The Art Collector Meets the Tax Collector

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An increasing number of taxpayers today view their art and other collections as investments, and look to their collections for financial gain. When a collection is used as an asset to be borrowed against, sold, exchanged, or gifted, of course tax wrinkles arise. This article explores various methods of disposing of art and other collectibles, detailing the pros and cons of each alternative, including related tax plusses and pitfalls.

Introduction

Investing today is more complicated than ever. “Alternative investments” are of interest to an increasing number of investors. Among the new asset classes are art and other collectibles. Traditionally, collecting has been the province of passionate individuals. Now the interest in collecting has extended beyond passion to the investment quality of objects. In addition to providing personal pleasure, individuals are looking to their collections for financial gain as well—using the collections as assets to borrow against, sell, exchange, gift, and otherwise create value, just as they would any other assets. This article explores some of the various alternative methods of disposing of art and other collectibles and sets out the advantages and disadvantages of each alternative, including the special nature of the taxation of collectibles.

Taxable Sales of Collectibles

An individual holding a work of art or other collectible has the option of selling the piece to another party. This sale triggers a tax on the gain, if any, equal

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to the difference between the selling price and the individual’s basis in the property sold. The applicable income tax rate and the availability of deductions will depend on the status of the taxpayer and the nature of his or her activity. Accordingly, it is important to understand the distinctions among the three classifications of taxpayers, and how they affect the tax consequences of the sale.

**Defining Dealers, Investors, and Collectors.** The tax consequences are dependent upon how the taxpayer is classified, as discussed below.

**Dealers.** A dealer is someone who is engaged in the trade or business of selling works of art, primarily to customers. In 1987, the United States Supreme Court stated, in *Commissioner v. Groetzinger*, that in order to be engaged in a trade or business the taxpayer must be involved in the activity with continuity and regularity. Furthermore, the taxpayer’s primary purpose for engaging in the activity must be for income or profit. Mere investment activities do not qualify as a trade or business. Art or other collectibles held in the hands of a dealer are considered inventory.

**Investors.** By contrast, an investor is someone who buys and sells works of art or other collectibles primarily for investment, rather than for personal use and enjoyment or as a trade or business. “Primarily” has been interpreted to mean of first importance. The central inquiry in determining whether an individual is an investor is whether the individual is engaged in the investment activity with the primary objective of making a profit. Art or other collectibles held in the hands of an investor are considered capital assets rather than inventory.

*Wrightsman v. United States,* decided in 1970, provides insight into the inquiry process used to determine whether a person holds art for investment purposes. The Wrightsmans began collecting eighteenth century French art, which, according to the Wrightsmans, developed into an investment activity. To determine whether costs incurred in maintaining their art collection were deductible under Code Section 212, the Court of Claims engaged in a highly factual inquiry, considering factors such as the Wrightsmans’ personal lives and extensive personal use of the art. The court ultimately denied the deduction, pointing out that the Wrightsmans

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3 Id.

4 Higgins v. Comm’r, 312 U.S. 212 (1941).

5 428 F2d 1316 (Ct. Cl. 1970).

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had the burden of proving that they acquired and held the works primarily for investment.6

Treasury Regulation Section 1.183-2(b) provides additional guidance, which may be cited to establish whether an activity is engaged in for profit, by setting forth a number of factors similar to the indications of investment activity listed in Wrightsman. These indications of investment intent include:

- The manner in which the taxpayer carries on the activity;
- The expertise of the taxpayer or his advisers;
- The time and effort spent by the taxpayer in carrying on the activity;
- The expectation that the assets may appreciate in value;
- The taxpayer’s success in carrying out the activity;
- The taxpayer’s history of income or losses with respect to the activity;
- The expectation of future profit; and
- The elements of personal pleasure and recreation.

It is important to keep these factors, as well as those mentioned in Wrightsman, in mind when determining whether a given taxpayer qualifies as an investor in collectibles.

Collectors. A collector is an individual who buys and sells works of art or other collectibles primarily for personal pleasure. Art or other collectibles held in the hands of a collector are considered capital assets rather than inventory.

Applicable Tax Treatment. Once a taxpayer’s status is known, the applicable tax rates and availability of deductions can be determined.

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6 In Wrightsman, the dissent noted that the case was a very close one and pointed out several factors that could help establish investment intent. These factors included the taxpayers’ desire to find an investment that would act as a hedge against inflation, the taxpayers’ businesslike recordkeeping system, and the little time that they spent at home with the majority of their collection. Other courts have examined various factors in determining whether a transaction is primarily from the operation of a business or from investment, including: (1) the purpose for which the property was acquired; (2) the purpose for which it was held; (3) the frequency, continuity, and substantiality of sales; (4) the duration of ownership; (5) the use of the proceeds from the sale of the property; (6) the business of the taxpayer; and (7) the time and effort that the taxpayer devoted to sales activities relating to the asset in question by developing or improving that asset, soliciting customers, and advertising. See, e.g., David Taylor Enters., Inc. & Subs. v. Comm’r, TC Memo 2005-127; Bramblett v. Comm’r, 960 F2d 526 [69 AFTR 2d 92-1344] (5th Cir. 1992); Maddux Constr. Co. v. Comm’r, 54 TC 1278 (1970); Ralph J. Oace v. Comm’r, 39 TC 743 (1963); and James G. Hoover v. Comm’r, 32 TC 618 (1959). None of the above factors are conclusive standing alone, but rather all of the factors taken as a whole govern. W.T. Thrift, Sr. v. Comm’r, 15 TC 366 (1950).
**Income Tax Rates.** It is important to note that the tax rate upon disposition of art or other collectibles will differ depending on whether a person is a dealer, investor, or collector.\(^7\) As noted above, a dealer is engaged in a trade or business, and therefore the dealer’s works of art and collectibles are considered inventory. Upon disposition, a dealer is taxed on the gain from the sale of property at ordinary income tax rates, up to a maximum of 35 percent. By contrast, an investor or collector is taxed on the gain from the sale of collectibles held for more than one year at the long-term capital gains rate of 28 percent.\(^8\) If an investor or collector holds collectibles for one year or less, the gain is generally treated the same as ordinary income. The spread between the 28 percent capital gain tax rate and the 35 percent ordinary income tax rate provides a tax advantage for those who can make their transactions qualify for capital gain treatment.

**Deductibility of Expenses and Losses.** Classification as a dealer, investor, or collector also determines whether the individual can deduct his or her ordinary and necessary expenses incurred in connection with the property and any losses upon disposition. Maintaining a collection in good condition is expensive, and taxpayers have an incentive to deduct these expenses.\(^9\) The Internal Revenue Code provides guidance for each classification in order to determine the deductibility of expenses and losses.

**Deductions Available to Dealers.** Pursuant to Section 162, dealers can deduct the ordinary and necessary business expenses incurred in their trade or business,\(^10\) and also can deduct any ordinary losses under Section 165(c)(1).\(^11\)

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\(^7\) IRC § 408(m)(3) specifically excludes the following from the definition of “collectible”:

(A) any coin which is—
   (i) a gold coin described in paragraph (7), (8), (9), or (10) of section 5112(a) of title 31, United States Code,
   (ii) a silver coin described in section 5112(e) of Title 31, United States Code,
   (iii) a platinum coin described in section 5112(k) of Title 31, United States Code, or
   (iv) a coin issued under the laws of any State, or

(B) any gold, silver, platinum, or palladium bullion of a fineness equal to or exceeding the minimum fineness that a contract market (as described in section 7 of the Commodity Exchange Act, 7 U.S.C. 7) requires for metals which may be delivered in satisfaction of a regulated futures contract.

\(^8\) IRC § 1(h)(4)(A)(i). Note that the sale of capital assets held for more than one year which are not “collectibles” is generally taxed at a capital gains rate of 15 percent in 2012 and, if Congress does not act, this rate is scheduled to increase to 20 percent in 2013 and thereafter. The term “collectible” is defined as any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage or any other personal property which the Secretary of the Treasury designates. IRC § 408(m).

\(^9\) These expenses can include framing, reframing, lighting, air conditioning and humidity control, cleaning, security, insurance, and other similar expenses.

\(^10\) IRC § 162.

\(^11\) IRC §165(c)(1).
More Limited Deductions Available to Investors. Under Section 212, an investor who buys and holds works of art primarily for investment can deduct the ordinary and necessary expenses incurred in connection with property held for the production of income.\(^{12}\) A taxpayer who is able to deduct related expenses under Section 212 can claim these deductions as a miscellaneous expense on Schedule A of Form 1040. However, Section 67(a) limits the deduction for such expenses to amounts that, together with other miscellaneous itemized deductions, exceed 2 percent of the taxpayer’s adjusted gross income.\(^{13}\)

For an investor, qualifying for a deduction of expenses under Section 212 does not guarantee that a loss upon disposition will be deductible under Section 165(c)(2). To qualify for deductions under Section 165(c)(2), the taxpayer must prove that the transaction was entered into for profit.\(^{14}\) The test for deductibility of a loss under Section 165(c)(2) is stricter than that required for the deduction of expenses under Section 212. Therefore, an investor may have a more difficult time qualifying for a loss deduction.

Very Limited Availability of Deductions for Collectors. Unfortunately for the collector, Section 262 specifies that expenses in connection with activities as a collector constitute nondeductible personal expenses.\(^{15}\) Section 183(a) further limits deductions of losses from activities not engaged in for profit.\(^{16}\) However, all hope is not lost for collectors. Section 183(b) allows collectors to claim deductions for expenses attributable to an activity not engaged in for profit up to the amount of the gross income derived from the activity.\(^{17}\) To take advantage of Section 183(b), the collector must first deduct items, such as interest and taxes, that are allowable without regard to whether the activity is engaged in for profit. Expenses that are deductible under Section 183(b) are subject to the 2 percent rule of Section 67(a), which limits miscellaneous deductions to amounts that exceed 2 percent of adjusted gross income.\(^{18}\)

A collector generally cannot deduct a loss on the sale of a collectible, but can look to Section 183(b) for some relief. A collector who can prove that the collection is an activity within the meaning of Section 183 will be able to

\(^{12}\) IRC § 212.
\(^{13}\) IRC § 67(a).
\(^{14}\) IRC § 165(c)(2).
\(^{15}\) IRC § 262.
\(^{16}\) IRC § 183(a).
\(^{17}\) IRC § 183(b).
\(^{18}\) Taxpayers should be aware that the regulations contain detailed provisions on how to calculate the gross income from an activity for purposes of determining the amount available to offset deduction items.
deduct his or her capital losses under Section 183(b) up to the amount of the gross income derived from the collection during the taxable year, after first subtracting such items as interest and taxes that are otherwise deductible. Accordingly, capital losses from the sale of collectibles can be used to offset capital gains from the hobby under Section 183(b).

**Sales and Use Taxes.** Sellers of art and other collectibles should keep in mind that state or local law may require the seller to collect sales tax from the purchaser and remit the tax to the appropriate jurisdiction. Generally, a seller who is engaged in the business of selling those items and has an office or other location in the jurisdiction where the sale occurs will be responsible for the collection, reporting, and payment of sales taxes unless an exception is available. If the seller does not collect the tax, the purchaser will most likely be responsible for the reporting and payment of a use tax with respect to the purchase. While many jurisdictions exempt “occasional sales” from sales or use tax, the rules regarding what constitutes “occasional sales” vary greatly.

**Like-Kind Exchanges of Collectibles**

It is not uncommon for individuals to exchange objects to alter their collections. With the present long-term capital gain rate at 28 percent applicable to gain from the sale of collectibles, it may be advantageous to defer any gain by utilizing the tax-free exchange provisions of Section 1031. As discussed above, the sale of property generally triggers a tax on the gain equal to the difference between the fair market value of the property received and the basis of the property being sold. If the transaction is properly structured, the provisions of Section 1031 will allow this gain to be deferred if replacement property is purchased.

In general, Section 1031 limits such “like-kind” exchanges to property held for productive use in a trade or business or for investment that is exchanged solely for property of a like kind to be held for productive use in a trade or business or for investment. The taxpayer must satisfy three requirements in order to take advantage of Section 1031 tax-free treatment:

1. Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment;

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19 IRC § 183(b).

20 For example, an exemption may be available if the purchaser is purchasing the item for resale.

21 IRC § 1031.
2. The replacement property must be of like kind to the property relinquished; and
3. There must be an exchange.\textsuperscript{22}

The first requirement specifies that the properties to be exchanged must be held for investment or used productively in a trade or business by the taxpayer. Note that art or other collectibles held by a dealer will not qualify for like-kind exchange treatment since inventory does not qualify.\textsuperscript{23} Furthermore, it is important that the parties hold the property primarily for investment or use in a trade or business. This may be a difficult requirement for a typical collector to meet. In an attempt to satisfy this requirement, the collector may argue that he held the property for “investment” purposes. However, as noted above, the Wrightsman holding places a high burden on the taxpayer in establishing investment intent.\textsuperscript{24} Collectors who cannot satisfy this burden will need to report the transaction as a taxable exchange.

Another consideration that must be addressed is what constitutes like-kind property. Under Section 1031, the standard for determining like kind property involves “reference to the character of property and not to its grade or quality.”\textsuperscript{25} Grade or quality generally refers to differences of artists, style, medium, age, and value. Thus, an investor or collector could exchange an abstract painting for an impressionist painting or an oil painting for a watercolor. Since the Code and Regulations provide little guidance on this issue, it is unclear whether a painting is like-kind with respect to a sculpture.\textsuperscript{26}

Finally, there must be a qualifying exchange of property. While the simplest type of Section 1031 exchange is a swap involving two parties, the difficulty with such exchanges is finding two parties who have suitable property they want to exchange. When the buyer of the relinquished property does not have suitable replacement property, one option is to have the

\textsuperscript{22} IRC § 1031(a).
\textsuperscript{23} IRC § 1031(a)(2).
\textsuperscript{24} See supra notes 5–6 and accompanying text.
\textsuperscript{25} Treas. Reg. § 1.1031(a)-1(b). For a detailed discussion of like-kind exchanges of art, see Bradley T. Borden, “Tax-Free Exchanges of Art and Other Collectibles,” 29(3) J. Tax’n Invs. 3 (Spring 2012).
\textsuperscript{26} In PLR 8127089 (Apr. 10, 1981), the IRS ruled that, for purposes of IRC § 1033 (which deals with involuntary conversions of property), lithographs are not “similar or related in service or use” to artwork or “other artistic media,” such as oil paintings, watercolors, sculptures, or other graphic forms of art. Under the facts of the ruling, the property had been destroyed by fire. Would the IRS reach a similar result under IRC § 1031(a)? In a 1992 Field Service Advice, the Internal Revenue Service National Office indicated that it would not rule on the issue unless “forced to do so on audit.” FSA from Branch 5 of Office of Chief Counsel, Income Tax and Accounting (Nov. 25, 1992).
buyer purchase replacement property so the exchange can then occur. Doing this creates another issue, however: A potential buyer may be unwilling to go through the inconvenience of purchasing like-kind property solely to accommodate the seller, and a transaction in which the taxpayer sells property to one party and buys suitable replacement property from another does not qualify as a like-kind exchange. The solution to this problem is to use a qualified intermediary to complete the exchange. The regulations under Section 1031 allow the sale of property using a third-party qualified intermediary who reinvests the proceeds in replacement property. When a taxpayer sells the relinquished property and later acquires replacement property, the sale proceeds must be kept out of the taxpayer’s control. It is important as well to observe the two time requirements in a typical like kind exchange: (1) the replacement property must be identified no more than 45 days after the sale of the relinquished property and (2) title to the replacement property must be taken no more than 180 days after the sale of the relinquished property.

Charitable Contributions of Collectibles

Certain pieces of art or collectibles may be attractive for a charitable gift. There are many incentives for individuals to contribute, during their lifetime or upon their death, works of art or other collectibles to charitable organizations such as qualified museums and universities, and other organizations that display and make use of works of art in furtherance of their tax-exempt purposes. A donation of art or other collectibles during lifetime may provide the taxpayer with various benefits, including:

- An immediate income tax charitable deduction, which is determined by the type of charity he or she contributes to and the type of contributed property;


28 IRC § 1031(a)(3).

29 However, where the donor is also the creator of the art object, the donor’s deduction is limited to the cost basis. A donor who has already deducted the costs attributable to the creative work as a business expense is not permitted to take a charitable deduction for the contribution of his or her own art creation. Treas. Reg. § 170A-1(c)(4). In any event, the out-of-pocket costs associated with creating many types of artwork, like paintings, are likely to be very small. This limited deduction also applies where the donor received the property by inter vivos gift from the creator. In contrast, a donor who inherits the art object from the creator can deduct the full fair market value for a later charitable contribution. Similar rules apply to contributions of taxidermy property. Thus, when the creator of the taxidermy contributes the property, his or her deduction is limited to the lesser of basis or fair market value. Only the cost of preparing, stuffing, and mounting is considered when determining the basis of taxidermy property; the donor may not consider indirect costs, such as traveling. IRC § 170(e)(1)(B), (f)(15).
- Avoidance of the tax on capital gains on appreciated assets; and
- A charitable gift tax deduction.\(^{30}\)

In addition, an individual may also wish to donate art or other collectibles to a charitable organization upon death. While the donation upon death will not provide an income tax deduction, the deceased’s estate will be entitled to an estate tax charitable deduction so that the donated art or other collectibles will not be subject to estate tax. The following paragraphs highlight the issues involved with donations of art and other collectibles.

**Gifts of Art and Other Collectibles During Lifetime.** With the benefit of an immediate income tax deduction, gifts of art and other collectibles to charitable organizations become even more appealing. An individual who makes a donation of art to a charitable organization during lifetime will generally receive an income tax charitable deduction. An individual’s charitable income tax deduction for a charitable contribution of art or other collectibles is determined by three main factors discussed below.

Where a donor contributes art or other collectibles that qualify as capital gain property to a 50 percent charity and that organization uses the art or other collectible for a purpose or function related to its tax-exempt status, the donor can deduct the fair market value of the item for income tax purposes (subject to applicable ceilings). If an individual contributes art or other collectibles to a 30 percent charity or if the individual contributes the items to a 50 percent charity, but either the art or other collectible does not qualify as capital gain property or the item is not used by the charity for its related use, then the individual generally is entitled only to a charitable deduction equal to the individual’s adjusted basis (subject to applicable ceilings).

**The Related Use Rule.** A taxpayer’s income tax deduction for a gift of art or other collectible that is capital gain property is dependent on its use by the donee charity, referred to commonly as the “related use rule.”\(^{33}\) Accordingly, in addition to determining the value of the item, determining how the charitable organization will use the item is one of the most common issues

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\(^{31}\) A “50 percent charity” consists of public charities as well as private operating foundations, pass-through foundations, donor-advised funds, and pooled-fund foundations.

\(^{32}\) A “30 percent charity” consists of private non-operating foundations (other than pass-through foundations), veterans organizations, fraternal societies, and cemetery organizations.

in contributing art or other collectibles. The related use rule ensures that charitable organizations use the contributed property rather than selling it immediately after the contribution.

The related use rule requires that the use of donated art or other collectible by the donee charity be related to the purpose or function constituting its tax-exempt status. If this rule is satisfied, the donor can deduct the fair market value of the art or other collectible for income tax purposes (assuming the art qualifies as capital gain property and the gift is to a 50 percent charity). It is important to note that the charitable organization’s related use of the art or other collectible does not have to be immediate. For instance, if a donor contributes a painting to a museum to put on display and the museum puts the painting in storage rather than immediately on display, the donor may still deduct the fair market value of the art because it was reasonable to anticipate at the time of the contribution that the property would eventually be displayed.\textsuperscript{34} If the donated painting is of a type generally retained by museums for museum purposes, it is generally reasonable for a donor to anticipate that the painting will be put to a related use by the museum unless the donor has actual knowledge that the museum is not going to put the painting to a related use. This is the case even if the museum later sells or exchanges the object. In addition, since very few museums have sufficient space to exhibit all their art at one time, the fact that a donor can anticipate that the gift may be placed in storage part or even most of the time will not cause the value of the gift to be reduced.\textsuperscript{35}

However, if the charitable organization does not use the art or other collectible for a purpose related to its tax-exempt status, the charitable deduction is generally limited to the donor’s adjusted basis. For example, if a donor contributes a painting to a hospital for display, rather than to a museum, the donor’s deduction will most likely be reduced to the donor’s basis because the display of a painting is generally not related to a hospital’s tax-exempt purpose. The rationale, in part, behind the reduced deduction is that the Internal Revenue Service assumes that the charity will sell, rather than retain the property.

Whether a charitable organization is using an art object in a manner related to its tax-exempt purpose is not always clear. For instance, if an art object is donated to a university and placed in a library for display and study by art students, the art is used for a related purpose and the donor may deduct the full fair market value of the object.\textsuperscript{36} However, if that university sells the

\textsuperscript{34} Similarly, the fact that an art object is normally displayed but regularly undergoes time away for conservation or maintenance should not affect the determination that the art object is being used for a related use.

\textsuperscript{35} Treas. Reg. § 1.170A-4(b)(3)(ii).

\textsuperscript{36} Treas. Reg. § 1.170A-4(b)(3).
art object instead of placing it in the library for display and study, the use of the object is not related to the university’s tax-exempt purpose and, accordingly, the donor’s deduction is reduced. But what happens to the donor’s tax deduction if the university places the art object outside of the library for artistic display? There are still many unanswered questions concerning what is a related use. Due to this ambiguity, a donor should determine a charitable organization’s potential use of an art object prior to contribution to ensure the donor receives the maximum tax benefits.

A donor may also run afoul of the related use rule if the charitable organization sells, exchanges, or otherwise disposes of the art within three years of the contribution. If this occurs, a donor may protect his or her full fair market value deduction by obtaining certification from the charitable organization stating that the use of the art object prior to sale or exchange was substantial and related to the organization’s tax-exempt status. The certification must also specify how the organization used the property and how such use furthered the organization’s purpose or function. Alternatively, if the charitable organization did not use the art object for a related use prior to sale or exchange, the donor must obtain certification from the organization stating its intended use of the property at the time of the contribution and why such use became infeasible. Under either circumstance, a donor who obtains the required certification may receive the maximum fair market value tax deduction for the contribution despite the subsequent sale or exchange.

Often, a donor will not want to give an unconditional contribution to a charitable organization, preferring instead to attach strings to the contribution while also obtaining recognition for his or her generosity. However, charitable organizations tend to want as much flexibility as possible when determining how to utilize a contribution, and are hesitant about accepting contributions encumbered with restrictions. Many of the issues surrounding problem gifts may be avoided by entering into a gift acceptance agreement between the donor and the charitable organization.

Donating a Fractional Interest in Tangible Personal Property. Often an individual may want to contribute tangible personal property, such as an art object, but retain primary possession of the property for the near future.

37 IRC § 170(e)(7)(A).

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Generally, a donor must contribute his or her entire interest in the property to be eligible for a tax deduction; however, an exception applies where the donor contributes a “fractional interest” in the property. This exception requires a donor to contribute a portion of an undivided interest in the property to a charitable organization.\textsuperscript{41} The remaining interest in the property must be contributed within 10 years of the initial contribution.

Depending upon the circumstances, a fractional donation may be a desirable option for many taxpayers. For example, assume a donor who lives in Illinois but spends part of the year in a second residence wants, eventually, to contribute a painting to an art museum, but for the immediate future would like to maintain possession of the painting when in her primary residence. The donor could contribute a 25 percent fractional interest in the painting to the art museum, allowing the museum to have unrestricted use and possession of the painting for three months every year, while she retains possession of the painting for the other nine months. Assuming the art object qualifies as capital gain property, doing this would enable the donor to deduct 25 percent of the fair market value of the art object for this contribution.\textsuperscript{42}

Although the fractional interest option may seem ideal to many potential donors, careful planning prior to exercising this option is necessary, due to the tax ramifications:

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  \item \textit{Capped value}: Most significantly, when a donor contributes a fractional interest in tangible personal property, all subsequent contributions of interest in the property are limited to the lesser of its fair market value at the time of the initial contribution or at the time of the additional contribution. Accordingly, a donor may not deduct any appreciation in the property that might occur between the time of the initial contribution and the subsequent contribution. For instance, say the donor in the example above contributed a 25 percent fractional interest in a painting valued at $100,000 and deducted 25 percent of the then-value, i.e., $25,000, but three years later, when she wants to contribute her remaining 75 percent interest, the painting is worth $120,000. Despite the painting’s appreciation, the donor’s deduction is limited to 75 percent of the painting’s fair market value at the time of the initial contribution—i.e., only $75,000. Because of the inability to deduct for appreciation after an initial fractional-interest
\end{itemize}

\textsuperscript{41} In such a case, the donor and the organization should be sure to establish who will be responsible for wear and tear at various times of possession, perhaps through a gift acceptance agreement.

\textsuperscript{42} The donor may also be able to get the reduced insurance rates available to museums on some or all of the property.
contribution, such contributions require careful tax planning, especially if the art object has potential to appreciate.

- **Possibility for recapture:** If a donor fails to contribute the remaining interest in the partially contributed property to a charitable organization within 10 years of the initial contribution, the donor’s previous tax deduction for the fractional interest contribution may be recaptured. Additionally, if the charitable organization does not maintain substantial physical possession of the property in accordance with the fractional interest contribution or does not use the property for a purpose related to the organization’s tax-exempt status, the donor’s previous deduction—plus interest and a 10 percent tax penalty for the taxable year—may be recaptured.

**Valuation of Donated Artwork and Collectibles.** An individual who makes a charitable donation of art worth $20,000 or more must attach to his or her tax return a complete copy of a signed appraisal. A photograph of any individual objects of art valued at $20,000 or more must be provided upon request by the Internal Revenue Service. Furthermore, an individual who donates an item of art valued at $50,000 or more may request a Statement of Value for that item from the Service. This statement must be requested before filing the tax return that reports the donation. There is a user fee of $2,500 for up to three items of art and an additional user fee of $250 for each item in excess of three. If accepted, the individual may rely on a Statement of Value issued to such individual unless the representations upon which the Statement of Value was based were not accurate statements of the material facts.

The Art Advisory Panel assists the Internal Revenue Service by reviewing and advising on the acceptability of property appraisals submitted by taxpayers in support of fair market value claims of art in the $20,000-plus category. The Panel is made up of dealers, museum directors, and curators. At their annual or bi-annual meetings, the Panel reviews the taxpayer’s appraisal and other supportive evidence, along with the Panel’s own research and findings. The Panel’s conclusions are then reviewed by the office of Art Appraisal Services. Taxpayers are informed of the basis of the decisions and may request reconsideration of an adjusted claimed value, but only if they provide additional information or evidence.

43 IRC § 170.
44 IRC § 170(o)(1).
45 Horwood, supra note 38.
Pledging Collectibles for Liquidity

Despite the economic downturn in many markets, the art market has stood up reasonably well. Therefore, more individuals (and organizations) are utilizing their art and other collectibles as security for loans. Borrowing against the value of art or other collectibles avoids the potential tax liabilities upon sale while still allowing a taxpayer to generate cash. Additionally, many taxpayers find pledging art or other collectibles to secure loans an attractive option because they may still keep their collection while it is being used as collateral.

For example, the Metropolitan Opera in New York pledged two valuable Chagall murals as collateral for an existing loan from JP Morgan Chase.\textsuperscript{48} Another example involves a luxury condominium developer who secured an $80 million loan to build a tower in Miami. Instead of obtaining a construction loan, the developer obtained a personal loan secured by 59 pieces of modern art from his collection.\textsuperscript{49}

In order to structure loans that involve art or other collectibles as collateral, banks generally will consider various issues, including evidence of title, authenticity, and valuation and marketability.\textsuperscript{50} First, ensuring that the borrower is the legal owner of the work is of paramount importance to the lender. The borrower may prove ownership of title from the provenance, wills, trusts, deeds, deeds of gift, purchase invoices, and similar documentation. However, it should be noted that, unlike other tangible property, ownership of art and other collectibles is typically not documented through a formal title agreement or a deed.\textsuperscript{51} Because there is no universally recognized method for documenting art ownership, individuals must be diligent in collecting and maintaining as much documentation as possible in order to protect their ownership interests.\textsuperscript{52} Alternative forms of proof of ownership include items such as the bill of sale, related import or export documents, personal notes, insurance records, and affidavits from prior owners.

In the absence of fully documented evidence of authenticity, a lender may require advice from acknowledged experts. The borrower should be aware that the loan documentation will likely contain warranties which will leave the borrower liable for any inadequacy in the security.\textsuperscript{53} Additionally,  

\textsuperscript{49} Robbie Whelan, “Plots and Ploys: Art of the Condo,” Wall St. J. (Mar. 7, 2012), at C8. \n
\textsuperscript{50} Davis & Ludlam, supra note 48. \n
\textsuperscript{51} Horwood, supra note 38. \n
\textsuperscript{52} Id. \n
\textsuperscript{53} Davis & Ludlam, supra note 48.
lenders routinely require valuation of the art at least every six months and will involve lending auction houses and dealers in the process. Because lenders are concerned about the collateral’s liquidity, they will examine a variety of factors to determine whether there is an active market for the art, including the status of the artist in question, the work itself, and the current desirability of the works of art.  

Conclusion

The expanding reasons for collecting (and using collections as an investment asset class) require a fresh look at tax consequences. Planning in advance is essential to ensure that investments in art and collectibles yield the best after-tax return in addition to the traditional benefit of the visual enjoyment.