Journal of the National Association of Administrative Law Judiciary

Volume 37 | Issue 1 Article 6

5-15-2017

Please Don’t Make Me Pay Taxes: How New IRS Law Helps Art Collectors Avoid Hefty Taxes

Stephanie Dunn

Please Don't Make Me Pay Taxes: How New IRS Law Helps Art Collectors Avoid Hefty Taxes

By Stephanie Dunn*

I. THE CURRENT STATE OF THE ART MARKET AND TAXES

Although it can sometimes be overlooked, today's art market is comprised of large financial transactions and is a popular way for investments to be made. An investor can buy a painting for one million dollars, hold onto it for five to ten years, and resell it for ten million dollars, which gives them a nine million-dollar profit. Additionally, the auction houses that participate and facilitate most of these sales gain a profit as well. Art auction results from leading auction houses such as Christie's or Sotheby's can range anywhere from one hundred thousand to millions of dollars per auction depending on the type of sale and how the market is fairing in that area of art.[1] In addition to selling your art through an auction house, there are other options such as going through a private dealer or selling the work yourself.

Looking at the day-to-day activities of a collector, the concept is fairly straightforward: A collector who has the available funds buys a piece of art, holds on to it for some time so the value can appreciate, and then sells the work, gains a profit, and reinvests the money. Because of the straightforwardness of the collecting process, it is perplexing as to why the art market isn't a larger investment field such as that of the stock market. One potential reason for this is the complications that arise when taxes are applied to both the buyer and the seller of the work. If the seller makes a profit from the resale, which is always the hope when one buys art for investment purposes, then the seller must pay taxes on the capital gain that they have made. In return, the buyer must pay sales tax on the artwork. Together, both the buyer and the seller's taxes can amount to hundreds of thousands of dollars, and sometimes even millions.[2]

---

[*] Stephanie Dunn is currently completing her law degree at Pepperdine University. She previously earned her M.A. in the History of Art and Architecture at the University of Oregon and her B.A. in Art History from Oklahoma State University. Stephanie is interested in how the production and collection of art intersects with the law.

[1] *See Art Auction Results*, SOTHEBY'S, http://www.sothebys.com/en/auctions/results.html (last visited Apr. 9, 2017); and *Past Auctions: Results, Sales, Price Realized*, CHRISTIE'S, http://www.christies.com/results/?year=2017&initialpageload=true (last visited Apr. 9, 2017).

[2] *See infra* note 22.

To combat the high amount of taxes, smart buyers and sellers are always looking for a way to lower the amount owed from a sale transaction. Some examples include donating the artwork to a museum for a few months before they take actual possession or buying the work in a specific state that has low or no use taxes. One could argue that these tax breaks are a way to incentivize investors to continue to participate in the art market while simultaneously gaining revenue for the states through required taxes. This article will provide the reader with an in-depth analysis of the new IRS tax incentive that was recently enacted and how it will affect the inner workings of the art market. Additionally, it will analyze past and current IRS tax incentives that impact the art world and the new tax incentives impact on existing law. Finally, it will conclude by addressing potential future problems that the new IRS tax incentive might create and discuss potential amendments that could be made

II. New IRS Tax Saving Strategy for Art Collectors: Using Charitable Remainder Trusts

Taxation has always played a crucial role in American history. As children, we commonly learn about our country's revolution and the phrase "no taxation without representation!" Over time taxes have evolved into the very specific IRS code that we are accustomed to today. There are taxes on everything but also multiple ways to use the tax system to avoid paying taxes. The art world has a very special relationship with the IRS code. With the art market consisting of sales that can reach up to $20 million for one work of art, a high sales tax can hamper the market's economic development.

It is for this reason that, throughout the past, the IRS has made various art tax incentives to help collectors and sellers by offsetting the hefty taxes that are typically imposed during the sale of an artwork.[3] Most recently, in August 2016, the IRS created a new tax rule that makes selling art from a charitable remainder trust (CRT) a way for collectors to defer taxation on the purchase or sale of an

[3] Examples of art tax incentives will be discussed in depth later in the paper. They include states like Oregon, Montana, Delaware, and New Hampshire that do not have sales tax, states that will provide a charitable deduction if the work is lent to a museum for a specific period of time (again Oregon), and the Pension Protections Act of 2006.

artwork and ultimately creates another IRS incentive aimed at promoting the economics of the art world.[4]

III. WHAT IS A CHARITABLE REMAINDER TRUST?

The new IRS provision, set forth early August 2016, made it possible for art collectors to use certain CRTs as channels for tax deferrals.[5] Under the Internal Revenue Code (IRC), section 664-1(a)(1)(iii)(a), a CRT is defined as a trust in which deductions are allowable under IRC sections 170, 2055, 2106, or 2522.[6]

It is a type of trust where a percentage of the trust's fair market value is paid yearly to one or more persons, one of which cannot be an organization as described in IRC section 170(c).[7] The individual must be living during the creation of the trust, and the yearly payments may not exceed twenty years or the life of the designated individuals.[8] In order to qualify as a CRT, the yearly percentage paid out cannot be below 5% or above 50%.[9] The CRT allows an individual to convert an asset that has highly appreciated over time into a form of income.[10] Furthermore, the CRT can create tax benefits for a person now as well as when they die by decreasing their income tax and estate taxes.[11] It has the ability to lower income

---

[4] Diana Wierbicki and Paul Roy, New IRS Rule Opens Tax Saving Strategy To Art Collectors, Forbes (Sept. 21, 2016, 11:25 AM), https://www.forbes.com/sites/janetnovack/2016/09/21/new-irs-rule-opens-tax-saving-strategy-to-art-collectors/#1a6824db2c53.

[5] *Id.*; Rev. Proc. 2016-42, 2016-34 I.R.B. 269.

[6] *See* Rev. Proc. 2016-42, 2016-34 I.R.B. 269 (discussing the requirements to qualify as a CRT in section 2 of revenue procedure). IRC sections 170 and 2522 prohibit deductions stemming from gift and income taxes "if the remainder interest of the *inter vivos* [Charitable Remainder Annuity Trust] does not satisfy, *inter alia*, the requirements [established by] § 1.170A-1(e) or § 25.2522(c)–3(b)(1)." *Id.* Sections 2106, 2055 prohibit testamentary estate tax deductions if the Charitable Remainder Annuity Trust "does not satisfy, *inter alia*, the requirements established under § 1.170A-1(e) and section 20.2055-2(b)(1)." *Id.*

[7] Rev. Proc. 2016-42, 2016-34 I.R.B. 269.

[8] *Id.*

[9] *Id.*

[10] WealthCounsel, LLC, *Understanding Charitable Remainder Trusts*, ESTATE PLANNING, https://www.estateplanning.com/Understanding-Charitable-Remainder-Trusts/ (last visited Apr. 9, 2017).

[11] *Id.*

taxes when the grantor, the one who transferred the assets to the trust, decides to sell an item from the trust.[12] Normally if a person sold a high-priced item, they would be required to pay a capital gains tax on the profit they made.[13] However, if the grantor sells the item from the trust instead of personally, they are not required to pay any taxes on the profit they make, which has both an *inter vivos* benefit and a testamentary benefit.[14] Lastly, in addition to potential tax savings for the grantor, the CRT also lets a person help a charity that has a special meaning to him or her.[15]

The basic steps of using a CRT seem simple at first, but once one reads all the governing regulations, the CRT becomes quite complicated. However, in order to start off simply, the basic steps will be outlined as follows: In creating a CRT, the grantor, who owns the original property, will transfer all of the property into the CRT.[16] Once the property has been transferred from the grantor's name to the trust, the property is no longer a part of the grantor's estate, which means that it cannot be subject to estate taxes when the grantor dies.[17] Furthermore, upon the creation of the CRT, the grantor will receive a charitable income tax deduction, which is another incentive for a potential grantor to create the CRT.[18]

After the grantor has transferred the property into the trust, it can be left there so its value can appreciate, or the grantor can sell the property right away.[19] When the grantor decides to sell the asset, he or she will not be required to pay a gains tax on the profit they make from the sale.[20] The granter can use the money earned from the sale to reinvest into the trust or into something else.[21] Furthermore, while the grantor is alive, the CRT will be paying the grantor income, which means that he or she will be receiving money from assets

[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] WealthCounsel, LLC, *supra* note 10.
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*

located in a trust and not in the grantor's own name.[22] Finally, once the trust ends, either because the grantor died or the trust is depleted, the remaining funds from the trust are dispersed to the charity that was chosen by the grantor when the trust was created.[23]

IV. What Would Life Be Like if the CRT Didn't Exist?

Some people might wonder if organizing assets into a CRT would actually make that much of a difference. Actually, choosing not to organize assets into a CRT can result in greater taxes and less income for the seller. For example, an investor has $100,000 in stock, and over time, its value appreciates to a total of $500,000.[24] After the value of the stock has gone up the investor decides that he or she wants to sell the stock.[25] If the investor sold the stock, they would have a net gain of $400,000 since they originally paid only $100,000 for the stocks, and they sold the stocks for $500,000.[26] The current capital gains tax rate is 15%, if the total amount of the gain is under $416,700.[27] This means that the investor would have to pay $60,000 in capital gains tax to the government after they sold the stocks.[28] After taxes, the investor has $460,000 remaining.[29] The investor is then free to do what they want with the money—they most likely will reinvest it to produce further income. For the purpose of this

---

[22] WealthCounsel, LLC, *supra* note 10.

[23] *Id.* Also, see *Understanding Charitable Remainder Trusts* for an illustration explaining the steps of a Charitable Remainder Trust. *See id.*

[24] *Id.* The example problem used in this paper was first used in *Understanding Charitable Remainder Trusts*. *See id.*

[25] *Id.*

[26] *Id.* The equation used to determine net gain is *Total Value ($500,000) – Original Cost ($100,000)= Net Gain ($400,000)*.

[27] *Id.* This type of investment would qualify as a long term capital gain because the investor owned the stocks and let them appreciate over a specified amount of time rather than buying an item and the selling it for a higher price within the same tax year. *See also* Topic 409 - Capital Gains and Losses, IRS, https://www.irs.gov/taxtopics/tc409.html (last visited Apr. 16, 2017).

[28] WealthCounsel, LLC, *supra* note 10. The equation used to determine the amount owed in capital gains is *Amount of Gains ($400,000) x Long Term Capital Gains Rate (Currently 15%) = Amount Owed ($60,000)*.

[29] *Id.* To get the amount left after taxes, the investor subtracts 15% of the overall gain from the total sale price ($500,000–$60,000).

example, the investor was able to reinvest the money and received a 5% return on it, which totaled to $572,000 before taxes were deducted.[30] However, when the investor dies, all of these assets are under their name. So there is nothing to stop the creditor from taking the money at that time, and there are no charitable income tax deductions that are available to the investor either.[31]

On the other hand, if the investor had put the stocks in a CRT instead of holding on to them as a personal asset, things would have turned out very differently. By simply putting the stocks in the CRT, the investor would automatically be allowed to make a charitable income tax deduction.[32] Based on the value put into the CRT in the example, the charitable deduction amounts to $90,357.[33] When the investor deducts this amount from their total income for that year, their tax bracket is also lowered.[34] The investor was in the highest tax bracket, which deducted 39% from the investor's total gross income, but after the charitable deduction, the investor's income dropped to the second highest tax bracket, which deducts 35% of an individual's gross income.[35] By simply using the CRT, the investor is able to save $31,625.[36]

If the same facts applied, the stock appreciated to $500,000, and the investor decided to sell, they would not be required to pay a capital gains tax because the stocks are not a personal asset but rather

---

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] WealthCounsel, LLC, *supra* note 10. In this case the investor would be in the highest tax bracket because they made $500,000. If your yearly gross income is over $415,050, then you are placed in the highest tax bracket, which deducts 39% from your income. *See 2016 Tax Table*, IRS, https://www.irs.gov/pub/irs-pdf/i1040tt.pdf (last visited April 9, 2017).. However, in this case if the investor is able to deduct $90,357 from the original $500,000, then their gross income will be lowered and they will be placed in the second highest tax bracket since they make less than $415,050 and more than $466,950. *2016 Tax Table*, IRS, https://www.irs.gov/pub/irs-pdf/i1040tt.pdf (last visited April 9, 2017). Lowering your income tax by 4% may not seem like a lot, but when it is applied to a gross income amount, as is the situation in this case it can make a great financial difference in the eyes of the savvy investor.

[35] WealthCounsel, LLC, *supra* note 10.

[36] *Id.*

a part of a charitable trust.[37] This means that there would not be a 15% capital gains tax deduction of $60,000, and the investor would be able to reinvest the entire $500,000 instead of $440,000.[38] If the reinvestment were subject to the same 5% return, it would produce a $25,000 annual return, which would ultimately result in a lifetime total of $650,000 instead of $572,000.[39] Ultimately, the investor receives a $78,000 gain simply by using the CRT instead of selling and investing the money themselves.[40] Furthermore, when the investor eventually dies, the money in the CRT is not a part of their estate and therefore would not be subject to estate taxes, which is another added benefit to using a CRT rather than keeping the stock or asset as a listed personal item.[41]

There are many types of charitable trusts. The trust structure determines the type of annual payment that the trustee will receive.[42] The two main types of CRTs are the charitable remainder unitrust (CRUT) and the charitable remainder annuity trust.[43] The unitrust option bases the annual payment on the regularity and success of the trust assets.[44] This means that at the beginning of each year the trust must be evaluated to determine the proper amount that the trustee will receive.[45] On the other hand, the annuity trust distributes a fixed payment each year and therefore provides a steadier income to the trustee.[46]

Additionally, it is important to remember that the grantor of the trust, the one who transfers all the money and assets into the trust, can also be the trustee, the one who benefits from the trust.[47] This means that even though you are creating a charitable trust, the CRT is simply working as a channeling instrument for one's own assets.

---

[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] WealthCounsel, LLC, *supra* note 10.
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Id.*

Furthermore, depending on the number of assets and their value in the trust, the CRT can last either: for the trustee's lifetime, for the trustee and their child's lifetime, or for a specified amount of years (no more than twenty).[48] For the purpose of this paper and in relation to art collectors using CRTs, the specific type of CRT that the new rule affects is based on the structure of the annuity and thus the requirements section for creating a CRT will focus on the Charitable Remainder Annuity Trust (CRAT).[49]

V. QUALIFYING FOR A CHARITABLE REMAINDER ANNUITY TRUST

Requirements for qualifying as a CRAT are defined in IRC section 664.[50] All the requirements must be met or the CRAT is automatically disqualified.[51] Under section 664(d)(1)(A), the first requirement states:

> [A] sum certain (which is not less than 5 percent and not more than 50 percent of the initial fair market value (FMV) of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals.[52]

The first requirement is one of the main ways that a CRT is differentiated from a CRAT. In a regular CRT, the payments from

---

[48] *Id.*

[49] The main reform for this specific tax incentive, the reforming of the probability of exhaustion test, only applies to a CRAT because the CRUT is already designed to never run out of assets. This is because the yearly payout percentage is based on the standing amount in the fund at the end of the year. Therefore, art collectors will only be concerned the probability of exhaustion test and its effects on the CRAT rather than the CRUT. *See* Wierbicki & Roy, *supra* note 4.

[50] 26 U.S.C.S. § 664 (Supp. III 2016).

[51] *Id.*

[52] 26 U.S.C.S. § 664(d)(1)(A) (Supp. III 2016).

the CRT are dependent on the value of the asset in the CRT.[53] Therefore if the value of the asset goes up, the amount of the payment goes up.[54] However, in a CRAT the amount of the payment is dependent upon a percentage of the fair market value of the asset, which is what section 664(d)(1)(A) addresses.[55] Section 664 specifies that the payment is a fixed dollar amount that cannot be less than 5% and no more the 50%of the FMV.[56] While there is a chance for the trust payment to change based on the value of the trust asset, when the annuity asset structure is compared to the traditional CRT, a more stable and predictable payment structure for the trust administrator is shown.

The second requirement under IRC section 664(d)(1)(B) states, "no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in section 170(c)."[57] Section 170(c) of the IRC articulates what the IRS considers as a gift and charitable contributions for tax purposes.[58] The general rule under section 170 is that a charitable contribution may be used as a deduction on one's taxes if the payment was made within that tax year, but only if the contribution is included in the definitions provided by subsection (c).[59] Section 170(c)(2) outlines that a charitable deduction must be made to a "corporation, trust, community chest, fund, or foundation" that either has been created and organized under U.S. law or one that now operates under U.S. law.[60]

According to section 170(c)(B), the IRS code requires that the trust or foundation[61] be organized for the specific purpose of "religious, charitable, scientific, literary, or educational purposes, or

---

[53] Wierbicki & Roy, *supra* note 4.

[54] *Id.*

[55] *Id.*

[56] 26 U.S.C.S. § 664(d)(1)(A) (Supp. III 2016).

[57] 26 U.S.C.S. § 664(d)(1)(B) (Supp. III 2016).

[58] 26 U.S.C.S. § 170 (Supp. III 2016).

[59] *Id.*

[60] 26 U.S.C.S. § 170(c)(2) (Supp. III 2016).

[61] For purposes of this section, the term "trust or foundation" encompasses a corporation, trust, community chest, fund, or foundation as defined by section 170(c)(2).

to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals."[62] For the purposes of this analysis, the relevant categories that collectors are concerned with are a trust or foundation for charitable and educational purposes since most museums can be considered an educational institution.[63] Furthermore, no part of the charitable contribution can benefit a private or individual shareholder of the organization.[64] Overall, the second requirement and the requirements specified in section 170(c)(B) sets forth the type of payment and to whom it can be made for the charitable donation or gift to qualify for a CRAT.

The third requirement states,

> following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in subsection (g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan [(ESOP)] (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined by subsection(g)).[65]

This means that after twenty years of payments are complete, the trust's remaining assets will be given to the designated organization, as long as that organization complies with the standards set forth in section 170(c).[66]

The fourth requirement to qualify as a CRAT is, "the value (determined under section 7520) of such remainder interest [must be] at least 10 percent of the initial net fair market value of all property

---

[62] 26 U.S.C.S. § 170(c)(2)(B).

[63] 26 U.S.C.S. § 170(c)(2) (containing many other requirements such as the donation cannot be used as a bribe to sway legislation, it cannot be a part of a political campaign in any way, shape, or form, and the charitable contribution or gift must be used in the United States.).

[64] 26 U.S.C.S. § 170(c)(2)(C) (Supp. III 2016).

[65] 26 U.S.C.S. § 664(d)(1)(C) (Supp. III 2016).

[66] *Id.*

placed in the trust."[67] This means that at the end of the trust term, the final amount left that will be donated to an organization has to be, at a minimum, 10% of the full market value of all the property from the trust. For example, if a collector had a CRAT with a $100,000,000 fair market value, then, at the end of the trust term, at least $10,000,000 would have to be donated to the organization. At first sight, this seems like an extremely large amount of money for a person to pay simply so they can avoid paying sales and use tax when they buy a piece of art. However, when a collector buys a piece of art they are typically required to pay both sales and use tax.[68] On the other hand, if they sell the work they are required to pay a capital gains tax on the profit.[69] Both taxes are usually in the 28% range, which is almost three times the percentage amount required of the trust to be paid out to the specified organization when the CRAT dissolves. Therefore, it is more economically beneficial for a collector to own their artwork through a CRAT than it is for them to own each piece as an individual asset.

VI. Defining the Scope of CRAT

In its new rule, the IRS defines the scope of the CRAT.[70] Unfortunately, this rule is not retroactive and only applies to trusts that are created on or after August 8, 2016, the date of the rule's implementation.[71] If the trust is created after August 8, 2016, there are three requirements that must be met for the trust to fall within the scope of the rule for the IRS. First, the requirements established by

---

[67] 26 U.S.C.S. § 664(d)(1)(D) (Supp. III 2016).

[68] Isaac Kaplan, *The Law Behind New York's Multi-Million-Dollar Art-World Tax Probe, Explained*, ARTSY (Jan. 16, 2017), https://www.artsy.net/article/artsy-editorial-the-art-world-s-multi-million-dollar-tax-probe-explained.

[69] Anna Hill, Antoine Cadeo de Iturbide, and Pierre Naquin, *11 Secrets Every Art Collector Needs to Know,* ARTSY (Apr. 12, 2015), https://www.artsy.net/article/artsy-editorial-11-tax-secrets-every-art-collector-needs-to; 26 U.S.C.S. § 664(d)(1)(D) (Supp. III 2016).

[70] 26 U.S.C.S. § 664(d)(1)(D) (Supp. III 2016).

[71] *Internal Revenue Bulletin 2016-34*, INTERNAL REVENUE SERVICE, https://www.irs.gov/irb/2016-34_IRB/ar09.html#d0e242 (last visited Sept. 1, 2016).

IRC section 664(d)(1) must be met.[72] Recall that section 664(d)(1) refers to the amount of money that must be paid and who or what type of organization it must be paid to. Second, annuity payments must be payable for at least one or more life periods.[73] This simply means that the assets in the trust must have enough value to allow payments to last for more than one beneficiary. Lastly, the governing instrument of the trust must contain the exact language provided in the sample provision from section five of this revenue procedure.[74]

Just like the earlier rules established in the bulletin, the scope creates even more rules that must be considered in order to be an established legal CRAT. Section five of the bulletin is the sample provision written specifically by the IRS for a CRAT that would measure the length of one life, making it an *inter vivos* CRAT.[75] The beginning of the CRAT starts on the day that the property is legally transferred into the CRAT, and the CRAT ends on the day that the recipient of the CRAT dies.[76] The CRAT can also end on the date of contingent termination.[77] The contingent termination is the date that precedes any annuity payment. If, once the annuity payment is made and the discount factor is applied, the value of the trust is less than 10% then the CRAT will be terminated.[78] The discount factor is established by the equation $[1/(1+i)]^t$.[79] In this equation, t is the time that has passed since the initial creation of the trust to the present date of the annuity payment.[80] The interest rate that has been previously determined by IRS Code section 7520 is represented by i.[81] This is because at the end of the CRAT, 10% of the initial trust value must be paid to the specified organization; if the total amount

---

[72] *Id.*
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Internal Revenue Bulletin 2016-34*, *supra* note 71.
[78] *Id.*
[79] *Id.*
[80] *Id.* The measurement of time for this equation is expressed by yearly increments and if it has not been a full year then time is can be expressed through fractions of a year.
[81] *Id.*

was less than 10% at the end, the CRAT would be disqualified and there would be legal consequences.

The CRAT's start date can be changed depending on the type of CRAT created. As mentioned above, if it is an *inter vivos* CRAT, the start date is the day that the property is transferred to the trust.[82] However, if the CRAT is testamentary, the start date established by the sample provision must say, "[t]he first day of the annuity period shall be the date . . . of my death."[83] Furthermore, the language required for the CRAT must also be changed depending on the life measure that one wants the annuity payments to survive. For example, if it is just one life measure then the CRAT's ending date should use the specific words "of the recipient's death."[84] However, if the trust is meant to last for two or more life periods then the language should say, "the death of the survivor of the Initial Recipient and the Successor Recipient(s)."[85] All of these rules and conditions are painstakingly specific and any diversion could disqualify the CRAT from being a legal trust under the eyes of the IRS.[86] Therefore, if collectors are going to use a CRAT form to save on owing taxes, they need to make sure they have a well-educated lawyer or a financial advisor that can make sure that they are following the IRS Code. Unfortunately, the complexity of the CRAT system is a potential deterrent for collectors to use it because it requires further time and money, in addition to the money they will already be spent on the art that they want to collect. A collector would certainly need to weigh the pros and cons of using a CRAT and make sure it is suitable their situation before using a CRAT.

VII. How Does the CRAT Work in Real Life?

The previous section set forth the various requirements that must be met in order have a legitimate CRAT, but recitation of those rules failed to show how the CRAT might actually work in the real world. Section 6 of IRS Bulletin 2016–34 sets forth an example created by

---

[82] *Internal Revenue Bulletin 2016-34*, *supra* note 71.
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *See* 26 U.S.C.S. § 664(d)(1)(D) (Supp. III 2016).

the IRS on how a CRAT will look when all the rules are followed. The example situation is based on a donor that transfers $1,000,000 of property into an *inter vivos* CRAT and whose start date is January 1, Year 1.[87] The IRS requires that the annuity payment cannot be less than 5% of the fair market value of the trusts. [88] Therefore, in this situation the minimum payment would be $50,000, since that is 5% of 1,000,000.[89] The CRAT specifies that the payment is to be made to S for the remainder of S's life; therefore, on a specified date (here, the example uses December 31 of the year) S will receive the annuity payment of $50,000 for the rest of her life.[90] After S's death, the remaining trust assets will be given to a chosen charity or organization.[91] Since the value of the trust will depreciate or appreciate based on the amount of the annuity payment and whether or not the assets in the trust are appreciating in value, the trustee should perform the calculations needed to determine if the trust will end early or if the annuity payment can be made while simultaneously leaving more than 10% of the FMV of the original trust assets in the trust.[92] In this case, because the initial value of the trust was $1,000,000, at least $100,000 must be left in the trust at all times since that is 10% of the FMV of the original trust assets.[93] If the value of the trust does not appreciate, then by year eighteen the amount left in the trust will reach below $100,000, and the trust will have to terminate.[94] The remaining amount in the trust is then

---

[87] *Internal Revenue Bulletin 2016-34*, *supra* note 71.

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *Id.* Please be advised that this is how a CRAT would work in the simplest of forms and that if for some reason the CRAT needed to end early, it would need to meet all of the requirements mention above and established in the Section 5 Sample Provision set forth by the IRS in the relevant Internal Revenue Bulletin. *See Internal Revenue Bulletin 2016-34*, *supra* note 71.

[92] *Id.*

[93] *Id.*

[94] *Id.* This can be illustrated by using the equation provided in the Sample Provision of the Revenue Bulletin, $[1/(1+i)]^t$. After eighteen years the amount left in the trust is $260,000 and the annuity payment is still $50,000 as established on the start date of the CRAT. The current IRS interest rate is 3% and the time elapsed since the beginning of the trust has been eighteen years. Therefore, the equation would look like this, $(\$210,000 - 50,000) \times [1 / (1 + .03)]^{18}$, which simplifies to

distributed to the charity or organization specified in the trust document.[95]

VIII. CHANGING THE PROBABILITY OF EXHAUSTION TEST

Before the IRS implemented its new rule in August 2016, many collectors who wanted to use the CRAT as a tax saving instrument were thwarted by what is referred to as the Probability of Exhaustion Test.[96] Unfortunately, this rule made it extremely difficult for anyone under the age of seventy-four to have the ability to create a CRAT, and thus younger collectors were left out of this tax saving strategy.[97] Under the Probability of Exhaustion Test, if there was more than a 5% probability that the CRAT funds would be exhausted before the designated charity was able to receive its funds from the CRAT, the CRAT would automatically be disqualified.[98] The Probability of Exhaustive Test made it difficult for younger collectors to use the CRAT because the younger someone is, the longer their trust must last. For example, if a person's average life expectancy is ninety-five years old and a collector creates the CRAT at the age of seventy-five, then the CRAT only needs to last about twenty years.[99] On the other hand, if there is a collector who is only fifty years old when the CRAT is created, then the CRAT must last about forty-five years.[100] If the CRAT needs to last forty-five years, the assets in the trust need to have an extremely high value, or the CRAT will run out of funds and be disqualified.

$160,000 × (1/1.03)18, then to $160,000 × 0.97087418, which ultimately results in $160,000 × 0.587397 = $93,984. The final total, $93,984, is less than the require $100,000 that must always be in the trust and that is why the trust must end after 18 years in this fact pattern. *See Internal Revenue Bulletin 2016-34, Section 6 Example*, INTERNAL REVENUE SERVICE, https://www.irs.gov/irb/2016-34_IRB/ar09.html#d0e242 (last visited Apr. 16, 2017).

[95] *Internal Revenue Bulletin 2016-34*, *supra* note 71.

[96] Wierbicki & Roy, *supra* note 4.

[97] *Id.*

[98] *Id.*

[99] The determining equation is Life Expectancy (95) – Age of Creator/Trustee (75) = Years required for the trust to last (20).

[100] The same equation used in footnote 130 is used to determine this, Life Expectancy (95) – Age of Creator/Trustee (50) = Years required for the trust to last (45).

The new IRS rule changed the Probability of Exhaustion test by allowing CRAT users to add in a trigger provision into the language of the CRAT that allows for early termination of the CRAT.[101] If the CRAT is terminated early all of the assets that are left in the trust will be immediately distributed to the chosen charitable beneficiary.[102] This specifically can be seen in the Section 6 Example provision of IRS Bulletin 2016-34.[103] The express language that the IRS uses in the sample provision is,

> In accordance with this revenue procedure, the IRS will treat the early termination contingency as a qualified contingency under [section] 664(f). Therefore, the early termination provision does not cause Trust to fail to qualify as a CRAT under [section] 664. In addition, Trust qualifies as a CRAT regardless of whether it passes the probability of exhaustion test on January 1, Year 1.[104]

The IRS first requires that the contingency be qualified under section 664(f).[105] Section 664(f) states that the CRAT must be qualified under 1(A) and 2(A) of subsection (d) of section 664.[106] Recall that sections 664(d)(1)(A) and (2)(A) simply require that no less than 5% and no more than 50% of the trust's original fair market value must be paid to the trustee annually, regardless of whether the CRT is a CRAT or CRUT.[107] The last part of the language in the sample provision, which states whether the CRAT passes or fails the Probability of Exhaustion test, does not matter since there is a contingency termination.[108] This contingency termination insures that the charitable organization attached to the CRAT will still receive the economic benefit it was originally promised.[109] Originally, the

---

[101] Wierbicki & Roy, *supra* note 4.

[102] *Id.*

[103] *Internal Revenue Bulletin 2016-34*, *supra* note 71.

[104] *Id.*

[105] *Id.*

[106] *Id.*

[107] 26 U.S.C.S. § 664 (Supp. III 2016). The difference between the two sections is that the CRAT payment will be fixed, and the CRUT payment will be based on the amount of the assets currently in the trust at the time of the payment.

[108] *Internal Revenue Bulletin 2016-34*, *supra* note 71.

[109] *Id.*

Probability of Exhaustion requirement worked like as an insurance mechanism to make sure that a CRAT wasn't going to be created simply to gain tax deductions, only to run out of funds and leave the charitable organization "high and dry."[110]

The contingency termination provisions that are now allowable when creating a CRAT serve to replace the Probability of Exhaustion test in a less user limiting way. As stated earlier, it was likely that only users at least seventy-four years old would create a CRAT because for the CRAT to last until the end of their life, it did not need to have as many assets as it would need to have in comparison to a collector that created a CRAT at the age of forty or fifty years old.[111] Now however, collectors younger than seventy-four who are interested in using a CRAT can simply add a contingency termination provision to the CRAT's governing document, and they will not have to worry about the Probability of Exhaustion Test disqualifying them as a CRAT user.[112] Under the contingency termination plan, the CRAT is required to maintain a minimum of 10% of the original fair market value of the trust.[113] Every year, before the annual annuity payment is distributed to the trustee, the trustee must perform the relevant calculations to determine if there is still more than 10% of the original value of the trust after the annuity payment for that year would be made.[114] If there are not enough funds to maintain the minimum value, the contingency early termination provision is enacted, and upon termination of the CRAT, the designated charity receives its money.[115] This means that regardless of whether the CRAT's grantor does not add in an early termination trigger and instead continues to use the probability of exhaustion text, or if the CRAT creator uses the new IRS rule, the charitable organization is guaranteed to receive their money. In summary, the new IRS rule keeps the same outcome as the Probability of Exhaustion Test, but in a less limiting manner. Therefore, the amount of potential CRAT creators is increased overall, which creates a larger benefit to

---

[110] Wierbicki & Roy, *supra* note 4.
[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Internal Revenue Bulletin 2016-34*, *supra* note 71.
[115] *Id.*

charities by increasing the chance that they will be chosen as a beneficiary of one of these CRATS.

IX. HOW THE CRAT BENEFIT COLLECTORS

When a collector decides to use a CRAT as a collecting structure to hold their property, there are many benefits that they would not be able to access if not for the CRAT. For one, when the collector purchases the work of art, the collector does not have to pay a capital gains tax because it is going straight to the CRAT as a trust asset and will not be listed as a personal asset under the collector's name.[116] Unlike the example discussed previously, which illustrated a 15% capital gains tax deduction on stocks that were put into a CRT,[117]art collectors will see an even bigger deduction. Currently, art and other forms of collectibles are subject to a 28% capital gains tax rate.[118] Furthermore, depending on the state that the collector buys the work from, they might also be subject to a net investment tax of 3.8%, in addition to state and local income taxes.[119] If the collector were located in California, after all of their tax obligations were added up, the collector could end up paying up to 45% taxes on the artwork that they bought.[120] In other words, without the CRAT a collector would buy a work of art and then be required to pay almost half of the work's value in taxes. To demonstrate a real world example, Sotheby's, a famous art auction house, recently held an auction of Old Master Paintings and Sculptures on January 25, 2017.[121] In the auction, a painting by Peter Paul Rubens, a famous Dutch painter, was sold.[122] The painting sold for $5,075,000.[123] If the collector bought the artwork without the use of a CRAT and was subject to California tax laws, he or she would be required to pay around

---

[116] Wierbicki & Roy, *supra* note 4.
[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] *Id.*
[121] *Sotheby's Auction Results*, SOTHEBY'S, http://www.sothebys.com/en/auctions/2017/master-paintings-n09601.html (last visited Jan. 13, 2017).
[122] *Id.*
[123] *Id.*

$2,283,750 in taxes.[124] This would make the collector's total cost for the artwork $7,358,750.[125]

In comparison to paying hefty taxes on collected works without the use of a CRAT, if the collector did use a CRAT, he or she would only have been required to pay the $5,075,000. Furthermore, if the collector lets the artwork accrue interest for a few years and then decides to sell the painting for an even higher price from the CRAT, he or she will not be required to pay any taxes on the profit they make from the sell.[126] Additionally, if the collector kept the artwork for themselves and then after many years passed away, the collector's family would not have to pay estate taxes on the artwork because technically it would not be listed as a personal asset but as an asset of the trust.[127]

X. It Can't All Be Fun and Games

As previously discussed, making sure that a collector's trust follows all the requirements to become and stay a legitimate and legal CRAT is a job in itself. However, once the CRAT is created, as long as there are sufficient funds to make the annual annuity payments, the CRAT should continue to run smoothly. This begs the question as to why more collectors aren't using CRATs to avoid taxes. This next section will focus on potential deterrents or obstacles to using a CRAT.

A potential challenge for a younger collectors is being able to acquire a substantial amount of money and valuable assets that is needed to create an initial working and successful CRAT. While the CRAT is in operation, the trustee will receive a yearly payment.[128] Hypothetically if the yearly payment is the only income for that trustee, then the collector would want to make sure that there are

---

[124] This is a rough estimate based on the percentages discussed in New IRS Rule Opens Tax Saving Strategy To Art Collectors. *See* Wierbicki & Roy, *supra* note 4. The equation used to get this number is Total Cost of the Work ($5,075,000) x Tax Rate (45%) = Total amount of taxes owed ($2,283,750). *See id*.

[125] The equation used to get this total was adding the cost of the work and the total amount of taxes owed. *See supra*, note 124.

[126] Wierbicki & Roy, *supra* note 4.

[127] *Id.*

[128] 26 U.S.C.S. § 664 (Supp. III 2016).

enough assets in the trust to provide a substantial payment to the trustee that would support him or her through until the next payment was disbursed. While it is not impossible for a young collector to amass this amount of money, it is rather limiting since younger people tend to still need to pay off house payments and student loans. It may be possible for a young collector to have the money to create the CRAT initially, but maintaining it regardless of whether there is an early termination provision is another issue. The whole benefit of getting rid of the probability of exhaustion test is that it allows for CRATs to be used by more people who are under the age of seventy-four.[129] However, if younger collectors still cannot gain enough money to have a CRAT that will last for more than a few years, then it might not be wise for these collectors to use the CRAT in the first place. This is because it is likely that these collectors will have to hire legal or financial counsel to make sure that the CRAT is created and maintained properly.

Another aspect of the CRAT that could be improved is that the benefit of the buying and selling process is extremely one-sided. As it currently stands, when the artwork is first bought and the grantor puts the artwork in the CRAT, the grantor or trustee does not need to pay any capital gains tax and receives a charitable deduction. When that same grantor or trustee decides to sell the work after the price has appreciated, the seller does not have to pay any capital gains taxes.[130] However, there are no yet known incentives to a collector who is buying an asset out of a CRAT. Unless the second buyer has a CRAT of his or her own that he or she plans to put the artwork into, he or she will still be required to pay the traditional 28% capital gains rate. [131] Even if the second buyer does not have a CRAT of his or her own, the purchase of the work indirectly benefits the charity attached to the original owner's CRAT; thus the second buyer should receive a benefit as well for his or her participation in the CRAT system. Furthermore, if there were a benefit for buying artwork from the CRAT system, it would encourage buyers to seek works that are being sold from CRATs rather than from private sellers, which would ultimately promote the entire CRAT system.

---

[129] Wierbicki & Roy, *supra* note 4.
[130] WealthCounsel, LLC, *supra* note 10.
[131] Wierbicki & Roy, *supra* note 4.

XI. THE GOAL OF TAXATION

Beyond the basic level of taxation, where the government uses taxpayer money to repair roads, there is a deeper level of taxation where taxes can be used by the government to direct private income in specific directions desired by the government.[132] The government is able to achieve this goal by using specifically created tax expenditures.[133]

Tax expenditures can be defined as an IRS code approved revenue loss that promotes some form of "societal good" that does not result in a governmental loss.[134] One of the most widely known forms of this is when individuals deduct and pay taxes from their yearly gross income.[135] The government's theory behind this is that it will allow an individual to pay less tax to the actual government if that individual instead pays taxes to another individual to help the public good (*i.e.* sales tax).[136]

XII. HOW ART AND TAXES INTERSECT

When one thinks about the ever-growing art market, taxes and law do not often come to mind. However, it is important for people, especially art enthusiasts and collectors, to fully understand the role the law plays in the art market. Laws that affect the art world are commonly placed in the group of intellectual property laws, such as copyright and trademark laws that protect the production and creative aspect behind the arts, because without protection for creativity there would be a weakened incentive to create any art at all.[137] This is specifically referenced in section 1221 of the U.S. Tax Code, as it

---

[132] Steven Rodgers, *Donate Your Art and Keep It Too: How The Government Subsidizes Art Collections for the Rich and What Congress Can Do About It*, 40 S. ILL. U. L. J. 45, 53 (2015)..

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] *Id.*

[137] *See generally,* 17 U.S.C. § 102 (2012), 15 U.S.C. § 1111 (2012).

defines what constitutes a capital asset.[138] Surprisingly, the art world also receives multiple benefits from the tax system, which can help the arts with economic and cultural development.[139]

XIII. TAXABLE ART

In the U.S. today, the buying, selling, donating, and gifting of artwork is regulated by the IRS and subjected to a variety of tax laws.[140] If a collector sells a work of art and makes a profit from the sale, he or she either must pay a capital gains tax or an income tax depending on the amount of time since the original purchase and the preference of the seller.[141] Additionally, the purchaser is required to pay sales tax on the artwork depending on the state in which the sale took place.[142] When a collector dies and his or her heirs inherit the artwork, they may be subjected to an inheritance tax, if the value of the work is past a certain value threshold as determined by the IRS.[143] Lastly, if a collector gifts an artwork to a person or a cultural institution, the entity that received the gift will be subjected to pay the IRS a gift tax based on the monetary value of the gift.[144]

Commonly, there are three major scenarios in the art market that illustrate the different ways artwork is taxed.[145] The first is the gallery scenario; a buyer walks into a gallery or establishment that sells art and buys artwork for his or her home in the same city where the artwork is being sold. As the buyer, he or she will be required to pay both federal and state taxes on the item.[146] The sales tax will depend on the state in which the work was bought and the purpose

---

[138] 26 U.S.C. § 1221 (2012) (determining that art objects that are for sale in the ordinary course of business are considered capital assets by the IRS Code for purposes of determining capital gains and losses).

[139] *See* Xuan-Thao Nguyen and Jeffrey A. Maine, *The History of Intellectual Property Taxation: Promoting Innovation and Other Intellectual Property Goals?*, 64 SMU L. REV. 795, 796.

[140] Hill et al., *supra* note 69.

[141] *Id.*

[142] Kaplan, *supra* note 68.

[143] Hill et al., *supra* note 69.

[144] *Id.*

[145] *Id.*

[146] *Id.*

for buying the work.[147] Use taxes can vary from state to state as it is established by state government.[148] This means it could be more advantageous to buy artwork in one state versus another. For example, the state of Oregon does not enforce a use tax against its citizens, while the state of New York enforces a 4% use tax on items.[149] Therefore, it is beneficial to a buyer to apply Oregon use tax rather than New York use tax. This might lead one to wonder why Oregon, or any other state that does not apply use tax,[150] is not a major mecca for artworks to be sold because of the beneficial tax break. One potential reason is that the buyer does not necessarily need to be in the same state as the one that he or she wants to apply the use tax from.[151] The requirement is that the purchased artwork is shipped immediately to the state in which the buyer wants the use tax from to be applied.[152] The work does not need to stay in that state forever as that would defeat the purpose of buying artwork for one's home in New York, but it must remain in the relevant state for at least a few months before being moved back to its home state.[153] In

[147] Kaplan, *supra* note 68.

[148] *Id.*

[149] *New York State Sales and Use Tax*, NYC DEPARTMENT OF FINANCE, http://www1.nyc.gov/site/finance/taxes/business-nys-sales-tax.page (last visited Oct. 9, 2016).

[150] Graham Bowley and Patricia Cohen, *Buyers Find Tax Break on Art: Let It Hang Awhile in Oregon*, THE NEW YORK TIMES (Apr. 12, 2014), https://www.nytimes.com/2014/04/13/business/buyers-find-tax-break-on-art-let-it-hang-awhile-in-portland.html?_r=0. Additional states that do not apply use tax are Montana, New Hampshire, Delaware, and Alaska. *See also* Kaplan, *supra* note 68.

[151] For example, if a buyer was in New York, they have the potential to apply Oregon use tax as long as the painting is used in Oregon.

[152] Kaplan, *supra* note 68.

[153] In recent years, many art collectors have been buying works in California and New York and then sending them directly to use tax-free states as mentioned above. *See* Graham Bowley and Patricia Cohen, *Buyers Find Tax Break on Art: Let It Hang Awhile in Oregon*, THE NEW YORK TIMES (Apr. 12, 2014), https://www.nytimes.com/2014/04/13/business/buyers-find-tax-break-on-art-let-it-hang-awhile-in-portland.html?_r=0. Typically, the museums that are sent the artwork are on the smaller side and therefore encourage and are substantially benefited from the temporary loan. *Id.* A good example of this is the Jordan Schnitzer Museum of Art at the University of Oregon. *Id.* The university museum recognized the potential benefits of collectors and investors utilizing this tax break and created the Masterworks on Loan program, which, as its title suggests, is

addition to the buyer, the seller of the work will have to pay taxes as well.[154]

The second scenario illustrating a way in which arts are taxed is the investment scenario. This situation is comprised of a buyer purchasing a work of art with the sole intention of later reselling that work to make a profit off of the sale[155]. When an investor buys a work of art with the purpose of reselling it, he or she is not required to pay either sales or use tax.[156] However, buyers and investors need to be careful when they choose to go down this route as it can easily get them in trouble if they do not follow the law correctly. [157]

When one buys artwork for investment purposes, it is unrealistic to believe the artwork is going to double in price overnight. Therefore, it is common practice for an investor to purchase a work of art and let it stay off the market for anywhere from one or more years for the value of the artwork to appreciate.[158] Artwork must be stored elsewhere during the time that it is sitting off the market. Sometimes collectors will place their work in some sort of storage facility that specializes in storing artwork, and sometimes the owner will choose to keep the artwork in his or her home or office where he or she conducts business until it is time to put the work back on the market for resale.[159] While storing the work of art until resale appears

---

dedicated solely to the display of masterworks that are on loan to the museum. *Id.* Artworks that are lent to the museum are typically on display for a minimum of three months, but can be displayed for longer depending on the preference of the lender. *Id.* While this tax break can seem a little one-sided as it can save collectors massive amounts of money owed in taxes for simply lending a painting to a museum for a few months, it is equally beneficial to the museums that are able to display the works as many of them are in smaller cities that normally would not be able to display and present artworks on that large of a scale in their educational programs. *See Id.*

[154] Bowley and Cohen, *supra* note 150.

[155] Kaplan, *supra* note 68.

[156] *Id.*

[157] *Id.*

[158] The time that the investor will want to keep the artwork off the market is determinate on a number of factors that cannot always be precisely calculated. These factors can include whether or not the artist is still living, the medium of the (painting, sculpture, etc.), and the style of the work. *See* Michael Findlay, *The Value of Art,*p 14-17, Prestel, New York, 2014.

[159] Kaplan, *supra* note 68. *See also*, Graham Bowley and Doreen Carvajal, *One of the World's Greatest Art Collections Hides Behind This Fence: The superrich*

to be the easy part of the investment process, it has actually led to serious trouble and legal issues for some. A good example of such issues is the recent tax probe by New York Attorney General Eric Schneiderman ("Schneiderman").[160]

To be exempt from being responsible for paying use and sales tax when buying an artwork for investment purposes, the artwork must remain *unused* from the initial time of purchase until the time of resale.[161] When one considers an artwork that is anywhere from twenty to hundreds of years old, how does one determine whether it has been used or not? Since qualifying for a tax exemption is dependent on whether or not the buyer actually uses the work, Schneiderman's tax probe focuses on what exactly constitutes use in terms of owning a piece of art.[162]

The issue of use is less of a problem for those investors who buy artwork for resale and keep the works in a storage facility; in this situation no one should come in contact with the artwork until it is taken out for resale.[163] However, the same cannot be said for the investors who choose to personally hold onto the work until they put it back on the market. According to Schneiderman, art is created for viewer consumption and thus the action of simply looking at the artwork constitutes use.[164] Is one absent glance at the work enough to make it a used product, or does one have to stare at the painting for at least an hour before it is fully used? What if an investor chooses to put the work in his office while he waits a year before resale? On one hand, the investor could be looking at the artwork every day for a year before it goes up for resale. Surely, being viewed for a year constitutes use. On the other side of the argument, the investor could

---

have stashed millions of works in tax-free storage. So what does that mean for the art?, THE NEW YORK TIMES (May 28, 2016), https://www.nytimes.com/2016/05/29/arts/design/one-of-the-worlds-greatest-art-collections-hides-behind-this-fence.html.

[160] Kaplan, *supra* note 68.

[161] *Id.*

[162] *Id.*

[163] Bowley & Carvajal, *supra* note 159.

[164] Janet Novak, *New York Sales Tax Settlement Could Change The Way Art World (And Others) Do Business,* FORBES (August 9, 2016), https://www.forbes.com/sites/novack/2016/08/09/new-york-tax-settlement-could-change-the-way-art-world-and-others-do-business/#6b2aba721ad1.

argue that buying a work of art for resale and profit is part of his or her business and how he or she makes his or her livelihood. Subsequently, his or her office is where he or she conducts business, so why would he or she store the artwork in his or her office? Should it really be relevant whether or not the artwork is being viewed by people during its time in the office? How does the law measure the use of an object when said use is intangible and does not leave a mark? Is it only okay for the work to be looked at if the viewer is not enjoying the work? Where is the line drawn?

Schneiderman wanted to investigate this issue to make sure investors weren't buying artwork for the purpose of a future investment in order to receive the tax break and then just keeping the work for themselves, with no real intention of reselling the work in the future.[165] This has resulted in the latest New York tax probes, which began in May 2016.[166] As a result of this tax probe, a few major collectors have had to make legal settlements regarding their investments in the art market for not paying proper sales and use tax for their purchases.[167] Schneiderman's rationale that hanging a work of art in a home or business during a waiting period before putting the work back on the market is not acceptable is changing the way buyers consider going about their investments.[168]

Two of the most well-known art investors who have been affected by the New York tax probe are Aby Rosen, a real estate developer, and Victoria Gelfand, a director at Gagosian, a prominent art gallery.[169] Schneiderman suspected Rosen of improperly avoiding sales and use taxes on art sales that reached over $80 million in sales.[170] In order to settle this claim, Rosen agreed to pay $7 million.[171] However, Rosen still maintained that he did not inappropriately avoid sales and use taxes.[172] Victoria Gelfand agreed to a smaller settlement in the amount of $210,000 regarding

[165] *Id.*
[166] *Id.*
[167] *Id.*
[168] Kaplan, *surpa* note 68.
[169] *Id.*
[170] *Id.*
[171] Kaplan, *supra* note 68..
[172] *Id.*

purchases that totaled just over $1 million.[173] Similar to Rosen, Gelfand additionally claims that she did not avoid paying sales and use taxes as she intended to sell the artworks that she bought.[174] Some of the works were shown to buyers at her home; this is likely what led Schneiderman to make the allegations of improper tax exemptions in Gelfand's case.[175]

If a buyer is always going to have to pay for a storage facility to put his or her artworks in before resale, what is the cost difference between that and simply paying use and sales taxes? Does it limit the resale exemption too much? Artsy editor Isaac Kaplan writes that this interpretation of "exclusively for resale" may create an "uncertain hurdle" for buyers to legally abide by.[176] The art market is a uniquely personal market; would not be out of the question for a seller to show artworks to a potential buyer from inside his or her private home.[177] This is especially applicable to those who are dealing art as a secondary job, since they are the least likely to own their own gallery space dedicated to this type of business.[178]

The third scenario in which art is taxed through sale is the buyer purchasing the artwork in one state with the specific intention of sending and keeping the artwork in another state.[179] This is similar to the first buy and sale scenario mention above as it revolves around sales and use taxes. Here, the buyer must pay sales tax in the state where the purchase is being made; then the buyer will pay use taxes as established by the state in which he or she plans to move the artwork to.[180] However, there is a way to avoid paying taxes twice on the same work of art.

Sales tax is applied to an item that has been bought and used in the state of the transaction.[181] However, if a buyer purchases a work of art and immediately ships it to the state where they intend the

---

[173] *Id*.
[174] *Id.*
[175] *Id.*
[176] Kaplan, *supra* note 68..
[177] *Id.* (quoting Wierbicki).
[178] Victoria Gelfand is an example of this since she is primarily the director of the Gagosian Gallery but also is an art dealer. *See* Kaplan, *supra* note 68.
[179] *Id.*
[180] *Id.*
[181] *Id.*

work to be displayed, then technically it was not used when it was purchased and sales tax will not apply to the sale.[182] However, as the New York tax probe has warned buyers and sellers, one should always make sure he or she is being transparent about the movement of the work to avoid being fined by the state government.[183] Fines for avoiding and improperly paying taxes for art market transactions are double the amount of unpaid taxes with an interest rate of 14.5 %.[184]

In the three straightforward scenarios illustrated above, it is clear how easy it can be to make a simple mistake in the selling and buying of artwork that can lead to legal tax issues and large fines owed to the state and government. Furthermore, even if a buyer or seller follows all the rules, they are still likely faced with large amounts of sales and use taxes in addition to the often hefty prices that artworks can be sold for today. The aforementioned reasons fuel the development of tax incentives that create alternative ways for art to be sold, such as the one that allows for exemptions when a work is sold from a CRAT as discussed in the beginning of this paper.[185] However, it is important to consider whether or not this particular incentive actually encourages buyers and sellers to use charitable trusts in a manner that will benefit the public as it was intended, or if this incentive will simply be used as a filter for buyers and sellers to pass artwork through and avoid paying large amounts in taxes to the state and the IRS.[186] First though, it is important to understand the other ways artwork owners have moved their works around and how it is affected by tax law other than the straight forward sell and buy scenarios that were discussed above.

XIV. GIFTING A WORK OF ART

When a collector makes the choice to be generous and donate artworks from their collection, they will be able to write-off the donation on their taxes.[187] This is a great incentive to promote the

---

182 *Id.*

183 *Id.*

184 Kaplan, *supra* note 68.

185 Wierbicki & Roy, *supra* note 4.

186 *Id.*

187 Charlotte A. Montgomery, *Your Museum Needs Money—Now What?*, AMERICAN ALLIANCE OF MUSEUMS, http://www.aam-

donation of artworks to cultural institutions like museums, which often have very limited budgets since they rely on government grants and private fundraising.[188] The arts and the humanities as a whole are not known for being well funded sectors in the United States, but they are important to our society.[189] Furthermore, the government has even created laws specifically with the intention of promoting the creation of the arts and protecting ideas, which demonstrates the importance that the country has established for the arts.[190] Therefore, many of these museums, especially the publicly funded ones, rely on their own fundraising in order to maintain their mission and day to day operations.[191] It is for this reason that tax incentives encouraging public donations to museums are so important. They are a way for the government to support the arts without directly taking money from the overall federal budget.

However, while the museum—or whoever receives the gift—does not have to pay for the work, if the monetary value of the work exceeds a specific amount determined by the IRS, the new owner of the work will be required to pay the IRS a gift tax.[192] It is this type of situation where the CRAT is both helpful to the donor and the museum whereas, before, traditional tax incentives were lacking in being able to lower to required taxes due on a charitable transaction like this. Additionally, both the positives and negatives of this the earlier incentive illustrate why it is important for tax laws relating to the arts to be continually developing and why the change to the probability of exhaustion rule is so important. The following section

---

us.org/resources/professional-networks/leadership-and-management/financial-management-feb-2014 (last visited Sept. 23, 2016).

[188] *Id.*

[189] When budget cuts need to be made, typically the humanities are targeted. *See* Isaac Kaplan, *Trump's Latest Budget Once Again Targets NEA for Elimination,* ARSTY (May 23, 2017).

[190] One of the prominent examples of this is the development of the United States Copyright Act, which states in the beginning of the act, its creation with the purpose of promoting and protecting the arts and sciences. *See generally* 17 U.S.C. § 102 (2012); 15 U.S.C. § 1111 (2012).

[191] Michael Phillips Moskowitz**,** *Museums Need More Than Rich Donors to Survive,* ARTSY (May 23, 2017) https://www.artsy.net/article/artsy-editorial-museums-rich-donors-survive.

[192] Hill et al., *supra* note 69.

will discuss the traditional rules for capital gains taxation in order to provide a comparison for the new IRS tax incentive.

XV. Buying and Selling: Capital Gains, Income, and Sales Tax

When a collector sells a work of art that has appreciated since the original date of purchase, the collector has two options for how they can be taxed.[193] The first is a "capital gains tax, which is the tax paid on the income that is generated by the sale of an asset."[194] This law is applicable to all artworks sold in the U.S. if one year or more has passed since the original date of purchase.[195] As of 2015, the current capital gains tax for art and collectibles was 28%[196], which is relatively high when compared to the 20% capital gains tax that is imposed on stocks and other forms of investment assets.[197] When less than a year has passed between the original purchase and resale of the artwork, the seller is required to list the gain or loss from the sale on their yearly income tax.[198] Therefore, depending on the seller's annual income, the tax on the sale ranges from 18% all the way to 39.6%.[199] This could result in quite a hefty burden on the seller. For example, if a collector bought an artwork for $1,000,000 and then sold the same work for $5,000,000 a few years later, the profit would be $4,000,000.

According to the 2015 IRS Income Tax Brackets, if the seller reported the profit as income tax, they would be taxed at a rate of 39.6%.[200] As of 2016, the taxation percentage for capital gains was

---

[193] *Id.*

[194] *Id.*

[195] *Id.*

[196] Hill et al., *supra* note 69.

[197] Wierbicki & Roy, *supra* note 4. *See also* 2015 Schedule D (Form 1040): Capital Gains and Losses, INTERNAL REVENUE SERVICE, available at https://www.irs.gov/pub/irs-pdf/f1040sd.pdf (last visited Oct. 17, 2016).

[198] Wierbicki & Roy, *supra* note 4.

[199] *Id.*; *see also* 2016 Tax Tables for Form 1040, INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/i1040tt.pdf (last visited Oct. 17, 2016).

[200] If an earner makes more than $413,350, he or she will be taxed at a rate of 39.6%. 2015 Tax Tables for Form 1040, INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/i1040tt.pdf (last visited Oct. 17, 2016).

only 28%;[201] therefore, it would be wiser for the seller to report the profit as capital gains, since it means less money out of their own pocket. However, 28% is still a heavy tax burden, and on a $4,000,000 profit they would be paying the IRS $1,120,000. If the work of art had been sold within the same year of the original purchase, the seller would be required to report the profit as part of his or her income tax that year. This would automatically set the seller in the last tax bracket,[202] imposing a 39.6% tax on the profit alone. The one-year time limit is what marks the difference between a smaller resale profit and a larger one. As stated earlier, when a seller purchases an artwork with the intention of reselling the work, the resale often takes multiple years because the seller wants the artwork to have a proper chance to appreciate in value. It is unlikely that the artwork's value will be able to change drastically in one year or less since the popularity and demand for a particular style is primarily dependent on the art market. One could argue this is comparable to fashion, where one style will be in for a few years and then another will be popular after that. Therefore, when the buyer resells the work within one year's time, it is likely that the profit they are going to make will be nowhere near as high as it could have been if the buyer had waited a few more years before selling the artwork. Furthermore, within a one-year resale, there is a higher chance that the buyer will either sell the work for a similar price from which it was purchased or will actually incur a loss on the sale. Lastly, if the original buyer is able to sell a work that quickly, it might be likely that buying and selling work as an art dealer is his or her primary profession. Therefore, it is more appropriate for the gain or loss on such a sale to be counted toward the seller's gross income from that year, rather than a separate financial transaction to be taxed on its own. On a $4,000,000 profit, the percentage of gross income tax that

---

[201] *Id.*

[202] The collector would be in the last tax bracket because the additional profit from selling the work of art would increase his or her yearly income on the tax form, meaning profit becomes reportable income. 2016 Tax Tables for Form 1040, INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/i1040tt.pdf (last visited Oct. 17, 2016).

would result in the seller owing the IRS is $1,584,000.[203] However, if the profit of a work sold within the first year is smaller, the higher tax will be less detrimental than it seems. If the profit from the sale was only $100,000, then the tax owed would be $39,600, which seems like pocket change when compared to $1,584,000.

It is important to remember that in addition to the seller paying capital gains tax when he or she sells the work, the purchaser also has to pay a sales taxes on the work he or she wishes to buy.[204] In the United States, sales tax varies from state to state. States such as Oregon, Montana, New Hampshire, and Delaware are not required to pay sales tax at all.[205] New York on the other hand is subjected to a high bracket of sales tax, which is 8.875%.[206] While this potential sales tax is far less than the capital gains tax of 28% or the 39.6% income tax, it can still impose a financial burden on the purchaser, especially when high works of art can sell for upwards of $20 million.[207] Using the example set forth above, a purchaser of a $5 million artwork, purchased in New York City, will be required to pay $443,750. Through the discussion above, it is easy to see how potential art collectors and sellers may be dissuaded from participating in the art market due to the strenuous financial burden that is inseparable from the transaction of the sell. However, with the new rule of the CRAT, collectors and dealers can put the title of the artwork in the CRAT rather than under their own personal name, and when the CRAT runs out, the remainder goes to the chosen museum or charity.[208] This means that while the CRAT might not be able to directly help out a museum as the collector is buying, selling, and investing work, the tradeoff for the seller receiving a pardon on paying capital gains tax is that at the end of the trust, the remaining amount goes to the charity.[209] Many times the remaining amount is in

---

[203] 2016 Tax Tables for Form 1040, INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/i1040tt.pdf (last visited Oct. 17, 2016). Applying the 28% capital gains tax to the purchase the hypothetical purchase of $4,000,000, you are let with $1,584,000 in taxes owed.

[204] Hill et al., *supra* note 69.

[205] *Id.*

[206] Bowley and Cohen, *supra* note 150.

[207] *See generally, Art Auction Results, supra* note 1.

[208] *Internal Revenue Bulletin 2016-34*, *supra* note 71.

[209] *Id.*

the form of money rather than in artwork, but this financial support will allow the museum or foundation to increase their overall endowment.

XVI. THE HISTORY OF IRS INCENTIVES FOR ART COLLECTORS

A. Fractional Giving

Before the Pension Protection Act of 2006 (PPA), art collectors were able to take advantage of fractional giving to art museums in order to receive yearly tax deductions.[210] Fractional giving would allow for a collector to donate a piece of their collection to a museum for a temporary amount of time. The collector would then be able to deduct 25% of the fair market value of the work from their yearly income tax. For example, if a collector donated one of their works of art worth $1,000,000 to a museum for a period of three months, they would be able to deduct $250,000 from their income tax that year.[211]

An important detail of fractional giving is that when the collector donates the work of art to the museum to receive the tax deduction, he or she allows the museum the right to possess the work for three months.[212] Technically, the museum does not have to take actual possession of the work for the collector to receive the tax deduction.[213] As the value of the artwork goes up, so does the amount of time that the museum has the right of possession for that specific artwork.[214] It is only when the donated work has a fair market value of over $5,000,000 that the museum gets possession rights for an entire year and must physically take possession of the artwork in order for the collector to be able to receive the tax deduction for proper fractional giving.[215] Like other art incentives, the purpose

---

[210] Rodgers, *supra* note 132.

[211] *Id.*

[212] *Id.*

[213] *Id.*

[214] *Id.* (illustrating on chart that for $1,000,000 the museum has possession rights for three months; $2,000,000 gets the museum six months; $4,000,000 earns the museum nine months; over $5,000,000 provides the museum with ownership rights for one whole year.).

[215] *Id.*

behind the act is to encourage collectors to lend their vast collections to museums so the public can see them.

B. Pension Protection Act of 2006

In 2006, former President George W. Bush signed the PPA, and the mechanics of fractional giving changed forever. The new law changed the "balance" between the fair market value of the artwork, the allowed tax deduction, and the amount of time that the museum was required to take physical possession of the artwork. The original fractional giving plan allowed tax deductions ranging from $250,000 to $1,250,000 depending on the fair market value of the artwork[216]. However, after the PPA[217] became law, no matter the fair market value of the artwork, the collector would only be able to deduct $250,000 on his or her yearly income tax of the donation year.[218] Furthermore, the previous version of fractional giving made the museum taking physical possession of the artwork an optional condition unless the artwork was worth more than $5,000,000.[219] The updated version of fractional giving made the museum taking physical possession of the artwork for a designated period of time a requirement instead of an optional condition.[220] Without the museum taking actual possession of the artwork, the collector would not be able to write off the tax deduction.[221]

Another important difference between the old and new version of fractional giving is illustrated by the ten-year requirement rule.[222] Previously, when a collector donated a work for a tax deduction, the museum could choose when it wanted to take possession of the work[223]. It did not necessarily have to be within the same year that the collector wrote off the deduction on his or her taxes.[224] This rule

---

216 *Id.*
217 Pension Protection Act of 2006, H. R. 4, 109th Cong. (2006).
218 *Id.*
219 Rodgers, *supra* note 132.
220 *Id.*
221 *Id.*
222 *Id.*
223 *Id.*
224 Rodgers, *supra* note 132.

added to the fractional incentive because an older collector could participate in fractional giving and then the museum could choose to take possession of the artwork after the collector had passed, which allowed for the collector to receive a tax deduction and maintain control of his or her artwork until the end of their life.[225]

In contrast, the new fractional gifting rules set forth a ten-year time limit in which the museum must take possession of the artwork for the designated amount of time.[226] This makes fractional gifting less appealing to young collectors who want to receive a tax write off, but who do not want to actually lose possession of their own artwork during their lifetime.[227] If the younger group of collectors becomes disinterested in the art market, a variety of problems can arise. A potential issue that could appear is the creation of a gap between older and younger collectors. If younger buyers back out of the art collecting game, this could lead to a disparity in the ownership of the majority of the artworks in the world. If the same age group continues to hold ownership of the masterworks of the art world, a large disparity regarding where the works end up could happen. It is possible that all of these collectors might pass away around the same time, and the majority of the artworks they own will collectively have to find a new home. Depending on their will, their artwork will either continue to stay in their family line and be inherited by their beneficiaries, or the work will be donated to museums or private foundations that the collector had an interest in.

If the domino effect from this scenario continues, there are two possible outcomes. The first is that the whole issue will repeat itself. There is a possibility that the beneficiaries of these collectors will also be similar in age and will all pass on within similar time frames, thus repeating the process all over again. The second possibility leads to a continued scattering of the ownership of art to different museums and foundations. This scenario is not necessarily a bad thing. However, if all the art in the world is only owned by museums, this could create a stigma that art is not meant for the masses, but for pristine museums and the upper-class citizens who have the time to go to said museums and learn about the arts. The reality of this issue

[225] *Id.*
[226] *Id.*
[227] *Id.*

actually occurring does not seem completely out of the question as this particular stigma was an issue after the initial development of museums, and is a stigma that most current museums fight against.

Another potential issue that could arise if young collectors back out of the art market is the lack of promotion of the contemporary arts. If one considers the artworks that are thought of when flipping through an art textbook, it is easy to see that certain master artists and their works (such as Leonardo, Rubens, Raphael, and so forth) will always be appreciated for their work. However, what about the artists that are currently making art? With the popular stereotypes of today, it is not hard to see that appreciating and understanding contemporary art is not for everyone. The contemporary arts tend to be for the younger collectors who have more open-minded. Consequently, if these collectors walk away from the market, a huge hole could be created in the development and continuance of the arts. There is also the potential for this type of problem to affect other economic industries as well.

Unlike the old masters, artists today have embraced our rapidly developing culture and are not as strictly confined to using only paint and canvas to create art.[228] Many contemporary artists have incorporated the tech industry and often collaborate with other artist and designers to create their work.[229] Therefore, if the contemporary art industry declines, other industries may be affected too. It is for the following reasons that a steady promotion of the arts is so important, and why it is crucial for tax law to continue to develop new incentives and options, like the one created last August, to provide options for collectors to buy and promote the arts. However, as stated before, these incentives will only work if used properly. It is important that the new law can actually help those who have an earnest interest in investing and promoting the arts as a whole, rather than simply creating some loophole that lets buyers get out of paying

---

[228] One example of many can be seen in the artworks of Kara Walker, who has made an entire sculpture out of sugar. *See* Roberta Smith, *Sugar? Sure, but Salted With Meaning: A Subtlety, or the Marvelous Sugar Baby' at the Domino Plant* New York Times (May 11, 2014), https://www.nytimes.com/2014/05/12/arts/design/a-subtlety-or-the-marvelous-sugar-baby-at-the-domino-plant.html.

[229] Examples can be seen in performance artists whose sole documentation of their work relies on photographers or videographers, or land artists who employ construction workers and contractors to accomplish their works.

taxes that should be going to help the state and federal governments. The development of the CRAT is especially helpful for the issues discussed above because the probability of exhaustion test arguably benefits younger collectors the most as it opens the use of the CRAT to collectors with smaller starting funds. As explained at the beginning of this paper, before the probability of exhaustion test was revised, CRATs were only really available for collectors who were seventy-four years or older since the funds in the CRAT needs to last until the end of the collector's life. However, with the new changes to the test, younger collectors can use the CRAT because a yearly analysis will be done to see if the funds in the CRAT will make it through another year. If it cannot, the CRAT will be terminated and the collector will be able to retain all the tax benefits that they received during the years the CRAT was in use. Therefore, the new CRAT rule helps to combat the financial troubles that some younger collectors face, and in turn helps keep variety in the age of the collectors in the art market.

XVII. CONCLUSION

JonelleAs discussed above, there are many ways for art collectors to use the tax system to their advantage in the process of collecting art. The new change to the CRAT system and allowing for an alternative to the Probability of Exhaustion Test is definitely a step in the right direction as it allows for a more inclusive group of collectors to be able to use the CRAT system in their collecting practices. However, there is always room for improvement; the IRS should consider addressing the amount of assets that would be necessary to create a CRAT that would be able to sustain itself long enough to make a difference to the collector. Ultimately though, when considered with the other forms of tax incentives that the IRS has provided to art collectors, no matter the situation or goal of the collector, he or she should be able to benefit from one or more of the IRS incentives out there. It is important that the IRS continues to create and develop these incentives as their overall use benefits not only collectors, but charities and art institutions as a whole.