Tax-*on* Pollack: Deconstructing the Charitable Deduction for Fractional Gifts of Art

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I. Introduction

Some of the most important pieces in American museum collections have been donated via fractional gifts. By donating a work of art using the fractional gift method, donors are giving museums a route to collect works that are vastly out of their price range and simultaneously giving the community a new work of art to visit at their favorite museum. Before 2006, fractional gifts were a popular tax planning vehicle that provided art collector donors with the incentive and means to make large donations of art to museums. These donations were an advantageous method of getting a charitable deduction and ensuring that artwork ends up in the hands of the public, by becoming part of a museum's permanent collection. The Walter H. Anneberg collection of Impressionist and Post-Impressionist paintings, drawings, and watercolors was donated to the Metropolitan Museum of Art using the fractional gift method. This collection was valued at $1 billion dollars at the time of announcement, and continued to increase in value with subsequent donations.[1] Thanks to the fractional gift by Mr. Anneburg in the early 1990's, the Met now owns more than 50 works by Monet, Manet, Degas, Renoir, Van Gogh, Gaugin, Cezanne, Matisse, and Braque. The twin objectives of this paper are to examine the checkered history of tax consequences affiliated with fractional giving and discuss the most effective methods of making gifts of art to museums in 2018 under the new tax plan.

a. Why do we give? Why do we deduct?

The benefits of making a charitable contribution are twofold. A charitable contribution can both create direct change within a community and, if correctly structured, decrease a taxpayer's tax liability. Museums and non-profits rely on a variety of sources for funding, and a portion of that funding comes from private donors. Donor-art collectors who share their collections create legacies and can qualify for deductions to their tax liability. [2]

By making charitable donations, individuals support the public good by indirectly funding services that would generally be furthered by the public. Section 170 of the Internal Revenue Code

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[1] John Russell, *Annenberg Picks Met for $1 Billion Gift* , Jan. 26, 1991, NY TIMES, *available at* https://www.nytimes.com/1991/03/12/arts/annenberg-picks-met-for-1-billion-gift.html.

[2] MFA Boston receives two collections of 17th century Dutch and Flemish art, including 2 Rembrandts! "Eijk and I couldn't be happier that our collection will find a home at the MFA, where it can be displayed, loaned and shared with the widest possible audiences," said Rose-Marie van Otterloo." Peter Libbey, *The Museum of Fine Arts, Boston to Receive Two Major Donations*, NY TIMES, Oct. 11, 2017, *available at* https://www.nytimes.com/2017/10/11/arts/the-museum-of-fine-arts-boston-to-receive-two-major-donations.html.

was enacted in pursuit of this goal[3] by permitting an individual or corporate taxpayer to deduct charitable contributions from their gross adjusted income.[4] The amount deducted is limited to sixty percent of the taxpayer's contribution base[5], however. Though the tax code caps how much a taxpayer can deduct annually, a taxpayer may carry over the remainder of his donation for each or the succeeding 5 years when the charitable deduction exceeds the taxpayer's adjusted gross income.[6]

b. What is Fractional Giving?

For many years, fractional giving was a practical recourse for a donor who wanted to donate a work of art while still retaining its possession for part of the year. Fractional giving occurs when a donor transfers an undivided fractional interest in a piece of property to a donee.[7] For example, a collector may make a gift to Museum of Art of a ¼ interest in his Manet. For three months, the Manet belongs to the Museum, and for nine months the Manet belongs to the donor. Our donor may not take back his ¼ interest the next year, although he may choose to give another piece of his ownership interest to the Museum at a later date, increasing the Museum's share. Under the old tax laws, the donor was entitled to a charitable deduction on his income taxes for each portion of ownership interest transferred to the museum.[8]

The Internal Revenue Code prohibits charitable deductions for certain types of gifts. Under I.R.C. §170(a)(3) and §170(f), transfers of future interests in property are not entitled to a charitable deduction until they are actually made.[9] The practical effect of these provisions require that no income, gift, or charitable deduction can be made until the property is transferred to the donee. Therefore, to qualify for a charitable deduction, the portion of the property being given to the donee must be a present, absolute right to use and possess and cannot be a remainder interest in the property. At this time, the code did not account for fractional gifts because the donee immediately had a right to possess the property, even though the property was not in the donee's actual *physical* possession.[10]

When the donor of a fractional interest of a piece of property dies, the ownership interest that still belonged to him is includable in his estate.[11] Generally, before a museum accepts a fractional

[3] In *Bob Jones University*, the Court articulated why the legislature permits charitable deductions stating that "The exemption from taxation of money and property devoted to charitable and other purposes is based on the theory that the Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds, and by the benefits resulting from the promotion of the general welfare.", Ipso facto—you give to the community, the government rewards you for doing its job. *Bob Jones University v. U.S.* 461 U.S. 574 (1983).
[4] Samuel G. Wieczorek, *Winkour, Lose, or Draw: Art Collectors Lose an Important Tax Break*, 8 HOUS. BUS. & TAX L.J. 90, 97 (2007).
[5] A taxpayer's contribution base is defined by the tax code as the taxpayer's gross adjusted income, minus any net operating losses carryover for the year. I.R.C. § 170(b)(1)(H).
[6] Reg. §1.170A-10.
[7] Emily J. Follas, Note, *"It Belongs in a Museum": Appropriate Donor Incentives for Fractional Gifts of Art*, 83 NOTRE DAME L. REV. 1779, 1781 (2008).
[8] Id at 1782.
[9] I.R.C. §170(a)(3), (f).
[10] *Winkour v. Comm'r*, 90 T.C. 733 (1988).
[11] The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death. I.R.C. §2033.

gift of art, they want to make sure that upon the donor's death, the museum will be entitled to the remaining ownership interest in the artwork.[12] This contract is negotiated by lawyers and accountants on both the donor and the donee museum side. Generally, a binding agreement will be established, stating that the art work will be donated to the donee museum in full (at some fixed point in time). Museums have always been hesitant to accept fractional gifts of art without some kind of guarantee that the donor will eventually transfer the entirety of his interest to the museum. Under the previous tax laws, if a bequest was made to a museum that already had an ownership interest, the percentage of the interest owned would be deducted from the estate tax, and subsequently multiplied by the fair market value of the art on the donor's date of death.[13] Without contractual assurance that the museum would gain control of the art work at a later date, the museum would likely not pursue possession because of the high potential for litigation against the decedent's over the interest in the property.

In 1993, the IRS issued Private Letter Ruling 9303007, stating that when a promise to transfer property in the future is made, the gift tax consequences are judged at the time the transfer is actually made.[14] Because the '93 private letter ruling did not put a cap on deduction by limiting the art work's fair market value at the time of the promise, donors could increase their deductions as the art work increased in value over time.[15]

II. Background: Legislative History

a. The *Winokur* Case Creates a Tax Loophole

Fractional giving reached a peak in popularity after a landmark tax case, *Winokur v. Commissioner*, was decided in 1988.[16] In 1977, James Winokur donated a 10 percent interest in 44 works of art to Pittsburgh Carnegie Institute. Winokur took a charitable deduction for his contribution and the Carnegie Institute did *not* take physical possession of the gifts of art that year.[17] The next year, Winokur did the same, taking a deduction despite the museum never gaining control over the artworks.[18] For every year that Winokur donated an interest, he took a deduction, and the Carnegie Institute didn't collect his artwork. Essentially, Winokur was receiving a charitable deduction for donating his art and hanging it in his own home.[19] The Internal Revenue Service soon took notice, eventually suing Winokur. The IRS claimed that because the Carnegie Institute never took possession of the artworks, the fractional interests had to be characterized as future interests and were therefore nondeductible.[20] The tax court ruled in favor of Winokur, agreeing with his argument that since the Carnegie Institute had the power to possess the artwork and a right to use the property, whether or not the Institute exercised that right, it was immaterial to a determination of Winokur's possible deduction.[21] The tax court reasoned that because the tax

[12] I.R.S. P.L.R. 9303007 (Jan. 22, 1993).
[13] I.R.S. P.L.R. 200223013 (June 7, 2002).
[14] I.R.S. P.L.R. 9303007 (Jan. 22, 1993).
[15] *Id*.
[16] *Winkour* at 733.
[17] *Id.*
[18] *Id.*
[19] *Id*.
[20] *Id*.
[21] *Id*.

code was absent any language *disallowing* a charitable deduction, the legislature did not intend to forbid a charitable deduction when a charity failed to take ownership of a piece of property.[22] Following the *Winokur* decision, a powerful estate planning tool came into the fore for many art collectors who desired to take advantage of the charitable deduction.

By making a fractional donation of a piece of work, a collector could retain part-time possession of his art and create custom donations to offset his tax liability under *Winokur*. By not giving the entire artwork as an outright gift, the collector was entitled to a deduction based on the art work's fair market value and *not* his cost basis in the work.[23] Another benefit to the fractional giving method is that each time a donor contributes a portion of their artwork to an institution, the work gets reappraised.[24] If the artwork increases in value since its last donation, the donor is entitled to a larger deduction proportionate to the increase in value. Additionally, when the entire artwork is donated, the collector is able to avoid the tax on capital gains he otherwise would have owed.[25]

Museums were also excited by the prospects of fractional gifts after *Winokur*. Since institutions are hesitant to pay the costs and insurance affiliated with storing, transporting, and installing works yearly, *Winokur* meant that over a period of time, without actually having to take physical possession of works, museums could expand their collections without some of the affiliated costs. The fractional giving scheme under *Winokur* encouraged donors, who would otherwise bequeath such artworks to family, to give their artwork to the public to enjoy.

The *Winokur* decision quickly made fractional giving a popular tool proffered to collectors by tax advisors and planned giving directors from museums across the country. This did not result in large numbers of fractional gifts of art outright, but it did provide museums and donors a new tool to contribute significant gifts. The Walker Art Center in Minneapolis houses a collection of almost 10,000 works of art, and according to museum officials, only 23 of these art works were made through a fractional gift.[26] However, the artworks acquired by fractional gifts are some of the largest and most important the museum.[27] Fractional giving under *Winokur* provided a mechanism by which donors were able to give away some of their most valuable artwork and take full

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[22] *Id*.

[23] An outright gift entitles a taxpayer to a charitable deduction equal to the taxpayer's full fair market value as determined by a qualified appraiser. Reg. §1.170A-13. The amount of the deduction that the taxpayer can take in the year of the gift is 30 percent of his adjusted gross income in the year that the gift is made. *Id*. The donor will then be able to deduct the residual deduction at a rate of 30 percent of his adjusted gross income for up to five years. *Id*.

[24] Wieczorek *supra* note 1 at 97.

[25] *Id*.

[26] Stephanie Strom, *The Man Museums Love to Hate*, NY TIMES, Dec. 10, 2006, *available at* https://www.nytimes.com/2006/12/10/arts/design/10stro.html.

[27] Ellsworth Kelly's *Gate*, now wholly in the Walker's possession was originally donated as a fractional gift by the collector Kate Butler Peterson. Gate is aluminum shaped into an "X" in orange with slight bend in center. It is one of Kelly's earliest sculptures and one of his first painted sculptures. Installed, it stands 63 x 63 x 17 inches and was completed in 1959. *Gate by Ellsworh Kelly*, WALKER ART MUSEUM, *available at* https://walkerart.org/collections/artworks/gate.

advantage of the value of their charitable deductions. Additionally, museums were able to acquire pieces they never could have afforded to purchase on their own.

b. Tax Abuse and the Legislative Response

With *Winokur* provided the opportunity for donors to maximize their charitable deductions while still maintaining possession of their art works, the potential for tax abuse ripened. Museums and tax planners were recommending fractional gifts as a way to avoid the capital gains tax associated with highly appreciated artwork while keeping the work in the possession of the donors. With its growing popularity, legislators began to consider the unfairness of fractional giving's tax consequences. While museums were collecting new works that would come into their possession in the coming years, *Winokur* essentially created a tax loophole that managed to give wealthy collectors the opportunity to slowly give away their art while both retaining its possession and reducing tax liability.

The system of fractional giving in the *Winokur* era created a tax loophole that benefitted the taxpayer donors, allowing them to take enormous charitable donations while retaining the artwork in their collections. In reaction to public criticism, Congress enacted the Pension Protection Act. The act's goal was to allow the public to view the artwork that it essentially paid for with tax deductions provided by making fractional gifts.[28]

III. Discussion: Closing the Loophole, Enactment of the Pension Protection Act (PPA) of 2006

The enactment of the PPA solved the tax loophole problems that were created by the *Winokur* case by (1) creating qualified property limitations; (2) enacting aggressive recapture provisions; (3) implementing a new valuation model for subsequent gifts. However, the PPA also creates a whole slew of new problems for collector donors and donee museums. The tools used to close the tax loophole have additional repercussions, including a mismatch estate and gift tax issue.[29] Instead of simply reducing or limiting the unfairness of giving a charitable deduction for keeping assets in your house, donor advocates argue that the PPA essentially strips fractional gifts of all tax incentive and thus removes them as a viable option for making a fractional gift.[30]

a. Qualified Property Limitations

The PPA limits what property is eligible for a charitable deduction and creates a pre-contribution ownership requirement. Under the Pre-PPA rules, a donor could be eligible for a tax

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[28] Senator Grassley, the PPA's pioneering champion on fractional gifts of art: "it isn't right for a donor to get a big tax break for supposedly donating a painting that hangs in his living room, not a museum, all year. A painting in a private living room doesn't benefit the public." Grassley has stated that the possibility of donating fractional interests in art can lead to significant tax abuse. Strom *supra* note 26, at 2.

[29] Glenn D. Lowry, director of the Museum of Modern Art in New York, said the new rules remove many of the incentives for fractional giving, making the practice "almost impossible to use and the issue for us is simply that as these regulations have been tightened, it also affects the ability of donors to make gifts." Strom, *supra* note 27.

[30] Carnegie Museum of Art trustee James H. Rich made a fractional gift of Peter Doig's 2004 painting *Red Boat (Imaginary Boys)* to the museum in late 2005. However, after the enactment of the PPA in 2006, Rich decided to buy back his 10 percent fractional interest in the painting from the Carnegie Museum in 2007, for $150,000, regaining full ownership. Rich consigned the painting to Christie's, where it sold for $9,897,195. Daniel Grant, *To Give and Give Not,* Oct. 30, 2011, THE HUFFPOST: THE BLOG, *available at* https://www.huffingtonpost.com/daniel-grant/to-give-and-give-not_b_941606.html.

benefit whenever the museum was given a right to enjoy a fractional percentage of the work.[31]After the PPA was enacted, section 170(o)(1)(a) of the Internal Revenue Code, states a charitable deduction is only permitted if either the taxpayer (a) owns the property that he wishes to donate outright or (b) the only owners at the time of the contribution are the donor and the charitable donee.[32] The PPA proposes an exception to this strict rule, allowing the Treasury to issue regulations that allow a deduction for property held by multiple owners so long as all owners give proportionate shares of their interest at the same time.[33] Accordingly, if two people own a work of art jointly and only one of them wants to give away a portion of their interest, that person is not entitled to a deduction for that contribution. However, no such regulations have been issued, and therefore the strict rule stands.

Though museums were initially concerned about the new qualified property limitations for fractional gifts, this section of the PPA subsequently had a positive impact on museum donees. Under the new laws, the cooperation requirement ultimately has enabled museums to easily gain access to works that were already partially owned, while simultaneously reducing the number of claims on any given piece of property, furthering a museum's ability to take full possession without spending valuable non-profit resources on litigation.

b. Recapture Provisions and the Risk of an Additional 10% Penalty

Another change in the fractional giving provisions permits the IRS to recapture a donor's tax benefits under limited circumstances. A recapture procedure is when the IRS essentially takes back a previously claimed deduction and requires income tax be paid on that amount. When a taxpayer's deduction is recaptured, the taxpayer must pay interest on the recapture amount, in addition to a 10 percent recapture penalty applied by the PPA.[34] There are three circumstances in which a failed gift can result in recapture and additional penalty, (1) when the gift fails; (2) when the donee museum fails to take actual physical possession; and (3) when the gift fails to meet the related use requirement for charitable donations.

First, penalties may be enforced when a makes a failed gift. A failed gift happens when the donor is unable to give the entire gift within the statutorily specified time period or at the death of the donor.[35] Before the PPA's enactment, donors were not required to complete their donation within a specified period of time.[36] Most commonly, gifts were completed at the time of death, when the museum would take ownership of the work of art according to a general bequest agreement. However, after the PPA, a donor must deplete his entire interest in a work of art "before the earlier of" the date 10 years from the first fractional contribution or the date of the donor's death.[37] In other words, if you gave a museum an initial contribution of a one-fourth percent interest in a work of art, from the first donation, a donor has 10 years to completely give the gift to the donee museum. If a donor fails to do so, or if the donor dies before completing the transfer

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[31] *Winokur* at 733.
[32] I.R.C. 170(o)(a).
[33] Pension Protection Act §1218 (2006).
[34] *Charitable Deductions*, I.R.S. Pub. No. 526, Cat. No. 15050A, 9 (March 12, 2018)., https://www.irs.gov/pub/irs-pdf/p526.pdf.
[35] *Id*.
[36] *See* Carolyn C. Clark & Jay W. Swanson, *Promised Gifts to Museums: Monet in the Bank?*, 6 Prob. & Prop.12, 15-16 (1992).
[37] *Charitable Deductions*, I.R.S. Pub. No. 526, Cat. No. 15050A, 9 (March 12, 2018)., https://www.irs.gov/pub/irs-pdf/p526.pdf.

of full ownership to the museum, all deductions that donor ever took for the fractional interests that given to the museum would be recaptured. The retroactive loss of the deductions previously taken, would suddenly incur substantial tax liability in the amount of extra tax for the years in which the deductions were taken, plus added interest and a ten percent penalty.

The timing limitations imposed by the PPA have some negative implications. These limitations may make donors hesitant in donating their entire collections to museums because they will be forced to part with all their artworks within 10 years of making the first gift. Though fewer problems arise when a donor makes an individual gift of art, making a significant gift becomes more precarious because a collector will be forced to give away her entire collection before death if she wants to take an immediate deduction for a fractional interest. Additionally, a younger collector may be more hesitant to donate art work under the PPA because their interest needs to be donated within 10 years. A younger donor may want to donate a fractional interest in their work, but refrain in fear of the recapture provisions coupled with a desire to hang onto their artwork. However, with careful planning this recapture penalty can be avoided. If a donor's fractional interest contract with the museum states that at death, the rest of the interest shall transfer to the museum, then the donor is in the clear and will not subject his estate to the recapture provisions.

The second situation in which both the recapture and penalty provisions will apply to a taxpayer taking a charitable deduction occurs when the donee museum fails to take actual, physical possession of the work.[38] This portion of the PPA essentially overturns the *Winokour* decision. *Winokour* permitted a taxpayer donor to take a deduction for a fractional interest in a piece of property, regardless of whether the donee museum actually took physical possession of the property.[39] The PPA now requires the donee institution to take *substantial* possession of the property; otherwise, the donor is subject to the recapture provisions (plus interest), coupled with the 10 percent penalty. The *substantial* possession requirement necessitates donee museums to take reasonable possession that complies with IRC 170's purpose. This provision has been the subject of adverse commentary by donor advocates because the provision requires the museum to take action, but punishes the donor for the donee organization's inaction. However, this contention has little merit. The *substantial* possession requirement may create issues for museums in actually collecting the artworks.[40] This provision can be especially vexing for donors who have already donated large portions of their fractional interest, because if the donee museum fails to take possession, then the donor will lose all the tax benefits of previous donations, subject to income tax plus the 10 percent penalty.

The third instance where the PPA's recapture and penalty provision occurs when the property does not satisfy the related use requirement laid out by IRC 170(e)(1)(B)(i)[41]. In other words, the

[38] *Id.*

[39] *Id.*

[40] "Requiring works to go back and forth, as has been suggested in the Senate, would be risky to very delicate works of art and completely impractical for works such as a big Richard Serra outdoor sculpture," Stephen Clark, counsel to New York's Museum of Modern Art (MoMA) points out. "Works would have to be crated and shipped; it would be an administrative burden, and then we would in all likelihood just put the works in storage, for the interim anyway." Grant, *supra* note 30.

[41] Where the use of tangible personal property is *related* to the tax-exempt purposes of the donee organization, a donor is allowed a fair market value deduction for the contribution of that property, the deduction is available to the extent of 30% of the donor's contribution base. 26 U.S.C. §170(e)(1)(B)(i). However, if the property is considered *unrelated* to the public charity's exempt

donor can incur the recapture provision and associated penalties even when the donee institution takes actual possession of the property. The statutes use of "and" requires the donee take both physical possession *and* that require the property satisfy the related use requirement from IRC 170. The related use provision requires that the donee organization use the property in a use which is related to the purpose or function constitution the organization's exemption under 501. Simply put, if a donor is giving a work of art to a charitable donee museum, the museum must use the art work in pursuit of its charitable purpose (e.g. providing educational museum services to the community). Failure to meet either prong results in the recapture of the deduction and the taxpayer must additionally pay the penalty. There have been no issues arising out of this requirement yet nor regulations issued clarifying what kind of use a donee museum must meet to satisfy the requirement. Donors will be hesitant to make gifts if the donee museum will be unable to show their art piece during the museum's custody of the work. It will also be difficult for donee museums to organize space for fractionally donated artworks to be on display when their custody begins. If there were some kind of regulation stating that museums were free to keep the artwork in storage during the museum's custody, donor's and museums might feel more comfortable donating fractional interests without fearing recapture resulting from failure to meet the related use requirement. However, if such regulation were to be issued it would exist contra to the example set by the overruling of *Winokur* by the PPA, because even though the donee museum was in possession, the public was still being denied its right to view the artwork.

c. Valuation of Subsequent Gifts

Before the enactment of the PPA, a donor whose art appreciated between subsequent partial deductions was able to increase his charitable deduction proportionally. The donor was entitled to a deduction that was proportionate with the fair market value of his gift at the time the gift was made.[42] For example, if a donor gave a 25% interest in his painting worth $100,000.00, the donor would be entitled to a deduction of $25,000.00 in the year the gift is made. If the donor's painting had increased in value four years later to $1,000,000.00. Further if the donor gave away an additional fractional interest of 25%, that deduction would be equal to the fair market value of the gift valued at $1,000,000 (not $100,000).

The PPA eliminated this advantage and imposed a new rule. Under the current laws, when a donor makes a fractional gift of art, the fair market value of the gift will either be (A) the fair market value at the time of the initial gift or (B) the fair market value of the property at the time of the additional contribution.[43] The post-PPA change in laws presents a double-edged sword for donors. On one hand, if the work in question appreciates, the donor will not be entitled to a greater

purpose, the deduction and is available to the extent of 50% of donor's contribution base is based on the lesser of its fair market value and its cost basis.

[42] I.R.C. §§ 170, 2055, 2522 (2005).

[43] I.R.C. § 2522(e)(1)(a).

deduction. On the other hand, if the art work depreciates, the donor will see a reduced benefit in making a charitable deduction.[44]

d. Estate and Gift Tax Issues: The Mismatch Problem

The PPA created what is known as a "mismatch problem," which occurs when a donor incurs estate or gift tax liability despite fully donating the item to a charity. This happened as a result of the PPA freezing the fair market value of the charitable deduction at the time of the first donation. 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. Therefore, because the PPA freezes the valuation of a fractional donation of art at the time of the first donation, there may be a mismatch in value between the artwork at the time of the first donation and its value upon his death if a donor dies before fully completing his gift. This creates an excess value in his estate, even though the collector no longer owns the artwork. This may result in donors incurring tax liability on the item, even though the art work was donated to a charitable organization. The mismatch problem results in a tax penalty for donor's who have complied with all of the PPA's formalities, but whose assets subsequently appreciate considerably.[45] Unless this problem was corrected it would be unwise for any taxpayer to donate a fractional interest in a work of art because of the potential that the work could increase in value and subject the donor to an additional tax burden.

IV. Post-PPA Resolutions

After the enactment of the PPA, donors and donee museums rallied to try to overturn some of the harsher provisions of the PPA. Legal scholars and legislators worked together to try to come up with creative solutions to minimize the effects of the PPA on gifts of fractional interests in works of art. The Promotion of Artistic Giving Act proposed several significant changes to the PPA including: (1) elimination of the donation time limit; (2) elimination of the negative treatment of subsequent gifts, and (3) strike the provision that created the mismatch in estate and gift taxes. While, PAGA never became law, the same year Congress passed the Tax Technical Corrections Act of 2007 which resolved the mismatch problem created by the PPA.

a. Promotion of Artistic Giving Act

The Promotion of Artistic Giving Act (PAGA), was proposed legislation that was introduced in 2007, but was never voted on. PAGA offered solutions to three of the major challenges the PPA introduced for donors making fractional gifts of arts. First, PAGA proposed an elimination of the 10-year time limit for donations. Alternatively, PAGA suggested the implementation of a recapture penalty for the deductions if the gift was not completed within nine months of the donor's death. If the timing limitations imposed by the PPA were removed, younger donors may have more incentive to make charitable gifts of art because they will not fear a recapture penalty for failing

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[44] "This discrepancy does not seem to promote any policy goal and produces a harsh result for individuals who are attempting to make charitable gifts. Not surprisingly, perhaps, donors have already informed us that because of this discrepancy, they will no longer make partial interest gifts. We therefore seek corrections that will eliminate this concern." Letter from James Cuno, President, Eloise W. Martin, Dir. & Julia E. Getzels, Exec Vice President, The Art Institute, to Charles E. Grassley, Chairman, Comm. On Fin., 45 (Oct. 31, 2006), *available at* https://www.gpo.gov/fdsys/pkg/CPRT-109WPRT31496/pdf/CPRT-109WPRT31496.pdf.

[45] Donald B. Marron, chairman and chief executive of Lightyear Capital and a major art collector, said that the mismatch provisions create a serious disparity. "Your children could find themselves in the position of having to pay tax on half a painting with a fair market value of $2 million that was valued at half that when you gave the other half away," Strom, *supra* note 29.

to complete donations within a 10-year period. The elimination of the timing limitation would also incentivize gifts of whole collections, because donors would be able to extend their gift periods and take advantage of the entirety of their charitable deduction (instead of having it limited by a percentage of their contribution base). Secondly, PAGA proposed eliminating the negative treatment of subsequent appreciated gifts. The Act proposed that the IRS Art Advisory Panel would examine fractional gifts with claimed deductions exceeding $1 million dollars. Supporters of the provision claimed that the additional oversight would still permit donors to take advantage of the fair market value of their gift, and keep the potential abuse at bay.[46] Though oversight from the IRS Art Advisory Panel would help combat major tax abuse, individuals who wanted to take advantage of the system would simply have claim a deduction of less than $1 million. Lastly, PAGA aimed to fix the mismatch problem caused.

b. Tax Technical Corrections Act of 2007

The Tax Technical Corrections Act of 2007 (TTCA) fixed the mismatch estate and gift tax issue created by the PPA. The PPA added a provision providing for special valuation of contributions of fractional interests in tangible personal property, under this rule consequences require the taxpayer to pay estate tax on a gift that was fully donated to a donee museum. The TTCA struck the special valuation rule for estate and gift tax purposes, eliminating the mismatch issue created by the PPA.[47]

V. The 2018 Tax Plan

The 2018 tax plan creates several changes that will likely have an effect on charitable donations of art to museums. The new tax plan alters the estate tax by raising the unified credit. The increase in the unified credit may disincentives donors from making gifts of art, because they will no longer have a tax advantage to relinquishing expensive assets. The plan also makes several changes to the income tax including: lowering corporate tax rates; increase of the standard deduction and decrease in the individual tax rate. Each of these changes may impact giving by reducing the tax advantages to individuals and corporations.

a. Estate Tax: Increase of the Individual's Unified Credit

The federal estate tax is a tax on the gross estate after an individual's death. The total amount due is calculated by adding up the fair market values of all the decedents assets (as of the date of death).[48] This amount is referred to as the gross estate.[49] Once the gross estate is calculated, credits and deductions are subsequently subtracted from the total, arriving at a taxpayer's taxable estate.[50] After the taxable estate is calculated, the value of lifetime gifts is added to this number and the adjusted for inflation.

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[46] Follas, *supra* note 7.
[47] Tax Technical Corrections Act §1218 (2007).
[48] The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated. I.R.C. §2031
[49] *Id*.
[50] I.R.C.§§ 2001(c), 2010, 2012–2014

If the taxable estate balance after deductions is over a statutorily defined threshold (e.g. the unified credit amount), then the decedent's estate is required to pay the 40 percent estate tax on the excess amount over the unified credit.[51] While the 2017 exemption amount was around $5 million dollars, the unified credit has been raised to $11.2 million dollars in 2018. Though the number of estates actually subject to paying the estate tax was relatively few in 2017, the number of estates subject to the estate tax is likely to plunge further in 2018. [52] With the number of estates subject to the estate tax shrinking, fewer of the estates that would previously be hit by the estate tax will be likely to make a charitable gift of a work of art. By removing incentive to shrink estates to fit within the generous exemption amount, large estates that are no longer subject to the estate tax may choose to keep their artwork in the estate.

b. Income Tax: Lowering of Corporate Taxation Rates

Charitable giving by corporations is driven by different factors than donations by individuals. Because corporations are designed to make profits, charitable giving generally happens because the giving will decrease tax liability or increase market performance. In recent years, consumers have championed corporations who practice some kind of corporate responsibility. A staggering 42 percent of North American online consumers say they are willing to pay more for goods and services provided by companies who make an active commitment to positive social and environmental impacts.[53] Accordingly, corporations and corporate foundations donated over $18.6 billion in cash and in-kind goods and services to United States charities in 2016.[54] By making charitable donations, corporations not only decrease their tax liability, but increase their community support, garnering more positive feedback and resulting in profits.

Small businesses also claim charitable deductions. About 75 percent of small business owners claim to donate a portion of their profits to nonprofit organizations, donating about six percent of their profits to charitable organizations, on average.[55] Large corporations who make charitable donations or engage in tax-deductible community outreach can forge pathways for their business by attracting investors, building their brand, and connecting with customers. Companies that prioritize investing in their communities financially outperform those that do not.[56] An ongoing

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[51] For example, taxpayer dies and her estate is valued at 20 million dollars, the unified credit ($11.2 million) will be applied to taxpayer's estate leaving a residue of eight million eight hundred thousand dollars. A flat tax of 40% would be due on the amount *over* the unified credit amount, i.e. the $8,800,000.00.

[52] More than 3,000 Americans will be phased out of paying the estate tax next year, according to Congress's Joint Committee on Taxation, there will be a 64 percent reduction of estate-taxpayers from the 5,000 people who qualified to pay under the 2017 laws. Heather Long, *3,200 Wealthy Individuals Wouldn't Pay Estate Tax Next Year Under GOP Plan*, Nov. 5, 2017, THE WASH. POST, *available at* https://www.washingtonpost.com/news/wonk/wp/2017/11/05/3200-wealthy-individuals-wouldnt-pay-estate-tax-next-year-under-gop-plan/?utm_term=.98375fa3b085.

[53] Nielsen, *Global Consumers are Willing to Put Their Money Where Their Heart is When it Comes to Goods and Services from Companies Committed to Social Responsibility*, NIELSEN, June 17, 2014, http://www.nielsen.com/us/en/press-room/2014/global-consumers-are-willing-to-put-their-money-where-their-heart-is.html.

[54] Una Osili *What Influences American Giving?,* THE CONVERSATION, July 24, 2017, *available at* https://theconversation.com/what-influences-american-giving-78800.

[55] This statistic is based on a survey done by American express based on interviews with more than 750 company owners who have less than 100 employees. Caron Beesley, *Understanding the Charitable Giving Tax Deduction – What Can Your Small Business Write Off?*, Sept. 16, 2016, U.S. SMALL BUS. ASSOC., available at https://www.sba.gov/blogs/understanding-charitable-giving-tax-deduction-what-can-your-small-business-write.

[56] Daniel Brewster, *The Win-Win of Giving*, Oct. 23, 2014 RACONTEUR.NET *available at* https://www.raconteur.net/business/the-win-win-with-giving.

need for corporate responsibility coupled with the potential to decrease tax liability, provide entities with twin objectives when making charitable donations.

Lowering the corporate tax rate could change corporations' charitable giving habits. While the business advantages associated with positive social and environmental giving-back will remain, the tax incentives are being minimized. Under the 2017 tax rules, the top corporate tax rate was previously 35 percent for taxable incomes greater than $10 million dollars.[57] The 2018 tax plan simplifies corporate tax rates, reducing them to a flat rate of 21 percent.[58] Therefore, corporations will have less of a tax incentive to make donations simply because they are paying less taxes. An argument could also be made that entities will be more incentivized to further their public image, as opposed to making charitable donations, due to lower of corporate tax rates and a rising demand from the public for increased corporate responsibility.

c. Income Tax: Increase of the Individual Standard Deduction

The current tax code allows a taxpayer to itemize deductions for every tax dollar donated to an approved charitable organization.[59] The deduction, allowable only to those taxpayers who elect to itemize their deductions, is limited to 50 percent of the taxpayer's adjusted gross income, and for the amount that was over his limit, the taxpayer could carry-over and deduct in the following year.[60] In 2014, 30 percent of Americans took advantage of itemized deductions and chose to elect it over the standard deduction.[61]

The new tax bill has increased the standard deduction, which is advertised as double what it previously was. Under the former tax plan, taxpayers were entitled to a standard deduction of $6,350 for individuals and $12,700 for couples filing jointly.[62] For individuals, the standard deduction has risen to $12,000 and to $24,000, respectively.[63]

The increase in the standard deduction, coupled with the depletion of available deductions[64], will likely decrease the number of taxpayers who choose to itemize. Museums will not have to worry about losing potential gifts of art from these taxpayers, however, the annual and monthly

[57] Tax Cuts and Jobs Act, §115, *available at* https://www.congress.gov/bill/115th-congress/house-bill/1/text?format=txt.
[58] I.R.C. §11(a).
[59] I.R.C. §170.
[60] I.R.C. §170(b)(E)(ii).
[61] Chenxi Lu, *Itemized Deductions: Tax Debate 2017,* Jan. 17, 2017, TAX POLICY CENTER, available at http://www.taxpolicycenter.org/publications/itemized-deductions/full.
[62] I.R.C. §63(c)(2)(B)(7).
[63] *Id.*
[64] I.R.C. §151 permits a taxpayer to take a personal exemption amount. The amount is defined in the statute and is altered for inflation. (I.R.C. §151.) Under the previous tax laws, the personal exemption was afforded to every person if they were filing as an individual, and allows an additional exemption amount for the taxpayer's spouse if the taxpayer is filing jointly. (Id). In 2017, a taxpayer was permitted an exemption of $4,150 (but is phased out for taxpayers earning more than a statutorily defined threshold adjusted gross income. In 2017, Couples earning more than $313,800 would not be entitled to take a personal exemption on their income taxes if they were filing jointly. Married couples filing separately were phased out of the personal exemption at $156,900, and $261,500 for all other taxpayers. (President Signs Tax and Jobs Act, 128 J. TAX'N 4, 4, 2018 WL 672527, 1.) Under the 2018 tax law the standard deductions are almost doubled. The taxpayer may take an amount for every dependent who relies on the taxpayer. The 2018 tax plan phases out the personal exemption until 2025. (Id.)
While the standard deduction is being raised, the personal exemption is being eliminated. In previous years, a taxpayer would be able to elect both the standard deduction as well as the valuable personal exemption. (Id.) An individual taxpayer (earning less than $261,500) would be entitled to the standard deduction ($6,500) and would be allowed a personal exemption ($4,150) totaling, $10,650. Under the new tax plan, though the standard deduction is essentially being doubled ($12,000), taxpayers are losing their personal exemption ($0), reducing taxpayer's tax liability by $1,350.

monetary gifts made to the museum from these individuals will likely decrease. By increasing the standard deduction, less individuals will choose to itemize their deductions. The choice to take the standard deduction may, in turn, decrease the number of individual donors contributing gifts of cash (or services) to museums because more potential donors will be taking the standard deductions, as opposed to itemizing.

d. Decrease in Individual Tax Rates

Tax rates provide that based on amount of income that brought in by a taxpayer, the rate at which that individual may be taxed.[65] The new tax plan retains the seven-bracket system for determining tax rates. However, it has decreased the top tax rate from 39.6 percent to 37 percent.[66] This creates a significant decrease in tax liability for individuals earning in the top one percent of Americans. These individuals may be less likely to make charitable contributions because they no longer are not taxed at the 39.6% rate. However, the tax liability of wealthy Americans earning between 500,000.00 and 1,000,000.00, will likely increase due to the shifting of the tax rates coupled with the elimination of many itemized deductions. Hopefully, the gutting of the state and local tax deduction[67] and the medical expense deduction[68], will incentivize these individuals to make larger charitable deductions to make up for the deductions being eliminated by the 2018 tax plan.

VI. Proposal: Alternatives to Making Fractional Gifts

Fractional giving in its pre-PPA form will likely never return. In examining the legislative history after the enactment of the PPA it is clear that there will likely be no relief for donors who want very generous tax incentives for their fractional gifts. Rather than putting more effort into lobbying for the museum community and promoting more legislation that will likely never even be brought to the congressional floor, it is important that museums and donors together start to examine some potential alternatives to making fractional gifts of art. Donors are looking for giving systems that provide some kind of tax advantage and create a legacy in their name, while museums are looking for innovative methods of acquiring large works of art that they would be unable to purchase on their own. Some potential methods of acquiring gifts of art that can provide relief to donors missing the opportunity to make a fractional gift are: joint purchase agreements and promised gifts.

a. Joint Purchase Agreements

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[65] Tax Cuts and Jobs Act, §115, *available at* https://www.congress.gov/bill/115th-congress/house-bill/1/text?format=txt.
[66] *Id.*
[67] Under the new tax plan, an individual taxpayer's combined deduction for state and local taxes cannot exceed $10,000. These taxes include, state and local income, sales, real estate or property taxes. I.R.C. §164(b)(6). In states with high local taxes, taxpayers will feel the limitations of this deduction sharply.
[68] With the passing of the Tax Cuts and Jobs Act, the medical deduction at Internal Revenue Code section 213 has been limited to unreimbursed medical expenses that exceed 7.5% of the taxpayer's adjusted gross income. I.R.C. §213.

Joint purchase agreements are structured similarly to fractional gifts, although they require more careful planning for both the donor and donee museum.[69] Unlike fractional gifts of art, joint purchase agreements do not have an immediate tax advantage. With a joint purchase agreement, a donor and museum enter into a contract to jointly purchase a work of art. This apportions the ownership interests proportionally between each party and, like a fractional gift, allows for proportionate physical possession[70]. At the time of purchase, the donor(s) agrees to either give the museum their interest at death or at a later date.[71] This contract is similar to a fractional gift in that in both circumstances the museums require a contract be formed resulting in the museum eventually retaining full ownership of the work. The art work will be appraised at the time of purchase, and can be reappraised before the donation is made.[72] This permits the donor to take a larger deduction if his artwork appreciates after the initial purchase agreement.

Unlike fractional donations, however, joint purchase agreements do not provide an immediate charitable deduction. When a donor enters into a joint purchase agreement with a museum, he is not entitled the charitable deduction until the point that he makes a gift of the rest of his interest in the art work. However, as mentioned just above, this is the best way for the donor to capitalize on appreciated art work.[73] The second distinguishment of joint purchase agreements from fractional gifts is that joint purchase agreements require the museum to dip its hand into its own coffers in order to purchase a partial interest in the art work. Under fractional gifts, the museum can sit back and collect without having to invest in anything aside from planned giving promotional materials and an appraisal here and there. If a museum is particularly keen on a piece that would add to the value of their present collection, a joint purchase agreement is could be a viable option.

b. Promised Gifts

[69] *Analogía I, (2da. versión)* by Victor Grippo was jointly acquired by The Art Institute of Chicago, prior gift of Adeline Yates; and the Philadelphia Museum of Art, with funds contributed by the Committee on Modern and Contemporary Art. *Analogía by*

Victor Grippo, ART INSTITUTE CHICAGO, available at http://www.artic.edu/aic/collections/artwork/196410.

[70] The use of joint purchase agreements raises its own set of potential problems if not structured appropriately. While joint ownership is relatively easy to establish, museums and donors must be careful to agree in advance on the rights and obligations to avoid future litigation. Additionally, how the parties apportion their ownership interests is also a question regarding joint purchase agreements. The parties may choose to hold the work as a joint tenancy or as tenancy in common. Ownership should be structured based on what the parties want to eventually do with their artwork!

[71] Alicia C. Beyer, *Gone but not Forgotten: The End of Fractional Giving and the Search for Alternatives*, 36 COLUM. J.L. & THE ARTS 459, 481(2013).

[72] *Id*.

[73] Potentially, fractional giving could make a comeback working in partnership with joint purchase agreements. For example, if a museum were to enter into a joint purchase agreement with a donor where they each purchase half of the art, instead of providing the charitable gift to the museum at death, donor could presumable offer a fractional interest 5 years from the date of purchase and another fractional donation several years later, providing the donor with a charitable deduction in life. This vehicle would have to be carefully planned to avoid recapture provisions and fueled with slow appreciating artwork.

A donor and museum may enter into a contractual agreement that specifies a gift of an artwork (or collection) be given to the museum when the donor dies. The donor will not be able to take a charitable deduction for his gift during his life time because the IRS prohibits a charitable deduction for future gifts. However, upon the death of the donor, his estate is entitled to a deduction equal to the fair market value of the gift, including any appreciation between the time of the contract execution and the donor's death. Promised gifts do not provide the same tax motivations as gifts of fractional interests in works of art. When a museum holds a fractional interest in a piece of art, if the donor fails to deliver his remainder interest to the museum, should litigation arise, the museum already holds a concrete interest in the work of art.[74] However, a promised gift results in a contract where, if the donor's estate fails to deliver the promised gift, the donor's estate will not be entitled to any deduction and the museums can chose to pursue a breach of contract claim against the donor's estate.[75]

Before the PPA was enacted, museums were hesitant to accept promised gifts and tried to steer donors in the direction of fractional gifts instead, because a fractional gift provided a museum with an actual interest in the property at the time of the gift, instead of having to wait until the death of the donor. After the PPA, museum professional claim there has been an increase in promised gifts and a reconsideration of the practice by donee institutions. When the options shift from *having an interest now* or *having an interest when the donor dies;* to *having an interest when the donor dies* or *no interest at all*; museums became more willing to take what they could get. Donors also saw the value in making promised gifts as a way to relieve their estates of any property that would be taxed heavily, and provide a deduction equal to the value of that costly property.

In 2018, with the rise of the unified credit, donors who previously wanted to remove items of heavy tax significance from their estates now have no incentive because they are no longer subject to the estate tax. Previously, promised gifts were a significant method of lowering a taxpayer's

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[74] Treas. Reg. §1.170A-1.

[75] Businessman Henry Kravis and his wife have sued art collector Donald L. Bryant Jr. over three paintings by the renowned artist Jasper Johns. The Kravises say they bought the artworks jointly with Bryant with the intention of sharing them, then eventually donating them to New York's Museum of Modern Art. All parties agreed to transfer possession of the works to one another's chosen residence annually, so they each could enjoy displaying them until they were donated to the MoMA. The now Kravises claim that Bryant is holding the works "hostage," until he gets a new agreement without the pledge to give the works to the museum. The MoMA announced the acquisition of the Johns works in a 2008 press release that said the trio of paintings were a "promised gift" of Bryant, then a MoMA trustee, and Marie Josee Kravis, president of the board of the museum, and her husband, Henry. Karen Friefield ,*U.S. Businessman Sues Art Collector Over Jasper Johns Paintings*, Jan. 25 2013, REUTERS, *available* at https://www.reuters.com/article/usa-art-lawsuit/u-s-businessman-sues-art-collector-over-jasper-johns-paintings-idUSL1N0AUFG520130125?RPC=49.

estate tax liability, but in 2018, with the inflation of the unified credit to $11.2 million, wealthy donors have even less incentive to move significant assets out of their estate.

VII. Conclusion

Fractional Giving will never return to the state it was in before the enactment of the PPA. Donors and museums should not expect to see any legislation that changes the provisions of the PPA, and though there are alternatives for donors making fractional gifts of art—none possess the same power that gifts had in the period after *Winokur* and before the PPA's passage. With or without the PPA, museums rely on donors to make their organizations function smoothly, and donors are still generally motivated by tax incentives when creating legacies. Now, museums need to expand their planned giving departments and work one-on-one with donors to create specific giving plans that will aid the individual donor in making a gift that provides some tax advantage for her situation. Though none of the alternative methods posed here are ideal replacements for fractional gifts, there are advantages that will appeal to a donor's desire to reduce their tax liability. By balancing donative intent with donee need, museums can work hand in hand with collectors and continue the tradition of making donations of artwork (and taking charitable deductions for them)!