YOU CAN'T TAKE IT WITH YOU

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But you don't want to leave it all to the taxman. Given today's high art values, estate planning is more essential than ever.

After a few too many whiskeys, a wealthy English art collector recently confided to us the crux of his estate tax plan: Following his death, his children had standing instructions to lock up all the good paintings in their castle's dungeon. Since most of our U.S. clients don't have castles—and don't want their heirs locked up in dungeons by the authorities—we advise them to do some thoughtful estate planning to maximize tax benefits and ensure that their art collections end up in the right hands. Here are several approaches to estate tax planning used by collectors today.

LETTING THE HEIRS PAY.

Surprisingly, this approach—also known as the "I'm dead and don't care" strategy—is used, intentionally or not, by many sophisticated people. The IRS currently taxes estates at an effective rate of 45 percent, with no tax due on the first $2 million or on anything passing to a surviving spouse. The exemption will increase to $3.5 million in 2009, and in the unlikely event that Congress takes no action, the estate tax will expire in 2010 (Note to collectors: That's a terrific year in which to die). Unfortunately for those who live into 2011, the exempted amount is currently set to return to $1 million that year. In addition, many states, including New York, New Jersey and Connecticut, impose their own estate taxes at effective rates of up to almost 9 percent.

Since art is an illiquid asset, executors often end up selling off works to pay estate taxes. This is apparently what happened with the billion-dollar-plus estate of the dealer Ileana Sonnabend, who died in October 2007 and whose daughter and adopted son reportedly covered the taxes by privately selling $600 million worth of sculptures and paintings.

A further complication for executors is that estate taxes are due no later than nine months after death. An auction is the preferred method of sale for many executors (who tend to view them, rightly or wrongly, as generating "fair market value"), but because the houses conduct only periodic sales, executors are occasionally forced to engage in quick private sales at below-market prices to raise cash to pay taxes. Alternatively, they might cover the tax obligation by selling other assets or by borrowing from a fine-art lender such as Emigrant Bank Fine Art Finance (formerly Fine Art Capital) or Citi Art Advisory Service.

Sophisticated collectors sometimes appoint special advisers in their wills to handle their art holdings. These specialists, who may be private dealers or even art attorneys, presumably have the necessary expertise to negotiate with auction houses, dealers and museums, all in accordance with the collector's final wishes. However, trusts and estates attorney Herb Nass cautions that the executor of an estate is not bound by this type of appointment in a will and may freely disregard it.

Moreover, Nass advises collectors drawing up a will to "be sure that your executors don't have conflicts of interest that may lead to decisions that aren't in the best interests of your beneficiaries." This was precisely the kind of situation involved in a famous 1977 New York Supreme Court case, In re Rothko. Shortly after the artist Mark Rothko died, his executors sold 798 of his paintings to Marlborough Gallery and a subsidiary at a price believed to be below market value, even though one of the executors, Bernard J. Reis, was an owner of Marlborough, and another executor, the artist Theodoros Stamos, wanted to exhibit at the gallery. Rothko's children and the New York attorney general successfully sued to have the contracts canceled and the executors removed in light of their clear conflicts of interest.

LIFE INSURANCE.
A frequently used method of preserving an art collection after death is to fund the estate tax through a life insurance trust. The collector estimates the projected tax (not always easy, given the changing laws outlined above), establishes a trust that purchases a life insurance policy in that amount and funds the trust each year with a sum equal to the policy's premiums. If the trust is structured correctly, the insurance proceeds are not part of the collector's taxable estate, and at his death the trust's beneficiaries can use the money to pay the estate tax.

GIFTS DURING LIFETIME TO FAMILY.
A very gratifying way to reduce estate tax is to bestow art on offspring during one's lifetime. A significant drawback of such gifts is that, depending on their size, they may trigger a hefty gift tax—payable by the donor, not the recipient. This tax is intended to ensure that people don't deprive the IRS of estate taxes by giving away all their property during their lifetimes, so it's not surprising that gift tax rates are essentially the same as those of the estate tax. Trusts and estates expert T. Randolph Harris notes that any appreciation in value between the date of the gift and the donor's death avoids estate and gift taxation (which is good), although the recipients of lifetime gifts must use the donor's cost basis for a piece when they sell it (which may be bad). By contrast, appreciated assets bequeathed through an estate receive a stepped-up tax basis equal to their value at the time of the donor's death.

GIFTS DURING LIFETIME TO CHARITY.
A more tax-friendly way to give away art during one's lifetime is through donations to charitable organizations, such as museums or qualified not-forprofits. Donors receive income tax deductions while they are living, and upon their death, no estate tax is due on the donated objects, since they are no longer part of the estate. Such a donation may reap the added benefit

of keeping an art collection together when the donor's ownership ends.

Special technical rules apply to donations of art to charities, including the important "related use rule": In order for a work to be deductible at its fair market value, as opposed to its original cost, the charity must use it in a way related to the organization's tax-exempt purpose.

When artists donate their own works to charitable organizations, their deductions are limited to the cost of the materials they used to fabricate the pieces. If passed, the proposed Artist-Museum Partnership Act may change this to permit artists to deduct the fair market value of such donations. But the bill has so far died seven times in Congressional committee, with opponents arguing that artists should not be allowed to "paint themselves a tax deduction."

Collectors should be realistic about the hurdles involved in trying to donate art to museums. Institutions will often decline such donations, not wanting to commit the funds needed to store, conserve and exhibit works that do not necessarily enhance their collections.

GIFTS DURING LIFETIME OF FRACTIONAL INTERESTS IN ART.

In the past, savvy collectors took advantage of an IRS provision permitting "fractional giving" of art to charity. A collector could give a stated portion—say, 10 percent—of a work each year and take a deduction for the corresponding percentage of its value at the time, even retaining possession of the piece for part of each year. Unfortunately for collectors and museums, a much-criticized law enacted last year created major disincentives for these fractional charitable gifts of art. A new patch to the law has to some degree corrected the problem, however, and there is hope that the proposed Promotion of Artistic Giving Act will do what its name suggests. One sign that fractional giving isn't totally dead: Last December, Janice and Henri Lazarof made a fractional and promised gift of 130 Modernist works to the Los Angeles County Museum of Art that are estimated to be worth $100 million.

PRIVATE OPERATING FOUNDATIONS.
Art held in a private operating foundation is not subject to estate tax, but the foundation itself is subject to strict irs rules [see "Creating an Art Legacy," August 2004]. For instance, the foundation must actively promote a charitable cause. It may be used to establish a privately funded museum accessible to the public, or for lending art to different public venues.

One example of the latter approach is the foundation established by the Los Angeles collector Eli Broad. He has decided to give his personal collection, which now comprises about 400 modern and contemporary works, to the Broad Art Foundation when he and his wife die. The decision was a blow to LACMA, which had received $56 million from the foundation for construction of the Broad Contemporary Art Museum on LACMA's grounds and was hoping to be the recipient of the billionaire's vast collection.

EUROPEAN APPROACH.
Britain allows heirs to pay its estate tax in art that is "preeminent for aesthetic merit or historical value," and France routinely accepts artworks as payment for its succession taxes. For instance, death duties for Picasso, who left no will, were paid largely in the form of his works, which now make up the core of Paris' Musée Picasso. The U.S., by contrast, generally does not accept in-kind payment of estate tax. It has done so only in very rare instances—each of which required special authorizing legislation—involving rare coins, historic photographic plates and land.

Collectors contemplating the cheerful topic of death and taxes—and mindful of the adage ars longa, vita brevis—should plan ahead. With solid professional advice and careful consideration, they may find ways of sparing their heirs a king's ransom in estate taxes, even if their castles are only condos in Queens.

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