

“IT BELONGS IN A MUSEUM”¹: APPROPRIATE
DONOR INCENTIVES FOR FRACTIONAL
GIFTS OF ART

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INTRODUCTION

Paul Cézanne’s *Boy with a Red Vest*, René Magritte’s *Kiss*, and Henri Matisse’s *Plum Blossom* share one unexpected characteristic: each became accessible to the museum-going public through fractional giving.² These important works as well as entire collections have been donated through this method. The Metropolitan Museum of Art (MMA) in New York, for example, owes its Annenberg Collection to a fractional giving plan.³ That impressive collection comprises fifty-three Impressionist and Post-Impressionist works, including renowned artists Claude Monet, Edgar Degas, Édouard Vuillard, and Paul Cézanne.⁴ Thanks to fractional giving, these works are now on public display.⁵

Fractional giving allows a collector to donate an artwork to a museum incrementally by gradually increasing the portion of each

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1 INDIANA JONES AND THE LAST CRUSADE (Paramount Pictures 1989).

2 See Jeremy Kahn, *Museums Fear Tax Law Changes on Some Donations*, N.Y. TIMES, Sept. 13, 2006, at E1.

3 See The Metropolitan Museum of Art—Works of Art: European Paintings, http://www.metmuseum.org/works_of_art/introduction.asp?dep=11 (last visited Apr. 1, 2008).

4 See The Metropolitan Museum of Art—The Collection: Recent Acquisitions, http://www.metmuseum.org/works_of_art/recent_acquisitions/2000/co_rec_eur_41-50.asp (last visited Apr. 1, 2008).

5 Cézanne and Matisse’s works are now on display at New York’s Museum of Modern Art (MoMA); the Houston Museum of Art displays the Magritte. See Kahn, *supra* note 2.

year during which the museum has rights to the work.⁶ A donor can, for example, give a museum a twenty-five percent interest in a work of art, which entitles the museum to possess the work for three months, or twenty-five percent of the year, while the donor keeps the work for the rest of the year. This donation method culminates in the donor's bequest of the work to the museum.⁷ Fractional giving provides tax benefits for the donors and encourages the time-honored American tradition of giving to public museums.

The Association of Art Museum Directors (AAMD) has declared that "[t]he mission of all art museums is to serve the public through art and education."⁸ Philippe de Montebello, longtime Director and Chief Executive of the MMA, strongly believes that "the purpose of a museum is not to entertain but to enlighten and instruct."⁹ The public availability of these great institutions relies on private support: American museums were built on private donations¹⁰ and, arguably, could not survive without them. The museum community itself "contends it could not exist as a public repository of exhibition objects without tax induced patronage."¹¹

While fractional giving is therefore highly beneficial, it leaves open some opportunities for tax abuse. The potentially significant tax deductions available to donors under § 170 of the Internal Revenue Code could, for example, tempt a donor to overvalue a donated work.

6 See Rachel Emma Silverman, *Joint Custody for Your Monet*, WALL ST. J., July 6, 2005, at D1.

7 See *id.* To ensure a smooth transition, the museum will ordinarily condition acceptance of a fractional donation on the assurance that it will receive the balance of the work upon the collector's death. See 3 RALPH E. LERNER & JUDITH BRESLER, *ART LAW* 1578-79 (3d ed. 2005). Glenn Lowry, director of MoMA, calls fractional giving "an eminently sensible way of allowing someone who has spent tens of millions of dollars acquiring a work to transfer it to a cultural institution that could never afford to buy it. The beauty is that at the end of the day, the museum owns the work outright." Elizabeth Schwinn, *Charity Leaders Seek to Decipher New Rules Designed to Curb Abuses*, CHRON. PHILANTHROPY, Sept. 14, 2006, at 21, 23.

8 Ass'n of Art Museum Dirs., *Art Museums, Private Collectors, and the Public Benefit* 3 (Oct. 2001), <http://www.aamd.org/papers/documents/PrivateCollectors.pdf>.

9 Charles McGrath, *Twilight of the Sun King*, N.Y. TIMES, July 29, 2007, § 2, at 1; see also JESSICA L. DARRABY, *ART, ARTIFACT AND ARCHITECTURE LAW* § 1:13, at 12 (2007) ("A museum . . . has an historical objective of preservation and a tax-exempt purpose of education."); JOHN MAXON, *THE ART INSTITUTE OF CHICAGO* 7 (1970) (describing the purposes behind the founding of the Art Institute of Chicago and noting that "there was a strongly didactic motivation which, in its turn, represented a genuinely ethical purpose").

10 See *infra* Part I.A.

11 See DARRABY, *supra* note 9, § 3:35, at 141.

It is also possible that a donor could make a fractional donation and receive an immediate tax deduction without giving up effective control and use of the work until the entire ownership interest is transferred.¹² In an attempt to eliminate these perceived problems, Congress passed the Pension Protection Act (PPA) of 2006.¹³ The Act succeeded in tightening the law to prevent its abuse; however, its changes have gone so far that they threaten to suffocate legitimate fractional giving. Anecdotal evidence already shows that the PPA's restrictive provisions and strong focus on abuse prevention have unraveled numerous incomplete and potential art donations.

Part I of this Note explains the state of fractional giving law leading up to the PPA, highlighting its incentives for donors and benefits to museums. Part II introduces the PPA. It considers Congress' reasons for passing the Act and describes how the Act modified fractional giving law. Part III discusses the Act's effects over the last year and what changes are necessary to revive fractional giving. This Part argues that Congress' goals would be better achieved with a more moderate and longer-term approach to fractional gifts.

I. CHARITABLE GIVING TO ART MUSEUMS

American museums owe their foundation and continued development to donations and support from private individuals. The law encourages this growth through tax incentives that benefit donors, museums, and ultimately the public. The PPA, by undermining those incentives with respect to fractional giving, reduces the advantages flowing to all of these beneficiaries.

A. *The Museums' Reliance on Art Donations*

Over ninety percent of the art held in American museums has been donated by private individuals.¹⁴ Further, donors provide an estimated eighty percent of museums' new acquisitions.¹⁵ While the thousands of works that have come to art museums by means of frac-

12 See *infra* notes 74–80. This kind of abuse became possible after *Winokur v. Commissioner*, 90 T.C. 733 (1988), *acq. in result*, 1989-2 C.B. 1, *superseded by statute*, Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780.

13 Pub. L. No. 109-280, 120 Stat. 780 (codified in scattered sections of 26, 29 I.R.C.).

14 See Ass'n of Art Museum Dirs., *supra* note 8, at 1; see also MAXON, *supra* note 9, at 7 ("In the United States, museums are the product of extraordinary private patronage . . .").

15 See Kahn, *supra* note 2.

tional donation¹⁶ constitute only around ten percent of new acquisitions, they often comprise the “most valuable and historically significant pieces.”¹⁷ Private owners hold some of the most important works of art; these owners are less likely to part with the works outright than they are to donate them a little at a time.¹⁸ Museums have an easier time convincing donors to share their collections if the transition can be both gradual and mutually beneficial. As such, museums consider fractional donations an “important tool to make the best art available to the American public.”¹⁹

Some museums rely more on fractional donations than do others. The collection of New York’s Museum of Modern Art (MoMA) includes about 650 works that began as fractional gifts and, importantly, has another 600 incomplete partial donations.²⁰ The Los Angeles County Museum of Art saw 80 fractional gifts reach completion between 2003 and 2006 and, as of fall 2006, had fractional interests in over 100 outstanding works.²¹ The San Francisco Museum of Modern Art (SFMOMA), which has the most fractional gifts of any museum in the country, has approximately 800 such gifts.²²

Donations remain vital to museum acquisitions in part for the simple reason that museums’ acquisition budgets cannot keep pace with the art market. In recent years, prices for “top” works of art have

16 *See id.*

17 *Id.*

18 Press Release, Representative Tom Udall, Arts Community Rallies Behind Udall-English Bill to Promote Charitable Art Contributions (Oct. 17, 2007), http://www.tomudall.house.gov/index.php?option=com_content&task=view&id=310&Itemid=1.

19 Letter from Gail Andrews, President, Ass’n of Art Museum Dirs., to Congressman John Lewis, Chairman of the House Ways and Means Oversight Subcomm. (July 27, 2007) [hereinafter Letter to Chairman Lewis], *available at* <http://waysandmeans.house.gov/hearings.asp?formmode=printfriendly&id=6391>.

20 *See Kahn, supra* note 2. The 650 completed fractional gifts are only a small percentage of the museum’s collection. *See* The Collection, <http://www.moma.org/collection/> (last visited Apr. 1, 2008) (noting that the museum’s collection “include[s] 150,000 paintings, sculptures, drawings, prints, photographs, architectural models and drawings, and design objects”). However, when the outstanding gifts are completed, MoMA will have 1250 works donated through this method, which is not an inconsiderable number.

21 *See* Ashlea Ebeling, *Will Democrats Ride to Museums’ Rescue?*, FORBES.COM, Nov. 22, 2006, http://www.forbes.com/2006/11/21/beltway-museums-tax-biz-wash-cz_ae_1122beltway.html.

22 *See* Looking Around, http://time-blog.com/looking_around/ (Oct. 15, 2007, 17:21).

climbed to four times their actual value,²³ making it very difficult for museums themselves to purchase museum-quality works. Neal Benezra, director of SFMOMA, has described museum acquisition of works via the art market as “impossible.”²⁴ He noted that art museum participation in art fairs has been reduced to “advising [the] collectors . . . to buy certain pieces that [the museums] hope will come [their] way.”²⁵ It follows that private donations have always been, and continue to be, essential to the art museum system.

Donations from private collectors do more than add works to a museum’s collection; they also infuse the collection with continued vitality: “[w]ith contemporary art, collectors can take greater risks than institutions in acquiring new art and making it accessible to the public through gift[s] and loans to museums.”²⁶ This freedom to take risks benefits the public when the works pass to museums through gifts and loans.²⁷ Therefore, it is important to support donations to these institutions through all available means, including the tax code.

B. *The Incentives to Donate*

The law supports the public interest in moving important works from the private to the public sphere by making such transitions

23 See Ed Pilkington, *Disastrous Sale Sends Sotheby’s Shares Falling by 37% in One Day*, GUARDIAN, Nov. 9, 2007, at 20.

24 Looking Around, *supra* note 22 (Oct. 15, 2007, 17:21).

25 *Id.*

26 Ass’n of Art Museum Dirs., *supra* note 8, at 1; see also, e.g., Press Release, Art Inst. of Chi., Art Institute of Chicago to Make Historic Loan of Impressionist and Post-Impressionist Master Works to Kimbell Art Museum 2 (Nov. 2, 2007), available at http://www.artic.edu/aic/aboutus/press/AIC_Kimbell_Loan_PR_.pdf (“Originating from the gifts of prescient Chicago collectors in the late 19th century, the museum’s collection of Impressionist and Post-Impressionist works—considered the vanguard art of its time—now includes paintings, sculptures, and more than 1,000 works on paper by dozens of recognized masters.”); Richard B. Woodward, *Robber Barons 1, Old Masters 0*, GUARDIAN UNLIMITED, Nov. 7, 2007, <http://arts.guardian.co.uk/art/visualart/story/0,,2203372,00.html> (“To purchase Joachim Wtewael’s *The Golden Age*, a tiny work on copper from 1605 and the kind of vivid Mannerist allegory that museums today covet, required avant-garde taste and the bequests of nearly 10 people in 1993.”).

27 Donors also help the museums through financial contributions. These resources allow museums to pay other important expenses that help them carry out their functions, including less noteworthy ones like utility bills. See Ass’n of Art Museum Dirs., *supra* note 8, at 1 (noting that donors’ gifts “support scholarship, publications, educational programming, capital projects and administrative expenses”); Woodward, *supra* note 26 (“Art institutions are expensive to run and need a steady cash flow for dozens of unglamorous line items, from window-washing and preservation to insurance and HVAC [heating, ventilation, and air conditioning].”).

mutually beneficial to the donor and the receiving institution. Over the years, favorable tax treatment has succeeded in encouraging art donations.²⁸ The law must continue to provide these benefits so that collectors do not turn to alternative ways of dispersing their unique and valuable property.

1. The Favorable Tax Treatment of Charitable Contributions

Section 170 of the Internal Revenue Code,²⁹ which addresses charitable giving, demonstrates Congress' recognition of the value of public access to works of art and its willingness to support the arts with tax incentives.³⁰ As relevant to museum donations, the tax code defines "charitable contribution" to mean "a contribution or gift to or for the use of . . . [a] corporation, trust, or community chest, fund, or foundation . . . organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes."³¹

In practical terms, donations to a charitable organization save a donor money on income taxes through deductions.³² An individual who itemizes deductions on her tax return can deduct the appreciated value of property she has donated.³³ One particularly critical feature of charitable donation law is donors' ability to omit recognition of gain on donated property.³⁴ It allows individual taxpayers to avoid counting capital gains as income by donating the property to a charitable institution; instead, they can reduce their taxable income (from other sources) by the amount of the gain. This tremendous benefit can hardly be overstated.

Section 170 places several conditions on the receipt of tax benefits for art donations and provides several steps to determine the value and extent of the allowable deduction. First, the receiving organization must itself be qualified. In § 170(c), the Code sets out the kinds of organizations to which a donation could result in a tax deduction.

28 See *infra* Part III.

29 I.R.C. § 170 (West Supp. 2007).

30 See DARRABY, *supra* note 9, § 3:35, at 141 ("Congress crafted Section 170 of the Internal Revenue code to stimulate and reward charitable contributions; Section 170 is considered by the arts community to be a government sanctioned method to transfer unique and valuable works from private collectors to institutions. The incentive to donate art from the private sector to the museum sector is central to America's position on the role of the arts in a democratic culture: art publicly accessible through geographic and socioeconomic dispersal.").

31 I.R.C. § 170(c)(2)(B).

32 See 3 LERNER & BRESLER, *supra* note 7, at 1554.

33 See BRUCE R. HOPKINS, CHARITABLE GIVING LAW MADE EASY 4 (2007).

34 See *id.* at 25.

Museums are eligible organizations for the same reasons that they qualify for tax-exempt status under § 501(c)(3)³⁵ and therefore qualify to receive donations that will trigger tax benefits for the donor.³⁶

The nature of the property is the next determinative factor. The Code places property into two categories: (1) long-term capital gain property and (2) ordinary income or short-term capital gain property.³⁷ The property's type determines the amount of the available deduction. Long-term capital gain property, when given to a public charitable organization, allows a deduction based on the property's full fair market value.³⁸ The Code defines long-term capital gain property as "any capital asset the sale of which at its fair market value at the time of the contribution would have resulted in gain which would have been long-term capital gain."³⁹ Personal property held for investment purposes is considered a capital asset.⁴⁰

On the other hand, the Code limits the deductibility of ordinary income property and short-term capital gain property.⁴¹ Ordinary income property is "property that, if sold, would give rise to gain that is not long-term capital gain."⁴² Short-term capital gain property also falls within this category, since, by definition, any gain from its sale would be short-term and not long-term gain.⁴³ For property in this category, the benefit derived from the donation is reduced by "the amount of gain which would not have been long-term capital gain . . . if the property contributed had been sold by the taxpayer at its fair market value."⁴⁴ This rule effectively limits the deduction to the donor's basis (or adjusted basis) in the property, which is often the price the donor paid for the property.⁴⁵ The Code, then, particularly encourages donation of long-term capital gain property by connecting to it greater benefits.

35 See I.R.C. § 501(c)(3) (2000).

36 See *id.* § 170(c)(2) (West Supp. 2007).

37 See HOPKINS, *supra* note 33, at 26.

38 See *id.* at 27.

39 I.R.C. § 170(b)(1)(C)(iv). A "long-term capital gain," in turn, is defined as "gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income." *Id.* § 1222(3) (2000).

40 See Treas. Reg. § 1.1221-1(b) (as amended in 1975).

41 See *id.*

42 HOPKINS, *supra* note 33, at 27.

43 See *id.* The Code defines short-term capital gain as "gain from the sale or exchange of a capital asset held for not more than 1 year, if and to the extent that such loss is taken into account in computing taxable income." I.R.C. § 1222(1).

44 I.R.C. § 170(e)(1)(A) (West Supp. 2007).

45 See I.R.C. § 301(d) (2000) (defining basis as the property's fair market value).

The donated property's classification also affects the percentage limitations on the deductions that § 170(b) prescribes. That is, no donor is eligible for an unlimited deduction; § 170(b) sets boundaries on the portion of a donor's contribution base for which deductions are allowable. Contribution base usually means adjusted gross income.⁴⁶ In general, for donations made to a public charity, the deduction available for long-term capital gain property will be limited to thirty percent of the donor's contribution base.⁴⁷ For example, the amount deductible would be capped at \$120,000 (thirty percent of \$400,000) for a donor whose contribution base is \$400,000. In the case of ordinary income or short-term capital gain property, the relevant limitation is fifty percent of the donor's contribution base.⁴⁸ The carryover provisions in § 170(d) mitigate these limitations to some extent. The provisions allow an individual whose donation exceeds the limitation on her contribution base to have the excess treated as a charitable contribution "paid in each of the 5 succeeding taxable years in order of time," subject to some limitations.⁴⁹ So, if the donor whose contribution base is \$400,000 were to donate that long-term capital gain property, valued at \$200,000, the donor would receive the deduction for that \$80,000 difference (that is, the difference between the full \$200,000 value of the donation and the \$120,000 donation cap) in the next year.⁵⁰

Calculating the value of any long-term capital gain property deduction therefore requires a determination of the property's value. The relevant value for tax purposes is a work's "fair market value" (FMV).⁵¹ If the resulting deduction will exceed \$5000, the Code

46 See I.R.C. § 170(b)(1)(G) (West Supp. 2007). The one modification to adjusted gross income that may apply is that contribution base does not take into account "any net operating loss carryback to the taxable year under section 172." *Id.* "Adjusted gross income," in turn, means an individual's gross income minus any of several possible deductions listed in the Code. *Id.* § 62 (2000).

47 See *id.* § 170(b)(1)(B) (West Supp. 2007). It is possible for an individual subject to this thirty percent limitation to elect a fifty percent limitation instead. See HOPKINS, *supra* note 33, at 74. Doing so, however, will result in the reduction of the deductible value to what the donor paid for the work; the value of appreciation must be subtracted. I.R.C. § 170(b)(1)(C), (e)(1).

48 See HOPKINS, *supra* note 33, at 70.

49 I.R.C. § 170(b)(1)(C)(ii) (thirty percent limitation); *id.* § 170(d)(1)(A) (fifty percent limitation).

50 Assuming the donor had a sufficient contribution base in that year.

51 Fair market value is commonly defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 1.170A-1(c)(2) (2005).

allows it only if the work is appraised and certain information regarding the qualified appraisal is attached to the donor's tax return.⁵² Compliance with this section does not mean that the appraisal will be accepted; the appraisal must satisfy the IRS's particular terms or it will “not be given much weight.”⁵³ Not surprisingly, disagreements tend to arise between the donor and the IRS as to the item's value.⁵⁴ These disputes ordinarily settle, but they are sometimes litigated in court,⁵⁵ where they are considered questions of fact.⁵⁶ The Code prescribes penalties for overstating the value of donated property.⁵⁷

Finally, donations of tangible personal property—like works of art—are subject to the “related use” rule. This rule requires that the organization receiving the property use it in a way that relates to the donee's exempt status under the Code.⁵⁸ Failure to comply results in a reduction in the amount of the deduction by “the amount of gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value.”⁵⁹ This reduction effectively limits the deduction to the donor's basis (or adjusted basis) in the property. After the amount of the available

52 See I.R.C. § 170(f)(11); see also Internal Revenue Serv., Dep't of the Treasury, Instructions for Form 8283 § B, at 4 (2006), available at <http://www.irs.gov/pub/irs-pdf/i8283.pdf> (noting that a copy of the qualified appraisal does not need to be attached to the return unless the donated art has a value of \$20,000 or more). To be a “qualified appraisal,” the appraisal must fulfill the regulations promulgated by the Secretary and be done by a qualified appraiser according to “generally accepted appraisal standards.” I.R.C. § 170(f)(11)(B)–(C), (E)(i)(II). The PPA added language now codified in this section to define more clearly this area of the law. A “qualified appraiser” is now subject to specific educational and experience-related requirements, must regularly appraise items in return for compensation, and must fulfill the terms of any regulations the Secretary should issue. *Id.* § 170(f)(11)(E)(i)(II).

53 INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUB. NO. 561, DETERMINING THE VALUE OF DONATED PROPERTY 8 (2007), available at <http://www.irs.gov/pub/irs-pdf/p561.pdf>.

54 See HOPKINS, *supra* note 33, at 130.

55 See *id.*

56 See DARRABY, *supra* note 9, § 3:21, at 127–28.

57 See Pension Protection Act of 2006 § 1219, I.R.C. §§ 6662, 6664, 6695A, 6696 (West Supp. 2007). These sections tighten the rules that relate to overstatement of the value of the gift. Section 6695A discusses the penalties involved for misstatements based on an incorrect appraisal.

58 See 3 LERNER & BRESLER, *supra* note 7, at 1561.

59 I.R.C. § 170(e)(1). This penalty rescinds that all-important benefit to the donor of not having to recognize gain on donated appreciated property. See *supra* notes 33–34 and accompanying text.

deduction is recalculated, the fifty percent limitation may apply to the (now reduced) deduction.⁶⁰

This rule raises the question of what constitutes a related use. The IRS has rendered few decisions to clarify this point. However, in the narrow category of donations to art museums, the related-use rule should be relatively easily satisfied. During the legislative process, House Ways and Means Committee chairman Wilbur D. Mills actually used art donations to explain the related-use rule:

What we are trying to say is that we will allow you to give this appreciated property and take today's market value as a charitable deduction without any tax consequences to you whatsoever if you give it to a charitable organization that normally would use the property for its exempt purposes. Now, a clear case of this is a gift of a picture or work of sculpture, or anything of that sort, to a museum.⁶¹

What the legislative history does not address—and what remains unclear—is whether merely taking possession of a work is enough to satisfy the related-use rule, or whether the museum must put the work on display.⁶²

2. The Tax Implications of Fractional Giving

Although fractional gifts remain in the donor's possession part time, they do fall within the scope of tax deductible charitable contributions.⁶³ This situation runs counter to the Code's more general rules, which restrict—and in many cases prohibit—deductions for donations of partial interests in property.⁶⁴ However, the Code specifically exempts the contribution of an “undivided portion of the taxpayer's entire interest” in property from the general rule.⁶⁵ Ordinarily the “undivided interest” is a portion of a whole asset, but the donation can also be given in terms of a percentage of a year. When a donor gives this undivided interest, the donor gives her *entire* interest. That is, she gives “a fraction or percentage of each and every

60 See HOPKINS, *supra* note 33, at 70.

61 115 CONG. REC. 40,869 (1969) (statement of Rep. Mills).

62 While the reading requiring the museum to put the work on display would place greater burdens on the museum, the related-use rule otherwise accomplishes little but to divest the donor of her object for a specified period. The mere gesture of transferring the work would not ensure compliance with the spirit of the fractional giving arrangement.

63 See 3 LERNER & BRESLER, *supra* note 7, at 1576.

64 See I.R.C. § 170(f)(3)(A); I.R.S. Priv. Ltr. Rul. 93-03-007 (Oct. 20, 1992).

65 I.R.C. § 170(f)(3)(B)(ii); Treas. Reg. § 1.170A-7(b)(1) (1994).

substantial interest or right" she has in the property.⁶⁶ In general, a donor who withholds specific rights fails to fulfill this requirement.

An art donor who conforms to this provision's requirements is eligible for a tax deduction. The fractional gift's value, for tax deduction purposes, will be the percentage donated times the work's full FMV at the time of donation.⁶⁷ For example, if the donor gives a twenty-five percent interest in a painting worth \$1 million, she is, other restrictions aside, eligible for a \$250,000 tax deduction.

Careful use of fractional gifts could, prior to the PPA, increase the donor's total charitable deduction in two different ways.⁶⁸ The first way fractional giving can increase the total tax benefit involves the Code's percentage limitations.⁶⁹ When an individual makes a fractional donation of qualified capital gain property to a public charity and does not choose the fifty percent limitation, the thirty percent limitation will apply.⁷⁰ Depending on the work's value and the donor's contribution base, fractional giving allows the donor to avoid forfeiting part of the donation's value:

[f]or example, if a taxpayer has a yearly adjusted gross income of \$400,000 and she wants to donate a collection with the value of \$1 million, the maximum deduction is \$120,000 each year (30% times \$400,000) for the year of donation and each of the next five carry-over years for an overall total of \$720,000 (six years times \$120,000).⁷¹

By donating this way, the donor loses the difference between the work's full value and the available deduction (here \$280,000). Structuring this donation instead as a pair or a series of fractional gifts would allow the donor to reap the full benefit of the Code's allowed deductions. In halves, for example, the donation amounts to \$500,000, twice. Where the donor's contribution base remains \$120,000, a fractional gift of \$500,000, unlike the full \$1 million, can be absorbed during the carryover years. Once the first half of the gift is fully deducted, the donor can make the second \$500,000 gift, again taking advantage of the carryover provisions. Using this method, the donor does not forfeit that \$280,000. Breaking the donation into two parts therefore allows the donor to use the law's full benefit.

66 Treas. Reg. § 1.170A-7(b)(1)(i).

67 See Rev. Rul. 57-293, 1957-2 C.B. 153, 155.

68 Under the PPA, the second method described here has become unavailable. See *infra* text accompanying notes 111-12.

69 See *supra* notes 46-50 and accompanying text.

70 See HOPKINS, *supra* note 33, at 72-73.

71 3 LERNER & BRESLER, *supra* note 7, at 1577.

The second and now unavailable method worked by taking into account the donated object's increasing value. That is, a fractional donor breaks up her donation over a period of years.⁷² A donor who has already donated a twenty-five percent interest in a painting can, years later, donate an additional twenty-five percent interest in the same work. At the time of the later donation, the work may have appreciated, either because of the passage of time or for the very reason that the work had been displayed in a museum. As such, twenty-five percent of the second donation's FMV exceeds that of the same proportion of the first. Under pre-PPA law, if this pattern continued until the whole work was donated, the charitable deduction could significantly exceed the painting's total value as of the first donation.⁷³

One additional aspect of pre-PPA fractional giving made it especially appealing to both museums and donors. This benefit came out of the key fractional giving case *Winokur v. Commissioner*.⁷⁴ In that case, the donor had given the Carnegie Institute a fractional interest in several works of art, but the museum did not physically take possession of the works during two of the years in question.⁷⁵ The issue arose whether the donor could receive a tax benefit for a donation made even though the works did not leave his possession.⁷⁶ The court answered the question affirmatively:

Neither the statute nor the regulations require the donee organization to take physical possession of the donated property during the year immediately following the gift. In order for an undivided interest to be treated as a present interest and not a future interest, the donee must simply have the right to interrupt the donor's possession and the right to have physical possession of the property during each year following the donation, equivalent to its undivided interest in the property, in addition to the other rights of a tenant in common.⁷⁷

The court noted specifically that the donor had not prevented the museum from taking possession; the museum voluntarily chose not to exploit its rights.⁷⁸ As a result of this case, the donee's right to possess the work sufficed to allow the donor to enjoy the tax deduction

72 See *id.*

73 See *id.*

74 90 T.C. 733 (1988), *acq. in result*, 1989-2 C.B. 1, *superseded by statute*, Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780; see *infra* text accompanying notes 105-08.

75 See *Winokur*, 90 T.C. at 734-35.

76 See *id.* at 736.

77 See *id.* at 740.

78 See *id.*

regardless of whether the museum actually took possession of the work.⁷⁹ Museums therefore had great flexibility with respect to their treatment of fractional gifts. A museum could leave the works with the donors during years in which the museum's plans did not require actual possession of the artwork.⁸⁰

Fractional giving law as it existed prior to the PPA succeeded in encouraging many private collectors to donate their holdings to art museums.⁸¹ The PPA restricted fractional giving law in important ways, rendering it uninviting to the donor and therefore unhelpful to art museums.

II. "THE DEATH OF FRACTIONAL GIFTS"⁸²: THE PENSION PROTECTION ACT OF 2006

Unfortunately, the widely beneficial nature of fractional giving law carried a risk of abuse by the less civic-minded. Congress saw fractional giving of art as both easy to abuse and inconsistent with most of the Code, which does not allow fractional gifts of tangible assets and usually requires that the benefit to the public and the corresponding tax deduction happen in the same year.⁸³

To address these perceived weaknesses, Congress included provisions directed at fractional giving in the PPA. Senator Chuck Grassley, chairman of the Committee on Finance, developed the Act's charitable-giving incentive package with the goal of preserving donor incentives while "shut[ting] down abuse of non-profit organizations' tax-

79 This benefit is important to collectors, many of whom collect out of a real love for art. One donor describes the experience of having art in his home thus:

The difference between having something in my bedroom, or living room, and looking at it in a museum is that I can see it any time of day or night. If I want to get up in the middle of the night and go look at it, I can go look at it. I can't go to the Met [Metropolitan Museum of Art] at midnight.

DANNY DANZIGER, *MUSEUM: BEHIND THE SCENES AT THE METROPOLITAN MUSEUM OF ART* 120–21 (2007). The same collector notes that his joy in giving money to the museum comes from the knowledge that "it's going to help other people have a place to see what we should all see, which is beautiful art, and in this way I can give back." *Id.* at 121.

80 Incidentally, the cost of insuring and preserving the artwork remained with the donor throughout the year. *See infra* note 165.

81 *See supra* Part I.A.

82 Art lawyer Ralph E. Lerner sounded the death knell of fractional giving shortly after the PPA's passage. *See Kahn, supra* note 2.

83 *See id.* The allowance for fractional giving of art falls under an *exception* in the tax code. *See supra* note 63–67 and accompanying text.

exempt status.”⁸⁴ With respect to fractional giving, the Act aimed to reduce the revenue the deductions cost the federal government and to address the delay of the donated art’s introduction to the public sphere.⁸⁵ The law attempted, in a sense, to ensure that the tax breaks delivered what taxpayers had paid for: “that all citizens have the right to view artworks that received federal subsidies.”⁸⁶ It is important to note that this goal recognizes the value of bringing the works to the public. In theory, then, all of the involved parties seek the same ends; their disagreement hinges on how best to accomplish those ends.

Congress particularly intended to prevent donors from receiving tax benefits for works that museums fail to call in despite their legal right to do so.⁸⁷ The *Winokur* decision enabled this perceived abuse by holding that the right to possess the work, not actual possession, triggered the tax benefit.⁸⁸ In a *New York Times* article that closely followed the passage of the PPA, Mr. Grassley called this point “a question of fairness.”⁸⁹ He argued that “it isn’t right for a donor to get a tax break for supposedly donating a painting that hangs in his living room, not the museum, all year. A painting in a private living room doesn’t benefit the public.”⁹⁰

Accordingly, the PPA made major changes to the law of fractional giving by means of a new Code section entitled “Special rules for fractional gifts.”⁹¹ Each of the PPA’s provisions is meant to reduce

84 Press Release, Senator Chuck Grassley, Memorandum on Charitable Package in Pension Bill (Aug. 7, 2006), *available at* http://grassley.senate.gov/public/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=89c47598-c231-42d5-b7e2-ec271887c2ae&Month=8&Year=2006. He commented,

“The pension bill includes a good package of charitable giving incentives and loophole closers. It makes sense to tighten areas of abuse while increasing incentives for charitable giving. Americans are very generous with their donations. They deserve to know that their money helps the needy, not the greedy. Some individuals are creative about exploiting non-profits’ tax-exempt status for personal gain, and Congress has to be just as smart about shutting down abuse.”

Id. (quoting Sen. Chuck Grassley).

85 See Pablo Eisenberg, *Congress Should End Special Tax Breaks for Art Gifts*, 19 *CHRON. PHILANTHROPY*, Oct. 12, 2006, at 35, 36.

86 *Id.*

87 The art museum usually does not take possession of the art on a yearly basis, as it legally could. Stephanie Strom, *The Man Museums Love to Hate*, *N.Y. TIMES*, Dec. 10, 2006, § 2, at 1. Instead, they call works in, for example, for special exhibitions. See, e.g., Ebeling, *supra* note 21.

88 See *supra* notes 74–79 and accompanying text.

89 Kahn, *supra* note 2.

90 *Id.*

91 I.R.C. § 170(o) (West Supp. 2007).

donors' opportunities to take advantage of the law at the public's expense. The PPA also reduces the opportunity for museum complicity.⁹² Each change, therefore, restricts some aspect of the pre-PPA donation framework. These changes have succeeded in closing the potential loopholes, but they have also gone so far as to create disincentives to legitimate fractional giving. Several changes in particular, discussed below, have caused concern for both donors and museums.

A. *Qualified Property Limitations*

The PPA first limited the property eligible for a deductible donation according to the donor's relationship to that property. Prior to the Act, a donor received a tax benefit whenever she gave the museum the right to enjoy for a percentage of the year all of the rights she held in the property.⁹³ The PPA narrowed this rule, allowing deductions only for the contribution of an undivided portion of the donor's interest if, immediately prior to donation, all interest in the property was held by either (1) the donor, or (2) the donor and the donee.⁹⁴ The law created an exception only for situations in which all of the parties who have an interest in the property donate proportional shares of their undivided interests in the work.⁹⁵

This change restricts the pool of works eligible for donation. Works wholly owned by individuals or by individuals in combination with institutions necessarily inhabit a subset of all privately owned works. Under the new law, donating works with multiple owners requires the owner group's cooperation: each owner must agree to donate her proportional share. But although it serves a limiting function, this change may ultimately help to ensure that partially donated works encounter few obstacles in permanently joining the museum's collection. The fewer the claims on a painting, the less likely museums will encounter difficulties in taking full possession. Given the fact that problems completing gifts rarely arose in the pre-PPA world⁹⁶—

92 One can imagine, for example, a museum courting a collector for a particular donation by promising never to take possession of the work until after the donor's death or complete transfer. The museum's interest diverges from the taxpayer's to the extent that the museum cares most about its collection's long-term growth. It takes less interest in ensuring that the tax deductions and public benefit occur simultaneously.

93 See *supra* notes 63–66 and accompanying text.

94 See Pension Protection Act of 2006 § 1218(a), I.R.C. § 170(o)(1).

95 See *id.* § 1218(a), I.R.C. § 170(o)(1)(B).

96 While there have been cases in which the works have failed to pass into the public collection, these incidents are the exception rather than the rule. See Kate Taylor, *Museums Worry New Law Will Discourage Donations*, N.Y. SUN, Sept. 8, 2006, at

and that museums take steps to protect themselves from ownership disputes⁹⁷—it is not clear that this change makes a significant practical difference.

B. *Added Recapture Provisions*

The PPA also creates several provisions under which a donor's tax benefits can be recaptured. Recapture here means that the donor will have to repay the deduction she received, with interest.⁹⁸ Further, the law adds a penalty: the donor will owe an additional ten percent of the amount recaptured.⁹⁹ Three different failures of compliance can provoke this result.

To begin, failure to give one hundred percent of the artwork within a specified period of time will result in recapture. Prior to the PPA, the law did not limit the amount of time over which the donor could complete her donation. Other than the general requirement in the agreement that the collector bequeath the work of art to the museum upon her death,¹⁰⁰ the time period was unregulated. Under the PPA, a donor must complete all of her remaining interest in the item "before the *earlier of*" the date ten years from the initial fractional contribution and the date of her death.¹⁰¹ Failure to complete the donation within that framework results in recapture of the tax benefit.¹⁰²

The time limitation is of concern for two primary reasons. First, younger collectors, who theoretically would have significantly more than ten years to spend with their art objects, may be discouraged from donating them to museums.¹⁰³ Second, the time restriction makes the donation of entire collections less appealing.¹⁰⁴ While no great inconvenience results from completing the donation of one

2D. The "notable exception" to this general rule involved a Paul Gauguin painting, *Still Life with Hope*. See Kahn, *supra* note 2. Twenty percent of this painting had been donated to the Metropolitan Museum of Art (MMA), which had the painting on display at the time of the donor's death. See Carol Vogel, *Inside Art*, N.Y. TIMES, Mar. 8, 1996, at C28. Even if the donor's will had made a private sale possible (which it did not), buying the painting would have cost the MMA so much as to prohibit other acquisitions. See *id.* Instead, the MMA received twenty percent of the painting's sale price, but lost the work. See *id.*

97 See *supra* note 7.

98 See § 1218(a), I.R.C. § 170(o)(3)(A).

99 See § 1218(a), I.R.C. § 170(o)(3)(B).

100 See *supra* note 7 and accompanying text.

101 § 1218(a), I.R.C. § 170(o)(3)(A)(i) (emphasis added).

102 See § 1218(a), I.R.C. § 170(o)(3)(A).

103 See Ebeling, *supra* note 21.

104 See Letter to Chairman Lewis, *supra* note 19.

work or a few works within ten years, collectors making significant gifts will have to give up an entire collection's worth of art objects within that period if they wish to take an immediate deduction for their fractional gift.

Next, the PPA modifies the *Winokur* decision, which held that the tax benefit resulted from the museum's *right* to possess the work rather than its actual physical possession of it.¹⁰⁵ *Winokur* allowed a donor of an undivided fractional interest in a work to receive a tax benefit for a work that never left her possession, which struck Congress as an unfairness meriting correction.¹⁰⁶ Under the PPA, the failure of a museum to take possession results in recapture of the tax benefit. The law requires the donee institution to have "had substantial physical possession of the property" during the period between the initial donation and the completion of the donation.¹⁰⁷ No longer will a donor receive a tax benefit for donating art which the public has no way to enjoy.

The extent of the difficulty this change creates depends on the meaning of "substantial" in the statute's language. While the requirement that museums take possession of works for which the donor receives a tax deduction is reasonable and comports with § 170's purposes, frequent exchanges become burdensome in both administrative and creative ways.¹⁰⁸ This provision also seems unusual because it requires the museum to act, but the penalty for inaction falls on the donor.

Third, under the PPA, merely taking physical possession of the work does not suffice to protect the donor from the threat of recapture. The PPA's use of "and" between the possession requirement and the related-use requirement means that the donee must also "use[] the property in a use which is related to a purpose or function constituting the basis for the organization[']s exemption under section 501."¹⁰⁹ Failure to do so results in recapture under the provision.¹¹⁰ Again, the donor will be exposed to a penalty if the museum fails to meet the PPA's requirements.

105 See *Winokur v. Comm'r*, 90 T.C. 733, 740 (1988), *acq. in result*, 1989-2 C.B. 1, *superseded by statute*, Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780; see also *supra* notes 74-79 and accompanying text (discussing *Winokur*).

106 See *supra* notes 87-90 and accompanying text.

107 § 1218(a), I.R.C. § 170(o)(3)(A)(ii)(I).

108 See *infra* Part IV.

109 § 1218(a), I.R.C. § 170(o)(3)(A)(ii)(II). Whether the museum must display the art is an open question. See *supra* notes 58-62 and accompanying text (discussing related use).

110 See § 1218(a), I.R.C. § 170(o)(3)(A).

C. *Unfavorable Valuation of Subsequent Gifts*

Under pre-PPA law, a donor's ability to exploit appreciation in the value of their donated property accruing after the date of their initial gift offered a potentially considerable benefit.¹¹¹ The PPA has eliminated this benefit. Now, if a donor gives a fractional interest in a work of art and several years later donates an additional fractional interest, the FMV of the subsequent gift will be "the *lesser* of—(A) the fair market value of the property at the time of the initial fractional contribution, or (B) the fair market value of the property at the time of the additional contribution."¹¹² This provision means that although donors will see a reduced benefit if the work depreciates, the donor will not enjoy an increased benefit if the work appreciates.

This rule prevents donors from taking advantage of the appreciation in value of the work. That is, if a donor were to give a twenty-five percent interest in a work whose FMV was \$1 million, a deduction for \$250,000 would be available. However, if that work were to appreciate in value to \$2 million, and the donor wanted to give an additional twenty-five percent interest, instead of receiving a deduction related to twenty-five percent of the work's appreciated value, or \$500,000, the donor would receive a deduction of \$250,000. On the other hand, were the work to depreciate to a value of \$500,000 and the donor then wanted to give the twenty-five percent interest, she would be eligible for a deduction of \$125,000, or twenty-five percent of the work's decreased value.

D. *Estate and Gift Tax*

The PPA's unfavorable appreciation rules combine with federal estate and gift tax to cause the change most damaging and discouraging to donors: what art lawyer Donn Zaretsky has called the "mismatch problem."¹¹³ That is, the law creates a disparity between the work's taxable and deductible values. This serious problem now exists in both the estate and gift contexts because the PPA added provisions to both those sections of the Code.¹¹⁴

Federal estate taxes apply to the value of an estate left to others upon the owner's death.¹¹⁵ Charitable deductions are ordinarily

111 See *supra* notes 72–73 and accompanying text.

112 § 1218(a), I.R.C. § 170(o)(2) (emphasis added).

113 The Art Law Blog, <http://theartlawblog.blogspot.com/> (Sept. 6, 2006, 09:53).

114 See § 1218(b), I.R.C. § 2055(g) (estate tax); § 1218(c), I.R.C. § 2522(e) (gift tax).

115 See BRUCE R. HOPKINS, *THE TAX LAW OF CHARITABLE GIVING* 234–35 (3d ed. 2005).

excepted from the "taxable estate," which provides a very important deduction for estate tax purposes.¹¹⁶ In the case of partially donated undivided interests in an artwork, the value left in the estate corresponds to the percentage of work the donor still held. As such, if a bequest was made to a museum, "the estate tax charitable deduction should be the percentage owned by the decedent multiplied by the full fair market value of the painting *on the decedent's date of death.*"¹¹⁷

The PPA limited the available charitable deduction to the lesser of the property's FMV at the time of the initial or additional contributions.¹¹⁸ However, the portion of the work still in the estate often will have continued to appreciate. In that situation, the increase in the taxable estate from the appreciated portion will exceed the available deduction, leaving the estate liable for tax on the difference. An example clarifies this dilemma.¹¹⁹ If a collector donated a fifty percent interest in a painting valued at \$5 million, her deduction (ignoring possible percentage-limitation issues) would be \$2.5 million. Over the next few years the painting could continue to appreciate in value. If the donor died a few years after her initial contribution and had bequeathed the remainder of the painting to the museum, and the painting had appreciated from \$5 million to \$6 million, a "mismatch" would result. That is, the charitable deduction from the taxable estate would be limited to \$2.5 million, but half of the painting's appreciated value (here \$3 million) would be included in the estate for estate tax purposes. Estate tax then would be due on that \$500,000 difference.

The new provisions work substantially the same way in the gift tax arena. The federal gift tax applies to inter vivos transfers where the donor receives inadequate consideration for her property.¹²⁰ A donor who completes a gift during her lifetime—which, in light of the new ten-year limitation, is likely—faces the same mismatch problem. The portion of the work remaining in her possession continues to appreciate, but the value of her charitable deduction remains frozen at its initial value. She must pay in gift tax the difference between those two values even though the recipient of the gift is a charity.

116 See HOPKINS, *supra* note 33, at 107–08.

117 3 LERNER & BRESLER, *supra* note 7, at 1578 (emphasis added).

118 See § 1218(b), I.R.C. § 2055(g)(1). Here "additional contribution" is defined as "a bequest, legacy, devise, or transfer . . . of any interest in a property with respect to which the decedent had previously made an initial fractional contribution." § 1218(b), I.R.C. § 2055(g)(2)(A).

119 This helpful illustration appears on Donn Zaretsky's art law blog. See The Art Law Blog, *supra* note 113 (Sept. 6, 2006, 09:53).

120 See HOPKINS, *supra* note 115, at 238.

The inevitable result of the current law is that “there *will* be significant adverse tax consequences *any time* a donor makes a fractional gift and then the work appreciates in value.”¹²¹ Some have called making a fractional gift under these new provisions “insane.”¹²² The PPA’s enactment has also left some current donors in an uncomfortable intermediate position. Contributions made prior to the enactment of the PPA are not initial fractional contributions under the law.¹²³ However, if the donor chooses to make an additional fractional donation of a work she had begun to donate prior to the law’s passage, that subsequent donation will count as an initial fractional donation.¹²⁴ Donors in this situation had begun their donations in reliance on pre-PPA law; they expected to be able to take advantage of the appreciation in their fractionally donated works of art. However, at this juncture, they cannot give an additional percentage of the work without becoming ensnared in the PPA and becoming vulnerable to a costly “mismatch” in the future. While a donor could avoid this problem by donating her entire remaining interest in the artwork, some of these donors have instead simply declined to take further steps on their giving plans.¹²⁵

III. THE FUTURE OF FRACTIONAL GIVING

From the moment the PPA’s changes became widely known, the museum community feared the worst. Ralph E. Lerner, an art law specialist, announced: “This is the death of fractional gifts.”¹²⁶ His words expressed the alarm of many art museum community members.¹²⁷ In fact, lawyers soon began to advise their clients not to make

121 The Art Law Blog, *supra* note 113 (Sept. 14, 2006, 00:44).

122 *Id.*

123 See STAFF OF J. COMM. ON TAXATION, 109TH CONG., TECHNICAL EXPLANATION OF H.R. 4, THE “PENSION PROTECTION ACT OF 2006,” AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, at 308 (Comm. Print 2006), available at <http://www.dol.gov/ebsa/pdf/x-38-06.pdf>.

124 *See id.*

125 Ebeling, *supra* note 21 (“Even donors who had started giving a work before Aug. 18 aren’t giving additional percentages, for fear that [doing so] will subject their estates to this extra gotcha tax.”).

126 *See* Kahn, *supra* note 2.

127 *See, e.g.,* THOMAS J. RAY, JR., CHARITABLE GIFT PLANNING 15 (2d ed. 2007) (“These rules will most likely impact contributions of undivided interests in artwork and similar collections to museums, a practice that has become increasingly popular.” (footnote omitted)); The Art Law Blog, *supra* note 113 (Sept. 6, 2006, 09:53) (“Unless the law is changed, the likely effect will be the end of fractional gifts of art to museums.”); Culture Grrl, <http://www.artsjournal.com/culturegrrl/> (Sept. 11, 2006, 11:00) (“Museum officials say this change could be a deal-killer for many donors.”).

fractional donations.¹²⁸ Perhaps compounding museums' apprehension in the face of this legislation was the general sense that it had been passed without much notice to the affected parties.¹²⁹

Museums had reason to fear these changes' impact on giving. After all, since "[a]lmost every year brings about a new tax bill and new provisions that affect works of art,"¹³⁰ it would not be museums' first experience with the tightening of tax laws. When the Tax Reform Act of 1986¹³¹ removed certain incentives for charitable giving, the AAMD reported a forty percent reduction in art donations.¹³² That change resulted in privately held art failing to move into the public sphere, partly because few museums could afford to buy the works.¹³³ Unfortunately, many of the Pension Protection Act's feared negative effects soon materialized, spurring calls for revision. The most concrete initiative is the Promotion of Artistic Giving Act.¹³⁴ In the meantime, museums face challenges in recruiting artwork from the private sphere through fractional giving.

A. *The Pension Protection Act's Negative Impact on Art Donations*

The PPA of 2006 came into effect on August 17, 2006.¹³⁵ Since that time, museums have experienced significant lost donations as a result of the changes to fractional giving law. In a letter to the House Ways and Means Oversight Committee sent not even a year after the law's passage, Gail Andrews, president of the AAMD's board of trustees and the director of the Birmingham Museum of Art, wrote that "the new restrictions imposed on fractional gifts have resulted in a pronounced reduction in donations of artwork to museums across the country."¹³⁶ She listed, as "just a few examples," five museums that suffered donation losses—including ruined negotiations, rescinded

128 See Kahn, *supra* note 2.

129 See, e.g., *id.* (noting that the relevant change took place "in a little-noticed section of the Pension Protection Act"); The Art Law Blog, *supra* note 113 (Sept. 6, 2006, 09:53) (commenting that the Act passed with "little fanfare"); Culture Grrl, *supra* note 127 (Sept. 11, 2006, 11:00) (noting that the change, with its "potentially catastrophic impact on gift-giving to museums . . . seems to have flown in completely under the radar").

130 Ralph E. Lerner, *Art and Income Taxes—The Changing Scene*, 14 NOVA L. REV. 533, 533 (1989).

131 Pub. L. No. 99-514, 100 Stat. 2085 (codified in scattered sections of the I.R.C.).

132 See DARRABY, *supra* note 9, § 3:35, at 141.

133 See *id.*

134 H.R. 3881, 110th Cong. (2007).

135 Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (codified in scattered sections of 26, 29 U.S.C.).

136 Letter to Chairman Lewis, *supra* note 19.

offers, and unfulfilled commitments—as a direct result of the PPA’s new restrictions.¹³⁷ Speaking for SFMOMA, Neal Benezra said that the PPA’s changes have “had an unbelievably negative impact on our acquisition program, a profoundly negative impact.”¹³⁸ He estimated that SFMOMA’s gifts, from one year to the next, dropped by approximately eighty percent.¹³⁹

Ironically, the private collectors themselves stand to benefit, to some degree, from these changes. Because the new law reduces the advantages of donating art to cultural institutions, the artworks will instead end up in estates and on the art market.¹⁴⁰ Because other collectors, rather than museums, will likely purchase objects on the art market, the law operates in opposition to § 170’s goals and keeps works in private hands, to be traded among and enjoyed by few. This effect brings to the forefront the importance of addressing the PPA’s shortsighted impact. In absence of sufficiently appealing tax benefits, private collectors can and often will find other, less socially beneficial, uses for their property.

B. *Attempts to Ameliorate the Pension Protection Act’s Effects*

Some commentators have suggested that the PPA brought unnecessary change to fractional giving law. And if change must be made, their reasoning continues, the Act has gone too far in accomplishing it. Given the PPA’s adverse effects, the art community has rallied in an effort to improve the law. A member of Congress has now proposed corrective legislation: the Promotion of Artistic Giving Act of 2007.

1. The Pension Protection Act’s Disputed Necessity

The AAMD has consistently taken the position that the PPA wrought entirely unnecessary changes. Not long after Act’s passage, Anita Difanis, the AAMD’s director of government affairs, asserted that because art donations account for only three percent of all charitable donations, they did not merit changing the tax laws.¹⁴¹ Gail

137 *Id.*; see also Ebeling, *supra* note 21 (“As a result [of the changes wrought by the PPA], fractional donations have come to a halt.”).

138 Looking Around, *supra* note 22 (Oct. 15, 2007, 17:21).

139 *See id.*

140 *See* Kahn, *supra* note 2 (“Museum directors said that without fractional giving, more works of art will ultimately end up in estates, where they are far more likely to be sold off to private collectors than to art institutions.”).

141 *See* Kahn, *supra* note 2. Nearly \$300 billion is given annually to charities in the United States. *See* HOPKINS, *supra* note 33, at 21.

Andrews, writing on behalf of the AAMD, remained unpersuaded that donors were substantially exploiting the law's supposed loopholes.¹⁴² After hardly conceding the Act's necessity, Andrews charged "that the changes made in PPA went far beyond addressing these concerns and have had an unnecessary detrimental impact on our nation's art museums."¹⁴³

The AAMD and those who share its views are not the only voices in the debate. On the opposite extreme stand those who say that restricting fractional gifts "was a major step in the right direction," but fell short of closing a significant loophole by not entirely foreclosing this method of donation.¹⁴⁴ The argument here is that "[d]onors shouldn't get any deductions unless they give away their art objects fully and completely."¹⁴⁵

The best position may lie somewhere between these two extremes. While art donations are only three percent of charitable donations, and fractional donations are a mere ten percent of art donations,¹⁴⁶ they remain an important source for museum collections, and therefore merit protection and indeed encouragement. However, encouraging this method of donation does not mean creating incentives so broad as to tempt abuse.

2. The Promotion of Artistic Giving Act of 2007

On October 17, 2007, Representative Tom Udall introduced the Promotion of Artistic Giving Act (PAGA) of 2007.¹⁴⁷ When he addressed the House, he spoke about his purpose in working on the legislation:

While well intentioned, the unnecessarily harsh provisions relating to fractional giving included in the Pension Protection Act of 2006, PPA, have effectively ceased charitable donations of partial interests in art to our Nation's museums and galleries. In trying to close a tax loophole, the PPA suffocated a time-honored method of giving By rolling back some of the most restrictive provisions

142 See Letter to Chairman Lewis, *supra* note 19.

143 *Id.* There is reason to believe that Congress did not intend the full extent of the law's effect, especially in the estate and gift tax arena. When the AAMD expressed hope that technical correction could undo the application of estate and gift tax rules to fractional gifts, *id.*, the PPA's sponsor responded that he would not be averse to that solution, see Ebeling, *supra* note 21.

144 See Eisenberg, *supra* note 85, at 27.

145 *Id.*

146 See *supra* note 17 and accompanying text.

147 H.R. 3881, 110th Cong. (2007). This legislation enjoys the AAMD's support. See Press Release, Representative Tom Udall, *supra* note 18.

of the PPA, this legislation strikes the right balance between tax and charitable giving policy, addresses concerns about tax evasion, removes fractional giving from estate and gift tax provisions, and again encourages lifetime donations of art for the enjoyment of the public.¹⁴⁸

To that end, the PAGA makes three major changes to the PPA in an effort to remedy the PPA's perhaps unintentional effects.

The PAGA first increases the time allowed for a donor to complete her gift. Under the PPA, a gift must reach completion no later than ten years after the initial contribution or be subject to recapture.¹⁴⁹ The PAGA strikes that provision and replaces it with one under which recapture results from failure to complete a donation upon "the day which is nine months after the date of death of the original donor."¹⁵⁰ This revision would allay museums' concerns that the post-PPA law will discourage younger donors from participating in fractional giving plans.¹⁵¹ Further, this change would correct the part of the law that might tend to discourage substantial donations, since the donor would not be required to give up an entire collection's worth of paintings in one fell swoop ten years after her initial contribution.¹⁵² However, it would allow significant delays in realizing the full public benefit from the deduction.

The PAGA next responds to the PPA's method of valuing subsequent gifts.¹⁵³ The PAGA removes the provision that eviscerates the donor's ability to take advantage of appreciation in the value of the donated property. Instead, the new provision requires that "[i]n the case of annual additional contributions in excess of \$1,000,000, the fair market value of such contributions shall be determined by using a certified appraisal from the Art Advisory Panel of the Commissioner of Internal Revenue."¹⁵⁴ This change would allow a donor to benefit from her work's appreciation; no longer would subsequent donations be limited to the FMV of the initial donation or its depreciated value. However, the new law also places large subsequent contributions—

148 153 CONG. REC. E2163 (daily ed. Oct. 17, 2007) (statement of Rep. Udall).

149 Pension Protection Act of 2006 § 1218(a), I.R.C. § 170(o)(3)(A)(i)(I) (West Supp. 2007); *see also supra* Part II.B (discussing recapture provisions).

150 H.R. 3881, § 2(a)(1). To correspond to this section, the PAGA adds a definition of "original donor" to those listed in § 170(o)(4) of the Code. *See id.* § 2(a)(2) ("The term 'original donor' means the donor who made the initial fractional contribution.").

151 *See supra* text accompanying note 103.

152 *See supra* text accompanying note 104.

153 *See supra* Part II.C.

154 H.R. 3881, § 2(b).

those in excess of \$1 million—under the supervision of the Art Advisory Panel.¹⁵⁵ The PAGA will, therefore, help to serve the PPA's goal of preventing abuses in valuation of gifts that come from inflating the value of the contributed works.

Finally, the PAGA repeals the PPA's estate and gift tax provisions.¹⁵⁶ Striking those provisions ends the "mismatch problem" identified by the art-law community as the greatest disincentive to fractional giving in the post-PPA world.¹⁵⁷ No longer will the disparity between a work's FMV at the time of its initial contribution and the appreciated FMV of the portion left in the estate prove costly to the donor. Substantial estate or gift taxes upon the gift's completion via bequest or inter vivos transfer do not lurk in the donor's future. The PAGA therefore removes the PPA's biggest disincentive to fractional giving.

These changes would "take effect as if included in the amendments made by section 1218 of the Pension Protection Act of 2006."¹⁵⁸ This provision holds special significance for the donors currently frozen between initial and subsequent donations in an attempt to avoid the mismatch problem. Those donors would be able to continue with their giving plans without worry that appreciation in their contribution's value will haunt them later.

Notably, the PAGA leaves untouched some of the PPA's changes. For example, the PAGA makes no attempt to alter the PPA's requirements in regard to ownership in the works immediately prior to their donation.¹⁵⁹ Further, the PAGA does not alter the "substantial possession" requirement—the legislative modification of the *Winokur* decision—that requires museums to call in their partially owned works.¹⁶⁰ While the PAGA would not return museums and donors to their pre-PPA positions, the Act goes far to temper or remove the provisions most likely impeding fractional donations to art museums. The PPA provisions that the PAGA lets stand probably improve fractional giving law. They are also unlikely to pose unexpected problems for current donors.

The requirement that the donor or the donor and the museum own all interests in the work immediately prior to its donation does narrow the list of works available to be donated. However, the narrowing may help avoid any dispute about ownership in the work when the

155 See *id.* § 2(b)(2).

156 See *id.* § 2(c).

157 See *supra* Part II.D.

158 H.R. 3881, § 2(d).

159 See *supra* text accompanying notes 93–97.

160 See *supra* text accompanying notes 105–07.

time arrives for the donation's completion. Further, this provision can apply only to donations not yet made, which will not subject the donor who has already embarked on her donation plan to unanticipated conditions on her gift.

The "substantial possession" requirement, on the other hand, may be an unwelcome surprise to donors who began their gifts in reliance on pre-PPA law.¹⁶¹ This requirement inconveniences museums¹⁶² and prizes the work from the donor's possession. It could be said merely to require compliance with an agreement already made. On the other hand, the parties may have relied on the *Winokur* precedent that the work need never actually change hands for the benefits to inure to each of them.¹⁶³ Even so, requiring the museum to take substantial possession of the work of art for which a tax benefit is granted may comport better with the public's expectations not only as museumgoers but also as taxpayers: if an art collector receives a tax benefit for her purported donation to the public, the public may well expect to receive a contemporaneous benefit.

IV. ADDITIONAL OBSERVATIONS AND PROPOSALS

The PAGA would undoubtedly help to lighten the burden the PPA places on fractional giving. However, because the PAGA has not yet become law and its chances of doing so remain unclear,¹⁶⁴ it is worth considering whether it provides the ideal balance for fractional giving law.

This inquiry begins with the recognition that fractional giving is ill-suited to work precisely as designed. Requiring museums to take yearly possession of their partially held artworks would create several impracticalities. A museum fortunate enough to have a sizeable number of outstanding fractional donations would face administrative burdens. Yearly possession would also significantly increase a museum's insurance costs.¹⁶⁵ Shipping and storage costs would also become an

161 See *supra* text accompanying notes 105–08.

162 See *infra* Part IV.

163 See *supra* text accompanying notes 74–79.

164 In addition to its sponsor, Rep. Udall of New Mexico, the PAGA has four cosponsors: Representative English of Pennsylvania, see 153 CONG. REC. H11728 (daily ed. Oct. 17, 2007), Representative Ramstad of Minnesota, see *id.* at H11847 (daily ed. Oct. 22, 2007), Representative Maloney of New York, see *id.* at H11935 (daily ed. Oct. 23, 2007), and Representative Matsui of California, see *id.* at H14158 (daily ed. Dec. 4, 2007).

165 Ordinarily, the donor's insurance covers the work while she has possession of it and the museum's insurance covers it during the museum's possession. See 3 LERNER & BRESLER, *supra* note 7, at 1581. Having a large number of works moving in and out

issue, especially for large or heavy pieces. Further, works vary in their ability to travel without damage. Moving some works entails disassembling and reassembling them, which creates risk of damage, loss, and human error. Because of the burdens inherent in subjecting certain kinds of works to a yearly pilgrimage, museums would find the kinds of donations they could accept—and therefore their creative and curatorial needs—hampered by their concern for the works' safety. These concerns could eventually affect the collection's long-term development.

Additionally, unproductive creative burdens would result from the combination of the possession rule and related-use rules. Admittedly, it is unclear whether the museum will be required to display the work consistently with the related-use rule each time it takes possession. In the face of this uncertainty, museum curators may feel obligated to display such works so as to avoid potentially placing the donor's deduction at risk. Interpreted this way, the rule would create curatorial restrictions. Fractional giving works best when it allows museums to use their partial holdings as an extension of their permanent collections. For example, the Whitney Museum of American Art enjoys a ten percent interest in a Willem de Kooning painting, *Untitled VII*. The painting "complements other examples of de Kooning's work in the Whitney's collection and allows the museum to have works representative of the full arc of his career."¹⁶⁶ However, in spite of the work's value to the collection, the museum called it in only four times between 1983 and 2006.¹⁶⁷ Presumably, the curators kept the work in mind and, when the work added something of specific curatorial value, exploited their rights in the work for the benefit of museumgoers. Curators care that their exhibits promote museumgoers' education and experience.¹⁶⁸

of the collection could affect insurance costs at a time when they are already becoming more burdensome for art museums. See Ass'n of Art Museum Dirs., 2007 State of North America's Art Museums Survey 7 (2007), http://www.aamd.org/newsroom/documents/2007SNAAMReleaseData_FINAL.pdf. During 2006, forty-nine percent of the 167 responding member museums reported increased insurance premiums from the previous year. See *id.* Rates have reportedly increased most in the areas of traveling exhibitions, collections, buildings, and loans. See *id.* While museums attribute this change in part to "[i]ncreased potential for natural or man-made disasters," another important factor is the inflated commercial art market. *Id.* at 8.

166 See Ebeling, *supra* note 21.

167 See *id.*

168 See, e.g., Ass'n of Art Museum Dirs., *supra* note 8, at 2 (listing among factors bearing on a donation's acceptance whether "the work enhance[s] the educational opportunities provided by the museum to the public").

If fractional giving worked literally according to its design, surely one factor that would aid museums in the administration of fractional gifts under this kind of scheme would be the gifts' reduced number going forward. Fractional gifts of art will not—and should not—require museums and collectors to make yearly transfers of artworks. It follows that fractional giving will result in donors receiving tax deductions for works that they continue to possess, at least in some years. Some would argue that fractional giving, because of this perceived unfairness, should not exist.¹⁶⁹ However, fractional giving should be viewed as a kind of investment in American museums: while the benefits to the public are delayed, they are valuable and long-lasting once achieved. Fractional giving provides an important means through which museums can gather the museum-quality pieces that make their collections of value to the public.

A multifaceted, long-term view of § 170's objectives must guide the formation of an ideal fractional giving law. The PPA's greatest failure lies in its focus on abuse prevention and corresponding sacrifice of other important factors. That is, it narrows benefits available to all donors as a result of a few bad actors' conduct and does so at the expense of museum collections' long-term growth.

To some extent, the unfairness of a donor's receiving a tax benefit at the public's expense for a work remaining in the donor's private possession motivated Congress to change fractional giving law.¹⁷⁰ It is worth remembering that the unequal distribution of art to the wealthy is the more fundamental unfairness. Tightening the tax laws will not remedy inequality between the wealthy donor and the average American taxpayer. Instead, it will result in the donor's simply opting out of charitable giving, which accomplishes nothing toward making works of art more widely available to the public. In ensuring that donors face greater difficulty in abusing the law's privileges, the PPA loses sight of the reason those privileges exist: to encourage donations to museums and to bring works into the public trust. The PPA ignores the reality that a dearth of fractional gifts now will result in an overall reduction in new acquisitions in the coming years.¹⁷¹ To keep museums current, relevant, and varied so that they can bring beauty and education to the American public, the law must encourage donations. The PPA's strict nature does not comport with § 170's efforts to stimulate charitable giving.

169 See *supra* notes 144–45 and accompanying text.

170 See *supra* note 84.

171 See *supra* Part III.A.

Although the PPA works against the spirit of § 170, it is equally clear that leaving the law open to abuse also betrays § 170's goals. Tax breaks for those who do not share their art serve no public purpose. However, it seems preferable in the long run to create a system that may leave open some room for abuse but encourages charitable giving rather than closing the door completely as the PPA has, in effect, done.

A relaxed possession requirement, for example, represents a reasonable compromise.¹⁷² It would relieve the donors of having to part with the work and relieve the museums of the administrative and creative burdens that the substantial possession rule creates when combined with the related-use rule. Such a rule would naturally delay the public's access to the works and create a disparity between when the donor and the public receive their benefits.¹⁷³ However, in encouraging donations, it also creates an opportunity for the public to receive the work; it is preferable that a work move gradually and eventually into the public sphere than not at all.¹⁷⁴ Further, the benefit the public receives from the museum's present possession of any work of art is of the highest quality when the museum actually needs the work for a curatorial purpose.¹⁷⁵ Last, the fact that the public's benefit is delayed does not mean that the public receives no benefit. In fact, once the work moves into a museum's permanent collection, the public benefit has no end in sight. The public's benefit, although later received, is the greater one.

The PPA found one way to mitigate the delayed-benefit effect: shorten the period over which the donation can be made.¹⁷⁶ However, the PAGA correctly identifies the PPA's ten-year window for

172 Whether the PPA achieved balance here depends on what exactly "*substantial physical possession*" means. Pension Protection Act of 2006 § 1218(a), I.R.C. § 170(o)(3)(A)(ii)(I) (West Supp. 2007) (emphasis added); *see also supra* text accompanying notes 107–09 (discussing the implications of requiring the donee to have taken "substantial physical possession" of a donated work in order to receive at tax benefit).

173 It is possible to see the initial donation as an immediate benefit: "the public has the right to ownership to that very valuable piece of art. It can't go anywhere else. In the end, it goes to the museum. So that first [donation] is very valuable." Taylor, *supra* note 96.

174 The PPA has resulted in a dramatic decrease in the number of fractional gifts. *See supra* Part III.A.

175 *See supra* text accompanying notes 167–68.

176 The PPA does this by means of a recapture provision. § 1218(a), I.R.C. § 170(o)(3)(A)(i).

active donations as a serious disincentive to donors.¹⁷⁷ As between these two options, the PAGA's approach seems better calibrated to produce the desired result of continuing to appeal to donors and attract fractional gifts. The PAGA may, however, err on the side of being too generous to the donor. If the museum had more frequent possession of the work, allowing the donor to keep it during her lifetime would seem less egregious. However, giving the donor a tax deduction for a work that she not only keeps in her possession most of the time but also holds until her death asks too much.

Although necessarily arbitrary, a line drawn somewhere between the PPA's ten-year rule and the PAGA's after-death rule seems to be the best option. A twenty-year window, for example, has the virtue of being simultaneously quite generous to the donor as well as sufficiently definite and limited to serve the public. Further, those who object to such an extended window should bear in mind that during this twenty-year period, the museum is well within its rights to call in a work and display it. The public need not, and almost always will not, wait twenty years to see the object.¹⁷⁸

The other major areas of potential abuse of fractional giving law arise around the donated property's valuation. First, overvaluation of the property concerns the IRS; it results in the federal government losing tax revenue. The PPA and the PAGA both attempt to address this problem.¹⁷⁹ The PAGA placed a \$1 million floor on claims requiring IRS Art Advisory Panel appraisal.¹⁸⁰ Placing a relatively high floor on the Art Advisory Panel appraisal value has two virtues. First, when dealing in valuable works of art, a \$1 million floor could be

177 The PAGA would not activate the recapture provisions unless the work failed to pass to the museum nine months after the donor's death. Promotion of Artistic Giving Act of 2007, H.R. 3881, 110th Cong. § 2(a)(1) (2007). This method has the added benefit, due to its timing, of making sure that the agreements donors have made with museums to transfer works at their death are carried out as intended. The provision manages to be generous to the donor while still preventing the Gauguin situation. *See supra* note 96.

178 Museums should also consider exploiting the full "bundle of rights" they hold in these works. The fractional gift is a gift of all of the donor's rights in the work. *See supra* note 66 and accompanying text. Therefore, even if the museum does not take physical possession of the work every year, it has other rights that can work to its benefit, such as reproduction. Also, those museums creating an online catalogue of their collections could make the work available on their websites.

179 *See supra* note 57 and accompanying text (PPA); *supra* note 154 and accompanying text (PAGA).

180 *See* H.R. 3881, § 2(b). This rule applies in addition to the qualified appraisal required for any donations for which a deduction in excess of \$5000 is claimed. *See supra* note 52.

broadly applicable. Second, the IRS has limited resources and asking it to perform more appraisals—especially in light of the disagreements they cause¹⁸¹—imposes a burden. However, setting a lower floor on claims to be appraised may provide a good solution. A rule subjecting the works to closer inspection may better prevent overvaluation than a higher ceiling and a very slight chance of incurring penalties under § 170. In light of the significant benefits to the donor that fractional giving allows,¹⁸² the cost of their recapture, when joined with a fine, is quite significant. However, while enforcement remains an extremely unlikely risk, donors will not likely shape their behavior so as to avoid it.

The second significant valuation issue is how to account for a partially donated work's appreciation. In light of the mismatch problem,¹⁸³ the best resolution for this issue from an estate and gift tax point of view seems clear. Donors who stand to face large estate and gift tax penalties because their fractionally donated works have appreciated will choose other methods of dispersing their collections. However, in light of the fact that the best rule from an estate and gift tax perspective would be the pre-PPA rule where those provisions did not apply to fractional gifts, the valuation issue is better considered from an income tax perspective, where its solution is less obvious. From an administrative point of view, it would be simplest to lock the work's value at its FMV at the time of initial donation. This method would reduce the number of times the works had to be appraised and examined. It would also be a reasonably fair solution: while it would work to a donor's disadvantage when a work appreciated in value, it would advantage a donor whose gift depreciated over the years. However, the fairness aspect of this solution reveals its weakness: donors may be less likely to donate works they expect to appreciate in value. This fact could result in museums' receiving fewer high-quality donations.¹⁸⁴ Works that hold their value or grow in value are precisely those that should appear in museums. While frequent revaluation of donations creates administrative burdens, it gives donors a reason to give their best works to museums. It also ensures that the government does not give excessive tax benefits to a donor whose gift depreciates.

181 See *supra* notes 54–56 and accompanying text.

182 See *supra* Part I.B.

183 See *supra* Part II.D.

184 The fact that appreciation is such an important issue supports the contention that fractionally donated works tend to be of particularly great value and quality. See *supra* notes 16–19 and accompanying text.

Therefore, the best rule would calculate the deduction based on donated property's FMV at the time of each donation.¹⁸⁵

CONCLUSION

The Portland Art Museum recently received the unexpected donation of a Vincent Van Gogh painting which had been hanging in a Connecticut family's dining room since 1950.¹⁸⁶ Hopeful that this important donation would spur others, Brian Ferriso, the museum's executive director, said, "I have always thought collectors are not necessarily owners, they're more renters."¹⁸⁷ He continued, "They rent these works for a period of time and ultimately the works transcend all of us. And they really do belong to a larger institution and mission and to our larger ideals about what art and culture is."¹⁸⁸

Mr. Ferriso addresses the idea at the heart of this Note: these works belong, properly, in the place where the largest number of people can enjoy and learn from them. The law should be designed to serve the purposes of allowing the renting donor to surrender the work to the public trust. It must balance incentives for art collectors against the invitation to abuse. The PPA of 2006 attempted to strike this balance, but its overly restrictive provisions have strangled fractional giving and have been counterproductive to § 170's goals. A more moderate, less restrictive law would better serve the donors, the museums, and most importantly, the public.

185 Neither the locked-in value approach nor the variable approach would seem to affect the donor's choice to continue on her donation path. That is, once a portion of the work has been donated, the collector would be better off donating even a depreciated portion and receiving some tax benefit than simply holding the work until death.

186 See Susan Stamberg, *Gift Brings Van Gogh's 'Ox-Cart' to Oregon Museum*, NPR, Dec. 3, 2007, <http://www.npr.org/templates/story/story.php?storyId=16792247>.

187 *Id.* (quoting Brian Ferriso).

188 *Id.*