established. *Id.* See also *Estate of David Smith*, 510 F.2d 479, 480 (2d Cir.) (recognizing that a forced sale of creative property to meet the estate tax bill might depress the value of the work), *cert. denied*, 423 U.S. 823 (1975).

In addition, great expense might be incurred in the process of selling the works, and this expense may not be deductible from the estate tax bill. Compare *id.* at 482-83 (expenses are deductible only if incurred for the benefit of the estate rather than for the benefit of individual beneficiaries) with *Estate of Park*, 475 F.2d 673, 676 (6th Cir. 1973) (all selling expenses are deductible).

105. Mr. O'Sickey has had to appraise collections containing hundreds of works by an artist who had sold only a few items during his lifetime. See O'Sickey Interview, *supra* note 84.

See also *Estate of David Smith*, [57-58] Tax Ct. Rep. Dec. (P-H) § 57.67 (The case of the now well-known sculptor who died in 1965 dealt with the valuation process and the possibility that no significant market for the artist's work existed. In the 25 years before his death, Smith had sold less than 100 pieces of sculpture, yet 425 works remained in his collection that had to be valued.); Schaaf, *Estate Planning for Authors and Artists*, 423 Tax Mgmt (BNA), at A-32 to A-35 (1981) (a detailed analysis of the valuation of assets from an estate tax perspective).

106. See O'Sickey Interview, *supra* note 84.

107. Mr. O'Sickey stated that he was considering destroying certain works and his sketchbooks so as not to saddle his son with a significant debt. *Id.*

108. *Id.*

trol<sup>109</sup> of the artist's works, whereas if he died intestate, the property would be divided among distributees depending on the laws of the state.<sup>110</sup> One of the main benefits of executing a will is that it allows the artist to specify where the art will go, who is responsible for paying the taxes and other expenses, and who must care for the works while they are in the estate and afterwards.<sup>111</sup>

The will also provides the artist with an opportunity to control state estate taxes, particularly where the collection is spread among different states on long-term museum loans. The estate plan can avoid a myriad of state proceedings by assembling the works in the area where the artist resides.<sup>112</sup> Thus, the artist has the ability to direct the distribution of his creations through the proper drafting of his will.<sup>113</sup>

In addition, numerous estate planning techniques are available to alleviate the potentially onerous tax burden facing the artist's beneficiaries.<sup>114</sup> The gross estate value is reduced by a number of substantial tax-saving deductions before the total amount of tax due is determined.<sup>115</sup> The marital deduction<sup>116</sup> and the charitable de-

109. See Schaaf, *supra* note 105, at A-30. "[U]nifying management and control of creative property is to ensure that control is consolidated in the hands of a fiduciary who will not only protect the interests of the estate and its beneficiaries, but who will have sufficient expertise to exploit the property properly." *Id.* No matter how good one's estate planning may be, it still may be necessary to sell some works in order to pay the estate taxes. It is essential to get a fiduciary who is "versed in the techniques for marketing creative property as will ensure that it is disposed of at its true market price." *Id.* at A-31.

110. See Schaaf, *supra* note 105, at A-30; Joseph Speech, *supra* note 17, at 34.

111. Joseph Speech, *supra* note 17, at 34.

112. T. CRAWFORD, *supra* note 101, at 178.

113. A will is useful in ensuring the organized handling of an artist's estate, but its use is not foolproof. See *Matter of Estate of Rothko*, 84 Misc. 2d 830, 379 N.Y.S.2d 923 (Sup. Ct. 1975), *modified* 56 A.D.2d 499, 392 N.Y.S.2d 870 (1976), *aff'd*, 43 N.Y.2d 305, 372 N.E.2d 291, 401 N.Y.S.2d 449 (1977) (even though the artist had a will to handle his \$2 million estate, mismanagement of the disposition of the artwork led to substantial fiduciary liability).

For a more detailed analysis of the Rothko case, see Feldman, *The Rothko Estate: The Case of the Beleaguered Executor*, II ART & THE LAW 1 (1976); Harrow, *The Final Word in the Rothko Case: Salient Legal Holdings of the Court of Appeals*, IV ART & THE LAW 33 (1978); Harrow, *Reflections on Estate of Rothko: The Role of the Legal Advisor in Relation to the Artist*, 26 CLEV. ST. L. REV. 573 (1977) [hereinafter Harrow, *Reflections*].

114. While this Note will not attempt to discuss details of estate planning techniques for the artist, an overview on the many ways the estate can lessen its tax burdens is appropriate to counteract the artists' outcry for change. For an overview of the available estate planning techniques, see Schaaf, *supra* note 105, at A-13 to A-37.

115. See I.R.C. §§ 2053-2056 (1982).

116. I.R.C. § 2056(a) (1983). "For purposes of the [estate] tax imposed . . . the value of the taxable estate shall . . . be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse . . ." *Id.*

The marital deduction once was limited to the greater of \$250,000 or 50 percent of the

duction<sup>117</sup> are two of the most significant deductions reducing the gross estate value.

Another estate planning technique available to the artist is to make gifts of his works during his lifetime.<sup>118</sup> Such a gift will preclude further appreciation in the work from being included in the artist's gross estate,<sup>119</sup> and if the gift falls within certain statutory limitations, it may not be subject to taxation at all.<sup>120</sup> The artist may also be able to set up a family partnership<sup>121</sup> or foundation.<sup>122</sup>

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value of the adjusted gross estate. Now, the deduction is unlimited. See Economic Recovery Tax Act of 1981, Pub. L. No. 93-34, § 403(a)(1)(A), 95 Stat. 172, 301 (striking out subsection (c) which contained this monetary limitation).

The marital deduction is only a deferral tax provision; the present deductions will eventually be taxed in the estate of the surviving spouse. See Crawford, *supra* note 101, at 180-81.

For a general discussion of the marital deduction, see Covey, *Structuring and Funding Marital Deduction Provisions—an Outline*, 2 EST. GIFTS & TR. J. 4 (1979).

117. I.R.C. § 2055 (1982). If an artwork is retained by the artist who created it and is donated to a charitable organization by his estate, the deduction will be equal to the fair market value of the item rather than the material cost, as would have been the case had the artist donated it before he died.

In order to achieve maximum tax benefits, it was essential, prior to the Economic Recovery Tax Act of 1981, to combine the marital and charitable deductions. Since the passage of the Act, however, the unlimited marital deduction makes it unnecessary to use the charitable deduction to reduce the federal estate tax to zero, if the decedent leaves the entire estate to the spouse. Lerner, *How to Coordinate Income and Estate Tax Savings of Donating a Collection to Charity*, 11 EST. PLAN. 147-48 (1984) [hereinafter Lerner, *How to Coordinate*].

In fact, the collection should be left to the surviving spouse even if the artist wants to bequeath the entire collection to a charitable organization. The spouse would then donate the works, garnering the normal § 170 deductions and avoiding federal estate taxes under the unlimited marital deduction. The deceased artist, however, must be certain that his or her spouse will, in fact, transfer the collection according to the artist's wishes. *Id.*

Several types of transfers qualify for the charitable deduction, but certain limitations can be imposed. For a survey of these possibilities, see Bateman & Kligman, *supra* note 36, at 71; see also Lerner, *Final Sec. 2055(e)(4) Regs. May Result in Loss of Charity Deduction for Artist's Estate*, 62 J. TAX'N. 300 (1985) (discussing the section's impact on artists who bequeath their works to charities and do not provide for the disposition of the copyright).

For a good discussion of copyrights as they pertain to the artist and his estate, see Schaaf, *supra* note 105, at A-5 to A-13.

118. The artist must be careful in employing this technique since gifts made in anticipation of death will be included in the gross estate of the transferor. In fact, there arises a rebuttable presumption that the transfer was made to accomplish a testamentary purpose if it occurs within three years prior to death. See I.R.C. § 2035 (1982).

By making the gift, the taxpayer must give up possession of the item in order to receive the tax benefits. Partial inter-vivos transfers are available, however, which allow the donor to maintain possession but still receive the tax and estate planning benefits of a complete transfer. See Lerner, *How to Coordinate*, *supra* note 117, at 146-47.

119. See Schaaf, *supra* note 105, at A-18.

120. I.R.C. § 2503(b), (c) (1982). The code allows every taxpayer to give up to \$10,000 annually to any individual donee without having to pay a gift tax.

The possibility of a unified credit against gift tax also exists. See I.R.C. § 2505 (1982); see also Speiller, *supra* note 61, at 247-48 & n.138 (discussing the credit).

121. For a complete discussion of this area, see Massey and O'Connell, *Keeping it All in*

Furthermore, at least one state allows a credit against state estate taxes by transferring ownership of some of the artist's artwork to the state for exhibition in public institutions.<sup>123</sup> Finally, if the artist has the ability to forgo profits from the sale of his works during his lifetime, his estate or beneficiaries can sell the property at potentially significant tax savings after his death.<sup>124</sup>

Besides the artist's ability to lessen his estate tax burden through planning devices, the courts have offered their help by recognizing the financial realities of the art market, as illustrated in *Estate of David Smith*.<sup>125</sup> As a result of that case, the courts acknowledged "blockage," a term referring to the inability of an estate to sell an artist's collection because no market for the works exists.<sup>126</sup> Previously, the estate would have been required to pay taxes based on fair market value, regardless of how long it would take to disperse the collection without depressing the market value. The court in *Smith*, however, held that blockage may properly be considered in valuing an artist's unsold works.<sup>127</sup> Now, the courts may determine a fair dispersal time, and the estate pays taxes based on the present value of that figure.<sup>128</sup>

Congress also provided help for the illiquid market problem in the Tax Reform Act of 1976.<sup>129</sup> Whereas an estate normally has only twelve months to pay its taxes,<sup>130</sup> it may be permitted to extend payment over a period of ten years upon a showing of reasonable cause.<sup>131</sup> The estate may also elect to delay the initial payment

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*the Family: Use of Family Partnerships and Section 704(b)(2) Special Allocations to Control Estate Tax Valuation*, 33 U. FLA. L. REV. 1 (1980).

122. See, e.g., Harrow, *Reflections*, *supra* note 113, at 580-83.

123. ME. REV. STAT. ANN. tit. 27, § 93(1) (Supp. 1985).

124. I.R.C. § 1014(a) steps up the basis in property acquired from a decedent. Thus, gain or loss on subsequent sales or exchanges will be determined according to this higher basis, and any appreciation in the work which occurred prior to death will never be taxed. See Schaaf, *supra* note 108, at 2.

125. See *supra* note 105.

126. The estate might be put into this forced sale situation in order to raise the money to pay off estate tax obligations. See Lyons, *Tax Breaks for Artists' Heirs*, VI ART & THE LAW 24 (1980).

127. Estate of David Smith, *supra* note 105, at 445.

128. The Tax Court considered the element of blockage in the case of Alexander Calder's widow, allowing disposition periods of 18 to 22 years and discount rates of 18% to 25%. *Louisa J. Calder v. Commissioner*, 85 TAX CT. REP. (CCH) 42, 467 (1985).

129. Pub. L. No. 94-455, § 2004, 90 Stat. 1520, 1862 (1976).

130. I.R.C. § 6161(a)(1) (1982). "The Secretary . . . may extend the time for payment . . . for a reasonable period not to exceed . . . 12 months . . . from the date fixed for payment thereof." *Id.*

131. *Id.* § 6161(a)(2) "The Secretary may, for reasonable cause, extend the time for payment of [estate taxes] for a reasonable period not in excess of 10 years." *Id.* See also *Id.*

for up to five years.<sup>132</sup>

Thus, although artists may offer strong arguments in favor of changing estate tax valuation of their creative works from fair market value to material cost,<sup>133</sup> the hardships threatening the estate can be greatly minimized with careful estate planning. This, combined with the presence of horizontal equity, makes a change in our estate law unnecessary. The solution to the problem of inequitable treatment of artist donations does not lie in the estate tax area but in changing the income tax laws themselves.

### B. *Modification of Income Tax Laws*

One of the primary catalysts behind the amendment of Internal Revenue Code section 170(e) by the Tax Reform Act of 1969 was the need to combat the problem of government officials' donation of their papers,<sup>134</sup> but Congress went too far.<sup>135</sup> The changes which prevented politicians from abusing the system handicapped the artist, yet left the collector virtually unaffected.<sup>136</sup> Valuation abuses were just as extensive among collectors as they were among artists prior to the changes.<sup>137</sup> Furthermore, the ability to profit more by donating an item than by selling it applied equally to both the collector and the artist.<sup>138</sup> Now that these problems have been addressed,<sup>139</sup> it is necessary to bring equity to the situation by changing the income tax laws.<sup>140</sup>

One of the general goals of our tax code is to ensure equal treatment of similarly situated taxpayers<sup>141</sup> through application of the

§ 6166 (for reasonable cause, the Secretary can extend payment of estate taxes for 10 years when the estate consists largely of an interest in a closely held business).

132. *See id.* § 6166(3). If an election is made under section 6166, the estate can delay the first installment for five years, although interest charges may apply.

133. *See supra* notes 98-100 and accompanying text.

134. 119 CONG. REC. 9400 (1973) (statement of Senator Frank Church).

135. *Id.*

136. *See supra* notes 31-34 and accompanying text.

137. *See Turner Interview, supra* note 78.

138. *See supra* note 45 and accompanying text. That example also applies to the collector. Assume the collector purchased the painting for \$100, which becomes his adjusted basis. The numbers once again prove that the collector benefits more by donating than by selling the item.

139. *See supra* notes 55-71 and accompanying text.

140. "It would appear that such unequal treatment could be viewed as a violation of the fundamental concept of equal treatment under the law. There would seem to be no mitigating factors that differentiate between the two groups of donors and which would justify different methods of tax evaluation." 1981 Hearings, *supra* note 80, at 349 (statement of American Arts Alliance).

141. *See, e.g., Pechman, supra* note 19, at 70.

“horizontal equity” principle.<sup>142</sup> The application of the principle in the donation of artwork situation dictates that “[c]ontributions of creative compositions by creators or collectors should be treated as similarly as possible, irrespective of the difference in which the contributed compositions were acquired.”<sup>143</sup> This was the case prior to the Tax Reform Act of 1969,<sup>144</sup> but since that enactment, collectors may take a fair market value deduction while only a material cost deduction is allowed to artists.<sup>145</sup> Equity dictates a reversion to the former valuation method to ensure that individuals with comparable incomes who donate equally valued property receive comparable tax treatment.<sup>146</sup>

Those who oppose this income tax change argue that while equity is desirable, the present treatment is justified since the artist's and collector's investments in the work are different and thus they are not similarly situated.<sup>147</sup> According to this line of reasoning, the collector is using after-tax income to buy the art, and thus he is entitled to capital gains benefits<sup>148</sup> and a charitable deduction at fair market value.<sup>149</sup> The artist, on the other hand, is not entitled to the capital gains treatment on artwork that he has created.<sup>150</sup> Any charitable contribution of his work is determined by his adjusted basis in that item, which is essentially his material cost.<sup>151</sup> Basically, the difference between the artist's cost and the fair market value reflects his personal efforts; under this line of reasoning, a charitable contribution of an artist's work is thus analogous to a donation of his services.<sup>152</sup> Just as a doctor or lawyer doing pro bono work could not deduct the value of time spent volunteering,<sup>153</sup> an artist should not be allowed to deduct the value of his labor.<sup>154</sup>

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142. *Id.*

143. Note, *Tax Treatment*, *supra* note 20, at 161. Efficiency considerations also dictate similar treatment of the two groups, “for fear that the creator may be influenced to devote fewer of his resources to holding personally created property and more to collecting, or investing, than would be optimal.” *Id.*

144. *See supra* note 4 and accompanying text.

145. *See supra* note 22 and accompanying text.

146. Note, *Tax Treatment*, *supra* note 20, at 162.

147. *See Feld*, *supra* note 24, at 625.

148. *Id.*

149. *See supra* notes 31-34 and accompanying text.

150. *See supra* notes 24-26 and accompanying text.

151. *See supra* notes 25-26 and accompanying text.

152. Note, *Tax Incentives*, *supra* note 20, at 711.

153. “No deduction is allowable under section 170 for a contribution of services.” TREAS. REG. § 1.170A-1(g) (1979).

154. Since the value of the creative part of an artist's work is totally due to his labor, there should not be a deduction allowed for his labor. L. DUBOFF, *supra* note 17, at 650.



One may rebut these arguments by first illustrating the difference between a doctor and an artist providing services to charity. First, while the artist's services are encompassed in a tangible gift which can be objectively valued, the services of the doctor are much more difficult to value.<sup>155</sup> Second, it is possible to consider the creator's own work as capital gain property instead of ordinary income property.<sup>156</sup> This type of treatment is not foreign to our tax code. The inventions of amateur inventors are afforded capital asset treatment,<sup>157</sup> as are the patents secured by both professionals and amateurs.<sup>158</sup> These groups are given capital gains treatment because Congress recognizes the value of their inventions to society and wants to promote their continuing creativity.<sup>159</sup> But art, too, provides comparable societal benefits and thus should be accorded equal tax treatment.

One of the driving forces behind the 1969 changes seems to be the fear of artists "painting a deduction" at income tax time.<sup>160</sup> This concept entailed an artist discovering at year end that he needed a deduction to offset income. He would then quickly produce a painting, donate it to a museum, and realize the tax savings. The occurrence of this scenario, however, is not the problem that some politicians believe it to be.<sup>161</sup>

155. One reason for disallowing a deduction for the donation of services is the administrative difficulty of accurately and equitably measuring the value of those services. With the artist and his artwork, this obstacle can be overcome, since the artist's services are embodied in tangible personal property having an ascertainable market value. See *1973 Hearings, supra* note 48, at 6143-44 (testimony of Richard E. Oldenburg, Director, Museum of Modern Art, New York).

156. This classification could be accomplished by allowing an artist to hold his work as an investment. Under that approach, any gain on the sale of the item would be considered capital gain; thus, charitable contribution of the work could also be deducted at fair market value. For a manner in which to accomplish this investment characterization, see *infra* notes 204-06 and accompanying text.

157. The amateur inventor escaped the wrath of the Revenue Act of 1950. See *supra* note 27. This is the act which prohibited capital asset treatment for an artist's own creation.

158. See I.R.C. § 1235 (1982). "A transfer . . . of property consisting of all substantial rights to a patent . . . by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year . . . . For purposes of this section, the term "holder" means any individual whose efforts created such property. . . ." *Id.*

159. As originally enacted by the House of Representatives, the § 1221(3) exception included amateur inventors. The Senate rejected this part of the bill, stating that "[y]our committee believes that the desirability of fostering the work of inventors outweighs the small amount of additional revenue which might be obtained under the House bill, and therefore the words 'inventions,' 'patent,' and 'design' have been eliminated." S. REP. NO. 2375, 81st Cong., 2d Sess. 44 (1950).

160. See *1973 Hearings, supra* note 48, at 6082 (statement of Ralph F. Colin, Administrative Vice President and Counsel, Art Dealers Association of America, Inc.).

161. This concern has been addressed in recently proposed legislation. See *The National*

The notion that an artist can quickly paint up a tax deduction has been dispelled by a recent survey, which showed a wide range of museum policies with regard to accepting gifts or bequests of art.<sup>162</sup> The results revealed that museum directors were highly selective in the works they accepted for their institutions. A donation might be rejected for the obvious reason that it does not meet the standards of the museum,<sup>163</sup> or that the maintenance and display costs associated with receipt of the gift are prohibitive.<sup>164</sup>

Just as museums will not accept all gifts, most artists will not donate their works to just any museum.<sup>165</sup> Artists take pride in their creations and are sensitive to public perception of their efforts. Before the creator makes a donation, he must be assured that the method of display, lighting, and maintenance will be handled according to his specifications.<sup>166</sup>

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Heritage Resources Act, H.R. 3087, 99th Cong., 1st Sess., 131 CONG. REC. E3564 (daily ed. July 26, 1985), requiring that all property for which deductions are taken must be in existence for one year prior to its donation, preventing the quick production and donation of property at tax time.

162. Vencel & Whitman, *Giving Art to Museums: Special Considerations for the Estate Planner*, 122 TR. & EST. 35, 35-37 (1983). The surveyed museums were the San Francisco Fine Arts Museum, the Metropolitan Museum of Art in New York City, the Mattatick Museum in Waterbury, Connecticut, and the William Benton Museum of the University of Connecticut.

163. *Id.* A museum might not accept a work outside of its realm. For example, a museum specializing in southwestern art might not accept a work in the French impressionist style. *But see* Speiler, *supra* note 61, at 232 (asserting that museums are *not* selective).

164. Museums have been forced to become much more cost conscious as the costs of storage, insurance, security, and preservation increase. Vencel & Whitman, *supra* note 162, at 35, 37.

165. *But see* Turner Interview, *supra* note 78 (While established artists are selective in the museum to which they will make a donation, newer artists are not. They will readily sacrifice the sale of a work to have it accepted by a museum; the subsequent prestige and increased earning potential will more than compensate them for this present loss of sale revenue.).

166. *See* Harrow, *Reflections*, *supra* note 113, at 573, 582. The author discusses artist Mark Rothko's intense concern for the display of his art and its perception by society. Rothko wrote:

A picture lives by companionship, expanding and quickening in the eyes of the sensitive observer. It dies by the same token. It is, therefore, a risky and unfeeling act to send it out into the world. How often it must be permanently impaired by the eyes of the vulgar and cruelty of the impotent who would extend their affliction universally!

*Id.* at 573.

Rothko's daughter discussed her father's concern:

My father was always deeply concerned with the fate of his paintings, how and to whom they would be disposed of, the conditions in which they were seen or exhibited and the environments in which they were placed. This deep concern, over the span of his artistic life, caused him to be reluctant to sell his paintings, very cautious as to whom they were sold, and extremely concerned about the way they were exhibited.

*Id.* at 582-83.

Another argument in favor of changing the income tax laws is to encourage more efficient use of assets. As the tax laws stand now, the only way an artist can receive a fair market deduction for the donation of his work is for his estate to make the donation after his death.<sup>167</sup> A change in the income tax laws would allow the work to be put to more efficient use while the artist is still alive, rather than languishing in the artist's studio for what could be many years, awaiting his death and the subsequent beneficial tax treatment.<sup>168</sup>

A final argument for income tax law changes has been presented by the executive branch of the government. When President Reagan realized the need to stimulate private support for the arts, he organized the Presidential Task Force on the Arts and Humanities to examine this area.<sup>169</sup> The Task Force's report recommended the following change to the tax code: creators of works of art should receive "the same tax treatment, as a result of the charitable contribution of their work, available to a collector or other donor giving a purchased work or manuscript."<sup>170</sup>

Even though recommendations for changing the income tax laws have received support from the executive branch itself, there are still those who feel change is unnecessary. They assert that allowing artists a fair market value deduction for the donation of their artwork is just a loophole for the rich.<sup>171</sup> It hardly seems equitable, however, to penalize the artist and his gift of appreciated property when potential abuses obtain in other areas of the system.<sup>172</sup> For example, tax shelters in oil and gas, real estate, and equipment leasing all lend themselves to abuse.<sup>173</sup> Although tax shelters have come under close scrutiny,<sup>174</sup> their primary purpose—encouraging certain activities beneficial to the economy—can be

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167. See *supra* notes 36 & 117 and accompanying text.

168. But see *supra* note 37.

169. See Exec. Order No. 12,308, 46 Fed. Reg. 30,485 (1981).

170. 1981 *Hearings*, *supra* note 80, at 354 (statement of American Association of Museums).

171. Kinsley, *The Art of Deduction: Writer's Loophole*, Wall St. J., Mar. 11, 1983, at 27, col. 1 (since the artist is not taxed on the worth of his art unless he sells it, he should not be allowed a fair market value deduction upon donation).

172. Note, *Tax Incentives*, *supra* note 20, at 687.

173. See Hershey, *The Boom in Tax Shelters*, N.Y. Times July 19, 1983, at D1, col. 3. Tax shelters are "investment devices designed to shelter income from taxation, usually for a period of years." *Id.*

174. The Tax Reform Act of 1986 severely limits the amount of losses that a taxpayer can deduct if he is technically not at risk. Furthermore, a passive relationship with the shelter can substantially reduce its tax benefits. See Tax Reform Act of 1986, *supra* note 70, at — (codified at I.R.C. § 469 (1986)).

upheld.<sup>175</sup>

Income tax law changes, as applied to the artist, would have a similar effect of encouraging favorable activities.<sup>176</sup> Permitting artists a charitable contribution deduction<sup>177</sup> of fair market value could be considered a recognition of quality and, at the same time, an inducement for them to donate their works for the benefit of society.<sup>178</sup> In other countries, the government provides this incentive for artists by either completely or partially exempting them from income tax or allowing them to credit charitable contributions of their work against tax liabilities.<sup>179</sup> While this Note does not advocate such radical measures, some change in our income tax laws is needed to bring about the desired results.

## V. PROPOSED LEGISLATION

While bills have been proposed to alter the negative effects of the 1969 tax changes, none has been able to garner the support necessary for passage.<sup>180</sup> The proposals have ranged from restoring the artist to the position he held before the passage of the Act to providing a credit against the donating artist's income tax.<sup>181</sup> Even though every proposal contained provisions to eliminate abuses,<sup>182</sup> each has died in committee.

The proposed National Heritage Resources Act is the most recent attempt to alter this area of the law.<sup>183</sup> Introduced in July of 1985, the bill proposes income tax changes which would provide

175. Hershey, *supra* note 173, at D6, col. 3.

176. "There is no question that [charitable donation deductions] benefit the rich, as do a lot of other provisions in the tax code . . . , [b]ut what you're doing is giving an incentive to affluent people to give works of art to museums so that the general public receives the benefits." ARTNEWS, *supra* note 75, at 25 (quoting Gilbert Edelson, Secretary-Treasurer of the Art Dealers Association of America).

177. Artists would still be limited to the charitable contribution limitations of I.R.C. § 170(b)(1)(A).

178. Note, *Tax Incentives*, *supra* note 20, at 711.

179. 1973 *Hearings*, *supra* note 48, at 6117, 6120 (statement of Elias Newman).

180. Renato Beghe seems to blame the lack of support on the furor that still exists in Congress over the Nixon papers deduction fiasco. See Beghe, *supra* note 21, at 516.

181. See, e.g., S. 852, 97th Cong., 1st Sess. (1981) (would allow an income tax credit for contributions of self-created compositions based on the greater of \$2500 or one-half of the taxpayer's total income tax for the year).

182. Provisions in the previously proposed bills are similar to those incorporated into H.R. 3087. See *supra* note 182; *infra* notes 185-87.

183. See Resources Act, *supra* note 161. The bill was introduced by Congressman Thomas J. Downey of New York and was referred to the Committee on Ways and Means. While the bill died at the close of the 99th Congress, Congressman Downey is almost certain to reintroduce it in the 100th Congress. Telephone conversation with Dan Horwitz, Assistant to Congressman Thomas T. Downey (Dec. 19, 1986).

living artists with a fair market value charitable contribution deduction for the donation of their works to cultural institutions.<sup>184</sup> Specific stipulations have been included to prevent deductions for quickly produced works of art.<sup>185</sup> The donated item must also be directly related to the primary purpose of the accepting institution,<sup>186</sup> and no deduction may be taken by an official of the federal government if the work was produced during his term in office.<sup>187</sup>

While the bill requires a statement from the donee that it will use the property for its tax-exempt purpose,<sup>188</sup> the bill should also compel the accepting organization to vouch for the work's value. Such a requirement would deter falsification, because museums, which strive to protect their prestigious reputations, could be held liable for misrepresenting the value of donated works.<sup>189</sup> A further safeguard against abuse would be to require institutions to insure contributed items for the amount the institution claims they are worth. The higher the value a museum assigns to a piece, the more it will cost in insurance premiums. Because the museum's interests are diametrically opposed to those of the artist, who seeks a higher appraisal for deduction purposes, a system of checks and balances against abuse would result.<sup>190</sup>

Ironically, an essential part of these proposals already exists. The Tax Reform Act of 1969, which amended Internal Revenue

184. The language of the Act states that "[s]ubsection (e) of section 170 of the Internal Revenue Code of 1954 . . . is amended by adding . . . that in the case of a qualified artistic charitable contribution . . . the amount of such contribution shall be the fair market value of the property contributed." H.R. 3087, 99th Cong., 1st Sess. § 2 (1985).

185. The donated work must be "created by the personal efforts of the taxpayer making such contribution no less than 1 year prior to such contribution." *Id.*

186. The charitable contribution applies only if "the use of such property by the donee is related to the purpose or function constituting the basis for the donee's exemption under section 501 . . ." *Id.*

187. The deduction does not apply "in the case of any charitable contribution of any letter, [or] memorandum . . . which was written, prepared, or produced by or for an individual while such individual was an officer or employee of the United States . . ." *Id.*

The legislative restrictions also include appraisal requirements, deduction limitations (the amount cannot exceed the taxpayer's gross income from artistry for that year), and stipulations against using the deduction in computing the minimum tax. *Id.*

188. "[T]he taxpayer [must receive] . . . from the donee a written statement representing that the donee's use of the property will be in accordance with [its section 501 purpose]." *Id.*

189. See Turner Interview, *supra* note 78. Dr. Turner indicated that museums themselves could be liable if they vouch for inaccurate appraisals.

190. *But see* Turner Interview, *supra* note 78. The problem with this type of requirement is that museums do not insure each individual work of art. Instead, museums determine, based on conjecture, the maximum loss potential from a single tragedy. They insure for this amount, which is considerably below the value of the collection *in toto*. To insure each piece individually would be prohibitively expensive.

Code section 170(e), also instituted the related use restriction,<sup>191</sup> which would have prevented many abusive charitable deduction ploys without the section 170(e) changes and their harsh consequences to the artist.<sup>192</sup> Before the provision went into effect, artists seeking deductions found that charitable organizations such as churches, hospitals, universities, and the like were convenient dumping grounds for their works.<sup>193</sup> These organizations were indiscriminate in what they accepted, since their intention was to realize a cash gain by selling the works, frequently at a price below the artists' claimed deductions.<sup>194</sup> They often were unconcerned with the value artists placed on their works, and once the pieces were sold in "distress" sales, the IRS was unable to prove that the artists' deductions were not valid.<sup>195</sup>

The related use restriction prevents this practice by providing that if the donated item is not related to the donee's tax-exempt purpose, then the taxpayer must reduce his deduction by the appreciated value of the item.<sup>196</sup> In other words, the artist is placed in the same position as if he had sold the item, recognized the gain, and then donated the proceeds to the institution—he receives no tax benefit for making this donation. The related use provision thus serves to remove the incentive for artists to give to non-related organizations.

The proposed National Heritage Resources Act and its fair market value deductions for artists<sup>197</sup> appears to achieve the sought-after results: tax treatment of the artist consistent with other taxpayers in the same situation; incentive for the artist to donate self-created work to appropriate museums; and protections against system abuse. Furthermore, the bill would accomplish all this without

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191. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a)(1)(B), 83 Stat. 487, 549 (codified as amended at I.R.C. § 170(e)(1)(B)(i)).

192. This restriction makes the related use provision in the National Heritage Resources Act superfluous. *See supra* note 186.

193. *See Turner Interview, supra* note 78.

194. Note, *Tax Incentives, supra* note 20, at 677.

195. *Id.* Since the organizations characterized their actions as "distress" sales, i.e., selling the piece for whatever price obtainable due to a need for money, the IRS could not use the sale price as a factor in verifying the artist's deduction.

196.

"The amount of any 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 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.

I.R.C. § 170(e)(1)(B)(i) (1986).

197. *See supra* note 184.

significant revenue loss to the Treasury.<sup>198</sup>

While the National Heritage Resources Act<sup>199</sup> is theoretically a step in the right direction, critics might oppose the bill on the ground that it allows artists a deduction for their services, while other professionals are not afforded such a benefit.<sup>200</sup> This practice, however, does not differ from the treatment artists received before 1969, when they were allowed fair market value deductions for charitable donations,<sup>201</sup> which included the service component. Before the deduction provision was changed, the issue of allowing artists to deduct the value of their donated services was not a source of contention. Congress had several concerns which led to the Tax Reform Act of 1969,<sup>202</sup> but the "services" issue was not one of them. Furthermore, patent holders and amateur inventors are allowed fair market value deductions for what arguably are their services.<sup>203</sup> Thus, a return to a fair market value deduction for artists has its precedents.

If, however, Congress adopts the purist's position of strict adherence to disallowing a personal services deduction, this Note would propose the following: allow the artist the option of paying taxes on the personal services portion of his work (essentially, fair market value minus material costs) in the year it is completed.<sup>204</sup> At that point, the artist would be viewed as an investor in his own work. Any subsequent gain or loss, computed from the new increased adjusted basis, would be given capital treatment since the work would no longer fall under the section 1221(3) exception.<sup>205</sup> In other words, the creation is now a capital asset and no longer ordinary income property. After one year, the artist could donate the work to a charitable organization, deducting fair market value in the same manner as any other collector.<sup>206</sup>

This proposal might be objected to on the grounds that it provides a temptation for an artist to value his work too low initially.

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198. See *supra* note 96.

199. See *supra* note 161.

200. See *supra* note 153 and accompanying text.

201. See *supra* note 20 and accompanying text.

202. See *supra* notes 39-48 and accompanying text.

203. See *supra* notes 157-59 and accompanying text.

204. See Feld, *supra* note 24, at 658. Professor Feld advocates a similar approach which would allow the artist to treat the work as if he sold it immediately after completion.

205. *Id.*

206. *Id.* An additional benefit from this type of election would be the artist's ability to fall within I.R.C. § 1031 since he would, by statute, be holding the art for investment purposes. Under § 1031, he would not pay any additional tax if he exchanged like-kind property. Feld, *supra* note 24, at 658.

He would thereby pay less taxes up front, thus increasing both his capital gains and, as a result, his contribution deduction potential.<sup>207</sup> This possibility is always a factor, but an artist must still meet substantiation requirements<sup>208</sup> and is subject to IRS audit.<sup>209</sup> Additionally, one scholar has suggested that by requiring an artist to offer his work for sale at his stated value, any abusive lure would be nullified by the fear of losing the piece at too low a price.<sup>210</sup>

The above proposal to allow an artist to be treated as an investor seems a fair and equitable way to accomplish the goals of the National Heritage Resources Act.<sup>211</sup> While the artist might not benefit to the same extent as if the Act were enacted as written, since he will be required to recognize gain on the personal service portion of his creation, horizontal equity would nevertheless be achieved. In either case—whether returning to the fair market value deduction for donations or providing the artist with an opportunity to obtain investor status in the artwork—the artist would now be treated, for tax purposes, like any collector who has made a charitable contribution of art. The injustices created by the Tax Reform Act of 1969 would thus be alleviated.

## VI. CONCLUSION

The Tax Reform Act of 1969 changed the amount artists could deduct for the donation of their self-created works from fair market value to material costs. This was a gross injustice, because horizontal equity, one of the goals of the Internal Revenue Code, was disturbed. The tax treatment of the artist was no longer consistent with that of the collector, who was still permitted to deduct fair market value for donations, nor was it compatible with the artist's collection being assessed at fair market value for estate tax purposes.

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207. *Id.*

208. *See id.* at 658-59 for methods the IRS could use to verify the value.

209. *See* I.R.C. §§ 7601-7602 (1982).

210. Feld, *supra* note 24, at 659. Feld also counters the argument that any subsequent gain should be characterized as inventory-type gain rather than capital, and thus treated as ordinary income pursuant to I.R.C. § 1221. Feld contends that since the service component is included in income and the artist is required to retain the work for more than one year before getting beneficial treatment, the inventory classification is illogical. Feld, *supra* note 24, at 659.

211. An inequity that will remain, however, is that once the artist makes the election and pays taxes on the service portion of his work, he is then locked into this investment classification. In the future, if he decides that he does not desire to sell or donate the painting, he will be forced to adhere to this earlier decision, thereby paying taxes on a gain he normally would not have been required to pay.



The artists' response to the tax changes has been to stop donating their works to museums and cultural institutions, instead selling that art to private collections, many of which are in other countries. Such dispersal will seriously hamper future scholarship on contemporary American artists.<sup>212</sup> Moreover, the nation itself will be deprived of its cultural heritage.

The catalyst for the 1969 tax amendment seemed to originate with President Nixon's large deduction for the donation of his vice presidential papers. The more basic concerns, however, were valuation abuse and the possibility of artists benefiting more by donating their work than by selling it. Additionally, some legislators seemed to feel that increased government funding of the arts justified the reduction in private sector incentives to support our cultural organizations.

It is no longer more profitable to donate a self-generated item than to sell it, however, and valuation techniques have become more sophisticated and more closely regulated. Furthermore, proposed bills contain restrictions to preclude the recurrence of past abuses. Finally, the federal government has cut back severely on government funding of the arts. Thus, the need for changes in the tax laws to restore incentives for artist donations is ever more pressing.

One possible solution is to change the estate tax laws to provide that an artist's collection is valued at material cost, consistent with the value applied when the artist donates the item. Although some artists feel the estate tax laws themselves are the source of the problem, their estates are nevertheless treated like those of other taxpayers, a fact which cuts against the argument for a change in the estate tax laws. In addition, many planning strategies are available to alleviate a high tax bill and the subsequent burdens it would place on the artist's heirs.

The change, therefore, must take place in our income tax laws in order to allow artists to deduct fair market value for the donation of their self-created works. If critics strongly object to the concept of allowing artists a deduction for their services, a viable alternative exists whereby an artist would be permitted to pay taxes based on the personal service portion of his work immediately after completion of a creation. Any appreciation in the value of the artwork after this time would be capital gain and thus entitled to a fair market deduction upon donation to a qualified museum. In either case,

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212. See 1981 Hearings, *supra* note 80, at 317 (statement of Daniel Boorstin).

horizontal equity would be restored, since the artist would be treated in the same manner as the collector who donates an identical piece. Not only will tax symmetry be achieved, but the incentive for artists to donate their work will be enhanced as well.

The accrued benefits from the proposed change would be immediate as well as long-lasting. Museums and libraries would once again be able to make major acquisitions without cost, artists would be able to donate their work to museums where it will best be displayed and maintained, and, most importantly, the presence of these important works of art in our museums will preserve America's cultural heritage for present and future generations to enjoy.<sup>213</sup>

DOUGLAS J. BELL

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213. *Id.* at 317-18.