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Bank of America Private Wealth Management

Today's agenda

- Collection Management Practices
- Case studies
- Planning options
- Summary

Collection Management Practices

- Risk Management
- Valuation considerations
- Provenance /Authenticity/Good title
- Liquidity
- State income and estate taxes

Case studies

Case Study #1

- Client has $40 Million net worth, including $6 Million contemporary art collection
- Single (divorced), 3 adult children
- Client expressed desire to use the then $5.12 Million gift tax exemption before end of 2012 when it was scheduled to expire
- Children's interest in the art is unknown

Case studies

Case Study #2

- Client has $20 Million net worth, with at least $2 Million of art currently located in primary and vacation residence
- Single, late 50's, 2 adult daughters
- Daughters are not interested in the art, beyond sentimental value
- Client is considering leaving 1 piece of art to each daughter, with rest of the art being left to a museum

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Case studies

Case Study #3

- Matriarch of family, early 80's, with net worth in excess of $50 Million, consisting of $25 Million in cash and liquid investments, $7.5 Million in real estate (primary and second homes), and $20 Million in art
- 4 adult children, all wealthy from previous planning and sale of family business
- Current will leaves entire estate to existing private foundation
- Issue presented was how to transfer entire art collection to the children

Case studies

Case Study #4

- Patriarch of family, early 90's, with net worth in excess of $1 Billion, including $250 Million in art
- 2 adult children, all wealthy from previous planning and sale of family business
- Comprehensive, sophisticated planning completed for everything…except the art

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Planning options

- Three real options, each exercised potentially twice, provide six total planning options.

Three real options	Two potential times to exercise
• Sell • Give to non-charity • Donate to charity	• During life • At death

Planning options

- Or, there is always the option of doing nothing.
  - Default option
    - The most expensive option in terms of administration
    - The least desirable option in terms of disposition
    - It may be the best option for probate litigation attorneys

Planning options

- One final issue must be addressed before effective planning can take place.

Question
Does the family — children or other heirs — share your passion? • More often than not, they don't • Often they resent the money and attention lavished on the collection

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Planning options

Option 1 — Sell during life

- General rule: gain on a sale or exchange of art is subject to income taxes (and this includes state income taxes)
  - Dealers — ordinary income for those who engage in the business
  - Collectors/investors — capital gain
    - Short-term is ordinary income
    - Long-term is capped at…

Planning options

Option 1 — Sell during life (continued)

- 15% ?   20% ?
- Not if it is a "collectible"
  - IRC Section 408(m) includes any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible personal property specified by the Secretary of the Treasury for such purposes
  - Collectibles are taxed at a rate of up to 28%
  - Also subject to:
    - Healthcare surtax
    - State and local income taxes
    - Transaction costs such as commissions, shipping, insurance, etc.

Planning options

Option 1 — Sell during life (continued)

- "Investors" can defer tax through a "like-kind exchange"
  - That doesn't cause any tax, but it also does not dispose of the art, just substitutes one piece for another

Summary of Option 1

- Assume a federal tax rate of 31.8%, plus possible state capital gain rate, on gain
- Selling may be the right option, but it will likely be the most expensive asset that the collector ever sells

Planning options

Option 2 — Give during life — Non-charitable donee

- Normal gifting rules:
  - Annual exclusion gifts of $14,000
  - Taxable gifts — gift tax credit for the first $5 Million (adjusted for inflation) of gifts
  - Taxable gifts beyond the credit
  - Generation skipping taxes considerations for transfers two generations down

Planning options

Option 2 —
Give during life — Non-charitable donee (continued)

Strategies beyond direct gifts:

Art LLC (or FLP)	Allows continued control of the collection regardless of underlying ownership, though valuation planning unlikely for transfers
SIDGT	Sale of collectibles (or FLP holding collectibles) to the intentionally defective grantor trust for a note, hoping that appreciation exceeds interest rate on the note
Art GRIT	Transferring the collectibles to non-family members
TPP-GRIT	Art GRIT for family members

Planning options

Option 2 — Give during life — Non-charitable donee (continued)

- Main challenge — valuation planning, via fractional interest gifts or indirect gifts (FLPs, LLCs, SIDGTs) is challenging
- The IRS has consistently challenged all attempts to discount gifts of art

Planning options

Option 2 — Give during life — Non-charitable donee (continued)

- That *may* have changed with the *Elkins* case

Summary of Option 2

Gifts to family and friends might be the right option, but art is the least desirable asset to use to accomplish leveraged wealth transfer.

Planning options

Option 3 — Donate during life — Charitable donee

- Overall, subject to the client's goals, this is the most tax efficient way to keep the collection intact
- But, tax traps for the unwary

Summary of charitable giving rules

- Types of charities
- Types of property
- Combining to determine AGI limits

Planning options

Option 3 — Donate during life — Charitable donee (continued)

- Special rules:
  - Related use — If the use of the donation is related to the donee's exempt purposes, generally will be entitled to a *fair market value* deduction capped at 30% AGI; otherwise, *cost basis deduction* capped at 30% AGI (gift to a non-operating private foundation is cost basis, capped at 20% AGI)
    - Only makes sense to give to public charity or private operating foundation
    - Both are 30% AGI cap, at fair market value

Planning options

Option 3 — Donate during life — Charitable donee (continued)

- Special rules:
  - Partial interests — gifts of non-qualified partial interests are not deductible
    - Exceptions to this rule provide planning opportunities
  - Fractional interests
    - Subsequent fractional interest gifts frozen at value used for initial fractional gift for charitable income tax deduction
    - Gift of entire interest must be completed within 10 years of initial gift (or earlier death)
    - Donee must actually take possession of the art for their ownership period

Planning options

Option 3 — Donate during life — Charitable donee (continued)

- Planning options:
  - Direct gift of entire interest to charity
  - Direct gift of a fractional interest to charity
  - Bargain sale to charity
  - Loan of the art to charity
  - Charitable Remainder Trust
    - Delayed income tax deduction
    - Always an unrelated use gift — always use a “Flip CRUT”

Planning options

Option 3 — Donate during life — Charitable donee (continued)

- Planning options:
  - Charitable Lead Trust — rare, if ever, during life with art; will discuss below with testamentary planning
  - Private Operating Foundation
    - Creating a museum for own collection
    - Even though it is a private foundation, it is treated as a public charity for many purposes

Summary of Option 3
Subject to the family's interest in the collection, this is the most tax efficient manner to keep the collection intact.

Planning options

Option 4 — Sell at death

- This is probably the most common outcome
- Full fair market value includable in estate for estate tax purposes
- Basis step up, though post-death (or alternate valuation date) appreciation subject to income tax
  - For non-taxable estate, sale at death is most combined tax efficient solution

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Planning options

Option 5 — Bequeath at death – Non-charitable beneficiary

- Full fair market value included in estate
- Basis step up, with that basis carrying over to the beneficiary
- Normally not part of the A-B funding, but rather as part of disposition of Tangible Personal Property
- Be careful not to give surviving spouse a first right of refusal, as that may be a terminable interest and not qualify for the marital deduction even if the spouse elects to take that property

Planning options

Option 6 — Bequeath at death — Charitable beneficiary

- Most charitable planning options available during life are also available at death
- Charitable Lead Trust — if used with art, is usually testamentary
  - Structured to provide full estate tax deduction
  - Contemplates a sale of the collection shortly thereafter, with reinvestment of proceeds

Summary

Revisit the case studies

- Case Study 1
  - Client also says
    - I want to use my art to fund the gift to my children
    - I want to keep the art at my house
    - I don't want to do anything risky
  - LOL
  - Client wasn't really doing art planning, but wealth transfer planning
  - Wanted to use the exemption but not give up liquid assets
  - This was a common scenario in 2012 – need to distinguish between art planning, and planning to use the exemption

Summary

Revisit the case studies

– Case Study 2

  - Identify which pieces to leave to children, and either give during life or as a bequest
  - She knew which museum she wanted to leave rest of art to; I suggested that she contact the museum and discuss the parameters of use of the art after she left the art to them at death. She could also make gifts of individual works during life if she wished

Summary

Revisit the case studies

- Case Study 3
  - Nationally known law firm, in conjunction with a valuation firm, suggested
    - Transfer art to LLC
    - Fund an Intentionally Defective Grantor Trust with sufficient cash for a "seed" gift
    - Sell LLC interests to the IDGT for cash (10%) and a 9-year note, with note structured as self cancelling at death of matriarch
    - Matriarch leases art work back from LLC, with lease payments going to the IDGT to use to service the note

Summary

Revisit the case studies

- Case Study 3
  - Nationally known law firm, in conjunction with a valuation firm, has suggested (cont.)
    - At Matriarch's death, note balance cancels
    - LLC owns all art
    - LLC is owned by the IDGT, which can be set up to generation skip
  - This transaction is being done around the country, but it is fraught with risk
  - An alternative may include the use of fine art lending to facilitate the transfer of the artwork via purchase by the next generation

Summary

Revisit the case studies

- Case Study 4
  - Family set parameters
    - Patriarch retains possession for rest of life
    - Patriarch not willing to pay any gift taxes, nor would next generation pay any gift taxes for a net gift
    - No charitable intent with the art (though family has made significant charitable gifts)
  - Result is that this is a financial asset for the family, and solution is to compare after tax consequences pre and post death of patriarch
  - Given amount of gain, post death sale was best after tax result

Summary

- These options are exhaustive, but they are not mutually exclusive
- Starting point is to determine the interest of the family in the collection
- The inventory done in conjunction with securing insurance coverage is useful to plan with respect to specific pieces

Additional Resources

- Lerner, Ralph E., and Judith Bressler. *Art Law*. 4th ed. New York: Practicing Law Institute, 2012.
- Slugg, Ramsay H., Handbook of Practical Planning for Art Collectors and Their Advisors. Chicago: American Bar Association Real Property Trust and Estate Law Section, 2015.
- A number of articles written by Richard Horwood that have appeared in the *Family Foundation Advisor.*
- Leibell, David T., and Daniel L. Daniels, "Practical Planning Strategies for Art and Collectibles," Thomson Reuters/RIA (2010).