FEATURE:
ART, AUCTIONS & ANTIQUES

By **Darren M. Wallace** & **Alexis Gettier**

Using Family Entities for Planning With Artwork

An LLC can provide many benefits

Collecting artwork is a personal experience. Families of means invest significant time and resources developing their art collections and enjoy their artwork in their daily lives. They hang prized pieces above their mantles, share intimate details about the works with friends and even plan the décor in their homes around the colors of a specific work. Like other investors, art collectors typically intend to pass the enjoyment of their unique collections on to the next generation in a sensible—and equitable—manner. However, works of art stir emotions, making equal distribution more complicated than, say, a portfolio of securities. Artwork also has some unique attributes—and some very distinct Internal Revenue Code treatment—that require specific consideration. Given the personal and emotional investment in artwork, estate planning with art can be a highly sensitive area. Unlike other tangible personal property, difficulty in valuing artwork and the elusive element of emotional worth ascribed to it make it impractical to leave the decision regarding distribution to a collector's heirs. As practitioners, it's incumbent on us to advise and plan in accordance with our clients' goals, of which tax efficiency may be only one.

If a collector is willing to part with at least a fractional interest (and fractional enjoyment) in certain works of art during her lifetime, a family entity, such as a limited liability company (LLC), to which the collector contributes her collection in exchange for a membership interest, may be an appropriate planning option. A family LLC provides benefits for the management of artwork during life, creates an asset with which to make equal lifetime gifts of artwork and provides solutions to some difficult situations that can arise after death.[1]

Darren M. Wallace is a partner in the Individual Clients Department and **Alexis Gettier** is counsel, both at Day Pitney LLP, in the Stamford, Conn. office

The Problem With Emotions

Often, people direct in their wills that their "tangible personal property" be divided equally among their children, and they may direct that the children must agree on the distribution (or that the distribution be based on a lottery or on drawing lots). The allocation of items can often be settled through horse trading and deal-making. In some states, a collector may leave a binding memorandum directing the distribution of personal property, which can be useful in allocating these items. But, whether the collector or his descendants determine the ultimate distribution of these personal effects, feelings are difficult to protect. Siblings all remember the same painting hanging above the mantle; they all know which was mom's favorite. The one who ends up with the favorite painting—whether it has the most financial or sentimental value—may be deemed by her siblings to have been favored by their parents.

Perhaps the most difficult situation to deal with in administering estates is the feuding family. And, it often seems that no disputes are so heated as those budding from disagreements over the distribution of physical things. This problem is magnified when those items are significant in terms of monetary value and explodes when sentiment is added to the mix.

The Problem With Valuation

For a variety of reasons, it's nearly impossible to equalize children from a valuation perspective when it comes to an art collection, either as gifts during lifetime or as specific bequests at death. While a collection may be comprised of a sufficient number of works to equalize children from a pure quantity perspective, it's impossible to predict that each child will end up with an allocation of equal value.

Art is effectively illiquid. While there's technically a public market for collectible works of art at most times, that market is subject to periods of concentrated decline and periods of intense appreciation, both of which are impossible to predict. The death of an artist, for instance, or an unexpected price obtained at auction for a similar piece, can quickly increase the value of a work. Of course, it's also possible for certain genres to gain popularity—as modern art has in recent years—and for others to fall out of favor. One other factor, of which any collector is well aware, is that forgeries plague the art market. New information—having a positive or negative effect—may come to light about the provenance of a piece. Even works that have been authenticated may be later determined to be fakes, resulting in a complete loss of value for the owner.

> Annual appraisals of art can be cumbersome and costly, but for significant collections, it may make sense to conduct one appraisal every year.

So, while art can be traded at public auction, many factors contribute to the value of a work at any given moment, and it's unlikely that all of a collection's works will appreciate and depreciate in tandem. The fact that two paintings—selected expertly to control for genre, artist, period and quality—yesterday fetched identical prices is no guarantee that a sale tomorrow would have the same result.

Save for an actual sale of the piece itself, no person and no set of factors can predict with certainty the price that should be ascribed to a particular work. But, with art being the unique and personal asset that it is, collectors and their heirs are unlikely to view wholesale liquidation as the best way to equalize among family members.

The Problem With Sales

Sometimes, the instinct is to hold artwork until death and then direct that the executor of a collector's estate sell the works to dispense with the problems inherent in physically distributing the works. The emotional investment aside, this instinct can be an expensive and inefficient one, however, and may not be in the best interests of the beneficiaries or the estate.

A sale during life would incur capital gains at the unfavorable capital gains rate of 28 percent.[2] A sale of artwork at death would avoid most, if not all, of the capital gains taxes because the estate receives a stepped-up basis in the works for income tax purposes equal to their value on the date of death. During the course of a typical estate administration, sales of assets are often relied on to establish estate tax values—for homes, business interests and vehicles, among other things.

Unfortunately, unless a sale of art occurs nearly contemporaneously with death, it's risky to rely on the sales price in reporting the value for federal estate tax purposes. A sale that occurs a year after death, for example, may be perfectly reasonable from the perspective of a properly administered estate and the timeliness within the art market. Courts tend to prefer sales over any other method of valuation and, for sales of artwork, an auction has generally and consistently been determined to be the appropriate method of sale.[3] For sales of assets other than artwork, courts have confirmed that sales prices more than two years after death are still highly probative of the date-of-death value.[4] However, because this particular market can fluctuate wildly, a sale that isn't contemporaneous with death may not accurately reflect the date-of-death value, and the Internal Revenue Service could suggest that a particular piece's value was greater on the date of death than on the date of sale. Of course, the IRS is likely to take whichever position benefits its coffers. For example, the IRS has argued successfully that the date-of-death value of a work sold nearly a year after death (for a price substantially higher than that claimed on an estate tax return) should be the sales price.[5]

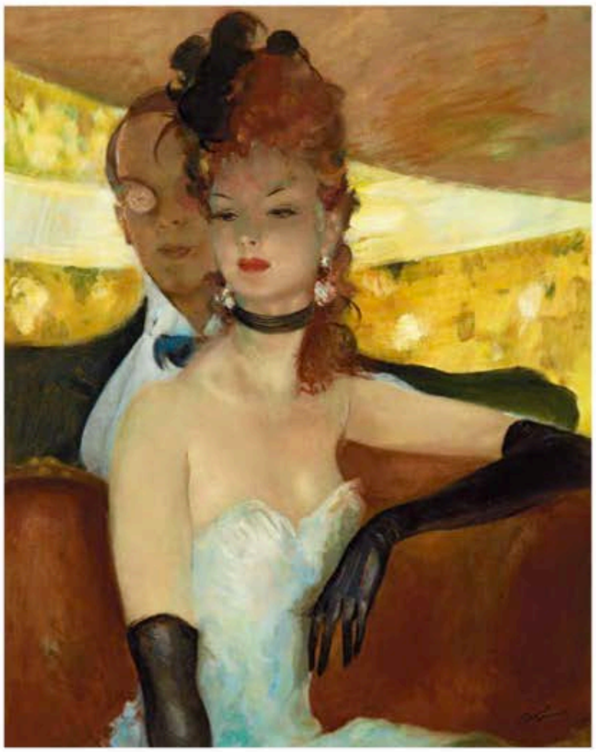
Another issue is that sales commissions and buyers' premiums may not be deductible for estate tax purposes. A buyer's premium is a commission paid by the purchaser directly to the auction house. A sales commission is the traditional commission paid by the seller directly to the auction house. Unless a sale of the work was necessary for the administration of the estate (for example, if the sale is directed in the collector's will or if liquidation is the only way to raise liquidity necessary to pay taxes), sales commissions and buyers' premiums are added to the sales price of the work to calculate the item's value for estate tax purposes.

The marketing of items from an estate can also signal a fire sale to buyers, artificially deflating the sales price of the works. Further, to the extent a collector has multiple works by the same artist, offering them for sale at the same time could flood the market, thereby deflating the value each would have fetched separately.

Why an LLC?

An LLC structure provides several benefits, including centralized management of art and a decision-making structure that can establish a method for resolving disputes. The LLC can address the problems of valuation and dispense with the necessity of selling works to equalize assets among children. It also permits multiple beneficiaries to enjoy the same works—albeit on an alternating basis. The manager of the LLC can provide necessary services, such as maintaining adequate insurance, storing and transporting the artwork safely and appropriately and making decisions regarding the equitable possession of works among members. A manager can also help with the decision to sell individual works. The LLC may even be a structure that can assist in deriving liquidity to pay estate taxes, either through lease arrangements or secured loans.

> Because art isn't a liquid asset that can contribute towards its share of estate taxes, an estate will require an external source of liquidity to pay the estate taxes attributable to the art collection.



SPOT LIGHT

Très Chic

"La Loge de l'Opera," by Jean-Gabriel Domergue, sold for $34,375 at Doyle's recent Impressionist & Modern Art auction in New York City on May 3, 2016. Domergue's career took a turn in the 1920s when he began to specialize in portraits. In addition to being an artist, he was a clothing and accessories designer for various French couturiers and one of the main organizers of famous Parisian gala events.

Shared Benefits

Although the works in a collection are unlikely to wax and wane in tandem, it's sometimes possible to ascertain a moment when one work is likely to fetch a high price relative to others given the temperature of the art market. Accordingly, if the sale of a particular work becomes attractive, a family LLC can sell it without unfairly benefiting or hurting one or more family members because all the members of the LLC would share equally in the proceeds. The family entity, therefore, allows the entire family to benefit from opportunistic sales opportunities without generating a windfall for a select few. At the same time, were a work to be devalued (perhaps due to catastrophe or to the work being determined to be a fake), the members of the entity would share the loss equally.

Lifetime Gifts and Enjoyment

Once the entity is created and funded with works, the family matriarch may make gifts of her membership interest to use annual exclusions and lifetime exemptions, if desired. Annual appraisals of art can be cumbersome and costly, but for significant collections, it may make sense to conduct one appraisal every year. However, an appraisal for the entity as of Dec. 31 of one year is likely to suffice for the making of additional gifts in January of the following year, which can reduce the appraisal costs somewhat.

> A family LLC can help to avoid emotionally charged family disputes and insulates individual family members from disproportionately positive or negative exposure to a waxing and waning art market.

Generally speaking, lifetime gifts are less expensive from a transfer tax perspective than gifts at death, but lifetime gifts do have some practical drawbacks. While a collector still owns a work of art, she may enjoy it as she pleases. Once ownership is exchanged for a membership interest in an entity of which the collector isn't the only member, it's the manager who decides which works may be displayed in the members' homes and for what periods of time. So, while the collector doesn't have to part entirely with the work, she won't be able to continue her enjoyment in the same manner in perpetuity because the manager should permit possession and enjoyment of one work commensurate with an individual's membership interest.

Of course, creating a family LLC needs to be done with care[6] to avoid triggering IRC Section 2036 at the death of senior family members, which operates to include in a decedent's estate assets that she transferred legal title to during life but over which she retained "possession or enjoyment," the right to income from the property or the right to designate individuals who could possess or receive income from the property. To the extent the collector desires to retain possession of a particular work, she could pay rent to the entity, distributable to the members in proportion to their shares, for the fair market value use of the work. While establishing the fair market rent is the key to this structure, the reputable auction houses are beginning to provide rental appraisals for artwork due to the demand for these arrangements.

Liquidity at Death

Because art isn't a liquid asset that can contribute towards its share of estate taxes, an estate will require an external source of liquidity to pay the estate taxes attributable to the art collection. An LLC can assist with this by centralizing the ownership of an entire collection and renting works either to members or to third parties. In fact, in the high-end real estate market, it's becoming increasingly common for brokers to use valuable rented works to stage properties for sale.

In addition, large lending institutions are now providing secured loans against valuable artwork. While a lender may require possession of a work for the duration of the secured loan, a loan against a piece intended to be retained for the long term until liquidity can be raised through the sale of a different work may provide some flexibility to pay necessary estate taxes. As noted above, while a sale after death may be appropriate and necessary, waiting for a ripe market may not provide necessary liquidity within the very short 9-month window in which to pay the government, thereby making a loan an attractive option.

Fractional Discounts

While family entities can often avail themselves of fractional discounts for estate tax purposes, attributable to marketability restrictions and lack of control, entities owning artwork are less likely to be successful advancing this position. Unlike an operating business or real estate that can be enjoyed simultaneously, multiple members can't enjoy artwork at the same time, save for living together in the same home. Even practically speaking, it's difficult for members to enjoy specific works of art directly in relation to their ownership of the overlying entity. The IRS seems to be holding fast to the tenet that there's no actual market for fractional interests in art and appears unwilling to condone a discount for the value of a fractional interest in the entity vis-à-vis the value of the underlying works.[7]

Although one recent case out of the U.S. Court of Appeals for the Fifth Circuit —*Elkins v. Commissioner*[8]— suggests that discounts may be available for this type of planning, the case was one in which the taxpayer invested heavily and was willing to take the case to court, where the IRS has the burden of disproving credible evidence proffered by the taxpayer as to the percentage of any available discount.[9] At least in *Elkins*, the court refused to accept the IRS' position that no discounts should be available, but the IRS hasn't acquiesced on the issue. So, while discounts may be available for this type of planning, it shouldn't be the driver of establishing a family LLC.

Even assuming a discount is permissible, because the underlying assets are themselves so difficult to value, valuing a fractional interest in the entity is even more complex. The collector should be wary that IRS scrutiny may result in a higher gift tax burden than originally anticipated if the artwork values are finally determined to be higher than reported or the discount taken is finally determined to be lower than reported.

It's worth noting that fractional discounts, as they relate to artwork, may not be entirely taxpayer friendly because many collectors donate fractional interests in artwork to museums during their lifetimes (something we'll explore in the second part of this article appearing in the August 2016 issue of *T&E*). A consistently applied policy that permitted discounts on artwork would have to cut the other way, reducing income tax incentives for charitable donations of fractional interests in art.

A family LLC structure provides a centralized management structure (both during life and after the donor's death) and is an attractive option for collectors desiring to make gifts of their collections during life. In addition, a family LLC can help to avoid emotionally charged family disputes and insulates individual family members from disproportionately positive or negative exposure to a waxing and waning art market. Families with substantial art collections should consider a family LLC to hold these valuable family assets.

Endnotes

1. This is Part 1 of a two-part series in planning with artwork and explores some of the many benefits and potential pitfalls of planning with family entities.
2. 26 U.S.C. Section 1(h)(4)(A).
3. *Estate of Scull v. Commissioner*, T.C. Memo. 1994-211; *Estate of Smith v. Comm'r*, 57 T.C. 650, 658 (1972), *aff'd* 510 F.2d 479 (2d Cir. 1975).
4. *Estate of Kaplin v. Comm'r*, 748 F.2d 1109, 1111 (6th Cir. 1984).
5. *Scull, supra* note 3.
6. 26 U.S.C. Sections 2036(a)(1) and (3); Steven M. Fast et al., "Context Matters: Rules for Reducing Taxable Value," 120 *Yale L.J. Online* 141 (2010), *www.yalelawjournal.org/forum/context-matters-rules-for-reducing-taxable-value*.
7. Paul Sullivan, "A Potential Game Changer for Estate Taxes on Art," *The New York Times* (Oct. 3, 2014).
8. *Elkins v. Comm'r*, 767 F.3d 443 (5th Cir. 2014).
9. 26 U.S.C. Section 7491.

SHARE this article — Click for more ESTATE PLANNING