

How to...

Value Assets for Tax Purposes

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Learning Objectives

- Recognize that everyone – including the IRS – sees “value” differently
- Understand that fair market value (FMV) may be based on any substantiable method
- Learn that valuation is crucial for tax reporting purposes
- Identify the elements of a qualified appraisal
- Find and ascertain the credentials of a qualified appraiser

Topics we will cover...

- Value is in the Eye of the Beholder
- Definition & Importance of Valuation
- Establishing Value
- Charitable Contribution Rules Reviewed
- Qualified Appraisals & Appraisers
- Art Appraisals
- The Art Market

After Bill fixed his best friend Joe up with a blind date, Joe called to complain...

“What were you thinking?! That gal you fixed me up with was cross-eyed, almost bald, had a nose that was long & crooked, hair growing on her face, flat-chested, & ankles as thick as thighs!”

Bill quietly replied, “Either you like Picasso or you don’t.”



A rare yard sale find...



What's it worth?

If you're eco-minded, you could recycle the bottle for its redemption value...



5 ¢

If you're Mikey, a 4-year old who hates everything except LIFE cereal and anything slathered in ketchup...



\$3.97

What's it worth?

If you are Jim Croce who wants to save time in a bottle...



C\$9.07

If you're Martha Stewart and you've recently had plenty of time to come up with a new crafts project...



\$16 subscription

What's it worth?

If you're Alexander Graham Bell who hopes to revolutionize the world of communications by connecting 2 bottles with a string...



\$79 on e-Bay

If you're Major Anthony Nelson [Larry Hagman] and you need the bottle to recapture that mischievous genie...



\$218.96 boxed set

What's it worth?

If you're Thomas Andrews, builder of the Titanic, and you'd like to try something a bit less grand...



\$279 kit

If you're Chuck Noland [Tom Hanks] cast away on a remote island and you desperately need to send an SOS...



\$100K/yr lost wages

What's it worth?

If you're Andy Warhol and you are out of Campbell's Soup...



\$1,052,500
(11/10/09)

If you are Sherlock Holmes and you want to catch the perpetrator by dusting the bottle for fingerprints...



\$80 million
Movie production costs

What's it worth?

If you're a lovesick teenager just dying to play *Spin the Bottle*...



Priceless!

Value is in the Eye of the Beholder



Forget zillow.com!



...as seen by YOU



...as seen by your LENDER



...as seen by your BUYER



...as seen by your APPRAISER



...as seen by your TAX ASSESSOR

Definition of Value

- Utilitarian Value = worth in usefulness or importance to the possessor
- Market Value = amount considered to be the equivalent for something else [FMV]

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Importance of Value

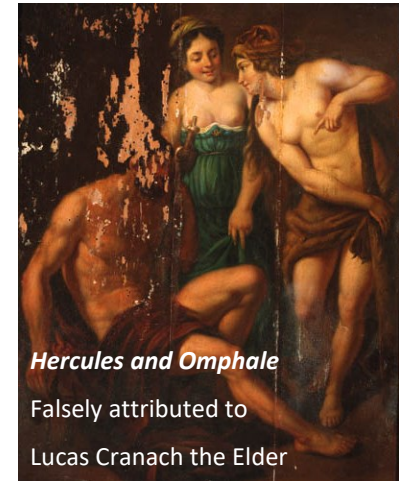
- Insurance coverage
- Division of marital or business assets
- Assess property, gift & estate taxes
- Compute depreciation & amortization
- Claim charitable deductions
- Satisfy curiosity
- One-upsmanship

A Different Value for Every Purpose

Purpose of Valuation	Party seeking HIGH value	Party seeking LOW Value
Insurance Premiums	Insurance Company	Policy Holder
Insurance Claim	Policy Holder	Insurance Company
Divorce Settlement	Husband or Wife	Husband or Wife
Intangible Assets	Seller	Buyer
Inventory	Buyer	Seller
Casualty Loss	Taxpayer	IRS
Depreciation	Taxpayer	IRS
Charitable Contribution	Taxpayer	IRS
Estate & Gift Tax	IRS	Taxpayer

Never the two shall meet!

- *Rebay v. Commissioner*: Taxpayer claimed charitable deduction of \$169,000; IRS valued donated painting at only \$7,000
- *Peters v. Commissioner*: IRS doubted the authenticity of donated paintings valued by taxpayer at \$100,000 and decreased allowable deduction to \$8,150
- *Rolfs v. Commissioner*: Taxpayer donated house valued at \$76,000 to fire department for training exercises but IRS disallowed deduction since taxpayer was spared the cost of demolition



How is FMV established?

- Comparable Sales – use values of similar items
 - Kelly Blue Book
 - www.zillow.com

BUT requires similarity of items, timing of transactions, market conditions & other circumstances

- Retail Market (vs. Dealer Market) – venue where public can participate

BUT does not always exist

Retail Pricing Depends on Timing

Father transfers new car to Son...

- If GIFT
 - value at retail purchase price
(b/c Father could have instead given cash to Son to buy car)
- If ESTATE
 - value at retail sales price
(since executor would otherwise be req'd to sell car at death)

Valuation Methodology

Book Value

Total assets minus total liabilities, with assets typically valued at historical cost

Income Approach

Analysis of average earnings over several years, projected cash flows & earnings

Market Approach

Compares one business to other firms in similar line of business

Blended Valuation

Combines multiple valuation methods by assigning weighted percentage to each



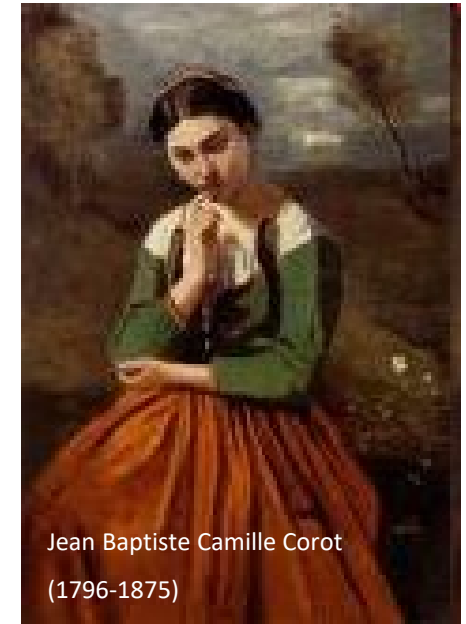
Examples of IRS Valuation Rules

- Stocks/Bonds – average of high/low prices on DOD (average of highs/lows on Friday & Monday if weekend death)
- Mutual Funds – Net Asset Value at close of business on DOD (Friday's NAV if weekend death)
- Minority/Closely-held Business Interests – may be discounted by as much as 10 – 45%
- Family Limited Partnership – may be discounted up to 20 – 30%
- Auction Purchase – Hammer price incl. buyer's premium

Comparable Sales of Art

- Art pieces are intended to be *unique*
- Often impossible to compare similar works by different artist or different works by same artist
- Instead, base current value on prior sale of specific piece

**BUT... \$250,000 charitable deduction
(based on earlier sales price of
\$310,000 of same piece) denied
by Tax Court since the painting
had been over-painted and poorly
restored**



Jean Baptiste Camille Corot
(1796-1875)

Valuation Depends on Property Type

- Capital Gain Property (CGP)
 - any asset that, if sold, would yield LTCG
 - valued at FMV
- Ordinary Income Property (OIP)
 - all other property
 - valued at cost

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CGP vs. OIP in Art World

Depends on donee...

- If ARTIST

painting = OIP

→ may only claim deduction for cost of materials

- If COLLECTOR

painting = CGP

→ may claim deduction for FMV at time of donation

UNLESS collector received artwork as gift from artist; then painting retains character as OIP



Contribution Rules Reviewed

Charitable deduction allowed if:

- Voluntary contribution made to a
- Qualified organization and
- Nothing received in exchange



(IN)ELIGIBLE DONEES

Eligible Donees	Ineligible Donees
Religious Institutions	Civic Groups, Fraternal Organizations, Social Clubs
Non-profit Schools & Hospitals	Lobbyists & Political Groups
Public Parks & Recreation Facilities	Homeowner's Associations
Human Service Organizations	School Tuition or Value of Time Donated

Amount of Allowable Deduction

- Taxpayer may deduct FMV of property donated
- Contributions typically limited to 50% of AGI [Contribution Base]
- Excess contributions may be carried forward 5 years

Carry-over provisions apply even if Standard Deduction is claimed → amount of carryover is reduced by amount that *would* have been deductible had the taxpayer itemized

Example of Allowable Deduction

Donor with AGI of \$100,000 contributes \$60,000 cash...

- Donor may deduct \$50,000 (1/2 of AGI) on current return
- Excess amount (\$10,000) may be carried forward

**Income
Limits
on
Charitable
Deductions**



Example of Carry-forward

Taxpayer's contribution base is \$20,000 (in 2020) & \$30,000 (in 2021).
Taxpayer contributed \$12,000 in 2020 and \$13,500 in 2021...

→ 2020 deduction = \$10,000 (2,000 excess carried-forward 5 years)

→ 2021 deduction = \$15,000 (= 13,500 + 1,500 of carry-forward)

Taxpayer's contribution base for 2022 is \$10,000.

Taxpayer contributed \$300 in 2022 but claims Standard Deduction...

→ 2022 deduction = \$0 (did not itemize)

→ 2023 deduction = treat \$500 remaining carry-forward from 2020 as though claimed on Schedule A in 2021; thus, no further carry-forward now available

Contribution Base

- Annual deductible limit for contributions is 50% of AGI
- BUT only 30% of AGI if:
 - Donation given to veterans' organizations, fraternal societies, or certain private foundations (30% Organizations), OR
 - Appreciated property (CGP) is donated to 50% Organization

Special Rules

- If CGP donated to 50% Organization, deduction can be raised to 50% of AGI if asset valued at cost (not FMV)
- If CGP donated to 30% Organization, deduction limited to 20% of AGI *unless* valued at cost

Example of AGI Limitation

Taxpayer with \$50,000 AGI donated \$15,000 CGP to 50% Organization & \$10,000 cash to 30% Organization...

- \$15,000 CGP gift subject to 30% AGI limit
- \$10,000 cash gift subject to 30% AGI limit

Both gifts are fully deductible since...

...each gift is $\leq 30\%$ of AGI (\$15,000), AND

...total gifts $\leq 50\%$ of AGI (\$25,000)

Rules must be applied in sequence!

Related Use Rule

- Taxpayer's charitable deduction may be limited to property's cost if donee organization does not use property appropriately
- Donor can assume "related use" if there's no evidence to the contrary at the time of the donation
- Donee organization must notify IRS if donated property > \$5,000 is sold/transferred within 2 years after date of donation

Examples of Related Use

Donation	Related Use (deductible at FMV)	Unrelated Use (deductible at cost)
Painting → museum for display	✓	
Painting → church for fund-raising auction		✓
Stamp collection → school for engraving curriculum	✓	
Antique car → university that did not have antiques restoration course		✓

Contributions & AMT

Charitable deductions are not preference items, BUT...

- Charitable contribution limits are set at either 30% or 50% of regular AGI
 - These limits are not recalculated based on AMT's AGI
- Thus, charitable deduction does not reduce taxable AMT income by same percentage as it reduces regular taxable income



Substantiation Requirements

Taxpayer has the burden of proof...

- Cash contributions < \$250: Canceled check, credit card receipt, or letter from donee organization acknowledging donation
- Cash contributions > \$250: Written acknowledgement from donee organization *required*
- Non-cash donations: *Written* receipt from donee organization with description of items donated
- Non-cash donations > \$5,000: Written appraisal

**Form 8283 may be used instead of appraisal
if art valued < \$20,000 or other property < \$500,000**

Penalties for Improper Valuations

For Over-valuations:

- 20% of underpaid tax due to over-valuation $\geq 200\%$
- 40% of underpaid tax due to over-valuation $\geq 400\%$

For Under-valuations:

- 20% of underpaid tax due to under-valuation 50 – 75%
- 40% of underpaid tax due to under-valuation by $\geq 75\%$

Appraiser Penalty

- Lesser of 10% of underpaid tax or 125% of gross appraisal fees charged (minimum \$1,000)



Appraisals

- May be required by IRS to substantiate donations, casualty losses, depreciation, gifts, decedent's estate
- Appraised Value \neq Assessed Value
 - Appraisal: Valuation of property as per an expert
 - Assessment: Worth assigned to property by taxing authority



What is a Qualified Appraisal?

- Prepared no earlier than 60 days before contribution
- Must include:
 - Description of property, including physical condition
 - Dates of contribution & appraisal
 - Terms between donor & donee
 - FMV of the property; methodology used
 - Statement that appraisal was prepared for tax purposes
 - Name, address & TIN of appraiser & fee arrangement

Fee cannot be based on percentage of FMV

Fee is generally non-deductible

- Must be signed by a qualified appraiser



Who is a Qualified Appraiser?

- Holds himself out to the public
- Performs appraisals on a regular basis
- Is subject to penalties for overstatement of value
- May not be donor or donee, a related party, or party to the transaction
- Must demonstrate competency, education/experience in valuing subject property, & earned appraisal designation from recognized appraisal organization



Examples of Failure to Comply

- *D’Arcangelo v. Commissioner*: \$40,000 deduction for art supplies to school disallowed because “appraisal” performed by high school’s principal
- *Hewitt v. Commissioner*: Deduction for stock donated to church disallowed because appraisal not attached to return & value was based on sporadic private party transactions

BUT...

- *Bond v. Commissioner*: Deduction for donation of two blimps upheld based on substantial compliance, even though appraiser’s qualifications were only provided after return was filed

Appraisals of Art

Must include:

- Cost, date & manner of acquisition
- Provenance & proof of authenticity
- If $\geq \$20,000$, copy of signed appraisal
 - must accompany return & photo must be available on request
- If $\geq \$50,000$, taxpayer may request Statement of Value from IRS prior to filing



“I’ve got this fantastic new app – I point my phone at a painting and it tells me its current market value.”

Statement of Value

- Taxpayer may request SOV *after* donation, gift or inheritance, but *prior* to filing return
- \$7,500 user fee for ≤ 3 items; \$400 for each additional item
- IRS may decline request if in the interest of efficient tax administration (fee is refunded)
- SOV is binding on IRS if taxpayer uses it in lieu of private appraisal
- If taxpayer prefers to rely on qualified appraisal, he must nevertheless submit SOV (once requested and received)

Special Rules for Art

- Qualified appraisal should be prepared by individual specializing in the kind & price range of subject art
 - Art historian
 - Museum curator
 - Auction house
 - Qualified Source List of the Department of the Treasury
 - Art Dealers Association of America [IRS typically accepts valuation but ADAA often does not appraise until *after* donation]
- Commissioner's Art Advisory Panel
 - 25 experts evaluate validity of submitted appraisals for art > \$50,000
 - Evaluate works in alphabetical order by artist (not donor) to avoid valuation of collection as a whole
 - Provide guidance to IRS auditors & appeals officers—determinations are binding
 - In 2019, Panel adjusted 136 of 250 total cases reviewed (54%), resulting in a net decrease of value of \$69 million (4% of \$1.7 trillion claimed by taxpayers)

Disputed Valuations

- Taxpayer may request written explanation from IRS
- IRS must respond within 45 days & provide copy of appraisal used
- Seek redress in court



Nature of the Art Market

Characterized by secrecy, illiquidity, volatility, lack of comparable sales, unique/not fungible, plagued by forgeries & mis-attributions



Vincent Van Gogh



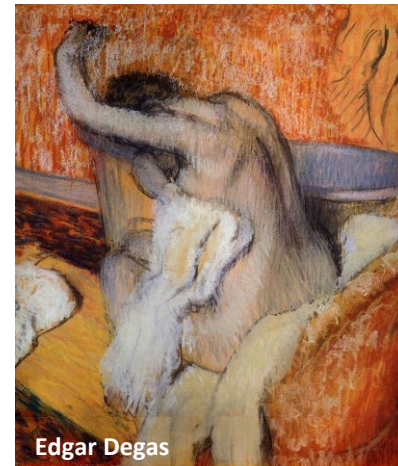
Catherine Mary



Pierre August Renoir



Wm.-Adolphe
Bouguereau



Edgar Degas

Dealer vs. Auction Market

- IRS requires that FMV must equal the sales price in market where item is most commonly sold to the public
- But most art sales occur between dealers (even at auction)
- Difficulties:
 - Auction fever may drive prices up
 - Hammer price includes buyer's premium which is not passed on to seller

Blockage Discount

- Simultaneous sales of same/similar properties could depress market
- Example:
Estate of Georgia O'Keefe applied a 75% blockage discount arguing that the value of each painting would be decreased if 400 paintings were sold in bulk. The court, instead, grouped works based on immediate salability versus long-term marketing.



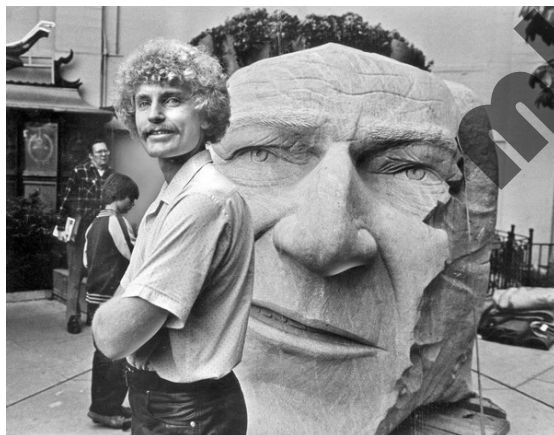
Lack of Comparable Sales

- *Rebay v. Commissioner*: Taxpayer's deduction disallowed because only one painting sold to inexperienced business associate
- *Cambridge Hotels, Inc. v. Commissioner*: Taxpayer allowed to claim full value of painting contributed because she had been professional artist for 30 years & had previously sold numerous pieces

EXPERIENCE

The Glamour Factor

Murphy v. Comm: In 1979, 100-ton “Malibu Rock” above Pacific Coast Hwy removed to protect residences. Sculptor Livingstone-Strong bought chip for \$100 & chiseled face of John Wayne while news circulated that actor would soon die. Taxpayer bought the sculpture, constructed building to house the piece & a float to transport it as part of Hollywood parade. [Court decreased valuation from \$500,000 to \$30,000]

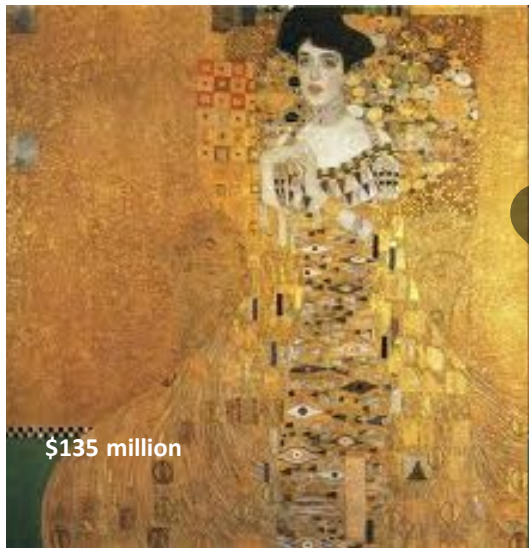


Perdue v. Comm: Spanish galleon Nuestra Senora de Atocha sailed from Cuba in 1622 carrying gold/silver treasure; sank 40 miles off Key West. Rediscovered in 1985, shipwreck became subject of 3 films, 2 Natl. Geographic documentaries, movie starring Cliff Robertson, & several books. [Charitable deduction of \$311,000 upheld based on notoriety; IRS had sought to revalue at \$74,000]



The Stolen Klimts

Maria Altmann (1916 – 2011) successfully sued Austrian govt. for return of 5 Gustav Klimt masterpieces valued at \$150 million in 2006; sold at auction shortly thereafter for \$416 million, thanks to the publicity generated by lawsuit. Altman was niece of Adele Bloch-Bauer, patron of & model for artist. She died in 1925 and willed artwork to Austrian govt. after husband's death but Nazis looted before Frederick died in 1946.



\$193 million



Pop Art



Fractional Giving

- Previously, collectors gave partial ownership to museum in exchange for pro-rated deduction of item's value. As item appreciated, collector would donate another fraction & claim new tax deduction based on increased valuation.
- IRC now requires museum to take complete possession within 10 years & limits donor's deduction to FMV at time of original donation.



Lack of Predictability

When the value of a collection takes off, the result can be bad news for estate plan...

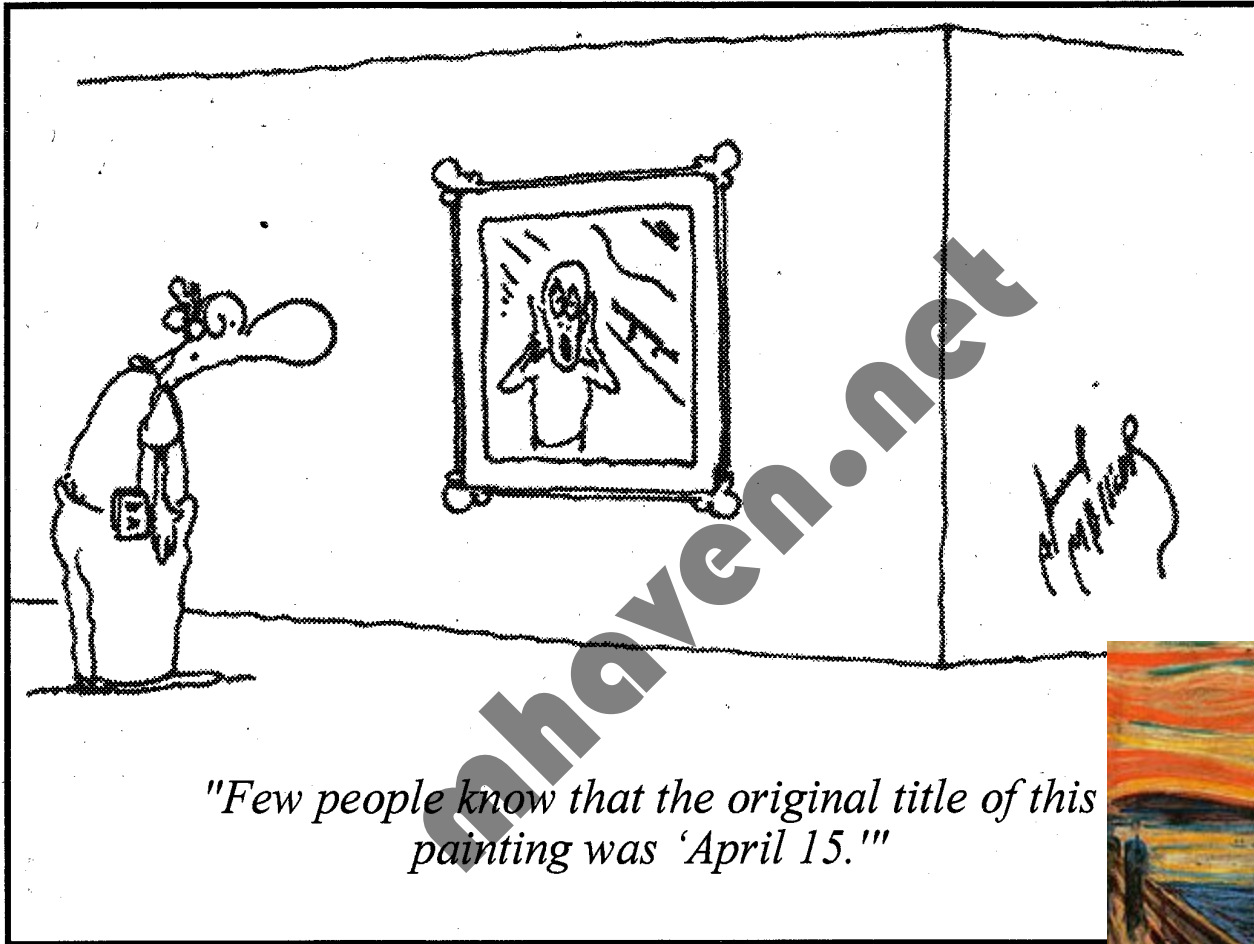
- Taxpayer with net worth of \$15 million (incl. 2 sculptures valued at \$5 million) anticipated estate tax of \$4.5 million & planned to satisfy obligation with life insurance policy.
- Sculptor died before collector & value of 2 pieces climbed to \$32 million! Resulting estate tax rose to \$12 million; an amount no longer covered by insurance or all remaining assets in estate.

Tax Avoidance Schemes

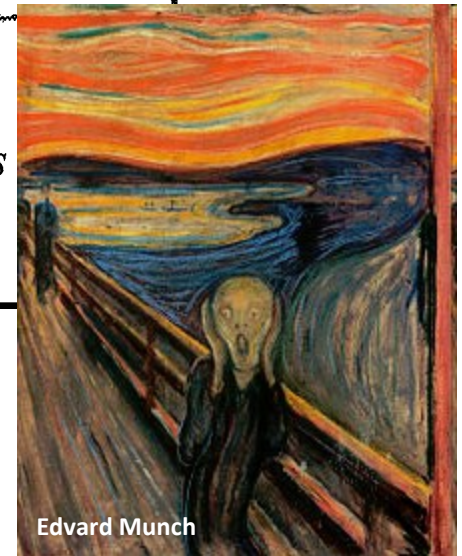
- 100,000 taxpayers save \$1 million each year with art donations
- As per IRS, > ½ of donations are appraised at double their value
 - Art-flipping: Taxpayer buys art at low price from promoter, then donates art to charity at inflated value established by promoter
 - From 1973 to 1985, Getty Museum accepted donations of Greek/Roman antiquities from wealthy “collectors,” who never owned the objects they gave. Instead, curator imported objects, inflated their values in forged appraisals, & asked high net worth individuals to lend their names to charitable donations in exchange for tax write-offs.
 - Tyco International President Dennis Kozlowski had \$13 million of art purchases shipped out of state to avoid 8.25% sales tax (\$1,072,500) & then smuggled art back to his Fifth Avenue apt.

If abuse is rampant, why encourage charity?

- As a matter of public policy
- BUT...
 - Contribution rules benefit the wealthy most
 - Contributions often not made for philanthropic reasons; instead help donor acquire fame & recognition
 - Govt. loses control of discretionary spending by granting taxpayers power to direct funding toward privately selected beneficiaries
 - Valuation problems make it virtually impossible to guarantee tax uniformity



"Few people know that the original title of this painting was 'April 15.'"



Edvard Munch

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