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# Big Picture, Fine Print: The Intersection of Art and Tax

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## **Big Picture, Fine Print: The Intersection of Art and Tax**

Anne-Marie E. Rhodes\*

All passes. Art alone  
Enduring stays with us.<sup>1</sup>

The world of art and the world of income tax appear to be polar opposites. A work of art at its best is dazzlingly original and heartstoppingly thought provoking, while an income tax return is not. Nothing more than a standard-issue 1040 form with a straightforward, even somnolent, acceptance is the filing goal. Yet these worlds co-exist and, of necessity, routinely intersect. In that annual crossing, one wonders if the shape of one world is influenced by the other. At its core, is the question: Is art given special treatment in the Internal Revenue Code? It is, and this Article discusses this income tax question primarily from the perspective of an individual collector making a disposition of an artwork.

### **I. SPECIAL CONSIDERATIONS REGARDING WORKS OF ART**

There are two big picture themes in art that require a brief introduction. The first is art as “cultural property,” a term that through various international treaties, U.N. Conventions, and domestic laws may well be emerging as a distinct type of property within our legal system, and others as well. This theme is of art at its best—a creative ennobling testament to the human spirit. The second theme is decidedly less ennobling (one might fairly call it the underbelly of the art world) and that is the illicit trade in art. This illicit trade involves stolen, smuggled, and forged or fraudulent works of art.

#### **A. CULTURAL PROPERTY AS A NEW TYPE OF PROPERTY**

When experienced American lawyers think of property in our legal tradition,

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1. HENRY AUSTIN DOBSON, *Ars Victrix*, stanza 8, in *THE COMPLETE POETIC WORKS* 141, 142 (Oxford U. Press 1923).

Blackacre with its bundle of rights looms large.<sup>2</sup> First year property courses focus extensively on real property,<sup>3</sup> with students often reciting dutifully that it is the uniqueness and permanence of Blackacre that require the application of highly developed legal rules to it. Some lesser amount of classroom time is generally allotted to discussions of the non-real property—personal property—in those property courses.<sup>4</sup> The discussions on personal property sometimes have the quality of a bas-relief—our student understanding of personal property is based not on personal property's intrinsic merits but rather on its contrasts or overlaps with real property. In other words, how personal property is the same as real property, and how it differs or thrusts apart from real property. The differences are often due to the fungible and moveable nature of personal property as opposed to the uniqueness and permanence of Blackacre. If the property professor really manages her time well, there might be some mention of intangible property (today read as intellectual property) as an emerging third category to be studied as an elective.<sup>5</sup>

Today, of course, intellectual property is well ensconced in the academic world and in the real world. Questions of law and technology challenge our legal system, and new rules are being discussed, developed, and tried out on a global scale.<sup>6</sup>

Now there is, perhaps, a new emerging fourth category or “estate” of property—that of cultural property.<sup>7</sup> For the purposes of this Article, cultural property refers

2. “Blackacre is the most celebrated tract of land in the world of the law . . . .” JOHN E. CRIBBETT, *PRINCIPLES OF THE LAW OF PROPERTY* 1 (1st ed. 1962).

3. See, e.g., JOHN E. CRIBBETT ET AL., *CASES AND MATERIALS ON THE LAW OF PROPERTY* (8th ed. 2002); JESSE DUKEMINIER & JAMES E. KRIER, *PROPERTY* (5th ed. 2002); JOSEPH W. SINGER, *PROPERTY LAW: RULES, POLICIES, AND PRACTICES* (3d ed. 2002).

4. “Basically, this is a book on the law of land and personal property is treated only incidentally to illuminate certain property principles, such as the nature of gifts and the importance of possession.” JOHN E. CRIBBETT, *PRINCIPLES OF THE LAW OF PROPERTY*, at viii (1st ed. 1962); cf. JOHN E. CRIBBETT ET AL., *CASES AND MATERIALS ON THE LAW OF PROPERTY*, at v (8th ed. 2002). “This edition retains and updates its substantial coverage of personal property, which has been popular with many users of prior editions.” Of 1253 pages, about 100 pages (pp. 83-181) are focused on personal property.

5. See, e.g., EDWARD H. RABIN ET AL., *FUNDAMENTALS OF MODERN PROPERTY LAW*, at v (4th ed. 2000) (“[T]his fourth edition emphasizes two other dimensions of property law. First, this edition provides a comprehensive introduction to Intellectual Property Law”); JOSEPH W. SINGER, *PROPERTY LAW: RULES, POLICIES & PROCEDURES*, at xliii (3d ed. 2002) (“There has been a surge of interest among some property law professors in introducing some aspects of intellectual property into the first-year course. This trend is especially evident among new teachers in the field . . . . There has always been a subset of intellectual property in this and other casebooks.”). Also GRANT S. NELSON ET AL., *CONTEMPORARY PROPERTY*, at vi (2d ed. 2002) (“We are especially happy . . . [to have] added an entirely new chapter on . . . intellectual property law.”)

6. See, e.g., Cynthia M. Ho, *Attacking the Copyright Evildoers in Cyberspace*, 55 *SMU L. REV.* 1561(2002); CYNTHIA M. HO, *International Intellectual Property Issues for Biotechnology*, in *ENCYCLOPEDIA OF ETHICAL, LEGAL, AND POLICY ISSUES IN BIOTECHNOLOGY* 761 (2000).

7. Other phrases are also being used today, such as cultural heritage; however, because of the narrow technical focus here (generally on the dispositions of property, whether charitable or not), the phrase “cultural property” seems more appropriate. See Lyndel V. Prott & Patrick O’Keefe, “*Cultural Property*” or “*Cultural Heritage*,” 1 *INT’L J. CULTURAL PROP.* 307, 312-19 (1992). The estates currently recognized are the first estate of real property; the second estate of movables or chattel; and the third estate of intangible property, including the intellectual property in copyright, trademark, rights of publicity, and patent.

to items of artistic, archeological, ethnological or historical interest.<sup>8</sup> There is ongoing global pressure to preserve cultural property as important for humankind.<sup>9</sup> Recall the worldwide outcry over the Taliban's 2001 destruction of the ancient Buddha statues in Afghanistan.<sup>10</sup> There is also a growing scholarship on the need to treat cultural property differently from other types of personal property.<sup>11</sup> Whether a true fourth estate of cultural property will be acknowledged and recognized within the American legal system remains an open question. The practical issue for a lawyer with a client owner of an item of cultural property (or that could become an item of cultural property) will be understanding the contours of the client's proprietary rights. Important questions include: What ownership rights does the client actually acquire? What does ownership of the item of cultural property allow and disallow? How does one transfer or dispose of whatever it is that the client has? Over time the American legal system will undoubtedly respond to this big picture theme since it challenges our current concepts about ownership of property that may be deemed to have unique cultural value.<sup>12</sup>

The relationship between cultural property and the Internal Revenue Code is not

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8. Convention for the Protection of Cultural Property in the Event of Armed Conflict, May 14, 1954, 249 U.N.T.S. 215, 242 (hereinafter Hague Convention). Its Article I definition speaks of cultural property as "moveable or immoveable property of great importance to the cultural heritage of every people, such as . . . works of art."

Professor John Henry Merryman noted, "[T]he entire question of the proper definition of cultural property for legal and policy purposes is a large and unruly one . . ." John Henry Merryman, *Two Ways of Thinking About Cultural Property*, 80 AM. J. INT'L L. 831, 831 n.1 (1986).

9. Hague Convention, *supra* note 8. See also UNESCO Convention on the Means of Prohibiting the Illicit Import, Export, and Transfer of Ownership of Cultural Property (1970), 823 U.N.T.S. 231; see also UNIDROIT Convention on the International Return of Stolen or Illegally Exported Cultural Objects, June 24, 1995, 34 I.L.M. 1322.

Today there is a debate concerning the meaning of ownership and belonging of cultural property, especially when repatriation of cultural property is at issue. The principal opposing views are generally referred to as "cultural internationalism" and "cultural nationalism." Professor John Henry Merryman is often associated with the arguments based on cultural internationalism. See, e.g., John Henry Merryman, *Two Ways of Thinking About Cultural Property*, 80 AM. J. INT'L L. 831 (1986), and John Henry Merryman, *Thinking About the Elgin Marbles*, 83 MICH. L. REV. 1881 (1985); cf. David Rudenstine, *The Rightness and Utility of Voluntary Repatriation*, 19 CARDOZO ARTS & ENT. L.J. 69 (2001). See also Sarah Harding, *Value, Obligation, and Cultural Heritage*, 31 ARIZ. ST. L.J. 291, 302 (1999) (proposing a different approach—to seek the "normative similarities in our attitudes toward cultural heritage and to search for a common, non-rights and non-instrumental based understanding of its significance").

10. E.g., *U.N. Pleads With Taliban Not to Destroy Buddha Statues*, N.Y. TIMES, Mar. 3, 2001, at A3; Berry Bearak, *Over World Protests, Taliban Are Destroying Ancient Buddhas*, N.Y. TIMES, Mar. 4, 2001, § 1, at 10. There still may be at least one Buddha remaining. Liz Sly, *Tale of Sleeping Buddha Stirs inside Afghanistan*, CHI. TRIB., July 28, 2002, § 1, at 1.

11. E.g., Richard Crewdsin, *Cultural Property as the Fourth Estate?*, 81 L. SOC'Y GAZETTE 126, 129 (1984); Steven Wilf, *What Is Property's Fourth Estate? Cultural Property and the Fiduciary Ideal*, 16 CONN. J. INT'L L. 177 (2001); see also Marci A. Hamilton, *Four Questions About Art*, 13 CARDOZO ARTS & ENT. L.J. 119 (1994) ("Why do we treat art in our legal culture like nonart?").

12. Wilf, *supra* note 11, at 182. ("But we do not always know where that interest lies—and, in fact, there may be competing public interests as well as private interests. The fiduciaries envisioned. . . create competing claims. . . . Cultural property's fiduciary ideal, then, is complex and rarely a question of vesting one bundle of rights upon one party.")

always clear. Positioning cultural property as the fourth estate has enormous conceptual implications as it represents a fundamental shift in our legal notion of ownership. As such, the Code is not the place we would expect to find a pioneering spirit, and we do not. The Code is the fine print for this theme, nevertheless Code sections may evolve over time if art as cultural property becomes accepted. Looking closely, even now there is evidence of the Code's reacting to changes in art law. One ready example is the addition of section 2055(e)(4) and section 2522(c)(3) to the Code by ERTA number '81,<sup>13</sup> changes necessitated by the enactment of the Copyright Act of 1976.<sup>14</sup> These two sections provide that for certain works of art, the work of art and the copyright on the work of art shall be treated as two separate properties for the split interest rules for estate and gift tax purposes and not as two interests in one property as previously held. It is particularly interesting to note that changes in property's third estate, as it were, prompted this revision in the Code.

Whether a fourth estate will exist, and what its bundle of rights will be, makes predictions of future Code changes impressionistic at best.<sup>15</sup> Given the Code's thematic property touchstones of ownership, dominion, and control,<sup>16</sup> the scope and shape of future Code changes in response to a cultural property category would likely be directly proportional to changes in the proprietary meanings of ownership, dominion, and control for an item of cultural property.

## B. ILLICIT ART TRADE

The second big picture theme is quite gritty and much less ennobling—the world of the illicit art trade, involving stolen, smuggled, and forged or fraudulent works of art.<sup>17</sup> This art market is not always genteel or refined—murder, assault, and kidnapping have happened.<sup>18</sup> It ranks third in international criminal activity.<sup>19</sup>

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13. Economic Recovery Tax Act of 1981 (ERTA '81), Pub. L. No. 97-34, § 423, adding § 2055(e)(4) and § 2522(c)(3) (1981).

14. 17 U.S.C. § 202 (1976). The Copyright Act of 1976 made sweeping changes to domestic copyright law. See Robert A. Gorman, *An Overview of the Copyright Act of 1976*, 126 U. PA. L. REV. 856 (1978).

15. On the transfer tax side, one possible change could be the U.S. adoption of a *dation en paiement* provision, i.e. using art of the highest stature instead of dollars in payment of the tax. The French tax system provides for this, and one sterling consequence is the Picasso Museum in Paris. Safeguards concerning the process as well as the stature of the work of art need to be part of any proposal. See Anne-Marie Rhodes, *The Medium of Payment: An Option in Estate Tax Reform*, 57 NOTRE DAME L. REV. 285 (1981).

16. *E.g.*, *Helvering v. Clifford*, 309 U.S. 331, 335 (1940): "In this case we cannot conclude . . . that respondent ceased to be the owner of the corpus after the trust was created . . . . So far as his dominion and control were concerned it seems clear that the trust did not effect any substantial change. . . ."

17. The late Professor Paul Bator raised the level of discussion about this market in his seminal article, Paul M. Bator, *An Essay on the International Trade in Art*, 34 STAN. L. REV. 275 (1982).

18. *In Search of Stolen Art*, on-line discussion Aug. 10, 2000, transcript available at <http://discuss.washingtonpost.com/wp-srv/zforum/00/fbi0810.htm>, cited in Patty Gerstenblith, *The Public Interest in the Restitution of Cultural Objects*, 16 CONN. J. INT'L L. 197, 202 n.16 (2001). For interesting articles on looting, see RICHARD B. CUNNINGHAM, *ARCHEOLOGY, RELICS, AND THE LAW*

From the monetary perspective, this market is a thriving one, estimated well into the billions of dollars annually and is regarded as the easiest way to launder money internationally.<sup>20</sup> It is a market said to be fueled by the spiraling prices for works of art, aggressive practices of auction houses, the collapse of Communism and corresponding rise of organized crime in Eastern Europe, grinding poverty in art rich countries, insatiable demand in art poor countries, lax enforcement of international and domestic laws,<sup>21</sup> and, some would argue, the Internal Revenue Code.<sup>22</sup> “[The] use of art investments as tax shelters is a prime factor for the flourishing illicit trade in stolen or counterfeit art.”<sup>23</sup> “Tax shelter,” as so used, seems to mean receiving a deduction for a charitable donation, usually at an inappropriately inflated value,<sup>24</sup> and not what tax lawyers today would generally consider a tax shelter.<sup>25</sup> There is also an international perception, noted by

14-36 (1999).

19. It is obviously difficult to know the actual size of any illicit trade. Respected estimates confirm that the illicit art trade is substantial. See Hugh Eakin, *The World's Top Art Cop*, ARTNEWS 158, 160 (Summer 2002) (“According to insurance estimates, the worldwide trade in stolen art and antiquities is now worth \$6 billion to \$7 billion a year—a number surpassed on the black market only by drugs and armaments.”). See also Steven Bibas, *The Case Against Statutes of Limitation for Stolen Art*, 103 YALE L.J. 2437, 2452 (1994). (“As of 1990, art theft was second only to drug smuggling as the most lucrative crime in the world.”)

20. Eakin, *supra* note 19, at 160, quoting General Roberto Conforti, head of Italy's *Comando Carabinieri Tutela Patrimonio Artistico* (Carabinieri Command for the Preservation of Cultural Heritage) (“Fine art is a vehicle for organized crime. Mobsters use cultural goods for money laundering or investments. On many occasions a work of art is used to back a drug deal.”) See also Gerstenblith, *supra* note 18, at 202 n.16.

21. Adina Kurjatko, *Are Finders Keepers? The Need for a Uniform Law Governing the Rights of Original Owners and Good Faith Purchasers of Stolen Art*, 5 U.C. DAVIS J. INT'L L. & POL'Y 59, 60-61 (1999). But for an account of a recent sting operation with international cooperation, see Ralph Blumenthal, *Spanish Police and F.B.I. Get Their Men and Stolen Art*, N. Y. TIMES, June 26, 2002, at E1. For a description of the large scale Italian art police, see Eakin, *supra* note 19. General Conforti has stressed the need for international cooperation, noting that “the abolition of frontiers (in Europe) has favored illicit trade. . . . We depend on the concept of co-operation, it is the only way to deal with the globalisation of this phenomenon.” UNESCO Press, *Launch of Code of Ethics for Art Dealers at Anniversary Celebration of Ending Illicit Trade in Cultural Property*, (Nov. 16, 2000), available at <http://www.unesco.org/bpi/eng/unescopress/2000/00-119e-shtml>.

22. Leah Antonio, *The Current Status of the International Art Trade*, 10 SUFFOLK TRANSNAT'L L. REV. 51 (1986).

23. *Id.* at 58.

24. STAFF OF THE JT. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE DEFICIT REDUCTION ACT OF 1984 (H.R. 4170, 98th Congress; Pub. L. No. 98-369), at 503 (1984):

At the same time, Congress recognized that in recent years, opportunities to offset income through inflated valuations of donated property have been increasingly exploited by tax shelter promoters. Under typical tax shelter promotions, individuals acquire objects such as limited edition lithographs, books, gems, and the like, hold the property for at least the capital gains holding period, and then contribute the items to a museum . . . at their “appreciated” fair market value. The shelter package may include an “independent” appraisal, and the potential donor may be assured that his or her subsequent gift will be accepted by a charitable organization.

*Id.* See also LEONARD D. DU BOFF & SALLY HOLT CAPLAN, *THE DESKBOOK OF ART LAW* N-85-88 (2d ed. 1997).

25. I.R.C. § 6111(c) (2003). Actually, some very well respected tax lawyers in the past would not have considered it a tax shelter either: “Such schemes are often referred to in the media as exotic tax shelters, but we call them what they really are—abusive. These schemes claim tax benefits beyond

Europeans in particular, that American tax policy in providing for a charitable deduction has caused an unwarranted rise in prices that has subsequently placed the rest of the art world at a competitive disadvantage.<sup>26</sup>

Thus this second theme of the illicit art market is not really as elusive vis-a-vis the Code as the first theme of cultural property. Indeed, in the Code there are direct and indirect references to works of art that respond to elements of this illicit market. Many of these references are in the context of making dispositions of artworks, often to charities.

## II. DISPOSITIONS OF ART

### A. SALES

As background for considering the tax implications for dispositions of art, recall the basics. Gross income includes gains derived from dealings in property.<sup>27</sup> Gain is the excess of amount realized over adjusted basis.<sup>28</sup> The preferential capital gains tax rates<sup>29</sup> are generally applicable to sales of capital assets held for more than one year.<sup>30</sup> Although the typical capital gains rate is 20%, a 28% rate is applied to collectibles.<sup>31</sup>

Under § 1 (h)(6)(A), “collectibles gain” is defined as, “gain . . . from the sale or exchange of a collectible (as defined in § 408(m) without regard to paragraph (3)

those intended by law and, in some cases, cross the boundary of tax avoidance into tax evasion.” IRS Commissioner Roscoe L. Egger, Jr., *Defusing Abusive Tax Shelters*, HEART AM. TAX INST., Kansas City, Mo. (Oct. 6, 1981), reprinted in full, 13 TAX NOTES 863 (Oct. 12, 1981).

26. Antonio, *supra* note 22, at 58.

27. I.R.C. § 61(a)(3).

28. I.R.C. § 1001(a).

29. I.R.C. § 1(h). From the Revenue Act of 1921 until the Tax Reform Act of 1986, the taxation of capital gains received favorable tax treatment, whether through the mechanism of a stated maximum rate or a percentage of gain deduction. With TRA '86, 65 years of preferential tax treatment was abolished; but after a particularly bruising political battle in 1989, the capital gains preference resurfaced in 1990. Its reappearance was indirect because “Congress, with President George Bush’s acquiescence, raised the top individual permanent rate on ordinary income to 31% in 1990 while maintaining the 28% ceiling on capital gains. This had the effect of restoring a capital gains preference.” John W. Lee, *Critique of Current Congressional Capital Gains Contentions*, 15 VA. TAX REV. 1, 2 (1995). A thorough discussion of the taxation of capital gains is beyond the scope of this article, but for the classic presentation of the arguments for and against, see Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957). For more recent scholarship, see articles from the May 1993 New York University Colloquium on Capital Gains, collected at 48 TAX L. REV. 312-738 (1993).

30. I.R.C. § 1222; see William M. Speiller, *The Favored Tax Treatment of Purchasers of Art*, 80 COLUM. L. REV. 214, 251 (1980).

31. I.R.C. § 1(h)(6)(a) (2003) The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 311(a), amending I.R.C. § 1(h) (2003), generally lowered the maximum long term capital gains rate for individuals from 28% to 20%. For “collectible gains,” however, the top rate “will remain” at 28%. See Brian R. Greenstein, *The Taxpayer Relief Act of 1997—Provisions Affecting Individuals*, 87 J. TAX'N 261, 264 (Nov. 1997). Instinctively, many people think of 20% as the current capital gains rate, or perhaps as the maximum capital gains rate. See, e.g., William G. Gale & Peter R. Orszag, *A New Round of Tax Cuts?*, 96 TAX NOTES 1397, 1398 n.8 (Sept. 2, 2002).

thereof) which is a capital asset held for more than one year but only to the extent such gain is taken into account in computing gross income.”<sup>32</sup>

Under § 408(m)(2), the term “collectible” means:

- (A) any work of art,
- (B) any rug or antique,
- (C) any metal or gem,
- (D) any stamp or coins,
- (E) any alcoholic beverage, or
- (F) any other tangible personal property specified by the Secretary for purposes of this subsection.<sup>33</sup>

Thus, a sale of \$11,000 worth of stock held for three years with a basis of \$1,000 would generate a maximum tax of \$2,000, whereas a similar sale of a work of art would generate a maximum tax of \$2,800 (a potential 40% differential in tax treatment).

There is little direct legislative history for this 1997 enactment of distinctive treatment in the capital gains rates for works of art,<sup>34</sup> although the idea of distinctive treatment for collectibles was not totally new. Its origins can be traced back at least to 1989 when President Bush unsuccessfully proposed to reintroduce a capital gains preference.<sup>35</sup> His proposal specifically carved out depreciable and depletable assets and collectibles from the preferential treatment, “since realizations on excluded assets are relatively insensitive to change in tax rates” and consequently would not further the “Administration’s goal of reducing the Code’s role in influencing economic decisions.”<sup>36</sup> In the 1997 enactment of this new

32. I.R.C. § 1(h)(6)(A).

33. I.R.C. § 408(m)(2).

34. STATEMENT OF THE MANAGERS, 105TH CONG., COMM. REPORT ON TAXPAYER RELIEF ACT OF 1997 (H.R. 2014), § 311, at 64 (1997).

35. President Bush’s unsuccessful 1989 proposal was built on his campaign issue of reintroducing preferential tax treatment for capital gains, which had been effectively abolished by the Tax Reform Act of 1986. See *supra* note 29. His plan was twofold: first, to exclude 45% of the gain realized on the disposition of qualified capital assets and, second, to set a 15% maximum tax rate on realized capital gains. The maximum effective rate therefore would be 8.25%. Ian K. Loudon & R. Eliot Rosen, *The Bush Budget: Chock Full of Tax Changes*, 42 TAX NOTES 766 (Feb. 13, 1989).

36. Pat Jones writes:

Conspicuously absent from the list of capital assets benefiting from the reduced rate are depreciable assets and depletable assets and collectibles. Depletable assets include timber, a fact not lost on [Sen. Bob] Packwood [R. Ore.], who used the Finance Committee hearing to give the Administration a stern warning “I cannot accept that, period,” he said, promising to block the Bush proposal unless it is amended to include timber.

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With timber still on his mind, Packwood questioned [Acting Assistant Treasury Secretary for Tax Policy Dennis E.] Ross about Treasury’s rationale for excluding some assets. Ross responded that Treasury officials believe that realizations on excluded assets are relatively insensitive to changes in tax rates. Thus, he said, the Administration’s goal of reducing the Code’s role in influencing economic decisions would not be furthered by including these assets.

Pat Jones, *Taxwriters Look at Capital Gains; Brady Nixes Rate Trade*, 42 TAX NOTES 1407, 1408 (Mar. 20, 1989).

Despite this professed goal of reducing the Code’s influence, some saw this distinctive treatment for



legislative category of “collectibles gain” for rate purposes, the House did not refer to any particular rationale but merely concluded that “[t]he tax on the net capital gain . . . of collectibles will remain at a maximum rate of 28 percent.”<sup>37</sup> In doing so, however, it did reference an established tax tradition for a “collectible.”<sup>38</sup>

Section 408(m)(1) provides that an IRA that purchases a “collectible” is treated as if the IRA had made a distribution of the fair market value of the collectible to the IRA participant. In effect, this constructive distribution removes the tax advantages of an IRA for this type of property but does not prohibit investments in collectibles. ERTA ‘81 added this constructive distribution treatment because:

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collectibles in a manner reminiscent of prior debates: “Collectibles are excluded, and we applaud the Administration’s goal of forestalling tax sheltering.” Charles E. Walker & Mark A. Bloomfield, *The Case for the Restoration of a Capital Gains Tax Differential*, 43 TAX NOTES 1019 (May 22, 1989). If the Administration’s goal was to move toward limiting capital gains treatment to corporate stock, on the other hand, “the principle difficulty with a proposal applied only to capital stock is that it does nothing about the problem of inflation.” Gene Steurle, *More Capital Gains Issues*, 43 TAX NOTES 1533 (June 19, 1989).

The 1989 Bush proposal was defeated, but interestingly, other legislative proposals on capital gains picked up on the collectibles exclusion. For example, the also-unsuccessful 1989 bipartisan efforts of Representatives Jenkins, Archer, and Flippo on capital gains would also have excluded collectibles. “Almost all capital assets are covered under the JAF, though collectibles (art, stamps, and the like) are excluded.” J. Andrew Hoerner, *Rumors and Opinions Fly on Competing Capital Gains Plans*, 44 TAX NOTES 839 (Aug. 21, 1989).

In 1990, President Bush advanced his new capital gains proposal, which incorporated a sliding rate of tax depending on the length of the holding period and which still held onto a collectibles carve out from the preference. Under that proposal, if one sold qualified capital assets that had been held for 3 or more years, the exclusion was 30% of the gain. The exclusion rate dropped to 20% for assets held for 2-3 years, and further dropped to 10% for assets held 1-2 years. “Basically, a qualified asset would generally be defined as any asset qualifying as a capital asset under current law and satisfying the holding period requirements, except for collectibles.” Ian K. Loudon, *No Tax Surprises in ‘91 Budget As Bush Seeks Capital Gains Cut, Family Savings Initiatives*, 46 TAX NOTES 607 (Feb. 5, 1990). President Bush’s 1990 plan was not adopted.

37. Taxpayer Relief Act of 1997, *supra* note 29; H.R. REP. NO. 105-220 at 382 (1997). The failure to provide a rationale may be because there was no principled policy rationale for this solitary carve out, rather just the back and forth of tax politics. A comparison of the 1997 capital gains provision in the House, Senate, and President Clinton’s tax proposals shows that both the Republican dominated House and Senate lowered maximum capital gains rates in general while retaining the maximum 28% rate for collectibles. Alternatively, Democratic President Clinton proposed a 30% exclusion for all capital gains (with no mention of collectibles gain) with a special exclusion for gain up to \$500,000 on the sale of a principal residence. Martin A. Sullivan, *Preliminary Side-by-Side Comparison of House Bill, Senate Bill, and Recent Proposals by the President*, 76 TAX NOTES 16, 18 (July 7, 1997).

In conference and negotiations, the end result on capital gains was no percentage exclusion, up to \$500,000 exclusion of capital gains on the sale of a principal residence, and an exceedingly complex set of lowered maximum capital gains tax rates except for collectibles, which stayed at 28%. Daniel Q. Posin, *The Big Bear: Calculating Capital Gains After 1997 Act*, 76 TAX NOTES 1450 (Sept. 15, 1997).

Interestingly, two years previously, in the 1995 Republican Contract with America era, lowering capital gains rates had been a significant element. At that time, however, the Republican plan did not specifically carve out collectibles from the benefits of the proposal. For Rep. Charles Rangel (D-NY), this omission was not palatable. “We don’t want people to laugh at this contract.” *Lee supra* note 29, at 6 n.16.

As it turned out, none of the capital gains proposals, the omission of the collectible carve-out, or the political disbelief mattered in 1995, since the capital gains proposal was not successful. The significance of 1995 may be in foreshadowing the 1997 legislation on collectibles.

38. I.R.C. § 1(h)(6)(A) expressly referencing §408(m).

Congress concluded that investments in collectibles do not contribute to productive capital formation. There was also concern that the present-law rules regarding self-dealing under qualified plans and IRAs are not adequate to prevent personal use of collectibles.<sup>39</sup>

In short, the constant underlying disquiet about the potential for abuse of a tax benefit because of the nature of art helped to shape the special IRA treatment in 1981, which, in turn, may very well also have shaped the distinctive capital gains tax treatment in 1997.

## B. LIFETIME CHARITABLE TRANSFERS OF ENTIRE INTEREST

For many taxpayers, it seems axiomatic that a gift to a charity entitles the donor to an income tax charitable deduction.<sup>40</sup> Tax lawyers know that the charitable deduction under § 170 is hedged with many limitations, both qualitative and quantitative. These limitations are especially complex when a work of art is involved.<sup>41</sup>

In order to determine the availability and amount of a charitable deduction for a transfer of a work of art for income tax purposes, the donor needs to know four items:

- (1) the status of the charitable organization;
- (2) the type of property being transferred;
- (3) whether that property meets the related use rule; and
- (4) whether a qualified appraisal by a qualified appraiser is obtained.

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39. STAFF OF THE JT. COMM. ON TAXATION, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 (H.R. 4242, 97th Cong., Pub. L. No. 97-34), 212 (1981). The dual concerns of lack of productive capital formation and potential for self-dealing reflect commentators' concerns as well:

Growing concern with the problem of how to cope with inflation has recently led to increasing recommendations that employee benefit funds should be invested in a variety of tangible personal property: gold and silver bullion, rare coins, diamonds, Chinese porcelains, and other works of art all have had their advocates. The hallmark of all these investments is of course that they are non-income producing; their justification as an investment for an employee benefit plan must be the expectation that the property can and eventually will be sold at a profit.

....

Inflation or no, investment managers should also be aware of the risks run by certain types of conduct of being adjudged imprudent *prima facie* or *per se*, particularly with doctrines embedded in private trust law and other non-ERISA rules. If we are to have a Federal law of investment prudence in the employee benefit field, it is not asking too much of Congress to deal with certain of these doctrines directly, either through express legislation or through express delegation of rule-making authority.

Arthur D. Sporn, *Prudent Investments for Today's Fiduciary*, 38 NYU ANN. INST. FED. TAX (ERISA SUPP.), at 3-23 to 3-24, 3-27 (1980).

40. I.R.C. § 170.

41. See RALPH LERNER & JUDITH BRESLER, *ART LAW: THE GUIDE FOR COLLECTORS, INVESTORS, DEALERS, AND ARTISTS* 1133-1422 (2d ed., 1998).

## 1. Status of Charity

In general, charitable organizations are classified as either public charities or private charities.<sup>42</sup> Public charities are those that receive part of their support from the general public, and include churches, schools, hospitals, museums and other publicly supported charities; private operating foundations; certain organizations that are operated in connection with another public organization; as well as private foundations that distribute all their receipts each year. Private charities include all the other charities, including the usual private foundations.<sup>43</sup> The granting of exempt status under § 501(c)(3) is not the same as a determination of “public” status under § 509(a).<sup>44</sup>

The tax consequence for a donor of a work of art is, in general, the difference between a charitable deduction limited to basis if the transfer is to a private charity as opposed to a deduction of full fair market value if the transfer is to a public charity.<sup>45</sup> Because of this striking difference in the amount of the deduction, one should consider requesting from the charity an opinion of counsel as to the charity’s “public” status.

## 2. Type of Property Donated

### *a. Capital Gain Property or Ordinary Income Property*

The work of art will either be capital gain property or ordinary income property. Under § 170(b)(1)(C)(iv), “capital gain property” means “any capital asset the sale of which at its fair market value at the time of the contribution would have been long-term capital gain.”<sup>46</sup> Most works of art held by a collector could, therefore, qualify as capital gain property.<sup>47</sup>

Nevertheless, some works of art held by a collector would be considered as ordinary income property (not qualify as capital gain property). These would include works of art that:

- 1) would produce short-term capital gain if sold (i.e., held for less than a year);
- 2) would produce a capital loss; or
- 3) had been acquired by the collector from the artist who created it (or as a gift from someone else who so acquired it).<sup>48</sup>

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42. I.R.C. § 509(a); § 170(b)(1)(A)(i)-(vi), (E)(i)-(iii); Treas. Reg. § 1.170A-9 (as amended in 2002). See also BRUCE R. HOPKINS, *THE TAX LAW OF CHARITABLE GIVING* 111-122 (2d ed., 2000).

43. LERNER & BRESLER, *supra* note 41, at 1183.

44. *Id.* at 1184.

45. *Id.*; see *infra* text accompanying notes 49-71.

46. I.R.C. § 170 (b)(1)(C)(iv).

47. Jeffrey C. McCarthy, *Federal Income Taxation of Fine Art*, 2 *CARDOZO ARTS & ENT. L.J.* 1, 42 (1983).

48. I.R.C. § 1221(a)(3)(C).

*b. Quantitative Limitations*

The tax consequence of labeling the work of art as (long term) capital gain property or ordinary income property is once again generally speaking the difference between a deduction for full fair market value versus a deduction limited to basis. Another consequence of labeling the work of art as (long term) capital gain property or ordinary income property is the difference in quantitative limitations that are applicable.<sup>49</sup> There are two types of quantitative limitations for charitable transfers. The first is the general percentage limitation for all transfers made by the taxpayer to charities within that taxable year.<sup>50</sup> The second quantitative limitation depends on distinctions between the type of property donated (capital gain property or ordinary income property) and the status of the donee charity as public or private.<sup>51</sup>

*General Overall Percentage Limitations*

The general percentage limitation for all transfers of cash and ordinary income property in the aggregate to public charities is 50% of a donor's contribution base.<sup>52</sup> A donor's contribution base is generally the donor's adjusted gross income but without regard for any net operating loss carryback.<sup>53</sup>

For transfers to private charities, the general percentage limit under § 170(b)(1)(B) is the lesser of (i) 30% of the contribution base, and (ii) the excess of 50% of the contribution base over the amount of charitable contributions allowable to public charities.<sup>54</sup>

*Ordinary Income Property Amount Limitations*

For a work of art that is ordinary income property and donated to a public or private charity, the deduction for that item is limited to its basis.<sup>55</sup> That deduction amount is then subject to the overall 50% or 30% (depending on public or private status of charity) percentage limitations.<sup>56</sup> Any excess amount over the 50% or 30% general percentage limitations may be carried forward for five years.<sup>57</sup>

*Capital Gain Property Amount Limitations*

For a work of art that is capital gain property, satisfies the related use rule, and is donated to a public charity, the deduction is the full fair market value of the work

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49. *Id.* § 170(b)(1).

50. *Id.*

51. *E.g.*, I.R.C. § 170(b)(1)(C), (D).

52. *Id.* § 170(b)(1)(A).

53. *Id.* § 170(b)(1)(F).

54. *Id.* § 170(b)(1)(B).

55. *Id.* § 170(e)(1)(A).

56. *Id.* § 170(b)(1)(A), (B).

57. *Id.* § 170(d)(1)(A), (b)(1)(B).

of art.<sup>58</sup> This amount, however, is specifically subject to the overall 30% of contribution base limitation.<sup>59</sup>

If that work of art is instead donated to a private charity (but without regard to use), the deduction is reduced by 100% of the appreciation, and thus is essentially a deduction limited to basis.<sup>60</sup> It is then potentially further limited by the overall percentage limitation to the lesser of (i) 20% of the contribution base, and (ii) the excess of 30% of the contribution base over the charitable contribution allowable to public charities.<sup>61</sup>

Any excess amount over the applicable general percentage limitation may be carried forward for five years.<sup>62</sup>

### *Alternative Minimum Tax Impact*

The Tax Reform Act of 1986 added a wrinkle to the charitable giving of appreciated property. From 1987 through December 31, 1990, the long-term appreciation in the value of donated property was a tax preference item for AMT purposes.<sup>63</sup> After 1990, there was political, legislative and regulatory skirmishing<sup>64</sup> that ultimately led to the repeal of the then-subsection 57(a)(6), so that the appreciation in the value of tangible personal property donated to a charitable organization is no longer a tax preference item for AMT.<sup>65</sup> Nevertheless, even today a donor may otherwise be within the AMT snare and that, of course, will have a quantitative impact on the tax consequences of the charitable transfer.

### **3. Related Use Rule**

Section 170(e)(1) was amended by the Tax Reform Act of 1969 to add another requirement for favorable tax treatment for charitable contributions of “tangible personal property.”<sup>66</sup> In order to keep the deduction for full fair market value

58. *Id.* § 170(b)(1)(C)(i).

59. *Id.* There is a special election available to the donor to increase the 30% contribution base to 50%. If this election is made, however, the amount of the deduction must be reduced by the entire amount of appreciation, thus resulting in a deduction limited to basis. I.R.C. § 170(b)(1)(C)(iii), (e)(1).

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

61. *Id.*

62. *Id.* § 170(d)(1)(A), (b)(1)(C)(ii), (b)(1)(D)(ii).

63. Tax Reform Act of 1986, Publ. L. No. 99-514, § 701(a), *adding* I.R.C. § 57(a)(6).

64. *See generally* DU BOFF & CAPLAN, *supra* note 24, at N-37-40; for the flavor of the debate, *see* Helvering von Eisner, *Moynihan, Art, and the AMT*, 49 TAX NOTES 1579 (Dec. 31, 1990).

65. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13171(a), effective for contributions of tangible personal property made after June 30, 1992; *see also* HOPKINS, *supra* note 42, at 378-79.

66. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a)(1), amending Code § 170(e)(1) to reduce the charitable deduction by 50% of the appreciation in value if the related use rule is not satisfied; Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(b)(2), amending Code § 170(e)(1) to limit the amount of the deduction to basis if the related-use rule is not met by striking out the then current 40% figure. One of the goals of the Tax Reform Act of 1969 was to “substantially restructure the charitable contribution deduction.” Meade Whitaker, *Dealing With Outright Gifts to Charity in Kind*, 30 NYU ANN. INST. FED. TAX’N 46, n.2 (1972).

(subject to the general overall percentage limitation), of (i) capital gain property, that is also (ii) tangible personal property, (iii) donated to a public charity, that charity's actual use of that tangible personal property must be related "to the purpose or function constituting the basis for its exemption under § 501."<sup>67</sup>

Thus, a gift of a work of art to Loyola's D'Arcy Museum that the D'Arcy displays publicly and prominently and uses educationally satisfies the related use rule and could qualify for a full fair market value deduction.<sup>68</sup> On the other hand, a gift of the same work of art to Loyola School of Law for its annual public interest auction would not satisfy the related use rule and the deduction would be limited to basis.<sup>69</sup> A donor may treat a contribution of tangible personal property to a public charity as not being put to an unrelated use according to the regulations if:

(a) the donor establishes that the property is not in fact put to an unrelated use by the donee, or

(b) at the time of the contribution it is reasonable to anticipate that the property will not be put to an unrelated use by the donee. In the case of a contribution of tangible personal property to or for the use of a museum, if the object donated is of a general type normally retained by such museum or other museums for museum purposes, it will be reasonable for the donor to anticipate, unless he has actual knowledge to the contrary, that the object will not be put to an unrelated use by the donee, whether or not the object is later sold or exchanged by the donee.<sup>70</sup>

Written documentation of the use of such property can be critical to full deductibility. In fact, one should request written confirmation from the public charity not only about their "public" status, but also about their intended use for the

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67. I.R.C. § 170(e)(1)(B)(i). See generally HOPKINS, *supra* note 42, at 143-45; see also Laurence C. Zale & Philip T. Temple, *Donations of Art: They Are Not Just Appropriate for Museums*, 140 TR. & EST. 41, 43-44 (Apr. 2001).

68. The related use requirement apparently first appeared at the level of the Conference Committee. "The House-Senate Conference Committee . . . in arriving at a compromise . . . introduced out of the blue the concept of "related use." Robert Anthoine, *Deductions for Charitable Contributions of Appreciated Property—the Art World*, 35 TAX L. REV. 239, 243 (1980). There was no House or Senate version, no hearing, and no Treasury recommendation. See Whitaker, *supra* note 66, at 57. Rep. Wilbur D. Mills (then Chair of the House Ways and Means Committee) may have provided the only legislative intent for the provision, saying on the floor of the House:

What we are trying to say is that we will allow you to give this appreciated property and take today's market value as a charitable deduction without any tax consequences to you whatsoever if you give it to a charitable organization that normally would use the property for its exempt purposes. Now, a clear case is a gift of a picture or work of sculpture, or anything of that sort, to a museum. The question does arise with respect to a college or university as to whether or not they are using this for their exempt purpose, whether it is used in their teaching. Of course, the college could have a course in art, and if the gift were to be used for that purpose, it would probably qualify as such a gift.

115 Cong. Rec. H40869 (1969).

69. HOPKINS, *supra* note 42, at 145.

70. Treas. Reg. § 1.170A-4(b)(3)(ii) (as amended in 1994). The last sentence in subparagraph (b) was added in the final regulation apparently in response to museum concerns that the proposed regulation would unduly restrict a museum's ability to exchange or sell the donated works of art and immediately reinvest the proceeds in equivalent property. Anthoine, *supra* note 68, at 247.

item.<sup>71</sup>

#### 4. Qualified Appraisal by a Qualified Appraiser

The Tax Reform Act of 1984 amended § 170(a) to require that a charitable contribution is allowable “only if verified under regulations prescribed by the Secretary.”<sup>72</sup> Pursuant to this statutory authorization, final regulations were issued on May 4, 1988, with respect to charitable transfers made after December 31, 1982.<sup>73</sup> The rules apply to any charitable transfer of an item of property (other than money or publicly traded securities) the claimed value of which exceeds \$5,000.<sup>74</sup> The \$5,000 amount applies to a single item of property as well as to the aggregate of similar items of property donated during a calendar year, such as a collection or set of books, coins, or stamps.<sup>75</sup>

If the \$5,000 threshold is met, the substantiation requirements<sup>76</sup> are as follows:

- 1) a “qualified appraisal” by a “qualified appraiser” must be obtained for the item;<sup>77</sup>
- 2) a fully completed appraisal summary must be included with the tax return claiming the deduction<sup>78</sup> (Form 8283 satisfies this requirement<sup>79</sup>); and
- 3) specific records about the contribution must be maintained.<sup>80</sup>

These rules are of course subject to future modifications and there are, not surprisingly, unanswered questions and ambiguities in the rules. As a practical matter, the most critical decision made by the taxpayer may be the choice of the “qualified appraiser” who will actually prepare the qualified appraisal. If it is determined that the chosen appraiser is not a “qualified appraiser,” then the taxpayer has not provided a qualified appraisal within the required time frame, and

71. Some examples of related use: Priv. Ltr. Rul. 77-51-044 (Sept. 22, 1977) (lithographs to camp for handicapped children, with instruction in art appreciation: related use); Priv. Ltr. Rul. 80-09-027 (Nov. 29, 1979) (antique car to University without related course: unrelated use); Priv. Ltr. Rul. 81-43-029 (July 29, 1981) (porcelain art collection to public charity operating retirement center with purpose of creating living environment: related use); Priv. Ltr. Rul. 82-08-059 (Nov. 25, 1981) (stamp collection to college with course in engraving skills: related use); Priv. Ltr. Rul. 84-39-005 (June 20, 1984) (manuscripts to University: related use); Priv. Ltr. Rul. 94-52-026 (Dec. 30, 1994) (violin to CRAT: unrelated use); Priv. Ltr. Rul. 98-33-011 (Aug. 14, 1998) (paintings to JCC: related use). See also *Coleman v. Comm’r*, 56 T.C.M. (CCH) 710 (1988) (gift of horse to American Cancer Society: unrelated use); *Jennings v. Comm’r*, 56 T.C.M. (CCH) 595 (1988) (paintings to cancer center: unrelated use). See LERNER & BRESLER, *supra* note 41, at 1190-91.

72. Tax Reform Act of 1984, Pub. L. No. 98-369, § 155.

73. Treas. Reg. § 1.170A-13 (as amended in 1996).

74. Tax Reform Act of 1984, Pub. L. No. 98-369, § 155(a); Treas. Reg. § 1.170A-13(c)(1) (as amended in 1996).

75. STAFF OF JT. COMM. ON TAX’N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 (H.R. 4170, 98th Congress; Pub. L. No. 98-369), at 506 (1984).

76. Treas. Reg. § 1.170A-13(c)(2)(i) (as amended in 1996).

77. *Id.* § 1.170A-13(c)(3)(i)-(c)(5).

78. *Id.* § 1.170A-13(c)(4).

79. *Id.*; LERNER & BRESLER, *supra* note 41, at 1146.

80. Treas. Reg. § 1.170A-13(b)(2)(ii) (as amended in 1996).

no deduction is allowable.<sup>81</sup> There is no objective or regulatory independent certification process that makes an appraiser a “qualified appraiser.” It is primarily a subjective evaluation.<sup>82</sup>

### C. FRACTIONAL GIFTS

#### 1. Background

The prior discussion was premised on a transfer of the entirety of a donor’s right, title, and interest in and to the work of art to a charity. In fact, a tax lawyer’s instinct probably warns that transfers of less than everything are suspect. The Code confirms that suspicion with its split interest rules for charitable gifts. Section 170(f)(3)(A) provides:

In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer’s entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowable as a deduction under this section if such interest had been transferred in trust. For purposes of this subparagraph, a contribution by a taxpayer of the right to use property shall be treated as a contribution of less than the taxpayer’s entire interest in such property.<sup>83</sup>

One of the least known exceptions to this rule is for “a contribution of an undivided portion of the taxpayer’s entire interest in property.”<sup>84</sup> This exception to the split interest rule allows the donor to transfer an undivided, say 25%, fractional interest in a work of art to a charity and claim a charitable deduction for the value of that 25% interest (subject of course to the overall percentage limitation).<sup>85</sup> Essentially, from the legal ownership perspective, the donor and the charity become tenants in common.<sup>86</sup> From the tax perspective, how does ownership of a fractional

81. See, e.g., *Bond v. Comm’r*, 100 T.C. 32 (1993); see also *Todd v. Comm’r*, 118 T.C. No. 19 (Apr. 19, 2002); *Conrad Teitell, No Qualified Appraisal, No Deduction*, 134 TR. & EST. 84 (Mar. 1995).

82. According to the regulations, a “qualified appraiser” is an individual who holds himself or herself out to the public as an appraiser who is an expert as to the particular type of property being appraised; who understands that he or she may be subject to a civil penalty under § 6701 for a false or fraudulent statement; and who is independent of the donor. Treas. Reg. § 1.170A-13(c)(5)(i). See also Yvonne E. Lee, *Paying the Price Under the Internal Revenue Code: For How Much Should Fine Art Appraisers Be Liable?*, 16 COLUM.-VLA J.L. & ARTS 143, 145 (1991); Jessica L. Furey, *Painting a Dark Picture: The Need for Reform of IRS Practices and Procedures Relating to Fine Art Appraisals*, 9 CARDOZO ARTS & ENT. L.J. 177 (1990).

83. I.R.C. § 170 (f)(3)(A) (2003).

84. *Id.* § 170 (f)(3)(B)(ii). This exception was explicitly added by the Senate Finance Committee to the Tax Reform Act of 1969 “to insure that [the Act] will not result in the denial of a deduction where an outright gift is made of an undivided (e.g., one-fourth) interest in property.” S. REP. NO. 91-552, at 84 (1969).

85. See Whitaker, *supra* note 66, at 80 (“A contribution of an undivided interest in a painting, whereby the charitable donee is entitled to possession and enjoyment of the painting for part of a year is also within the exception . . .”).

86. JOHN E. CRIBBETT ET AL., *CASES AND MATERIALS ON THE LAW OF PROPERTY* 311-12 (8th ed.



interest in a unique work of art qualify for a current income tax deduction? The key, according to the Treasury Regulations, is the charity's "right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property."<sup>87</sup> Whether this right has in fact been transferred would seem to require at least three layers of analysis: a conveyancing test, a whole document approach, and an operational analysis.<sup>88</sup>

The conveyancing test requires that the actual deed of transfer conforms to the basic statutory requirements. Here that is a transfer of an "undivided portion of the taxpayer's entire interest." If the deed specifically reserves to the taxpayer the exclusive right to sell the entire work, then it fails the conveyancing test.

The second level of analysis is the whole document approach. If the basic transfer meets the conveyancing test, then one needs to read the entire rest of the document with a critical eye. Is there anything in the rest of the document that could be seen as undercutting the actual conveyance? For example, would a requirement of the charity's giving six months notice in order to exercise its right of possession, compromise its rights as a tenant in common?

Finally, if the written document is clean, one needs an operational analysis to consider how this transfer will actually work. In short, there can be nothing that will indirectly defeat the rights transferred. For example, in *Winokur v. Commissioner*,<sup>89</sup> the Tax Court held that it was the charity's legal right to have physical possession of the works of art, not the charity's actual physical possession, that is the controlling factor. Nevertheless, the Court made it clear that the charity's failure to demand actual physical possession was "voluntary" on its part and not caused by any act of the taxpayer.<sup>90</sup> Moreover, "the evidence does not indicate that any side agreement existed between petitioner and the Carnegie Institute to the effect that the Carnegie Institute would not take possession of the works of art for the portion of each year represented by its partial ownership interests therein."<sup>91</sup>

## 2. Uses of Fractional Dispositions to Charity

At this point, one may wonder what would compel a collector to give up fee simple absolute to become a tenant in common with a public charity? There are two primary scenarios (one qualitative, and the other quantitative) where fractional gifting is appropriate. In each case tax incentives certainly play an important role,

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2002).

87. Treas. Reg. § 1.170A-7(b)(1)(i) (as amended in 1994).

88. This three-layered analysis is one way to think about the concrete meaning of Code statutory requirements such as "directly or indirectly," or the actual application of an overall notion of "form and substance." It has proved a useful template for students in drafting exercises. I, however, specifically do not claim authorship for this approach; nor can I give an appropriate citation. Like air, its origins are obscured by time.

89. 90 T.C. 733 (1988).

90. *Id.* at 740.

91. *Id.* at n.4.

although it is worth noting that the collector is generally also predisposed to charitable giving.<sup>92</sup>

*a. Quality of Life Example*

Quite simply, a collector may not want to give up the lifetime possession of a work of art if she enjoys its presence in her home. Her will bequeaths the appreciated work of art purchased by her husband and her years ago to an art museum that is a public charity. By transferring an undivided 25% fractional interest to the museum now, she can receive a current income tax deduction for that 25% interest and she is entitled to retain possession for 9 months out of the year.<sup>93</sup> If the taxpayer normally spends time each year at another home, her actual loss of enjoyment may be minimal (assuming the museum in fact exercises its right to physical possession of the work of art).

*b. Percentage Limitation Example*

The collector decides to transfer an appreciated work of art that he purchased many years ago to an art museum that is a public charity. Its value is \$1,500,000; the collector's AGI is \$500,000. The maximum deduction is \$150,000 (30% of \$500,000) for the year of transfer and for each of the succeeding 5 years.<sup>94</sup> The total maximum deduction therefore is \$900,000. In order to receive the full tax deduction of \$1,500,000, the donor could transfer a 60% fractional interest in year one and then in year seven, transfer the remaining 40% (assuming values held constant). By using two fractional gifts, the full \$1,500,000 of charitable deduction is available over a 10 year span and none of it is lost due to the general percentage limitation.

While gifts of undivided fractional interests in property generally raise the (happy) possibility of discounts for transfer tax purposes,<sup>95</sup> apparently the IRS position is to accept as the income tax charitable deduction for a fractional interest in works of art the undivided percentage interest of the work's fair market value.<sup>96</sup> This pro-rata position may be historically based on an example provided in Revenue Ruling 57-293.<sup>97</sup>

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92. Many professionals involved with charitable giving recognize that major donors generally have a connection with, or affection for, a particular institution or cause, and that is, in general, the prompting motivation for a significant gift. Tax concerns, however, can dictate the structure of a particular donative transfer. See, e.g., Craig Wruck, Nat'l Com. Planned Giving White Paper: Estate Tax Repeal and Charitable Giving (2000).

93. See *supra* text accompanying note 85.

94. See *supra* text accompanying notes 58-59.

95. See, e.g., *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982); *but cf.* *Young Est. v. Comm'r*, 110 T.C. 297 (1998).

96. Note, *Contribution of Partial Interest to Charity*, 52 J. TAX'N 112 (1980); see also Priv. Ltr. Rul. 93-03-007 (Jan. 22, 1993).

97. Rev. Rul. 57-293, 1957-2 C.B. 153. (N.B. Part of this ruling is out of date due to changes in I.R.C. § 170(f).) This approach is, however, consistent with the long-held IRS view that "in the absence of evidence to the contrary, the fact that the interest involved is a fractional interest does not warrant any

More recently in Private Letter Ruling 9303007, the Service continued this proportionate valuation approach even though the donor in that case had a possibility of reverter if certain conditions concerning display and publicity were not followed.<sup>98</sup> The Service determined that those conditions had no effect on value since the possibility of reverter was so remote as to be negligible.<sup>99</sup>

### III. VALUATION

The valuation of unique works of art is difficult,<sup>100</sup> and whether for tax reasons or non-tax reasons, there is no doubt that it must depend on expert appraisals by expert appraisers.<sup>101</sup> The general valuation rule of fair market value applies,<sup>102</sup> but its application to works of art has at least two procedural twists.

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discount, *i.e.* the value of such interest is equivalent to the proportionate part of the value of the entire interest.” Michael F. Beausang, 830 BNA T.M., Valuation: General and Real Estate A-23 (Oct. 22, 2001).

98. Priv. Ltr. Rul. 93-03-007, *supra* note 96.

99. See also Priv. Ltr. Rul. 2002-02-032 (Oct. 26, 2001); *cf.* Estate of Scull v. Comm’r, 67 T.C.M. (CCH) 2953 (1994), where the Tax Court allowed a five percent (5%) discount for a 65% undivided interest in art that was bequeathed to an individual.

100. The truth of this obvious statement seems neatly captured by an oft repeated telling of an auction involving a Rembrandt etching. At a May 1973 auction in New York, two impressions of the same Rembrandt etching were sold, one for \$3,600.00 and the other for \$70,000.00, a price that is almost twenty times higher. The \$70,000.00 etching was an early impression and the less expensive one was a strike pulled after the plate was worn. Speiller *supra* note 30, at 228.

The difficulty of valuation is not a new issue. See Rev. Proc. 66-49, 1966-2 C.B. 1257, as an initial attempt by IRS to address the importance of appraisals in the valuation of works of art; Marie Garibaldi, *Some Final Problems for the Charitable Taxpayer: Gift Annuities; Pooled Income Funds; Split Interests; Valuation of Charitable Gifts*, 30 NYU ANN. INST. FED. TAX’N 117, 153 (1972) (“Another very difficult valuation problem is the determination of the fair market value of an object of art.”). Nor is it an issue that will likely disappear. A quick comparison of auction house pre-auction estimates with the actual sales prices at auction confirms this ongoing difficulty under arguably the best of circumstances. Christie’s recently placed a pre-auction estimate of \$9-13.5 million for Picasso’s “Nu au Collier” (Nude with a Necklace). It sold at auction for \$23.97 million on June 25, 2002. *Picasso Painting Sells for \$24 Million*, CHI. TRIB., June 26, 2002, at §1, 6. Aside from the overvaluation present in the early “tax shelters,” as discussed *supra*, at text accompanying notes 22-25, another unsavory aspect of the valuation difficulty is the predatory use of false valuations for the expert appraiser’s personal benefit. Philadelphia antiques dealer Russell Pritchard III recently pleaded guilty to charges of defrauding artifact owners by giving low appraisals on items, then reselling the artifacts at much higher prices, making between \$800,000.00 and \$1,500,000.00 on the fraudulent transactions. *Antiques Dealer Fined for Fake Appraisals*, CHI. TRIB., July 12, 2002, at §1, 13.

Even in the hypothetical world of a US wealth tax, the difficulty of valuing “the proverbial Rembrandt in the vault” is noted, although the authors’ overall impression is that only a medium degree of difficulty in valuation would occur. David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 TAX L. REV. 607, 612 (2000). This assessment did not go unchallenged. James R. Repetti, *It’s All About Valuation*, 53 TAX L. REV. 607, 612 (2000).

101. For a charitable deduction for income tax purposes of a work of art exceeding \$5,000.00 in value, of course, a qualified appraisal by a qualified appraiser is one requirement. See *supra* text accompanying notes 72-82.

102. Treas. Reg. § 20.2031-6, 25.2512-1, 1.170A-1(c)(2) (as amended in 1996).

### A. ART ADVISORY PANEL

Ever since 1968, there has been an Art Advisory Panel of the Commissioner.<sup>103</sup> The Panel is appointed by the Commissioner and is now composed of 25 persons, drawn from art dealers, museum curators, and auction house experts.<sup>104</sup> It meets generally twice a year in closed door sessions to review the appraisals submitted by taxpayers with their income, estate, or gift tax returns.<sup>105</sup> The panel is not told whether the appraisal is for income or transfer tax purposes.<sup>106</sup> All taxpayer cases selected for audit which include works of art with a claimed value of \$20,000 or more must be sent to the National Office Art Appraisal Service for review by the Commissioner's Art Advisory Panel.<sup>107</sup>

In 2000, the Panel reviewed a staggering total of 2,546 items with a taxpayer claimed value of \$266,541,577 on 79 taxpayer returns.<sup>108</sup> For charitable contributions for income tax purposes, deductions claimed by taxpayers totaled \$1,734,288.<sup>109</sup> The Panel's aggregate recommendation was \$477,250, or approximately a 75% reduction in the overvalued items for charitable contributions.<sup>110</sup> For estate and gift tax returns (referencing 2533 items), the taxpayers claimed value was \$264,807,289.<sup>111</sup> The Panel's recommendation was \$337,454,635, or a 47% increase on the undervalued items for transfer tax purposes.<sup>112</sup>

Interestingly for 2001, the Panel reviewed a significantly lower<sup>113</sup> number of items (687) with an equally lower taxpayer claimed value of \$114,951,036 in 89 taxpayer returns. Equally interesting, however, was the dramatic increase in the percent of taxpayer valuations that were accepted by the Panel. For the income tax

103. I.R.S. News Release, IR-68 (Feb. 1, 1968); see also Maurice F. O'Connell, *Defending Art Valuations for Tax Purposes*, 115 TR. & EST. 604 (1976) (briefly outlining the beginning and early operations of the Art Advisory Panel). The creation of the Art Advisory Panel may have been an art world attempt at self-policing or perhaps even self-preservation in light of abusive valuations. "Pressures evolving in the art world caused the American Association of Art Museum Directors to suggest creation of an art advisory panel. The art museum directors were concerned with the rise in grossly inflated appraisals of art works that were donated to charitable institutions during the early 1960's. These inflated appraisals reached such epidemic proportions that Congress considered removing art donations from the tax exemption list." McCarthy, *supra* note 47, at 15.

104. 1 INTERNAL REVENUE MANUAL—AUDIT (CCH) 42(16) 4.1. See also Furey, *supra* note 82, at 182.

105. Art Advisory Panel of the Commissioner of Internal Revenue, ANNUAL SUMMARY REPORT FOR 2001 (Closed Meeting Activity).

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.* Of the 13 items reviewed, 2 valuations were accepted as filed, and 11 were adjusted downward.

111. *Id.*

112. *Id.* Of the 2,518 items reviewed, 1,551 (61%) were accepted as filed, and 967 (38%) were adjusted. Of those 967 items, 919 (36%) were adjusted upward and 48 (2%) were adjusted downward.

113. From the nature of the raw data, it is purely speculative as to why there was such a drop. A recent Wall Street Journal article suggested that museums are getting choosier about accepting works of art. Brooks Barnes, *Take My Art—Please*, WALL ST. J., Apr. 5, 2002, at W14.

charitable contributions, the Panel accepted 63% of the taxpayer valuations in 2001 compared to 14% in 2000.<sup>114</sup>

### B. ADVANCE VALUATION RULING PROCEDURE

As part of the Revenue Reconciliation Act of 1993, the House and Senate Conference Committee expressed its intent that the Secretary of the Treasury will report to Congress on the development of a procedure for a taxpayer to obtain an advance ruling on the value of tangible personal property for income tax purposes before the charitable contribution.<sup>115</sup> An advance procedure has not yet truly been developed.

The Service, however, did issue Revenue Procedure 96-15.<sup>116</sup> A taxpayer can now request a Statement of Value for income tax purposes a work of art (1) after the transfer to a charitable organization, but prior to the filing of the income tax return reporting the transfer, (2) with the submission of a qualified appraisal and payment of the user fee (\$2,500 for one, two or three items plus \$250 for each additional item), and (3) for an item of art that has been appraised at \$50,000 or more.<sup>117</sup> Revenue Procedure 96-15 also applies to transfers for estate and gift tax purposes, including transfers to individuals as well as charities.<sup>118</sup>

## IV. CONCLUSION

This brief synopsis of the income tax treatment for dispositions of works of art demonstrates that art is, in fact, accorded special treatment in the Code. This special treatment, however, is not easily categorized as positive or negative. Sales of works of art can qualify to use the preferred capital gains rate structure in computing the tax, and not the higher, ordinary income rates. Yet, sales of other kinds of property can qualify for capital gains rates even lower than that mandated for works of art as “collectibles gain.”

Similarly, a charitable donation of a work of art can, in fact, qualify for a full fair-market value charitable deduction for income tax purposes. Yet the requirements for the property, the donee, the use, and the procedural requirements of a qualified appraisal by a qualified appraiser are significantly beyond what many other charitable donations require.

The current Code represents a pragmatic balance and is reminiscent of Justice Holmes’s “bad man” of the law.<sup>119</sup> Society’s decision to promote and preserve the

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114. Art Advisory Panel of the Commissioner of Internal Revenue, ANNUAL SUMMARY REPORT FOR 2000 (Closed Meeting Activity).

115. H.R. REP. NO. 103-213, at 561 (1993).

116. Rev. Proc. 96-15, 1996-1 C.B. 627.

117. *Id.*

118. As of year end, there have only been a dozen or so requests made by taxpayers pursuant to Rev. Proc. 96-15. HOPKINS, *supra* note 42, at 372: “Why would someone engage in this process? . . . Only the most cautious will utilize this process . . .”

119. Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897) (“If you want to know the law and nothing else, you must look at it as a bad man . . .”).

soaring good of cultural property is advanced by the Code but not naïvely. Current and future promotion and protection of cultural property is and must be tempered with a realistic assessment of the fiscal temptations that some would illicitly exploit. And for that, even the Code has a role to play.

