Putting Art in the Picture ©

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Donating art collections to charity can bring myriad benefits to philanthropists and the causes they support. But understanding the tax rules is essential to smart donations. Here are some savvy ways to make the most of your gifts.

If a valuable art collection is left to heirs, federal and state estate tax may be due. If the art collector owns homes in more than one state, multiple jurisdictions may claim estate tax on the same tangible property. If the collector decides to sell the collection instead, he or she will need to pay capital gains tax at the rate of 28 percent.

Smart collectors can bypass both capital gains tax and estate tax -and do good at the same time -by donating their collections to charity. In fact, with today's substantial spread in the long-term capital gains tax (now 15 percent on the sale of securities while remaining at 28 percent on collectibles), it is more advantageous than ever to donate appreciated collectibles to charity.

In addition to bypassing capital gains and estate taxes, charitable donations earn an immediate income tax deduction. But IRS rules about deductions for donations of tangible property are tricky and need to be followed to the letter. Many donors are turning to their local community foundations for help with gifts of tangible property.

Know the Tax Rules

All charitable deductions are limited to a percentage of adjusted gross income (AGI). However, while cash donations of up to 50 percent of AGI may be deducted in a single year, donations of appreciated assets fall under different rules.

When it comes to assets other than publicly traded securities, the key is what the IRS calls "related use." In order to obtain maximum tax benefits, assets must be donated to charities that will use them in a way related to the purpose that qualifies the charity as tax exempt. If you donate a sculpture to a museum that will display the work, the related use test is met. Donate the same sculpture to the same museum, and if the museum sells the work to raise money for its endowment, the test is not met.

When an appreciated asset is given to a public charity for a related use, the donor is entitled to a deduction of up to 30 percent of fair market value. If the use is not related, the deduction is for no more than 20 percent of the asset's cost basis. In either case, excess amounts may be carried forward for five years.

Valuation and Appraisals

Deductions must also be based on current appraisals. When donated artwork is worth more than

$5,000, the donor must obtain a written appraisal of the property from a qualified appraiser and attach a summary of the appraisal to the federal income tax return, using Form 8283. When donations exceed $20,000, a complete copy of the signed appraisal must be attached to the tax return.

Two cautionary notes apply to the valuation of donated art objects. First, the IRS Art Advisory Panel reviews all appraisals submitted to substantiate deductions of artwork with a claimed value of $20,000 or more. Although the panel did not know whether it is reviewing appraisals connected with income tax returns (when the taxpayer wants a higher valuation) or estate tax returns (where the opposite is the case), adjustments were recommended on just over half of the appraisals reviewed in 2003.

The second issue is related to concerns about possible fraud connected with charitable donations. Senator Charles Grassley, chairman of the Senate Finance Committee, is conducting hearings on whether donors are inflating values as a way of dodging taxes.

Donors can resolve questions from both issues by keeping documentation in the form of detailed appraisals from qualified appraisers. Donors also need written receipts from the charity. Writing in Steve Leimberg's Charitable Planning Newsletter, California attorney Joy Gibney Berus notes that the letter should indicate that the organization is a qualified public charity and intends to use the gift in a manner related to its tax-exempt status.

Double Benefits

There are two gifting strategies that enable donors, in a sense, to have their cake and eat it too.

The first involves making a "partial interest donation." If you own artworks you want to keep on your walls to enjoy, consider sharing ownership with a charity. As Ms. Berus points out, a gift of a one-third interest in a painting to a museum would mean that the museum could display the painting for four months a year while the donor would have it at home for the remaining eight months.

The tax deduction in this instance would be one-third of the appraised value of the painting. Give an additional piece of the painting at a later date, and you can deduct the additional fractional interest of the then-current fair market value. At the end of a specified term or at the donor's death, the painting would fully belong to the museum.

Gifts of partial interest have several advantages. Donors receive an immediate tax deduction and the continued enjoyment of the art. According to the PricewaterhouseCoopers Guide to Charitable Giving, the donor can also precisely control the current charitable amount -and therefore the deduction -by adjusting the percentage donated. Insurance costs may also be lowered because the museum will pay for insurance while the art is in its possession.

The second strategy is making the donation to a charitable remainder trust. Setting up a CRT can be a wise move if you are willing to part with your collection and also want an ongoing income stream along with an income tax deduction. Community foundations are expert at structuring CRTs for donors.

When assets are donated to a CRT, the trust typically sells them and reinvests the proceeds to provide a stream of income to the donor. That income, according to Neuberger Berman Trust Company, may be paid, at the donor's option, as a fixed dollar amount or as a percentage of the trusts value each year.

At the donor's death, the balance remaining in the trust goes to the charity or charities designated by the donor. Meanwhile, the donor receives an immediate tax deduction based on the projected value of the gift to charity. While the donor must pay income tax on the income received each year, there is no capital gains tax. And there is no estate tax, because the art is left to charity. In some situations, this can be the best of all possible worlds.

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