Key Issues for Collectors: Income, Gift, and Estate Tax Planning

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Like other taxpayers, collectors can’t “take it with them.” But after death, the tax authorities might indeed “take it.” There are a number of strategies individual collectors should consider when planning what will happen to their art or other collections once they are no longer around. With careful planning, collectors can make sure a collection is maintained—while also ensuring the best possible financial result for their heirs and for the charities they support.

Introduction

Tax considerations are always important for collectors. Whether selling, exchanging, donating, or gifting, during lifetime or at death, tax planning is often a key element. Collections differ from other assets in several important ways for tax purposes. This article highlights some of the key tax issues involving art and other collectibles (sometimes referred to in this article as “collectibles”) to review.

Income Tax Planning

Individuals often start their collections without any consideration of tax implications. However, tax matters become a critical aspect of collecting. Keeping financial records is, of course, important even for collectors who see their activity as a hobby. The tax collector views a collection from a financial standpoint from the very beginning.

Classification for Income Tax Purposes. The first issue regarding income tax planning relates to whether an individual is classified as a dealer,
investor, or collector. This classification is critical to determining how the individual is taxed, what rate the individual is taxed at, the extent to which expenses may be deducted, and the applicability of other tax provisions. It is important that the individual consciously make a decision and structure activities consistent with such classification in case his or her classification is challenged by the Internal Revenue Service.

**Classification as a Dealer.** A “dealer” is someone who carries on a trade or business selling art or other collectibles. The United States Supreme Court stated that, in order to carry on a trade or business, the taxpayer must be involved in the activity with continuity and regularity, and the primary purpose for the activity must be for income or profit. If a person is classified as a dealer, collectibles are considered inventory. A dealer generally holds a valid resale certificate and therefore does not pay sales tax on purchases but does collect sales taxes from purchasers to the extent required by law (see “Sales and Use Taxes” below).

One tax aspect of being classified as a dealer is that a dealer may deduct all ordinary and necessary expenses. These expenses are deductible even if they result in a loss. Because the art or other collectibles held by a dealer are considered inventory, the disadvantage of dealer classification is that operational income, including gains on the sale of collectibles, is taxed at ordinary income tax rates (which currently are at a maximum rate for individuals of 39.6 percent). Another disadvantage is that the gain on the sale of collectibles held by a dealer may not be deferred under the like-kind exchange provisions of Section 1031. In addition, a dealer who makes a charitable deduction of collectibles is only entitled to deduct an amount equal to the dealer’s basis, not fair market value. Furthermore, a dealer is generally subject to self-employment tax on the net income earned by the business.

**Classification as an Investor.** An “investor” buys and sells collectibles primarily for investment as opposed to merely for personal use. The central inquiry in determining whether an individual is an investor is whether that individual is engaged in the investment activity with the primary objective of making a profit. Moreover, an investor has the burden of proving that the

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3 IRC § 162. Unless specifically stated otherwise, all references in the text to Section(s) are to the Internal Revenue Code of 1986, as amended (the IRC).
4 IRC § 165(c)(1).
5 IRC § 1031(a)(2)(A).
6 IRC § 170(e)(1).
collectibles are held primarily for investment purposes. An investor typically does not hold a resale certificate and pays applicable sales taxes on purchases.

The advantage of being classified as an investor is that gain on the sale of collectibles held more than one year by the investor is taxed at a maximum capital gains rate of 28 percent. In addition, an investor may be able to defer any gain by structuring any sale in accordance with the like-kind exchange provisions of Section 1031 (see “Like Kind Exchanges of Collectibles” below). Furthermore, an investor should be able to offset any gains on the sale of collectibles he or she held by any losses on the sale of other collectibles incurred in the same tax year.

The disadvantage of being classified as an investor is that the individual’s ordinary and necessary expenses related to the collection (i.e., the investment) are deductible only as a miscellaneous itemized deduction, subject to the 2 percent floor, excluding mortgage interest and taxes. Even to the extent the expenses exceed the 2 percent floor, taking a miscellaneous itemized deduction for such expenses could subject the investor to the alternative minimum tax.

Classification as a Collector. A “collector” is merely engaged in a hobby, buying and selling art or other collectibles primarily for personal pleasure. If the activity generates a profit for three or more of the last five years, the presumption is that such activity is not a hobby. However, even if that test is not satisfied, it is possible for an individual to establish that the activity is not a hobby, but rather a profit-motivated venture. Factors to be considered in determining whether an activity is engaged in for profit include:

- The manner in which the taxpayer carries on the activity;
- The expertise of the taxpayer or the taxpayer’s advisers;
- The time and effort expended by the taxpayer in carrying on the activity;
- The expectation that assets used in the activity may appreciate in value;

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8 Depending on the frequency that an investor sells collectibles to third parties, the investor may not be required to collect sales taxes on such sales since many jurisdictions provide for an exemption for “occasional sales.” However, the definition of what constitutes occasional sales varies widely.
9 IRC § 212. Note that deductions for investment interest are limited to the amount of investment income. See IRC § 165(d).
10 See IRC § 67(a).
11 Miscellaneous itemized deductions cannot be taken for purposes of computing alternative minimum taxable income. See IRC § 56(b)(1)(A)(i).
12 IRC § 183(d).

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The success of the taxpayer in carrying on other similar or dissimilar activities;
The taxpayer’s history of income or losses with respect to the activity;
The amount of occasional profits, if any, which are earned;
The financial status of the taxpayer; and
The elements of personal pleasure or recreation.

All facts and circumstances are to be taken into account and no single factor or group of factors is determinative.\textsuperscript{13}

The advantage of being classified as a collector is that gain on the sale of collectibles held more than one year by the collector is taxed at a maximum capital gains rate of 28 percent. However, a collector may not be able to defer gain on the sale of collectibles under the like-kind exchange provisions of Section 1031 since the property may not be held “for productive use in a trade or business or for investment.”\textsuperscript{14}

The disadvantage of being classified as a collector is that the collector’s ordinary and necessary expenses are deductible as miscellaneous itemized deductions (but only to the extent of income earned by such activity),\textsuperscript{15} and further subject to the 2 percent floor, excluding mortgage interest and taxes. Even to the extent the expenses exceed the 2 percent floor, the deduction of these expenses as a miscellaneous itemized deduction could subject the investor to the alternative minimum tax.\textsuperscript{16}

\textbf{Like Kind Exchanges of Collectibles.} With the present long-term capital gains rate at 28 percent for collectibles, individuals who are investors can utilize the tax-free exchange provisions of Section 1031. Normally, an individual would be taxed on the difference between the fair market value of the property received and the basis of the property being sold. However, Section 1031 allows for the tax to be deferred if replacement property is purchased. “Like-kind” exchanges are limited 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.\textsuperscript{17}

\begin{footnotes}
\footnotetext[14]{IRC § 1031(a)(1). See also Moore v. Comm’r, TC Memo. 2007-134.}
\footnotetext[15]{These expenses are deductible only to the extent that the miscellaneous itemized expenses exceed 2 percent of the individual’s adjusted gross. IRC §§ 183(b), 67.}
\footnotetext[16]{See supra note 11.}
\footnotetext[17]{IRC § 1031(a)(1).}
\end{footnotes}
Under Section 1031, the standard for determining like-kind property involves “reference to the nature or character of property and not to its grade or quality.” Grade or quality generally refers to differences of artists, style, medium, age, and value. Therefore, an investor could exchange an abstract painting for an impressionist painting or an oil painting for a watercolor. Moreover, Section 1031 maintains time requirements to qualify as a like-kind exchange. First, the replacement property must be identified no more than 45 days after the sale of the relinquished property; second, title to the replacement property must be taken no more than 180 days after the sale of the relinquished property.

It is important to note that if the like-kind exchange is not just an exchange between two parties, it will generally be necessary to use the services of a qualified intermediary to hold the sales proceeds and purchase the replacement property in order to properly defer the gain under Section 1031. If the seller sells the art or other collectible to one party and uses the proceeds to purchase replacement property without using a qualified intermediary, the gain may not be deferred under Section 1031.

**Charitable Gifts During Lifetime.** From an income tax standpoint, the primary benefit of donating art or other collectibles to charity during one’s lifetime is that the individual receives an income tax deduction. If (1) the individual donates art or another collectible which is classified as a capital asset to a public charity or a private operating foundation, and (2) the charitable organization uses the object for a purpose or function that is related to its tax-exempt status, the taxpayer is entitled to a charitable income tax deduction equal to the fair market value of the object. If the contribution is made to a private foundation, and the item is not classified as a capital asset or if the charitable organization uses the object for a purpose or function that is unrelated to its tax-exempt status (the “related use” rule), the taxpayer will only be entitled to a charitable income tax deduction equal to his or her adjusted basis in the object.

**Related Use Rule.** As noted above, in order to satisfy the related use rule, the charitable organization must use the item in a way that is related to the purpose or function constituting its tax-exempt status. However, the use

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18 Treas. Reg. § 1.1031(a)-1(b).
19 IRC § 1031(a)(3).
20 For a more detailed discussion of like-kind exchanges of collections, see Bradley T. Borden, “Tax-Free Exchanges of Art and Other Collectibles,” 29(3) J. Tax’n Invs. 3 (Spring 2012).
22 Id.
does not have to be immediate. This would allow, for example, a museum to place a painting in storage upon its donation, as long as the donor reasonably believes the painting will eventually be displayed. If the donor knows that the organization does not plan to display the painting, he or she may not take the fair market value as a deduction, but rather can deduct only the adjusted basis. There are many questions surrounding the related use rule; therefore, a donor should do what is reasonable to determine the charitable organization’s plan for the work. IRS Publication 526 provides an example of what is, and what is not, related use. If a painting contributed to an educational institution is used for educational purposes, such as being displayed for study by art students, the use is not unrelated use. But if the painting is sold by the donee, the use is an unrelated use, even if the proceeds are used by the organization for educational purposes. Accordingly, it is imperative that taxpayers communicate with the charitable organization to ensure the work’s related use.

Annual Limit on Deductions. Taxpayers need to review their charitable giving annually. The allowable annual deduction will vary depending on the nature of the donation and the donor’s personal income. Each year, a donor may deduct:

- Up to 50 percent of his or her adjusted gross income (AGI) for contributions to a public charity of cash and non-cash contributions if the donor’s deduction equals his or her basis in the property;\(^{24}\)
- Up to 30 percent of his or her AGI for contributions to a public charity of non-cash assets if the donor’s deduction equals the fair market value of the property;\(^{25}\)
- Up to 30 percent of his or her AGI for contributions to a charity that does not qualify as a public charity of cash or non-cash assets if the donor’s deduction equals his or her basis in the property;\(^{26}\)
- Up to 20 percent of his or her adjusted gross income for contributions to a charity that does not qualify as a public charity of non-cash assets if the donor’s deduction is based on the fair market value of the property.\(^{27}\)

\(^{24}\) IRC § 170(b).
\(^{25}\) Id.
\(^{26}\) Id.
\(^{27}\) Id.
Art Conservation and Restoration—Effect on Basis. The object of conservation is to use methods and materials that do not endanger the original object. It is important not to add or remove any materials that may jeopardize the original integrity of the piece. Therefore, treatments are designed to be as reversible and noninvasive as possible.

Alternatively, restoration consists of additions that are distinguished from the original. The owner can choose to make allowances so that the object appears like it was new. However, with historical items, a decision must be made whether to keep the historical character or alter it with restoration.

Both methods can become a significant cost. Restoration of damaged property can be added to the cost basis, but collectors must be careful not to endanger the historical significance by going too far. The IRS maintains that restoration and conservation costs should be capitalized, not expensed, when they become part of a sellable product (inventory). Therefore, a dealer will have to capitalize these expenditures because art and other collectibles in the hands of a dealer are considered sellable products.28

Sales and Use Taxes. As mentioned above, whether or not the individual collects sales and use tax may be an important factor in determining the individual’s classification for income tax purposes. An individual who is a dealer must also be careful to ensure that he or she is complying with the laws of the state and local jurisdictions in which the dealer is conducting business since the seller will be responsible for the collection, reporting, and payment of sales taxes in such jurisdictions unless an exception is available.29 Generally, a person will be conducting business in a jurisdiction if the individual is engaged in the business of selling items and has an office, employee, agent, inventory, or other physical presence in the jurisdiction where the items are sold.

States and local jurisdictions are becoming more aggressive in determining what activities constitute conducting business. However, it is not just sellers that states and local jurisdictions are aggressively pursuing. Even if the seller is not responsible for collecting sales taxes, the purchaser may have an obligation to pay the tax in the form of a use tax. States are also pursuing purchasers who are not paying the appropriate use taxes on collectibles purchased out of state or country by examining import declarations and bills of shipment. Art collectors have been caught in the middle of investigations as a result of tax avoidance—intentional or not.

For example, the former CEO of Tyco International, Dennis Kozlowski, was recently forced to pay $3.2 million in sales tax and interest on 12 paintings—along with serving at least eight years in prison. Kozlowski was connected to the avoidance of millions of dollars in sales taxes as a result of

29 An exemption may be available if the purchaser is purchasing for resale.
the purchase of expensive art objects. He had purchased artwork from several New York dealers. These transactions were documented so as to indicate that the artwork was shipped to New Hampshire, where Tyco had corporate offices. However, the artwork was actually sent to Kozlowski’s personal residence in New York City. One art dealer claimed the works were shipped to New York City so that Kozlowski could decide if he actually liked the pieces. Kozlowski’s charge was the result of a broader investigation by the district attorney into more than 300 customers across nearly a dozen galleries who evaded sales tax. Prosecutors collected $37.5 million in state and city sales taxes and fines as a result of the investigation.  

**Estate and Gift Tax Planning**

The owners of a substantial collection of art or other collectibles may be pleased with their acumen but are often concerned that a high estate tax value will be placed on these objects. As a result, the estate of an individual with a substantial collection may have insufficient liquid assets to pay the estate tax. In some cases, a portion or all of a collection must be sold in order to satisfy the estate tax obligations. Generally, a forced sale of all or part of a collection may result in realization of less than the fair market value of the collectibles.

When planning an estate that consists of a collection with a substantial fair market value, therefore, it is important that special attention be given to disposition of the collection on or before the collector’s death. Sophisticated

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30 See Anemona Hartocollis, “Ex-Tyco Chief to Settle Tax Evasion Charges” (N.Y. Times, May 13, 2006), available at http://www.nytimes.com/2006/05/13/business/13tyco.html?_r=0 (the total settlement was $21.2 million—$17.9 million in city income tax, interest, and penalties).

31 See, e.g., Estate of Smith v. Comm’r, 57 TC 650 (1972). When David Smith, a sculptor, died in 1965, his main assets were 425 pieces of his abstract metal sculpture. The IRS valued the pieces at $5.3 million while the executor valued them at only $714,000. The Tax Court compromised at a value of $2.7 million. In liquidating the estate to pay taxes and expenses, Smith’s executors paid $1 million in commissions to Marlborough-Gerson Galleries. The Tax Court ruled that the estate could deduct only $750,000 of the commissions since this was the portion which reflected sales actually needed to settle Smith’s estate and pay its taxes.

A more bizarre example concerns Arizona artist Ted DeGrazia, who burned 100 of his paintings (valued at over $1 million) to protest the federal estate tax. DeGrazia’s reason for destroying his work was that, because of the estate tax, his heirs could not afford to inherit his works.

32 The concept of “blockage” generally utilized in connection with the sale of a large number of securities is applicable to the situation where a collector’s estate is attempting to sell a large number of art objects. Each willing buyer in the retail art market will take into account, in determining the price he would be willing to pay for any given object, the number of other objects available for sale at the same time. The presence of a large number of pieces on the art market at one time results in a lower value placed on each piece than would be the case if each piece were sold separately.
estate planners can draw from myriad planning techniques that can effectively limit the amount of transfer tax payable. The following discussion describes some of these techniques.

**Lifetime Gifts to Family Members.** By making lifetime taxable gifts, an individual may be able to avoid more transfer taxes than if he or she waits until after death to pass the property. The gift tax is “tax exclusive”—that is, it is paid for out of money that is not being taxed. On the other hand, the estate tax is “tax inclusive,” paid for out of money that is subject to tax. The Example illustrates this concept.

*Example:* Assume Taxpayer has used the federal gift tax exemption, and is now in the 40 percent gift and estate tax bracket. If Taxpayer gives his children $1 million as a gift during his lifetime, the gift tax will be $400,000. The donor is responsible for paying that gift tax. Therefore, the children receive the full $1 million, and the donor, Taxpayer, must pay a $400,000 gift tax—a hefty tax bite to be sure, but it will reduce the amount of his taxable estate upon death.\(^\text{33}\) Simply put, it will cost Taxpayer $1.4 million to gift $1 million to his children. However, that’s a bargain. If he waits until death, because the estate tax will kick in, it will instead cost $1,666,666 to leave the children that same $1 million (40% estate tax × $1,666,666 = $666,666 tax payment owed; leaving $1 million for heirs).

As the Example shows, gifting during life allows the donor to pass more assets and pay less in taxes because the individual is taking advantage of the tax-exclusive nature of the gift tax. Current law allows an individual to gift $14,000 per person to as many different individuals as he or she desires. A gift that comes within the $14,000 annual exclusion makes sense since it will entirely avoid gift and estate taxes. If the collector is married, having the spouse consent to the gift increases the couple’s annual exclusion to $28,000 per donee.

*Getting the Most Out of the Annual Exclusion.* The individual should analyze the items in the collection and determine the items worth less than $28,000 (or $14,000). If an appraisal reveals a large number of items worth less than the annual exclusion, the individual should consider embarking on a lifetime gift program. Gifts of partial interests in more substantial items

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\(^{33}\) Under IRC § 2035, the donor must survive for three years after the payment of the gift tax.

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may also come within the annual exclusion. The availability of the annual exclusion is often all that is necessary to make an entire transfer effective for a collector with a modest collection.\textsuperscript{34} Note that possession needs to be with the donees, however.

A married couple can shift large amounts out of the estate simply by making annual exclusion gifts. For example, a married couple with four children may gift a total of $112,000 ($28,000 to each of the children) in cash or property. Each spouse may use the other’s exemption (with the consent of the other party). The gift amount will be the fair market value of the asset or collectible at the time of the gift. Therefore, it is essential to obtain verified appraisals from valuation professionals. This practice can gradually remove the asset transfer tax-free.

In addition, a gift-giving program has built-in estate freezing benefits. The items transferred may well be appreciating in value, and this future appreciation is shifted from the donor to the donee. Furthermore, a gift-giving program does not necessarily entail loss of control over the collection by the donor. These gifts can take the form of a minority interest in an art holding entity over which the collector maintains voting control.\textsuperscript{35}

\textbf{Using the Lifetime Gift Exemption.} In certain cases, it may be appropriate to make larger gifts of collection items to the next generation. A large gift can effectively remove a rapidly appreciating collection item from the collector’s estate. In addition to annual exclusion gifts, the individual may also make gifts that utilize the lifetime gift exemption of $5.25 million without incurring gift tax.\textsuperscript{36} However, any gift that utilizes the individual’s lifetime exemption reduces the individual’s estate tax exemption upon death. If the individual is willing to incur a gift tax by making a gift that exceeds the $5.25 million gift tax exemption, the payment of this gift tax will also reduce the individual’s estate—so long as the individual survives the payment of the gift tax by three years. As with the annual exclusion, a married couple may combine the two individual exemptions to permit transfers of $10.5 million. However, prior to making any large gift, the estate tax savings to the individual should be compared with the potential capital gains tax to the donee.

\textsuperscript{34} For example, consider a married collector in his fifties with a collection valued at $500,000, with two married children and four grandchildren. If he includes the spouses of his children in a gift-giving program, there would be eight potential beneficiaries of gifts. By making gifts to each beneficiary in the amount of $28,000 per year, he could give away $2,240,000 in the course of 10 years, free of any gift tax.


\textsuperscript{36} This exemption is $5.25 million in 2013 and will be increased for inflation in future years.
since there is no basis step-up for gifts and a step-up to fair market value applies to transfers on death.

*Planning Pointer.* Sometimes gifts of art objects to members of the individual’s family are difficult to prove to the satisfaction of the Internal Revenue Service. In this regard, it is a good practice when making lifetime gifts to have a written deed of gift, an appraisal, and a properly filed gift tax return containing a description of the gift.

**Installment Sale of Art.** Another possible transfer tax planning technique used to freeze the value of certain assets at a point in time is the installment sale. While there are many variations to structuring an installment sale, the basic approach has the individual transfer collectibles to the intended recipient in return for installment notes. The price for the collection should be its appraised fair market value, and in return the individual receives promissory notes of equal value.\(^{37}\) Meanwhile, if the individual wishes to retain possession of the collection, a lease may be entered into with the purchaser.

The installment sale technique accomplishes several transfer tax planning objectives, without significant cost to either party. The primary benefit of the installment sale occurs when the collection increases in value. Since the purchaser is vested with complete ownership of the collection, the individual’s estate is relieved of any subsequent appreciation of the collection. If the individual dies before the notes are entirely satisfied, only the value of the notes would be included in the collector’s estate.\(^{38}\)

The installment sale technique also makes it possible to defer income taxes.\(^{39}\) Alternatively, if the sale is made to an irrevocable trust that is excluded from the individual’s estate for estate tax purposes but is considered a grantor trust for income tax purposes, the sale would be ignored for income tax purposes. However, as mentioned above, the purchaser will need to take possession of the purchased collectibles.

**Lifetime Gifts to Charities.** In addition to the income tax benefits offered by making gifts to charities during the individual’s lifetime, such gifts also reduce the individual’s estate for estate tax purposes. Several recent cases suggest that there is a benefit to combining a donor’s desires to satisfy both

\(^{37}\) To the extent that the transfer is deemed to be made for money or money’s worth, no taxable gift will be deemed to be made under IRC § 2512(b).  

\(^{38}\) IRC § 2033 includes in the estate of a decedent the value of all property in which the decedent held an interest. Since the decedent in this case would have an interest only in the notes, the appreciation of the collection would not affect the estate.  

\(^{39}\) Note that the installment method is not available for art or other collectibles that are considered inventory. IRC § 453(b)(2)(B).
charitable and non-charitable goals. Doing so can create a situation in which the IRS may not be able (or at least will have much less incentive) to challenge the appraisal obtained by the donor by incorporating a defined value clause into the donor’s planning.

**The Petter Transaction.** In *Estate of Petter v. Commissioner*, the Tax Court, which was affirmed by the Ninth Circuit, upheld the use of a defined value clause that reallocated limited liability company (LLC) units between charitable and noncharitable donees when the value of the LLC units was later increased on audit. Mrs. Petter wanted to transfer UPS stock that she inherited from her uncle to her two children. She first transferred the stock, worth $22.6 million, to a newly created LLC known as the Petter Family LLC. She then made two separate gifts of 940 membership units, with a portion of such membership interests equal to “one-half the minimum dollar amount that can pass free of federal gift tax by reason of Transferor’s applicable exclusion amount allowed by Code Section 2010(c)” passing to an irrevocable trust for the benefit of each of her children and the balance of the gifted membership units passing to a donor advised fund: the A.Y. Petter Family Advised Fund.

The transfer document also contained a reallocation provision where each trust and the donor advised fund agreed to transfer membership units to the other party in the event that one party initially received more membership units than it was entitled to receive based on values as “finally determined for federal gift tax purposes.”

Mrs. Petter also sold 8,459 membership units in the LLC to each trust using a similar defined value clause providing that any membership units with a fair market value in excess of $4,085,190 would pass to two charitable organizations. In exchange, each trust issued to her a secured promissory note with an initial principal amount of $4,085,190, which provided for quarterly payments over a 20-year term. The sale documents also contained a reallocation provision similar to the one contained in the transfer documents for the gifts.

Shortly thereafter, a formal appraisal of the membership units was obtained which applied a 53.2 percent discount to the value of the membership units. Based on the appraisal, the attorney allocated the appropriate number of units among the parties.

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40 TC Memo. 2009-280.
41 653 F3d 1012 (9th Cir. 2011).
42 The court noted that this was a scrivener’s error and was meant to be “maximum” rather than “minimum.”
In August 2003, Mrs. Petter filed her gift tax return and reported the above transactions. The IRS audited the return and increased the value of the units so that a 29.2 percent discount was applied, instead of the original 53.2 percent. More important, the IRS would not honor the reallocation clause and, therefore, did not allow any gift tax charitable deduction for the additional units that were passed to charities based on the increased valuation. She filed a petition with the Tax Court. The parties agreed on a 35 percent discount for the units, so the only issue was whether the formula allocation (which resulted in an increase in the gift tax charitable deduction due to the additional units passing to the charitable organizations) would be respected.43

The court upheld the defined value clauses, despite the IRS’s argument that they were void as contrary to public policy. The court went all the way through the history of “savings clauses,” ending with an examination of the recent Christiansen case.44 In that case, a formula disclaimer, with the excess passing to charity, was found not to violate public policy. The Petter court drew a distinction between Christiansen and earlier cases that invalidated “savings clauses.” In doing so, the court noted that “a gift is valued as of the time it is completed, and later events are off-limits. Also, gift tax is computed at the value of what the donor gives, not what the donee receives.” The Christiansen court found that a later audit did not change what the donor was giving, but, rather, prompted final allocation of the shares that the donees received.

Nonetheless, the Petter court pointed to various factors in upholding the use of the defined value clause, stating that the charitable foundations were not aiding “shady dealing.” Rather, the foundations were protecting their interests and promoting gifts to charities. The gift made the charities equal members in the [LLC], giving to charities power to protect their interests through suits for breach of the operating agreement or breach of a manager’s fiduciary duties, as well as for the right to vote on questions such as amending the operating agreement and adding new members. These features leave us confident that this gift was made in good faith and in keeping with Congress’s overall policy of encouraging gifts to charities.

Moreover, the directors of the foundations owed a duty to their organizations to ensure that the appraisal was acceptable before approving the gift.

43 This case did not involve collectibles. Note that if collectibles are used, the availability of valuation discounts are more problematic.

44 Estate of Christiansen v. Comm’r, 586 F3d 1061 (8th Cir. 2009), aff’g 130 TC 1 (2008).
The Hendrix Transaction. Another recent case that approved the use of defined value clauses is Hendrix v. Commissioner. In Hendrix, the parents transferred stock in an S corporation to trusts for their daughters and a charitable donor advised fund using a defined value formula clause. The formula essentially transferred a specified dollar amount to the trusts, and the balance of the shares passed to the donor advised fund. The transfer instrument provided that the amount passing to the trusts was to be determined by looking at “the price at which shares would change hands as of the effective date between a hypothetical willing buyer and a hypothetical willing seller, neither under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” Moreover, the transfer instrument provided that the transferees, rather than the parents, would determine the allocation. The trust and the donor advised fund each obtained their own independent counsel and their own independent appraiser to review the original appraisal. The trust and the donor advised fund negotiated for about three months, eventually coming to an agreement on value.

The IRS argued that the transaction was not an arm’s length transaction, and that it was contrary to public policy because it inhibits the IRS incentive to audit the tax return. As to the arm’s length argument, the court recognized that the daughters were close to the parents but said that relationship did not necessarily negate an arm’s length transaction. The court also stated it was not essential to have adverse interests and negotiations. Moreover, the trusts assumed economic and business risks under the transactions. As to the donor advised fund, the court listed several factors indicating it was an arm’s length transaction:

1. The transaction was consistent with prior charitable transfers by the parents;
2. The donor advised fund accepted potential risks such as the loss of tax exempt status if it failed to exercise due diligence;
3. The donor advised fund negotiated some elements of the transaction, by insisting that the parents pay income taxes attributable to the S corporation income if the corporation did not distribute enough cash to pay those taxes;
4. The donor advised fund was represented by independent counsel;
5. The donor advised fund conducted its own independent appraisal; and
6. The donor advised fund had a fiduciary obligation to ensure that it received the proper number of shares.

45 TC Memo. 2011-133.
As to the public policy argument, the court used reasoning similar to that in *Petter*. It analyzed *Christiansen* and decided that although the *Christiansen* case involved a formula disclaimer and this one involved a direct formula transfer, there was no reason to distinguish the two. The court summarized its holding when it noted that no additional value passed to the foundation after the parents transferred the stock. Therefore, the court said if no additional value passed to the foundation, then implicitly no additional value passed to the trusts.

**Transfers to Charity Upon Death.** An individual may also wish to donate art or other collectibles to a charitable organization upon death. While such a donation will not provide an income tax deduction, the deceased’s estate will be entitled to an estate tax deduction so that the donated collectibles will not be subject to estate tax.

Where available, retirement assets such as IRAs or 401(k) plan accounts are especially attractive to use for charitable gifts upon death because the charity, unlike a family member, will not be subject to income tax when the funds are distributed out of the retirement plan. In order to properly document the gift of these funds to charity upon the individual’s death, the beneficiary of the retirement account should be changed to reflect the charity. The individual’s estate can then independently sell the collectibles to the charity, which would use the retirement funds it received as retirement account beneficiary for the purchase. Since the estate has a stepped-up basis in the collectibles, the estate should not recognize any gain on such sale.

**Gift Acceptance Agreements.** A large part of planned giving is the donor’s desire to see the contribution put to effective use. Therefore, a donor may not want to give an unconditional gift. Instead, it may be beneficial for the donor 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 restricted contributions. Many of the issues surrounding the conflicting desires can be resolved by a gift acceptance agreement between the donor and the organization. This agreement can be used for both cash and non-cash contributions, and can outline the terms of the contribution so that the donor and organization agree on how the contribution will be used. For example, if a donor wants to contribute cash to a university over the course of five years, yet wants to ensure the funds will be put towards the

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development of the school’s art studies program, the parties can come to an agreement that specifies how the university can use the contribution.47

Conclusion

If taxpayers plan carefully, the tax code can be used to great advantage. For example, Ronald Lauder, son of the cosmetic mogul, Estee Lauder, has used the tax code to qualify for “deductions worth tens of millions of dollars in federal income taxes over the years, savings that help defray the hundreds of millions he has spent creating one of New York City’s cultural gems (the Neue Galerie).”48 While outsiders may criticize the billionaire’s ability to weave through the tax code, a former IRS commissioner complimented Lauder on his ability to balance the private interests with the public good; “If an art collector makes significant contributions, and the public actually gets access to the works they are donating, then the major thing the collector gets is prestige and social status.”49


49 Id. (quoting Sheldon Cohen).