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Estate and Charitable Planning for Art and Collectibles

Daniel L. Daniels and David T. Leibell
Cummings & Lockwood LLC

Auction prices for many categories of art and collectibles are at or near historic highs. Recent news articles have highlighted the case of hedge fund founders and other wealthy individuals who are accumulating large collections of valuable art work as part of their estates. Often, unfortunately, advisers fail to focus adequate attention on planning for these important assets. In this article, we highlight important steps advisers should consider in planning for collectibles, including valuation, charitable gifts, and non-charitable planning.

THE IMPORTANCE OF VALUATION OF ART AND COLLECTIBLES

One of the most important considerations in planning for the disposition of art and collectibles is how the items are to be valued. If the collectibles are incorrectly valued for tax purposes, additional tax, plus penalties and interest can be imposed. The general rule for federal estate, gift, and income taxes is that the transferred items are to be valued at their fair market value. Sometimes, the tax authorities will accept the buyer's cost, or a recent sale, as evidence of fair market value. Most often, however, fair market value will need to be determined by an appraisal of the transferred property. Note that if the client is making a gift of art worth more than $5,000 to charity and wants an income tax charitable deduction, the property must be appraised by a qualified appraiser and the client should be sure to attach Treasury Department Form 8283 to his/her income tax return reporting the transfer.

CHARITABLE GIFTS OF ART AND COLLECTIBLES

Some of the most exciting opportunities for planning for art and collectibles are charitable techniques. Structured properly, charitable gifts and bequests of art and collectibles can be a tax-efficient way of keeping a collection intact. Unfortunately, along with the planning opportunities, there are a number of tax traps regarding transfers of collectibles to charity.

The income tax charitable deduction for a gift of appreciated art work or collectibles to a public charity depends on whether the charity's use of the gift is deemed "related" or "unrelated" to the charity's exempt purposes. If the gift's use is related, the client is entitled to a deduction for the property's fair market value—up to 30% of the client's adjusted gross income. If the gift's use is unrelated to the charity's exempt purposes, the client is only entitled to a deduction equal to his/her cost basis in the property—up to 50% of the donor's adjusted gross income. For example, if a painting contributed to a university is used for educational purposes by being placed in its library for display and study by art students, the use is related to the university's exempt purposes (and, therefore, a fair market value deduction is available). If, on the other hand, the painting is sold and the proceeds used for educational purposes, the use of the property is unrelated to the university's exempt purposes, and the client would be entitled only to a cost basis deduction. Note that no income tax charitable deduction will be allowed when an artwork is donated to charity unless both the work of art and any copyright the donor holds in the work are transferred to charity. This rule does not apply if the donor only owns the work of art and not the copyright as well.

Seven examples of charitable planning for art and collectibles are:

1. Fractional Interest Gifts of Artwork. An income tax charitable deduction is not allowed for an outright gift of a partial interest in property; that is, a gift of less than the donor's entire interest in the property. However, a deduction is allowed when a donor gives an undivided portion of his/her entire interest in the property. What is the difference between a partial interest (no deduction) and an undivided interest

(deduction allowable)? When a donor retains a “substantial” right or interest in property donated to charity, he/she has given a “partial interest” for which a charitable deduction will not be allowed, unless the partial interest is in a specific form sanctioned by federal tax law (e.g., charitable remainder trusts and charitable lead trusts). An “undivided portion” of the donor’s entire interest, on the other hand, consists of a fraction or percentage of each and every substantial interest or right the donor has in the property; it must extend over the entire term of the donor’s interest. If a donor contributes an undivided interest in artwork, he/she can retain personal possession proportionate to the noncharitable interest in the artwork. For example, if an individual gives a 1/12 interest in a painting to a museum, he/she will be entitled to an income tax charitable deduction equal to the value of 1/12 of the painting and will be able to continue to hang the painting in his/her home for 11 months of the year. The painting must reside at the museum for only one month each year. Typically, museums will only accept fractional interest gifts if there is a written agreement that the painting will eventually belong exclusively to the museum.

2. Bargain Sales. It is very common in estate planning for art and other collectibles to use a part charitable, part noncharitable technique known as a “bargain sale.” A bargain sale is a sale of appreciated property to charity at a price lower than its present fair market value. A charitable deduction is allowed for the difference between the sale price and the property’s fair market value. The donor must allocate the property’s cost basis between the gift element and the sale element, based on the fair market value of each part. The donor has a taxable gain on the difference between the sale price and the cost basis allocated to the sale element, but is not taxed on the gain allocated to the gift element.

3. Loans. Loans of artwork to charity are a popular technique. Under a special provision of the Internal Revenue Code, a loan of art work to charity will not generate an income tax deduction and will not be treated as a taxable gift. This avoids the need for the client to obtain an appraisal of the loaned artwork. Clients looking to loan artwork to museums and other institutions should be sure to have their adviser review the loan agreement regarding such items as the length of the loan term, insurance, and other issues.

4. Charitable Remainder Trust. Tangible personal property—such as paintings, sculpture and jewelry—can sometimes be an appropriate asset with which to fund a charitable remainder trust (CRT). A CRT is an irrevocable trust that provides distributions to individuals during their lives (or for a term of not more than 20 years), with the remainder passing to charity. Because a CRT is a tax-exempt entity, it is ideal for the tax-efficient diversification of highly appreciated assets. When a contributed asset is sold, no capital gains tax is payable at the time of the sale—making the full proceeds of the sale available for reinvestment by the trust. When an individual funds a CRT, he or she is entitled to receive an income tax charitable deduction equal to the present value of the charity’s remainder interest. There are a number of tax traps associated with gifts of artwork to CRTs. Three are of particular importance. First, the grantor’s income tax deduction is *delayed* until the property is actually sold by trustee. Second, the grantor should be informed that his or her income tax deduction for the remainder interest will be based on the *lesser* of the property’s fair market value or its cost basis because a gift to a CRT is never a related use gift. Third, the type of CRT to use with collectibles is almost always a Flip Charitable Remainder Unitrust (FlipCRUT).

5. Charitable Lead Trust. A charitable lead trust (CLT) is sometimes referred to as a charitable remainder trust “in reverse.” In a typical CLT, a donor transfers assets to an irrevocable trust, either during life or at death, providing that charity shall receive a qualified annuity or unitrust interest for a set term. The term may be a term of years or the life or lives of certain individuals. The donor to the CLT is entitled to a gift or estate tax deduction for the actuarial value of charity’s interest in the trust. If the CLT is established as a grantor trust for income tax purposes, the donor is also entitled to an income tax deduction for the value of charity’s interest in the trust. The most commonly used CLT for art and collectibles is the testamentary CLT. The testamentary CLT can be structured to provide the donor’s estate with an immediate estate tax charitable

deduction for the full value of the collection transferred to the trust. If the trustee sells the collection shortly after it is transferred to the CLT and reinvests the proceeds in a manner which produces investment returns greater than the discount rate mandated by the IRS in valuing the charitable interest in the trust, the donor's family will receive any excess appreciation estate tax free.

6. Private Operating Foundation. There are circumstances in which a donor might not want to transfer his collection to a museum, but would rather establish his own museum for the collection. This can be accomplished through the creation of an entity known as a private operating foundation (POF). The donor is entitled to a fair market value deduction, offsetting up to 30% of adjusted gross income (AGI), for the gift, but gets to retain control as a member of the Board of Directors of the POF. Note that a POF is very different from the standard private foundation, which typically exists only to write checks to other charities. To be classified as a POF, a private foundation must directly operate an active charitable program (e.g., a museum) and expend or dedicate a sufficient amount of its resources to that program. The foundation must qualify as a POF by submitting a detailed application to the IRS showing that it engages in active charitable programs meeting various tests set forth under the Internal Revenue Code.

7. Testamentary Charitable Gifts of Art and Collectibles. Most of the charitable gift techniques described above can be implemented at death as well. However, since no income tax charitable deduction is available to a donor for charitable transfers made at death, it is generally preferable to make charitable gifts during lifetime. Note, however, that an estate tax charitable deduction is not allowed if the amount of the charitable bequest is not "ascertainable" at the donor's death. In the seminal case on this subject, under the decedent's will, the executors had discretion to make bequests to noncharitable beneficiaries, with the residue of the estate payable to two public charities. The court denied an estate tax charitable deduction because the executors' discretion to make noncharitable bequests resulted in the estate tax charitable deduction not being ascertainable as of the donor's death. Proper drafting could have cured this problem.

NON-CHARITABLE PLANNING

Examples of non-charitable techniques for art and collectibles are simple annual exclusion gifts, gifts to an irrevocable trust, unified credit gifts, and an Art LLC.

1. Annual Exclusion Gifts. A donor is permitted to make gifts of up to $11,000 per beneficiary annually free of federal gift tax, and $22,000 per year for married couples. Any property gifted in this manner is entirely removed from the donor's estate, even if death occurs immediately after the gift. For works of relatively modest value, use of the $11,000 annual exclusion can be a simple and effective means of removing the value of art and collectibles from the client's taxable estate.

2. Irrevocable Trusts. For larger collections of greater value, if the donor has a large number of children and grandchildren, he/she could consider making gifts to an irrevocable trust containing Crummey withdrawal powers for each child and grandchild. For example, suppose a married individual has three children and six grandchildren. He/she could establish an irrevocable trust for the benefit of all nine descendants, granting each one a Crummey withdrawal power. Gifts of up to $198,000 per year could be made to such a trust without the imposition of federal gift tax. The trust approach provides two additional benefits over simple gifts directly to the children and grandchildren. First, the donor would not be required to break up the collection among individual beneficiaries in order to make the gifts. Instead, the collection could be kept intact in the hands of the trustee. Second, the trust could be structured as a generation-skipping trust designed to remove the gifted property not only from the donor's estate, but also from the estates of the children and even the grandchildren.

3. Unified Credit Gifts. In addition to the $11,000 annual exclusion, each individual has a lifetime exemption

from federal gift tax of $1,000,000. Note, however, that gifts made using the $1,000,000 lifetime exemption are effective only to remove any appreciation in value of the gifted property from the taxable estate; they do not remove the property itself. Accordingly, the art or collectibles chosen to be the subject of a lifetime exemption gift should be works that are expected to appreciate in value. The irrevocable generation-skipping trust described above could be structured to be the repository of such a gift as well.

4. Art LLC or Art Partnership. A more aggressive approach would be for the donor to place the art or collectibles in a family limited partnership or family limited liability company (an Art LLC). The Art LLC would serve the following purposes. First, it would provide a convenient vehicle through which to manage and control the collection, regardless of who the owners of interests in the LLC might be from time to time. Second, if interests in the Art LLC are gifted to family members or trusts, it should be possible for an appraiser to apply discounts to the value of the gifted property to reflect the fact that the gifted LLC interest is not readily marketable and does not permit the recipient to control the affairs of the entity. As a caveat, however, planners should advise clients that some courts have taken a dim view of family limited partnership and family limited liability planning. Recent cases indicate that if the client retains too much control over the LLC and/or if the LLC lacks a legitimate business purpose, the entire value of the LLC's assets can be brought back into the client's taxable estate, even if some or most of the LLC interests have been given away prior to the client's death.

CLOSING THOUGHTS

Clients looking to remove art or collectibles from their taxable estate should also be advised to respect all of the formalities of transferring such property. The transfer should be documented with a written deed of gift, the item should be removed from the donor's insurance policy and added to the donee's policy, and the transfer should be reported on a gift tax return. It is critical that there be actual delivery of the gifted item from the client to the donee. The most beautifully drafted deed of gift will not be worth the cost of the paper if the donor retains physical possession of the gifted item. Under the Internal Revenue Code, if a donor makes a gift of property, but retains the possession or use of the property for life, then the property remains in the donor's estate.

Finally, while there is an enormous variety of possible legitimate techniques for removing the value of art or collectibles from the estate, one technique that clearly does not make sense is what is sometimes referred to as "moving van" planning (i.e., shortly before or after the client's death, the children back up a moving van to the house and remove the valuable art and collectibles without reporting the transfers as taxable). Although the IRS has limited ability to audit, and rarely investigates, modest unreported transfers of tangible personal property among close family members, at the time of death of a wealthy individual, the estate tax examiner will expect to see a certain level of personal property reported on the estate tax return commensurate with the client's level of wealth. Auditors also routinely request copies of any insurance policies on art and other collectibles owned by a decedent. It is of course illegal for a client to make a taxable transfer and fail to report it, and it is unethical for an adviser to advise him/her to do so.

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