WORTH KNOWING

YOUR ART COLLECTION AND LEGACY PLANNING

Whether selling, giving or donating your art collection, early planning is critical to ensuring your goals are fulfilled.

By Mitchell A. Drossman and Ramsay H. Slugg

It is important to determine what you would like to see happen to your collection when you are gone. Preparing now can safeguard the legacy of your collection. U.S. Trust has special expertise and extensive resources in this area. We can help clients who appreciate and collect art to navigate the financial and estate planning issues for potential financial benefits from their collection.

ESTATE PLANNING FOR ART

As an art collector, you have invested time, energy and resources in developing expertise in art, and built a collection that fits your aesthetic criteria and interests. This often leads to, or results from, an interest in a particular artist, period or medium, and the cultivation of relationships with artists, auction houses and galleries. While the foundation of collecting is participating in this "dialog" and enjoying the beauty that art affords, extensive art holdings should also be considered when addressing personal finances and estate planning.

After investing time, effort and financial resources to establish an art collection, many collectors find it difficult to consider its future and final disposition. Unlike financial assets or real estate, art is intensely personal. A collection reflects who you are and how you have lived. Estate planning with art can be a much more emotional process compared with traditional financial assets. Often, art is less about numbers and more about heartstrings and passion. As a result, many collectors find it extremely difficult to make planning decisions about the ultimate disposition of their art.

However, the very personal connection to art, and the fact that art cannot be sold as quickly as financial assets, makes it essential to diligently plan ahead.

Your legacy options. The default "choice" for many collectors is to do nothing in terms of estate planning for their collection. This means that the collection is likely to end up in the hands of an executor without adequate direction or distributed to family members who may not share the passion for your art. Either way, it is possible that the collection will be sold at death. While this non-planning approach is always an option, it is the most expensive in terms of administration and the least desirable in terms of directing the disposition of the collection.

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For those who want to affirmatively plan, the first step is to ascertain whether your children or other heirs are interested in your art collection. Don't be surprised if they are not. Quite often, they don't share your passion for your collection in particular, or maybe even art in general. If by chance they are interested, you must determine more precisely what is more relevant to them — the $10 million painting or the very different $10 million value of the painting — which will help determine the outcome. Another possibility is that they will be divided over what to do with the art, with one keen to keep a piece and another eager to sell. Exploring these options in advance might be painful, but it is necessary to begin the planning process.

After the children or other heirs' interest, if any, is determined, the planning process may commence. Collectors should be aware that they have three basic options, according to the U.S. Trust wealth strategists, with respect to their collection:

1. Sell the collection
2. Give it to a non-charitable beneficiary, such as your children or other heirs or
3. Donate it to a charitable beneficiary, such as a museum

And there are two different times when these options take effect — during life or at death.

Selling the collection. Selling your collection may be the right choice for you. However, you should be aware that it is more expensive to sell art (and other collectibles) than many other assets. This is because of higher capital gains tax rates (28% compared to the current top rate of 20%) associated with art work and other collectibles. And we can add to that other costs — sales commissions, insurance and shipping costs and sales tax — which are not common with most other assets.

Selling at death is perhaps less expensive from an income tax point of view, as the tax basis of the art collection is increased to fair market value at death, reducing (or perhaps eliminating) capital gains tax for a subsequent sale by the estate or heirs. The tradeoff is that the entire value is included in the estate for estate tax purposes. Further, disposing of a collection at death often connotes a fire sale and could lower its perceived value.

You can take advantage of certain tax breaks while building a collection — trading up to more expensive pieces as part of an exchange — but the bottom line is that art collectibles are very expensive to sell — during life or at death — compared with other assets.

Gifts to non-charitable beneficiaries. Most gifting options available to individuals during life for traditional assets are also available to the collector for gifts of artwork. For example, you may use your annual gift tax exclusion (currently $14,000) or the more generous lifetime exclusion (currently $5,490,000) to gift full or fractional ownership interests in works of art to your heirs. One significant difference, though, is that a popular technique of "discounting" the value of assets through the use of fractional interest gifts and/or using a family limited partnership or limited liability company (LLC) is more difficult to achieve with respect to artwork. More effective wealth transfers might be accomplished by using other assets.

OWNERSHIP OF A COLLECTION ACROSS BENEFICIARIES

Using a limited liability company (LLC) can make good sense when there are numerous beneficiaries with varying interests.

If the next generation is in fact interested in maintaining the artwork as a collection, or if you want to keep a collection together within a family rather than giving individual paintings to family members, it may make sense to transfer it to an LLC. Family members can own LLC interests rather than the art itself. An entity such as an LLC can be formed during your lifetime while the collection is being built; in this case, the LLC is the actual owner of the art, not you personally. The art is controlled by one or more managers you select. The managers are usually responsible for maintaining appropriate insurance, storage, display of the art and making decisions regarding sales of individual pieces. This control feature must be carefully crafted for estate tax reasons to avoid certain pitfalls and adverse results. For example, if you have 30 paintings and three children, instead of giving each child 10 paintings, or a one-third fractional interest in all 30 paintings — a situation that is primed for conflict — they would each receive a one-third interest in the LLC. If the LLC decides to sell 20 paintings, for example, then the proceeds either stay within the LLC or could be distributed equally to the LLC's members. The benefit of this arrangement is that it separates legal ownership from beneficial ownership. What's more, the transfer of ownership involves an intangible partnership interest rather than tangible personal property — the artwork, that is, and the emotional connections attached to it.

Another option, especially if you do not want to transfer the art during life, is to simply pass on artwork to your heirs in your will, based on any number of criteria — such as what works would interest them or what works you believe they would want themselves to have.

Donations to charitable organizations. While wandering through museums, you are likely to see pieces of artwork identified with not only information about the artwork and the artist, but also information about how the museum acquired the piece (often through a personal loan or donation) with attribution to the benefactor. Donating art to a museum is a personally satisfying gesture that bestows art that was once in private hands for the public to enjoy. Of course, there are tax advantages too, especially if the work is donated while you are alive. If you are not planning on giving it to your children and are willing to part with the artwork, taking care of the work's disposition now, rather than at death, can offer several advantages.

GIVING ART TO A MUSEUM HAS MANY BENEFITS

Whether during your lifetime or after your death, giving art to a museum can offer meaningful tangible and intangible benefits, and can be accomplished in a number of ways.

Art donated to a museum or other charitable organization entitles you to an income tax deduction of up to 30% of your adjusted gross income based on the value of the work at the time of the gift (provided that the charity uses the artwork in furtherance of its charitable activities). Of course, you will have to deliver the artwork to the charity to receive the deduction.

For those that simply cannot fully part with their artwork, another option is to arrange a fractional donation over time. For example, you can give a 10% share of a $100,000 painting to a museum, and you would be entitled to a $10,000 income tax deduction. Also, the museum would be entitled to have the work for 10% of the time. Over time, you may give additional fractions to the museum; tax rules require that the entire artwork must be donated to the museum within 10 years of the original donation (or at your death, if earlier). This rule makes this arrangement more attractive to older collectors rather than younger ones, who might not want to fully part with their treasured artwork just yet.

Donating artwork to a museum at death is simpler. Your collection is delivered to the institution and your estate receives an estate tax deduction based on current valuation at death.

In any scenario with donations to institutions, it is important to specifically describe the conditions under which you want your art to be displayed — in a special wing, for example, with your name on it — and any special rules pertaining to the exhibition, care and upkeep of the artwork. It is preferable that this be agreed to before delivery of the artwork. Conditions too onerous could actually reduce the value of the collection and jeopardize the charitable deduction for estate, gift and income tax purposes.

Any charitable gift of artwork must comply with a number of special rules, so it is imperative that you work with a qualified and knowledgeable advisor.

Creating your own museum. There is a long and storied American philanthropic tradition behind creating individual and family museums, dating back to the Frick Collection in New York and the Barnes Foundation in Philadelphia, among other famous museums that originated with individual bequests from wealthy individuals. For instance, the City of Miami has seen a number of private museums take shape — as venues to exhibit their art, to maintain the integrity of a collection, and to gain some tax advantages.

A MUSEUM TO CALL YOUR OWN

A private museum with your name on it is more likely to keep a collection intact, if that is your desire, rather than bequeathing individual pieces to a museum or to your heirs, which would mean less control over its final disposition.

For collectors who wish to maintain their collections intact, and whose families have little or no interest in continuing that legacy, it may be best to first seek out an existing museum that would satisfy your requirements in terms of space, location, infrastructure, and shared aesthetic interests. If no museum fits the bill and you decide to pursue establishing your own museum, there are several factors to consider, including the size and value of your collection. A person with a $100 million collection is a better candidate for a private museum than someone with a $5 million collection, due to the relatively high fixed costs involved with the creation and upkeep of such an institution.

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If you decide to create your own museum, the next step would be to consider establishing a private operating foundation that would control the assets and oversee the running of the museum. Moreover, you will have to provide substantial financial backing or a sufficient endowment to cover the museum's operating expenses, from curators to conservators, and ongoing maintenance of the facility.

A private museum with your name on it is more likely to keep a collection intact, if that is your desire, in contrast to bequeathing individual pieces to a museum or to your heirs. A museum will also ensure your legacy as a contributor to the public appreciation of art and be a revered destination for art lovers.

EARLY PLANNING IS CRITICAL

Whatever art planning option — or combination of options — you choose, thorough early planning is critical to ensuring your goals are met now and in the future.

No matter your goal, careful planning is critical

Whatever option you choose for the future management and planning for a beloved art collection, you are most likely to feel more secure and satisfied — and gain more tax efficiency — by outlining a precise strategy and guidelines now or in the near future. At U.S. Trust, we have the experience, expertise and resources to help you with all aspects of art collection management and planning.

ART COLLECTION AS LOAN COLLATERAL

Fine art is an asset that should be considered as part of your overall wealth management strategy. That can include using your collection as collateral to gain liquidity for other financial goals you wish to fulfill. As a client of U.S. Trust, you have access to a team of credit specialists who can help you borrow against your art collection while maintaining ownership of every piece in it. Talk to your advisor about our companion article, Worth Knowing: Art Collection as Loan Collateral.

To learn more about how to prepare the legacy of your collection in the future and navigate financial and estate planning issues for potential financial benefits from their collection, please visit ustrust.com/art.

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