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Fractional Gifts of Art

Reducing capital gains taxes with charitable remainder trusts

In last month's issue, we wrote about the related use test for getting full fair market value (FMV) deductions for appreciated artworks; the no-second chance for complying with the many appraisal and substantiation rules; and the Internal Revenue Service Commissioner's Art Advisory Panel.[1]

In this follow-up, we'll discuss the treacherous rules governing fractional gifts of art and the severe penalties for not giving all the interest by the end of 10 years.

You'll also learn about transferring an appreciated artwork to a charitable remainder trust (CRT). That can be a substitute for a no-longer available tax-free Internal Revenue Code Section 1031 exchange. This technique avoids or reduces dreaded capital gains taxes.

The Situation

Your client wants to give a painting to a museum and, of course, get an income tax charitable deduction. But, she also wants to continue to enjoy the painting in her home. Why not give a fractional interest; each has the painting for part of the year.

This type of donation not only benefits the donor but also the recipient. Many museums own more art than they can store, let alone display. Museum collections have grown tenfold over the last 10 decades, forcing many major institutions to build more storage or dispose of a portion of their collections.[2]

By retaining a fractional interest, a donor may continue to physically possess a donated artwork for a period of time each year, thereby postponing and possibly preventing the property's banishment to an overcrowded basement.

Fractional Gifts: The Basics

Generally, a gift of an undivided portion of a donor's entire interest in property is deductible. That interest must consist of a fraction (or percentage) of each and every substantial interest or right owned by the donor and must extend over the entire term of the donor's interest. To qualify a gift as an undivided portion of a donor's interest, the donee-charity is given the right, as a tenant in common owner with the donor, to possession, dominion and control of the property for a portion of each year appropriate to its interest.

Charitable deductions are only allowable for a contribution of a fractional interest if, immediately before the contribution, all interests in the item are owned by the: (1) donor, or (2) donor and the donee charity.[3] The Treasury is authorized to make exceptions to this rule, however, if all persons who hold an interest in the item make proportional contributions of undivided interests in their respective shares of the item to the donee charity.

For example, suppose Able owns an undivided 40% interest in a painting, and Baker owns an undivided 60% interest in the same painting. The Treasury is authorized to provide that Able may take a deduction for a charitable contribution of less than her entire interest, provided that both Able and Baker make proportional contributions of undivided fractional interests in their respective shares of the painting to the same donee charity. The requirement is met if Able contributes 50% of her interest and Baker contributes 50% of her interest.

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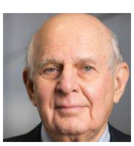
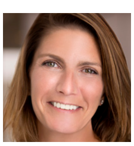


Caveat donor: A charitable deduction isn't allowable for a gift of a future interest in tangible personal property. The IRS says a "future interest" is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, the donor a right to the use, possession, or enjoyment of the property."[4]

An undivided interest isn't necessarily considered a future interest even when a donor maintains some control over the property. Such an interest can be deductible under some circumstances. For example, a contribution of an undivided one-quarter interest in a painting for which the donee is entitled to possession during three months of each year is deductible and shall be treated as made on the receipt by the donee of a formally executed and acknowledged deed of gift. The caveat: The period of initial possession by the donee may not be deferred for more than one year.[5]

> After passage of the Tax Cut and Jobs Act, Section 1031 can no longer be used to defer taxes for transactions including those involving tangible personal property.

Deducting the initial contribution. The value of a donor's charitable deduction for the initial contribution of a fractional interest in tangible personal property is based on the FMV of the artwork at the time of the contribution of the fractional interest and whether the use of the artwork is "related" to the donee's exempt purposes.[6]

Deducting additional contributions. Before the Pension Protection Act of 2006 (the PPA), the deduction for each additional contribution of an interest in the same property was simply the FMV of the property at the time of the contribution. That was great for donors when their artworks continued to appreciate. Each fractional interest gift was based on the value at the time of the gift.

After the PPA, the deductible amount of each additional contribution is the lesser of: (1) the FMV used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the FMV of the item at the time of the additional (and subsequent) contribution.

To appreciate (no pun intended) the impact this change has had on taxpayers, consider this: In Year 1, a donor gives a public charity for a related use an undivided one-fifth interest in a long-term appreciated painting valued at $1 million. In each of Years 2, 3, 4 and 5, she gives the charity an additional one-fifth interest, so in Year 5, the charity owns the entire painting. The painting continues to appreciate in value: in Year 2, it's worth $1.2 million; in Year 3, $1.4 million; in Year 4, $1.6 million, and in Year 5, $1.8 million. Prior to the enactment of the PPA, the donor would have deducted: $200,000 in year one (one-fifth of the initial FMV of $1 million); $240,000 in Year 2 (one-fifth of $1.2 million); $280,000 in Year 3 (one-fifth of $1.4 million); $320,000 in Year 4 (one-fifth of $1.6 million); and $360,000 (one-fifth of $1.8 million) in Year 5. After the PPA, the donor's deduction in each of Years 2, 3, 4 and 5, as well as Year 1 (the initial contribution) is limited to $200,000.

Side effects. As initially enacted, the PPA applied the same rule for determining the deduction of an additional fractional gift of tangible personal property for gift and estate tax purposes as it did for income tax purposes. However, as the Joint Committee on Taxation noted, the special valuation rule "creates unintended consequences" under the estate and gift tax laws.[7] The Tax Technical Corrections Act of 2007 strikes that rule for estate and gift tax purposes but retains it for income tax purposes.

The Fractional Gifts Minefield

Ten-year-or-earlier death rule. Oy! If a donor makes an initial fractional contribution, then fails to contribute all her remaining interest in the property to the same donee before the earlier of 10 years from the initial fractional contribution or the donor's death, the donor's income and gift tax charitable deductions for all previous contributions of interests in the item will be recaptured, plus interest.[8]

Physical possession requirement. If the donee of a fractional interest in an item of tangible personal property fails to take physical possession within one year of the initial gift (and within one year of any additional gifts)—for a period equal to the donee's fractional ownership—the donor's income and gift tax charitable deductions for all previous contributions of interests in the item will be recaptured, plus interest.[9]

Related use requirement. If the donee doesn't use the property for a use related to its exempt purpose, the donor's income and gift tax charitable deductions for all previous contributions in the item will be recaptured, plus interest.[10]

Additional penalties. If deductions are recaptured under the physical possession or related use rules, an additional tax is imposed equal to 10% of the amount recaptured.[11]

Change of mind. What happens if a donor changes her mind? Suppose a donor who made an initial fractional interest gift on or before Aug. 17, 2006 pledged to give additional fractional interests during her life, by will or both. But, now she doesn't want to make additional fractional gifts because of the current valuation rules. It's the duty of the donee-charity's fiduciaries to see that pledges are fulfilled. And, the state Attorney General can often intervene and require that the donee and its fiduciaries enforce pledges. In some cases, the penalties for excess benefits (under the intermediate sanction rules) can come into play if an enforceable pledge isn't enforced.

Valuation of fractional interests for estate tax purposes. Fractional interests in artwork can be valued differently for estate tax purposes than for gift and income tax purposes. For example, suppose a donor dies with an art collection worth $100 million. That amount is includible in her gross estate. If the collection is bequeathed to a charity, her estate will receive an offsetting $100 million charitable deduction.[12] Suppose

instead that the $100 million collection that's includible in her gross estate is bequeathed to four museums, each having a 25% interest as tenants in common. Would the estate still receive a $100 million charitable deduction? The IRS may maintain that the total estate tax charitable deduction isn't $100 million but only $80 million because fractional interests are often discounted on a sale. A buyer who would be willing to pay $100 million for the entire collection wouldn't be willing to pay $25 million for a one-fourth sale.

Valuation of fractional interest. How a fractional interest is valued depends on several factors, including: (1) the type of property (for example, marketable securities, closely held securities, real estate or artworks); (2) the reason for the division; (3) agreements among the parties; and (4) who's doing the valuation (the IRS, an appeals court or a willing buyer and seller, both having reasonable knowledge of relevant facts and not being under compulsion to buy or sell).

IRS Pronouncements

Who's bound by what? In a 2013 case involving the valuation of fractional interests of an art collection given to family members, *Estate of Elkins v. Commissioner*,[13] the IRS took the position that the estate couldn't take a discount on the fractional interests in a collection of artwork for a lack of marketability and control because it was inconsistent with the Commissioner's longstanding position that fractional interests in art aren't discounted for purposes of valuing charitable contributions. The Tax Court rejected the IRS' argument by distinguishing the IRS' prior charitable contribution rulings from the estate valuation at issue and by reminding the IRS that courts aren't bound by the IRS' revenue rulings or private letter rulings.

A question not before the court in *Elkins*: Is the IRS bound by its own pronouncements? In an earlier case, *Rauenhorst v. Comm'r*,[14] the Tax Court held that the IRS couldn't disavow its own favorable-to-taxpayers revenue rulings, noting "taxpayers should be entitled to rely on revenue rulings in structuring their transactions, and they should not be faced with the daunting prospect of the Commissioner's disavowing his rulings in subsequent litigation."

Decision to Sell

For an art lover who's ready to sell all or a piece of her collection, the exposure to capital gains taxation is an important consideration. Under IRC Section 1031, a taxpayer could, in the past, defer taxation on the transfer of investment property (real property or tangible personal property) when it was exchanged for like-kind property. After passage of the Tax Cut and Jobs Act, Section 1031 can no longer be used to defer taxes for transactions including those involving tangible personal property.

A taxpayer may avoid or reduce capital gains taxation by transferring her tangible personal property to a CRT.[15] While the charitable deduction would be minimal, the avoidance of taxation on any gains resulting from the subsequent sale of the tangible personal property is the true objective.

PLR 9452026 (Sept. 29, 1994) illustrates the IRS' acceptance of this tactic on the proposed transfer of an appreciated musical instrument to a charitable remainder annuity trust (CRAT). Prior to the transfer to the trust, the taxpayer requested a ruling that, among other things, any gains resulting from the subsequent sale of the instrument by the trust wouldn't be attributable to the taxpayer.[16] Relying on *Palmer v. Comm'r*,[17] the IRS determined that, provided there's no prearranged sale contract in which the trust is legally bound to sell the musical instrument on the contribution, the taxpayer wouldn't be required to recognize any gains from the sale of the instrument by the trust. In addition, the annuity payments would be reportable as income by the beneficiary only to the extent such amounts of income or gains are ultimately distributed by the trust in accordance with IRC Section 664(b).

When transferring personal property to a CRT for this purpose, we suggest using a net income with make-up charitable remainder unitrust or a flip-charitable remainder unitrust[18] and avoiding standard (fixed percentage) charitable remainder unitrusts and CRATs.

Willing Recipient

Regardless of the method a taxpayer chooses to dispose of all or part of her collection, it's always wise to make sure there's a willing recipient. For example, take the Sacklers—the family connected to the painkiller OxyContin. The Sackler family was once lauded for its charitable giving. Now, the family serves as a cautionary tale for would-be donors. Over recent months, protests calling for the rejection of donations from the Sacklers

have been held at several leading art institutions, including the Guggenheim and the Metropolitan Museum of Art in New York City.[19] And, Britain's National Portrait gallery ultimately rejected a long-discussed $1.3 million donation from the family.[20]

Takeaway. For lifetime gifts of art, the ability to navigate through the IRS' tax minefield is only beneficial to your client if a museum is willing to accept the artwork in the first place. In almost all cases, however, a museum's decision whether to accept an artwork and agree to display it depends on whether it fits in with its policies and whether the museum has the facilities to display the artwork.

Endnotes

1. Conrad Teitell, Laura Weintraub Beck and Sarah A. Ricciardi, "Deducting Charitable Art Donations," *Trusts & Estates* (May 2019).
2. *See* Robin Pogrebin, "Clean House to Survive? Museums Confront Their Crowded Basements," *New York Times* (March 12, 2019), *www.nytimes.com/interactive/2019/03/10/arts/museum-art-quiz.html*.
3. Internal Revenue Code Section 170(o)(1)(A).
4. Treasury Regulations Section 1.170A-5(a)(4).
5. Treas. Regs. Section 1.170A-5(a)(2).
6. IRC Section 170(o)(3). Under the Pension Protection Act of 2006, a gift made on or before Aug. 17, 2006, however, won't be treated as an initial fractional contribution. Instead, the first fractional contribution by a taxpayer after Aug. 17, 2006 will be considered the initial fractional contribution. *See also supra* note 1.
7. "Description of the Tax Technical Corrections Act of 2007, As Passed By The House of Representatives," Joint Committee on Taxation (Dec. 18, 2007) at p. 3.
8. Section 170(o)(3)(A).
9. Treas. Regs. Section 1.170A-5(a)(2).
10. *Ibid.*
11. Section 170(o)(3)(B).
12. Keep in mind related use isn't an issue because the related use requirement doesn't apply to the estate tax.
13. *Estate of Elkins v. Commissioner*, 140 T.C. 86 (2013).
14. *Rauenhorst v. Comm'r*, 119 T.C. 157 (2002).
15. IRC Section 664 governs the administration and taxation of charitable remainder trusts.
16. The taxpayer also sought rulings regarding the qualification of the trust as a charitable remainder annuity trust under Section 664(d)(1), as well as the extent to which the charitable contribution of the stock could be deducted under various circumstances.
17. *Palmer v. Comm'r*, 62 T.C. 684 (1974). In *Palmer*, a donor had voting control of both a corporation and a tax-exempt private foundation (PF). By design, the donor contributed shares of the corporation's stock to the PF and then caused the corporation to redeem the stock from the PF. The Tax Court held that the transfer of stock to the PF was a valid gift on the grounds that: (1) the PF wasn't bound to go through with the redemption at the time it received title to the shares, and (2) the corporation's right to redeem was based on a purchase at fair market value. The IRS acquiesced to this decision in Revenue Ruling 78-197.
18. A flip charitable remainder unitrust is a trust set up as a net income with makeup charitable remainder unitrust or net income charitable remainder unitrust. On a qualifying triggering event specified in the trust instrument (that is, the sale of the unmarketable asset used to fund the trust) it switches (flips) to a standard (fixed percentage) charitable remainder unitrust. The regulations sometimes refer to this trust as a "combination of methods unitrust."
19. *See, e.g.*, Colin Moynihan, "Opioid Protest at Met Museum Targets Donors Connected to OxyContin," *New York Times* (March 10, 2019), *www.nytimes.com/2018/03/10/us/met-museum-sacklerprotest.html?action=click&module=RelatedCoverage&pgtype=Article&region=Footer*.
20. Alex Marshall, "British Gallery Turns Down $1.3 Million Sackler Donation," *New York Times* (March 19, 2019), *www.nytimes.com/2019/03/19/arts/design/national-portrait-gallery-sackler-donation-goldin.html*.

SPOT LIGHT

Seeing Double

Two Women by Nuri Iyem sold for 23,750 GBP at Sotheby's 20th Century Art/Middle East auction on April 30, 2019 in London. Iyem is particularly known for his portraits of Anatolian women, such as the ones that appear here. He's inspired by the eyes and face of his older sister, whose death he unfortunately witnessed at a young age. The sad faces he portrays represent both the suffering of women during the modernization in Turkey and the grief he suffered over the loss of his sister.