

DONATING TANGIBLE ASSETS

Alternatives to Selling Art and Collectibles

Many people take pleasure in “collectibles,” perhaps even amassing sizable and valuable collections of art, stamps and coins, jewelry, antiques, and other forms of tangible personal property.¹ However, despite the pervasiveness and often high value of collectibles, owners of these items often fail to plan adequately for their disposition. This article outlines the options available to a collector or artist in disposing of collectibles, and highlights the benefits of donating such items to a non-operating private foundation.

The first consideration is determining whether to divest oneself of the collection during one's lifetime or upon death. In either case, the collector can (i) monetize the collection by selling it; (ii) gift it to family or friends during one's lifetime or as an inheritance at death; or (iii) donate it to charity.

SELLING A COLLECTION

There may be some initial uncertainty as to the selling price of a collection because market values fluctuate with demand, an item or collection may be extremely rare, etc. However, once an offering price is determined, a second key factor in selling a collection involves tax considerations, and specifically, the collection's cost basis. The cost basis will depend on how the collection was acquired.

- ➔ If the items in the collection were created by the owner, the cost basis is the cost of the materials.
- ➔ If the collection was acquired by purchase, the cost basis is the price paid for the collection plus subsequent capital investments, such as restoration.
- ➔ If the collection was received by way of gift, the cost basis is the prior owner's cost plus subsequent capital investments.



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- ➔ If inherited, the cost basis is stepped-up to the fair market value as of the deceased owner's death. Any appreciation from the date of death to date of sale is capital gain.

A creator of the collection, or a dealer who held the collection as inventory, will report the sale price minus the seller's cost basis as ordinary income (usually taxable at the highest tax rates). If the seller did not create the work and is not a dealer, the seller will report the sale price minus cost basis as capital gains (usually taxable at a lower tax rate than ordinary income). A seller who can demonstrate that he or she is a professional collectibles investor or dealer will be able to take a deductible loss if the sale is for less than cost basis. For most collectors, a collection is held “for personal use,” such as display in their homes, and no loss on a below-basis sale is allowed. The current federal tax rates for different types of sales of collectibles are as follows: (a) up to 37% if ordinary income or capital gain on assets held for less than one year; (b) a flat 28% on all other collectible sales plus a 3.8% Medicare surtax for certain high income sellers. In addition, some states may have their own tax rates on sales of collectibles.

If the sale of the collection can be delayed until the collector dies, and then sold soon thereafter, there will be little or no capital gain due to the stepped-up basis at death. Correspondingly, if the collection has depreciated prior to the owner's death, the collection will receive a step-down in basis.

For a large estate (one that exceeds the applicable federal gift and estate tax exemption), selling a rapidly appreciating collection during life—even at a 28% capital gain rate—and making gift-tax-free annual exclusion gifts over time may be preferable to paying federal estate tax at a 40% rate. Artists and collectors with illiquid estates should aim to

¹ For a definition of tangible personal property for charitable purposes, see IRS Pub. 526.

avoid a potential “fire sale” of a collection in order to pay estate taxes. Moreover, large sales from a single artist within a short time period can reduce the value of the collection² and therefore should also be avoided.

TRANSFERRING A COLLECTION

An artist or collector who wants to pass on her collection to heirs must weigh the loss of possessing and enjoying the collection herself with reducing her future estate tax exposure. One solution would be to form a separate entity, such as a limited partnership or limited liability company, with the artist or collector owning 100% of the entity and then selling or gifting fractionalized interests in the entity to her heirs. The value of the ownership interests in the partnership or LLC that were not gifted would be included in the artist's or collector's estate, but would potentially be discounted on account of her now minority interest and lack of marketability. (After all, buyers may not line up to become partial owners of a collection shared with strangers and/or relatives of the collector.)

The collection also could be transferred to a spouse outright or with the direction to sell the collection without gift tax implications. Another option would be to transfer the collection to a trust that, if properly structured, could provide an income stream and eliminate future appreciation from the estate. Alternatively, a trust could be established for a surviving spouse who can, if desired, authorize the sale of the collection. Such a trust can ensure that the artist's or collector's intended beneficiaries receive the collection itself or the proceeds from the collection's sale.

DONATING A COLLECTION TO A PUBLIC CHARITY

By donating the collection to charity, the collector could receive both a tax benefit and leave a legacy, thereby showcasing the collection for future generations. For income, gift, and estate tax purposes, the charity must be a “qualified” charitable organization.³ In addition, to maximize the amount of a charitable deduction for income tax purposes, the collection must be used in a manner related to the charity's tax-exempt purpose (rather than sold upon receipt of the donation). For example, if a donor donates a painting to an art museum to add to its holdings, unless the donor knows otherwise, it may be reasonable for the donor to assume



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that the painting will be put to a related use (e.g., mounted in an exhibition, used to teach restoration techniques, etc.). By contrast, if the painting is sold within three years of the contribution, part of the donor's charitable contribution deduction could be recaptured.⁴ This can be avoided, however, if the charity “certifies” that the property donated was intended for a related use, but that such use is now impossible or unfeasible. If counsel drafts the gift agreement, the donor should ask about including a term in the agreement requiring the charity to use the donated item(s) for an exempt purpose related to its mission for a stated minimum period of time.

If the collection is donated to the charity upon death, there is no capital gains tax liability (as with any gift) and no estate tax due to the estate tax charitable deduction. If donated during his or her lifetime, the donor avoids capital gains taxes, removes the value of the collectibles from his or her estate, and also receives an income tax deduction (limited to certain percentages of adjusted gross income). The income tax deduction for donations of art, collectibles, and other forms of tangible personal property is limited to 30% of the donor's adjusted gross income if the charity is a public charity or a private operating foundation (20% if a private non-operating foundation). Any excess contributions generally can be carried forward for five years.

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For deductions greater than \$5,000, the donor must file Form 8283 and include a “qualified appraisal” from a “qualified appraiser.” Tax returns selected for audit where donated artwork is valued greater than \$20,000 or more should follow guidelines by the IRS Art Advisory Panel. This panel will automatically scrutinize donated artwork valued in excess of \$50,000.

DONATING TO ONE'S OWN PRIVATE FOUNDATION

For an artist or collector who wishes to transfer ownership of a collection, a private foundation (either operating or non-operating) offers yet another option. Unlike a publicly supported charity,

² The IRS recognizes this fact and provides a “blockage discount” in valuing collections for estate tax purposes.

³ Consult a tax advisor prior to making a donation of art or other valuable collectible.

⁴ The donor would include in his or her income the deduction originally claimed minus the basis in the property when the contribution was made.

such as an art museum that depends on fund-raising for its operations, a private foundation is funded and controlled by an individual, family, or corporation. It therefore offers some of the benefits associated with donating to a publicly supported charity, but with a greater level of control. There are many reasons why an artist or collector might want to create a private foundation:

- The donor can retain a level of control over the foundation, including holding the collection within it. He or she can make sure the pieces stay together, determine where, how often, and how they are displayed, and ensure that they're on exhibit instead of languishing in storage.
- The art can remain a permanent holding of the foundation: Because a private foundation can own and hold any type of asset (unlike donor-advised funds, which typically require the donor to sell the asset first and then donate the proceeds), the collection can remain in the permanent possession of the foundation.
- A foundation may hold collectibles and other tangible property strictly as an investment (with no intention to display it publicly). Alternatively, if the tangible property is publicly displayed or actively used by the foundation in carrying out its mission, the donation may be classified as a charitable use asset. As we will explain, there are a number of advantages to designating the contribution as a charitable use asset.
- If created during his or lifetime, the donor can personally experience the joy of directly sharing his or her collection with the public.
- Unlike donor-advised funds and other charitable vehicles that typically liquidate donations of tangible property immediately upon receipt, a private foundation can accept and hold them indefinitely. The artist or collector therefore avoids having to sell the collection quickly and, potentially, at distressed prices.
- If contributed during the collector's lifetime, the collector receives an income tax deduction for the donation's fair market value, provided the foundation is an *operating* foundation and that the donated tangible property is put to a related use. For a *non-operating* (or grant-making) foundation, or where the donor is



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also the creator of the donated collection, the deduction is limited to cost basis (or the lower of fair market value and basis if the property is depreciated at the time of donation).

- The donor can involve his or her family members in the foundation. Not only will family members get to have hands-on experience with philanthropy, but if their work is helpful and appropriate, they can also be paid a salary that is commensurate with the foundation's size and the individual's experience, time, commitment, and responsibilities.
- Whereas a museum might want to sell off lesser examples of a collection or even part with the collection altogether if its curatorial priorities change, a private foundation can preserve all options for the donor and future foundation directors. The collection can be sustained in perpetuity, grow over time, or be sold in part or in whole.
- Private foundations can employ a wide variety of IRS-sanctioned philanthropic capabilities related to its mission. These might include awarding music school scholarships to talented street buskers, making loans to cash-strapped museums to mount new exhibitions, or running programs that help artists inspire and beautify their communities with public murals.

OPERATING OR NON-OPERATING FOUNDATION?

If the donor decides that setting up his or her own a charitable organization is the way to go, there are two distinct categories of private foundations to consider:

- Non-operating foundations
- Operating foundations

At the most basic level, the primary difference between non-operating foundations and operating foundations is the extent to which its resources and operations are dedicated directly to charitable activities and services, and whether such operations are carried on continuously or merely sporadically.

Non-Operating Foundation

These foundations typically make grants to public charities, and they make up the vast majority of the private foundation community. They can conduct their own direct charitable activities but running their own programs is not their primary focus. In addition, these foundations can make grants to individuals, award scholarships, make

international gifts, and follow special procedures to make grants to organizations that aren't recognized as 501(c)(3) organizations. These foundations are the kind that Foundation Source establishes and supports.

Operating Foundation

An operating foundation directly operates its own charitable activities (rather than making grants to nonprofits) and must be significantly involved in its own projects in a continuing and sustaining fashion. (Examples might include the operation of a museum, zoo, library, or research facility.)

The Case for an Operating Foundation

For collectors, the primary appeal of donating to an operating foundation is that it confers the same tax benefit as gifting to a museum or other public charity while allowing the donor to retain complete control over the collection. Moreover, the donor can determine how the foundation uses the collection to fulfill its exempt purpose.

The foundation can then lend the art to a museum or university (as opposed to gifting it outright), which ensures it won't be sold or warehoused. And when art is exhibited at a prestigious museum or institution, it benefits from that institution's reputation and cachet, which may have the effect of increasing the perceived quality and monetary value of the collection should the foundation one day decide to sell it.

If the donor wants to exert even more control over the art (or if prestigious institutions aren't clamoring to borrow it), the foundation itself can choose to display the art—either in a by-appointment private gallery or in a privately funded museum that is open to the general public. Art owned by the foundation cannot, however, be displayed privately in the home or on the property of a disqualified person⁵ as this is a disallowed personal benefit (“self-dealing”). Instead, the foundation's art must be housed in a space that's allocated specifically for that purpose.

Considerations

An operating foundation can be used to run a private gallery or museum, enabling the donor to retain full control over how the collection is displayed and presented. However, to ensure that

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operating foundations are adequately engaged in directly carrying out their charitable activities, each year, they are required to spend the major portion of their net investment income (85%) directly on the active conduct of their charitable operations (direct charitable expenditures).

If the foundation's charitable purpose is to share its collection with the public, and the donor puts it in a private gallery or museum, the public must have ready access. The foundation's tax status can be imperiled by restrictive limitations, such as “by appointment” viewing, that severely limit that access. There also can be considerable costs associated with this approach. Every expense, whether it's related to maintaining a clean, safe, insured, and climate-controlled building, or hiring staff to care for the art, manage public relations, or admit museum-goers, must be borne by the operating foundation.

But perhaps the biggest drawback of an operating foundation established to house a collection is that it doesn't give the donor flexibility to do much else. To maintain its status, an operating foundation is required to prove on a periodic basis that it is using most of its assets to conduct its pledged charitable purpose.⁶ Although an operating foundation can make grants to organizations that are not directly relevant to its charitable purpose, those grants will not count as qualifying distribution. In practice, this means that an operating foundation may be confined to the narrowly restricted purpose for which it was established.

The Case for a Non-Operating Foundation

If the collector doesn't want the pressure or ongoing obligation of running an operating foundation, he or she might want to contribute the collection to a private non-operating foundation. Because the annual charitable contribution deduction is limited to 20% of AGI, and the deduction will be limited to cost basis, (or fair market value if it is less than the price the donor originally paid), donating the art to a private, non-operating foundation may be less tax-efficient than donating to a public charity or operating foundation. However, a non-operating foundation may be the best choice if the collector wants to maintain control over the collection while engaging in other philanthropic interests.

⁵ Generally, a disqualified person (“insider”) is any and all of the following: foundation managers (directors, officers, trustees, and those with similar powers or responsibilities); substantial contributors and individuals or entities with a 20% or greater interest in an entity that is a substantial contributor; the family members of all such individuals; certain entities partially or wholly owned, directly or indirectly, by disqualified persons.

⁶ There is an income test that must be passed, having to do with ensuring that a sufficient percentage of the foundation's distributions relate to its stated operating purpose (e.g., running a museum). Additionally, an operating foundation must pass one of three other tests, one of which concerns distributions, a second of which concerns assets used in furtherance of the foundation's stated operating purpose, and a third of which concerns contributions.

Here are some advantages of a non-operating foundation:

Control: Like an operating foundation, a non-operating foundation gives the donor complete control over the disposition of the collection.

Philanthropic flexibility: Non-operating foundations aren't limited to a narrowly restricted purpose. This means that in addition to sharing a collection with the public, the foundation could support nonprofits relevant to its mission or fund unrelated charitable objectives. The foundation could make grants to nonprofits providing relief to hurricane victims, provide support to a community hospital, fund a pioneering STEM education program, build housing for the homeless, etc. The possibilities are almost limitless.

The donor can display the collection: Just like an operating foundation, a non-operating foundation can be used to share a collection with the public. A non-operating foundation can lend its collections to museums and other institutions or choose to display it in a dedicated space. That's because, in addition to making grants (the primary way that non-operating foundations further their missions), these entities are also permitted to use their assets to run programs. However, unlike an operating foundation, a non-operating foundation can run programs that are outside its stated operating purpose.

Considerations

If art is held strictly as an investment, there are some considerations to keep in mind. All non-operating foundations are required to distribute a minimum of 5% of the previous year's net average investment assets annually. (This is colloquially known as the "minimum distribution requirement" or "MDR.") Therefore, if a non-operating foundation is funded primarily with collectibles held as investments, the collection will need to have sufficient liquidity to meet the foundation's annual payout requirement and maintain its operations. And because the market for collectibles and individual pieces can fluctuate considerably, the foundation will need to conduct regular annual appraisals to determine its 5% payout requirement for the next year.

Once donated, tangible assets held as an investment need not be held forever. It is possible for the foundation to dispose of works over time by gifting them to a museum or other institution. Alternatively, the foundation can liquidate the collection, in part or in whole, and use the funds

to meet to meet its annual payout requirement. If and when the foundation does sell these assets, the sale will only be subject to a 1.39% excise tax on the foundation's net capital gains. Whether the foundation sells the collectibles slowly over time or the entire collection all at once, it should make sure there's a ready market for these assets. Note that family members cannot buy back the collection because they are disqualified persons (i.e., foundation "insiders"). Should a sudden need for cash arise, the foundation would not be able to sell it to a disqualified person. If the foundation were to do so, a self-dealing violation would result.

If holding collectibles as an investment becomes problematic at any point, the foundation could always *convert* the collectibles held as investments into charitable-use assets by lending them to other charities, putting the items on public display, etc. Once converted, such charitable use assets are excluded from the 5% payout calculations.

Because holding collectibles as an investment requires additional planning to ensure sufficient liquidity, holding them as charitable use asset may be a preferable option. If the collection will be publicly displayed or actively used by the foundation in carrying out its mission (for example, by lending it to a public museum), the value of the assets may be excluded from the calculation of the foundation's MDR.

As outlined above, the private foundation offers numerous benefits to donors. And with advances in technology, the cost and complexity in starting and administering a private foundation have dropped precipitously. Given that nearly all high-net-worth individuals embrace a commitment to philanthropy, and the often-overlooked opportunity of donating tangible personal property, ranging from artwork to a baseball card collection, this topic should be a part of many estate planning discussions.

Non-operating foundations aren't limited to a narrowly restricted purpose.

ABOUT FOUNDATION SOURCE

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