

# ART AND THE ESTATE: WHY PLANNING IS IMPORTANT, PART I – U.S. TAXPAYERS

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## Tags

Artwork  
Estate Planning

*“I’m not afraid to die, I just don’t want to be there when it happens.”*

– Woody Allen

The painting you bought when you were a student may worth something today. Or maybe you have accumulated a collection of artwork that has a significant value. If you acquired the artwork for your living room, you should be aware of the consequences of having such valuable assets in your estate. In this article, we will outline various options available to deal with expensive artwork in the family, mostly concentrating on the rules applicable to collectors and the relevant planning tools.

## WHO ARE YOU?

Taxpayers that hold valuable art receive different tax treatment depending on their characterization: artist, dealer, investor, or collector. The difference is not always clear; each case must be carefully analyzed.

Simply put, an “artist” is an individual who creates the artwork. When any artist sells his or her work, it is taxed as an ordinary income. This ordinary income treatment is not limited to the artist. If the artist gifts the art, the art will be ordinary income property in the hands of the donee.

A “dealer” is someone who engages in the trade or business of selling works of art, primarily to customers. “Trade or business” means an activity that is conducted with continuity and regularity and with the primary purpose of making a profit. If a dealer sells artwork it is treated as ordinary income and not as capital gain. Even though the dealer does not get to use the preferred capital gains rate, he or she has the advantage of deducting all ordinary and necessary expenses related to the dealing.<sup>1</sup>

An “investor” is someone who buys, sells, and collects the artwork primarily for investment, rather than for personal use and enjoyment (or as a trade or business). The key is whether the taxpayer is engaged in the investment activity with the primary objective of making a profit.<sup>2</sup> When the artwork is sold, the investor has a capital gain. In addition, an investor can qualify for a like-kind exchange and also deduct ordinary and necessary expenses related to the art investment.<sup>3</sup>

And finally, a “collector” is a someone who buys and sells art primarily for personal pleasure or recreation. Similar to the investor, a collector’s gain on a sale of artwork is treated as capital gain. While collectors can deduct ordinary and necessary

<sup>1</sup> Code §§162, 165(c)(1).

<sup>2</sup> Treas. Reg. 1.183-2(2)(b).

<sup>3</sup> Code §212.

expenses attributed to the artwork as miscellaneous itemized deductions, the deduction is limited to the profits generated from the artwork.<sup>4</sup>

## HOW DO YOU PLAN?

No matter who you are and what your goals are, careful planning is very important. If you are a collector and hold expensive artwork at the time of your death, its full fair market value will be included in your estate and a 40% Federal estate tax will be levied on the amount above the lifetime gift amount (\$5.49 million in 2017). Here are a some of the planning options available to collectors:

### **Sale of Artwork During Lifetime**

As mentioned above, collectors can benefit from capital gains treatment when selling artwork. It is important to know that the I.R.S. does not treat capital assets all the same. Artwork is considered to be a “luxury asset” that is considered to be a collectible. The I.R.S. defines “collectible” as any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible personal property specified by the Secretary.<sup>5</sup> Net capital gain from selling collectibles is taxed at a maximum rate of 28%.

### **Gift or Bequest**

Another strategy available to collectors is to gift the artwork. Taxpayers may lower the value of their estates without realizing gain on the gift. Generally, taxpayers have an annual gift exclusion amount that can be gifted to each donee each year. In the 2017 calendar year, the annual gift exclusion is \$14,000 (or \$28,000 for a married couple). If the value of the artwork is higher than the gift exclusion amount, the difference will be counted toward the lifetime gift amount. The basis of the donee is the same as in the hands of the donor. Nevertheless, the transaction may still be beneficial if the donee is in a lower tax bracket than the collector.

Collectors can also transfer the ownership of artwork by bequest. A bequest involves property given by will or estate plan. If a collector makes a bequest of artwork, it will be included in his or her estate at the time of the death. This may be beneficial if the estate is below the lifetime exclusion amount. Generally, artwork bequeathed to a beneficiary will receive a step-up basis, and if the artwork is below the exclusion amount, it can be transferred without estate tax while receiving a step-up basis. However, if the estate is above the exclusion amount, the estate will have to pay the 40% Federal estate tax and state estate tax on the full value of the artwork.

Alternatively, the collector can utilize the unlimited marital deduction when leaving artwork to a surviving spouse. The property can either be given directly or through a qualifying trust. The art will then receive a step-up basis in the hands of the surviving spouse.

### **Donation to a Charitable Organization**

Taxpayers can receive a deduction on their tax returns for artwork donated to a charity. The amount of the deduction varies depending on the type of taxpayer.

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<sup>4</sup> Code §§67(a), 183(b).

<sup>5</sup> Code §408(m)(2).

A collector can deduct the full fair market value (“F.M.V.”) of the donated artwork as long as it is (i) donated to a charitable organization and (ii) the charitable organization uses the artwork for a purpose related to its tax-exempt status.<sup>6</sup> This deduction is limited to 30% of the collector’s adjusted gross income (“A.G.I.”). If the charitable organization does not use the artwork for a related purpose, the collector is limited to the adjusted basis of the donated artwork, and the deduction is limited to 50% of A.G.I. When the value of the donated artwork exceeds the amount deducted, the remaining value can be carried forward up to five years.<sup>7</sup> When artwork is donated to the charity at death, the full value of the art can be deducted on the estate’s tax return without any percentage limitation.



Bear in mind that if a public charity sells the artwork within three years of its receipt, the collector must amend the tax return to reflect the cost base value as a deduction and not the full value of the property at the time of donation. It is important, therefore, to restrict the charity from making such a sale.

In addition, the other drawback of donating artwork to a charitable organization is that the collector is permanently giving up the ownership. In such cases, it is important to choose the right charity to donate that artwork. Alternatively, some collectors choose to retain partial possession of the artwork and delay the transfer of full title to the charitable organization. A collector can transfer a fractional interest in artwork to a charitable organization, retaining the remainder interest that will be transferred over time. The transfer of the remaining interest must be completed within ten years.<sup>8</sup> The transfer provides an F.M.V. deduction at the time of the transfer for an undivided interest that was transferred. If the value of the artwork increases over the ten-year period, the deduction value is capped at the time of the initial donation.

### **Formation of an Art Foundation**

In theory, for a very large collection consideration can be given to create an art foundation (*i.e.*, museum). An art foundation is a private operating foundation described under Code §4942(j)(3). The foundation has to dedicate the majority of its resources to conducting tax-exempt activities. There are certain benefits associated with this transaction. A collector can retain control over the artwork, making sure the donated artwork is used for purposes related to the art foundation’s tax-exempt activity. This will provide an F.M.V. deduction to the donor, which will still be limited to the 30% of A.G.I. If the artwork is later sold by the art foundation, it does not pay capital gains tax for any gains realized. Furthermore, an art foundation is not subject to state and local tax.

## **CONCLUSION**

It is often the case that a person may be unaware of the full value of artwork. Don’t be that person that forgets about the art on the walls, only to discover its real value when it is too late to implement an estate plan. Find out the value of your work, and plan accordingly. Understanding the rules associated with the sale or donation of artwork is an important key.

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<sup>6</sup> Code §170(b).

<sup>7</sup> Code §170(d).

<sup>8</sup> Code §170(o).