Gifts With Strings Attached

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CATEGORY:
ARTICLE

In the US it is quite common for a collector to donate all or a part of a collection to a museum or other charity either during the collector's lifetime or on death. Such donations are particularly appealing in that they allow the general public to enjoy the art collection while providing the donor with significant tax benefits. Often, owners of the artwork will want certain restrictions placed on the collection to ensure that it is being displayed in a manner consistent with their wishes. For example, a donor may require that the artworks be displayed together, place restrictions on the lending of the artworks to other institutions, prohibit sale or mandate that the collection be maintained in a specified manner over the course of its display in the museum. While some restrictions on a gift or bequest to charity are consistent with the tax laws permitting charitable deductions, other restrictions can be detrimental, if not fatal to the desired tax benefits. Therefore planners must be careful to ensure that the collection is donated in a way that will avoid pitfalls.

Restricted Bequests

Donation through a testamentary disposition (a bequest) is attractive as it allows the owner of the artwork possession during his entire lifetime. If the artwork is bequeathed to a charitable organization, the Internal Revenue Code includes the entire value of the artwork in the estate. However, the Code then allows for an offsetting deduction in the amount of charitable transfers. If restrictions are placed on the artwork, a risk is that the value of the collection in the hands of the museum or other charity is less than its fair market value in the estate. When this is the case, the IRS may attempt to limit the estate's deduction to less than the fair market value of the artwork to the museum. The estate will be taxed to the extent that this amount is lower than the fair market value of the artwork included in the estate.

Certain case law and IRS private letter rulings have aided in determining which restrictions are allowable without a separate valuation. As a general rule a donor will be granted leeway in imposing certain restrictions so long as the transferability of the artwork is not hindered. For example, through private letter rulings the IRS has approved restrictions which require the museum : to display the artwork in a continuous and particular manner, only to loan the artwork under certain conditions, prominently to display the names of the donor alongside the collection, to maintain and preserve the artwork, and to replace the collection with similar artwork in the event it is sold. By contrast, absolute limitations on the museums' ability to dispose of the artwork could trigger an IRS valuation. In multiple letter rulings in which the IRS allowed the deduction in full, the IRS found of particular importance the ability of the museum to sell or loan the collection. Although case law is sparse in this area, in two separate cases the US Tax Court found that temporary restrictions on the transferability of artwork had a negative impact on its value to the charity, and thus decreased the allowable deduction. However, both cases dealt with an allowable deduction for an inter vivos transfer, rather than in respect of a transfer taking place at death. Therefore, it is not entirely clear that, in the estate tax context, a temporary restriction on transferability will trigger a valuation of the restriction. Nevertheless, when combined with the private letter rulings, it seems that a permanent restriction on the ability of a museum to dispose of the art will likely trigger a valuation by the IRS that could create a discrepancy between the amount required to be included in the estate and the counterbalancing deduction.

Restricted Lifetime Transfers

The other option available to a donor is a lifetime transfer of the artworks. Although the individual will not be able to retain the works for his entire lifetime, they will be effectively removed from his estate. This avoids the risk that the amount included in the estate will be higher than the deduction allowed by the IRS. Further, the donor will receive an income tax charitable deduction on the transfer in the year of the gift, which is a benefit above and beyond what the taxpayer would have received if the donation took the form of a testamentary transfer. If the IRS does require a valuation due to restrictions placed on the artwork, the effect will be on the income tax charitable deduction rather than the estate tax deduction. As was the case with the testamentary gift, certain restrictions can be placed on the grant. Typically, lifetime donative transfers of artwork will be accompanied by a gift agreement that sets forth the parameters to which the museum must adhere. The donor may restrict the museum in substantially the same way as discussed above in connection with testamentary transfers, although this method requires the donor to give possession of the art to the museum within a year of the gift. As with testamentary transfers, as long as the charity is not prohibited from resale, the value of the deduction for income and gift tax purposes should not be reduced by reference to such restriction.

As originally set out in IRS regulations, and case law and as confirmed by federal legislation enacted late in 2006, a donor may transfer a fractional interest in artwork and retain possession for a "period of time each year commensurate with their proportional interest in the item." For example, a donor may retain a half interest in the art collection and maintain possession for half of the year. The donor will receive a current income tax deduction equal to half the value of the collection. If the donor chooses this path, the gift agreement should include a provision that the remaining interest is given to the museum at the time of the donor's death. This will allow for an offsetting estate deduction in the amount of the remaining interest in order to ensure that the full value of the artwork avoids estate taxation. The Pension Protection Act enacted in August of 2006 placed new restrictions on a donor's ability to make a partial gift of artwork. A full discussion of these restrictions appeared in the last issue of this newsletter.

In certain situations, a donor may want to donate the artwork during his lifetime in order to make it publicly available, but may also want to retain complete control and avoid estate taxation on the value. When this is the case, a gift loan agreement will provide the museum with use of the collection, subject to the donor's restrictions, and will allow the donor the right to extinguish the loan at any time. If this path is taken, no income tax charitable donation is available to the donor during the term of the loan. Rather, the gift loan agreement should state that upon death of the donor all interest in the loaned artwork is transferred to the museum. In that case, the full value of the gift is included in the donor's estate, but the donor received an equal offsetting deduction for the value of the artwork at death.

Conditional Transfers

Regardless of whether a gift is made during lifetime or at death, the donor should avoid retaining any right to receive an interest in the artwork in the future (a so called "reversionary interest"). A transfer for charitable purposes that is dependent upon the museum's performance of certain obligations will disallow any deduction unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. So, for example, a donor who gives a collection of Picassos to a museum on the absolute condition that the Museum build a new wing to display the Picassos may not be able to deduct the value for income or estate tax purposes if he or his heirs are entitled to the return of the Picassos if the museum defaults. In contrast to the valuation risk discussed above, this will disallow the entire deduction rather than only the difference in fair market values with and without the restrictions. In order to avoid this fate, the gift agreement should vest any remaining interest, in the event of default, in a different charitable organization. In that way neither the donor nor the donor's heirs will have a remaining interest in the works and the donor would avoid the risk that the deduction will be disallowed in its entirety.

There are multiple methods the donor of an art collection may utilize to avoid estate taxation on his art collection. Donors should consider the unique positive and negative aspects of each method as well as the allowable restrictions that accompany them. This is particularly important as the tax treatment may depend on the chosen method.