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Donations Of Artwork

The importance of a qualified appraisal.

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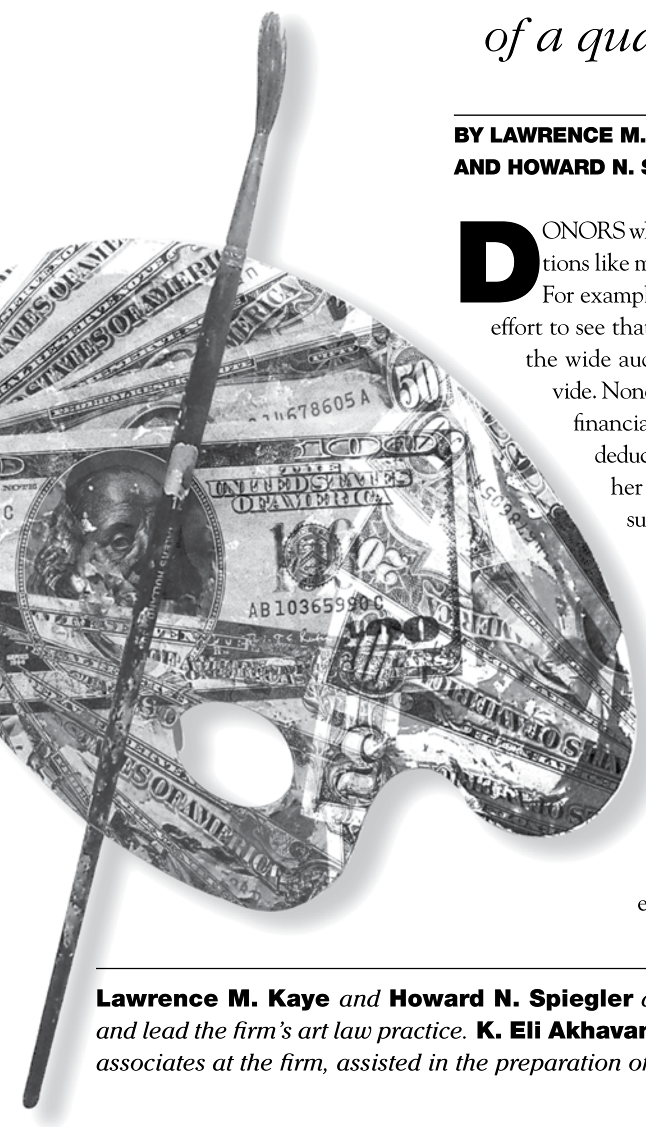

DONORS who give artworks to not-for-profit institutions like museums have many different motives. For example, the gift may represent an altruistic effort to see that important artworks are available to the wide audiences that only museums can provide. Nonetheless, the donations inevitably have financial implications because the donor can deduct the value of the donation from his or her taxable income, providing a possibly substantial economic benefit.

To ensure that the donor gets that benefit, a "qualified appraisal," as defined by the federal tax laws, may have to be submitted to the Internal Revenue Service with the donor's tax return. Failure to follow the IRS's guidelines regarding "qualified appraisals" when submitting an appraisal can result in disaster: the complete loss of a tax deduction to which the donor would otherwise be entitled. This article will address a set of appraisal pitfalls that must be avoided, including the problems that can arise for donors of artworks seeking deductions for charitable contributions if the appraisal required by the IRS is not properly prepared.

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General Rule

As a general rule, §170(a) of the Internal Revenue Code allows for the deduction from the donor's taxable income of any charitable contribution made within the donor's taxable year. An individual claims his or her charitable deductions on the annual tax return, Form 1040.

A charitable deduction is allowed only if the donation meets the substantiation requirements promulgated by the IRS. For noncash contributions exceeding $5,000, a donor must: (1) obtain a "qualified appraisal"; (2) attach a completed appraisal summary (IRS Form 8283) to the tax return on which the deduction is claimed; and (3) maintain appropriate records pertaining to the claimed deduction. For contributions of works of art where the deduction claimed is $20,000 or more (and for other noncash contributions in excess of $500,000), the IRS requires that the taxpayer attach to his return a complete copy of the signed appraisal; an appraisal summary is not sufficient.

Qualified Appraisal

The Pension Protection Act of 2006 (PPA) amended the Code to provide that a qualified appraisal is an appraisal completed by a qualified appraiser pursuant to "generally accepted appraisal standards." A qualified appraisal must: (1) be prepared no earlier than 60 days before the date of the contribution of the donated property and no later than the due date of the return on which a deduction is first claimed; (2) be prepared, signed and dated by a "qualified appraiser"; (3) include required information such as, but not limited to, a detailed description of the property as well as its physical condition; and (4) include the appraised fair market value of the property on the date of contribution. It should be noted that while an appraisal fee does not necessarily disqualify an otherwise "qualified appraisal," appraisal fees may not be based on a percentage of the appraised value.[1]

Qualified Appraiser

A qualified appraiser must meet all of the following requirements:

(1) The individual either: a) has earned an appraisal designation from a recognized professional organization or demonstrated competency in valuing the type of property being appraised; or b) has met certain minimum education and experience requirements;

(2) The individual regularly prepares appraisals for which he or she is paid;

(3) The individual demonstrates verifiable education and experience in valuing the type of property being appraised; and

(4) The individual has not been barred from practicing before the IRS at any time during the three-year period ending on the date of the appraisal.

Nevertheless, some individuals may not serve as qualified appraisers even if they meet these requirements. These include: (i) the donor; (ii) the donee; (iii) any person employed by the donor or the donee; and (iv) any individual who is regularly used by the donor or donee and who does not perform most of his or her appraisals for other people.

Recent Cases

There are two recent tax court cases that, although they do not involve donations of artworks, nevertheless illustrate the importance of adhering to the rules regarding "qualified appraisals." The result in both cases was that because the donors did not follow the relevant regulations, they were denied the deductions they sought.

In *Ney v. Commissioner* (TC Summary Opinion 2006-154, Sept. 19, 2006), the donors, Mr. and Mrs. Ney, contributed real property development rights via a bargain sale to a Delaware land preservation foundation and claimed a deduction. Although the Neys had obtained appraisals of the development rights, they were not "qualified appraisals" within the meaning of the Treasury Regulations. For example, one of the appraisals was disqualified because it was signed by an employee of the donee. The same appraisal also failed to meet the requirement that the appraisal must be made no more than 60 days before the date of the contribution. Another of the appraisals was made more than three years after the due date of the donor's tax return and was, therefore, untimely. As a result of these and other technical failings, the court disallowed the entire $210,000 deduction claimed by the Neys.

In *Obiakor v. Commissioner* (TC Summary Opinion 2007-185, Oct. 31, 2007), the donors' failings were even more egregious. The Obiakors had made noncash charitable contributions of clothing, accessories, household furniture and appliances to the Salvation Army. The donors attached both a receipt from the Salvation Army as well as a form to their tax return, itemizing their contributions with a total value of approximately $18,000. Because the total contribution was over $5,000, the Obiakors were required to obtain a qualified appraisal and to attach IRS Form 8283 (Noncash Charitable Contributions) to their return. The Obiakors, however, did not comply with any of the substantiation requirements. The court held that even though the Obiakors had both a receipt from the Salvation Army and an itemized list of their contributions, they did not comply with the qualified appraisal requirements. Accordingly, the court denied the Obiakors their claimed deduction.

When dealing with donations of important artworks, the repercussions of failing to follow the regulations can be magnified. Imagine, for example, the reaction of the donor of a multimillion-dollar artwork to a museum who finds out that his entire deduction was disqualified because of his failure to meet the requisite standards. Also, artworks present their own complications. Expertise in one area of the market may not translate directly into others and, thus, an appraiser's view of an artwork within his particular area of expertise will be given more weight than his view of an artwork outside of his area of expertise.[2] For example, contemporary sculptures by Jeff Koons and paintings by Rembrandt are not only stylistically distinct but also appeal to buyers in different segments of the market, and may therefore raise very different issues when it comes to questions like the artwork's condition. An expert who is perfectly qualified to value one piece may not be the best qualified person to appraise another.

Failure to follow the IRS's guidelines regarding 'qualified appraisals' when submitting an appraisal can result in disaster: the complete loss of a tax deduction to which the donor would otherwise be entitled.

Misstatement of Value

There are also other potential perils associated with the appraisal of donated property for tax purposes. Even if the appraisal meets all of the requirements for a "qualified appraisal," the appraiser and the taxpayer may both be subject to penalties if the value of the appraised artwork(s) is significantly overstated. The IRS penalizes two types of valuation misstatements: (1) "substantial" valuation misstatements; and (2) "gross" valuation misstatements. Substantial valuation misstatements trigger a penalty of 20 percent of the amount of underpayment due to the IRS, while gross valuation misstatements carry a penalty of 40 percent. With donations of artworks, this could become an area of particular concern: recent press reports have suggested that donated artworks are often overvalued, which results in large losses of revenue for the Treasury, and that legislation is being contemplated that would require more careful review of these donations.[3]

Donor Penalties. For purposes of the federal income tax, a valuation misstatement is considered "substantial" when the donor values the donation at 150 percent of the correct value as determined by the IRS, or, if the matter is litigated, by a court of competent jurisdiction. For example, if the donor values a gift at $150,000, but the correct value is only $100,000, a 20 percent penalty will be imposed on the amount of the underpayment due to the IRS. With respect to a "gross" valuation misstatement, the 40 percent penalty on the amount of underpayment will be triggered where the misstatement is at least 200 percent of the correct value as determined by the IRS or a court of competent jurisdiction. Therefore, if the donation was reported as having a value of $200,000 but the correct value is $100,000, then the 40 percent penalty will be triggered.

Appraiser Penalties. An appraiser is subject to a penalty if the appraiser knew or reasonably should have known that the appraisal would be used in connection with a tax return and the claimed value of the property would result in a substantial or gross valuation misstatement. The penalty to which an appraiser is subject is the greater of (i) $1,000 or (ii) 10 percent of the amount of tax attributable to a substantial or gross valuation misstatement (capped at 125 percent of the gross income received by the appraiser for the valuation). Furthermore, appraisers should be aware that they can be barred from practicing before the Treasury or the IRS for valuation misstatements. The IRS will not penalize an appraiser, however, if it is determined that the value established in the appraisal is "more likely than not" the correct value.

Conclusion

There are significant areas of concern when seeking a deduction for any kind of charitable contribution. The donor faces possible consequences that range from the complete loss of the donation to the imposition of stiff penalties if a required appraisal is not appropriately and accurately prepared. Appraisers themselves can also face penalties. With donations of artworks, the need for careful attention to the appraisal process can be significantly increased. Care must be taken to find an appraiser with expertise in the particular type of artwork donated. In addition, there are indications that donations of artworks could be subject to greater scrutiny by the IRS in coming years.

1. See Appraisal Standards Board, "Ethics Rule," Uniform Standards of Professional Appraisal Practice (2008-2009) at U-8.
2. See, IRS Publication 561, "Determining the Value of Donated Property" (Rev. April 2007).
3. Jason Felch and Doug Smith, "Inflated Art Appraisals Cost U.S. Government Untold Millions," Los Angeles Times, March 2, 2008.