



# The art of planning for the collector

## Considerations when selling, gifting and donating your art

When framing a conversation regarding estate planning for art, it is helpful to note that there are generally three main options with six potential outcomes. Art collectors can sell, gift or donate their art to charity. Each of these options can take place during life or at death.

The tax consequences and related planning considerations for each of these transactions can be vastly different. In addition, other factors may need to be addressed, including legacy planning and family dynamics, art held in trust, philanthropic goals, and the benefits of art lending. Due to recently proposed changes to the tax law referenced herein, it is critical that art collectors review their current planning or begin the estate planning process as soon as possible.

### I. Legacy planning and family dynamics

Discussing the potential destiny for each piece, or collection of art is a great place to start the legacy planning process. Art is unique and is considered a legacy asset. Families are also unique and so every conversation about the future of the art owned in an estate will naturally be one-of-a-kind. However, there are some guideposts to help along the way. They revolve around the destiny you envision for the art, fostering family harmony and understanding the current generation of potential heirs.

First of all, having the legacy conversation is important so you can determine each family member's interest level or degree of passion related to the art. For example, does an heir want one piece or an entire collection? What if receiving the art may compromise receiving other assets from the estate? Also, sometimes heirs feel responsible to the public to preserve an important collection. If so, should you allocate estate resources for the maintenance of the collection?

Additionally, you want to uncover potential conflicts. All heirs may be interested in receiving an art collection or a particular piece with sentimental value. You'll want to know this in advance so you can plan your estate in a manner that will foster family

harmony. Finally, understanding the heirs who will be receiving the art is critical. For example, one of the defining characteristics of our current younger generation is that they want to be good stewards of the family legacy, but they strive to take it beyond what it has been before.

Once you have held the legacy conversation and ensured that each family member feels they will receive a meaningful bequest, the next step is to document your intentions in your estate plan.

### II. Tax planning\*

Art is an illiquid asset that can give rise to income, estate and gift tax liabilities. Art is often treated differently than other assets for tax purposes. Understanding how taxation applies can help inform the legacy you envision for your art. If art is going to be sold either by you or by an heir, it is important to know that for assets held for more than one year the federal long-term capital gains tax rate for art (and other collectibles) is the highest, set at 28% versus the standard 20% currently recognized on other capital assets. The 3.8% Medicare Surcharge imposed on unearned income also applies. In addition, there are state taxes to consider. Some states impose a separate capital gains tax, while other states such as New York and California impose the tax at ordinary income tax rates.

\*Foreign collectors should consult with their local tax and estate planning advisors. If a foreign collector sells, disposes of or maintains art in the U.S., additional tax liabilities and reporting requirements in other jurisdictions may apply. Income tax and estate and gift tax treaties may mitigate potential double taxation. The U.S. currently has income tax treaties with more than 60 different countries and estate and gift tax treaties with 15 different countries.

The tax rate is not the only consideration when constructing your tax plan around art. The basis of an asset is critically important as well. If an asset is gifted, the recipient takes a carry-over basis. In other words, the recipient takes the asset with the donor's basis. Transferring a low-basis asset via gift includes an embedded capital gains tax liability if it is later sold by the recipient. If art is passed through the collector's estate instead, it will receive a step-up in basis to fair market value (FMV).

Planning for a step-up in basis is sometimes known as basis shifting. For example, Husband owns highly appreciated, low-basis artwork as his separate property and Wife is ill. Husband gifts the art to Wife during lifetime. If Wife survives for at least one year following the gift and then leaves the art to Husband through her estate, the art will receive a step-up in basis to FMV. Husband can then sell the art without incurring a capital gains tax on the appreciated value over the original low basis.

If art is gifted during life, or is left to heirs through an estate, then the estate and gift tax may apply. The current maximum estate and gift tax rate is 40%. There is also a generation-skipping transfer tax (GSTT) of 40% imposed on gratuitous transfers made to someone more than one generation below you, such as a grandchild. The estate tax exemption represents the total value that an individual can give away free of the estate or gift tax either during life or at death and is historically high. The current exemption amount is historically high, having been increased under TCJA from a base of \$5 million plus inflation to a base of \$10 million plus inflation. As of January 1, 2024, the exemption has risen to \$13.61 million per person/\$27.22 million per married couple. The GSTT exemption amount is tied to the estate tax exemption and changes in lock-step. Under existing law, the elevated exemption will automatically expire in December 2025. Although unsuccessful, legislative proposals have targeted an earlier reduction.

For those who are charitably inclined, contributing low-basis art to a charitable split-interest trust established as a charitable remainder trust (CRT) can be a tax-efficient strategy. A CRT is a tax-exempt entity. The low-basis art can be donated to the tax-exempt CRT and then sold without having the trust itself incur a capital gains tax. The amount that would have been paid in capital gains tax remains in the trust to be managed and to increase over time. The donor or a chosen heir takes an upfront income or lead interest, while the charity receives the remainder interest, taking what is left at the end of the term. The

capital gains taxes will be spread out and payable as the lead beneficiaries receive payments from the CRT. Importantly, the charitable income tax deduction to the donor is limited to the cost basis allocable to the charity's remainder interest.

### III. Art held in trust

Trusts can provide an integral and advantageous foundation for the creation of a tax-efficient estate plan for a single piece of art or an entire collection. When a trustee receives works of art as an asset class within its trust fund, there are several duties and obligations that must be honored, including proper due diligence, ensuring the legal transfer of title to the trust, and providing prudent ongoing administration and management of the artwork.

Initially, a full inventory of each piece of art must be completed. Then, working with external legal counsel, the most efficient ownership structure must be identified (a U.S. limited liability company (LLC) or partnership is often recommended) and the trust's receipt of full legal title to each piece of art should be confirmed. Artworks purchased through auction houses or art dealers often come with a written guarantee of quiet possession, making it easier to establish provenance and clear title. If the artwork is inherited as part of a family collection, it may be more difficult to prove its history. Art title insurance is now available to corroborate and confirm clear title, authenticity and provenance. Moreover, possible risks to selling are identified.

Property/fine art insurance should be secured to insure the replacement value against theft, accidental damage, fire and other casualties. Specialized appraisal companies will provide appraisals of single pieces of art or collections as a whole, and most well-known auction houses offer appraisal services. The trustee should maintain sufficient liquidity to meet the related costs of appraisals and insurance and to make required payments for ad-hoc expert advice, curators, specialized warehouses, specialized transportation and other related expenses.

Trustees usually prefer to have large and valuable collections stored in specially designed warehouses with climate control and sophisticated security systems. Art is sometimes loaned to a museum or kept in a private residence which, in most cases, is also owned by the trust, particularly in the U.S. A record of the location of each piece of art should be maintained with recurrent visits to the site, inspection of the art, and periodic confirmation of title.

The trustee must have a clear understanding of the tax and estate planning advice provided by legal or tax counsel. Further, the trustee should carry out the intent of the grantor pertaining to ongoing maintenance and administration during the grantor's life, as well as effecting the desired disposition upon the grantor's death.

Artwork and collections may make up only one of several asset classes within the trust, or may be the sole asset class. The trust purpose is often to preserve and protect the art for the benefit of future generations as part of the family legacy. Choosing the right trustee with an established track record and expertise in this area is paramount.

#### IV. Philanthropic considerations

Notable trends in art include tremendous growth in private art museums around the world. They provide the opportunity to keep large collections together, foster access to artists, and allow for collector control and the ability to play a greater role in the art world. In the U.S. a private museum is typically formed as a private operating foundation (for more information, see below).

Another growth area is the use of CRTs, discussed above. They are often used by a donor with highly appreciated art looking to provide a deferred benefit to a charity. The income tax charitable deduction is limited to the donor's basis in the art. Direct contributions to charitable organizations are also on the rise. This type of donation provides an opportunity to partner with donor organizations.

When considering a lifetime charitable donation of art, the donor should be aware that there are two main factors that will impact the amount of the available charitable income tax deduction:

1. Related use – If the charity's use of donated art is unrelated to its exempt purpose, the charitable contribution deduction will be limited to the donor's basis and not its FMV.\*
2. Type of charitable organization – The type of charitable organization receiving the donated art will impact the donor's charitable deduction. The two types of charitable organizations include public charities (such as churches, hospitals, schools and museums) and private foundations. Public charities receive substantial funding from the public, while a private foundation is usually funded by a

single donor or family. A private foundation can be either operating or non-operating. A private operating foundation is a private foundation that expends its assets on activities related to its exempt purpose. A non-operating private foundation generally makes grants to public charities and to private operating foundations.

A donor may claim a deduction for a charitable contribution made to a qualifying charitable organization, subject to limits that range from 20% to 60% of adjusted gross income (AGI) depending on the type of contribution and the type of charity. For 2024, the deduction for contributions of capital gain property, such as art, to a public charity or to a DAF is limited to 30% of AGI, but the same donation made to a private foundation would be limited to 20% of AGI. In contrast, a contribution of cash to a public charity or to a DAF may result in a deduction of up to 60% of the individual's AGI, while the same cash donation to a private foundation would be limited to 30% of AGI. (Excess contributions may be carried forward for up to five tax years.) A higher AGI limit for a cash donation will not always yield the best tax result; however, donating appreciated assets that carry an embedded tax liability may be a more tax efficient strategy. One of the most common planning mistakes is to contribute cash while paying capital gains tax.

The rules for donating art to charity at death can differ from those associated with lifetime gifts of art. When a collector makes a testamentary charitable contribution of art, the estate tax charitable deduction is unlimited (unlike the income tax limitations imposed on lifetime charitable contributions, discussed above). Additionally, and very significantly, there is no related use requirement for testamentary gifts. A testamentary gift of art would also allow a collector to gift to international organizations without the lifetime restrictions.

In addition to the estate tax savings, testamentary charitable gifts of art remove illiquid assets from the estate. This can be especially beneficial when the art is difficult to value and/or is not wanted by the heirs. A private operating foundation or a private foundation may be formed at death to receive the art and keep a collection together. This may be a good way to include the next generation in philanthropy and continue the legacy of the collection.

\*Due to the related use rule, a Donor Advised Fund (DAF) is typically not the vehicle of choice for a donation of art.

## V. Benefits of art lending

Fine art can be more than simply a collectible to appreciate and admire. Leveraging a fine art collection provides an opportunity to monetize an otherwise illiquid asset that does not pay interest or a dividend. In most cases, the art pledged for the loan may remain with a collector as long as it is in the U.S.: typically, in their home or office. This option serves as an alternative to the sale of art or other collectible assets, which may have income tax consequences. Fine art lending is priced as a spread over the SOFR index with an upfront and/or unused commitment fees. The use of proceeds is generally unlimited. Art held within a trust may also be pledged, depending on the terms of the trust.

In conclusion, there are many planning options available to art collectors, depending on their desired goals and objectives. Our wealth planning team will be happy to work with you and your tax and legal advisors to determine the optimal planning strategies for your current art holdings.

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