

# FAMILY FOUNDATION *Advisor*

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## Double Exposure: The Benefit of Private Operating Foundations for Collectors

by Richard M. Horwood

When they first begin to purchase art, few collectors consider developing a comprehensive plan to build a collection. Even fewer consider tax-efficient strategies. Instead, the collection usually begins with an innocent impulse purchase of an object that the buyer finds appealing or intriguing. For example, a young couple with a shared interest in modern art may come across one of Frank Auerbach's early paintings that they feel would look perfect in their den, and they decide to purchase it. Then, over the next few years, the couple purchases a few more Auerbachs to complement their initial purchase, and maybe a few by George Bellows to satisfy their fascination with old New York. As the couple begins to acquire more and more artwork, their collecting evolves from a casual hobby to a passion and a substantial financial investment. The collection has amassed a sizable monetary and emotional value for the couple. Now, they are faced with the daunting task of effectively managing it.

Foremost, the couple wants to be able to

enjoy and retain control over the collection they have built. Further, they want to ensure that their life's passion will not be dismantled after their deaths. However, given the value of the collection, they need to protect themselves from paying sizable capital gains taxes whenever they decide to

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sell an object, and protect their heirs from possibly onerous estate taxes upon death. Often, the only way the couple knows to minimize taxes is to donate the artwork, frustrating their ability to enjoy and control the collection.

This article explores an option to resolve this quandary by illustrating the use of a private operating foundation as an effective means to facilitate several primary goals collectors typically have: enjoyment, preservation, and tax efficiency. Thus, they achieve "double exposure"—still seeing the collection after giving it away.

### Typical Donations of Art

**Advantages of Donations to a Museum.** Collectors often contemplate donating their collection to a museum, especially if the museum expresses a genuine interest in the collection. This is understandable as such a donation has multiple advantages.

Most notably, the collector may take an income tax deduction based on the fair market value of the donation, subject to certain restrictions. The collector can deduct the donation's fair market value from adjusted gross income (AGI), subject to a limit of 30% of AGI.<sup>1</sup> If the donation's value exceeds 30% of the collector's AGI, the collector can carry over the excess deduction for up to five years.<sup>2</sup> In addition to the income tax advantage, the collector can minimize potential estate tax liability through the donation. Because the collector transferred all title to the artwork to the museum by donating it, the value of the artwork will not be included in the collector's estate upon death. With the top federal estate tax rate at 40%, and some states assessing their own estate taxes, removing the collection from the estate can have a significant impact on the collector's tax liability.<sup>3</sup>

From a more altruistic perspective, a donation to a museum may afford the opportunity to share a collection with the general public. A museum can provide a secure location to display the collection, allowing others to freely enjoy and appreciate it.

*See DOUBLE EXPOSURE, next page*

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ciate the works. Just as the collectors were once inspired by art objects they saw in museums, they can help inspire a new generation by allowing the museum to display their collection.

#### **Drawbacks of Museum Donations.**

One of the potential drawbacks to donating to a museum is that there is no guarantee that all, or even any part, of the collection will be displayed. Museums have limited exhibition capacity and thus are often required to keep the bulk of their pieces in storage.<sup>4</sup> Even if the collection is initially displayed, museum curators acknowledge that tastes change over time and an artist's career may "fizzle," resulting in a collection being locked away indefinitely in the museum's warehouse. For this reason, museums are generally reluctant to accept donations that have restrictions on them, such as a requirement that the collection be permanently displayed.<sup>5</sup> In addition, museums want to reserve the right to sell (deaccess) donated works to purchase other works that become more desirable.

If the museum believes some of the donated pieces are duplicative of objects they already have on exhibit, they are likely to relegate the pieces to storage or refuse the donation. In fact, some museums decline to accept a majority of the donations they are offered. For example, the Houston Museum of Fine Arts estimates that it only accepts 1 out of every 10 objects it is offered.<sup>6</sup>

Another issue is that the museum may close or change its focus, making the fate of the collection uncertain. Recently, Ansel Adams's personal collection was subject to this issue. Adams donated a number of his prints to the Fresno Metropolitan Museum with the intent that the prints be exhibited for the public's enjoyment.<sup>7</sup> However, after the museum went bankrupt, it planned to sell the prints at auction. Attempting to prevent the prints from being sold to private buyers, contrary to Adams's original intent, Ansel Adams's son, Michael, filed suit to enjoin the museum from going forward with the auction. Ultimately, the Fresno Metropolitan Museum agreed to return five prints to Michael in order to settle the lawsuit.<sup>8</sup>

Sales of a collection may occur even if the museum does not go bankrupt. The

Delaware Art Museum recently sold a number of objects in order to cover a portion of the cost of a building renovation.<sup>9</sup> While museums can lose their accreditation with the American Alliance of Museums for selling objects to cover construction or operating costs, the loss of this accreditation was not significant enough of a deterrent, given the museum's financial needs, to prevent the Delaware Art Museum from going forward with the sales.

**Practice Point:** Essentially, the potential issues for collectors of a typical donation to a museum center around one major point: a lack of control. Once the museum has title to it, the collector and his or her heirs typically are unable to dictate what happens with the collection that took years to build. Whatever their vision or plan for the collection, it is now the museum's vision that will be fulfilled.

#### **Museum Loans as an Option**

To overcome the issues presented by giving up control of a collection, collectors can lend their objects to a museum for a specified period of time. For example, collectors may lend their art to the museum as part of a special, limited-time exhibition. Where longer-term loans are contemplated, however, a collector may be concerned that the collection will end up sitting in storage—say, if the museum's curator decides that he or she no longer wants to exhibit the objects. To assuage that concern, the museum may be required to return the collection under the terms of the loan agreement.

**Practice Point:** By lending their art, collectors retain the altruistic benefit of sharing their collection with the general public. The primary drawback to making a loan, rather than a donation, to a museum is that the collector does not receive an income tax benefit. Further, when the collector dies, the full fair market value of the collection will be included in the collector's estate for estate tax purposes, unless it is donated to charity upon death. In other words, lending the collection affords the collector minimal tax benefits.

#### **Establishing a Private Operating Foundation**

For some collectors, the optimal tax-efficient solution for managing their col-

lection may be establishing a private operating foundation. A private operating foundation is a private foundation that dedicates the majority of its resources to conducting certain tax-exempt activities,<sup>10</sup> affording it some of the same tax benefits that are given to public charities. A private operating foundation's permissible tax-exempt activities include

1. The exhibition of an art or antiquities collection in the foundation's own museum; or
2. Lending objects for display in other public museums.

#### **Benefit #1: Collector Retains Control.**

A collector can establish a private operating foundation for the exclusive purpose of managing and exhibiting her collection. In doing so, the collector indirectly retains control over the collection. The collector retains the authority to display, sell, loan, or gift any of the pieces in the collection.

Also, the foundation can establish the private museum in a space conveniently located near the collector's residence, allowing her to fully enjoy the collection at her convenience. (For example, the Glenstone museum, established by Mitchell and Emily Wei Rales to manage their postwar art collection, is located on the other side of a small duck pond from their house.<sup>11</sup>)

Further, while the foundation's private museum must make the collection accessible to others, the foundation retains the ability to limit the amount of public access. A notable example of this ability to limit access is the Hall Art Foundation, which has had less than 1,600 visitors to its museum since it opened in 2013 and is only open to the public for six months of the year.<sup>12</sup>

**Benefit #2: Tax Savings.** Perhaps most important, once a collector donates her collection to her private operating foundation, he realizes a number of tax benefits. Foremost, the collector receives the same income tax deduction for the fair market value of the collection as if it had been donated to a museum. Additionally, since the foundation assumes ownership of the collection, the collection is not considered

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*DOUBLE EXPOSURE, from page 2*

a part of the collector's estate for estate tax purposes.

The private operating foundation also enables collectors to actively manage their collection without having to be concerned about tax consequences. In addition, the private operating foundation generally is not subject to sales taxes when it purchases new objects for the collection.<sup>13</sup>

Further, the foundation does not have to pay capital gains taxes on any gains that are realized from the sale of an object. In other words, the foundation can freely add and subtract from the collection, allowing the collector to modify the collection based on changes in taste or vision, without having to incur tax liability for each transaction or having to worry about complying with complicated like-kind exchange rules.<sup>14</sup>

### Conclusion

In short, a private operating foundation affords collectors the best of both worlds: the tax benefits of donation plus continued control. As a result, the collectors can enjoy the collection, dictate how it is managed, and minimize tax liability, possibly creating their own unique "masterpiece" of personal tax planning.

### Endnotes

1. See IRC §170(b)(1)(B).

2. As a simple example, a collector who donates \$200,000 of artwork to a museum, and whose AGI is \$100,000 can deduct \$30,000 from AGI for that year. This means \$170,000 of the donation has not been deducted. The collector can carry over the unused donation amount for the next five years; thus (assuming her AGI remains \$100,000 each year), she can deduct \$30,000 from her AGI each of the next five years. In the

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end, she will be able to deduct a total of \$180,000 (\$30,000 x 6).

3. See IRC § 2001(c).

4. For example, a California cattle breeder who amassed a large Asian art collection opted not to donate his collection to the San Francisco Asian Art Museum due to the high probability that a portion of the collection would indefinitely sit in storage. See Mary Abbe, "Minneapolis Institute of Arts Given \$25 Million Collection of Japanese Art," *Star Tribune*, June 5, 2013. Available at [www.startribune.com/minneapolis-institute-of-arts-given-25-million-japanese-art-collection/210139451/](http://www.startribune.com/minneapolis-institute-of-arts-given-25-million-japanese-art-collection/210139451/).

5. *How to Donate Art: A Primer*, ArtBusiness.com. Available at [www.artbusiness.com/donateart.html](http://www.artbusiness.com/donateart.html).

6. Daniel Grant, "How to Say 'No Thanks' to Donors," *Wall St. J.*, May 19, 2010. Available at

[www.wsj.com/articles/SB10001424052702304222504575173803616852666](http://www.wsj.com/articles/SB10001424052702304222504575173803616852666).

7. Robert Kahn, "Ansel Adams' Son Sues Museum for Prints," *Courthouse News Service*, Mar. 5, 2010. Available at [www.courthousenews.com/2010/03/05/25298.htm](http://www.courthousenews.com/2010/03/05/25298.htm).

8. "Fresno Museum Won't Sell Rare Ansel Adams Prints," *Clancco*, Apr. 26, 2010. Available at [www.clancco.com/wp/2010/04/ansel\\_adams\\_fresno\\_museum](http://www.clancco.com/wp/2010/04/ansel_adams_fresno_museum).

9. Marie C. Dooley, "Delaware Museum of Art Receives Generous Donation Despite Recent Move to Sell Off Art," *Fox Rothschild Art Law*, Nov. 13, 2014. Available at <http://artlaw.foxrothschild.com/2014/11/articles/art-finance/delaware-museum-of-art-receives-generous-donation-despite-recent-move-to-sell-off-art/>.

10. To qualify as a private operating foundation, the foundation must (1) meet an income test, and (2) meet an asset test, endowment test, or support test. IRC §4942(j)(3).

11. Patricia Cohen, "Writing Off the Warhol Next Door," *N.Y. Times*, Jan. 10, 2015. Available at [www.nytimes.com/2015/01/11/business/art-collectors-gain-tax-benefits-from-private-museums.html?\\_r=0](http://www.nytimes.com/2015/01/11/business/art-collectors-gain-tax-benefits-from-private-museums.html?_r=0).

12. *Id.*

13. Most purchases of artwork and other collectibles are subject to a sales tax at the time of purchase. However, if the collector purchases the item from a seller located in a different state, instead of being subject to sales tax, it is usually subject to the collector's resident state use tax when brought into the resident state.

14. Under IRC §1031, a collector may be able to avoid paying capital gains tax on the sale of a piece if she buys another piece with the proceeds from the sale within 180 days. However, the piece that was sold must have been held for productive use in a trade or business or for investment at the time it was sold, and the piece that is purchased must be of "like kind"—if a painting was sold, a painting must be purchased—to be eligible for a 1031 exchange. See IRC §1031.