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ARTISTS, ART COLLECTORS AND INCOME TAX†

ALAN L. FELD*

The federal income tax law treats artists and art collectors differently. Similar transactions concerning artworks produce disparate income tax results, depending on whether they involve the artist or the collector. On balance, these results seem to favor the collector over the artist. But notwithstanding the dismay of some artists and their advocates, the differences in result flow, in the main, from the differences in the source of the taxpayer's investment in the work.

The collector buys the work with after-tax income. Any gain is properly treated as an investment return and is eligible for capital gain benefits.[1] The collector, however, does not escape questions of tax characterization entirely. Often his motive in acquiring the work reflects the happy congruence of personal gratification and investment opportunity. If the former dominates, the transaction loses its profit-seeking character and, with it, the deductibility of losses and certain expenses.[2]

In contrast, the artist acquires his work only partly with tangible investment, such as canvas and paint or clay; he adds his personal efforts which often are the chief source of the work's value. The artist pays no tax on this value he creates with his services until he realizes income in some way, as by the sale of the work. The return to the artist is partly personal services income and partly payment for holding the work after completion, a kind of investment return we shall examine further.[3] In addition, the artist's deduction of certain expenses and losses may depend on his state of mind; like the collector, he may find it necessary to distinguish his profit-seeking activities from his pleasurable ones.[4]

This Article traces these income tax distinctions through a number of common transactions, including sale of property at a gain, sale of property at a loss, expenses incurred to produce or preserve the property, exchanges, and gifts to charity. In each case, the treatment of collectors and artists is contrasted and the appropriateness of any differences is considered. This Article limits the analysis to artworks embodied in the form of unique tangible personal property, primarily painting and sculpture; although some of the discussion bears on authors, book collectors, and others, this Article does not deal with the tax problems of their transactions.

As we will see, most of the differences in treatment derive from the

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[1] *See* notes 10-22 and accompanying text *infra*.

[2] *See* notes 72-86 and accompanying text *infra*.

[3] *See* notes 23-34 and accompanying text *infra*.

[4] *See* notes 87-104 and accompanying text *infra*.

well-established tax differentiation between services income and gains on the sale of property. A few instances, however, go beyond this justification. In Part V, I will propose two changes, one that enhances the tax position of artists and one that limits the benefits currently available to collectors.

I. SALE OF ARTWORKS FOR GAIN

A person's taxable income generally includes gain realized on the sale of property; *i.e.*, any money and property the taxpayer receives, less his investment in the property, enters into the computation of gross income.[5] Under certain conditions, however, the taxpayer may claim a capital gains deduction in the amount of sixty percent of the gain.[6] Availability of the capital gains deduction turns on whether the property sold was a capital asset as that term has been defined and limited by the Code[7] and the courts.[8]

The following section considers artworks as capital assets in the hands of creators of art, collectors of art, and related parties. The taxpayer generally seeks the favorable tax treatment that follows from capital asset characterization.[9] Under existing law, however, collectors often succeed in this quest, while artists rarely do. This section examines the rationale underlying this differing treatment, analyzes possible methods to improve the artist's position in characterizing his artworks as capital assets, and discusses further consequences for artists posed by ordinary income characterization.

A. *The Collector*

A work of art in the hands of a collector will usually meet the capital asset definition without difficulty. The Code defines a capital asset as "property held by the taxpayer"—words carrying few limitations[10]—and then simply excludes six classes of property, notably inventory-type property and certain arts property, from capital asset status.[11] Within broad limits, the definition distinguishes gain realized on the sale of property held for investment from gain realized as personal services income or from the normal operation of a trade or business. Collectors who sell works of art ordinarily do not realize gain attributable to personal services; nor in the usual case do they engage in buying and selling on so

[5] I.R.C. § 1001. All references herein to the Internal Revenue Code (Code) refer to the Internal Revenue Code of 1954 unless otherwise specified.

[6] I.R.C. § 1202. In limited cases, the alternative minimum tax, § 55, may offset part of this benefit.

[7] *See* I.R.C. § 1221.

[8] *See, e.g.*, Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955).

[9] The taxpayer generally prefers capital asset treatment when there is gain, but prefers noncapital asset treatment for losses in order to avoid the limitations on deductibility provided by § 1211.

[10] *See* I.R.C. § 1221; Miller v. Commissioner, 299 F.2d 706 (2d Cir.), *cert. denied*, 370 U.S. 923 (1962).

[11] I.R.C. §§ 1221(1)-(6).

recurrent a basis as to warrant trade or business treatment. Their artworks, therefore, are treated as investments and are properly accorded capital asset status on sale or other disposition.

Conceivably, a collector who energetically trades his collection, frequently buying and selling, could find his property characterized for tax purposes as held "primarily for sale to customers in the ordinary course of his trade or business."[12] In one case, *Hollis v. United States,*[13] the taxpayer formed a joint venture to purchase Japanese *objets d'art* after World War II. The venture was his first effort in such investment; it began selling objects almost immediately after the taxpayer's return from Japan, but without advertising or extensive sales effort. The court held that the venture earned ordinary, not capital, income from its first sale.[14] The taxpayer's case for escaping the "primarily for sale" exception assuredly was not helped by his formation of a second joint venture shortly thereafter to deal in Japanese art on a regular basis.

No other cases or rulings appear to have dealt directly with this question; the point at which a collector's activities transform him into a dealer remains uncertain.[15] Presumably, criteria similar to those applied to determine when real estate transactions rise to the dignity of a trade or business[16] might apply equally as well to artworks.[17] Cases involving taxpayers who buy and sell real estate bear significant resemblance to art sale situations.[18] The much-vexed questions of what quantum of activity is necessary to constitute a trade or business, at what point purchasers

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[12] I.R.C. § 1221(1).

[13] 121 F. Supp. 191 (N.D. Ohio 1954). The case concerned the predecessor to § 1221(1), § 117(a)(1)(A) of the 1939 Code, the language of which was identical. *See also* Estate of Chandor v. Commissioner, 28 T.C. 721 (1957), *acq.* 1957-2 C.B. 4.

[14] 121 F. Supp. at 196.

[15] *But cf.* Rev. Rul. 79-256, 1979-2 C.B. 105 (the Service reduced the amount of a charitable contribution deduction for fine art prints under § 170(e)(1)(A) because the contributed property fell under § 1221(1), notwithstanding that the taxpayer/collector had not sold any prints).

[16] For simple sales of artworks, real estate cases that involve subdivision of property would be inappropriate as analogies, *see* Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir.), *cert. denied,* 429 U.S. 819 (1976); United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969), because collectors ordinarily do not break up original works of art into smaller pieces. Lithographs and other fine art reproductions might be closer in concept to subdivision of real estate. *See* Rev. Rul. 79-256, 1979-35 I.R.B. 5. Also closer to a subdivider of real estate is the purchaser of a collection of artworks who then sells off the unwanted works and keeps the balance.

[17] Anthoine, *Deductions for Charitable Contributions of Appreciated Property—The Art World,* 35 TAX L. REV. 239 (1980), opts instead, without much discussion, for application of the rules for stock and securities. *Id.* at 270-73. This seems inappropriate, however, for artworks are less fungible in nature. The special history of the stock and securities area, including the reluctance of Congress in the depression years to allow ordinary losses, limits its usefulness as an analogy. *See* Burnett v. Commissioner, 40 B.T.A. 605 (1939), *nonacq.* 1940-1 C.B. 6, *aff'd in part and rev'd in part,* 118 F.2d 659 (5th Cir. 1941).

[18] *See* Turner v. Commissioner, 540 F.2d 1249 (4th Cir. 1976); South Texas Properties Co. v. Commissioner, 16 T.C. 1003 (1951), *acq.* 1951-2 C.B. 4; Hamilton v. Commissioner, 33 T.C.M. (CCH) 463 (1974); Levin, *Capital Gains or Income Tax on Real Estate Sales,* 37 B.U.L. REV. 165 (1957).

become "customers," and what property is held "primarily" for sale would have to be analyzed in this fresh factual context.[19]

In the typical case, nobody questions capital asset treatment. To obtain the sixty percent capital gains deduction, the collector also must hold the work for at least one year.[20] If he obtained the artwork by gift, the collector may benefit from the donor's holding period.[21] Similarly, the heir or beneficiary who takes a work on the death of another enjoys long-term treatment no matter how short a time the two in fact held the work.[22] Unless there is some special impediment to capital asset treatment, the collector usually can look forward to favorable tax treatment.

B. *The Artist*

1. Capital Gain or Ordinary Income

In 1950, Congress enacted section 1221(3) of the Code to exclude from capital asset treatment artworks held by the artist who created them.[23] The Committee reports indicated discontent with the then-current tax treatment of the amateur writer or artist as compared with that of the professional.[24] The latter, it said, receives ordinary income on the sale of a work because he holds it primarily for sale to customers in the ordinary course of his trade or business. The amateur, however, could avail himself of the "loophole"[25] allowing capital gain on the "product of his personal effort."[26] To close this loophole, Congress provided a statutory exception to capital asset treatment for an artist's own work, whether professional or amateur.[27]

Section 1221(3)(C) extends the no-capital-asset characterization of an artist's work to others if they determine basis in the work in whole or in part by reference to the artist's basis. In effect, the section generally preserves ordinary income treatment until someone transfers the work and the artist's basis is no longer relevant to the measurement of gain.

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[19] As to amount of activity, *compare* Kelly v. Commissioner, 281 F.2d 527 (9th Cir. 1960) *with* Goldberg v. Commissioner, 223 F.2d 709 (5th Cir. 1955); as to customers, see Goldsmith v. Commissioner, 143 F.2d 466, 467 (2d Cir. 1944) (L. Hand, J., concurring); as to "primarily for sale," see Malat v. Riddell, 383 U.S. 569 (1966) (per curiam).

[20] I.R.C. § 1222(3).

[21] I.R.C. § 1223(2).

[22] I.R.C. § 1223(11).

[23] Revenue Act of 1950, Pub. L. No. 81-814, § 210(a), 64 Stat. 906 (codified at I.R.C. § 1221(3)).

[24] H.R. REP. No. 2319, 81st Cong., 2d Sess. 54, *reprinted in* 1950-2 C.B. 380, 420-21; S. REP. No. 2375, 81st Cong., 2d Sess. 43, *reprinted in* [1950] U.S. CODE CONG. & AD. NEWS 3053, 3097.

[25] *Id.*

[26] *Id.*

[27] The most notorious "amateur" case apparently was Dwight Eisenhower's sale of the rights to his book *Crusade in Europe* at capital gains rates. *See Eisenhower to Pay Tax as an "Amateur Writer,"* N.Y. Times, June 2, 1948, at 31, col. 5. Another noted amateur was Kathleen Winsor, author of *Forever Amber. See* Herwig v. United States, 105 F. Supp. 384 (Ct. Cl. 1952). The effect of the 1950 change is discussed in Shine, *Some Tax Problems of Authors and Artists,* 13 TAX L. REV. 439 (1958).

This provision prevents artists from avoiding ordinary income treatment by giving their work to family members or other related taxpayers.[28] Property passing from the artist on his death now escapes section 1221(3) treatment; the basis of the inherited property to the recipient becomes the work's fair market value,[29] as if the property had been sold, breaking the bar to capital asset treatment. Section 1221(3) thus seeks to ensure ordinary asset treatment for transfers within the artist's lifetime.

This rule makes it unnecessary in the usual case to determine the nature of an artist's income from the sale of his work. But for purposes other than sale and in assessing whether section 1221(3) is overinclusive, it is useful to analyze the elements of the artist's financial return. At least three characterizations are possible. The work might be treated as the embodiment of the artist's untaxed services, and gain realized on the sale of the work would represent the equivalent of compensation for services. Alternatively, the income might be viewed as gain from the sale of property having an inventory-like character, property the artist holds for sale to customers as part of his business. In either of these cases, the gain should be treated as ordinary income. But a third possibility exists: if the work is not inventory, the artist can be characterized as holding it for investment and any gain on the sale of the work should be taxed like other investment gains—as capital gain and not ordinary income.

It may seem unusual to describe an artist as an investor in his own works. Like anyone else, however, an artist may be an investor. When he buys stocks and bonds, land, or the works of other artists, he treats them as capital assets. No logical bar exists to his investing in the same way in his own work.[30] A real estate dealer may hold some real estate for sale and some for investment[31] and a dealer in securities may hold some stock or securities in the ordinary course of his trade or business and some for investment.[32] The practical problem is to determine when this is so and how to account for it.

The broad ordinary asset rule contained in section 1221(3) always denies the artist investment income treatment. This result can be supported both logically and on grounds of administrative convenience. In-

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[28] This follows from § 1015, which determines the basis of appreciated property acquired by gift by reference to the donor's basis. Thus, the donee's basis will be determined by reference to the artist's basis and capital asset treatment is precluded by operation of § 1221(3)(C).

[29] I.R.C. § 1014(a). If the estate elects alternate valuation pursuant to § 2032, the same result follows. Under carry-over basis, now repealed, ordinary income characterization would have descended to the next generation as a probably unintended consequence. I.R.C. § 1023 (repealed in pertinent part by the Crude Oil Windfall Profit Tax of 1980, Pub. L. No. 96-223, § 401, 94 Stat. 299).

[30] At least one case seems to confirm the artist's status as an investor in his own works. *See* Estate of Chandor v. Commissioner, 28 T.C. 721 (1957), *acq.* 1957-2 C.B. 4. The court acknowledged that § 1221(3) usually prevents this kind of inquiry but was able to decide the case, because of its specific facts, on the basis of the pre-§ 1221(3) statute.

[31] *See* notes 16 & 18 *supra.*

[32] *See* I.R.C. § 1236.

come that the artist receives from the sale of his work immediately after completion derives from the artist's services and the ordinary income characterization resulting from section 1221(3) properly follows. In the case of a sale some time after completion of the work, the artist's gain derives both from services and from appreciation in the value of the property during the "investment" period. Ordinary income treatment for this latter component can be differentiated from a capital gain on investment of after-tax income. The income can be regarded as inventory-type gain, which is specifically excluded from capital asset treatment;[33] or it can be seen as return on an "investment" of untaxed services that have not been augmented with significant after-tax expenditures. Moreover, ordinary income treatment can be defended on the grounds that it would be too difficult to separate the portion of the sale price that was payment for the original services performed in creating the artwork from the portion that was a return on "investment."

Nonetheless, from the artist's perspective, the general correctness of ordinary income treatment creates an unfair result when the artist sells his work after he in fact assumes the position of an investor in it. To take an extreme example, suppose the artist paints two similar abstracts, *Alpha* and *Beta,* his only works. He sells *Alpha* to a collector for $1,000 and includes the proceeds in income. He keeps *Beta* with an eye towards receiving a greater return through appreciation over time. Two years later, the collector and the artist each sell for $50,000. The collector will enjoy a $49,000 capital gain. The artist will include $50,000 as ordinary income pursuant to section 1221(3), notwithstanding that $49,000 of the proceeds represents a return that differs from that enjoyed by the collector on the sale of *Alpha* only in that the artist failed to include $1,000 of services income on *Beta* two years earlier.

To place himself on an equal footing with other investors, the artist could attempt to "cap" the ordinary services income element of value in the work by paying his tax currently and converting himself into an investor; any subsequent gain would be realized as capital gain. The statute, however, contains no explicit mechanism through which he might do this.[34]

The artist apparently could use self-help to "cap" his ordinary income under section 1221(3). If he transfers his work by sale to a family member, for instance, the transfer would fall outside the ambit of section 1221(3)(C). Suppose the artist sells a work to his wife at its fair market value. If the exchange is treated for tax purposes as a sale, her basis would be her cost,[35] and would not be determined "in whole or part" by reference to the artist's basis. Section 1221(3)(C) by its terms would not

[33] *See* note 11 and accompanying text *supra.*

[34] As an analogy, consider the similar position of the employee who receives, as compensation, property subject to a restriction. Section 83(b) now allows him to limit ordinary income by electing current taxation.

[35] I.R.C. § 1012.

apply and, unless the wife's activities amounted to a trade or business, the work would constitute a capital asset in her hands. Thus, if she sold the work after a year, the sale should give rise to long-term capital gain or loss.

The price of these future capital gain possibilities is that ordinary gain is accelerated into income in the year of the interspousal sale. Worse yet, if the spouse never sells the work, the artist will have paid tax on gain that the family never realizes. Nevertheless, an artist may deem this an appropriate gamble in order to obtain capital asset treatment on subsequent appreciation.[36] The gamble may be especially worthwhile if his income is low in the year of interspousal sale and the tax generated is modest.

The Service might challenge the interspousal sale as not bona fide, arguing that the wife acted merely as an agent for the artist in this transaction.[37] The government, however, will have difficulty maintaining this argument because the Code treats husband and wife as separate taxable entities except in specific instances where it explicitly denies such treatment.[38] The Service may also question whether her ownership can be characterized as transitory or illusory and therefore disregarded—as would presumably be the case if the wife sells the work to a third party shortly after the interspousal sale, pursuant to an understanding. That husband and wife file a joint return that reports their income together does not by itself prevent their treatment as separate taxable entities.[39]

To state the best case for the taxpayers, suppose their sale in other respects resembles an arms length transaction between unrelated parties. Both husband and wife own assets independently. The sale is at a fair price.[40] The wife pays for the work from her own separate funds. Moreover, the artist places no restrictions on the future use of the work and retains no proprietary interests. At this point, there is a substantial nontax

[36] Capital asset treatment may be important in determining not only the character of gain on sale, but also the amount of any deduction if the work is donated to charity. *See* text accompanying notes 154-59 *infra*.

[37] Section 267(a)(1) disallows certain deductions of losses from transactions between related persons, including husband and wife. Section 267, however, by its terms does not apply to gain transactions.

[38] For attribution purposes, the Code often treats stock owned by a taxpayer as constructively owned by the taxpayer's spouse. *See* I.R.C. §§ 318(a)(1)(A), 544(a)(2), and 554(a)(2). These results obtain, however, only where provided by express statutory rule. *See, e.g.*, I.R.C. § 318(a)(1)(A) which applies only where "expressly made applicable."

[39] I.R.C. § 6013. Prior to 1948, the income tax generally treated single earner couples who lived in community property states more favorably because the earned income of one spouse could be divided and reported on separate returns. *See* Poe v. Seaborn, 282 U.S. 101 (1930). The joint return provisions enacted in 1948 in effect allow husband and wife in common law states as well to split income. But joint return filing does not alter the independence of husband and wife as taxpayers when that independence is not otherwise modified by law.

[40] The Service could not defeat the artist's plan by showing that the interspousal transfer involved a small amount of gift in the hope of invoking the basis transfer rule of § 1221(3)(C). If the wife paid more than the husband's basis in the work, a part sale, part gift, transfer would result and produce a basis of cost. Treas. Reg. § 1.1015-4(a), T.D. 7207, 1978-2 C.B. 106. Thus, basis still would not be determined in whole or part by reference to the artist's basis.

change in their respective financial positions in that she exchanges her cash or property for his artwork. If the transaction meets these conditions, it accords with the rationale for the section 1221(3) rule and the desired tax consequences should follow. The artist will pay tax on gain derived from services and his wife will have capital gain (or loss) on an investment of her after-tax dollars. On this analysis, sale at a fair price is the critical element in preventing that element of gain in the work which reflects the value of previously untaxed services from being taxed as capital gain instead of ordinary income.

Although no case or ruling has dealt with the effect of this kind of sale under section 1221(3), the principle upholding separate taxpayer treatment of spouses has recently been elaborated by two cases concerning installment sales. Legislation now pending[41] would alter the specific results of these cases for installment sale purposes but would not fundamentally change the separate tax entity rule. In *Nye v. United States,*[42] Dr. Mary Jane Nye owned appreciated stock. Her husband, Charles, a lawyer, needed ready cash to meet certain obligations. Both maintained substantial independent property. Mary Jane sold the stock to Charles at its fair market value for cash and deferred payments. Shortly thereafter he sold most of the stock in the market and used the proceeds to pay his outside obligations. Mary Jane reported gain on the installment basis. Charles reported a short term capital loss on the sale. The Nyes filed a joint return. The net effect from the family's perspective was to realize cash on the disposition of the stock, defer the gain on the appreciation under the installment arrangement, and report a loss in the year of sale. If Mary Jane and Charles were unrelated, each step would unquestionably have been proper.

Even given their marital status, however, the District Court upheld the transaction in all respects; it refused to treat Charles as Mary Jane's agent. The court could not conclude that Mary Jane, rather than Charles, had control of the proceeds or possessed the economic benefits of the sale by Charles. "The simple fact of their marriage relationship, standing alone . . . [was] insufficient to deprive Mary Jane Nye of the benefits of section 453(b)."[43]

The Tax Court distinguished *Nye* in *Wrenn v. Commissioner.*[44] Again, both spouses had substantial separate net worth. He sold appreciated

[41] H.R. 6883, 96th Cong., 2d Sess., 96 CONG. REC. 5073 (1980). The bill, the Installment Sales Revision Act of 1980, was referred to the Senate Finance Committee on June 20, 1980.

[42] 407 F. Supp. 1345 (M.D.N.C. 1975).

[43] *Id.* at 1350. The court quoted with approval from Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971), in which the Fifth Circuit held that installment sale treatment was appropriate for taxpayers who made installment sales of stock in their wholly-owned corporation to a trust for their children. The sales occurred after the corporation had adopted a § 337 liquidation plan but before distribution of assets took place. Nevertheless, the court decided that the taxpayers were entitled to the benefits of the installment sales provision. *Cf.* Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1973) (gain taxed on a § 337 liquidation to donor of stock to charity because donor retained control over the liquidation).

[44] 67 T.C. 576 (1976).

securities to her on a deferred payment basis. She agreed to sell them and secure the obligations to him by investing the proceeds in an equivalent amount of stock in a designated mutual fund. She redeemed enough of the mutual fund stock each month to make the payments to him. The effect of these transactions was to realize gain from the securities while at the same time deferring the payment of tax on that gain. The court disregarded the sale. It saw no independent purpose on her part for making the purchase in view of her sale of the stock immediately thereafter and the prior agreement that tied up the proceeds. Her financial position had not materially changed; the Tax Court held that in the absence of a credible nontax motive, the sale between husband and wife lacked substance.

Many an artist can arrange a sale to his wife that meets the *Nye* and *Wrenn* criteria. If we view husband and wife as separate financial entities, she will have exchanged a fixed sum for an investment position in the artwork, a significant change in her financial position. Moreover, purchases of artworks often involve subjective motives; she may be able to show that she wanted this particular work for personal or aesthetic reasons and thus provide a further nontax motive for the transaction. As long as the work is not sold immediately after the purchase, all of these will constitute nontax motives sufficient to meet the *Wrenn* court's stated objections.

Assuming that an interspousal sale would successfully avoid section 1221(3)(C), limitations inhere in such an approach. For example, a multiplicity of such sales might not pass judicial scrutiny. Or a large number of sales might evidence a brokerage or agency relationship instead of purchase and sale. In addition, the spouse might independently fall under section 1221(1) if she frequently resells the purchased artworks.[45]

Thus, the interspousal sale to "cap" the ordinary income element in an artist's work cannot be used too frequently by any given artist. Further, it depends upon the fortuity of a spouse, family member, or other related entity with independent means. Moreover, although the favorable tax effects follow analytically, they have not been squarely sanctioned by precedent. Finally, it has the shabby air of a gimmick. If the artist's cap on ordinary income is appropriate, as I think it is, the Code should provide for it more forthrightly. I discuss such a proposal in Part V below.[46]

2. Earned Income or Unearned Income

(a) *In General*

The artist occasionally finds that he can obtain a more advantageous tax result if his sales do not produce capital gain, but rather are treated as ordinary earned income derived from personal services. For qualified

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[45] *See* Rev. Rul. 79-256, 1979-2 C.B. 105.

[46] *See* text accompanying notes 160-68 *infra*.

pension plan purposes,[47] including individual retirement accounts,[48] gain on the sale or other disposition of property by the artist whose personal efforts created that property count toward retirement benefits as long as the gain is not taxed as capital gain.[49] Section 1348, which provides, in general, a maximum tax rate of fifty percent for personal services income, incorporates the qualified plan definition of earned income,[50] so that the artist's ordinary income will benefit from this fifty percent limitation.

(b) *Foreign Transactions*

Section 911 of the Code provides an exclusion from United States taxable income for income earned abroad. Until recently, the Service took the position that income to artists from their work in foreign countries did not come within this provision because it was income derived from the sale of property rather than compensation for personal services.

The question of the correct characterization of foreign income to artists was squarely addressed in *Tobey v. Commissioner.*[51] The taxpayer-artist maintained a domicile in Seattle, Washington, but resided in Switzerland, where he did his painting and work in other media. For the years at issue—1965 and 1966—section 911 excluded from the gross income of a U.S. citizen, resident abroad for an entire taxable year, up to $25,000 of "earned income" from sources outside the United States. Section 911(b) defined earned income to mean wages, salaries, professional fees, or other "compensation for personal services actually rendered"; where capital was a material income-producing factor, the statute required allocation between services and return to capital. Tobey excluded $25,000 of gross income on the sale of work created in Europe. The parties stipulated that capital was not a material income-producing factor. The issue in the case thus narrowed to whether an artist's gain from the sale of his work constituted personal services income or gain from the sale of property.

The government argued that the form of realization—a sale of property—determined its character. This position reflected earlier published rulings. In GCM 236,[52] a 1927 ruling, the government had drawn a distinction regarding the character of different amounts of income received by a writer. When he agreed to write articles for a stipulated amount of cash, the proceeds received constituted earned income. However, when he transferred property rights in a literary work for a royalty interest, the proceeds constituted gain from the sale of property.[53] In 1971, the Service restated this position[54] and extended the reasoning to

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[47] *See* I.R.C. § 401.
[48] I.R.C. § 408.
[49] I.R.C. § 401(c)(2)(C).
[50] I.R.C. § 1348(b)(1)(A).
[51] 60 T.C. 227 (1973), *acq.* 1979-1 C.B. 1. *See also* Rev. Rul. 79-85, 1979-1 C.B. 246.
[52] VI-2 C.B. 27, *superseded by* Rev. Rul. 71-315, 1971-2 C.B. 271.
[53] *Id.* at 27.
[54] Rev. Rul. 71-315, 1971-2 C.B. 271.

an assignment of copyright to a musical work by a composer and to a sale of artworks by an artist.[55] The Service maintained consistently with these rulings that Tobey's income constituted gain from the sale of property.

The Tax Court, however, rejected this formal distinction between a sale of services and a sale of the property rights in which the services are embodied. It concluded that the relevant concern in section 911 is to distinguish personal services income from income derived from capital.[56] For this purpose, it said, the artist should be viewed as a taxpayer who deals in services rather than as an entrepreneur who makes a product. The court drew support from the qualified plan provision of the Code that treats gains of an artist from the sale of his work as earned income; this legislation had overturned the prior administrative position of the Service.[57] Tobey's income therefore qualified for the section 911 exclusion. After an almost six-year pause, the Service acquiesced in *Tobey* and revoked the earlier inconsistent rulings concerning musical copyright and art works.[58]

The *Tobey* reasoning has been applied with equal force to the source rules under sections 861-863. The source rules determine when income is derived from sources within the United States and have numerous applications with regard to the taxation of international transactions. Under these rules, the source of gain from the sale of personal property is the place where right, title, and interest in the property passes,[59] whereas the source of services income generally is the place where the services are performed.[60] In *Cook v. United States,*[61] the Court of Claims applied *Tobey*'s characterization of the artist's gain as services income and held the source of a sculptor's income was determined by the place where he performed services. *Cook* declined to decide whether capital was a material income-producing factor—the question *Tobey* left open. If it were, an allocation between services and return to capital would be required for section 911 purposes. For a sculptor, the costs of raw materials and processing can be substantial; at some point capital becomes "material." Moreover, the reasoning of *Cook* could extend to fine crafts work, where the capital component may be even greater. This question undoubtedly will arise again.[62]

[55] Rev. Rul. 71-182, 1971-1 C.B. 214 (composer); Rev. Rul. 71-183, 1971-1 C.B. 215 (painter or drawer). The Service relied on Oppenheim v. Commissioner, 31 B.T.A. 563 (1934) (royalties paid to author not compensation for services). *See also* Kluckohn v. Commissioner, 18 T.C. 892 (1952), *acq.* 1953-1 C.B. 5 (sale of property rights in article not earned income).

[56] Tobey, 60 T.C. at 230.

[57] In Rev. Rul. 55-636, 1955-2 C.B. 17, the Service had held that such gain was derived from the sale of property, not personal services.

[58] Rev. Rul. 79-85, 1979-1 C.B. 246, *revoking* Rev. Ruls. 71-182 and 71-183. Curiously, Rev. Rul. 79-85 says nothing about Rev. Rul. 71-315, see note 54 *supra,* concerning authors.

[59] Treas. Reg. § 1.861-7 (1957).

[60] Treas. Reg. § 1.861-4, T.D. 7378, 1975-2 C.B. 272.

[61] 599 F.2d 400 (Ct. Cl. 1979).

[62] *Cf.* Holland v. Commissioner, No. 79-1090 (4th Cir. May 29, 1980) (where capital, in the form of depreciable property, was determined a material income-producing factor, "earned income" was limited to 30% of profits).

The Foreign Earned Income Act of 1978[63] revised the treatment of income earned abroad, primarily by replacing the fixed dollar exclusion under section 911 with a series of deductions reflecting cost-of-living differentials, housing expenses, and other special living conditions.[64] But the issues passed on in *Tobey* and *Cook* remain important for the American artist living abroad[65] because the deduction may not exceed earned income from sources outside the United States.[66]

The United States tax characterization of the artist's gain as personal services income rather than gain on the sale of property may conflict with the treatment of the same gain by other countries. Suppose, for example, that a U.S. artist who creates his work in the United States sells it in France under circumstances that permit the French government, under its law, to tax the gain on the sale. Under Code section 901, the artist ordinarily might claim a credit against U.S. tax for the applicable French tax. But section 904 limits the credit by the ratio of the artist's taxable income outside the United States to his entire taxable income.[67] Under the *Tobey-Cook* line of cases, the source of the artist's income is the United States. As a result, the artist has no taxable income outside the United States, the limiting fraction is zero and there would be no credit; thus the gain would be taxed twice, once in the United States and once in France. The United States-France treaty contains language, common to other U.S. tax treaties, that allows a victim of international double taxation to consult with the "competent authorities" in cases of double taxation arising out of inconsistent characterization.[68] But such remedies may be ineffective.

As this example suggests, the artist sometimes may find the blessings of *Tobey* and *Cook* dubious. He might wish to elect in such circumstances to treat his gain as derived from the sale of property and not as personal services, with alternative source rules applicable. In Part V, I propose such an election.[69]

II. Deduction of Expenses and Losses Related to the Property

The Code generally limits deductions for expenses or losses to those incurred in a trade or business or in other profit-seeking activities.[70] Personal losses and expenses are not deductible.[71] People paint or buy

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[63] Pub. L. No. 95-615, §§ 201-203, 92 Stat. 3097 (codified in scattered sections of I.R.C.).

[64] I.R.C. §§ 911-913.

[65] The parallel problem of the nonresident alien artist selling into the United States is discussed in Beghe, *The Artist, The Art Market and the Income Tax*, 29 Tax L. Rev. 491, 500 n.44 (1974).

[66] I.R.C. § 911(c).

[67] I.R.C. § 904(a).

[68] *See, e.g.*, Convention with Respect to Taxes on Income and Property, July 28, 1967, United States-French Republic, art. 25, 19 U.S.T. 5281, T.I.A.S. No. 6518.

[69] *See* text accompanying notes 160-68 *infra*.

[70] *See, e.g.*, I.R.C. §§ 162, 165(c)(1)-(2), 167, and 212. Certain specified expenses and losses may be deducted without any profit-seeking nexus. These include interest, § 163; certain taxes, § 164; casualty losses, § 165(c)(3); and charitable contributions, § 170.

[71] I.R.C. § 262; Treas. Reg. § 1.165-9(a), T.D. 6712, 1964-1 C.B. 106.

paintings for a variety of motives, sometimes recreational and sometimes in pursuit of profit. Deductibility of art-related expenses will often depend on which motive predominates. This section examines the application of these concepts to collectors of art and artists.

A. *The Collector*

Most collectors hardly can or wish to contend that they are in the trade or business of buying and selling artworks.[72] They therefore cannot benefit from those provisions of the Code that condition deductibility on engaging in a trade or business, such as sections 162 and 165(c)(1). Section 212, however, permits a deduction in the absence of a trade or business for the ordinary and necessary expenses incurred in the production or collection of income and for the "management, conservation, or maintenance" of property held for the production of income. To obtain the deduction, the collector must manifest profit-seeking motivation.[73] As the regulations make clear, "income" for the purpose of section 212 includes gains from disposition of appreciated property, as well as from recurrent returns.[74]

Wrightsman v. United States[75] involved deductions claimed under section 212 for maintenance and restoration of artworks, and for subscriptions and travel. Mr. and Mrs. Wrightsman began buying art as a hobby, but in 1951, when they received one million dollars as part of a corporate liquidation, they turned to the art market rather than stocks as a hedge against inflation. By the end of 1960 they had purchased $5.2 million worth of art that appreciated substantially while in their possession.

The Wrightsmans specialized in 18th century French art. They pursued a course of self-education: reading, visiting exhibits, restoring and conserving their own art objects. Both became recognized as experts in their specialty. They kept almost all of the artworks either in their Palm Beach, Florida home or in their New York City apartment. Record-keeping was done in an extremely detailed, business-like fashion. The catalog of their works filled 26 volumes. The Wrightsmans installed air conditioning and humidity control systems similar to those in the Metropolitan Museum of Art to preserve the artworks. Based on the serious and business-like treatment of their artworks, the Wrightsmans contended that profit-

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72 In Judge v. Commissioner, 35 T.C.M. (CCH) 1264 (1976), the court disallowed the taxpayer's claimed depreciation deduction on decorative paintings used to furnish his office, for failure to show a reasonable useful life. *See also* Rev. Rul. 68-232, 1968-1 C.B. 79.

73 Treas. Reg. § 1.212-1(c) (1960). Section 183, promulgated in 1969, makes the profit-seeking requirement explicit, but adds little, except a statutory presumption, to the prior formulation. *See* Treas. Reg. § 1.183-2(a) (1972). The regulations also list several factors taken into account in making this determination, Treas. Reg. § 1.183-2(b) (1972).

74 Treas. Reg. §§ 1.212-1(b) (1960) and 1.183-2(b)(4) (1972). *See* text acompanying notes 85-86 *infra*.

75 428 F.2d 1316 (Ct. Cl. 1970).

making was their primary objective and that their expenses properly were deducted under section 212. The Court of Claims disagreed.[76]

Most of the scant authority on which the parties relied in the Court of Claims arose not under section 212 or its predecessors but under the similar standard of section 165(c)(2) and its pre-1954 Code antecedents that allows a deduction to an individual for a loss arising out of a transaction entered into for profit. In *Hamilton v. Commissioner,*[77] the Board of Tax Appeals barred a deduction under this provision for a loss sustained on the sale of a Gainsborough painting that the taxpayer inherited from her father, J. Pierpont Morgan. The taxpayer had kept it in her home, occasionally lending it out. The Board disallowed the claimed capital loss because the property had been devoted to personal use rather than to a transaction for profit. On the other hand, a profit motive was found in *Reynolds v. Commissioner,*[78] where the taxpayer inherited a necklace and sold it at a loss.[79] The Tax Court and the First Circuit permitted a capital loss deduction because the taxpayer engaged in no conduct that contradicted his realizing the necklace's maximum value: immediately upon inheriting it, he placed the necklace with a reputable jeweler for sale.[80]

Somewhere between these cases and closer to the *Wrightsman* situation lay the facts of *Tyler v. Commissioner.*[81] The taxpayer there collected stamps for investment and as a hedge against currency inflation. From 1926 to 1940 he bought $448,000 worth of stamps, all on the recommendation of a professional philatelist. He maintained careful records of his stamps. The philatelist testified that Mr. Tyler did not evince an interest in stamps as a hobbyist or collector. Mr. Tyler never gave specific instructions to seek or purchase stamps nor did he engage in activities common to stamp collectors. Collecting did give him pleasure and he kept his albums at home. When he wished to increase his liquidity in 1938 through 1941, Mr. Tyler sold portions of the collection. He incurred a loss of $210,000. The Tax Court held that the taxpayer's primary intent was investment and allowed a capital loss deduction. His personal motives were found to be secondary.

The Service subsequently issued a brief ruling[82] stating that if a taxpayer collects stamps as a hobby, the sale of his stamps at a loss would be nondeductible under section 165. Although hardly a disputable result, the ruling did not illuminate the difficult cases involving multiple motives.

The *Wrightsman* trial commissioner in the Court of Claims applied these authorities and found that the taxpayers' primary motive was investment,

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[76] *Id.* at 1323.

[77] 25 B.T.A. 1317 (1932).

[78] 155 F.2d 620 (1st Cir. 1946), *aff'g* 4 T.C.M. (CCH) 837 (1945).

[79] The court rejected ordinary loss treatment because the taxpayer was not in a trade or business related to necklace sales. *Id.* at 840-41.

[80] *See also* Marks v. Commissioner, 5 T.C. 173 (1945), *acq.* 1946-1 C.B. 3.

[81] 6 T.C.M. (CCH) 275 (1947).

[82] Rev. Rul. 54-268, 1954-2 C.B. 88.

not hobby. The full Court of Claims reversed this finding. It rejected the per se legal standard proposed by the government, that to qualify under section 212 the taxpayer had to show either segregation of the art so as to preclude personal pleasure or at least a course of conduct inconsistent with pleasure. Instead, on the basis of the same balancing test of motives that the trial commissioner had used, the Court of Claims found the taxpayers' investment motive not primary. It relied on the Wrightsman's extensive personal use of many items in the collection in their Palm Beach home and New York apartment: walls were hung with 18th century oriental wallpaper, floors were inlaid with 18th century parquet flooring, and bedrooms were furnished with Louis XVth furniture.

On the facts before it, the Court of Claims probably reached the correct result. Stated in the negative, the section 212 regulations for pre-1970 years and the section 183 regulations for post-1969 years mandate non-deductibility if the transactions are carried on "primarily" as a sport, hobby, or recreation.[83]

The court had to determine the primacy of one subjective motive over another, but by reference to objective facts and circumstances. The extensive personal satisfaction and use the Wrightsmans derived from their collection necessarily weighed heavily in the court's determination. It properly rejected the standard urged by the Service, that investment motivation can be shown only where the taxpayer is shut off from the pleasure of the collection; nevertheless, the Wrightsmans' failure to deal at a distance with their collection obviously swayed the court. The court did not foreclose the possibility of a deduction for collectors under section 212, but if the collector lives with and enjoys his collection he can hardly expect to present a better case than did the Wrightsmans. All of the other traditional criteria for deductibility—careful record-keeping, business-like dealings, professional training, and high probability of ultimate profit through appreciation—appeared in the case, but without decisive impact. Presumably, when the taxpayer does separate himself physically from his collection—as when it is maintained at the premises of a dealer or on loan to a museum for an extended period—deductibility will be seriously entertained under the *Wrightsman* holding. How much—if anything—is left of the *Tyler* notion, that access to the collection without much enjoyment also may give rise to deductions, remains unclear.[84]

Another argument bears on the result, one that apparently was not made or considered in the Court of Claims. Suppose the Wrightsmans intended never to sell their collection but only to pass the property to a charity upon their death. In that event, though they would expect their collection to appreciate, they would not seek "income" from it in the traditional income tax sense of "gross income." For section 61 purposes,

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[83] Treas. Reg. § 1.212-1(c) and § 1.183-2(a) (1972), T.D. 7198, 1972-2 C.B. 177.

[84] *Wrightsman* reflects the view of the Court of Claims. The tax court or a district court might conceivably apply the § 212 standard in a fashion more favorable to the taxpayer.

appreciation alone is not income;[85] were the Wrightsmans to die holding the property, the appreciation never would be realized and would not enter their gross income. Arguably, property that appreciates is not held for the "production of income" under section 212 unless the taxpayer has a more than negligible expectation of future realization of gain and gross income inclusion.[86]

In any given case, of course, the government might find it difficult to negate all intention by the taxpayer to realize gain in the future. Some of the same elements that bore on the hobby loss determination in *Wrightsman,* such as personal use of the artworks as part of the collector's intimate surroundings, would bear on this point too. Evidence that the collector expected to leave the collection to a museum would also be relevant. If the likelihood of realization were found to be negligible, section 212 might bar deduction of expenses on this ground alone.

B. *The Artist*

1. The Trade or Business Requirement: Deduction of Expenses in General

The artist who claims deductions for expenses related to his work may also be called upon to show that recreation-seeking motives were subordinate to profit-seeking motives. The inquiry differs from that for collectors in that the artist may come within section 162, which provides for the deduction of ordinary and necessary expenses incurred in pursuit of a trade or business. In the relatively small number of cases that have considered the question, the artist devoted substantially full time to his art work, but did not enjoy net income from the activity in the tax year. Instead, the artist sought to deduct expenses related to his art against either investment income or income of a spouse. The artist optimistically professed the expectation that his work soon would be discovered and that he would profit from appreciation in its value. He contended that his activities constituted a trade or business, not a hobby, so that the net loss was deductible.

Occasionally, the great disparity between the income derived from the artworks and the expenses incurred over a substantial period of time has led the court to conclude that there was no reasonable expectation of profit. In *Estate of Hailman v. Commissioner,*[87] the taxpayer had been active

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[85] Eisner v. Macomber, 252 U.S. 189 (1920).

[86] Some support for this view may be found in case law and the § 212 regulations. In Hunter v. United States, 219 F.2d 69 (2d Cir. 1955), the United States Court of Appeals for the Second Circuit construed the word income in § 212(1) to require the creation of "increased gross income." *Id.* at 72. The § 212 regulations provide that "income" for purposes of the section includes gain from the "disposition of property." Treas. Reg. § 1.212-1(b). The corresponding regulation under § 183, however, construing activity engaged in for profit, is ambiguous. It first states that "profit" encompasses appreciation in the value of assets used in the activity but then explains that an overall profit may result when appreciation is "realized." Treas. Reg. § 1.183-2(b)(4).

[87] 17 T.C.M. (CCH) 812 (1958). The case arose under § 23(a)(1)(A) of the 1939 Code, the predecessor to § 162 of the 1954 Code.

in both horticulture and the arts and maintained a studio on her grounds. In the period from 1920 to 1953, she sold 50 paintings, including portrait commissions, out of about 600 that she executed. From 1950 to 1954 she had no arts receipts but claimed over $40,000 in expenses due to salaries for domestic help, club dues, auto expenses, utilities, and expenses related to her studio. The Tax Court concluded that she did not have a profit-seeking motive and was not engaged in a trade or business; it therefore denied the deductions. Similarly, in *Porter v. Commissioner*,[88] the taxpayer worked as an artist, studied and painted, and even had a one-man show in 1948. From 1950 to 1966 he sold $600 worth of paintings; for the three years in issue, 1964 to 1966, he deducted $861, $1,142, and $3,080, respectively, for paint, canvas, frames, studio, and other expenses. The court had little difficulty finding that he was not engaged in a trade or business. But sincerity without financial success has triumphed on at least one occasion. In *Adams v. Commisioner*,[89] the taxpayer, who never sold any of his works, was allowed to deduct studio expenses. The court was impressed by his family's relative penury, indicating that he was no hobbyist but seriously engaged in his art.

Artists who have gained professional recognition, particularly from their peers, have succeeded in establishing that their art is a trade or business. *Rood v. United States*[90] concerned a sculptor of international reputation who had been a professor at the University of Minnesota and, for two years, president of National Artist's Equity. By the date of the trial he had completed 500 works of sculpture and he had sold approximately 25 percent of them. The partnership into which he entered with his second wife for the creation and sale of his sculpture made money in 1948, 1949, and from 1957 to 1959, but lost money in the years 1950 to 1956. The District Court found that the taxpayer entered into his sculpture with the expectation of profit, that the partnership was engaged in a trade or business, and that the losses for the years in issue were deductible.

The Tax Court confronted a closer case in *de Grazia v. Commissioner*.[91] Anna Maria de Grazia had studied under famous artists in Italy and achieved some recognition as an artist there. She had several exhibitions and was a member of the Professional Artist's Union. She testified that for the year 1957, the year in issue, she attempted to build up her inventory of paintings rather than concentrate on sales. From 1957 to 1960 she had receipts of $1,800 but claimed expenses of $23,000. Her receipts from art increased in each of these three years and she kept careful records of her work. Stressing her professional connections, the Tax Court held that she was engaged in a trade or business.

A more recent case in this general area is *Churchman v. Commissioner*,[92]

[88] 28 T.C.M. (CCH) 1489 (1969), *aff'd per curiam*, 437 F.2d 39 (2d Cir. 1970).
[89] 25 T.C.M. (CCH) 1239 (1966).
[90] 184 F. Supp. 791 (D. Minn. 1960).
[91] 21 T.C.M. (CCH) 1572 (1962).
[92] 68 T.C. 696 (1977).

decided under section 183 and its regulations, which spell out the factors to be taken into account in determining whether an activity is entered into for profit. Gloria Churchman, an artist, worked in a number of media but was primarily a painter. She taught courses at San Francisco State College, exhibited her painting and sculpture at galleries, and had several one-woman shows. She had been involved in artistic activities for twenty years but in none of those years did income from the sale of artworks exceed her art-related expenses. For the years in issue, 1970 to 1972, she had $250 of income in 1972 but none in the other two years. The taxpayer made posters and books in order to make her work more available to the public, and she also kept careful records.

Applying the criteria set out in Treasury Regulation section 1.183-2, the Tax Court found a number of factors that militated against a finding of a trade or business—a history of losses, a lack of dependence on the income from the artistic activities, and the presence of a significant recreational element. These were overborne, however, by still others that supported her claim—she carried on the activities in a businesslike fashion, had trained to become an artist, and had devoted substantial time to her artistic activities. The Tax Court emphasized the artist's involvement in nonrecreational aspects of her work, especially marketing. It considered the failure to realize current income less important in visual arts than other fields, because beginning artists first must attain a degree of public acclaim before their serious work will command a price sufficient to provide a profit. A long gestation period before profitability is to be expected and should not of itself undercut a finding that the activity was entered into with the expectation of ultimate profit.

It is instructive to compare the application of the factors enumerated in the section 183 regulations to the Wrightsmans—collectors—and to Churchman—an artist. Both cases involve some factors favorable to the government and some factors favorable to the taxpayer. The disparate results cannot be explained by the number of factors on each side. Instead, the rather different contexts in which the cases arose mandated a different weighting of the applicable factors. *Wrightsman* turned on a comparison of personal gratification with the expectation of ultimate profit as the motive for investing in the artworks. In *Churchman*, we take as a given the creation of the artworks and its attendant recreational elements, looking instead to see whether the activities were carried out together with other activities normally pursued by professional artists.

Churchman and the prior cases suggest that full-time artists are likely to find the courts more receptive to their claims for deduction than are collectors. Professionalism in the form of peer recognition, attention to business detail, and training weigh heavily. Lack of current income can be excused—at least in some situations—on the grounds that income has been subordinated to the need to build inventory or establish a reputation.

Comparison of Wrightsman *and* Churchman *in Regard to Factors Now Listed in Treasury Regulation Section 1.183-2(b)*

	Wrightsman	*Churchman*
1. Manner in which the taxpayer carries on the activity	T	T
2. Expertise of the taxpayer or his advisors	T	T
3. Time and effort expended by the taxpayer in carrying on the activity	T	T
4. Expectation that assets used in activity may appreciate in value	T	T*
5. Success of the taxpayer in carrying on other similar or dissimilar activities	G	G*
6. Taxpayer's history of income or losses with respect to the activity	G	G
7. Amount of occasional profits, if any, which are earned	G	G*
8. Financial status of taxpayer	G	G
9. Elements of personal pleasure or recreation	G	G

T = Factor was favorable to Taxpayer; G = Factor was favorable to Government

* The Tax Court did not expressly state whether taxpayer met this standard, but the thrust of the opinion indicates the result listed.

2. Studio Expenses

A finding that the artist is engaged in a trade or business is a necessary but not sufficient condition for deductibility of many artists' expenses. Typically, a working artist will seek to deduct expenses related to his studio. If the studio is maintained independently of the artist's residence, this should present no added problem. But where the artist lives and works in the same space—a common arrangement—deduction of studio expenses must also leap the new hurdle erected by section 280A. This section was added by the Tax Reform Act (TRA) of 1976[93] to curb the deduction of expenses arising from vacation homes and home offices.

Section 280A imposes additional conditions on deductibility that an artist may find difficult to meet. For example, the artist must use the studio either "exclusively" as his principle place of business or as a place of business used by his customers in meeting or dealing with him in the ordinary course of his trade or business.[94] If the studio space doubles as

[93] Pub. L. No. 94-455, § 601(a), 90 Stat. 1569 (1976) (codified in scattered sections of I.R.C.). Proposed regulations for § 280A have recently been issued. *See* Proposed Regs. §§ 1.280A-1–1.280A-3, 45 Fed. Reg. 52,399 (1980).

[94] I.R.C. § 280A(c)(1).

living space, these criteria cannot be met. Moreover, the expenses allocable to the studio can be deducted only to the extent of gross income from the sale of artworks less deductions not dependent on trade or business or profit motive.[95] This limitation may severely reduce the studio-related deductions of an artist who has few sales in a particular year.

3. Travel Expenses and Education Expenses

On the other hand, artists who pass the trade or business test may be in a better position to qualify for deduction of education and travel expenses. Like any other taxpayer, an artist may deduct education expenses to maintain or improve skills but not to qualify the artist for a new trade or business.[96] The amateur artist's expenses for art classes should therefore be nondeductible; they constitute an "inseparable aggregate of personal and capital expenditures."[97] To someone who has crossed the trade or business threshold, however, the same classes properly will be treated as a deductible expense.

Although travel and entertainment questions have been litigated extensively, few cases have had occasion to articulate what travel expenses might be deducted by a professional artist.[98] Some illumination can be obtained from cases concerning travel for education by school teachers. The courts have struggled to determine whether a particular trip is related primarily to the teacher's business, the test of deductibility.[99] When the trip was only remotely related to the occupation, the courts have denied a deduction. Thus, a European trip taken by a driver education instructor did not become deductible because he observed world traffic problems and made inquiries about vehicle codes and license requirements in other countries.[100] This information, if learned, would not have aided materially in his teaching of driving in California.[101] Similarly, where the trip in fact did little to enhance the teacher's skills, the cost of travel was nondeductible. An art teacher who traveled to the Carribean, the Soviet Union, and Hawaii—but visited only one art museum—did not render his vacation deductible by bringing back inexpensive native handcrafts to show his classes.[102]

The Tax Court, however, has allowed travel deductions to teachers where the travel more integrally related to the teacher-taxpayer's subject

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[95] I.R.C. § 280A(c)(5).

[96] Treas. Reg. §§ 1.162-5(a) and (b)(3), T.D. 6918, 1967-1 C.B. 36.

[97] Treas. Reg. § 1.162-5(b)(1), T.D. 6918, 1967-1 C.B. 36.

[98] In de Grazia, 21 T.C.M. (CCH) at 1576, the Tax Court allowed a deduction for part of the artist's travel expenses to Italy.

[99] *See* Treas. Reg. §§ 1.162(a)-(d), T.D. 6918, 1967-1 C.B. 36.

[100] Gino v. Commissioner, 60 T.C. 304 (1973), *rev'd on other grounds*, 538 F.2d 833 (9th Cir.), *cert. denied*, 429 U.S. 979 (1976).

[101] *See also* Cochran v. Commissioner, 32 T.C.M. (CCH) 466 (1973); Baker v. Commissioner, 32 T.C.M. (CCH) 962 (1973).

[102] Schrimpf v. Commissioner, 36 T.C.M. (CCH) 1275 (1977). *See also* Allison v. Commissioner, 36 T.C.M. (CCH) 1114 (1977).

matter. In *Marlin v. Commissioner,*[103] both husband and wife taught school—he Latin and she history. As they toured France, they visited abbeys, cathedrals, chateaux, museums, and other historical sites. The court found that she maintained and improved her skills as a history teacher, but that visits to ancient Roman ruins was not sufficiently connected with his skills as a teacher of Latin to render his expenses deductible.[104]

By a parity of reasoning, the practicing artist may require travel to repositories of art. Artists traditionally have learned much from study of the old masters. A trip to Paris to visit the Louvre, to Florence to view Renaissance painting, or to New York to observe avant garde styles, if the primary purpose of the travel is study, should be deductible under section 162.

III. EXCHANGES

The Code requires a taxpayer to recognize any gain realized on an exchange.[105] Section 1031, however, permits nonrecognition of gain on certain exchanges of like-kind property. The Code treats such exchanges as inappropriate occasions for taxation. Both the property received and that given must be held either for "productive use in trade or business" or for investment. Property held primarily for sale and intangible personal property such as stock or securities do not qualify. Both collectors and artists may seek to swap one work of art for another and to come within section 1031, thereby avoiding present taxation on the disposition of their works while obtaining new artworks for investment purposes or their own enjoyment.

A. *The Collector*

When a collector exchanges an appreciated work of art for another, he may try to characterize the exchange as of like kind to fall within the ambit of section 1031. As noted, the section applies only to property held for investment or for productive use in trade or business. For most collectors, the only possibility for qualification lies in holding for investment, since their activities involving artwork do not amount to a trade or business. Under *Wrightsman,*[106] however, the collector who derives significant personal enjoyment from the art he owns rarely will be able to show that his investment motives outweigh his personal motives, and like kind treatment may be denied. Although no authority equates the standards for "investment" under sections 1031 and 212, there is no good reason to develop a rule more favorable to taxpayers for section 1031 exchange

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[103] 54 T.C. 560, *acq.* 1970-2 C.B. xx.

[104] *See also* Gibbons v. Commissioner, 37 T.C.M. (CCH) 366 (1978); Weiman v. Commissioner, 30 T.C.M. (CCH) 372 (1971); Smith v. Commissioner, 26 T.C.M. (CCH) 1281 (1967); Oehlke v. Commissioner, 26 T.C.M. (CCH) 663 (1967).

[105] I.R.C. § 1001(c).

[106] *See* text accompanying notes 75-76 & 83-86 *supra.*

purposes, and it is unlikely the Service would do so.[107] Most collectors, therefore, cannot find a safe habor in section 1031 and a swap of artworks will be a taxable event to them.

Even if the collector can demonstrate the requisite investment motive, he must make the further showing that the works exchanged were of "like kind."[108] The regulations provide that "like kind" refers to the nature or character of the property, rather than to its grade or quality.[109] The application of this regulation to unique, original artworks is unclear without an understanding of the kinds of differences that are of quality, as opposed to character. Is an exchange of works in two different media, such as a swap of a painting for a sculpture, of different character while a swap of one painting for another a question of quality? Are ten decorative oversized paintings and a small old master of "like kind"? Or should all fine artworks be treated as of like kind, just as the regulations treat all real estate as of like kind whether improved or unimproved no matter what the location?[110]

A recent ruling suggests that the Service is unlikely to construe "like kind" broadly in new areas. In Revenue Ruling 79-143,[111] the taxpayer exchanged coins held for investment for other coins. The old coins were numismatic-type, the value of which depends on date, condition, scarcity, and the like. The taxpayer received bullion-type coins, the value of which is determined by the quantity of precious metal they contain. The ruling held that the exchange was not of like kind. Curiously, it drew support from section 1031(e), added in 1969—a provision that treats a swap of livestock of different sexes as not constituting an exchange of property of like kind. The ruling and its citation of section 1031(e) suggest a narrow view of "like kind" property in new areas, including artworks: just as section 1031(e) corrects a "city-feller" confusion in equating a cow with a bull, perhaps a Renoir peasant girl and a Warhol soup can will not be considered "like kind." The critical element in appropriately defining this narrow view appears to be whether the exchange leaves the owner in a different economic position.[112]

Thus, either because the collector lacks an investment motive or because the exchange is not of "like-kind," most swaps by collectors fall outside section 1031 and should be reported as taxable. Anecdotal evidence suggests, however, that collectors frequently exchange artworks and fail to report gain on these exchanges, perhaps because they are unaware that the swap is a taxable event or because they realize that the

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[107] *Cf.* Starker v. United States, 602 F.2d 1341 (9th Cir. 1979) (equating § 165 standard of investment with that of § 1031).

[108] I.R.C. § 1031(a).

[109] Treas. Reg. § 1.1031(a)-1(b), T.D. 6935, 1967-2 C.B. 272.

[110] *Id. See* Crichton v. Commissioner, 42 B.T.A. 490, *aff'd*, 122 F.2d 181 (5th Cir. 1941); Braley v. Commissioner, 14 B.T.A. 1153 (1929), *acq.* VIII-2 C.B. 6 (1930).

[111] 1979-1 C.B. 264.

[112] *Cf.* Liant Record, Inc. v. Commissioner, 303 F.2d 326 (2d Cir. 1962) (construing the related standard under § 1033 of what is "similar or related in service or use").

Service has no effective way to discover the gain.[113] The appreciation on the first work may thus escape tax permanently. To illustrate, suppose a collector purchases a painting for $10,000 and swaps it for a second work in a later year when both works are worth $50,000. Subsequently, the collector sells the second work for $70,000. He reports gain of $20,000 using as his basis $50,000, the fair market value of the property when he acquired it.[114] If gain had been recognized on the earlier swap this would be an appropriate result. Use of the $50,000 basis under the circumstances postulated, however, effectively excludes from tax the $40,000 appreciation the collector enjoyed on the first work.

The Service may be unaware of the untaxed gain on the first work and therefore raise no questions as to the proper treatment of a sale of the second. If it becomes aware of the earlier exchange, the Service will be unable to tax the gain on the swap directly if the limitations period has expired for the earlier transaction.[115] The Service nevertheless might seek relief at the time of the later sale under the mitigation provisions, sections 1311-1314. These provisions allow for adjustments in later years to correct errors in earlier years when the error is described in section 1312. Use of the $50,000 basis by the collector appears to fall under section 1312(7)(C)(i): a determination that affects the basis of property and involves erroneous nonrecognition treatment of a prior transaction on which basis depends. An example in the regulations seems to confirm this application of the statute.[116] The Service accordingly could assess a tax on the $40,000 gain at the later date under section 1314.

B. *The Artist*

The artist also may find it difficult to qualify for section 1031 nonrecognition of gain on exchanges of art; but if he succeeds, he may enjoy not only deferral of tax on gain, but also permanent loss of its ordinary income character under section 1221(3). Like the collector, the artist faces the question of what constitutes "like kind" property. He too must show in addition that he holds the work for investment. In the case of the artist, however, the initial problem is to avoid the exclusion from like-kind treatment for property held "primarily for sale."[117] As discussed earlier, an artist may hold some of his properties for sale and some for investment so that at least some of his works might qualify in theory for section 1031 exchange treatment.[118] Although the ordinary asset rule of section

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[113] The Service's problem of discovering the gain is not limited to exchanges—it applies as well to sales of artworks and other collectibles.

[114] I.R.C. § 1012.

[115] Section 6501(a) provides a general limitation period of three years after a return has been filed for the assessment and collection of tax. Omission from gross income of more than 25% of the amount stated in the return extends the period to 6 years, § 6501(e)(1)(A).

[116] *See* Treas. Reg. § 1.1312-7(c), example (1)(ii) (1956).

[117] I.R.C. § 1031(a).

[118] *See* text accompanying notes 29-34 *supra*; Estate of Chandor v. Commissioner, 28 T.C.

1221(3) obviates the need in most cases to decide when an artist holds for investment, direct authority to guide the artist or the courts in close cases is almost nonexistent.[119] To complete the section 1031 conditions, the artist must receive on the exchange artworks that he will hold for investment; if he sells the new work too soon after acquiring it, he arguably received it for sale and not for investment.

If the artist qualifies, an exchange of one of his works for a work by someone else under section 1031 not only defers recognition but probably succeeds in divesting him of the ordinary income increment in the old artwork. The new work can qualify as a capital asset because it falls outside section 1221(3)—the artist did not create the new work with his own personal efforts, nor is his adjusted basis in the new work determined by reference to the basis of the artist who did create it; his basis under section 1031(d) is determined by reference to his basis in the property exchanged. No relevant part of section 1221(3) applies and the new work thus can have capital asset status in his hands. Indeed, as an extra bonus, the artist's holding period in the new work includes that of the old,[120] so that capital gain on the sale of the work may qualify as long-term sooner than one year after the exchange.

The Service might argue that section 1031 in any event should not apply because the untaxed element in the new work does not represent capital appreciation, as normally would be the case, but rather personal services.[121] The Service would argue that the personal services element should not qualify under section 1031, even though it is embodied in "property" and is so treated for other purposes. In *Fleming v. Commissioner*, decided together with *Lake v. Commissioner*,[122] the Supreme Court held that an exchange involving a carved out oil payment fell outside section 1031, notwithstanding that the payment constituted an interest in real property under state law. The oil payment was a substitute for ordinary income, and the exchange triggered current taxation. This analogy to assignment of income is apt in some respects; the section 1221(3) treatment of an artwork resembles the tax treatment of an assignment of income in that, on a gift of the work by the artist and subsequent sale at a gain by the donee, the gain retains its ordinary character.[123] But it differs

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721 (1957), *acq.* 1957-2 C.B. 4. Similarly, real estate dealers and subdividers may hold some land separately for investment. *See* Turner v. Commissioner, 540 F.2d 1249 (4th Cir. 1976).

[119] Section 1031 speaks of property held primarily for sale. Section 1221(1) adds "to customers in the ordinary course of the trade or business." The extra words are restrictive. *See* Burnett v. Commissioner, 40 B.T.A. 605 (1939), *nonacq.* 1940-1 C.B. 6, *aff'd in part and rev'd in part*, 118 F.2d 659 (5th Cir. 1941). Prior to 1950, it was generally accepted that gain from the sale of works enjoyed by a professional artist was ordinary because his works came under the predecessor of section 1221(1). *See* text accompanying notes 23-27 *supra*. It is not clear, however, whether the possibility that the artist might hold some of his works for investment ever was presented squarely.

[120] I.R.C. § 1223(1).

[121] The Tax Court so held in another context. Tobey v. Commissioner, 60 T.C. 227 (1973), *acq.* 1979-1 C.B. 1.

[122] 356 U.S. 260 (1958).

[123] I.R.C. § 1221(3)(c).

in that the gain is taxed to the donee, not the artist.[124] Furthermore, the Service, prior to the 1969 TRA, allowed artists to deduct the fair market value of their works contributed to charity, treating the entirety as property, not as income interest.[125]

As with much tax alchemy, the benefits of an artist's like kind exchange may be too good to approve. Qualification under section 1031 undercuts the purpose of section 1221(3): to close the capital gain "loophole" for the artist's personal services income. If a court wished to prevent the conversion of such income into capital gain, it could find against the artist on any of the threshold points discussed above without reaching the assignment of income question. Moreover, if there are multiple swaps or immediate sales, it might find section 1031 inapplicable, either because the old work has become property held primarily for sale or because the new work has become such property rather than investment property.[126] Again, the policy problem is to segregate the services income component of value in the artist's work and tax it as ordinary income while treating investment appreciation as eligible for other statutory benefits—in this case, deferral of gain on a like-kind exchange. I discuss a proposal that makes this distinction in Part V.

IV. Gifts to Charity

When the creator or collector of artworks donates them to a charity, he closes out his investment experience. The donor ordinarily receives no money or property in return, but enjoys an income tax deduction that provides him some financial benefits.[127] This section examines the special problems that arise with charitible gifts of artworks, paying particular attention to the question of valuation.

A. *The Collector*

The measure of the deduction for a charitable contribution in kind is the fair market value of the property donated.[128] Unrealized appreciation—gain on which no tax has been paid—therefore gives rise to an ordinary deduction in many cases. This violates the usual rule that limits deductions to previously taxed income.[129] Beyond providing an additional

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[124] *Cf.* Helvering v. Horst, 311 U.S. 112 (1940) (income from donated property taxed to donor; short-term gifts of income ineffective to change taxpayer).

[125] The 1969 TRA altered the charitable deduction rules for ordinary income property. *See* text accompanying notes 154-56 *infra.* Under the old rules, however, the Service did contest the artist's valuation on occasion. *Compare* Rebay v. Commissioner, 22 T.C.M. (CCH) 181 (1963) (value reduced) *with* Kuderna v. Commissioner, 24 T.C.M. (CCH) 749 (1965) (claimed value upheld).

[126] *See* Rev. Rul. 75-291, 1975-2 C.B. 332; Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 77-297, 1977-2 C.B. 304; Rev. Rul. 77-337, 1979-2 C.B. 305.

[127] *See* I.R.C. § 170.

[128] Treas. Reg. § 1.170A(c)(1), T.D. 7340, 1975-1 C.B. 81.

[129] It is instructive to compare the tax treatment of appreciated property in other circumstances that give rise to deductions. If a thief steals a painting that has appreciated in value, the collector's deductible loss is limited to adjusted basis, and the precise value of the

subsidy to induce donors who enjoy substantial appreciation in the value of their artworks to make contributions, this rule appears to have little to commend it.[130] Like the charitable contribution deduction itself, the benefits for deduction of untaxed appreciation rise with the donor's income bracket and run primarily to the wealthy. One practical difficulty of the rule is that it creates the need to put a numerical value on the artwork, a value that has little or no significance except for tax purposes.

Despite important statutory modifications of the charitable deduction in 1969,[131] valuation remains a central issue for charitable gifts in kind. Under the best of circumstances, works of art are difficult to value. All original artworks are unique; unless the work was bought and sold in the market in an arm's length exchange within a reasonable time of the donation, its dollar value must be estimated by reference to the sale prices of comparable works, and to numerous other potentially relevant data. The range of expert opinion regarding the value of a particular work may be wide. Data concerning the sale of comparable items is itself often difficult or impossible to obtain. Furthermore, valuation may depend not only on extrapolation of the prices paid for other works by the same artist or of the same period, but also on the medium, size, and genre of the work, its condition, and perhaps most important of all, its authenticity.

Moreover, the conception of fair market value as a particular dollar amount, although necessary to compute the donor's deduction, is itself artificial. Fair market value can be expressed more correctly as a range of dollar amounts, any one of which represents a reasonable price for the work. For example, two experts may value a donated work at $12,000 and $15,000 respectively, but each might well agree that the other's estimate lies within the range of reasonableness. Yet calculation of the donor's income tax liability requires the selection of a particular point in the range.

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painting is irrelevant so long as it exceeds adjusted basis. I.R.C. § 165(b); Treas. Reg. §§ 1.165-8(b), T.D. 6786, 1965-1 C.B. 117 and 1.165-7(b)(1), T.D. 7522, 1978-1 C.B. 59. If a collector transfers the painting to a business employee in payment for accrued salary due, the collector deducts the fair market value of the work (if a cash payment in the same amount would have been deductible) but recognizes gain on the difference between adjusted basis and fair market value. *See* Rev. Rul. 69-181, 1969-1 C.B. 196. Either the appreciation drops out in computing the deduction, or it is recognized and taxed as gain. Inclusion of the gain in income does not always offset the effect of the deduction. This lack of offset might occur, for example, if the gain is long-term capital gain.

Artworks can decline in price as well. The text does not deal with this variation.

[130] *See* Andrews, *Personal Deductions in an Ideal Income Tax,* 86 HARV. L. REV. 309, 371-72 (1972); McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction,* 27 TAX L. REV. 377, 407-09 (1972). *But see* Bittker, *Charitable Contributions: Tax Deductions or Matching Grants,* 28 TAX L. REV. 37, 63 (1972).

[131] For a gift of appreciated property, § 170(e)(1) now reduces the charitable contribution deduction by the portion of the appreciation that would have given rise to ordinary income on a sale of the property at fair market value and also by part of the remaining unrealized appreciation under specified circumstances. A gift of appreciated property which has been held for over a year to a public charity for use in connection with its exempt purpose, such as a donation of a painting to a museum, generally incurs no reduction. Section 170(f) regulates split interest gifts, a fact pattern neglected prior to 1969.

Valuation for tax deduction purposes hardly constitutes the best of circumstances for ascertaining "true" value. The taxpayer, the appraiser he selects, and the charitable recipient have every incentive to fix the value as high as possible. The taxpayer's benefit is obvious—once he has determined to give away a work of art, the difference between $12,000 and $15,000 is $3,000 in extra deduction. The charity benefits in a secondary fashion: the more attractive the donor finds the act of giving, the more likely he is to repeat it. The charity has every reason to be grateful and to hope for further gifts, and has no reason to question value. The appraiser in good conscience can support the highest reasonable value. The only loser is the absent party, the Treasury—and by extension, other taxpayers, who will have to make up the shortfall. We should be surprised if donors failed to give themselves the benefit of any doubt—and occasionally more. One commentator has found overvaluation by donor-collectors to be widespread.[132]

A recent case suggests the possibilities for abuse.[133] A corporation bought a collection of paintings for $12,000 and sold an undivided fractional interest to the taxpayer for $1,200. The corporation supplied an appraisal for the collection of $250,000 and arranged for a charity to receive the artworks as a donation. The collection included paintings attributed to David, Murillo, Crespi, Master, and Zurbaran. Two experts at trial, one of whom was the Los Angeles County Art Museum Director, pronounced them all fakes. When an IRS auditor visited the charity to inspect the paintings, he was told that two had been lost and one stolen. Taxpayer's expert witness, the corporate vendor's appraiser, exhibited little familiarity with the artists or the period. The Tax Court had little difficulty deciding to cut the taxpayer's deduction to what he paid, $1,200.[134]

The opening gun in the valuation battle belongs to the taxpayer. He places the first value on the work when he claims the deduction on his return. The auditing agent is unlikely to be able to value artworks himself, and the engineering and valuation minions at the call of most district directors generally have little training in such work. In 1968, to curb valuation abuses, the Commissioner established the Art Advisory Panel (AAP) at the suggestion of the Association of Art Museum Directors.[135] The AAP reviews taxpayer valuations of artwork contributed to charity or transferred by death or gift. In the charitable gift situation, the taxpayer generally desires a high value and the Commissioner a low one; for transfer tax purposes their positions are reversed. In theory, impartiality

[132] Speiller, *The Favored Tax Treatment of Purchasers of Art*, 80 COLUM. L. REV. 214, 238-40 (1980).

[133] Vander Hook v. Commissioner, 36 T.C.M. (CCH) 1394 (1977).

[134] Query whether even this amount was justified.

[135] I.R.S. News Release, [1968] 7 STAND. FED. TAX REP. (CCH) ¶ 6573. The Commissioner of Internal Revenue recently filed a notice of determination of necessity for establishment of an Art Print Panel. [1980] 10 STAND. FED. TAX REP. (CCH) ¶ 6587.

is preserved by the fact that the panel does not know which kind of issue is before it.[136] At its most recently reported meeting, in November 1977, the AAP considered 55 charitable contribution cases, involving 243 appraisals. It concluded review of 131 of these, accepting 92 and adjusting 39. It recommended a reduction from $13.2 million to $10.2 million of the aggregate value claimed.[137]

The Commissioner apparently has adopted the AAP value in at least some instances when challenging taxpayer valuations, though an expert may be found supporting an even lower value. This tactic may induce a favorable judicial response—a court faced by two sets of experts may seek a reasonable compromise between the two alleged values and adopt the AAP valuation as a justifiable stopping point. In *Posner v. Commissioner,*[138] for example, the taxpayer donated a painting by the Italian artist, Zanchi, called *The Death of Seneca.* The taxpayer argued that Zanchis were rare in this country and had an expert testify that the painting was worth $15,000. This appraisal was marred by the fact that the appraiser had initially mistaken the painting for another subject, *The Good Samaritan.* The Commissioner's expert testified that Zanchi painted in an anachronistic style, using Baroque style long after it had lost its popularity. Moreover, the composition of the painting was "unpleasant" and the positioning of the figures awkward. This expert concluded that the painting was of greater value to scholars than to collectors and was worth only $1,500. Two years after the contribution, another Zanchi was sold at auction in Milan for $2,592. The Tax Court sustained the Commissioner's AAP value of $5,000.

One case has challenged the dual role of an expert in serving on the AAP and then testifying at trial on the Commissioner's behalf. *Furstenberg v. United States*[139] involved the value of a Corot figure painting, *La Meditation,* in 1967 and 1968. The painting brought $51,800 at auction in 1963. The purchaser then "restored" the painting, the restoration including excessive overpainting which distorted the underlying figure. But the reduction in the value of *La Meditation* caused by excessive overpainting was more than offset by the advance in the art market generally and the market for Corot figure paintings specifically. Two months before the first charitable contribution, a Corot called *Girl in Red with Mandolin* was sold at auction for $310,000. The experts testifying at trial put the value of *La Meditation* at $40,000, $90,000 and $250,000 respectively. The AAP had valued *La Meditation* at $85,000. The trial judge rejected or discounted the testimony most favorable to the taxpayer as coming from a long-time friend and business associate. He likewise rejected or discounted the

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[136] In practice, knowledgeable participants in the art market may know who owns particular works and therefore deduce which way the valuation benefits may run.

[137] 1977 Annual Summary Report of Closed Meeting Activity of the Art Advisory Panel of the Commissioner of Internal Revenue, [1979] 9 STAND. FED. TAX REP. (CCH) ¶ 5975.

[138] 35 T.C.M. (CCH) 943 (1976).

[139] 595 F.2d 603 (Ct. Cl. 1979).

testimony of one government expert, Eugene Thaw, that the painting was worth $40,000—on the grounds that he had served on the AAP and therefore might be biased. The trial judge took the remaining expert value, $90,000, and adjusted it upward to give more weight to the sale of *Girl in Red with Mandolin*. He found a value of $160,000.

The Court of Claims thought the attribution of bias to Mr. Thaw improper. It found no reason to believe that an expert witness will cease to remain independent because of his service on the AAP. In this particular instance, Mr. Thaw's valuation of the painting, $40,000, was far below that of the AAP. There was no evidence that he felt constrained to support the AAP value. After giving substantial weight to his view, the Court of Claims cut the value to $125,000. As the Court of Claims recognized, a contrary finding regarding Mr. Thaw might well have discouraged experts from serving on the AAP. An imputation of personal bias might reduce volunteers for the AAP or the availability of expertise at trial.

Once the question of value enters the courtroom, the judge may be presented with difficult factual questions, inevitably obscured further by differences among experts. Among the most difficult is that of authenticity. Many artworks carry a cloud as to their origin. A work alleged to be that of an old master instead may be an outright forgery, a work from a student of the artist, or a work by an unrelated artist of the same period. Although the source would seem not to affect the aesthetic appreciation of the work, it does greatly affect price.

A number of cases have dealt with questions concerning authenticity of contributed works. In two instances in the Tax Court, Judge Tannenwald sidestepped deciding whether the work originated from the claimed source. Instead, he properly valued the work with the cloud created by reasonable doubts as to source, discounting heavily for serious uncertainties as to authenticity.[140] Absence of provenance contributed to the discount.[141]

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[140] *Cf.* Holtzmen v. Commissioner, [1980] Tax Ct. Mem. Dec. (P-H) ¶ 80,174 (similarly as to authenticity of ancient coins).

[141] In one case, Mathias v. Commissioner, 50 T.C. 994 (1968), there was doubt as to the authenticity of a painting, a purported Gilbert Stuart, and also as to the identity of the subject. Declining to resolve these doubts, Judge Tannenwald took these "blemishes" into account as depressants on value. He emphasized the absence of provenance as bearing on these depressants.

In Farber v. Commissioner, 33 T.C.M. (CCH) 673 (1974), *aff'd per curiam*, 76-1 U.S. Tax Cas. ¶ 9118 (2d Cir. 1975), the taxpayers donated a painting entitled *Susanna*, allegedly by Tintoretto, to Hofstra College (now Hofstra University). The painting was unsigned, but Tintoretto rarely signed his work. A fully authenticated painting by the artist, *Susanna and the Elders*, depicts the same nude female with other people, animals, and a different background. The experts at trial differed regarding the authenticity of the work; the taxpayers claimed a value of $150,000 and the Commissioner asserted a value of $2,000. The taxpayers offered no proof as to how and when they bought the painting or how much they paid for it. There was no provenance of the work or any mention of it in art literature or catalogs. Judge Tannenwald emphasized that settlement is more appropriate in connection with "inherently imprecise" valuation questions than submission to the court and again declined

A related and equally difficult fact question concerns restoration. Old works often need to be restored as paint flakes off or other wearing takes place. The quality of a restoration affects the work's value. In the two Tax Court cases referred to above, the paintings were examined under a "black light" to ascertain the amount of overpainting.[142]

Aside from subsidiary factual problems that relate to the condition or authenticity of the work, the important concept of fair market value itself as applied to artworks contains an ambiguity: the proper market for the art. The price for a work will vary depending on whether the purchaser buys it directly from the artist, through a gallery, or at auction; and often there may be geographic differences in markets as well. The regulations state the classic formulation of fair market value—the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.[143] Also, they direct that if the property contributed is of the same type the taxpayer regularly sells in the course of his business, then value shall be determined by reference to the price usually received in his customary market.[144] Furthermore, if a donor makes a charitable contribution of property at a time when he could not reasonably have expected to realize its normal selling price, the value of the gift is the actual amount he could have obtained.[145] These general rules, although useful in some situations, may afford little guidance in valuing charitable donations by collectors. Suppose, for example, a collector buys a work directly from an artist for $500. Later when a similar work of the same artist is offered for sale by a gallery for $1,200, the collector gives his work to a museum. Does the gallery offering price reflect the best estimate of value, or may the government discount that price by the substantial commission, perhaps half the selling price, that the gallery will earn on the sale?

Sometimes the taxpayer gives the charity less than his complete interest in the work in the form of an undivided fractional interest.[146] This form of gift may provide a convenient way around the percentage limitation on contributions provided by the Code.[147] Donors, the Service, and the

to make any determination as to authenticity. *Id.* at 674. Instead, he took account of the conflict as a serious depressant on value. On the basis of the entire record, Judge Tannenwald found a value of $10,000.

[142] Furstenberg, 595 F.2d 603, involved a substantial reduction in value for bad restoration. *See* text accompanying note 139 *supra*.

[143] Treas. Reg. § 1.170A-1(c)(2), T.D. 7340, 1975-1 C.B. 81. *Cf.* Treas. Reg. § 20.2031-6 (1964) (valuation for estate tax purposes).

[144] Treas. Reg. § 1.170A-1(c)(2), T.D. 7340, 1975-1 C.B. 81.

[145] *Id.* § 1.170A-1(c)(3).

[146] The gift must satisfy the current possession requirement of § 170(a)(3) in order to qualify for the deduction. This condition is met if the charity has possession for a period proportionate to its undivided fractional interest. Treas. Reg. § 1.170A-5(a)(2) (1972). For gifts made after 1969, the requirements of § 170(f)(3)(B)(ii) must also be met in order to obtain the deduction.

[147] I.R.C. § 170(b)(1)(A), (B), and 170(d) fix maximum charitable contribution deduction limits of 20, 30, or 50% of the individual's contribution base—generally, his adjusted gross

courts all seem to presume for valuation purposes that the deductible amount is the proportionate share of the whole work:[148] an undivided one-quarter interest in a sculpture worth $50,000, for example, is valued at $12,500. Yet for other tax purposes, including the analogous case of intrafamily transfers, a discount from the proportionate value for a minority interest is understood to be appropriate. Thus, for estate tax purposes, the Service routinely reduces the taxable value of minority interests.[149] The Service properly should seek a similar discount here.

A related problem concerns restrictions placed by the donor on the use of the property by the charity. Donors occasionally limit the charity's freedom to deal with the gift. They may provide that the charity cannot sell a painting or even that it must be displayed in a particular way. The charity receives less than the full value of the work: an unrestricted work plainly is worth more than a restricted one to the recipient. Yet there is no evidence that the reduction in value to the charity attributable to the restrictions is taken into account in valuing the gift for deduction purposes.[150] The argument for reduction of the deductible amount is clear: the charity gets less than full ownership so the donor should deduct only the value of the benefit he has conferred.

Such restrictions on the charity's use do not mean the donor has retained an interest in the work. If he had, the entire deduction may be denied under section 170(f)(3). The regulations qualify a gift with a condition limiting the charity's freedom to deal with it only if the donation conveys the donor's entire interest. The regulation test is whether the possibility that the charity will lose the work by reason of the condition is so remote as to be negligible.[151] But it does not follow that simply because this test can be passed the charity has received the full value of the work; an adjustment in the amount of the deduction to reflect any reduction in value should be required.

More generally, the collector's ordinary deduction based on untaxed appreciation rests on no sound theoretical foundation. Its justification lies in a series of untested assumptions about empirical matters: the asserted inducement to collectors to alter their behavior and make donations to museums and the belief that institutions would not otherwise obtain the

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income—depending upon the nature of the charity and the type of property donated. The excess can be carried forward in some cases. I.R.C. § 170(d).

[148] *See, e.g.*, Furstenberg, 595 F.2d 603.

[149] Tishman v. United States, 207 F. Supp. 830 (E.D. Va. 1959); Chertkoff v. Commissioner, 72 T.C. 1113 (1979); Campanari v. Commissioner, 5 T.C. 488 (1945). For a discussion of the analogous problem for stock in a closely held corporation, see Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares*, 122 U. PA. L. REV. 934 (1974). *See also* Cooper, *A Voluntary Tax? New Perspectives On Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 170-77 (1977). *But see* McColgan v. Commissioner, 10 B.T.A. 958 (1928).

[150] In Gordon v. Commissioner, 35 T.C.M. (CCH) 1227 (1976), the parties stipulated that certain unnamed restrictions reduced the value of the work by 13%. *See also* Silverman v. Commissioner, 27 T.C.M. (CCH) 1066, 1075 (1968).

[151] Treas. Reg. § 1.170A-7(a)(3) (1972); § 1.170A-1(e), T.D. 7340, 1975-1 C.B. 116.

amount and quality of works they presently do. But the tax cost to the Treasury may be far greater than previously believed when all of the imperfections in the valuation process that the collector can exploit are taken into account. And the benefits to institutions may be diluted when undue donor influence on the operation of the institution is considered.[152] Even if the unrealized appreciation rule were altered, as I propose in Part V, a range of other federal tax incentives—notably retention of the ordinary deduction for gifts out of previously-taxed income and the estate tax charitable contribution deduction[153]—and nontax incentives—including personal benevolence—would assure art institutions a continued flow of gifts. Any shortfall could be adjusted at less cost to the Treasury through direct grants.

B. *The Artist*

Prior to the 1969 TRA, the statute treated the artist in the same fashion as the collector and allowed a deduction for the full fair market value of works donated to charity. In some instances, valuation was contested.[154] The TRA added section 170(e)(1)(A),[155] a provision that reduces the amount of the charitable deduction dollar for dollar by any gain that would have been ordinary had the donor sold the property instead. An artist's sale of his own works gives rise to ordinary gain.[156] The new provision thus reduces the artist's deduction to adjusted basis, frequently zero or a nominal amount.

The present rules painfully contrast the charitable deduction treatment of artists and collectors. The theoretically proper rule—disallowance of deductions for untaxed appreciation—applies in full vigor to artists but not at all to collectors. This result flows from the distinction between ordinary income appreciation and capital gain appreciation drawn by section 170(e)(1)(A): the collector's untaxed gain is property income, the artist's is services income.

If the artist could avoid the ordinary asset treatment of section 1221(3), the reduction in section 170(e)(1)(A) no longer would apply. Two possibilities for accomplishing this were suggested earlier. When the artist sells a work to his spouse or other related person in an arm's length sale, the spouse takes the work free of the section 1221(3) characterization.[157]

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[152] The impact of donor influence on the tax expenditure portion of the gift is analyzed in a study prepared for the Twentieth Century Fund by Feld, O'Hare, & Schuster, tentatively titled "Public Money and Private Choice; The Case of Indirect Aid to the Arts" (forthcoming).

[153] I.R.C. § 2055.

[154] *See, e.g.*, Rebay v. Commissioner, 22 T.C.M. (CCH) 181 (1963) (value reduced from $169,000 to $9,300). In some cases, the courts sustained the artist's value. *See, e.g.*, Cambridge Hotels, Inc. v. Commissioner, 27 T.C.M. (CCH) 1411 (1968); Kuderna v. Commissioner, 24 T.C.M. (CCH) 749 (1965).

[155] Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a), 83 Stat. 487 (codified at I.R.C. § 170).

[156] I.R.C. § 1221(3). *See* text accompanying notes 23-33 *supra*.

[157] *See* text accompanying notes 35-46 *supra*.

If the spouse holds the work for more than a year, gain on a sale would be treated as long-term capital gain. If the spouse instead donated the work to charity, section 170(e)(1)(A) would not apply and the deduction would equal fair market value. This result obtains even when artist and spouse file a joint return. The result is justified for the same reason that capital gain treatment to the spouse upon sale is justified. The artist pays ordinary income tax on his services income when he sells the work to his spouse. The excess over this amount plausibly can be treated as an increment accruing to capital gains. One function of section 170(e)(1)(A) is to obviate the possibility that a charitable contribution would net the taxpayer more in tax savings than a sale would net him in after-tax proceeds. Section 170(e)(1)(A) meets these objectives as applied to the spouses' contribution.

Another approach to the artist's avoidance of section 1221(3) lies in the section 1031 like-kind exchange provisions.[158] If the artist can meet the statutory tests, the work he receives on the exchange would obtain capital asset treatment under section 1221(3) and a subsequent donation of the work to a charity might thus escape section 170(e)(1)(A). But as we have noted,[159] this approach should not succeed because it defeats the purposes of section 1221(3) in that the increment representing the artist's services will never be taxed at ordinary income rates.

If the artist or his family can avoid ordinary income characterization, he assumes the same tax posture as a collector and the problems of valuation, condition, and restrictions discussed in reference to collectors will arise. In the usual case, however, section 170(e)(1)(A) precludes any tax advantage for artists through charitable gifts of appreciation in artworks and these problems are largely absent.

V. PROPOSALS

As we have seen, the different treatment accorded the art collector and the artist under the federal income tax derives largely from the different sources of their investment in the work. Consistently with the generally accepted distinction between personal services income and gains on the sale of property, it seems appropriate to tax the artist at ordinary rates on his personal services income and to afford the collector the more favorable capital gain benefit on the return of his after-tax investment. The general appropriateness of this treatment breaks down in two areas—the failure to acknowledge the artist's position as an investor and the overly generous treatment of gifts by collectors to charity.

A. *An Artist's Election*

The artist has no assured way of converting his before-tax services investment in a work into a capital, after-tax investment by electing to pay the tax. We have noted two possible ways to achieve this result, the

[158] *See* text accompanying notes 117-26 *supra*.
[159] *See* text accompanying note 126 *supra*.

interspousal sale and the like-kind exchange. As we have seen, the results under neither approach are assured under current law. Moreover, one of the two approaches mentioned—the like-kind exchange—appears to defeat rather than accord with the statutory scheme. Finally, both approaches are theoretically unsatisfactory in that they make the artist's tax status turn on a fortuity—a spouse or other family member with an independent estate or another artist in whose works the taxpayer wishes to invest. A statutory device to permit the artist to pay taxes on his personal services and commence a position as an investor in his own work would be far preferable.

I propose a statutory election to permit the artist to include the fair market value of the work, less basis, in income in the year the work is completed as if he had sold it.[160] The value so included would become the artist's basis for purposes of taxing future gain or loss. Once the artist makes the election, the work would fall out of section 1221(3). The artist's holding period for capital gain and loss purposes would begin with the election. This approach is not foreign to our tax laws.[161]

The income tax benefits of the election to the artist would extend to several areas. First, a sale after a year would produce capital gain rather than ordinary income. After a year, the artist could give the work to charity without reduction of the deductible amount under section 170(e)(1)(A). In addition, the artist could meet the threshold holding-for-investment requirement of section 1031 and could diversify his portfolio of artistic works without paying additional tax. Since the artist will have paid his tax under the election, the purposes of the statutory scheme would be met. Finally, the artist's election could extend to cover characterization under the source rules for foreign income.[162]

From the Treasury's perspective two objections should be considered. On a practical level, an artist would have a strong incentive to value the work too low and thereby convert some services income into capital gain. The Treasury would have traditional audit remedies available to it and could adjust values. But as we saw in connection with works held by collectors, valuation is likely to be more difficult here than in other tax areas. Unlike a collector who gives the work away, however, the artist retains the work and any later sale or donation by the artist gives rise to a sale price or fair market value for a deduction that would be of some evidentiary value in judging the earlier value claimed. Moreover, for the successful artist, there would be sales of comparable works in most years

[160] *See* Feld, O'Hare, & Schuster, *supra* note 152, at ch. X. As noted below, the statute could limit the election to a percentage of the artist's other income realized from his artworks if an unlimited election is thought to be too broad.

[161] I.R.C. § 83(b) currently allows for a similar election in the year of property transfer when a person performs services and receives property subject to a substantial risk of forfeiture in exchange.

[162] In the view of one District Court, a change in the character of post-election income to capital gain apparently would not of itself alter the source rule result. AMP, Inc. v. United States, 79-2 U.S. Tax Cas. ¶ 9606 (M.D. Pa. 1979).

that would narrow the range of appropriate values. These remedies could be supplemented by express provision for adjustment of the value placed on the work by the artist at the time of the later sale or other disposition of the work. Such a look-back might contain a safe-haven rule that would give the artist the benefit of an assumption that the work increases in value at a fixed rate of compound interest from the date of the election.[163] For example, it might be assumed that the value of the painting increases at an eight percent compound rate of interest from the date of the election and that on a subsequent sale or contribution of the property a value that reflects such an increase would be accepted for income tax purposes.

If further deterrence against undervaluation is needed, the election might require as a condition that the artist offer the work for sale at the price he elects. If the artist sets the price too low in order to avoid income taxes, he runs the risk of losing the painting at a bargain price.

A second objection to the election is more theoretical. Assuming that the election properly separates services income from gain on property, why should the latter necessarily be treated as capital gain? As we noted at the outset, gain on appreciation of a work of art in the hands of the artist may be thought to constitute an inventory-type gain rather than an investment-type gain.[164] But once the services component is included in income, the need to classify the gain under section 1221(1) diminishes. By reason of the holding period, long-term capital gain treatment will apply only to a sale more than a year after the election; this makes an investment motive rather than a sale motive more plausible. Moreover, although the income tax pretty firmly prevents the conversion of services income into capital gain,[165] there are exceptions that expressly grant capital gain treatment to gain on property held primarily for sale.[166] These considerations, however, are not conclusive. At bottom, a decision to characterize as investment return the artist's gain that exceeds the value of his creative services reflects a judgment that an artist's business generally consists of creating works for immediate sale. Retention of a work reflects an investment in it rather than entry into a related but new business of trading in the works.[167] The income tax has allowed capital treatment in the analogous cases of others who deal in investment assets, such as real estate dealers and brokers who deal in stock and securities.[168] To guard against taxpayers treating gains as capital and losses as ordi-

[163] Section 1023(h)(3)(B)(ii), now repealed, *see* note 29 *supra*, would have operated in a similar fashion. The § 482 regulations also provide similar safe-haven rules.

[164] *See* text accompanying notes 28-33 *supra*.

[165] *See, e.g.*, Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974); United States v. Frazell, 335 F.2d 487 (5th Cir. 1964).

[166] *See, e.g.*, I.R.C. §§ 1231(b)(2), (3), 1237.

[167] The artist may view retention as a failure to sell rather than as an investment. But the "failure" usually reflects an unwillingness to sell below a particular price. Like any investor, the artist pits his sense of the "right" price against the current market.

[168] I.R.C. § 1236.

nary, classification of the property from the outset as a capital asset, or denying that classification, is essential. The proposed election implicitly provides for such classification. Note that the characterization as an investment rather than as inventory need not be taken on an all or nothing basis covering all of the artist's works. The artist's election could be limited to some percentage of his total arts income or in some other respect.

B. *Charitable Gifts of Appreciated Property*

A second proposed change concerns the treatment of collectors.[169] The rule permitting a fair market value deduction for charitable contributions of appreciated property results in permanent loss of tax on the accrued gain. The argument in support of the rule rests on the additional incentive it creates for donors to make contributions. This incentive varies with the marginal tax bracket of the donor and with the amount of appreciation, so that the most successful and wealthiest investors get the largest tax benefits from the rule. Furthermore, contrary to the general discussion in the literature, we have seen that the tax benefit may not be limited to the tax foregone on the appreciation; by reason of defects in the valuation process,[170] an unintended part of the incentive in fact may consist of deductions claimed for nonexistent appreciation through inflated valuations.

A more appropriate result, one that is more consistent with the treatment of untaxed gain elsewhere in the Code, would reduce the amount of the contribution for deduction purposes in a manner similar to the mechanism now provided by section 170(e)(1)(B). The contribution would be treated, in effect, as a sale coupled with a contribution of the proceeds of the sale: the donor includes in income the amount of the gain, deducts sixty percent of the gain under section 1202 for the sale of a capital asset, and deducts the fair market value of the property. Instead of doing so in three steps, however, the donor simply deducts fair market value less forty percent of the gain—the net result of the above three steps.

This solution would mitigate but not eliminate the problem of donor overvaluation of contributed artworks. If excess valuation is as systematic, widespread, and difficult to control as Professor Speiller has suggested,[171] a more stringent limitation on the charitable contribution of property in kind is called for. A limitation of the amount of the deduction to the collector's investment, *i.e.*, basis, allowing no benefit for appreciation, would obviate the valuation question. To be sure, a collector who holds a work that has in fact appreciated significantly then would do better by selling the work, recognizing the gain, claiming the capital gains deduction, and contributing the proceeds of sale to the charity, than he would

[169] If the artist's election is adopted, the artist will be treated like a "collector" for purposes of the proposed change in treatment of charitable gifts.

[170] *See* text accompanying notes 131-51 *supra*.

[171] *See* Speiller, *supra* note 132, at 238-40. Anthoine tends to minimize the enforcement difficulties produced by this problem. *See* Anthoine, *supra* note 17, at 275-79.

by donating the work. Requiring the collector to take this additional step is far from outlandish. The market would give a more accurate reading of the work's value than the collector and his appraiser together are likely to provide. In addition, the charity may be better off if it receives cash to buy works of its own selection as opposed to accepting gifts of art selected by a collector that may carry with them an implied undertaking by the museum to hold and display rather than sell immediately in the market.

Critics of proposals to limit the charitable deduction for contributions in kind do not defend the present treatment as theoretically correct. Instead, they point to incentives that they claim the deduction creates for individual collectors to enrich public art institutions. Any alteration of the rules, they say, will impoverish these institutions by depriving them of private gifts. The weakness of this defense is both empirical and theoretical. No reliable data supports their assertions: none exists as to the annual amount of appreciation that enters the charitable contribution deduction for gifts in kind, let alone what the effects of a reduction or elimination of these tax benefits on the amount of charitable gifts to the arts would be. Doubtless, feelings of personal benevolence, social pressures, estate tax concerns, and a variety of other non-income tax incentives would continue to call forth some gifts to museums, and the reduction in the level of contributions might well be small.[172]

We should also pause to reflect whether we aid museums better by encouraging gifts of appreciated property or gifts of cash. Gifts of property might well divert from the choices that otherwise would be made in the professional judgment of curators and other museum staff.[173] The tax benefits provided by the government—indirectly paid for by every taxpayer—may in fact subsidize only an accumulation of second rate *objets d'art* to be stored in museum basements. Under the proposed change in the law, a donor who desires to place a particular object with a museum may of course continue to do so, but without the present high cost to the government. Finally, if a reasonable estimate of loss to art institutions by reason of the proposed change in the charitable deduction rules can be made, the government simply can compensate the institutions for the loss through direct grants.

VI. CONCLUSION

This article has traced the different income tax consequences to collectors and creators of art through a number of their common transactions such as the sale of works at a gain, exchanges, and gifts to charity. We

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172 For 1973, data from the Commission on Private Philanthropy and Public Needs, National Study of Philanthropy (1974), analyzed by Feld, O'Hare, & Schuster, *supra* note 152, at Table III.3, shows that gifts in kind constituted about 10% of all charitable gifts. For gifts to culture, however, they amounted to about 57% of the total of $325 million. What proportion of the gifts in kind represented gain is not known, nor does the data distinguish art objects from other appreciated property, such as corporate stock.

173 *See* Feld, O'Hare, & Schuster, *supra* note 152, at ch. 6.

have also examined the deductibility of certain expenses incurred by these taxpayers. I have concluded that the different tax treatment afforded collectors and artists is generally appropriate, owing to the different sources of the taxpayer's income. The artist's income is equivalent to everyday wages—the fruit of personal services—and is taxed accordingly. The collector realizes gain on the investment of after-tax income and is taxed consistently with that status.

I have discussed two areas where the Code could be improved. An artist should be allowed to assume the position of an investor in his own works—and obtain the tax treatment that accrues to that classification—once he has completed the work. This would be consistent with other Code provisions. Furthermore, gifts by collectors to charity currently receive unduly favorable treatment. The current rules are difficult to administer and are amenable to taxpayer abuse. The commonly accepted goal of support for museums could be met without the problems discussed. I have suggested changes in the statute to conform these problem areas with the rest of the statutory scheme while preserving their stated objectives. Tax provisions can never attain the sensitivity and elegance of art itself, but those who work with them can aspire to greater internal consistency, clarity, and equity.

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