WINOKUR, LOSE, OR DRAW: ART COLLECTORS LOSE AN IMPORTANT TAX BREAK

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"In Iowa, where I live, it's pretty simple. Giving is not keeping."[1]

"The current law works, it isn't broken, so why fix it?"[2]

I. INTRODUCTION

Buried deep within the Pension Protection Act of 2006, a minor change to the tax laws governing charitable donations is causing much hand-wringing in the art world.[3] Section 1218 of the Pension Protection Act makes several changes to the rules governing fractional donations of tangible personal property.[4]

A quirk in the old rules allowed donors of tangible personal property to donate the property piecemeal over many years and take a valuable charitable tax deduction even if the donee failed to take physical possession of the property.[5] This gifting technique became particularly popular among wealthy art collectors, who enjoyed the ability to take charitable tax deductions yet at the same time keep their artwork in their homes.[6] This method worked particularly well for donations of artwork because the donee art museums usually refused to take immediate possession of the artwork, citing the difficulty, cost, and danger inherent in transporting fragile works of art.[7] A collector could, for example, donate ten percent of a painting to an art museum, take a deduction for ten percent of the painting's fair market value, yet retain possession of the painting.

Citing the seeming unfairness of this method, Congress quietly slipped into the massive Pension Protection Act of 2006 revisions to the rules governing fractional donations of art that sought to end this perceived "loophole."[8] The new rules require a

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1. Steve Inskeep, *Fractional Giving of Art Threatened by New Rules* (Nat'l Pub. Radio Dec. 22, 2006) (interview with Sen. Charles Grassley by David Schaper).

2. Diane Freda, *Museums Fear Pension Bill Would Discourage Gifts of Major Artworks*, PENSION PROTECTION ACT CENTER (BNA), Aug. 18, 2006, http://subscript.bna.com/pic2/ppa.nsf/id/BNAP-6SSLGZ?OpenDocument&PrintVersion=Yes (quoting Stephen Clark, deputy general counsel of the Museum of Modern Art in New York).

3. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, § 1218, 120 Stat. 780 (2006).

4. *Id.*

5. *See infra* Part II.B–C (discussing the rules under the tax laws allowing a charitable deduction despite the donee not physically taking the item).

6. Rachel E. Silverman, *Wealth Manager: Joint Custody for Your Monet; 'Fractional Giving' Hits the Art World, as Donors Share Works with Museums*, WALL ST. J., Jul. 6, 2005, at D1.

7. *Id.*

8. *See* Pension Protection Act of 2006 § 1218.

fractional donation of tangible personal property to be completed within the earlier of ten years of the time of the first donation or the donor's death.[9] Failure to comply results in recapture of all charitable deductions plus a ten percent penalty.[10] The new rules further require the donee to take physical possession.[11] Finally, the new rules freeze the value of the charitable deduction at the time of the first donation, rather than allowing the donor to deduct the fair market value of each donation.[12]

Estate planners need to be aware of this new rule. It has grave consequences for those clients who would like to donate artwork and other appreciating, tangible personal property. Quite simply, it is inadvisable under the new rules to suggest that one's clients begin a course of fractionally donating art as may have been advisable in the past.

This article first discusses the tax law governing charitable donations of tangible personal property.[13] It then discusses the famous case of *Winokur v. Commissioner*, 90 T.C. 733 (1988), which allowed donors to take a charitable deduction for donating artwork even if the donee museum refused to take immediate possession of the artwork.[14] Next, the article discusses how the so-called Winokur method of donating fractional shares of artwork became a popular planning technique for wealthy people and how members of Congress and the public began to grumble about this supposed loophole for the rich.[15]

The article then discusses the new rules enacted in the Pension Protection Act, which severely constrain this method of donation.[16] Finally, the article addresses the likely impact these new rules will have on fractional donations[17] and proposes some changes to the new rules which should help the conflicting sides come to a compromise.[18]

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9. *Id.* at § 1218(a)(3)(A).
10. *Id.*
11. *Id.*
12. *Id. at* § 1218(a)(2). The new rules also modify the rules governing appraisals of artwork, but that topic is outside the scope of this article. *See id.*
13. *See infra* Part II.A–B.
14. *See infra* Part II.C.
15. *See infra* Part II.D–E.
16. *See infra* Part III.
17. *See infra* Part IV.
18. *See infra* Part V.

II. BACKGROUND

A. *Deductions for Charitable Contributions in General*

Section 170 of the Internal Revenue Code graciously allows taxpayers to deduct charitable contributions from their adjusted gross income.[19] This deduction is subject to several "percentage limitations" that cap the total amount that a taxpayer can deduct for charitable donations.[20] Overall, the charitable deduction cannot exceed fifty percent of a taxpayer's "contribution base,"[21] which is defined as the taxpayer's adjusted gross income minus any net operating loss carryback for the year.[22] When an individual donates an item of appreciated tangible personal property, the Code caps the deduction at thirty percent of her charitable base.[23] If the taxpayer makes a donation in excess of the thirty percent limit, the excess may be carried-forward to "each of the succeeding five years."[24]

In general, commentators view tax deductions as a federal subsidy.[25] As marginal tax rates increase, donations to charitable organizations likewise increase.[26]

Economists have found that the "dollar-efficiency" of the charitable deduction is high, meaning that the loss of federal tax funds for allowing a deduction is offset and usually exceeded by the gain to the charitable organization.[27] This logic suggests that for a wealthy taxpayer, money is better spent in a donation to a

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19. I.R.C. § 170(a)(1) (2000).
20. *Id.*
21. *Id.* § 170(b)(1)(A).
22. Treas. Reg. § 1.170A-8(e) (2007).
23. I.R.C. § 170(b)(1)(B).
24. *Id.*
25. *See, e.g.*, JAMES J. FREELAND, STEPHEN A. LIND & RICHARD B. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION 471 (9th ed. 1996) (citing Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970)).
26. Higher marginal tax rates may encourage donations because a donor taxpayer could get larger deductions for the same donation amount. *See* Richard L. Schmalbeck, *The Impact of Tax-Exempt Status: The Supply-Side Subsidies*, 69 AUT LAW & CONTEMP. PROBS. 121, 132 (2006) (explaining that a donor may deduct from gross income the amount equal to the value of the donation times the taxpayer's marginal tax rate). *But see* Wendell Bird, *Effect of Estate Tax 'Repeal': The Shape of Charitable Gift Planning After 'Repeal' of the Federal Estate Tax*, 14 TAX'N OF EXEMPTS 114, 121 (2002) (discussing a study which concluded that as marginal tax rates decrease, an increase in donations would most likely occur).
27. *See* WILLIAM A. KLEIN, JOSEPH BANKMAN & DANIEL N. SHAVIRO, FEDERAL INCOME TAXATION 368 (14th ed. 2006) (compiling studies tending to show that the value of a dollar donated to a charity is higher than the value of a dollar paid in taxes).

charitable organization than in taxes paid to the federal government.

As briefly illustrated above, it benefits wealthy taxpayers to make charitable donations because it lowers their adjusted gross income, the donations can be carried forward, and arguably their money is better spent by charities than by the government. For these reasons, many wealthy taxpayers seek different methods of making charitable donations, and one of the more popular methods is donating valuable artwork.

B. *Deductions for Charitable Contributions of Artwork*

As with donations of cash, the Code also allows taxpayers to donate personal property to a charitable organization and take a deduction.[28] The deduction, however, is subject to a few special rules governing contribution of personal property.[29] First, the "related-use rule" says that if a charitable organization does not use the property for a use related to its charitable exemption, the donor's deduction is limited to his basis in the property.[30] If, by contrast, the charitable organization uses the property for a related use, the donor can take a deduction based on the fair market value of the property.[31] In the case of highly appreciated property, such as a painting, the donor would like to take a deduction based on the fair market value rather than his basis in the property for two reasons: first, he gets a higher deduction; and second, he can avoid payment of capital gains upon his disposition of the appreciated painting.[32]

The second special rule is that a donor cannot take a charitable deduction if he transfers less than his entire interest in the property.[33] One rationale for this rule is that it prevents donors from claiming a larger charitable deduction than they are allowed based on the value of the interest donated.[34]

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28. I.R.C. § 170(a)(3), (e)(1).

29. *Id.*

30. *Id.* § 170(e)(1)(B)(i).

31. *Id.*

32. Some recent examples of the appreciation of certain paintings show how much a donor would save by not having to declare capital gains on a painting. *See, e.g.*, Carol Vogel, *Big Prices, Big Risks At Fall Art Auctions*, N.Y. TIMES, Nov. 2, 2006, at E1 (noting that composer Andrew Lloyd Webber purchased a Picasso painting in 1995 for $29.1 million which he was expecting to sell at auction for $40 to $60 million and that art dealer William Acquavella purchased a Cezanne in 2000 for $18.1 million which he expected to sell for $28 to $35 million).

33. I.R.C. § 170(f)(3)(A) (2006). This rule is often called the "partial interest rule."

34. BRUCE R. HOPKINS, THE TAX LAW OF CHARITABLE GIVING 342 (3d ed. 2005).

The following example illustrates the rule: if a movie buff donates prints of historical films to a charity, but retains the right to make reproductions of the films and sell the reproductions, the movie buff has donated less than her entire interest in the films. Therefore, she may not take a deduction.[35] Contributions that constitute an "undivided portion of the donor's entire interest in property," however, do qualify as charitable contribution deductions.[36] For example, if a donor contributes to a charitable organization an undivided one-half interest in one hundred acres of land that he will share with the charitable organization as tenants in common, the partial interest in property would be deductible as a charitable contribution.[37]

With this framework in place, wealthy art collectors (or their attorneys) quickly realized that they could donate partial interests in their highly appreciated artwork to tax-exempt museums and take a valuable deduction based on the fair market value rather than their basis in the artwork. James L. Winokur was one such donor.

C. Winokur v. Commissioner *(1988)*

In *Winokur v. Commissioner*, the Tax Court had to determine whether an art collector was entitled to a charitable deduction when he donated a ten percent interest in 44 works of art to a museum, where the museum did not take possession within a year following the date of donation.[38] The facts of *Winokur* are as follows:

In December 1977, James L. Winokur[39] donated to Pittsburgh's Carnegie Institute a ten percent interest in 44 works of art.[40] The deed of gift provided that the Carnegie Institute had the right to possess the artwork for ten percent of the year.[41] During the twelve months after the donation, however, the Carnegie Institute never took possession of any of the artwork.[42]

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35. This example was taken from THOMAS J. RAY, JR., CHARITABLE GIFT PLANNING: A PRACTICAL GUIDE FOR THE ESTATE PLANNER 15 (Phyllis M. Rubinstein ed., Am. Bar Assoc. 2006) (citing Treas. Reg. § 1.170A-7(b)(1)(i)).

36. I.R.C. § 170(f)(3)(B)(ii) (2000); *see also* Treas. Reg. § 1.170A-7(b)(1).

37. Treas. Reg. § 1.170A-7(d) Ex. 2.

38. 90 T.C. 733 (1988), *acq.*, 1989-2 C.B. 1.

39. *Id.* at 734 (Actually, the case involved James's ex-wife Sara, but for simplicity's sake, the court discussed the case as though James made the donation himself.).

40. *Id.* (The works of art were all a part of the COBRA school, which was a European artistic movement founded in 1948 by the painter Asger Jorn and the poet Christian Dotremont.).

41. *Id.* (The language of the deed of gift stated, "The Donee shall have sole discretion to decide the days during which it shall have possession of the Collection.").

42. *Id.* at 735.

The next year, in December 1978, Winokur made another ten-percent donation of the same 44 works of art, and once again the Carnegie Institute never took possession for any portion of the subsequent twelve months.[43]

In each tax year, Winokur took a charitable deduction for the fractional interest that he donated.[44] The IRS took the position that the donations did not qualify for the charitable deduction because the Carnegie Institute never took physical possession.[45] According to the IRS, because the Carnegie Institute never took possession, the fractional interest in the works of art was a future interest, and was therefore not deductible.[46] Winokur, by contrast, argued that he should be allowed a deduction because the Carnegie Institute had the right to possess the works of art, but it chose not to exercise that right.[47]

The Tax Court held that Winokur could take the deduction.[48] The court reasoned that it was the *right* to possess, and not the actual possession, that should govern the analysis.[49] The court found no language in the statute or regulations that required the donee to take physical possession of the donated property for the taxpayer to be allowed the deduction.[50] Winokur gave the Carnegie Institute the unequivocal right to possess the works of art, but the Institute voluntarily chose not to take physical possession.[51]

Soon after the *Winokur* case, the IRS recommended acquiescence[52] and then acquiesced in the decision.[53] Following

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43. 90 T.C. 733, 735 (1988), *acq.*, 1989-2 C.B. 1.

44. *Id.* at 735-36.

45. *Id.* at 739.

46. *Id.* at 739. Under Code § 170(a)(3), a taxpayer cannot take a charitable deduction for a donation of a *future interest* in tangible personal property. I.R.C. § 170(a)(3). Treasury Regulation 1.170A-5(a)(4) defines *future interest* as an interest where the donor and the donee have an agreement that the donor will retain some interest in the property. Treas. Reg. § 1.170A-5(a)(4) (as amended in 1994).

47. *Winokur*, 90 T.C. at 739.

48. *Id.* at 740.

49. *Id.* at 739 ("The relevant statutory and regulatory language suggest, among other things, that it is *the right or entitlement to possession, not actual physical possession,* that controls whether a purported present interest will be regarded as a future interest.") (emphasis added).

50. *Id.* at 739-40.

51. The court found no evidence of any side agreements between Winokur and the Carnegie Institute. *Id.* at 740 n.4. Had there been such an under-the-table agreement, the deduction would have been disallowed under the future interest rule. *See* I.R.C. § 170(a)(3); Treas. Reg. § 1.170A-5(a)(4).

52. *See Winokur, action on dec.*, 1989-08 (June 19, 1989).

53. *Winokur, acq.*, 1989-2 C.B. 1.

the IRS's apparent approval of this giving technique, wealthy donors and their sophisticated estate planners began using fractional donations of artwork as a planning tool.

D. *The* Winokur *Technique Becomes a Popular Planning Tool*

Realizing that the *Winokur* method of fractional donation of artwork could be a powerful planning tool, some estate planners began recommending this technique to wealthy clients.[54] The method had many benefits. It allowed art collectors to retain possession of the artwork on a part-time basis.[55] It gave an immediate charitable deduction.[56] It allowed the fair market value of the artwork to be deducted as opposed to the taxpayer's cost basis.[57] It allowed the donor to custom tailor his donations along with fluctuations in his income.[58]

For instance, assume a wealthy art collector owned a $10 million painting, and earned $1 million in Year 1 and $5 million in Year 2. He could donate a larger portion of the painting in Year 2 to an art museum to offset his higher income. Alternatively, if the wealthy art collector had a lower-than-expected income of $500,000 in Year 3, he could elect not to donate any portion of the painting at all or only a smaller portion. All the while, it is likely the museum never took possession of the painting because of the high costs of shipping the painting and insuring it. Therefore, during these years, the art collector was getting the best of both worlds—a valuable income tax deduction and the painting remained in his home. It is no wonder this was a popular technique.

For several reasons, art museums enjoyed this donation technique as well.[59] First, as alluded to above, art museums did not want to bear the cost of transporting and insuring artwork

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54. *See, e.g.*, Ralph E. Lerner, *What to Do with Art and Other Valuable Stuff: Planning for Collectibles*, SJ016 ALI-ABA 43, 60–61 (2003).

55. This benefit was somewhat comically illustrated by Agnes Gund, a trustee of the Museum of Modern Art, in an article in the *New York Times*. "If you are collecting because you love the art, you want to be able to enjoy the work while you have it and not give it away very soon." Jeremy Kahn, *Museums Fear Tax Law Changes on Some Donations*, N.Y. TIMES, Sept. 13, 2006, at E1 (quoting Agnes Gund). This sense of entitlement to both the charitable deduction and retention of the artwork was a motivating force in passing the revised law.

56. *See, e.g.*, Lerner, *supra* note 54, at 60.

57. *Id.* at 50.

58. *Id.* at 61.

59. *See, e.g.*, Association of Art Museum Directors, *Position on Fractional Gifts*, Tax Update SL077 ALI-ABA 137, 161–62 (2006) (arguing against reforming the rules governing fractional giving).

unless they knew that they would be keeping the artwork permanently.[60] Other costs involved the installation or storage of the artwork while the museum retained possession of the work.[61] Second, art museums felt that it would be contrary to their mission of protecting valuable works of art by unnecessarily transporting them.[62] Any time a work of art needs to be moved, the danger of damaging or destroying the work increases.[63] Finally, museums felt that such a beneficial donation scheme encouraged art collectors to donate their artwork rather than sell them to another art collector or bequeath them to a descendant.[64] Donation, the argument goes, benefits all of society by placing the artwork within the public realm and keeping it out of private hands where only a limited few can enjoy it.[65]

As word spread of this giving technique, it became more and more popular in sophisticated estate and charitable-giving plans.[66] Even world-famous jeweler Harry Winston used this fractional giving technique when he donated the Hope Diamond to the Smithsonian Institute.[67] This popularity culminated in a widely read 2005 *Wall Street Journal* article which sounded the death knell for fractional giving of works of art.

E. *The Backlash Begins*

On July 6, 2005, the *Wall Street Journal* published an article entitled, "Wealth Manager: Joint Custody For Your Monet; 'Fractional Giving' Hits The Art World, as Donors Share Works With Museums."[68] The article summarized the technique of fractionally donating works of art, and it gave numerous examples of museums that were actively advocating fractional donations from their wealthy patrons.[69] The article cited several examples of wealthy donors who employed a fractional donation method including Donald G. Fisher, the founder of Gap, Inc.,

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60. *Id.*

61. *Id.* at 161.

62. *Id.*

63. *Id.*

64. *Id.* at 162.

65. *See* Jeremy Kahn, *Museums Fear Tax Law Changes on Some Donations*, N.Y. TIMES, Sept. 13, 2006, at E1.

66. *Id.*

67. Ashlea Ebeling, *Will Democrats Ride To Museums' Rescue*, FORBES.COM, Nov. 11, 2006, *available at* http://www.forbes.com/2006/11/21/beltway-museums-tax-biz-wash-cz_ae_1122beltway.html.

68. Rachel Emma Silverman, *Wealth Manager: Joint Custody For Your Monet; "Fractional Giving" Hits The Art World, as Donors Share Works*, WALL ST. J., July 6, 2005, at D1.

69. *Id.*

Peter Haas, the heir of Levi Strauss & Co., and David Rockefeller.[70]

The article listed all the benefits of this type of donation, highlighting the ability to avoid capital-gains taxes on highly appreciated artwork and the ability to keep the artwork in the donor's possession year round.[71] It further mentioned that many museums were actually advertising this method of donation in an effort to increase their collections.[72]

This system struck many as patently unfair and seemed to confirm peoples' worst suspicions regarding the tax system.[73] Namely, the wealthy were benefiting from a tax loophole that allowed them to take massive charitable deductions while concurrently retaining the artwork they supposedly donated.[74] The average taxpayer obviously does not have the ability to donate Jackson Pollock paintings or Cindy Sherman photographs to an art museum, much less take a deduction for such a donation while simultaneously keeping the art. Nor can the average taxpayer donate clothes or an old automobile, take a deduction, and still wear the clothes or drive the car.[75]

This seeming unfairness caused commentators to begin to question the equity of fractional donations. For instance, Pablo Eisenberg, a senior fellow with the Georgetown University Public Policy Institute, without citing any authority, claimed that fractional giving "has cost the federal government hundreds of millions, if not billions, of dollars in lost revenue."[76] He also asserted that not requiring museums to take immediate possession of the artwork "delay[s] for many years the public's access to works of art."[77] Finally, Eisenberg asserted, "[w]ealthy Americans should be ashamed of themselves for letting their greed trump the notion of charitable generosity."[78]

The argument that the public is robbed of its right to view the artwork that it has essentially paid for through the charitable tax deductions, is one that may be wielded by critics of

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70. *Id.*

71. *Id.*

72. *Id.*

73. *See, e.g.*, Pablo Eisenberg, *Congress Should End Special Tax Breaks for Art Gifts*, 19 CHRON. PHILANTHROPY 27, 27 (2006).

74. *Id.*

75. The careful reader might suggest that the taxpayer could still drive the car or wear the clothes if he could find a donee to take the items on a fractional basis, following the rules set forth under I.R.C. § 170(a) and *Winokur*. *See supra* notes 46 and 49. Clearly, this does not happen very often, if ever.

76. Eisenberg, *supra* note 73, at 27.

77. *Id.*

78. *Id.*

the fractional gift scheme.[79] As is apparent from the Eisenberg article, the scheme of fractionally donating artwork caused at least one critic to resort to name-calling and accusations of immoral tax dodging.[80] One person in particular who read the *Wall Street Journal* article which discussed "how fractional giving was becoming more popular as a tax tool" happened to be a United States Senator.[81] Before the article, news of the fractional-donation method was largely limited to specialized sources, such as estate-planning journals. After reading the article, Senator Charles Grassley, a Republican from Iowa, immediately began work to close this apparent loophole.[82]

III. DISCUSSION

On August 17, 2006, President George W. Bush signed into law the Pension Protection Act of 2006.[83] As the name of the law suggests, the majority of the law addresses federal pension law.[84] Indeed, President Bush's signing statement called the law "the most sweeping reform of America's pension laws in over 30 years."[85] Although this massive law was entitled the "Pension Protection Act," buried deep within the bill and passing without any opposition, was § 1218.[86] Section 1218 of the Pension Protection Act makes three important changes to the current law governing fractional giving. This section will discuss each change in turn.

The first change addresses ownership of property.[87] Under § 1218, a charitable deduction will not be allowed for a contribution of a fractional interest unless at the time of the donation the donor owns the property (1) outright or (2) jointly with the donee organization.[88] The new rule, however, authorizes the Secretary of the Treasury to create an exception in

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79. *See, e.g., id.*

80. *Id.*

81. *See* Stephanie Strom, *The Man Museums Love to Hate*, N.Y. TIMES, Dec. 10, 2006, at Arts, pg 1. Although Strom does not specifically mention the Silverman article, it is understood that it is the article Senator Grassley is referring to, as it is the only article published in 2005 which discusses fractional giving.

82. *See id.* (stating that Senator Grassley "ripped the article out," gave it to his staff, and immediately set out to do something about this system).

83. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006).

84. *See id.*

85. Remarks on Signing the Pension Protection Act of 2006, WEEKLY COMP. PRES. DOC. 1469–70 (Aug. 17, 2006) *available at* http://www.whitehouse.gov/news/releases/2006/08/20060817-1.html.

86. Pension Protection Act § 1218.

87. *See id.* § 1218(a).

88. *Id.*

cases where multiple owners of an item make a proportional contribution of the item.[89]

The best way to illustrate this change is by an example. Assume that Andy owns sixty percent of a painting, and Betty owns forty percent of the same painting. Under the new law, neither would be able to take a charitable deduction if they donated a fractional interest in the painting to a museum.[90] If, however, the Secretary of the Treasury adopts the exception, the donors could presumably take a deduction for a fractional donation so long as they make their donations in the same proportion as their interest in that painting (e.g., if Andy were to donate thirty percent of the painting and Betty were to donate twenty percent).[91]

The second change affects the valuation of fractional donations.[92] Under the new rule, if the taxpayer makes a subsequent donation of a fractional interest, the value of the deduction is limited to the lesser of (1) the value at the time of the first donation and (2) the fair market value at the time of the subsequent donation.[93] In essence, the values of any future fractional gifts are frozen at the time of the first gift unless the value of the item has decreased.[94]

Again, an example will help illuminate this new provision. Assume that Clyde owns a sculpture that he bought in 1980 for $600,000. He now wants to donate it fractionally to his local art museum. In April 2007, the sculpture is worth $1.4 million. If he donates ten percent this year, he can take a charitable deduction of $140,000, assuming he meets all the other requirements and the $140,000 does not exceed thirty percent of his contribution base.[95] In 2008, he wants to donate another ten percent of the sculpture. Now, however, the sculpture is valued at $1.8 million. Under the new tax law, his deduction would be

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89. *Id.*

90. Under the new law, "no income or gift tax charitable deduction is allowed for a contribution of a fractional interest in an item of tangible personal property unless immediately before such contribution all interests in the item are owned (1) by the donor or (2) by the donor and the donee organization." STAFF OF J. COMM. ON TAXATION, 109th Cong., TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006" 308 (JCX-38-06) (Comm. Print 2006), *available at* http://www.house.gov/jct/x-38-06.pdf.

91. *Id.*

92. *See id.* at 307.

93. *Id.* (noting that "[t]his portion of the provision applies for income, gift and estate tax purposes").

94. *See id.*

95. *Id.* (applying the calculation explained *supra* text accompanying note 93).

frozen as of the 2007 donation, and he could only deduct $140,000.[96]

It should be noted that this new law went into effect immediately upon its enactment.[97] Any contributions predating August 18, 2006, will not be counted as the "initial contribution" for valuation purposes.[98] Instead, the first contribution after August 17, 2006 will be counted as the initial contribution.[99] Therefore, if Clyde's first donation occurred in 2005, when the sculpture was worth $900,000, his "initial contribution" for valuation purposes would still be the first donation after August 17, 2006, which would freeze the sculpture's value at $1.4 million.

The third, and arguably most important, change is the new recapture provision.[100] Under this new provision, the IRS will recapture all the charitable deductions made, along with interest and a ten percent penalty, in two circumstances: (1) if the donor fails to donate the entire property within ten years from the first donation or the death of the donor; or (2) if the donee fails to take substantial physical possession or use the item in a related use during the prescribed period.[101]

In other words, to avoid the recapture penalty, the donating act must satisfy three requirements: (1) the donor must donate one hundred percent of the property within ten years or upon his death; (2) the donee must take substantial physical possession of the item; and (3) the donee must use the property for a purpose related to its charitable function within that ten-year timeframe.[102] The failure of any of these three requirements will

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96. *Id.*

97. "The provision is applicable for contributions, bequests, and gifts made after the date of enactment." *Id.* at 308. The Pension Protection Act of 2006 was enacted on August 17, 2006. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006).

98. "It is intended that a contribution occurring before the date of enactment not be treated as an initial fractional contribution for purposes of the provision." STAFF OF J. COMM. ON TAXATION, 109th Cong., TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006" 308 (JCX-38-06) (Aug. 3, 2006), *available at* http://www.house.gov/jct/x-38-06.pdf.

99.

> Instead, the first fractional contribution by a taxpayer after the date of enactment would be considered the initial fractional contribution under the provision, regardless of whether the taxpayer had made a contribution of a fractional interest in the same item of tangible personal property prior to the date of enactment.

Id.

100. *Id.* at 307.

101. *Id.*

102. *Id.*

trigger recapture, interest on the recapture, and a ten percent penalty.[103]

For example, assume Debbie owns an ancient Greek vase worth $350,000. Beginning in 2007, she wants to donate it fractionally in ten percent annual installments to her local natural history museum. If Debbie does not donate the entire vase before 2017, the recapture penalty will take effect.[104] Alternatively, if the natural history museum does not take physical possession of the vase, the recapture penalty will take effect.[105] Finally, if the natural history museum takes the vase, but does not use it for a purpose related to the museum's charitable function (e.g., by reselling it instead of displaying it for the public), the recapture provision will take back Debbie's charitable deductions plus interest and a ten percent penalty.[106]

Arguably, the new rule that requires the charitable organization to take possession at some point within the ten years reverses the *Winokur* case. Recall that under *Winokur* it was the *right* to possession and not *actual* possession that made the deduction allowable.[107] Under the new fractional-donation rules, the donee's *actual possession* is now an element for the donor to receive the deduction.[108]

Each of these changes has had an astounding impact on the rules governing fractional donation of tangible personal property. The next section analyzes the impact of these rule changes more closely.

IV. IMPACT

Immediately upon its passage, art world denizens were shocked and dismayed that, with such little fanfare, such a popular charitable-giving technique was suddenly turned upside-down. Art museums, in particular, dislike the new rules.[109]

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103. *See id.* at 307-08.

104. *Id.*

105. *Id.*

106. *Id.* at 307-08.

107. Winokur v. Comm'r., 90 T.C. 733, 739 (1988).

108. TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006" *supra* note 98, at 308.

109. *See, e.g.*, Letter from Sara Geelan, Associate General Counsel, Solomon R. Guggenheim Foundation, to William M. Thomas, Chairman and Charles B. Rangel, Ranking Member, House Committee on Ways and Means (Oct. 31, 2006), *available at* http://waysandmeans.house.gov/hearings.asp; Letter from Millicent Hall Gaudieri, Executive Director and Anita M. Difanis, Director of Government Affairs, Association of Art Museum Directors, to Charles E. Grassley, Chairman and Max Baucus, Ranking Member, Committee on Finance and William M. Thomas, Chairman and Charles B. Rangel, Ranking Member, House Committee on Ways and Means (Oct. 30, 2006),

This section addresses three main impacts arising from the new rules. First, the mismatch problem is a situation caused by the new valuation rules where a donor who has fully donated an artwork might still owe estate or gift tax. The second impact of the new rules is that because of the threat of the mismatch problem, fractional donations of artwork have completely ceased. Third, because of the effects on their efforts to attract donors, art museums have become the most vocal critics of the new rules.

A. *The Mismatch Problem*

The "mismatch problem" describes a scenario whereby a donor of an artwork might still owe estate or gift tax despite having fully donated the item. This peculiar outcome results from the Pension Protection Act's freezing of the value of the charitable deduction at the time of the first donation.

Under §§ 2031 and 2512 of the Code, estate and gift taxes are based on the fair market value of an item at the date of death or the date of the gift, respectively.[110] Under § 1218 of the Pension Protection Act, however, the value of a fractional donation of an artwork is frozen at the time of the first donation.[111] Thus, subsequent fractional donations of a sculpture that appreciates in value are limited to the value of the sculpture at the time of the first donation. The problem occurs when a donor dies before he has fully completed his donation scheme, and his will directs the donation to be completed. Because of the "mismatch" between the value of the artwork at the time of the first donation and its value upon his death, the donor will have excess "value" in his estate even though he no longer owns the art. This excess value will be includable in the donor's gross estate. As a result, the donor may have to pay taxes on it even though the item was fully donated to a charity.

Admittedly, the mismatch problem is somewhat confusing, and an illustration will help clarify. Suppose Edwin owns an oil painting currently worth $800,000. Then, if Edwin donates fifty

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available at http://waysandmeans.house.gov/hearings.asp; Letter from James Cuno, President, Eloise W. Martin, Director, and Julia E. Getzels, Executive Vice President, The Art Institute, to Charles E. Grassley, Chairman and Max Baucus, Ranking Member, Committee on Finance and William M. Thomas, Chairman and Charles B. Rangel, Ranking Member, House Committee on Ways and Means (Oct. 31, 2006), *available at* http://waysandmeans.house.gov/hearings.asp; Letter from Fred Goldstein, General Counsel, Los Angeles County Museum of Art, to House Committee on Ways and Means (Oct. 31, 2006), *available at* http://waysandmeans.house.gov/hearings.asp [hereinafter Letters].

110. *See* I.R.C. §§ 2031, 2512 (2000).

111. *See supra* Part III (describing this new valuation rule).

percent of the oil painting this year to an art museum (and assuming he meets all the other requirements), he can deduct $400,000 from his adjusted gross income. Now suppose Edwin provides in his will that he will donate the remaining fifty percent interest in the oil painting upon his death to the museum. Edwin dies eight years hence, when the oil painting is worth $1.5 million. Because of the new rules, Edwin will be limited to an estate-tax deduction of $400,000, which was the value at the time of the initial donation. But, Edwin will have an asset in his gross estate worth $750,000 (half of the $1.5 million fair market value), which makes his estate liable for the $350,000 excess remaining in the estate after the $400,000 deduction.

The unfairness in this situation is obvious. Edwin, despite charitably donating the entire oil painting, still owes estate tax on the painting. It seems at odds with the purpose of a charitable deduction to impose a tax upon donors of art, even after they have fully given up an item. Commentators recognized this problem early on, and most seem to concur that the result is unfair.[112] For instance, *Forbes* magazine considered the result and called it a "crazy situation—presumably unintended by Congress."[113] Whether intended by Congress or not, the impact of the new rule seems to be that would-be donors have completely stopped charitably donating their works of art.

B. *No More Fractional Donations Under the New Rules*

Owing to the mismatch problem, potential art donors have stopped making fractional donations.[114] It is easy to understand why. The risk of dying before completing the entire donation, and thus incurring an estate tax because of the mismatch problem, is too great to justify the charitable deduction.

Testimonies from the art museums support the conclusion that art collectors will not be donating artwork under the new regime.[115] For instance, in a letter to the House Committee on Ways and Means, the Art Institute of Chicago states, "Not surprisingly, perhaps, donors have already informed us that . . .

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112. *See, e.g.*, The Death of Fractional Gifts, posting of Donn Zaretsky to The Art Law Blog, http://theartlawblog.blogspot.com (Sept. 14, 2006, 12:44 A.M.) (stating that it would now be "insane" for anyone to donate artwork fractionally because of the mismatch problem).

113. Ebeling, *supra* note 67.

114. *See, e.g.*, Cuno, *supra* note 109; Gaurdieri, *supra* note 109.

115. *See* Letters, *supra* note 109.

they will no longer make partial interest gifts."[116] Likewise, the Association of Art Museum Directors declares, "Many have indicated to us that this potential mismatch, because it could result in an unintended estate or gift tax, will preclude fractional gift giving in the future because the risk is simply too great."[117] So it is clear from various examples of art museum testimony, and stories in the popular press, that estate planners have been advising their clients not to make fractional donations of artwork until the new rules have been remedied or repealed.[118]

Nevertheless, fractional donation is not the only way to donate artwork. An art collector could always just donate the artwork outright and take the charitable deduction. The problem with this approach is that if a donor with an especially valuable piece of artwork does not have enough income to offset the value of the donation, he is much less likely to make the donation at all. Moreover, the donor is limited to thirty percent of his contribution base in any case under the percentage limitation rules.[119] The five-year carry forward period tempers this result somewhat, but in the case of very expensive works of art this five-year carry forward is often insufficient.[120] For instance, consider an art collector with annual earnings of $500,000 who donates outright a $1 million painting. Under the percentage limitation rules, the art collector would be limited to a deduction of $150,000 (thirty percent of $500,000) each year. Even with the five-year carry forward, he could only deduct $750,000 ($150,000 multiplied by 5 years). He leaves a potential $250,000 of charitable deduction unused, not a result the art collector is likely willing to countenance.

Because of these undesirable options, commentators have suggested that the donations of artwork might dry up.[121] And even art collectors themselves have said that they will not continue donating art.[122] No critics have been as vociferous, however, as the art museums.

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116. *See* Cuno, *supra* note 109.

117. *See* Gaudieri, *supra* note 109.

118. *See* Letters, *supra* note 109.

119. I.R.C. § 170(b)(1)(B) (2000).

120. *Id.*

121. *See, e.g.*, Ebeling, *supra* note 67.

122. *See, e.g.*, *Fractional Giving of Art Threatened by New Rules*, (NPR radio broadcast Dec. 22, 2006) (interviewing art collector Sandy Vesser who says he will reconsider his fractional gifts under the new rules).

C. *Art Museums Decry the New Rules*

Art museums arguably have the most to lose from the new rules governing fractional donations.[123] Thus, art museums have tended to be the most vocal critics of the new rules.[124] Almost immediately upon enactment, the art museums began urging Congress to revise or repeal the new rules governing fractional donations.[125]

In general, the art museums sought several revisions. First, they sought elimination of the mismatch problem.[126] As one art museum representative said, "This discrepancy does not seem to promote any policy goal and produces a harsh result for individuals who are attempting to make charitable gifts."[127] Second, they sought to revise the new rules so that they do not apply to fractional gifts already in progress.[128] Under the new rules, subsequent donations of a work that has already begun to be fractionally donated to a museum would be subject to the new rules.[129] Because of the undesirable results of the new rules, in particular the mismatch problem, donors of these gifts-in-progress have suggested they will not complete the gifts.[130] Third, the museums want Congress to eliminate the ten-year time limit for donations before the recapture penalty arises.[131] The art museums argue that there is no good policy reason justifying this ten-year time limit.[132] The art museums generally suggest eliminating the ten-year time limit altogether or revising the rule so that the donors can commit to donating the entire artwork within their lifetime or upon death.[133]

With such strong feelings on both sides of the issues, the art museums on the one hand and tax critics on the other, it is important to come to a compromise. The next part proposes several fixes to the law that will help the opposing sides come to an agreement.

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123. *See* Letters, *supra* note 109.
124. *See id.*
125. *See id.*
126. *See* The Association of Art Museum Directors, *supra* note 109.
127. The Art Institute of Chicago, *supra* note 109.
128. *See, e.g.*, *id.*; the Solomon R. Guggenheim Foundation, *supra* note 109.
129. Pension Protection Act of 2006, Pub. L. No. 109-280, § 6034, 120 Stat. 780 (2006).
130. *See* Geelan, *supra* note 109.
131. *See* Letters, *supra* note 109.
132. The Association of Art Museum Directors, *supra* note 109.
133. *See id.*

V. PROPOSAL

In enacting the new rules governing fractional giving, Congress went too far in trying to close a supposed loophole. Admittedly, there is something unsavory about the thought of wealthy art collectors making "donations" of artwork yet keeping the artwork on their walls. As Senator Grassley put it, "It's unfair for a donor to get a big tax break for supposedly donating a painting that hangs in his living room."[134] Nevertheless, the new rules are too harsh on art collectors who want to donate art to museums. To determine how best to remedy the new rules governing fractional giving, this part begins by balancing the competing factors at play. This part will then suggest several reforms to the new rules that should alleviate concerns on both sides.

A. *Balance the Competing Factors*

Several opposing factors are at play in the debate of how to remedy the rules governing fractional donations. Deductions, as noted earlier, are often thought of as public subsidies.[135] Because they are public subsidies, and the public loses out on tax revenue by allowing deductions, the public should benefit in some way to justify a deduction. On the other hand, the interests of donors also need to be considered since the donors are the ones actually giving up something of value for no consideration, other than a possible deduction.

Critics of the old rules felt that the scales had been tipped too far in favor of donors.[136] The main complaint was that donors should not be able to take a charitable deduction while the artwork remained in the possession of the art collector.[137] Or as Senator Grassley put it, "Giving is not keeping."[138] Despite this oversimplified sound bite, several factors favor the old rules governing fractional donations.

First, the old rules encouraged art collectors to donate their artwork to museums.[139] Then, rather than hanging in someone's private home, the artwork would presumably be available to anyone in the public who visited the museum. Another upshot of

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134. Ebeling, *supra* note 67.

135. *See supra* notes 25, 27, and accompanying text (arguing that tax deductions can be thought of as a public subsidy).

136. *See* Eberling, *supra* note 67.

137. *See id.*

138. *Fractional Giving of Art Threatened*, *supra* note 122.

139. *See supra* Part II.B.

encouraging donations to museums is that museums have the resources and professional skills to care properly for valuable works of art. When held in a private collection, there is no guarantee that the private owner will necessarily know how to care for a valuable painting or sculpture.[140] Therefore, although the museums' physical possession was not necessarily immediate, at some point the museums would take possession of the artwork. At that point, the public benefited because it could then view the artwork and be assured that cultural treasures were being cared for properly.

The second factor in favor of the old rules is that they made it economically reasonable for donors to donate extremely valuable pieces of art. Because art donors could structure their donations by giving certain percentages each year so as to maximize their charitable deduction, the old rules fostered donations of extremely valuable works of art.[141] Under the new rules, as discussed previously, in many cases it will not be economically sensible to donate extremely valuable works of art because a donor will only have ten years to get the entire work to the donee.[142] If a donor has insufficient income to offset the entire donation within ten years, he is less likely to make the donation at all.[143]

By contrast, several factors favor the new rules governing fractional donations. First, the public should have the right to see the artwork that it essentially paid for by allowing a charitable deduction in the first place. As critics of the old rules have pointed out, there is something transparently unfair about allowing wealthy art collectors to take valuable charitable deductions while keeping artwork on their walls.[144] Although the art museums are free to demand the artwork for a specific period of time each year, even the art museums admit that they do not tend to do this except in extraordinary cases.[145]

The second factor in favor of the new rules is a simple sense of fairness—whether the wealthy really need more tax breaks

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140. For instance, Las Vegas casino magnate Steve Wynn famously punched a hole through a Picasso with his elbow in October 2006. Perhaps he was registering his disgust with the new rules governing fractional donations? Norm Clarke, *Wynn Accidentally Damages Picasso*, LAS VEGAS REV. J., Oct. 17, 2006, at 3A.

141. *See* Silverman, *supra* note 6.

142. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, § 1218(a)(3)(A), 120 Stat. 780 (2006).

143. This is because charitable deductions cannot exceed fifty percent of a taxpayer's adjusted gross income in any year. I.R.C. § 170(b)(1)(A)-(B) (2000).

144. Ebeling, *supra* note 67.

145. *See* Strom, *supra* note 81 (stating that the art museums, although given the right to possess, "rarely" exercise that right).

and loopholes—the kind of help that regular people cannot afford.[146] Therefore, among populist legislators, it is easy to decry fractional donations as "a subsidy for millionaires to buy art."[147]

The following proposals seek to balance these competing viewpoints. On the one hand, the proposals recognize that art donors should not be able to donate artwork that the museums do not take possession of for years. On the other hand, the proposals temper some of the more onerous results under the new rules so that donations to art museums do not dry up completely.

B. *Proposals*

1. End the Mismatch Problem

The most glaring problem with the new rules is the mismatch problem. The mismatch problem, therefore, needs to be eradicated. As discussed earlier, the mismatch problem arises from the new valuation rules for fractional giving which "freeze" the value of subsequent donations at the fair market value of the first donation.[148] This valuation freeze creates a harsh result when a taxpayer fractionally donates an appreciating work of art, but dies before the entire gift is completed.[149] The mismatch problem causes inclusion of the artwork's excess value in the taxpayer's gross estate despite the fact that the donor's estate no longer owns the work of art.[150]

The simplest way to eliminate the mismatch problem is by revising the new rules so that fair market value can be used for all subsequent donations, rather than freezing the value as of the first donation. This modification would ensure that, were a donor to die before he had completed his fractional donation of an artwork, the donor's estate would not be taxed on an item of property that his estate does not even own.

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146. *See id.* (discussing how fractional donations could be seen as a way for wealthy art collectors to win a big tax deduction while keeping the artwork in their possession). Although the debate about whether the wealthy really are able to avoid taxes by using loopholes is outside the scope of this article, in general, there is a sense that the wealthy are able to afford high-priced attorneys and accountants to help them minimize taxes.

147. *Id.* (quoting Senator Grassley).

148. *See supra* Part IV.A (describing the mismatch problem).

149. *See id.*

150. *See id.*

As noted previously, fractional donations have dried up completely because of the mismatch problem.[151] It is doubtful that Congress intended to eliminate fractional donations of art entirely.[152] Therefore, the harsh result of the mismatch problem serves no real purpose, has completely eradicated fractional donations of art, and should be ended.

2. Increase the Time Limit to Twenty Years and Require Physical Possession at the End

The next change that should be implemented extends the requirement that the donation be complete within ten years. The time should be extended to twenty years with a requirement that the museum take permanent physical possession at the end of the period. A twenty-year time limit would give donors sufficient time to plan their charitable donations, as they could under the old rules. Failure to complete the donation within twenty years would cause recapture of the deduction. An extension to twenty years would help balance the concerns of art donors and museums with critics of fractional donations.

The art museums, for instance, have recommended that the ten-year time limitation be completely abolished in favor of a system that would allow a donor to "promise" to donate the entire work of art upon the donor's death.[153] The problem with this approach is the logistical problem for the IRS in managing fractional donations. For instance, assume a forty-year-old art collector who makes a fractional donation and promises to donate the remaining interest in the artwork upon her death. With a lifespan of potentially another forty or even fifty years, the IRS (and the donor herself) would somehow have to keep track of this donation and ensure that it gets made upon the donor's death. Such a system is simply impractical.

Next, because of the chance that the donor may die before the twenty-year time limit expires, there should be an exception that allows the death of the taxpayer to avoid the recapture penalty. Most donors, however, probably have already directed by their estate plan how to dispose of the artwork. If not, allowing an exception would allow the representatives of the taxpayer's estate to decide what to do with the remaining

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151. *See supra* Part IV.B.

152. Members of Congress are mindful that fractional donations can encourage donation and provide for the public good. *See, e.g.*, Anne Tergesen, *These Gifts Don't Keep On Giving*, BUS.WK., Nov. 27, 2006, at 18 (statement of Senator Charles Schumer) ("[The new rules] will have a huge negative impact on donations. . . . We must find a better solution in the new Congress.").

153. *See* Association of Art Museum Directors, *supra* note 59, at 162.

interests in the artwork, without fear of triggering the recapture penalty.

A twenty-year time limit creates a compromise between the opposing sides. Art collectors and art museums are given a longer timeframe in which to plan and complete donations. The fears of shipping delicate artwork back and forth are eliminated because the transfer only needs to take place one time—at the end of the twenty-year period. By contrast, critics of the old rules would be appeased by the fact that within twenty years a museum will have to take physical possession. This eliminates the fear of the art collector who keeps the art on his wall for the rest of his life while taking piecemeal, valuable charitable deductions.

VI. CONCLUSION

Creating a fair solution to the problems inherent in fractional donations of artwork requires a balancing of opposing viewpoints. Because the public is subsidizing the donation by allowing a deduction, the rules need to ensure that the public is getting something in return. In this case, that "something in return" is the ability to view the artwork on display at a public art museum. But the interests of the art donor must also be considered, since she is ultimately the one deciding to forego her own self-interest by giving away a valuable asset.

The new rules governing the fractional donation of tangible personal property go too far in trying to serve the interests of the public. They have actually harmed the public because they have effectively ended fractional donations, which are an important part of museums' collections. The proposals suggested in this article—elimination of the mismatch problem and an increase in the time limit to complete the donation—serve the interests of the public and the donors fairly.

In the meantime, estate planners and advisors need to be aware of the new rules. As the rules stand now, it is inadvisable to recommend that an art collector proceed on a path of fractional giving unless the donor can afford to give away his entire interest in a work of art. This will remain the case unless Congress takes a more reasoned look at fractional giving and adopts the proposals made in this article.