The Art of Appraisals: Appraising for Tax Purposes

Summary

This course will help with the difficult process of assigning values, whether for income or estate tax purposes, for separation agreements or business mergers, or insurance and depreciation calculations. Topics will include valuation methodologies, contribution rules and restrictions, qualified appraisals, art appraisals, and tax avoidance schemes.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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I. Introduction – Value is in the Eye of the Beholder

In one of those e-mails that circulate on the internet and are passed indiscriminately from friend to friend, pictures were attached to illustrate a joke about home values: The first photo was of a modest three-bedroom tract home with lovely landscaping and was subtitled "Your house as seen by yourself." Successive photos showed a dilapidated shack reminiscent of those inhabited by migrant farm-workers during the Depression era (subtitled "…as seen by your lender"), a quaint log cabin of the sort Abe Lincoln called home (subtitled "…as seen by your buyer"), wind-blown remnants of a home destroyed by Hurricane Katrina (subtitled "…as seen by your appraiser"), and finally a mansion on the scale of Buckingham Palace (subtitled "…as seen by your tax assessor").

You

Your Lender

Your Buyer

Your Appraiser

Your Tax Assessor

Much like beauty that is in the eye of the beholder, so too are values. Where one individual sees majestic columns gracing an inviting portal; another sees two-by-fours holding up an awning above an inhospitable threshold. So what *is* it worth?

II. Valuation

A. Definition

"Value is more than a question of fact; it is a prophecy, a matter of opinion and judgment."[1] While value may simplistically be defined as the worth of an item, it cannot be measured uniformly. Indeed, even the IRS recognizes that "there is no single formula that always applies when determining the value of property."[2]

<u>Types of Value</u>
For example, value may represent the usefulness of an object or it may be determined by what can be obtained in exchange for the object. **Utilitarian Value** will, of course, vary depending upon the user. Where one individual might see a decorative vase "hidden" within an empty ketchup bottle, another less creative person might find no use whatsoever for the bottle and toss it in the trash—thus, the bottle may be worthless to one but valuable to another.

Indeed, an environmentalist might well find that the empty bottle is worth precisely 5 cents—the redemption value assigned to it by governmental regulatory authorities seeking to encourage individuals to recycle. Thus, in the "green market" frequented by conscientious conservationists, the **Exchange Value** of the ketchup bottle is established by law.

[1] Randolph Paul, General Counsel U.S. Treasury, as paraphrased by Lerner & Bresler, *Art Law: The Guide for Collectors, Dealers, and Artists*, 2nd ed., Vol. 2, 1135 (Practicing Law Institute, 1998).

[2] Department of the Treasury, Internal Revenue Service, *Publication 561: Determining the Value of Donated Property*, 2 (Rev. October 2005, Cat. No. 15109Q).

Market Value is generally accepted to be the price at which buyers would be willing to exchange money for an item and sellers would be willing to forgo the object. The agreed-upon exchange value should be the result of arm's length negotiations between parties, neither of whom would be compelled to transact but instead would choose to negotiate freely.[3]

It is this voluntary exchange between willing buyers and sellers that is most often used to establish the worth of an item, although the term "market value" is often substituted with such linguistically imprecise terms as salable value, actual value, fair value, reasonable value, or cash value, amongst others. From here on, we will refer to "value" or "fair market value" ("FMV").

MARKET VERSUS UTILITARIAN VALUE

Market Value:	amount considered to be the fair equivalent for something else
Utilitarian Value:	worth in usefulness or importance to the possessor

B. The Importance of Value

Whether determined with scientific precision or inexact estimation, value may be used to establish requisite insurance coverage and affordable premiums; to equitably divide assets in the event of marital or business dissolutions; to ascertain a baseline upon which to assess property, gift, and estate taxes; to compute depreciation and amortization allowances; or to claim charitable deductions on an income tax return. In all cases, some figure must be selected upon which to base all other computations.

Interestingly, even when valuing the same item, its FMV may differ depending upon the perspective of the evaluator and the purpose of the valuation. Where an individual may seek a high value for income tax purposes to claim more generous depreciation deductions, the same taxpayer may prefer a far lesser value to minimize any potential gift or estate tax liabilities.

Often value may simply be a matter of appeasing the curiosity of an owner or aspiring owner, as when neighbors inquire about the asking price of the home for sale across the street in an attempt to guess the value of their own home. Other times, value may be used to win a game of one-upmanship and to proclaim, "Mine is bigger than yours," or "I'm richer than you." After all, that's how the games of Monopoly and Life are won. Whatever the motivation, it becomes important to assign a value, to put a price tag on an item, and to know its worth.

PURPOSE AND USE OF APPRAISALS

- ⇩ Estate and gift taxation
- ⇧ Income taxation (charitable deduction)
- ⇩ Property taxation of personal or real property
- ⇧⇩ Sales of property
- ⇧⇩ Division of assets, including divorce, buy-outs, family limited partnerships
- ⇧ Insurance
- ⇧ Depreciation

[3] Rev Rul 59-60.

C. Methodology

Even under the Internal Revenue Code ("IRC" or "Code"), market value may be established by various methods. Valuation for gift tax purposes may be derived from "the price at which the item or a comparable item would be sold at retail,"[4] raising the question which items are in fact comparable and which market qualifies as retail.

1. Comparable Sales[5]

If the particular item at issue cannot itself be sold, it is often easiest to establish its likely value by determining the FMV of similar items. In that manner, values of used cars can be established by referencing prices of comparable vehicles listed in the Kelley Blue Book, and home values can be determined by looking to compilations of recent neighborhood sales available at www.zillow.com.

Sadly, the process of comparable valuations is not simple, as any homeowner will attest. Unless the home to be priced is identical in every aspect, neighborhood sales are but an indicator of actual value. In fact, consideration must be given to many factors, including similarity, timing, market conditions, and other circumstances of the sale. For example, if the transaction that is intended to serve as a basis for comparison occurred long ago or was the result of an accommodation between friends and relatives, the resulting price may not be indicative of current or true FMV.

Condition of the assets under scrutiny may also invalidate any legitimate comparisons. Kelley Blue Book, for example, attempts to account for these discrepancies by offering information about vehicles in excellent, good, fair, or poor condition. Kelley also differentiates between trade-in, private party, and retail pricing depending upon whether consumers are buying or selling their vehicles and whether the transactions will involve negotiations with dealers.

COMPARISONS & COMPARABLE VALUES REQUIRE…

- Similar items and condition
- Similar conditions and time-frame
- Distinguish between arm's length and related party transactions
- Retail or dealer market
- Purpose of valuation

[4] Treas. Reg. § 25.2512-1.

[5] IRS regulations suggest that if comparable values aren't available, the before and after method of valuation should be used but should not simply be "based on whatever use generates the largest profit [without] regard to whether such use is needed or likely to be needed in the reasonably foreseeable future." *Boltar v. Comm.*, 136 T.C. No. 14.

In the art world, comparisons are often difficult to make since uniqueness is precisely what lends value to an artistic creation—if the masterpieces were identical, little or no value would be attributed to them. But comparisons must nevertheless be made in an attempt to at least estimate the potential worth of a painting or sculpture. Where it may be impossible to compare similar works by different artists or different works by the same artist, valuations are often based upon a prior sale of the specific piece in question.

> A taxpayer sought to claim a charitable deduction in the amount of $250,000 for a painting that had previously sold for $310,000. However, the Tax Court found that this prior sale was not a valid basis for comparison since the painting had in the interim been over-painted and poorly restored. *Furstenberg v. United States*, 1978 U.S. Ct. Cl. LEXIS 663 (Ct. Cl. 1978).

TO MAKE ART COMPARISONS USE…

- Similar works by different artists
- Different works by the same artists
- Prior sales (but invalid where poorly restored)
- Library catalogs, pricing guides, newspaper advertisements, gallery quotations

The IRS offers suggestions for sources of comparable values for various items in its *Publication 561* that include library catalogs for stamp and coin collections; published pricing guides detailing private party sales of cars, boats, and aircraft; and price listings of publicly traded stock.

2. Retail Market – where the public has access

The IRS attempts to clarify that the retail market, as distinguished from the dealer or wholesale market, is that market in which a member of the general public could obtain the item.[6] But this definition presupposes that such a market indeed exists and that the item to be valued could be purchased by or sold to the public.

However, unique and rare items may find such a forum unavailable, thus precluding valuation by application of this simplistic retail pricing rule. Additionally, the purpose of the valuation may require the rule to be further modified:[7]

> A recently purchased car is given by a father to his son. For *gift tax purposes*, the value of the car is deemed to be the retail purchase price since the father could just as easily give cash to his son to buy the car. But if this same car passes by inheritance to the son, its value for *estate tax purposes* is deemed to be the retail sales price or proceeds the executor could garner if forced to sell the vehicle at the time of the father's death. In both cases, valuation will depend upon pricing in the retail market, but will vary as to timing.

3. Property Types

The Code distinguishes between Capital Gain Property ("CGP") and Ordinary Income Property ("OIP"), thereby complicating the valuation process further.

[6] Treas. Reg. § 20.2031-1.

[7] Lerner & Bresler, *Art Law: The Guide for Collectors, Dealers, and Artists*, 2nd ed., Vol. 2, 1136 (Practicing Law Institute, 1998).

NOTE: If the items are deemed OIP, charitable deductions granted are limited to the cost of donated items rather than FMV.

By default, OIP is property that cannot be classified as CGP which is any capital asset that, if sold at the time of its contribution to charity, would have yielded a long-term capital gain.[8] OIP, in contrast, includes property held by a donor for resale in the ordinary course of his trade or business; a work of art created or a manuscript prepared by a donor; or a capital asset that, if sold by a donor, would not have produced a long-term capital gain.[9]

Thus, it is important to note that values for the purpose of charitable deductions will vary depending upon the characteristics of the donor.

An *artist* who donates his own work may not deduct the FMV of his creation and may claim no more than the combined cost of his input materials such as canvas and paints. But a *collector* who purchased the artwork and later donates it to charity may be entitled to claim a charitable deduction for the FMV of the painting at the time of the donation, if the requisite parameters for CGP have otherwise been satisfied.

Differing treatment is not limited merely to the identity of the donor, but may extend further to the nature of his acquisition. Consequently, a collector who received a painting as a gift from an artist will, like the artist himself, be limited to claiming a deduction of OIP at cost. As per gift tax rules, the basis (cost) of property acquired by gift is the same as it would have been in the hands of the individual who made the gift.[10] Known as carry-over basis because the giver's cost carries over to the recipient, the new owner essentially has little or no basis; certainly no more than the artist had whose basis was limited to the cost of his oils and brushes. While this individual may claim a deduction for his donation when he later donates the artwork to charity, he may not claim a deduction for more than his negligible basis. Just as the artist's basis carries over to the collector who received the painting as a gift, so does the nature of the property. Deemed as OIP in the artist's hands, the property remains OIP when gifted to the collector.

CONTRIBUTION RULES FOR DIFFERENT PROPERTY TYPES

- Deduction for donated OIP limited to cost basis
- Deduction for donated CGP limited to FMV
- Character of donated property is established in the hands of the original owner and carried-over to all successor owners

III. CHARITABLE CONTRIBUTIONS

Value often comes into question when the IRS challenges deductions claimed on taxpayer returns. Seeking to minimize tax liabilities as much as possible, taxpayers will value donations as

[8] I.R.C. § 170(b)(1)(C)(iv).

[9] Treas. Reg. § 1.170A-4(b)(1).

[10] I.R.C. § 1015(a).

high as possible to reduce taxable income as much as possible. Conversely, the IRS will attempt to value donated items as low as possible to increase tax collections as much as possible. Merryman and Elsen have compiled a table of court cases involving the valuations of artwork that shows just how far taxpayers and the IRS are apart on the valuation spectrum.[11]

The taxpayer claimed a deduction for $169,000 based on her valuation of paintings donated to various educational institutions, but the IRS sought to disallow all but $7,000 of the valuation. *Rebay v. Commissioner* T.C. Memo 1963-42 (U.S. Tax Court Memos 1963).	The IRS doubted the authenticity of paintings donated by a taxpayer who claimed a $100,000 deduction and instead attributed a value of only $8,150 to the artwork. *Peters v. Commissioner* T.C. Memo 1977-128 (U.S. Tax Court Memos 1977).

Taxpayers donated their lake house to the local fire department for training exercises and sought to claim a deduction of $76,000 based on the difference of the property value with and without the house. The IRS disallowed the deduction stating that the taxpayers received a service from the Fire Department that saved them $10,000 they would have otherwise had to pay to demolish the unwanted house. And the Fire Department received a property that was worth no more than $10,000 due to the time and use constraints placed on the property by the donors who also retained possession of the underlying land. Because this was a quid pro quo exchange, taxpayers could not claim a charitable deduction for excess FMV that did not in fact exist.
Rolfs v. Commissioner 135 T.C. 24 (U.S. Tax Court Memos 2010).

Disputes of this nature may ultimately be settled in court. Values will be assigned and tax deductions will thereafter be allowed or disallowed. If permitted, these deductions will then minimize the tax due. However, it is incumbent upon the taxpayer who seeks to benefit from charitable deductions to understand and comply with the rules.

A. Basic Rules

A voluntary gift of money or property to, or for the use of, a qualified organization without receipt of anything in exchange may entitle the donor to a tax deduction. If eligible, the taxpayer may deduct an allowable amount as an Itemized Deduction on Schedule A of his federal income tax return. In that manner, he may reduce his taxable income and ultimately his tax liability.

CHARITABLE DEDUCTION ALLOWED IF:

- Voluntary contribution made to a
- Qualified organization and
- Nothing received in exchange

1. Types of Qualified Organizations

Generally, qualified organizations must be domestic entities operated for religious, charitable, educational, scientific, or literary purposes. Certain organizations that sponsor national or international sports competitions and those organized to prevent cruelty to children or animals may also qualify. Additionally, war veterans' organizations, domestic fraternal societies, certain non-profit cemetery companies, and political subdivisions of states, U.S. possessions, or

[11] Merryman and Elsen, *Law, Ethics and the Visual Arts*, 1007 (4th ed., Kluwer Law International, 2002).

Indian tribal governments are eligible.[12] IRS *Publication 78, Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986* specifically lists qualified organizations and should be consulted by a donor prior to making a charitable contribution to ensure that it meets at least the first of several requisite criteria.

Eligible Donees	Ineligible Donees
Religious Institutions	**Civic Groups, Fraternal Orgs, Social Clubs**
Non-profit Schools & Hospitals	**Lobbyists & Political Groups**
Public Parks & Recreation Facilities	**Homeowner's Associations**
Human Service Organizations	**School Tuition or Value of Time Donated**

2. Amount of Deduction

If a donation is made to an eligible institution and not set aside for use by a specific person, the donor may typically deduct the FMV of the property contributed as valued at the time of the donation. However, allowable deductions are limited to 50% of taxpayer's Adjusted Gross Income ("AGI").

A donor with an AGI of $100,000 who has made a cash contribution of $60,000 to the county museum will be entitled to deduct $50,000 as a charitable contribution on the current year's tax return, but amounts in excess of the AGI limitation must be carried forward into future years. Hence, $10,000 will be carried to next year and combined with next year's donations, if any, to determine the then-allowable deduction.

a. Carry-over Rules

Excess contributions may be carried over to each of the five succeeding years and are deducted only after deducting allowable contributions in that year. If there are carryovers from multiple years, the carry-over from the earliest year must be used first.[13]

Carry-over provisions apply even if the Standard Deduction is claimed in the contribution year. Carry-overs are reduced in subsequent years by any amount that would have been deductible had the taxpayer elected to itemize.

[12] Department of the Treasury, Internal Revenue Service, *Publication 526: Charitable Contributions*, 2 (Rev. December 2003, Cat.No. 15050A)

[13] Examples cited in Treas. Reg. § 1.170A-10, paraphrased here:
B has a contribution base for 1970 of $20,000 and $30,000 for 1971 and has contributed $12,000 to a church in 1970 and $13,500 in 1971. B may claim a charitable deduction of $10,000 in 1970. The $2,000 excess [$12,000 contribution over $10,000 (50% of B's contribution base)] may be carried-forward to 5 succeeding years. B may claim a charitable deduction of $15,000 in 1971[$13,500 contribution in 1971 plus $1,500 carried over from 1970]. $500 of the 1970 excess contributions will be carried forward to 1972.

B next has a contribution base for 1972 of $10,000. In 1972, B elects to claim the Standard Deduction, foregoing an itemized deduction of $300 actually contributed to charity in that year. B's deductions for 1972 are not increased by the $500 carryover from 1970 since B elected to take the Standard Deduction in 1972. But for purposes of determining the amount of the carryover to 1973, B must treat the $500 as though the charitable deduction had been claimed in 1972. Thus, no further carry-forward will be available in 1973.

b. Exceptions

The annual limitation based on a percentage of the AGI is known as the taxpayer's "Contribution Base." While the base is normally calculated on 50% of AGI, limitations that are more stringent may apply depending upon the type of property donated and the nature of the donee organization.

Known as "50% Organizations," most churches, educational institutions, and hospitals qualify, as do publicly-supported corporations and foundations organized and operated solely for charitable, religious, educational, scientific, or literary purposes. 30% Organizations, on the other hand, include veterans' organizations, fraternal societies, and certain private foundations. Thus, donations made to these organizations will be subject to a lower threshold and may therefore not be deductible in the current year.

In fact, there is a second 30% limitation: If Capital Gain Property is contributed to a 50% Organization, the deduction is limited to 30% of the taxpayer's AGI—Ordinary Income Property contributed to a 50% Organization is limited to 50% of AGI as would be anticipated by an unsuspecting taxpayer.[14] If CGP is donated to a 30% Organization, the deduction is limited to 20% of AGI. If the taxpayer elects to deduct cost rather than FMV of any CGP property donated,[15] he is not subject to the special 30% or 20% limitations mentioned above and may once again avail himself of the usual 50% limitation.

AMOUNT OF TAX DEDUCTION EQUAL TO FMV, LIMITED TO:

- 20% of Contribution Base (or elect 100% of Cost) if 30% Organization
- 30% of Contribution Base (or elect 100% of Cost) if 50% Organization

c. Related Use Rule

Although a taxpayer may qualify to deduct the FMV of tangible personal property he has donated, his deduction may in fact be limited to the property's cost if the donee organization does not employ the property in an appropriate manner.

[14] Example as cited in *IRS Publication 526: Charitable Contributions,* paraphrased here:
The taxpayer's AGI is $50,000. He donated capital gain property valued at $15,000 to a 50% limit organization, as well as $10,000 cash to a qualified 30% organization. The $15,000 gift of property is subject to the special CGP 30% limit. The $10,000 cash gift is subject to the organization 30% limit. However, both gifts are fully deductible because neither is more than the 30% limit that applies to each [30% of $50,000 AGI] and together they are not more than $25,000 [50% of $50,000 AGI].

[15] Treas. Reg. § 1.170A-8(d)(2)(iii) requires that this election must be made by attaching a written statement to the return by its due date.

A painting donated to a museum for display in its collection is deemed related to the organization's charitable purpose and so the taxpayer would be entitled to deduct FMV of the property. In contrast, if the same painting were donated to a church which in turn elects to sell the artwork to raise funds for the restoration of its altar, the donation would fail the Related Use Rule and the taxpayer could merely claim a deduction for his original cost of the painting.

If a donee organization would derive no benefit from the donation other than the proceeds that it could reap upon sale of the donated item, it is only fair that the taxpayer should not be allowed a greater benefit in the form of a tax deduction. Thus, it is incumbent upon the donor to ascertain the use to which the donee organization intends to put the donated property.

A donor may assume that the Related Use Rule will be satisfied either by actual fact or by reasonable assumption and may, if there is no evidence to the contrary at the time of the donation, presume that the donee organization will indeed use the donated item for related purposes. [16]

Some taxpayers have requested advance rulings from the IRS to preclude later disallowance of deductions. Typically, the IRS has deemed that artwork donated to educational institutions will satisfy the rule if it is displayed in connection with an art appreciation program[17] or used as an enhancement to a curriculum described by the course offerings;[18] whereas an antique car donated to a university that did not offer an antiques restoration course was deemed unrelated.[19]

To ensure proper application of the rule, the IRS requires that charitable organizations certify that they will notify the tax authority in the event that donated property valued in excess of $5,000 is sold or otherwise transferred within two years after the date of the donation [**Form 8283 Noncash Charitable Contributions**]. If such notification was not filed upon receipt of the contribution, the organization must file **Form 8282 Donee Information Return** within 125 days after the date of disposition. Failure to file may be subject to a $50 penalty.[20]

[16] Treas. Reg. § 1.170A-4(b)(3)(ii).

[17] P.L.R. 7751044 (PLR 1977): Donated lithographs to be displayed at a camping facility which promotes the social contact of children and furthers their appreciation of art

[18] P.L.R. 8208059 (PLR 1981): Donated stamp collection to be used by a college with an engraving curriculum for display.

[19] P.L.R. 8009027 (PLR 1979): Donated vehicle remains in storage in a professor's garage and has never been used by the school since it does not offer a suitable curriculum.

[20] Instructions, Form 8282 Donee Information Return (Rev December 2005, Cat. No. 62307Y).

DEDUCT COST (not FMV) WHEN:

- Election made (via written statement) when donating CGD
- If donation fails Related Use Rule

d. The Impact of AMT

As incomes steadily rise with time, more taxpayers fall victim to the Alternative Minimum Tax ("AMT") since its exemption has not been indexed for inflation.[21] Today taxpayers with even modest incomes may find themselves battling this demon, even though the tax that was originally intended only to ensure that certain high-income earners pay their fair share.

The AMT calculation begins with Taxable Income as calculated under the normal (regular) method. Thereafter, tax preference items are added back to eliminate what is thought to be a disproportionate benefit available to some taxpayers who have too many deductions of a certain type, such as state taxes, excess depreciation allowances, and personal exemptions.

While the **charitable deduction is not a preference item**, it is nevertheless negatively impacted by the AMT calculation. Because charitable contribution limits are set at either 30 or 50% of AGI—as calculated under regular tax rules—and not recalculated as a percentage of the preference-adjusted AMT income, the deduction will inevitably be limited to a smaller amount. In other words, victims of AMT may deduct contributions made to charity under both the regular and AMT systems, but can only do so to the extent that the deductions would have been allowable under the regular method. AMT income is almost always higher, certainly never less than regular income and yet, the allowable charitable deduction cannot be used to reduce taxable AMT income by the same percentage.

B. Substantiation Requirements

When claiming a deduction on a tax return, the burden of proof falls on the taxpayer to substantiate his claim. While donations of property in excess of specified limits may require formal appraisals, all contributions require at least minimal adherence to record keeping requirements.

1. Cash Donations

For small amounts (less than $250), canceled checks, credit card statements, or letters from recipient charitable organizations suffice to prove that a donation was

[21] Temporarily raised to $44,350 for single taxpayers in 2007—$66,250 for married taxpayers filing jointly—the AMT exemption is currently scheduled to drop back to $33,750 for single and $45,000 for married taxpayers in 2008, barring any further extension of the relief provision enacted under the *Economic Growth and Tax Relief Reconciliation Act of 2001*.

in fact made as claimed on the tax return. However, canceled checks are insufficient to support deductions claimed for donations in excess of $250. Instead, IRC § 170(f)(8) requires a written acknowledgement from the charity stating the amount of cash and a description of any non-cash property contributed, as well as a description and good faith estimate of value of any goods or services provided to the donor in exchange for the contribution. This acknowledgement must be received by the donor by the time the tax return is timely filed.

2. Non-cash Donations

The record keeping requirements for non-cash donations is more stringent, just as the deductions claimed are more susceptible to review and audit. Although receipts for donations deposited at unattended collection sites are not required if the property is valued at less than $250, written contemporaneous acknowledgements are required in all other cases.[22] Confirming letters or receipts must include the name and address of the receiving organization, the date and location of the contribution, a description of the property donated, and a statement detailing whether any goods or services were provided to the donor in exchange for his contribution. An acknowledgment is contemporaneous if it is obtained by the taxpayer on or before the earlier of (1) filing date or (2) the due date (plus extensions) of the original return.[23]

Taxpayers' deduction for $25,000 donated to their church, an eligible 501(c)(3) organization, was disallowed on audit. Although taxpayers could produce copies of canceled checks and a timely obtained letter of acknowledgement to support the deduction claimed, the deduction was denied because the letter di not state that "no goods or services were provided in exchange" for the amounts donated. Taxpayers requested a second letter with the requisite statement which they received in the year after filing the original return. Despite substantial compliance, the Tax Court denied the deduction for failure to satisfy strict compliance.[24]

NOTE: The tax code states that *no* deduction is allowed unless substantiation satisfies the criteria outlined – a written, contemporaneous acknowledgment along with an affirmative statement verifying how much of the contribution is actually deductible is mandatory.

For non-cash donations valued between $501 and $5,000, the taxpayer must also record when, where, and for how much he originally acquired the property. For contributions in excess of $5,000, appraisals are required. Form 8283, § B may be filed in lieu of a written appraisal if the donated property consists of non-publicly traded stock valued under $10,000; if the deduction claimed for a donated vehicle does not exceed the proceeds of its sale by the charity; certain intellectual property; securities with readily available quotes; certain inventory; or donations made by C-Corporations. Form 8283 may not be used as substitute to an appraisal for art valued in excess of $20,000.[25]

[22] IRC § 170(f)(8)(B).

[23] Treas. Reg. § 1.170A-13(f)(3).

[24] Durden v. Comm., TC Memo 2012-140.

[25] Instructions, Form 8283 Noncash Charitable Donations (Rev December 2005, Cat. No. 62299J).

SUMMARY OF SUBSTANTIATION REQUIREMENTS

- Taxpayer has the burden of proof to support the charitable deduction claimed
- For cash contributions < $250, taxpayer must retain canceled check, credit card receipt statement, or a letter from the donee acknowledging receipt of donation
- For cash contributions > $250, taxpayer *must* have written contemporaneous acknowledgement
- For non-cash donations, taxpayer must have *written* receipt from donee and a description of items donated
- For non-cash donations > $5,000 taxpayer must have written appraisal (Form 8283, may be sufficient unless art valued > $20,000 or other property valued > $500,000)

C. Penalties

Lack of proper records may result in complete disallowance of a deduction previously claimed, subjecting the taxpayer to additional tax and attendant penalties and interest.[26] The Late Payment Penalty is calculated based on 0.5% of the tax owed for each full or partial month that the tax remains unpaid from the due date until the tax is paid in full, for a maximum 25% penalty. The 0.5% rate increases to 1% if the tax remains unpaid ten days after the IRS issues a Notice of Intent to Levy.

The IRS may also assess penalties for over- and under-valuations that result in a substantial under-payment of tax. While "relatively small errors that might be expected to arise from good-faith differences of opinion concerning value" are not penalized,[27] the Code is concerned with valuations that misstate the true value of the property by 200% or more and cause the tax liability to be understated by at least $5,000. Under these circumstances, IRC § 6662(e) allows for an accuracy-related penalty of 20% assessed on the unpaid liability. Gross misstatements of value in excess of 400% are subject to a 40% penalty.[28]

Penalties may be waived for reasonable cause and proof that the taxpayer acted in good faith. To be eligible for the waiver, a taxpayer must have relied upon the property's value as determined by a qualified appraiser and must also have made his own good-faith investigation of the value claimed.[29]

[26] Currently set at 6%, effective April 1, 2008, as published in the IRS News Release: *Interest Rates Drop for the Second Quarter of 2008*, IR-2008-30 (March 3, 2008), available at http://www.irs.gov/newsroom/article/0,,id=179676,00.html (last accessed May 13, 2008).

[27] Robinson, *Federal Income Taxation of Real Estate: Analysis and Tax-Planning Ideas*, 6th ed., 11-64, Warren, Gorham & Lamont (1994-2005).

[28] I.R.C. § 6662(h).

[29] *Pacheco v. Commissioner*, T.C. Summary Opinion 2002-82 (TNT Tax Court Summaries 2002). Taxpayers were held liable for the accuracy-related penalty because they knew that the amounts claimed on their returns for charitable contributions were false and did not consult other tax professionals to verify the accuracy of the returns prepared by their preparer.

While valuations for charitable contributions are often over-stated, valuations for estate and gift tax purposes may be under-stated, leading again to an under-statement of tax. As per IRC § 6662(g), a 20% penalty may be assessed for "gross valuation misstatements" if the claimed value is 50 to 75% less than the actual property value. But if the claimed value is understated by more than 75%, a 40% penalty may be assessed. The IRS has discretion to waive both penalties for reasonable cause.

IRC § 6695A enacted as part of the Pension Protection Act of 2006 imposes additional penalty on the appraiser if "knows, or reasonably should have known" that a return or claim for refund would be prepared based upon his appraisal that then resulted in a substantial valuation misstatement. The penalty will be the lesser of 10% of any underpaid tax or 125% of the gross appraisal fees charged; with a minimum assessment of $1,000.

The IRS has not yet provided any guidance as to whether this penalty will be imposed on qualified appraisers only or anyone involved in the appraisal and tax preparation process.[30] Nor is it yet clear whether the IRS will impose the penalty only after final resolution of a tax controversy case (after all administrative and judicial appeals have been exhausted), or at the outset when a return is first audited and the valuation is called into question.

In late 2010, the IRS announced plans to issue Letter 4477 Appraiser Appointment Letter requesting a meeting with an appraiser suspected of misstatement "to discuss the facts or legal arguments of the appraisal so that the Service can determine if a… penalty is appropriate." Thereafter, either Letter 4485 Appraiser Penalty Assessment Notification Letter or Letter 4478 Appraisal Penalty No-Change Letter will be issued.[31]

SUMMARY OF PENALTIES FOR IMPROPER VALUATIONS

Penalties for Over-valuations
- 20% of any underpaid tax resulting from over-valuation of an item by 200%
- 40% of any underpaid tax resulting from over-valuation of an item by 400%

Penalties for Under-valuations
- 20% of any underpaid tax resulting from under-valuation of an item by 50 – 75%
- 40% of any underpaid tax resulting from under-valuation of an item by 75% or more

Appraiser Penalty
- Lesser of 10% of underpaid tax or 125% of gross appraisal fees charged (minimum $1,000)

[30] Fosberg and Drake, The New IRS Appraiser penalties Under Code § 6695A—Fair and Balanced or Simply Unworkable?, *Probate & Property* (September/October 2007), 46.

[31] IRS Responds to NACVA/IBA Testimony Regarding Appraiser Penalty Process, available at http://www.nacva.com/Association_News/2010qrtr4/IRSResponseOctober2010.htm (last accessed May 11, 2011).

IV. APPRAISALS

Contributions of property exceeding $5,000 in the aggregate require an appraisal to substantiate any deduction claimed by a taxpayer.[32] Appraisals may also be required to substantiate casualty losses[33] or to determine the value of a decedent's gross estate.[34] IRS regulations specifically state, "[p]roperty shall not be returned at the value at which it was assessed,"[35] thereby distinguishing appraisals from assessments. Property is typically "assessed" by regulatory officials to establish a basis upon which to levy a charge, fine, or tax; whereas an "appraisal" is used "to make a judgment as to the worth or value" of an item.[36]

APPRAISALS VERSUS ASSESSMENTS

- Appraised Value: an expert or official valuation for various purposes
- Assessed Value: the financial worth assigned to property by taxing authorities

This distinction is clearly illustrated in the Los Angeles real estate market where appraised values currently far exceed assessed values on most properties. Due to Proposition 13, a ballot initiative enacted in 1978 to cap property tax rates, real property is assigned an assessed value at the time of transfer between buyer and seller. Thereafter, the assessed value increases only nominally based upon a legislated percentage each year. In contrast, the appraised value of real estate generally reflects the market value of property—the price for which property could currently be sold. In a recent "hot" market environment, the double-digit growth rate of market and appraised values far outpaced that of assessed values which were limited to an annual rate of 2%.[37]

[32] I.R.C. § 170(a)(1): A charitable contribution shall be allowed only if verified under regulations described by the Secretary. [Effective January 1, 1985.] Treas. Reg. § 1.170A-13(c)(2): Donor must obtain a qualified appraisal, attach a fully completed appraisal summary to the tax return, and maintain records. [For purposes of this paragraph (c), the amount claimed or reported as a deduction for an item of property is the aggregate amount claimed or reported as a deduction for a charitable contribution for such items of property and all similar items of property by the same donor for the same taxable year (whether or not donated to the same donee).]

[33] Treas. Reg. § 1.165-7(a)(2): In determining the deductible loss, the fair market value of the property immediately before and immediately after the casualty shall generally be ascertained by competent appraisal.

[34] Treas. Reg. § 20.2031-3: Valuation of Business Interests by fair appraisal as of the applicable valuation date. Treas. Reg. § 20-2031-6: Valuation of household and personal effects by written statement, containing a declaration that it is made under penalties of perjury, setting forth the aggregate value as appraised by a competent appraiser or appraisers of recognized standing and ability, or by a dealer or dealers in the class of personalty involved.

[35] Treas. Reg. § 20.2031-1(b).

[36] *Roget's II: The New Thesaurus*, 3rd ed., Houghton Mifflin Company (1995), *Answers.com* at http://www.answers.com/topic/appraise (last accessed May 13, 2008).

[37] On an aside, valuations performed by the county assessor are based on fee simple only and do not consider potential decreases or loss of value resulting from leaseholds or life estates.

A. Qualified Appraisals

1. Requirements[38]

For tax purposes, the Code specifically requires appraisals that are deemed "qualified" to substantiate taxpayer claims and sets forth the obligatory criteria[39]. Specifically, the appraisal must be prepared no earlier than 60 days prior to the date of contribution of the appraised property;[40] be signed and dated by a qualified appraiser who may not charge a prohibited fee (based on a percentage of the appraised value); and contain all of the following information:

- A detailed description of the property, including its physical condition
- The date (or expected date) of contribution
- The terms of any understanding between the donor and donee regarding the use, sale, or disposition of the property contributed
- A statement that the appraisal was prepared for income tax purposes
- The date on which the property was appraised
- The appraised fair market value of the property
- The method, basis, and justification of the valuation used
- The name, address, and taxpayer identification number of the qualified appraiser, as well as his background and qualifications
- A description of the fee arrangement between the appraiser and the donor

A separate appraisal is required for each item of property that cannot be grouped with similar items contributed within the same year. Appraisals for grouped items must nevertheless list all of the requisite information for each individual item unless the total value of each grouping is less than $100.[41]

The cost of an appraisal obtained to substantiate a casualty loss or a charitable deduction may be deductible as a Miscellaneous Itemized Deduction subject to a 2% AGI limitation on Schedule A of the individual's tax return.[42] Appraisal fees—depending upon the type—may be fully deductible on the estate tax return or, if elected by the executor, on the fiduciary tax return of a decedent's estate.[43]

[38] Failure to follow the rules *to the letter* cost a California taxpayer dearly: While the Tax Court (*Mohamed*, TC Memo 2012-152) held that the donated property "was quite likely more valuable" than the $18.5 million deduction claimed by the taxpayer, the deduction was declined in its entirety (!) for failure to attach a copy of the qualified appraisal to the donation form. (Feldman, *A Harsh Lesson on Charitable Contributions*, Checkpoint Newsstand, June 4, 2012).

[39] Treas. Reg. 1.170A-13(c).

[40] *Rothman*, TC Memo 2012-163. The Tax Court denied the charitable deduction claimed by the taxpayer for the contribution of an historic preservation façade easement on the basis that the appraisal was made earlier than 60 days before the contribution date. Additional appraisal defects included an inadequate description of the contributed property and failure to establish that appraiser was licensed and experienced at the time of the appraisal. Although some of the shortcomings could have been viewed as potentially insubstantial, the cumulative failures did not satisfy the regulatory requirements of Treas. Reg. § 1.170A.

[41] Department of the Treasury, Internal Revenue Service, *Publication 561: Determining the Value of Donated Property*, 10 (Rev. October 2005, Cat. No. 15109Q).

[42] Treas. Reg. 1.67-1T(a)(1)(iii).

[43] Treas. Reg. 1-642(g)-1.

The standard of admissibility of an appraisal as evidence in a Tax Court case should not be lower than the admissibility standard at a jury trial – this so-called "Daubert" standard[44] requires that expert testimony may be admitted only after it has been established that the evidence is reliable and scientifically valid and must withstand testing, peer review, error rates and acceptability in the relevant scientific community. The US Supreme Court broadened the test to include expert testimony based on technical and other specialized knowledge.[45]

Taxpayer's charitable deduction ($3 million) for a conservation easement donated to a land trust was disallowed in its entirety based on a number of methodological problems and erroneous assumptions contained in the appraisal report, including a valuation that was more than 35 times greater than the value of comparable property, an unrealistic assumption of the highest and best use of a possible condominium development, and various factual inaccuracies about the easement's features.[46]

2. Qualified Appraisers

A qualified appraiser is an individual who holds himself out to the public as an appraiser or performs appraisals on a regular basis; is qualified to make appraisals of this type because of his expertise; is not an excluded individual; and understands that intentionally false valuations may subject him to penalties.[47]

Effective with the passage of the Pension Protection Act of 2006, qualified appraisers must use "generally accepted appraisal standards" (GAAS) still left undefined although proposed regulations suggest that this standard can be met by applying the Uniform Standards of Professional Appraisal Practice (USPAP). Proposed Regulations issued in 2008 further narrow the definition of a qualified appraiser to one who meets certain education and experience standards.[48]

Certain individuals are specifically precluded and may not provide appraisals of a particular property,[49] including the donor who seeks to claim the charitable deduction; the donee receiving the contributed property; any party involved in the acquisition of the property unless the donation is made within two months after acquisition and the appraised value does not exceed the purchase price; and any

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[44] *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579.

[45] *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137.

[46] *Boltar v. Comm.*, 136 T.C. No. 14.

[47] Department of the Treasury, Internal Revenue Service, *Publication 561: Determining the Value of Donated Property*, 10 (Rev. October 2005, Cat. No. 15109Q).

[48] Maloney, *Definition of "Qualified Appraiser" and "Qualified Appraisal" Continue to Evolve*, Appraisal Course Associates, 2009, available at http://www.appraisalcourseassociates.com/archive/newsletter/update10/proposedRegs.htm (last accessed May 11, 2011).

[49] Treas. Reg. § 1.170A-17(b).

person who performs appraisals solely for this donor, as well as any one who is employed by or related to any of the afore-mentioned individuals.[50]

Taxpayer's charitable deduction for his donation of real estate valued at $18.5 million was denied for improper valuation. Taxpayer was a certified real estate appraiser and, while otherwise qualified, violated the cardinal rule prohibiting self-appraisals. Taxpayer had purposefully undervalued the property to prevent claiming an excess deduction – in fact, an independent appraiser's valuation later yielded a value of $20.2 million.[51]

NOTE: Substantial compliance with a statute does not protect a taxpayer who fails to comply with an essential requirement of the statute.

Charitable deductions will be disallowed if either the appraiser is unqualified or the appraisal was received by the donor *after* the due date (including extensions) of the income tax return.

> The taxpayer's contribution deduction of $40,000 for art supplies to a local high school were disallowed even though an appraisal had been attached to the tax return as required. However, the appraisal had not been performed by a qualified appraiser and instead represented the opinion of the high school's principal—expressly disqualified because he neither held himself out to be an appraiser nor performed appraisals on a regular basis and because he was an employee of the donee institution.
> *D'Arcangelo v. Commissioner* T.C. Memo 1994-572 (U.S. Tax Court Memos 1994).

> The charitable deduction was similarly disallowed because the requisite appraisal summary for the value of stock donated to a church was not attached to the tax return. Instead, the taxpayers based their claim of value on the average per-share price of the stock traded in bona fide, arm's length transactions at approximately the same time as the date of the gift. While this might have been sufficient to prove the value of publicly-traded stock, the security in question was valued by the taxpayer based on sporadic private party transactions.
> *Hewitt v. Commissioner* 1998 U.S. App. LEXIS 29519 (4th Cir. 1998).

Conversely, courts have held "that a literal failure to comply with the substantiation requirements could be excused if the taxpayer substantially complied with those requirements."

> The taxpayer who donated two blimps to charity provided an appraisal summary as mandated by the regulations, but failed to include the appraiser's qualifications until after the return had been filed and was subsequently audited. The deduction was allowed based upon the theory of substantial compliance.
> *Bond v. Commissioner* 100 T.C. 32 (T.C. 1993).

Appraisers who intentionally misstate values for the purpose of under-stating the tax liability of another person may be subject to a $1,000 penalty and may be barred from appearing before or presenting evidence to the IRS.[52]

[50] I.R.C. § 267(b) defines a related party as a family member, large shareholder, a trust grantor, fiduciary, or beneficiary, amongst others.

[51] *Mohamed v. Comm*., TC Memo 2012-152.

[52] I.R.C. § 6701. The penalty may be increased to $10,000 if the appraisal relates to the tax liability of a corporation.

A *QUALIFIED APPRAISER*[53] MUST:

- Hold himself out to the public
- Perform appraisals on a regular basis
- Be subject to penalties for overstatement of value
- Not be the donor or donee, a related party (as defined by IRC § 267(b)), or a party to the acquisition transaction unless the donation occurs within 2 months and the appraised value does not exceed the acquisition value

B. Art Appraisals

1. Requirements – Additional items required for art appraisals (!)

Due to the singular nature of art and the peculiarities of the art market, special requirements apply to the valuation of art, including items which must be detailed in the appraisal summary:

- A complete description of the object, indicating its size, subject matter, medium, name of the artist (or culture), and approximate date created.
- The cost, date, and manner of acquisition.
- A history of the item, including proof of authenticity (provenance).
- The facts on which the appraisal was based, such as sales or analyses of similar works by the artist on or around the valuation date, quoted prices in dealers' catalogs of the artist's works or works by other artists of comparable stature, a record of any exhibitions at which the specific art object had been displayed, the economic state of the art market at the time of valuation with respect to the specific property, the standing of the artist in his profession and in the particular school or time period.[54]

Additionally, the following rules apply:

- For art valued in excess of $20,000, a complete copy of the signed appraisal must accompany the tax return. For individual objects valued at $20,000 or more, a photograph of the donated item must be provided upon request.
- For art valued in excess of $50,000, the taxpayer may request an IRS Statement of Value for that item prior to filing the tax return.

[53] IRS Notice 2006-96 offers transitional guidance, requiring that a Qualified Appraiser must have earned his appraisal designation from a recognized appraisal organization based on demonstrated competency, must demonstrate verifiable education and experience in valuing the type of property subject to the appraisal; and must have met minimum education and experience requirements depending upon the type of property and date on which the tax return is filed.

[54] Department of the Treasury, Internal Revenue Service, *Publication 561: Determining the Value of Donated Property*, 10 (Rev. October 2005, Cat. No. 15109Q).

A *QUALIFIED APPRAISAL* MUST:

- Be made within 60 days from the date of donation
- Be attached to Form 8283 *Noncash Charitable Contributions* if claiming a deduction for art valued in excess of $20,000 or any property valued in excess of $500,000
- Include identifying description of the donated property, its physical condition, and any terms stipulated by the donor restricting donee's use
- If appraising art objects, include size, subject matter, medium, artist's name and reputation, and date of creation; cost, date, and manner of acquisition; history of item and proof of authenticity; a high-quality photograph or other reproduced image of the item; facts upon which appraisal was based, such as comparable sales of similar works, catalog prices, a record of exhibitions, economic state of market in general

2. Advance-Valuation-Ruling Procedure (Statement of Value)

To preclude potential valuation disputes between taxpayers and the IRS, Revenue Procedure 96-15 offers taxpayers the opportunity to obtain a valuation determination for artwork appraised in excess of $50,000. *The IRS determination is binding upon the tax authority for income, gift, and estate tax purposes, but not upon the taxpayer who may nevertheless file his return based upon valuations as determined by his own qualified appraisal.* However, in that event, the taxpayer must submit both the IRS determination as well as his own when filing his return.

Although the IRS has the right to decline any request for a determination "when appropriate in the interest of efficient tax administration,"[55] a taxpayer may submit such a request for a Statement of Value ("Statement") *after* the transfer of a property by donation, gift, or inheritance, but *prior* to filing the tax return reporting the deduction or transfer.

The application must include a copy of a qualified appraisal of the item and a $2,500 user fee for the valuation of up to three items of art. The IRS will charge an additional $250 for each item in excess of three.[56] The fee will, of course, be refunded in the event that the IRS declines the application, but will not be returned if the taxpayer elects to withdraw his request any time before the Statement is issued.

3. Art Appraisers

The taxpayer's valuation will be afforded greater weight if his qualified appraisal was prepared by an individual specializing in the kind and price range of the art being appraised rather than by a more generalized art dealer or appraiser. *Publication 561* suggests that such experts could be located through the Official Museum Directory of the American Association of Museums which lists museums by state and category,[57] or by contacting an art historian at a nearby college or the curator of a local museum.

[55] Rev. Proc. 96-15, § 3.03 (IRB 1996).

[56] *Id.*, S 5.

[57] The directory may be ordered at http://www.officialmuseumdir.com/ (last accessed May 13, 2008).

The day after Bill fixed his best friend Joe up with a blind date, Joe called and complained, "What kind of a guy do you think I am?! That girl you fixed me up with was cross-eyed, almost bald, had a nose that was long and crooked, hair growing on her face, flat-chested, and her ankles were as thick as her thighs!"

Bill answered, "Either you like Picasso or you don't like Picasso."

Various professional associations, including the Art Dealers Association of America ("ADAA"),[58] provide appraisal services, as do auction houses and independent dealers. "While no licensing of appraisers is presently in place, a Qualified Source List of the Department of the Treasury does exist,"[59] which provides a directory of appraisers under contract to the government or selected on an as-needed basis. These same individuals are often available to the public as well.

"Because of the care and the professional competence with which the ADAA's appraisals are made," the IRS often does not challenge an Association appraisal. However, some taxpayers have been advised that the ADAA will not perform an appraisal until after the donation has been made.[60]

Prior to engaging an appraiser, the taxpayer should investigate the individual's qualifications, expertise, and credentials. Inevitably, different appraisers may value the same items differently and disagree not only amongst themselves but also with the valuation as determined by the IRS, ultimately requiring that such disparities be litigated in court. Much like the joke in which an employer tests various job applicants by asking each one, "What is two and two," the taxpayer must carefully select the best appraiser for the job. In answer to the employer's inquiry, the job applicant who was a mathematician immediately responded, "Four." The next applicant who was a physicist consulted the U.S. Bureau of Standards and performed numerous calculations before answering, "Four." The final applicant who was a lawyer responded only after closing all window shades and doors and conspirationally whispered, "What do you want it to be?" The taxpayer should be cautious and engage a qualified appraiser whose valuation can in fact be legitimately substantiated.

4. Art Advisory Panel

To establish the validity of art and antique appraisals submitted by taxpayers, the IRS has assembled a panel of experts to assist its auditors and appeals officers when dealing with *items valued in excess of $20,000*. The Panel consists of 25 unpaid experts who are not told whether the valuation is for donation or gift and estate tax purposes and must discuss the various works submitted to them in alphabetical order by artist's name to avoid consideration of a taxpayer's entire collection as a whole.

Panelists evaluate each item individually and then reach a consensus. The Panel's conclusions are reviewed by the office of Art Appraisal Services and recommendations of fair market value are sent to the requesting IRS office. A copy of the report is also provided to the taxpayer who may appeal the Panel's determination if he can provide additional information or new probative evidence.

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[58] Art Dealers Association of America, Inc. 575 Madison Ave, New York NY 10022, (212) 940-8590 or http://www.artdealers.org/ (last accessed May 13, 2008).

[59] *Linsner*, Appraising Personal Property and Fine Arts, *The CPA Journal (August 1994), available at http://www.nysscpa.org/cpajournal/old/15703017.htm (last accessed May 13, 2008).*

[60] Merryman and Elsen, *Law, Ethics and the Visual Arts*, 1009 (4th ed., Kluwer Law International, 2002).

The IRS considers the determinations of the Panel binding and will rely upon the Panel to prepare expert reports and engage expert witness when necessary. In 2010, the panel reviewed 475 items aggregately valued by taxpayers in excess of $234 million. The Panel recommended adjustments totaling $53 million—58% of the adjustments were due to overvalued contribution items, the remainder due to under-valuations of estate and gift appraisals.[61] The Panel's efficacy has been so great that the IRS has established a similar group charged exclusively with the valuation of art prints.

SPECIAL ISSUES FOR ART APPRAISALS

- Taxpayer may request an IRS Statement of Value for artwork valued over $50,000
- Artwork valued in excess of $20,000 will be evaluated if the taxpayer is audited
- Commissioner's Art Advisory Panel (created in 1968) consists of 25 unpaid art experts who are not told whether the valuation is for donation or estate and gift tax purposes [Art Print Advisory Panel established in 1980]
- Rev. Proc. 96-15 outlines procedures and requires that the taxpayer *requests* IRS valuation prior to filing his tax return (processing time may take 6 months to 1 year!)
- A non-refundable user (filing) fee must accompany the evaluation request: $2,500 for 1 – 3 items plus $250 for each additional item
- Taxpayer must submit the Statement (or his application) with the tax return, whether or not the IRS agrees with that taxpayer's own appraisal

C. Disputed Valuations

Where IRS and taxpayer valuations differ, the taxpayer may request a written explanation from the IRS detailing any computations used. He is also entitled to a copy of any expert appraisal made by or for the tax authority.[62] This statement by the IRS must be provided within 45 days after the valuation determination or receipt of the taxpayer's written request, whichever is later, and is not binding upon the tax authority. Its purpose is to facilitate the resolution of valuation issues as soon as possible based upon full disclosure to each party.

Unfortunately, not every matter can be resolved in this manner and must instead be litigated. Yet the courts appear to only reluctantly take on the task of determining FMV where qualified appraisers and other experts have failed to agree. "As we have said before, valuation is inherently imprecise; the settlement process is more conducive to the proper disposition of disputes such as this. However, since the parties have given us the task of valuing these paintings, we will discharge our duty" [*Peters v. Commissioner*]. One can almost hear the Court sigh!

[61] The Art Advisory Panel of the Commissioner of Internal Revenue, *Annual Summary Report for 2010 (Closed Meeting Activity)*, 4.

[62] I.R.C. § 7517.

V. SPECIAL ISSUES

A. The Nature of the Art Market

Characterized by illiquidity and secrecy, the art market (unlike the stock market, for example) has a dearth of comparable sales. While stocks are fungible—if not interchangeable between publicly-traded companies, then at least amongst the same class of shares of a particular corporation—art is inimitable. The value of 100 shares of XYZ can be readily determined on any given day and is indeed the same in the hands of different investors. In contrast, a Van Gogh is hardly comparable to a Rembrandt; nor are Van Gogh's *Irises* comparable to his *Potato Eaters.*[63]

But the art world is plagued by further difficulties, including forgeries and misattribution of works which may depress values. Indeed, even a hint of impropriety can negatively impact pricing. In *Vander Hook v. Commissioner* [T.C. Memo 1977-347 (U.S. Tax Court Memos 1977)], the IRS disputed the $250,000 appraised value of donated paintings claiming that their authenticity was in question. "The shadow cast by a question of the authenticity of painting acts as a depressant on its value" [*Doherty v. Commissioner*, T.C. Memo 1992-98 (U.S. Tax Court Memos 1992).].

1. Dealer versus Auction Market

The mechanisms of the art market also obfuscate valuations where the bulk of sales are transacted in the dealer market, precisely the market which is precluded from consideration by IRS Regulation § 20.2031-1. FMV must equal the sale price in that market in which the item "is most commonly sold to the public." Hence, one should look to the auction market. But it may be equally uncharacteristic of retail pricing since many auction participants are often dealers who may be acting on behalf of retail customers or bidding for their own accounts.

Assuming that the auction market is deemed to be determinative, pricing may still not reflect FMV when auction fever drives attendees into a bidding frenzy or when poor turn-out results in disproportionately low pricing. Furthermore, the IRS requires that FMV include the hammer price plus the buyer's premium, a charge levied by the auction house for the privilege of participating in the auction.[64] But because the premium is not passed on to the seller, it is a

[63] The art market is also volatile. For example, contemporary art—as tracked by the Mei Moses Art Index (artasanasset.com)—rose 30% in each year from 1985 – 1990, but lost 65% of its value in the next five years. Nevertheless, in the past 10 years, art has significantly outperformed stocks. David Adler, *For Art's Sake*, Financial Planning (August 2008).

[64] PLR 9235005 (PLR 1992): The buyer's premium is recognized in the industry as a component of the sales price of the art work. Accordingly, the premium paid by the buyer is commonly recognized as part of the cost of purchasing the art work and, therefore, is properly included in determining the fair market value of the property.

phantom amount from which the individual taxpayer does not benefit. Thus, it seems unrealistic to include it as a measure of FMV.

2. Blockage Discounts

Blockage discounts should also be factored into art valuations since simultaneous sales of the same or similar properties could depress the market, a concept well known to mutual fund managers.

> To avoid the possibility of negatively impacting market prices when buying or selling large blocks of stock, fund manager Peter Lynch elected to close Fidelity Magellan to new investors. Had he not done so, the fund would have mushroomed in size and Lynch would have been forced to engage in securities transactions of such enormity that his decisions to trade would in and of themselves influence market pricing.[65]

The estate of Georgia O'Keefe argued that the cumulative value of 400 paintings remaining after the artist's death did not fairly represent FMV since, if sold in bulk, the market price of each individual painting would be affected by the sudden availability of such a large block. "The fair market value of the aggregate of the works in the estate, therefore, as of the date of death, was substantially less than the total of the fair market values of each individual work."[66]

3. Lack of Comparable Sales

Other difficulties arise when the artist is less known or even unknown and hence, cannot provide an established market or prior sales to aid in the valuation process.

> The taxpayer donated her own creation to a church. She was allowed to claim the full value of her contribution because she had been a professional artist for 30 years, had won prizes at various museums and art associations, and had previously sold numerous works of art. Thus, the Court could look to an established market to determine FMV.
> *Cambridge Hotels, Inc. v. Commissioner* T.C. Memo 1968-263 (U.S. Tax Court Memos 1968)

> In contrast, the taxpayer's charitable deduction was disallowed because she had so far sold only one painting to an inexperienced business associate who had never before purchased a similar painting, did not have any training or specialized knowledge in art, and did not consult an expert regarding his purchase. The court deemed this single sale to be an unreliable indicator of comparable value.
> *Rebay v. Commissioner* T.C. Memo 1963-42 (U.S. Tax Court Memos 1963).

[65] Authers, *Fidelity Closes Magellan to New Investors*, SouthCoast Today, available at http://www.s-t.com/daily/08-97/08-28-97/a11bu107.htm (last accessed May 13, 2008). "The announcement was interpreted as an admission by the company that Magellan's portfolio had become too large to enable its managers to outperform the market."

[66] *Estate of O'Keeffe v. Commissioner*, T.C. Memo 1992-210 (U.S. Tax Court Memos 1992): Experts for the estate applied a 75% blockage discount based on the assumption that all of the works in the estate would be sold to a single buyer as a bulk purchase. But the Court elected to segment the artworks not by value but by quality, uniqueness, and salability and created two categories—works that were salable within a relatively short period of time at approximately their individual values and works that could only be marketed over a long period of years with substantial effort. Thus, the court did apply a blockage discount, but not of the scale suggested by the estate and ruled that the FMV was half of the $72 million value proposed by the IRS.

4. The Glamour Factor

Even when comparable sales are available, valuations may be affected by other factors, such as the condition of the artwork at the time of valuation or restrictions placed upon the donee by the donor that limit displays or future sales.[67] While these factors tend to negatively influence valuations, notoriety will often enhance values in a world that thrives on intrigue. In *Perdue v. Commissioner* [T.C. Memo 1991-478 (U.S. Tax Court Memos 1991)], the values of gold artifacts salvaged from Spanish galleon which sunk in 1622 were deemed to have been enhanced by their "romantic appeal and glamour" due to the much publicized discovery of "one of the Western Hemisphere's most famous shipwrecks." In a similar vein, the value of Maria Altmann's collection of Gustav Klimt paintings was increased due to the widespread media coverage of her restitution settlement.[68]

Jeanne McDowell reminds us that "collecting art used to be a rich man's sport… But times have changed. Now it's a *spectacularly* rich man's sport."[69]

5. Fractional Giving

In the past, art collectors often gave partial ownership (usually 10 to 20%) of a collectible to a museum in exchange for a pro-rated deduction of the item's value at the time of the donation, and allowed the museum to display the piece for a limited period of time. As the item appreciated over time, the collector would donate yet another fraction, reaping a new tax deduction based on a pro-rated portion of an ever-increasing valuation amount, eventually donating full ownership over many years. New York's Museum of Modern Art claims that roughly 650 of its works of

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[67] *Murphy v. Commissioner*, T.C. Memo 1991-276 (U.S. Tax Court Memos 1991): Taxpayer's $500,000 valuation of a rock sculpture of John Wayne was reduced by the Court to $30,000 where the IRS expert "found the sculpture to be disturbingly asymmetrical and missing parody in its grotesque chiseling." In addition to its inherent defects, the artwork was donated "on the condition that the University use it solely for educational purposes and not sell or otherwise dispose of the gifted sculpture for a period of 2 years from receipt."

[68] Willing, *Family to Get Back Art Taken in WWII*, USA Today (February 20, 2006) available at http://www.usatoday.com/news/nation/2006-02-20-klimt-holocaust_x.htm?POE=NEWISVA (last accessed May 13, 2008). "Schoenberg, Altmann's attorney, says he valued the Klimts at $300 million after consulting several private galleries and museum officials in the USA and Europe. He says the paintings were appraised in the late 1990s at $110 million to $160 million. Publicity produced by Altmann's lawsuit helped drive up the value, Schoenberg says dealers told him."

Update: An Austrian museum has elected to return another Klimt masterpiece to the grandson of its original owner. The painting was confiscated from Amalie Redlich when she was deported by the Nazis in October 1941 and murdered. It is estimated to be worth $29.2 – 43.8 million. Shields, *Austrian Nazi victim's heir to get Klimt painting*, Reuters as reported by Yahoo! News (April 21, 2011) available at http://news.yahoo.com/s/nm/20110421/stage_nm/us_finearts_austria_klimt (last accessed May 11, 2011).

[69] McDowell, Portrait of a Bull Market—What the latest record-setting prices say about the health of the U.S. economy, *TIME* (November 20, 2006), 64.

art have been acquired in this manner.[70] However, changes in the Code now require that the museum must take complete possession within 10 years and limits the donor's deduction the value of the item at the time of its original donation, not its appreciated value regardless of the timing of ownership transfer.

6. Lack of Predictability

When the artist asked the gallery owner if there was any interest in his paintings currently on display, the owner replied, " I have good and bad news: The good news is that one gentleman was asking about your work and whether it would appreciate after your death. When I told him it would, he bought all 15 of your paintings!"

The artist was thrilled and then asked for the bad news.

"That buyer was your doctor…"

While price inflation is usually welcomed by an art collector, dramatic valuation increases may in fact create problems with which the average Joe would hardly sympathize. A dramatic example of one man's estate plan gone awry illustrates the problem: This taxpayer with a net worth of roughly $15 million including two sculptures which were valued at $5 million when the estate plan was originally drafted, anticipated that his estate would be subject to an estate tax of $4.5 million. He planned to meet the tax obligation with the proceeds of a life insurance policy. But then the sculptor died and the value of the taxpayer's two-piece collection soared to about $32 million! The anticipated estate tax sky-rocketed to about $12 million; an amount no longer able to be covered by the insurance policy or even all of the remaining assets in the estate.[71]

Most of us might wish to have this man's troubles! But for this collector who wishes to own the artwork and control its future ownership, options may be limited. This man is emotionally, as well as financially invested in his collection. Yet, the market remains fickle and may soon rob the collector of his newfound wealth.

THE SPECIAL NATURE OF THE ART MARKET:

- It is secret, illiquid, lacking in comps, not fungible, inimitable and volatile
- Threatened by forgeries, misattribution and scandals
- IRS valuation is based on an auction market unavailable to the public
- Valuations may be severely depressed by block sales or irrationally raised by publicity and notoriety
- Donations of fractional ownership complicates valuation
- The art market is driven by emotion and other unpredictable elements

B. Tax Avoidance Schemes

Valuation issues are central to certain art-related schemes intended to defraud parties to the transaction or cheat the government out of taxes that should be paid.[72] One such machination is known as art-flipping whereby a taxpayer buys a work of art at a low price from a promoter and then donates his acquisition to charity at an inflated value

[70] See *id.* at 65.

[71] Erskine, The Collector's Dilemma—When the value of a client's collection takes off, the result can be bad news for the estate plan, *Financial Planning* (September 2010), 59.

[72] It is estimated that roughly 100,000 taxpayers reap the benefits of $1 million in tax write-offs each year due to art donations, but more than one-half of the donations verified by the IRS have been "appraised at nearly double their value." In 2004, for example, the IRS audited only seven (!) returns with donated art, but found that more than one-third of the 184 objects claimed were over-valued by "three times their true net worth." Felch & Smith, *Inflated art appraisals cost U.S. government untold millions*, Los Angeles Time (March 2, 2008).

established by the promoter, thereby garnering a tax deduction greater than his original expenditure.[73]

In a recent plea agreement, Texas art collector Edward Stanton admitted to a sale-donation scheme involving paintings by Mexican folk artist Chucho Reyes. Stanton originally bought the artist's entire collection of 1,500 works for about $750/piece. Nine years later—after allowing for "inflation" although no comparable sales occurred in the interim—the collector sold some of the paintings to buyers with the suggestion that they could garner large tax deductions if they donated the items to charity. Stanton helpfully recommended a charity and even provided appraisals valuing each painting at $23,000. He then repurchased the works from the charity for $1,000, re-titled them, and sold them once more to unsuspecting clients; this time, for $4,500![74]

While these schemes abound and are even investigated, few are ever prosecuted. From 1973 to 1985, the world-famous Getty Museum accepted donations of Greek and Roman antiquities from a network of wealthy "collectors," who often never saw—much less owned—the objects that they gave. Instead, the Getty's curator Jiri Frel imported recently excavated objects into the U.S., inflated their values in forged appraisals, and asked that high net worth individuals lend their names to the charitable donations in exchange for large tax write-offs. By the time the IRS began its inquiry in 1987, Frel was on paid leave in Europe. And when Frel finally passed away in 2006, the IRS still had not prosecuted any one in the case.[75]

When exposed, the museums invariably pledge to tighten their procedures for accepting donations and ensuring that they are properly valued, but little is accomplished. Gems donated to the Smithsonian Institution were found by the IRS to have been appraised at five times their true value. Museum officials made the usual promises but five years later, they accepted four Stradivari instruments appraised at $50 million even though they had been valued at only one-tenth of that amount a decade earlier.

Various state tax agencies are hot on the trail of other delinquent taxpayers who have avoided payment of sales or use taxes on out-of-state purchases of artwork. "The poster boy of art-related tax avoidance is former Tyco International President Dennis Kozlowski. He was charged with deliberately avoiding paying tax by shipping art purchases out of state and then quietly moving them back to his Fifth Avenue apartment." [76]

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[73] *Art-donation Schemes or 'Art Flipping'* (November 2002) available at http://www.professionalreferrals.ca/TMG/_article_PDF/article_589.pdf (last accessed May 13, 2008).

For example, Robert Olsen was recently accused by IRS investigators of selling $6,000 worth of artifacts (Thai antiquities) to an undercover agent which his appraiser later valued at $18,775. Amazingly, the inflated valuation would have yielded a tax benefit of only $6,500 to a taxpayer in the highest marginal bracket—just $500 more than the cost of the art!

[74] Release No. 11-049, *Art Collector Agrees to Plead Guilty in Tax Scheme Involving Inflated Appraisals for Charitable Gifts*, The United States Attorney's Office Central District of California (April 5, 2011).

[75] When the publisher of theeaesthetic.com learned that the former chief of The Getty Trust misappropriated funds to purchase a $72,000 Porsche, he suggested that the following works of art should be added to The Getty's collection: "Money to Burn (Dubriel, 1893), "Oh, Tax 'em by all means!" (Keene, 1888), "'Thou shalt not steal'" (Sargent, 1918), "The Ship of Fools" (Bosch, 1510), and "Pity" (Blake, 1795). *In Getty We Trust*, West Magazine (March 5, 2006).

[76] Hackett, *State's Tax Collector on Trail Of Art Collectors—Millions at Stake as 'Least-Known' Levy Often Goes Unpaid*, Seattle Post (December 15, 2004), available at http://seattlepi.nwsource.com/visualart/203778_arttax15.html?dpfrom=thead (last accessed May 13, 2008).

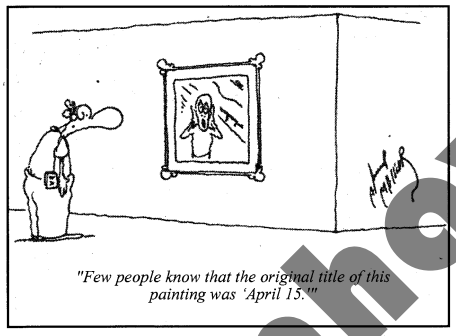
THE ART WORLD IS PLAGUED BY:

- Art-flipping = Buying artwork at a low price and donating it for an inflated value
- Minimal prosecution attempts
- Repeat offenders

VI. CONCLUSION

Charitable donations—especially donations of artwork—are encouraged as a matter of public policy to benefit those cash-poor institutions that might not otherwise be able to amass a worthy collection for display and educational purposes.[77] To reward taxpayers for their philanthropy, the Code grants a contribution deduction against gross income, thereby reducing tax liabilities by the applicable percentage of the marginal tax rate. Thus, an individual in the highest tax bracket—currently 35%—will save $35 in tax for every $100 of value contributed to charity.

But some oppose this below-the-line deduction on the grounds that it benefits high-income individuals most since low-income individuals typically do not have sufficient qualified expenses to itemize. Even if they did, their deductions would yield far less since they are in the lowest federal tax brackets. Thus, current rules benefit the wealthy; precisely those who can best afford to be charitable and should in fact make contributions irrespective of the tax savings afforded to them.



In fact, these individuals might well make contributions for non-philanthropic reasons, only to acquire fame and recognition with the help of government subsidies. And yet, the government loses control of its discretionary spending since the contribution deduction gives individual taxpayers the power to direct funding toward privately selected beneficiaries rather than allowing for Congressional allocation of the federal budget.

For practical purposes, the success of the contribution deduction hinges on proper valuation—a source of continuous disagreement between taxpayers and the IRS. Arguing in favor of amendments to the current rules, Ellen Aprill finds that "inaccurate reporting of charitable contribution deductions is a continuing and, in the aggregate, a significant problem for the tax system."[78] Problems range from a failure to recognize generally accepted valuation practices to a lack of competency requirements for qualified appraisers and IRS employees. "In the absence of recognized appraisal methodology and appraiser competency and training requirements, with no systematic monitoring, review and analysis of appraised values, it is a virtual impossibility that the right to tax uniformity guaranteed by the Constitution is being upheld by IRS."[79]

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[77] More than 80% of museum acquisitions result from donations. Felch & Smith, *Id.*

[78] Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, Boston College Law School Student Publications, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890386 (last accessed May 13, 2008).

[79] McErlean, *Report to the Treasury Inspector General for Tax Administration: IRS Violations of Taxpayers' Constitutional Right to Uniformity in the Assessment of Taxes Based on Appraised Values* (April 20, 1999), contact Matt McErlean at mcerlean@home.com to request a copy.

APPENDIX A
Substantiation Requirements for Charitable Contribution Deductions[80]

Charitable Contribution Substantiation Information Required		
Amount	**Documentation**	**Substantiation**
Cash donations of less than $250	Bank record	Includes canceled check; bank, credit union, or credit card statement showing name; and transaction posting date (credit card)
	Written communication from charity	Name of charity, date, and amount of contribution
	Payroll deduction	Pledge card and pay stub, W-2 wage statement, or other document furnished by employer, including total amount withheld for charity
Cash donations of $250 or more	Written acknowledgment from the charity for each donation	Name of charity, date, amount paid, description, and estimate of value of goods or services provided by the charity
Noncash contributions of less than $250	Receipt from donee or reliable records	
Property donations greater than $250 and not more than $500	Contemporaneous written acknowledgment	Name of charity, date, amount paid, and description (but not value) of goods or services provided by the charity
Property donations greater than $500 and not more than $5,000	Written acknowledgement	All of the above, plus: • How you got the property; • Date you got the property; and • Cost or other basis. Must file Form 8283, Noncash Charitable Contributions
Donations of $5,000 or more excluding stock, certain works of art, and autos	Qualified appraisal	Attach appraisal to return and complete page 2 of Form 8283
Donations of art valued at $20,000 or more	Signed appraisal and photograph	Attach signed appraisal to return and provide photograph of sufficient quality and size to fully show object if requested by the IRS
Stock of publicly traded corporation	No appraisal required if as of date of the contribution market quotations are readily available on an established securities market	Attach Form 8283 to return
Nonpublicly traded stock	Contributions greater than $5,000 and less than or equal to $10,000	A partially completed appraisal summary; complete Form 8283, Part I
	Contributions greater than $10,000	Attach qualified appraisal to return
Vehicle, boat, and airplane with value of more than $500	Value is the lesser of the gross sales proceeds or the FMV of the vehicle if no "significant use or material improvement"	Taxpayer needs contemporaneous written acknowledgement from donee organization; donee organization must use Form 1098-C to report value of vehicle donations, if vehicle is sold; this can be used to provide acknowledgement to the donor
Note: These rules apply to individuals making qualified contributions to IRC §501(c)(3) organizations. Additional rules apply when gifting a partial or restricted interest, gifts via trusts, and gifts with remainder interest.		

[80] *2012/2013 Fall Federal and California Tax Update Seminar, © 2012 Spidell Publishing, Inc.*

APPENDIX B
IRS Top 10 Valuation Red Flags[81]

1. Substantial grammatical errors
2. Use of a value definition other than Fair Market Value from IRR 59-60
3. Nom-cash donation appraisals past 60 days
4. Non-conformity to "Generally Accepted Appraisal Standards"
5. Use of Tax Court case law in support of a conclusion
6. Failure to prove highest and best use of the property as-vacant or as-unimproved
7. Extraordinary assumption invoked on the entitlement (Legal Permissibility) status of the property
8. Minimal support for physical possibility and financial feasibility
9. Discount rates that are inclusive of profit
10. Abnormally large minority interest discounts

[81] Garfield & O'Neall, *Property Valuations for Estate Tax Purposes and Related Property Tax Valuation Issues*, The Los Angeles County Bar Association Tax Practitioners' Conference, May 7, 2013.