VALUATION AND TAX ISSUES

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November 21, 2008

I. PENSION PROTECTION ACT OF 2006 – ART WORLD PROVISIONS

The Pension Protection Act of 2006[1] (hereafter the "PPA") added new section 170(e)(7)(A) that provides if a charitable organization receives appreciated tangible personal property as a charitable contribution and disposes of the property within three years of receiving it, the donor may not derive any tax benefit beyond a deduction in the amount of the property's basis.[2] However, this rule will not apply if the donee provides a "certification" from the donee charity that the property was intended to be used or was put to a use related to the donee's exempt purpose.[3]

A. RELATED USE RULE

The related use rule applies to capital gain property that is tangible personal property contributed to a public charity. The term "tangible personal property" includes paintings and art objects not produced by the donor. The related use rule requires that the use of the tangible personal property by the donee organization be related to the purpose or the function constituting the basis for the donee's exemption under section 501. If the use of the collection by the donee organization is unrelated to the purpose or the function constituting the basis for the donee's exemption, the amount of the charitable deduction must be reduced by 100% of the appreciation in value of the collection.[4] In that instance, after the 100% appreciation reduction, the remainder may be deducted up to 50% of the taxpayer's contribution base.[5]

One of the major changes made by the Tax Reform Act of 1986 was the amendment of section 170(e)(1) so that 100% of the appreciation in value is lost as a charitable deduction if the related use rule is not satisfied. The new rule is effective for contributions made on or after January 1, 1987. Under the law in effect before January 1, 1987, only 40% of the appreciation in value was lost as a charitable deduction. Therefore, a taxpayer must be careful to comply with the related use rule; otherwise, the

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1 The Pension Protection Act of 2006 (PPA), P.L.109-280, August 17, 2006.
2 I.R.C. § 170(e)(7)(C).
3 I.R.C. § 170(e)(7)(B).
4 I.R.C. § 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4(b)(3).
5 I.R.C. §§ 170(b)(1)(A); (c)(1).

charitable deduction for appreciated long-term capital gain property that is tangible personal property will be limited to his cost.

The regulations[6] provide that a taxpayer may treat the contribution of a collection as meeting the related use rule if:

1. The taxpayer establishes that the collection is not in fact put to an unrelated use by the donee; or if,

2. At the time of the contribution, it is reasonable to anticipate that the collection will not be put to an unrelated use by the donee organization.

If a collector donates a collection to a museum and the collection is of a general type normally retained by museums for museum purposes, it is reasonable for the donor to anticipate, unless he has actual knowledge to the contrary, that the collection will not be put to an unrelated use by the donee, whether or not the collection is later sold or exchanged by the donee. However, if an item is donated for the purpose of sale at an art auction to be run by the charity, that is an unrelated use, and 100% of the appreciation in value is lost as a charitable deduction.

Example 1: A painting contributed to an art museum that is a public charity and that can and, in fact, does from time to time display the painting prominently and publicly satisfies the related use rule. The contribution is deductible to the extent of the fair market value of the property within the 30% limitation.

Example 2: If the same painting is contributed to the Red Cross, which is a public charity and which from the outset intends to sell the painting and, in fact, promptly does sell it, the deduction must be reduced by 100% of the appreciation in value, with the balance deductible within the 50% limitation.

The regulations[7] also indicate that the related use rule is met even if the donee sells or otherwise disposes of only an "insubstantial" portion of the collection.

To date there have been few litigated cases on the subject of related use. However, a number of Private Letter Rulings in this area do shed some light on what the IRS considers a related use.

Private Letter Ruling 77-51-044

The IRS held that the related use rule was satisfied when lithographs were displayed in a camp and center devoted to handicapped and retarded children, since the lithographs were used in connection with an art appreciation program. (Private Letter

6 Treas. Reg. § 1.170A-4(b)(3)(ii), i.
7 Treas. Reg. § 1.170A-4(b)(3)(ii).

Rulings 79-11-109 and 79-34-082 reach similar results in dealing with the exhibition of works of art.)

Private Letter Ruling 80-09-027

The IRS held that the related use rule was not satisfied when a donor gave an antique car to a university, since the university did not offer a course in antique car restoration.

Private Letter Ruling 81-43-029

The IRS held that the related use rule was satisfied when a donor gave his collection of porcelain art objects to a public charity operating a retirement center, since the display of the art was related to the charity's exempt purpose of creating a living environment for its residents.

Private Letter Ruling 82-08-059

The IRS held that the related use rule was satisfied when a donor gave his stamp collection to a college, since it would be exhibited and the college had, as part of its curriculum, the teaching of engraving skills. In the ruling request the donor included letters from the college, explaining in detail how it would use the collection.

Private Letter Ruling 91-31-053

The IRS held that the related use rule was satisfied when a donor gave seeds, greenhouses, plants, livestock, animal semen, beds, desks, tilling equipment, and cafeteria equipment to a private school with exempt status under sections 501(c)(3) and 509(a)(1). The donated items of tangible personal property were to be used by the school in its plant science and animal science curriculum.

Private Letter Ruling 98-33-011

The IRS held that the related use rule was satisfied when a donor donated paintings to a Jewish community center that was not a museum but did have an arts wing and library. The community center proposed to solicit contribution of works of art that would be selected by a group of volunteers from the local community but would not be restricted to Jewish artists or to Jewish themes. The community center would accept only works of art that it expected to use in a manner related to the purpose or function constituting the basis for the community center's exemption under section 501(c)(3). The community center would display some of the works of art, and others would be put on loan with affiliated charitable organizations. The community center represented that it did not intend to sell the donated works of art except on a limited and infrequent basis when the collection exceeded the space available for display or an item was no longer relevant or it became too costly to provide maintenance and security for the work of art. The Private Letter Ruling held that so long as any loans to other charitable organizations further the community center's exempt purpose or function, then such activities will not be unrelated to the exempt purpose of the community center. However, the IRS pointed out that the community center may not rely on the exempt purpose or function of the charitable organization to which the works of art are loaned. The purpose of the loan must be to further the exempt purpose of the community center.

It is important to make sure that a proper paper trail shows that it was reasonable for the taxpayer to anticipate that the property would not be put to an unrelated use by the donee.[8]

1. Related Use Reporting

Prior to the PPA the IRS required the donee charity to file IRS form 8282 if the donee charity disposes of the property within two years of receipt. Presumably this would give the IRS the opportunity to audit the donor-taxpayer's income tax return if the price the donated item was sold for was less than the deduction claimed by the donor. Under the PPA the reporting requirement is increased to apply to dispositions made within three years after receipt by the donee charity[9]. Obviously, there is a new focus on the actual use the charity makes of the donated property. In addition, the information that must be reported now includes a description of the donee's use of the property and a statement indicating whether its use was related to its exempt purpose or function. If the donee charity does indicate a related use, it must include with the disclosure form the certification discussed below. Form 8282 was revised as of January 2007, a copy of which is attached.

Where there is no "certification" and a donee organization sells, exchanges, or otherwise disposes of the applicable property in the donor's tax year in which the contribution was made, the donor's deduction is limited to basis and not fair market value.[10] If the donated property is disposed of by a donee organization in a subsequent year within three years of the contribution, the donor must include as ordinary income for the year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.[11]

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8 *See also* Priv. Ltr. Rul. 8536022 (condominium to charity: unrelated use); Priv. Ltr. Rul. 8439005 (manuscripts to university: related use); Priv. Ltr. Rul. 8333019 (art collection to museum: related use); Priv. Ltr. Rul. 9452026 (musical instrument to be sold: unrelated use); Priv. Ltr. Rul. 9303007 (paintings to museum: related use); Priv. Ltr. Rule. 7911109 (lithographs to numerous schools: related use); Priv. Ltr. Rul. 7934082 (fractional interest in painting to museum: related use); Priv. Ltr. Rul. 9303007 (fractional interest in painting to museum: related use); Priv. Ltr. Rul. 9452026 (violin to charitable remainder trust: no related use); *See* Coleman v. Commissioner, 56 T.C.M. (CCH) 710 (1988) (horse to American Cancer Society: unrelated use); Jennings v. Commissioner, 56 T.C.M. (CCH) 595 (1988) paintings to cancer society, hospital, and college: unrelated use); Priv. Ltr. Rul. 9833011 (paintings to Jewish Community Center: related use).

9 I.R.C. § 6050L(a)(1).

10 I.R.C. § 170(e)(7).

11 I.R.C. § 170(e)(7)(A); I.R.C. § 170(e)(1)(B)(i).

The limitation on the deduction in the first tax year or the recapture of the tax benefit in a subsequent year does not apply if the donee organization makes a "certification" to the IRS. A certification[12] is a written statement signed under penalty of perjury by an officer of the donee organization which either—

(1) certifies that the property's use was related to the donee's exempt purpose or function and describes how the property was used and how such use furthered the exempt purpose of function; or

(2) states the intended use of the property by the donee at the time of the contribution and certifies that such intended use became impossible or infeasible to implement.

In essence, the claim that donated property was put to an exempt use now triggers much more scrutiny if the donee organization does not retain that property at least until the end of the third year after the property was donated.

These new rules do not apply to any contribution of exempt use property with a claimed value of $5,000 or less.

2. Related Use Penalty

In conjunction with the new recapture rules discussed above, there is a new penalty for the fraudulent identification of exempt use property.[13] In addition to any criminal penalty, any person who identifies applicable property (as defined in section 170(e)(7)(C)) as having a use that is related to the donee's exempt purpose or function and who knows that the contributed property is not intended for such a use, is subject to a $10,000 penalty.

B. QUALIFIED APPRAISAL

The PPA revised the definition of a "qualified appraisal"[14] to mean an appraisal of property which is:

(1) treated as a qualified appraisal under the regulations or other guidance prescribed by the IRS; and

(2) conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the IRS.

Effective for returns filed after February 16, 2007, the appraisal must contain a declaration that the appraiser understands that a substantial or gross valuation

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12 I.R.C. § 170(e)(7)(D).
13 I.R.C. § 6720B.
14 I.R.C. § 170(f)(11)(E)(i).

misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund, may subject the appraiser to a civil penalty under section 6695A.[15] This statement is in addition to the requirement that the appraisal contain a statement that the appraiser understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalty under IRC § 6701 for aiding and abetting an understatement of tax liability.

The existing IRC regulations still apply requiring that the appraisal not be prepared more than sixty days before the date of the contribution of the appraised property and that the appraisal be signed and dated by a qualified appraiser who charges an appraisal fee that is not based on a percentage of the value of the appraised property.[16] The qualified appraisal must contain the following information:

1. A detailed description of the property
2. The physical condition of the property
3. The date or expected date of the contribution
4. The terms of any agreement or understanding entered into or expected to be entered into by or on behalf of the donor that relates to the use, sale, or other disposition of the property contributed
5. The name, address, and taxpayer identification number of the appraiser
6. A detailed description of the appraiser's background and qualifications
7. A statement that the appraisal was prepared for income tax purposes
8. The date on which the property was valued
9. The appraised fair market value of the property
10. The method of valuation used to determine the fair market value
11. The specific basis for the valuation, such as any specific comparable sales transactions
12. A description of the fee arrangement between the donor and the appraiser

15 Notice 2006-96, 2006-46 IRB 902, § 3.04(2).
16 Treas. Reg. § 1.170A-13(c)(3).

Obviously, the cost to the taxpayer of having a qualified appraisal prepared is going to be high because of the detailed information required. A separate qualified appraisal is required for each item of property that is not included in a group of similar items of property. If the appraisal is for a group of similar items, the detailed information is required for each individual item other than items worth less than $100, for which a group description is allowed.

The qualified appraisal must be received by the donor before the due date (including extensions) of the taxpayer's income tax return.[17] That deadline is important, since the entire charitable deduction is lost if the taxpayer does not comply with that provision.

C. QUALIFIED APPRAISER

The PPA now includes in the Internal Revenue Code a definition of a "qualified appraiser"[18] to mean an individual who:

(1) has earned an appraisal designation from a recognized professional appraiser organization, or has otherwise met minimum education and experience requirements set forth in regulations;

(2) regularly performs appraisals for pay; and

(3) meets other requirements that the IRS may prescribe in regulations or other guidance.

An individual cannot be a qualified appraiser with respect to any specific appraisal unless he:

(1) demonstrates verifiable education and experience in valuing the property type being appraised; and

(2) has not been prohibited from practicing before the IRS at any time over the past three year period ending on the appraisal date.

It is now imperative that the donor check the credentials of the appraiser in order to ensure that the appraiser is an expert in the item being appraised. In other words, an expert appraiser for Dutch 17th century drawing will not be the correct appraiser for a work of contemporary art.

The existing IRC regulations still apply regarding the independence of the appraiser. Under these IRC regulations[19] the term "qualified appraiser" means an individual who holds himself out to the public as an appraiser who is an expert as to the

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17 Treas. Reg. § 1.170A-13(c)(3)(iv)(B).
18 I.R.C. § 170(f)(11)(E)(ii), (iii).
19 Treas. Reg. § 1.170A-13(c)(5)(i).

particular type of property being appraised; who understands that if he makes a false or fraudulent overstatement of value, he may be subject to a civil penalty under section 6701; and who is completely independent of the donor. To be independent of the donor, the qualified appraiser cannot be the donor or the donee, a party to the transaction in which the donor acquired the property, a person employed by any of the foregoing, or a person related (within the meaning of section 267(b)) to any of the foregoing.

For example, if a person acquired a painting from an art dealer and later donated the painting to a museum, the donor, the dealer who sold the painting, the museum, any person employed by the donor or the dealer or the museum, or any person related to any of the foregoing is not a qualified appraiser. The regulations are so broad that they appear to disqualify an auction house from being a qualified appraiser if the donor had purchased the property at auction from that auction house.

The final regulations adopted on May 4, 1988, did retain the provision that disqualifies someone who regularly performs appraisals for a person who is not otherwise excluded from being a qualified appraiser and does not do a substantial number of appraisals for other persons—for example, someone who performs appraisals for only one person. Also excluded as a qualified appraiser is any person who, if the donor had knowledge of the facts, would cause a reasonable person to expect that the appraiser would falsely overstate the value of the donated property. For example, the donor and the appraiser make an agreement concerning the amount at which the property will be valued, and the donor knows that the amount exceeds the fair market value of the property.

The appraiser selected must be a qualified appraiser because, if the donor chooses unwisely and the appraiser is later found not to be a qualified appraiser, the entire charitable deduction is lost, since it is then too late to correct the defect.[20] In order to obtain the income tax deduction, the taxpayer must attach to the income tax return a qualified appraisal prepared by a qualified appraiser.

There is a new penalty to be assessed against appraisers for certain types of valuation misstatements under section 6695A. A person who prepares an appraisal of property must pay a penalty if: (1) he knows or reasonably should have known, that the appraisal would be used in connection with a federal tax return or refund claim; and (2) the claimed value of the appraised property results in a substantial valuation misstatement or a gross valuation misstatement related to income tax. The penalty is the lesser of: (1) the greater of $1,000 or 10 percent of the tax underpayment amount attributable to the misstatement; or (2) 125 percent of the gross income received by the appraiser for preparing the appraisal. However, no penalty is imposed if the appraiser establishes that the appraised value of the property was more likely than not the proper value for the property, section 6695(A)(c).

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[20] Treas. Reg. § 1.170A-13(c)(3)(i)(A); D'Arcangelo v. Commissioner, 68 T.C.M. (CCH) 1223 (1994); Louderback v. Commissioner, 69 T.C.M. (CCH) 1675 (1995); Bond v. Commissioner, 100 T.C. 32 (1993).

1. Notice 2006-96–New Appraisal Requirements

Notice 2006-96 issued by the IRS in October 2006, offers some guidance as to the new appraisal rules introduced by the Pension Protection Act of 2006.[21] According to the Notice, an appraisal will be treated as a qualified appraisal under the new rules if the appraisal complies with all the requirements of the existing IRS regulations and is conducted by a qualified appraiser in accordance with generally accepted appraisal standards. An appraisal is treated as having been conducted in accordance with generally accepted appraisal standards if, according to the Notice, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice ("USPAP"), as developed by the Appraisal Standards Board of the Appraisal Foundation.[22]

An appraiser will be treated as having demonstrated verifiable education and experience in valuing the type of property subject to the appraisal if the appraiser makes a declaration in the appraisal that, because of the appraiser's background, experience, education and membership in professional association, the appraiser is qualified to make appraisals of the type of property being valued. For appraisals for returns filed after February 16, 2007, the appraiser will be treated as having met the minimum education and experience requirements if the appraiser has (i) successfully complete college or professional-level coursework that is relevant to the property being valued, (ii) obtained at least two years' experience in the trade or business of buying, selling, or valuing the type of property being valued, and (iii) the appraiser gives a full description of his educational background.[23]

D. FRACTIONAL GIFTS TO CHARITABLE ORGANIZATIONS

1. Fractional Gifts–Prior to August 2006

Prior to August 17, 2006 the collector who wanted to give away a collection and still enjoy its possessions on a part-time basis could convey an undivided fractional interest in the property to a charity. The transfer of an undivided fractional interest was not a transfer of a future interest than ran afoul of section 170(a)(3) or section 170(f).[24] Therefore, an immediate charitable deduction was allowable for the value of the undivided fractional interest donated. In the case of *James l. Winokur*,[25] the court held that it is the right to entitlement or possession, not actual physical possession, that controls whether a purported present interest is to be regarded as a future interest.

For example, Ms. Collector transfers an undivided one-fourth present interest in a painting to an art museum by deed of gift. She is entitled to the possession of

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21 Notice 2006-96, 2006-46 IRB 902, 10/19/2006.

22 *Id*. at § 3.02(2).

23 *Id*. at § 3.03(3)(b).

24 Treas. Reg. §§ 1.170A-5(a)(2); 1.170A-7(b)(1)(i); I.R.C. § 170(f)(3)(B)(ii).

25 Winokur v. Commissioner, 90 T.C. 733 (1988). *See also* Priv. Ltr. Rul. 8333019; Priv. Ltr. Rul. 8535019.

the painting for nine months each year, and the museum is entitled to possession for three months each year. Ms. Collector can deduct one-fourth of the fair market value of the painting as a charitable contribution on the date of the gift, subject to the permissible maximum.

The IRS position is to accept as the allowable charitable deduction the undivided percentage of the fair market value given to the charitable organization. Presumably, that position is based on Revenue Ruling 57-293,[26] which gives a specific example covering that situation. The part of that ruling dealing with a gift of a future interest is no longer applicable because of section 170(f).

2. Fractional Gifts–After August 17, 2006

The Internal Revenue Service was concerned that there was abuse of the fractional gift technique – that is, situations were discovered where a taxpayer claimed a deduction for a fractional interest in a work of art yet retained physical possession of the donated property for the full year. Under new section 170(o) introduced by the PPA, effective for contributions made after August 17, 2006, fractional gifts are no longer desirable.

i. Valuation Limitation.

Under section 170(o), the collector's initial contribution of a fractional interest in a work of art is determined as under current law and described above (full fair market value times the fractional interest donated). For purposes of determining the deductible amount of each additional contribution in the same work of art, the fair market value of the donated item is now limited to the **lesser** of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution.[27] For example, the collector who gives away a 50 percent interest in a painting when it is worth $1,000,000 would still be able to claim a $500,000 deduction. However, when the collector donates the remaining 50 percent interest 10 years later when the painting is work $2,000,000, the collector's donation would be limited to 50 percent of the initial fair market value of $1,000,000, that is $500,000, not 50 percent of the $2,000,000 current value.

ii. Timing Limitation.

The collector must complete the donation of his entire interest in the work of art before the earlier of (1) ten years from the initial fractional contribution or (2) the

[26] Rev. Rul. 57-293, 1957-2 C.B. 153. *See also* Priv. Ltr. Rul. 7728046; Priv. Ltr. Rul. 7934082; Priv. Ltr. Rul. 9303007; Priv. Ltr. Rul. 200223013.

[27] I.R.C. § 170(o)(2).

donor's death.[28] If the donee charity is no longer in existence, the collector's remaining interest may be contributed to another section 170(c) organization.

iii. Use Limitation.

Under the new provisions, the donee charity of a fractional interest in a work of art must (1) have substantial physical possession of the work of art during the donor allowed possession period (maximum of 10 years) and (2) use the work of art for an exempt use during such period – satisfy the related use rule.[29] The Joint Committee on Taxation Report[30] (the JCT Report) gives an example of an art museum described in section 501(c)(3) that is the donee of a fractional interest in a painting which includes the painting in an art exhibit sponsored by the museum, such use generally will be treated as satisfying the related-use requirement. However, the JCT Report contains no example as to the meaning of "substantial physical possession". For example, if a collector donates a 10 percent fractional interest in a painting to a museum and plans on donating the remaining 90 percent 10 years later, does the collector violate the substantial physical possession rule if the museum only has physical possession during the 10 year period for 10 percent of such period? The regulations will need to clarify this provision although, if the museum has physical possession for a period of time equal to the donated percentage interest, that should be sufficient to satisfy this requirement.

iv. Recapture of Deduction.

If the collector violates the 10 year timing limitation or the use limitation (the substantial possession or related-use requirement), then the collector's charitable income and gift tax deductions for all previous contributions of interests in the work of art are recaptured plus interest.[31] In any case in which there is a recapture of a deduction, the statute also imposes an additional tax in an amount equal to 10 percent of the amount recaptured.

v. Denial of Deduction.

No income or gift tax deduction is allowed for a contribution of a fractional interest in a work of art unless immediately before such contribution all interests in the work of art are owned (1) by the collector or (2) by the collector and the donee organization.[32] The IRS is authorized to make exceptions to this rule in cases where all persons who hold an interest in the work of art make proportional contributions of undivided interests in their respective shares of such work of art to the donee organization. For example, if collector A owns an undivided 50 percent interest in a painting and his brother, collector B owns the other undivided 50 percent interest in the

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28 I.R.C. § 170(o)(3)(A)(i).

29 I.R.C. § 170(o)(3)(A)(ii).

30 Staff of the Joint Committee on Taxation, "Technical Explanation of H.R.4, The Pension Protection Act of 2006".

31 I.R.C. § 170(o)(3)(A).

32 I.R.C. § 170(o)(1)(A).

same painting, the IRS may under regulations to be issued, provide that A may take a deduction for a charitable contribution of less than the entire interest held by A, provided that both A and B make proportional contributions of undivided fractional interests in their respective shares of the painting to the same donee organization (e.g., if A contributes 25 percent of A's interest and B contributes 25 percent of B's interest).

vi. Danger of Fractional Gifts and the Repeal.

The PPA contained similar limitations as described above for gift and estate tax purposes.[33] Like the income tax provision, the estate tax provision limited the estate tax charitable deduction to the **lesser** of: (1) the fair market value at the time of the initial fractional contribution; or (2) the fair market value at the time of the subsequent contribution.[34] In order to avoid the recapture of the income tax deduction, the transfer to the donee charity must be completed on the earlier of ten (10) years from the initial contribution or the donor's death. For example, the collector who gives away a 50 percent interest in a painting to a museum when it is worth $1,000,000 would receive a $500,000 income tax deduction. If the collector dies four years later when he still owns the remaining 50 percent interest and if the painting is then worth $2,000,000 his estate tax charitable deduction is limited to $500,000, that is, 50 percent of the initial value of $1,000,000 for the 50 percent interest. This would mean that the collector's estate would have a 50 percent interest in a painting going to a museum with a value of $1,000,000 (for the 50 percent interest) for which the estate was only entitled to a $500,000 deduction resulting in the estate having to pay an estate tax on the remaining $500,000. This is a trap for the uninformed and was not the result intended by the legislation. On December 29, 2007, President Bush signed the Tax Technical Corrections Act of 2007 (P.L. 110-172). The Act repealed the changes made to the estate tax and the gift tax that resulted in the tax trap described above in this paragraph. The net effect of this change is as if the special valuation limitation (value at time of initial gift) never existed for estate and gift tax purposes.

vii. Future Planning.

If the valuation limitation described above is corrected, then fractional gifts may still be useful for a collector who owns a very valuable work of art and therefore needs to spread the deduction for the initial value over a 12 year period (year of donation plus 5 year carryover for two transfers). For example, assume a painting with a fair market value of $5,000,000 owned by an individual with an average yearly adjusted gross income (AGI) of $1,000,000. Since the maximum allowable charitable deduction is 30 percent of AGI, his maximum deduction if the entire painting was donated is $1,800,000 ($300,000 x 6, i.e. 30 percent of AGI and a 5 year carryover). If a one-half fractional interest in the painting is donated, the same $1,800,000 deduction over a six year period is allowable (50 percent of $5,000,000 is $2,500,000). In year seven the individual can donate the remaining 50 percent interest in the painting and receive

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33 I.R.C. § 2055(g); I.R.C. § 2522(e).

34 I.R.C. § 2055(g)(1).

another $1,800,000 deduction spread over the following six years. Since the initial value of the painting is high, the individual would not be concerned with loss of the appreciation in value of the painting as a deduction. However, until there is a change in the tax code this type of fractional gift should not be made.

E. NEW PENALTY RULES

The Revenue Reconciliation Act of 1989 attempted to streamline rather complex provisions and to provide a fairer and more effective penalty system. Currently, section 6662 consolidates the generally applicable penalties relating to the accuracy of tax returns into one accuracy-related penalty equal to 20% of the portion of the underpayment to which the penalty applies. The PPA (effective August 17, 2006) further modified the thresholds for the application of the penalties.

For income tax purposes, there is a "substantial valuation misstatement" if the value of a work of art contributed to charity is 150% or more of the amount determined to be the correct amount of the valuation.[35] The 20% penalty is increased to 40% if the discrepancy is 200% or more, a "gross valuation misstatement."[36] No penalty is imposed for an underpayment of tax resulting from a substantial overvaluation of a charitable deduction for a work of art if it is shown that there was reasonable cause for the underpayment and if the taxpayer acted in good faith with respect to the underpayment.[37] However, that exception does not apply unless (1) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser and (2) the taxpayer also made a good-faith investigation of the value of the contributed property. To satisfy the second requirement, the taxpayer should keep a diary or a memorandum about his personal investigation of the value of the property.[38] That is, there should be careful documentation of the taxpayer's investigation of the property's value. Under section 6662(e)(2), at least $5,000 of additional tax must be due for the penalty to apply.

The reasonable cause exception for underpayments due to "gross valuation misstatements" on charitable deduction property is eliminated effective August 17, 2006. The reasonable cause exception does remain for a "substantially valuation misstatement".[39]

The willingness of the IRS to impose penalties in appropriate cases is illustrated by the *Jacobson*[40] case, which involved a stamp collector who had a collection of both postage stamps and postal stationery, that is, first-day-of-issue stamps that have passed through the mail. The taxpayer had acquired 60,484 first-day pages, which he owned for approximately twenty-five years. He never had any insurance on the contributive property, and he stored the property in boxes in his bakery warehouse. The

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35 I.R.C. § 6662(e)(1).
36 I.R.C. § 6662(h)(1).
37 I.R.C. § 6664(c)(1).
38 I.R.C. § 6664(c)(2).
39 I.R.C. § 6664(c)(2).
40 Jacobson v. Commissioner, 78 T.C.M. (CCH) 930 (1999).

court took note of the facts that the warehouse had a rodent problem, was very hot during the summer, and had almost no security. The taxpayer claimed a deduction for the donated stamp property in the amount of $949,030, but the tax court held that the correct value was $12,973. The question was then presented whether the section 6662(h)(2)(A) 40% penalty applies since there was a gross valuation misstatement, that is, the value of the property claimed on the tax return ($949,030) was 400% or more of the amount determined to be the correct value ($12,973). The taxpayer said he relied on his appraisal in claiming the $949,030 deduction and that he therefore acted reasonably even though the court found that the valuation was too high. The court pointed out that there is a two-part requirement to avoid the penalty: There must be reasonable cause for the taxpayer's position and the taxpayer must have acted in "good faith." The good-faith exception applies only if (1) the claimed value of the property was based on a "qualified appraisal" made by a "qualified appraiser" and (2) in addition to obtaining such an appraisal, the taxpayer made a good-faith investigation of the value of the contributed property. The court found that the taxpayer had not acted in good faith, because his conduct with respect to the contributed property was not consistent with a taxpayer's behavior if the property had substantial value: That is, there was no insurance; the property was inappropriately stored in a hot, rodent-infested warehouse; there was no security; and it was not treated like property that had a value of almost $1 million. Accordingly, the court assessed the penalty.

For estate and gift tax purposes, section 6662(g)(1) imposes the 20% penalty if the value of any property claimed on an estate or gift tax return is 50% or less of the amount determined to be correct. If the understatement is attributable to a gross valuation misstatement of 25% or less of the correct amount, the penalty amount is increased to 40% of the underpayment. At least $5,000 of additional tax must be due for the penalty to apply.[41]

Unlike the income tax law, estate and gift tax laws do not require a qualified appraisal by a qualified appraiser. The IRS has discretionary authority to waive all or part of the section 6662 penalty if the taxpayer establishes that there was a reasonable basis for the valuation claimed and that the claim was made in good faith.

The section 6662(g) penalty appears to apply for estate and gift tax purposes only to valuation understatements, not to overstatements. Therefore, if a decedent bequeathed artwork to a museum and an estate tax charitable deduction is claimed, no section 6662 penalty is imposed if the IRS determines that the work had a smaller value than that claimed on the estate tax return. In most cases, the estate tax does not increase or decrease in the case of a valuation overstatement of a charitable bequest, since the size of the gross estate increases as the charitable deduction increases; the two cancel each other out, leaving only the remainder subject to the estate tax. Therefore, the section 6662 penalty should generally not apply to an estate charitable bequest that may be overstated in value. However, a valuation overstatement of a work of art could

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41 I.R.C. § 6662(g).

increase the executor's commission (which is deductible on the estate tax return) and have the net effect of decreasing the estate tax.

A section 6662 penalty could be applied in an estate tax situation for income tax purposes. For example, when the unlimited marital deduction applies or when the estate is less than the estate tax exemption equivalent (that is, less than $2,000,000 in year 2006), there is no estate tax. However, any artwork, as well as other tangible property of the estate, receives a step-up in basis equal to the estate tax value. If the artwork that was overvalued for estate tax purposes is later sold at a loss, the estate or the heirs have a capital loss that may be deductible under section 165(c)(2). If the loss claimed to reduce the income tax results from the overvaluation, the IRS can invoke the penalty provisions of section 6662.

F. DONATION OF TAXIDERMY PROPERTY

For taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property or by a person who paid or incurred the cost of preparation, stuffing, or mounting, the amount of the claimed charitable contribution must be reduced by the amount of gain that would have been long-term capital gain if the property had been sold by the taxpayer at its fair market value.[42] Fair market value is determined at the time the contribution is made.[43] Thus, the amount that will be allowed as a deduction for a charitable contribution of taxidermy property is the lesser of the donor's basis in the property or the fair market value of the property.

If taxidermy property is contributed and a charitable contribution deduction is claimed by the person who prepared, stuffed, or mounted the property, or by any person who paid or incurred the cost of such preparation, stuffing, or mounting, only the cost of preparing, stuffing, or mounting the taxidermy property may be included in the calculating the basis of the property.[44]

This special rule for determining the donor's basis in taxidermy property is intended to include only the *direct* costs of preparing, stuffing or mounting that are paid or incurred by the donor claming the charitable contribution deduction. Indirect costs, such as transportation, equipment or other costs related to hunting or killing the animal may not be included in the donor's basis, and are, therefore, not deductible.[45]

Reducing the abuse of the lenient deduction rules for such charitable contributions was a primary motivation for amending the rules. According to the Humane Society of the United States, the charitable contribution deduction rules for taxidermy property were being exploited by trophy hunters; the rules allowed them to unfairly deduct the costs of their hunting excursions. The modified rules do not allow the

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42 I.R.C. § 170(e)(1)(B)(iv).
43 I.R.C. § 170(e)(1)(B)(iv).
44 I.R.C. § 170(f)(15)(A).
45 *Supra*, note 187.

donor to claim a deduction for such expenses and consequently, also eliminate the deduction for value based on the rarity of the animal.

> The term "taxidermy property"[46] means any work of art which—
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> (1) is the reproduction or preservation of an animal, in whole or in part,
>
> (2) is prepared, stuffed, or mounted for purposes of recreating one or more characteristics of such animal; and
>
> (3) contains a part of the body of the dead animal.

II. FRACTIONAL TRANSFERS–VALUATION ISSUES

A. BACKGROUND

When fractional donations were made to charity prior to August 17, 2006, the position of the IRS was to accept as the allowable charitable deduction the undivided percentage of the fair market value given to the charitable organization. Presumably, that position is based on Revenue Ruling 57-293,[47] which gives a specific example covering that situation. The part of that ruling dealing with a gift of a future interest is no longer applicable because of section 170(f).

When the collector dies, the value of the undivided fractional interest that was kept by the collector is included in his estate. Because of Revenue Ruling 57-293, it is difficult to argue that if the retained undivided interest is bequeathed to a noncharitable beneficiary, there should be a discount for the minority undivided interest retained. In *Estate of Robert C. Scull v. Commissioner*,[48] the value of the decedent's 65% undivided interest in an art collection was reduced by 5% to reflect the uncertainties involved in any acquisition of the interest, which was the result of a divorce proceeding still being appealed. If the bequest is made to a person who does not own the other part of the interest, the taxpayer should have a fair chance of convincing the IRS to allow some discount for the fractional interest. If the bequest is made to a museum that already owns a partial interest in the artwork, the estate tax charitable deduction should be the percentage owned by the decedent multiplied by the full fair market value of the painting on the decedent's date of death. Generally, before a museum will accept a fractional gift, it wants assurances that it will receive the balance of the undivided interest when the collector dies. The museum does not want to be left owning a fractional interest in a work of art with the donor's heirs fighting over the remaining fractional interest. Therefore, the collector should always discuss such a gift with the museum before making it.

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46 I.R.C. 170(f)(15)(B).

47 Rev. Rul. 57-293, 1957-2 C.B. 153.

48 Estate of Robert C. Scull, deceased v. Commissioner, 67 T.C.M. (CCH) 2953 (1994).

Although, as discussed above, fractional donations to charity no longer make sense, the following Private Letter Rulings are instructive for complete transfers of works of art to charity. Private Letter Ruling 93-03-007 should be reviewed by anyone contemplating a donation of works of art. The IRS ruled that the charitable deduction for the gift of an undivided fractional interest equals the product of (1) the fraction and (2) the fair market value (determined without regard to the existence of a certain loan agreement) of the entire work of art at the date of the gift of the fractional interest.[49] Under a gift-loan agreement, the taxpayer in that private letter ruling imposed conditions requiring continuous display of the collection and editorial control over publicity concerning the collection. If those conditions were not complied with, the collection would revert to the donor or his heirs. The IRS ruled that such conditions had no effect on the gift, since the chance that the work would revert to the estate of the donor is so remote as to be negligible.

When a fractional interest in a collection is donated to a charitable organization, the organization usually requires the donor to promise to donate or bequeath the balance to the organization. Private Letter Ruling 93-03-007 also states that when one promises to transfer property in the future, the gift tax consequences of the promise are judged as of the time at which it is possible to determine that the transfer must be made and that the transfer will be of a determinable amount. Therefore, the mere execution of a promised-gift agreement does not constitute a taxable gift, because at that time it is not possible to determine that the future transfer must be made by the donor. The promised gift could be satisfied by the donor's estate.

Private Letter Ruling 200223013 dealt with fourteen separate rulings pertaining to the federal income, gift, and estate tax consequences of gifts of fractional interest in works of art to be made by a married couple to a tax-exempt museum. The proposed gift was subject to a detailed and comprehensive gift and loan agreement (GLA) that contained a number of restrictions and limitations. So long as the museum complied with the GLA, the donors were not permitted to transfer during their lifetimes (or at the death of the first of them to die) by gift or otherwise any item of artwork to any party other than to each other or the museum. If the museum complied with the GLA, then the donors (or their legal representative) were obligated at a date no later than the death of the last to die of the donors to transfer to the museum all of the donors' remaining ownership interests in the artworks. If the museum breached the GLA, the artwork was to be distributed to other charitable organizations. Under the GLA, the museum was required to hold and display the artwork subject to numerous conditions, including that the museum was required to obtain the donors' consent to any changes in the gallery or installation design. In addition, the museum was permitted to deaccession any artwork, but only to the extent such work was replaced with a similar item of artwork

(1) typified by the collection,

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49 Pri. Ltr. Rul. 9303007.

(2) that is consistent with the spirit of the collection, and

(3) that has a value substantially equal to the value of the deaccessioned artwork in the collection.

Upon the death of the donors, these approval rights transferred to their daughter.

For income tax purposes, the IRS held, following the formula in Private Letter Ruling 93-03-007, that the amount of the income tax deduction allowable for a fractional interest is equal to the percentage of the artwork donated multiplied by the fair market value of the entire artwork. No reduction in the amount of the income tax deduction is required because only a fractional interest was donated or because of the restrictions placed on the donee with regard to the artwork as described above.

For estate tax purposes, the IRS ruled that the approval rights retained by the donor that pass to her successors in interest have no value for federal estate tax purposes under sections 2031 and 2033. The IRS also ruled that because the artwork will pass to other charitable organizations if the museum breaches the GLA, there is no possibility that the items will pass for other than a charitable purpose as defined in section 2055(a) and, hence, the value of the bequest will qualify for the federal estate tax charitable deduction under section 2055. Moreover, the IRS determined that the amount includable in the donor's gross estate under sections 2031 and 2033 with respect to the retained undivided fractional interest is the fair market value of the item of artwork multiplied by the donor's fractional interest therein and that the amount deductible under section 2055 with respect to such item is the value included in the donor's gross estate.

Finally, the IRS ruled with respect to the federal estate tax that when the donor died the bequest to the donor's spouse of any retained fractional interest in the artwork will qualify for the federal estate tax marital deduction permitted under section 2056(b)(7) (assuming the required election is made). The ruling went on to confirm that the amount of the marital deduction is the fair market value of the artwork (determined without regard to the existence of the GLA) multiplied by the fraction of the artwork transferred to the surviving spouse. This avoids any potential problem that the estate inclusion amount under section 2031 may not be the same amount as either the charitable deduction under section 2044 or the marital deduction under section 2056.

When considering whether or not to make a fractional gift to a museum, the donor should also be aware of the following questions that should be answered before making the donation.

1. Who will pay for packing and transportation each time the collection is moved?

2. Who will pay for insurance? Generally, the donor's insurance covers the collection when it is in the donor's possession, and the

museum's insurance covers the collection when it is in the museum's possession. Insurance coverage during the packing and shipping period should be discussed.

3. In the future operation of the museum, what will be done with the collection, how will it be exhibited, and will the museum consult with the donor?

4. Does the museum have an endowment; if so, how are funds allocated to its operation? As the museum expands in size, its expenses will increase. Will there be a special curator for the collection, and how will the curator be selected and paid?

5. What, if any, involvement will the donor have with respect to the exhibition of the collection at the museum?

6. What will happen if the artwork is damaged? Every time art is moved, there is always the risk of some damage. There should be some procedure involving condition reports, and perhaps some works of art should not be moved every year. For example, some Calder mobiles are susceptible to damage every time they are packed and rehung.

B. THE *STONE* CASE

In August 2007, the case of *Robert G. Stone v. United States*,[50] allowed a 5% discount to an estate that owned an undivided 50% interest in nineteen paintings that were left to family members. The Stone case is the first case to reflect on whether or not discounts based on lack of control, minority ownership, or lack of 100% interest with respect to ownership of works of art can lead to a discount for estate tax purposes as it does for real estate. In *Stone* the estate claimed a 44% discount for the undivided 50% interest in the painting owned by the decedent on the date of death. The IRS said that "art is simply not fungible" and the discount should be not more than 2%. The court concluded that a hypothetical willing seller of an undivided fractional interest in art would likely seek to sell the entire work of art and split the proceeds, rather than seeking to sell his or her fractional interest at a discount. In other words, the court thought that a hypothetical willing seller who is under no compulsion to sell would seek to gain consent from the other co-owner or co-owners to sell the collection and divide the proceeds or, barring such consent, would bring a legal action to partition. Therefore, at a minimum, because an undivided interest holder has the right to partition, a hypothetical seller under no compulsion to sell would not accept any less for his or her undivided interest than could be obtained by splitting proceeds in this manner. Rather than reach a conclusion, the court remanded the case to see if the IRS and the taxpayer could agree on an

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[50] Robert G. Stone v. United States, 2007 U.S. Dist. LEXIS 38332 (N.D. Cal., May 25, 2007); Robert G. Stone v. United States, 2007 U.S. Dist. LEXIS 58611 (N.D. Cal., August 10, 2007).

appropriate discount , between the 2% position of the IRS and the 51% position of the taxpayer, based on the cost of a hypothetical partition action. When the parties were unable to agree, the court was forced to make a decision.

The court in *Stone* then decided[51] that the taxpayer's appraisal methodology was flawed because (i) it failed to take into account that collectors of art are often drawn to the aesthetics of a particular work of art, rather than viewing art simply as an investment vehicle and (ii) the mathematical assumptions made by the appraiser as to the rate of return on investments in art and the appropriate net present value percentage was made without supporting evidence. The taxpayer could not meet his burden of persuading the court that a hypothetical buyer would demand, and a hypothetical seller would agree to, a discount greater than 5%. The case is a warning sign that art is treated differently from real estate or closely held businesses when it comes time to apply discounts. Accordingly, it should not be assumed that the discounts usually available for lack of 100% ownership interest will be available in the same manner as real estate.

A review of the IRS interpretation of fractional gifts beginning with Revenue Ruling 57-293 and then Private Letter Rulings 93-03-007, 200223013, and 200418002 shows that the IRS has been consistent in its interpretation for income tax, gift tax, and estate tax that the proper approach for determining the amount of the deduction, whether the work of art is donated during lifetime or is transferred at death, is to take the full fair market value of the work of art multiplied by the percentage transferred. The position of the IRS is that the same methodology is true whether the work of art is transferred to charity or to a noncharitable beneficiary, that is, a member of the taxpayer's family. In other words, fractional interests in works of art seem to receive a different treatment than fractional interest in real estate or other assets for which it is fairly common to claim a discount for lack of control, minority ownership, or lack of 100% interest.[52] Perhaps works of art are treated differently because one can still fully enjoy a work of art for a percentage of the time and, in fact, that percentage may have a market value equal to the percentage multiplied by the fair market value of the work of art. With no market data available for the sale of an undivided fractional interest in art, it

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51 Robert G. Stone v. United States, 2007 U.S. Dist. LEXIS 58611 (N.D. Cal., August 10, 2007).

52 Given the basic premises of valuation (the price a hypothetical willing buyer will pay to a hypothetical willing seller), the question arises whether there is a particular reason why a fractional interest in an item of property would make the property less appealing to the hypothetical willing buyer. Neither the Internal Revenue Code, nor the regulations (except for the reference in Treas. Reg. § 20.2031-1) contain any specific provisions on the issue of valuing fractional interests. See Hood, Jr., 830-2nd BNA T.M. Portfolio, *Valuation: General and Real Estate*, Section II.H.4; The IRS usually takes the position that, in the absence of evidence to the contrary, the fact that the interest involved is a fractional interest does not warrant any discount, that is, the value of such interest is equivalent to the proportionate part of the value of the entire interest. However, when it comes to a fractional interest in real estate, some discount is generally allowed. Iacono v. Comm'r, 41 T.C.M. (CCH) 407 (1980); In re Gilberts Est., 163 N.Y.S. 974 (1917); Stevens Est. v. Comm'r, 79 T.C.M. (CCH) 1519 (2000); Forbes Est. v. Comm'r, 81 T.C.M. (CCH) 1399 (2000); Baird Est. v. Comm'r, 82 T.C.M. (CCH) 666 (2001); TAM 199943003 where the National Office advised that, if a discount is appropriate, one method of determining the fair market value of a decedent's undivided interests in tracts of real property is to subtract the partition sale costs from the fair market value of the undivided interests.

could just as easily be assumed as not, that a hypothetical willing buyer would be willing to pay a percentage times the full fair market value of a painting equal to his percentage of ownership, in order to own and have personal use of the painting, even if it is only for a percentage of each year. Such is the passion of art collectors. If a transfer is made to a person who does not own the other part of the interest, the taxpayer should have a fair chance of convincing the IRS to allow some small discount for a fractional interest in the painting. If the transfer is made to a person (a museum) that already owns a partial interest in the painting, the charitable deduction should be the percentage transferred multiplied by the full fair market value of the painting on the date of transfer. However, in light of the foregoing rulings and the decision in the *Stone* case, if one is thinking of transferring works of art to family members either during one's lifetime or on death, it should not be assumed that the discounts usually available for lack of a 100% ownership interest will be available.[53]

III. BASIS FOR PURPOSES OF SALE

One of the most important tax consequences of death is that property included in a decedent's gross estate for federal estate tax purposes acquires a "step-up" in basis for income tax purposes equal to its federal estate tax value.[54] Section 1014 provides that the basis of property acquired from a decedent is the fair market value of the property at the date of the decedent's death or the alternate valuation date. In other words, if a collector purchased a painting for $10,000 and when he dies the painting is valued at $100,000 for federal estate tax purposes, his heirs will acquire the painting with a "step-up" in basis equal to $100,000. The fair market value of the property as of the date of the decedent's death or as of the alternate valuation date is deemed to be the value of the property "as appraised for purposes of the federal estate tax."

A. THE *JANUS* CASE

The *Janis*[55] case is an example of a taxpayer who wanted to have his cake and eat it too! Here the decedent, the well-known New York City art dealer Sidney Janis, died owning many works of art in the gallery that he ran as a sole proprietorship. The IRS Art Panel first determined the total value of the works of art owned at death to be $36,000,000 based on a per item appraisal submitted by the executors. The panel then allowed a $13,600,000 discount based on the following arguments made by the taxpayer:

(1) there were numerous works by individual artists;

(2) some of the art would be sold in the dealer market as opposed to the retail market;

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[53] *Supra*, note 48; note 50.
[54] I.R.C. § 1014.
[55] Janis v. Commissioner, 87 T.C. Memo 1322 (2004).

(3) the executor's inability to sell the gallery in the retail market for the sum of the value of the individual works of art;

(4) the fact that a buyer of the gallery would not pay the full resale price of the underlying assets in a bulk sale; and

(5) any buyer would consider the cost of maintaining the business for a reasonable period of time.

After accepting the taxpayer's arguments that reduced the value of the artworks by $13,600,000 the IRS Art Panel agreed to further apply a blockage discount. The panel first acknowledged that the blockage concept generally applies to a large number of works by one artist, usually in an artist's estate. It then went on to apply some of the general blockage discount principles to the gallery's inventory as follows:

> A number of factors have been considered in determining whether a blockage discount is appropriate and to what extent it should be applied to the subject properties. Consideration was given to the prominence of the artists; the types of works in the estate; the distribution of the items (for example, the number and types, and their quality and saleability); the number of similar items available in the marketplace; the market's response to such works around the valuation date; the number of sales and the prices at which sales were made during the period immediately preceding and following death; the annual sales of the gallery; length of time necessary to dispose of the items; the works that are saleable within a relatively short period of time; the works that can only be marketed over a long period; the demonstrated earning capacity of the business; the tangible and intangible assets, including goodwill; and the reputation of the gallery and provenance.
>
> In addition, consideration was given to the possible disbursement and handling of the gallery. One option would be the continuation of the gallery through Sidney Janis' surviving sons and the selling of the items in the course of business. Another option would be the sale of the gallery to a willing purchaser.
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> Attention was given to the gallery's annual gross and net receipts of the inventory since 1985.

This resulted in a further 37% reduction of the value of the gallery's inventory or a total combined discount of approximately 60.42%. This was a great success for the taxpayer—but it was not enough.

When the heirs of the estate sold some of the artworks, they used as their new stepped-up basis the original per item appraised value accepted by the IRS Art Panel before the application of the 60.42% discount. The heirs argued that the term "appraised value" in regulation section 1.1014-3(a) refers to the undiscounted fair market value since the discount determined by the IRS Art Panel was attributable to the collection as a whole and does not apply in determining the value of each work of art sold separately. In addition, the heirs argued that *Augustus v. Commissioner*,[56] a 1939 case dealing with the sale of stock, supported the use of the undiscounted value for income tax purposes. The Tax Court distinguished the *Augustus* case and found that because the substantive effect of the blockage discount was to establish a proportionate value for each work of art in the collection, it follows that the "appraised value" contemplated by section 1.1014-3(a) is a value that includes the blockage discount. Accordingly, the taxpayer's step-up in basis was limited to the discounted per artwork value.

The heirs of the estate appealed the Tax Court's decision to the Ninth Circuit[57] which affirmed the Tax Court's decision, holding that the Tax Court did not

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56 Augustus v. Commissioner, 40 B.T.A. 1201 (1939), *aff'd*, 118 F.2d 38 (6th Cir. 1941).

57 Janis v. Commissioner, 461 F.3d 1080 (2006).

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clearly err in determining the value of the art collection and was correct in concluding that the "duty of consistency" required the parties to use the same value on the income tax returns as agreed to for estate tax purposes. The duty of consistency applies when there is (1) a representation by the taxpayer, (2) on which the IRS relies, and (3) after the statute of limitations runs, the taxpayer changes his previous representation. The Ninth Circuit determined that the heirs had represented that the art collection had a value for estate tax purposes, the IRS had agreed to that value and to allow the heirs to now take the position that the art collection had a different value would "gut the duty of consistency."

ENDNOTES