FEDERAL INCOME TAXATION OF FINE ART

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I. Introduction

A. *The Relationship Between the Arts and Taxation*

Approximately twenty-eight thousand years ago, the dawn of recorded history was signaled by the discovery of an anonymous artist's petroglyph in an unknown cave. Since that time, art and artists have occupied a special place in human history. Through their artists, societies have left indications of their greatness or mediocrity. Perhaps in recognition of the fact that their place in history might depend on their artists' talents, governments and artists have always been intertwined. This Article will examine one aspect of this relationship: the role, workings and impact of federal income tax laws upon art and artists.

In many respects the relationship is not unique. Artists are for the most part taxed in the same manner as any other citizen, and objects of art are taxed in the same manner as are other items of personal property. In other respects, however, the relationship is unique. This uniqueness results from the nature of the art world and from the dual functions of federal taxation. Tax laws are designed to raise revenue and at the same time to serve a role of patronage. Both subtle and obvious inconsistencies have arisen in the federal tax laws as a result of the difficulties encountered in striking a balance between these two functions.

The function of patronage cannot be underestimated. The tax laws in this country provide a unique invisible subsidy to the artist in two ways: first, taxes are collected and monies distributed in order to directly foster values that society considers important; and second, private investment is encouraged through tax advantages in those areas deemed socially worthwhile.[1] Tax forgivenance, or the "tax expenditure" budget, is a principle means of art patronage.[2] This form of patronage includes the special provisions of the federal income tax system which allow for government expenditures directed towards achieving various social and economic objectives.[3] Although comparison figures are not available, it appears that tax expenditures in the form of deductions, credits, exclusions, exemptions, deferrals and

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[1] *See* Simon, *The Corporate Medici*, Colo. Q. 4 (Oct. 1978). Tax advantages are usually reserved for areas in which government is believed to be too burdensome or unimaginative to act as a proper guide or sponsor. *Id.*

[2] *See* Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 Harv. L. Rev. 705 (1970).

[3] *Id.*

preferential rates are the principle means of public support of the arts.[4]

Tax laws are subject to a constant tug-of-war as the functions of revenue and patronage compete.[5] For example, one provision of the Tax Reform Act of 1969 provoked a great deal of legislative response. The provision, Internal Revenue Code (I.R.C.) section 170(e),[6] limits an artist's charitable deduction for a donated work to the artist's basis. This section represents a clear victory for the tax system's revenue function.

Although section 170(e) was designed to curtail abuses by politicians who claimed deductions for donations of their private papers,[7]

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[4] *See* Price, *State Art Councils: Some Items for a New Agenda*, 27 HASTINGS L.J. 1183, 1202 (1976); *Tax Incentives*, *supra* note 2, at 706.

[5] A sampling of tax measures affecting the arts introduced in the 93rd through 96th Congress (1974-1979) is illustrative of the conflict between the revenue and patronage functions.

(a) 93rd Congress

(1) H.R. 3152, 93rd Cong., 1st Sess. (1976). H.R. 3152 would have allowed artists and donees of art with a carry-over basis a charitable deduction equal to the cost of the artist's materials plus one-half of the difference between the cost of such materials and the fair market value of the donated work.

(2) H.R. 2151, 93rd Cong., 1st Sess. (1976). H.R. 2151 would have allowed artists (but not donees) a charitable deduction equal to the fair market value of a work.

(3) H.R. 6764, 93rd Cong., 1st Sess. (1976). H.R. 6764 would have allowed artists and donees with a carry-over basis a charitable deduction equal to the cost of the artist's materials plus three-quarters of the difference between such cost and the fair market value of the donated work. The deduction, however, could only have been used to offset the artist's art-related income.

(4) H.R. 17613, 93rd Cong., 2d Sess. (1976). H.R. 17613 would have allowed buyers to deduct, within certain limits, the purchase price paid for contemporary American works of art.

(b) 94th Congress

(1) H.R. 585, 94th Cong., 1st Sess. (1977); H.R. 6829, 94th Cong., 1st Sess. (1977); and H.R. 7091, 94th Cong., 1st Sess. (1977). H.R. 585, H.R. 6829 and H.R. 7091 would have allowed artists a charitable deduction equal to the fair market value of a work donated to a charitable organization.

(2) H.R. 8274, 94th Cong., 1st Sess. (1977). H.R. 8274 would have allowed taxpayers to make a donation to the National Endowment for the Arts or Humanities by either designating a portion of a tax overpayment for such use or by including a contribution with the tax return.

(c) 95th Congress

H.R. 11183, 95th Cong., 2d Sess. (1978). H.R. 11183 would have allowed taxpayers to deduct their charitable contributions and, at the same time, take the standard deduction.

(d) 96th Congress

(1) H.R. 1720, 96th Cong., 1st Sess. (1979); and H.R. 2113, 96th Cong., 1st Sess. (1979). H.R. 1720 and H.R. 2113 would have eased the tax levied on heirs of artists' estates.

(2) H.R. 1785, 96th Cong., 1st. Sess. (1979). H.R. 1785 would have allowed charitable contribution deductions regardless of whether or not personal deductions were itemized.

(3) H.R. 1847, 96th Cong., 1st Sess. (1979). H.R. 1847 would have allowed artists a deduction equal to the fair market value of a donated work.

It should be noted that none of these bills were passed into law.

[6] I.R.C. § 170(e) (1982). Most of the tax measures discussed in *supra* note 5 were in reaction to I.R.C. § 170(e).

[7] *See generally* H.R. REP. No. 413, 91st Cong., 1st Sess., *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 164.

the arts have been adversely affected by the legislation. There has been a considerable decline in the number of works donated by artists to museums. One museum director, comparing the three years immediately prior to passage of the Tax Reform Act of 1969, and the three years immediately following passage, noted a 91% decrease in artists' donations.[8]

The section has been defended as being consistent with other provisions of the I.R.C. because it does not favor artists.[9] The important issue is not, however, whether the provision favors artists, but rather the extent to which the government is willing to support the arts through the tax expenditure budget. Although to some it may be comforting to note that the arts are not immune from the tax reform spirit, the dependency of the arts on the tax expenditure budget makes an understanding of the relationship between the arts and tax laws essential. A failure to understand the nature of this relationship is probably the reason why artists are not exempt from the workings of I.R.C. section 170(e).

Tax laws are not necessarily right or wrong, fair or unfair; they simply mirror policy. This simple consideration is the starting point in any analysis of the tax laws as they relate to art and artists.

B. *The Art World: The Backdrop*

Tax laws do not exist in a vacuum. They take on a color and character that is determined by the sphere in which they act. No analysis of tax laws is meaningful unless consideration is given to the environment in which those laws operate.

There was a time when art was an economic footnote. This is no longer the case; art has become big business. The number of working artists in the United States was recently estimated to be in excess of 950,000.[10] The budget of the National Endowment for the Arts increased from $2.5 million in 1966[11] to over $143 million in 1982.[12] During the ten years between 1965-1975, state support for the arts increased from $1.7 million to $55 million;[13] in 1982 these appropria-

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[8] F. FELDMAN & S. WEIL, ART WORKS: LAW, POLICY, PRACTICE 823-24 (1974).

[9] Colin, *Tax and Economic Problems of Artists* (pt. 1), 180(47) N.Y.L.J., Sept. 7, 1978, at 1, col. 2.

[10] M. Straight, Address to the Colorado Council on the Arts and Humanities (Nov. 10, 1979) (Mr. Straight is a former Deputy Director of the National Endowment for the Arts).

[11] T. CRAWFORD, LEGAL GUIDE FOR THE VISUAL ARTIST 202 (1977).

[12] 3 American Council for the Arts Update (Sept. 20, 1982), at 2.

[13] CRAWFORD, *supra* note 11, at 204.

tions totaled more than $210 million.[14] Auction house sales, the traditional barometer of the art market, have increased astronomically.[15] Art is threatening to become a new type of currency due to inflation and deflated monetary values.[16]

Art has also attracted big business. American businesses spend more than $250 million a year underwriting art exhibits.[17] As of 1978, the yearly contributions of U.S. businesses to the visual arts were more than two and one-half times that spent by the federal government throughout the thirteen-year history of the National Endowment for the Arts.[18] In 1979, New York's Citibank Corporation established an art investment program to provide for systematic investment of its clients' funds in art.[19] There has also been a virtual explosion of art tax shelter arrangements[20] involving such renowned artists as Larry Rivers, Alex Katz, Karel Appel, Robert Cottingham, Chryssa, Lowell Nesbitt, Cesar, Mel Ramos, Betty Parsons and Allan D'Arcangelo.[21]

Despite its growth, the art market receives minimal public scrutiny or government regulation. One commentator has opined that if the art world underwent supervision comparable to other industries, most dealers and gallery owners would go out of business overnight.[22] The purchase, sale and collection of art may be manipulated so that taxes are avoided through the concealment or inflation of income.[23] The Internal Revenue Service (IRS) is one of the few agencies with the power to examine art market dealings;[24] however, the IRS has informally admitted its own confusion regarding how to decipher dealers' records so as to enforce tax laws.[25]

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[14] NATIONAL ASSEMBLY OF STATE ARTS AGENCIES, ANNUAL LEGISLATIVE SURVEY (1982).

[15] In the early 1940's, Parke Bernet's average yearly sales were approximately $3.3 million. By the early 1960's sales rose to just under $10 million and, by 1974, after the acquisition by Sotheby's of London, sales soared to approximately $215 million. R. DUFFY, ART LAW: REPRESENTING ARTISTS, DEALERS AND COLLECTORS vii (1977).

[16] *See* Hughes, *Confusing Art with Bullion*, TIME MAG., Dec. 31, 1979, at 56.

[17] *Firms Replacing Tycoons as Patrons of the Arts*, Rocky Mtn. News, Dec. 26, 1979, at 141.

[18] *Id.*

[19] Rosenbaum, *Conflict with Interest: Citibank Meets Parke Bernet*, N.Y. MAG., Oct. 22, 1979, at 43.

In another investment plan municipal bonds were printed on 25" × 32" art quality paper with limited-edition prints by three well-known artists on their reverse sides. Upon maturity, a holder has the option of redeeming the bond or keeping it for its value as fine art. DUFFY, *supra* note 15, at 61; Wall St. J., March 18, 1976, at 1, col. 5.

[20] *Prints Make Good Tax Shelters*, Denver Post, Nov. 3, 1977, at 33.

[21] *Fact Sheet, Offering of Art Master*, Jackie Fine Arts, Inc., Sept., 1979.

[22] C. IRVING, FAKE 226 (1969).

[23] L. SELDES, THE LEGACY OF MARK ROTHKO 337 (1978).

[24] *Id.*

[25] *Id.*

Although the statement of the IRS's confusion may be slightly exaggerated, it does point out the diversity and complexity of the milieu in which the tax laws must operate. Acknowledging both this diversity and complexity, together with the growth of the arts into a notable economic force, is as important as understanding the policy considerations noted above when evaluating the role, workings and impact of the tax laws upon art and artists.

C. *Definitional Considerations*

The identification of working definitions for the terms "art" and "artists" might seem to be a major hurdle in an analysis of art taxation. However, while definitional problems are often pivotal in customs, copyright and patent cases, they are rarely important in tax cases.[26] The definitions of art in the customs and copyright areas are very specific.[27] In contrast, neither the I.R.C. nor the Revenue Regulations (Regulations) contain anything approaching a definition of art or artists. Although the Internal Revenue Manual attempts to define "work of art,"[28] the definition mentions neither originality nor creativity, nor any of the other qualifications found in the customs and copyright definitions.[29]

Perhaps the benign nature of the definitional problem in the tax area lies in the fact that for purposes of taxation there is no distinction made, or preferential treatment given, to any particular manifestation of what might loosely be termed "creative effort." Characteristics of art that are often relevant in copyright, customs, patent or even first amendment cases have no effect on the tax treatment of works of

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[26] An early customs case involving a sculpture by Constantine Brancusi entitled "Bird in Flight" is a good example of the type of definitional problem that can arise in the customs context. Upon its attempted importation into the United States by Edward Steichen, the customs officer thought that a piece so abstract could not possibly be classified as art and imposed a 40% duty on the piece as a "manufacture of metal." Although Steichen ultimately won, the definitional battle in the customs area continues to this day. Brancusi v. United States, T.D. 43,063, 54 Treas. Dec. 428 (1928).

[27] The customs definition excludes articles of utility for industrial use, items made by certain photochemical or other mechanical processes and all but the first ten castings of a work of sculpture. 19 U.S.C. § 1202 (1976) (Revised Tariff Scheds., Sched. 7, pt. 11, subpt. A). The copyright definition likewise excludes utilitarian objects unless the artistic features can exist independently of the utilitarian aspects and, in addition, requires that a work of art be original and creative. 17 U.S.C. § 101 (1976 & Supp. V 1981).

[28] The Internal Revenue Manual definition of a work of art reads, "A painting, drawing, print, sculpture or antique furnishing, but not literary, dramatic, music or historical memorabilia." *Criteria for Requesting Art Assistance*, II INTERNAL REVENUE MAN. (CCH) § 42(16) 4.2(2) (Oct. 23, 1980).

[29] *See supra* note 27.

art.[30] Art in all of its many expressions and manifestations is treated the same for tax purposes.[31]

II. Valuation of Art

Determining the value of a work of art is one of the first issues encountered in any art-related tax problem.[32] Although the discussion below is primarily concerned with visual art, the principles generally hold true for all artistic products whether they be manuscripts, poems, dramatic properties, musical compositions or choreographic notations.

To a large degree, the value of a work of art is determined by the renown of the artist or the pleasure and status possession will bestow

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[30] The distinction between the importance of certain characteristics of art in relation to the tax laws and these other areas of the law can be demonstrated by looking at six aspects of art:

(1) Physical and temporal characteristics of the work of art—creation, reification, permanence, size and detectability. A work must be conceived and reified, but its permanence and size are of no importance so long as the tax incidents take these factors into account. Similarly, a work of art need not be detectable; Rauschenberg's "Erased deKooning," although undetectable, is nontheless a work of art.

(2) Perceptual characteristics—simplicity, complexity and randomness; part-whole distinctions. In some areas of the law, copyright for example, a work that is so simple that it constitutes near nothingness or a work that is cacophonously complex, might raise a definitional problem. This is not so with respect to taxation. A "cacophonous" work by Jackson Pollock and the most minimal piece of minimal art are treated the same for tax purposes.

(3) Social and aesthetic characteristics attributed to art—utility versus non-utility, originality. This is a continuing battleground in customs, copyright and patent law, not in taxation. A Louis XV marquetry cabinet or Fabergé hippopotamus cigarette lighter might have trouble making the grade as works of art in the customs court, not in the tax court.

(4) States of mind regarding art works—objective and subjective tests. This might be a factor in a first amendment case involving protest art or obscene art, but not in a tax case.

(5) Physical behavior involved in creating works of art—who is the artist? This definitional problem most often arises in copyright cases where the issue involves the determination of rights where there are multiple creators. This problem rarely arises in tax cases due to the divisible nature of the tax incident. Where it is often difficult to allocate rights of ownership in a single copyrighted work, it is not so difficult to allocate and share the tax benefits or incidents flowing from the creation, use and disposition of such a work.

(6) The work of art versus the art related—craft, design and ornament. A person well versed in custom and copyright law would recognize these terms as signaling serious problem areas. In tax law, however, with rare exception, products of crafts, graphic and industrial design and ornament almost always share the same tax treatment as the fine arts definitional categories. Karlan, *What is Art?: A Sketch for a Legal Definition*, 94 Law Q. Rev. 383, 388-404 (1978).

[31] This may be a recognition of the sentiment early expressed by Justice Holmes when he said: "It would be a dangerous undertaking for persons trained only to the law to constitute themselves final judges of the worth of pictorial illustrations, outside of the narrowest and most obvious limits." Bleistein v. Donaldson Lithographing Co., 188 U.S. 239, 251 (1903).

[32] In this context, "value" refers to monetary rather than the larger philosophical or spiritual considerations of value; however, the latter considerations often have a direct bearing on the former.

upon the owner. The factors that lend value to a work of art, however, tend to change, therefore rendering the art market artificial and subject to great manipulation. Other than the fact that the artist has acquired a national reputation due to the efforts of an influential art dealer, a one-man show in a prestigious gallery or notice by the national art press, there is often no intrinsic difference between a work of art purchased for $500 and a work purchased for $5,000.

In perhaps no other business can a $500 item be transformed into a $5,000 item for some purposes and a $50 item for others. One observer has described the art market as an "incestuous world" where large sums of money change hands secretly and frequently, and where the price manipulation is not only expected but mildly condoned.[33]

At least eighteen sections of the I.R.C. and Regulations require determination of value in connection with situations ranging from political contributions to bartering for services.[34] For the most part,

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[33] L. SELDES, *supra* note 23, at 336-37.

[34] (1) Treas. Reg. § 1.61-2(d)(1) (1979) requires that the fair market value of property taken as payment for services be included in income; (2) Treas. Reg. § 1.61-2(d)(2)(i) (1979) states that if property is transferred by an employer to an employee or independent contractor as compensation for services, the excess of the fair market value of the property over the amount paid, if any, by the employee or independent contractor is to be included in income of the employee or independent contractor; (3) Treas. Reg. § 1.74-1(a)(2) (1960) requires inclusion in income of the fair market value of property received as a prize or award; (4) I.R.C. § 83(a) (1982) requires inclusion in income of the excess of the fair market value over the amount, if any, paid where the property is transferred in connection with the performance of services; (5) Under I.R.C. § 84 (a) (1982) a valuation might be required upon transfer of appreciated property to a political organization; (6) Treas. Reg. § 1.170A-1(c)(1) (1975) provides that if a charitable contribution is made with property other than money, the value of the contribution is determined by the fair market value of the property at the time of the contribution; (7) I.R.C. § 351(b)(1)(A)–(B) (1982) provides for recognition of gain to the extent of the fair market value of "other property" received in a § 351 transfer; (8) I.R.C. § 358(a)(2) (1982) states the general rule that the basis of "other property" received in a § 351 transfer shall equal its fair market value; (9) I.R.C. § 1001(b) (1982) provides: "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." This section, along with § 61 and regulations thereunder, would apply to artists' exchanging their artwork; (10) I.R.C. § 1011(b) (1982) provides for basis adjustment relative to the fair market value of property sold in charitable "bargain sale" situations; (11) I.R.C. § 1014(a)(1) (as amended by Revenue Act § 702(c)(1)(A) (1978)) provides the basis rule for property acquired from a decedent. The basis is the fair market value of the property at the date of the decedent's death; (12) I.R.C. § 1015 (1982) provides gain and loss basis rules for property acquired by gift, stating the situations under which the basis of the property shall be fair market value at the date of the gift, rather than a carryover basis from the donor; (13) I.R.C. § 1023(g)(3) (1982) (as amended by Revenue Act § 702(c)(2)(B)) provides for the use of fair market value of carry-over basis property where the facts necessary to determine the actual basis cannot be reasonably ascertained; (14) I.R.C. § 1031(d) (1982) provides that "boot" received in a § 1031 exchange is valued at fair market value and requires an allocation of basis to such property on the basis of its fair market value; (15) Prior to 1977, I.R.C. § 1040(a) (1976) provided that gain shall be measured on the basis of fair market value where appreciated carry-over basis property is used

the I.R.C. employs the term "fair market value" for income tax purposes.[35] The Regulations define fair market value 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."[36] This standard

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to satisfy a pecuniary bequest; (16) I.R.C. § 1491 (1982) provides for an excise tax based upon fair market value in cases of transfer of property to a foreign corporation as paid-in surplus or as a contribution to capital; (17) I.R.C. § 2031(a) (1982) requires inclusion of the value of all property, wherever situated, in the gross estate of a decedent; (18) I.R.C. § 2515(a) (1982) provides that the amount of gifts made in property shall be determined in relation to the value of such property. I.R.C. § 2515(b) (1982) provides that property transferred for less than full consideration shall be a gift to the extent of the value of the property over the value of the consideration.

[35] The text of this discussion concentrates on the concept of valuation in the context of income taxation. However, valuation is also an issue in estate and gift taxation. There is a semantic difference between the terms "fair market value," as used in federal income tax law, and "value" as used in federal estate and gift taxation, but in application the terms are nearly synonymous.

When the term "value" is used in the context of estate and gift taxation, it is assumed that the term is self-explanatory. *See* THE STUDY OF FEDERAL TAX LAW, ESTATE AND GIFT TAX VOLUME, ¶ 11,401 (Pedrick & Kirby ed. 1979). The Regulations indicate that the two terms encompass one another. Support for this is found in the cross reference in I.R.C. § 1023(g)(3) *amended by* the Revenue Act of 1978 in § 702(c)(3)(A) which states: "For the purposes of this section . . . the term 'fair market value' means value as determined under Chapter 11 [estate tax]."

[36] Treas. Reg. § 1.170A-1(c)(2) (1982). The fair market value rule is also defined three times in the estate and gift tax regulations. Treas. Reg. §§ 20.2031-1(b), -6(a), 25.2512-1 (1982). The income tax definition and one of the estate and gift tax definitions are almost identical. *See id.* § 20.2031-1 (1982). The definition in § 20.2031-6(a) (1982) contains a minor variation in wording: "[t]he fair market value . . . is the price which a willing buyer would pay to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." The definition in § 25.2512-1 (1982) is the same as the income tax definition except that the term "value" is used instead of "fair market value."

Even though the definition of fair market value is virtually identical throughout the I.R.C. and the Regulations, the interpretations of that phrase vary because of different concepts of the term "market." For purposes of the Regulations, the market for property sold in the course of the taxpayer's business is defined as "the usual market in which he customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed." Treas. Reg. § 1.170A-1(c)(2) (1982).

The estate tax provision states in pertinent part:

> The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

Treas. Reg. § 20.2031-1(b) (1982).

The gift tax provision echoes the estate tax section above, but makes the following addition:

> [I]n the case of an item of property made the subject of a gift, which is generally

has been soundly criticized for failing to take account of the unique nature of art and the art market.[37]

Estimating the market price of a work of art is a major difficulty. Artworks sold at auctions pose a special problem. For example, in October 1976, a painting by Jerome Myers entitled "Park Concert, New York"[38] was sold at Sotheby Parke Bernet for $9,500. Less than a year and a half later, the same painting was again sold at Sotheby's for $26,000.[39]

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obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail.

Treas. Reg. § 25.2512-1 (1982).

[37] R. LERNER, REPRESENTING ARTISTS, COLLECTORS AND DEALERS 21 (1979). The estate and gift tax market rules have been subject to the same criticism. *Id.* For example, Rev. Proc. 65-19, 1965-2 C.B. 1002, sets forth the procedure for applying the provisions of the market rule found in Treas. Reg. § 20.2031-1(b) (1982), *supra* note 36. The regulation provides that:

> [I]n the case of an item or property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail.

The Revenue Procedure provides that in application of this rule, "[w]here . . . there is a bona fide sale of an item of tangible personal property at a public auction, the price for which it is sold will be presumed to be the retail sales price of the item at the time of the sale. Rev. Proc. 65-19, 1965-2 C.B. 1002.

Neither of these provisions take into account the unique nature of the art market or the distinctive problems that arise in the valuation of art.

[38] Oil on canvas, 30″ × 25″, signed and dated.

[39] The recent auction history of the works of Willard Leroy Metcalf, a highly regarded American impressionist, provides an example of the difficulty of estimating the market price of art work. Over the course of a three-year period, Metcalf's paintings, sold at auction at Sotheby Parke Bernet, fluctuated in price considerably.

Painting	*Date of Sale*	*Sales Price*
"Springtime Festival" Oil on canvas, 26″ × 29″	October 28, 1976	$19,000.00
"Springtime Festival" (Same painting as above)	March 3, 1978	$17,000.00
"Boothbay Harbor" Oil on canvas, 26″ × 29″	April 21, 1978	$29,000.00
"Autumn Landscape" Oil on canvas, 40″ × 34″	October 27, 1978	Failed to meet reserve - no sale
"Deer in Forest" Oil on canvas, 16″ × 20″	October 27, 1978	Failed to meet reserve - no sale
"The Hills of February" Oil on canvas, 28″ × 33″	October 27, 1978	$32,000.00
"Coastal Scene" Oil on canvas, 10″ × 14″	April 20, 1979	$ 4,500.00
"The Thawing Pool" Oil on canvas, 35″ × 35″	April 20, 1979	$47,500.00
"Autumn Glory" Oil on canvas, 26″ × 20″	October 25, 1979	$36,000.00

Several factors can contribute to the distortion in prices of works sold at auctions. Some items receive greater publicity than others. In addition, the presence of an avid collector at the auction can raise prices.[40] Furthermore, the auction market is an artificial one; dealers have been known to buy back paintings they themselves have put up for sale in order to inflate prices.[41]

The fluid nature of the art market provides the opportunity for virtually any type of valuation manipulation.[42] Yet, due to the practical requirements of administering the tax laws, and in spite of the problems inherent in determining value, it is impossible to avoid the necessity for determining the worth of works of art. However, market value is so dependent on times, places, conditions, and people that what may be a good rule in one case may be no rule under other circumstances.

In dealing with subjects other than art, the Tax Court has recognized a concept of subjective valuation, a standard that primarily considers factors other than fair market value. In *Turner v. Commissioner*,[43] for example, the taxpayer won tickets to Brazil on a radio quiz show. The IRS sought to value the tickets at full retail fair market value. The Tax Court rejected the IRS analysis and found that the value of the tickets to the taxpayer was not equal to the retail fair market value.[44] Another example of subjective valuation can be found in *McCoy v. Commissioner*.[45] The taxpayer received an automobile from his employer for winning a sales contest. Shortly thereafter, the taxpayer traded in the car for a different model and $1,000 cash. The IRS sought to include the full retail value paid by the employer for the car in the taxpayer's income. The taxpayer sought to include only the value he received from the trade-in, about $800 less than the retail price. The Tax Court rejected both positions, stating that neither of those two amounts reflected the value of the car in the taxpayer's hands at the time he received it.

In both *Turner* and *McCoy*, the Tax Court refused to determine value solely by referring to the retail cost of the property received.

What is the value to be placed on a Metcalf painting at some point during this three-year period? The inconsistencies in the above figures reveal the difficulty of determining a work of art's retail value.

[40] *Appellate Conferee Valuation Training Program*, INTERNAL REVENUE SERVICE, (CCH) Ch. II § 5(b)(1)(f), at 65 (1978).

[41] L. SELDES, *supra* note 23, at 337.

[42] *See supra* note 33 and accompanying text.

[43] 23 TAX CT. MEM. DEC. (P-H) ¶ 54,142 (1954).

[44] *Id.*

[45] 38 T.C. 841 (1962).

Instead, the court arrived at an equitable valuation of the property received by the taxpayer through an examination of the facts in each case.

This, then, is the arena in which the valuation game is played: a subjective commodity in a highly manipulatable market with both sides taking inconsistent positions. The taxpayer presses for high valuations for his charitable contributions and low valuation in the estate and gift tax areas. The government, quite naturally, takes opposite and equally inconsistent positions.[46]

Statistics indicate the extremes of the conflict and inconsistencies. Of the twenty-eight charitable contribution valuation cases considered by the Commissioner's Art Advisory Panel in February 1977, 93% of the taxpayers' appraisals were considered unacceptable. Adjustments that would have resulted in a 17% reduction in valuations were recommended.[47] At the same meeting twenty-four estate and gift tax cases were considered. Seventy-two percent of the appraisals were unacceptable and increases amounting to a 130% adjustment were recommended.[48] During its November 1977 meeting, the Panel found 38% of the fifty-five charitable contribution appraisals unacceptable, recommending a 29% reduction in valuations.[49] With regard to the estate tax cases considered, 43% of the appraisals were unacceptable and increases of 14% were recommended.[50]

From these statistics, two factors are particularly noteworthy. First, assuming random samples in each case, there is considerable inconsistency between appraisals rejected and adjustments recommended in the February and November meetings. Second, there were neither recommendations for increases in the charitable cases nor were there recommendations for reductions in the estate and gift tax valuations. Together these factors suggest some highly subjective valuation standards. Given the requirement and the myth that some objective certainty can be found in valuations, the taxpayer is placed at

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[46] The Internal Revenue Service has acknowledged that there is no fixed rule that will result in an acceptable determination of fair market value. INTERNAL REVENUE SERVICE, *Publication* 561 (Valuation of Donated Property) at 5 (1980) [hereinafter cited as *Publication* 561]. This is especially true in the art world. Works of art, unlike most other commodities, have virtually no intrinsic value. *See, e.g.*, Echter, *Equitable Treatment for the Artist's Estate: The Tax Court Takes a First Step*, 114 TR. & EST. 394, 396 (1975).

[47] INTERNAL REVENUE SERVICE, *Statistical Summary of Cases Considered by the Commissioner's Art Advisory Panel at Meeting #24 and #25.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

an immediate disadvantage. In virtually all procedural settings, the taxpayer bears the burden of supporting a claimed art valuation.[51]

There are several levels of reporting requirements. In many cases there will be no reporting required. For example, reporting is not necessary for "section 1031 exchanges"[52] in the year of exchange or for charitable contributions in which a deduction of not more than $200 is sought.[53] In these cases the taxpayer must support the valuation if challenged, but need not file any supporting data with the tax return.

In the vast majority of cases, the issue of fair market value will arise only in reporting the dollar equivalent of property received as a prize or award under section 74.[54] Again, the taxpayer need only support these valuations (equivalencies) if challenged.

In some cases the Regulations require some fairly specific reporting. For example, when employees receive property as partial compensation for services, Treas. Reg. 1.83-2(e)(5)(1978) requires a statement indicating the fair market value of the property at the time of transfer. In specified instances of charitable contributions of property, Treas. Reg. 1.170A-1(a)(2)(ii)(e)(1975) requires a slightly more detailed statement that indicates the fair market value of the property at the time the contribution was made and the method utilized in determining that value. For charitable contributions of works of art where a deduction of more than $200 is sought, a very detailed statement must be attached to the tax return.[55]

In most cases, however, the burden of supporting a valuation is largely illusory. This issue of fair market value rarely comes under IRS scrutiny because valuations are infrequently challenged. In cases where the issue does arise, it is a result of either audits of tax returns in

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[51] *See, e.g.*, Goldman v. Commissioner, 388 F.2d 476 (6th Cir. 1967); Rev. Proc. 66-49, 1966-2 C.B. 1257; UNITED STATES TAX CT. R. 32.

[52] I.R.C. § 1031 (1982) refers to exchanges of property held for productive use or investment.

[53] INTERNAL REVENUE SERVICE, *Publication* 526 (Charitable Deductions) at 8 (1978) [hereinafter *Publication* 526.]

[54] I.R.C. § 74 (1982).

[55] *Publication* 526, *supra* note 53. The statement must contain: (1) the name and address of the donee institution; (2) the date of the contribution; (3) a description of the property in sufficient detail to identify it; (4) the manner and approximate date of acquisition of the donated property; (5) the fair market value of the property at the time of the donation; (6) the manner of determining that value; (7) the cost or adjusted basis of the property; (8) the amount of any § 170(e) reduction in the contribution; (9) the terms of any agreement entered into between the taxpayer and the donee institution relating to the use, sale or other disposition of the donated property; and, (10) the amount claimed as a deduction for the tax year as a result of the contribution and particulars regarding any donation of fractional interest.

the IRS District Office, or review of an appraisal attached to a return.[56]

The first step in the review process is at the District Office level.[57] If research at the District Office indicates a need for further verification, or if a taxpayer's appraisal of a single work of art exceeds $20,000, the matter is referred to the Internal Revenue Service's National Office.[58]

At the National Office there are three levels of review and assistance. The first is the Art Valuation Group which consists of five appraisers who prepare material for the Art Advisory Panel.[59] The Art Valuation Group performs independent appraisals on various items of cultural property including rare books and manuscripts, primitive art, historical memorabilia, paintings and sculpture.[60] The backgrounds of the appraisers vary, but all have studied art history in undergraduate or graduate school. In addition, most of the appraisers have completed property appraisal courses and have attended art and antique seminars.[61]

In cases where significant tax abuse is suspected or where there is a wide discrepancy in estimates of fair market value, prominent art authorities are called upon for independent appraisals which are used to supplement the Advisory Panel's review.[62]

The second level of review is conducted by the Art Advisory Panel,[63] created in 1968. It consists of a rotating board of nationally prominent art museum directors, art professors and art dealers.[64] The Panel meets at least twice a year to discuss and make recommendations regarding the acceptability of taxpayers' appraisals of works of art.[65] There are several actions the Panel can take if it recommends rejection of a taxpayer's appraisal. In addition to recommending a

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[56] *Annual Summary Report for 1978 of Closed Meeting Activity of Art Advisory Panel of the C.I.R.*, II INTERNAL REVENUE MAN. (CCH) § 42(16) 32(1), at 1 (1980). In one instance an appraisal is required to be filed with the return. *See* Treas. Reg. § 20.2031-6(b) (1982), which requires an appraisal if there are "included among the household and personal effects articles having marked or intrinsic value in excess of $3,000."

[57] INTERNAL REVENUE MAN., *supra* note 56, § 42(16) 32(1).

[58] *Id.* § 42(16) 32(1)-(2).

[59] *See infra* text accompanying notes 63-70.

[60] Letter from Geoffrey J. Taylor, Chief of the Engineering and Valuation Branch, I.R.S. National Office (Dec. 21, 1978).

[61] *Id.* (Feb. 16, 1978).

[62] *Art Advisory Panel*, II INTERNAL REVENUE MAN. (CCH) § 42(16) 4.1 (3) (Oct. 23, 1980).

[63] *Id.*

[64] INTERNAL REVENUE MAN., *supra* note 56, § 42(16) 31(1).

[65] 1978 I.R.S. Annual Summary Rep. of Closed Meeting Activity of the Art Advisory Panel of the C.I.R. 1 [hereinafter cited as 1978 Annual Report].

different valuation, the Panel can suggest the securing of additional information, or further consultation with a specialist.[66]

Almost half of the appraisal items received at the National Office are referred to the Art Valuation Group.[67] The Art Valuation Group reviews the appraisals on all single works of art valued at less than $20,000.[68] All items valued at over $20,000 must be referred to the Art Advisory Panel.[69] The Art Valuation Group has the additional function of providing the work-ups on the appraisals submitted to the Panel. These work-ups consist of photographs and written materials including information from the taxpayer's appraisal, results from the staff's independent authentication and market research, and statistics concerning public and private sales of similar works by the same artist.[70]

In the first nine years of its existence the Art Advisory Panel had already reviewed appraisals valued at over $211 million, and recommended valuation adjustments of over $63 million.[71] The influence of the Art Advisory Panel, however, extends beyond the review of appraisals. The Panel provides guidance to the Art Valuation Group and recommends appraisers that the Internal Revenue Service could employ to provide detailed evaluations of works of art.[72] An examination of the Panel's history will shed light on the milieu in which it operates.

Pressures evolving in the art world caused the American Association of Art Museum Directors to suggest creation of an art advisory panel.[73] The art museum directors were concerned with the rise in grossly inflated appraisals of art works that were donated to charitable institutions during the early 1960's.[74] These inflated appraisals reached such epidemic proportions that Congress considered removing art donations from the tax exemption list.[75] This kind of tax abuse became so extreme that the Commissioner issued a news release on the subject warning that charitable contributions of noncash items, especially works of art, were going to be subject to strict IRS scrutiny.[76]

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[66] *Id.*

[67] Letter from Geoffrey J. Taylor, *supra* note 60.

[68] INTERNAL REVENUE MAN., *supra* note 56, § 42(16) 32(3).

[69] *Id.* § 41(16) 4.2(2). The procedure for works of art in estates is slightly different.

[70] 1978 Annual Report, *supra* note 65, at 1.

[71] Commissioner of Internal Revenue, Annual Report (1977).

[72] INTERNAL REVENUE SERVICE, *News Release* (Feb. 1, 1968).

[73] *Id.*

[74] M. SHULMAN, ANYONE CAN MAKE BIG MONEY BUYING ART 95 (1977).

[75] *Id.*

[76] INTERNAL REVENUE SERVICE, *Appellate Conferee Valuating Training Program*, Ch. II § 5(b)(1) at 65 (CCC 1978).

Many of the pressures that led to the creation of the Art Advisory Panel led to the foundation of the Art Dealers Association of America, Inc. (ADAA) in 1962. The ADAA is a national organization created to improve the "stature and status of the art-dealing profession."[77] The organization functions as a protectionist lobby designed to counter the types of abuses which threatened to reduce favorable tax treatment of works of art—a serious economic issue to major art dealers. Membership in the ADAA is by invitation only.[78] As of October 1, 1982, there were 110 members.[79]

Since the establishment of the Art Advisory Panel, there has been a close relationship between the Panel and the ADAA. The IRS has chosen to rely heavily on ADAA members for composition of the Art Advisory Panel. This perhaps inevitably close relationship has drawn considerable fire.[80] A bit defensively, the IRS has made it clear that it cannot afford to give recognition "to any appraiser or group of appraisers from the standpoint of unquestioned acceptance of their appraisals"[81] and that membership in appraisal organizations will not automatically establish the appraiser's competence.[82] The IRS does, however, acknowledge that the arrangement is not without its prob-

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[77] AMERICAN ART DIRECTORY 3 (1978).

[78] Art Dealers Ass'n of Am., Inc., Activities and Membership Roster 4 (1980-82).

[79] *Id.* at 5.

[80] In 1962, a protectionist lobby, the Art Dealers Association of America [was founded] . . . [t]he organization also assisted dealers and collectors in encounters with the IRS by unifying standards of appraisals for tax purposes. . . . Later the ADAA became so established that, by 1968, the Internal Revenue Service would invite members of the association to join an official Art Panel to check suspect appraisals—many signed by fellow ADAA members.

L. SELDES, *supra* note 23, at 57.

Yet another highly questionable IRS practice had been instituted a year earlier [1968], when the official Art Panel was established to guide the IRS about tax deductions taken for works of art. Revolving appointments to the panel were made by the Commissioners from the art clique itself—dealer members of the ADAA and curators and directors of museums. Six days a year, these far-from-disinterested professionals would meet to evaluate the claimed deductions for art in artists' and collectors' estates and works of art donated to charities. In the microcosm of the art world, it was next to impossible for these outsiders not to know exactly whose works of art they were considering and though sworn to secrecy, whispers of the deliberations could easily be passed to interested parties.

Id. at 87.

Not only is supervision of art dealings unenforceable abroad, but in the U.S. tax officials depend on the art world to regulate itself. The Art Advisory Panel of the IRS is comprised of a handful of interested parties. Since 1968 when it was created, the Panel has confidentially reviewed declarations of appraised art by estates as well as the charitable gift deductions by collectors and other donors of art. By its very composition and the secrecy surrounding its deliberations, the Panel cannot help but foster some favoritism, inside tips, and conflict of interest.

[81] Rev. Proc. 66-49, 1966-2 C.B. 1257-59.

[82] *Publication* 561, *supra* note 46, at 6.

lems. The taxpayers' names or the identity of their appraisers are not revealed to the panelists until after the Panel has reached a consensus. However, the prominence in the art world of certain works often results in the panelists recognizing the identities of the taxpayers or their appraisers.[83] Although to date there have been no suggestions of wrongdoing or impropriety, there is at least the appearance of a conflict of interest. There have been enough embarrassing incidents to call into question the wisdom of the close relationship between the ADAA and the Art Advisory Panel.[84]

After the Panel has met, the National Office art appraisers prepare a valuation review report on each rejected appraisal. The reports are sent to the District Office that initially referred the taxpayer's valuation.[85] These reports generally contain a statement of the issue, the name of the painting, the artist, the work's claimed value and the Panel's finding of fair market value. Background information, including a photograph of the painting and a description of its dimensions and medium, is contained in the report as well as information concerning the qualifications of the taxpayer's appraiser, and an analysis by the Panel of the taxpayer's submitted data.[86] Although the report is only intended to be advisory,[87] the District Offices tend to consider the valuation reports binding.[88] In some cases the reports must be given to the taxpayer.[89] Since the District Offices tend to treat the reports as binding, the taxpayer is generally placed in the position of either agreeing with the National Office determination or having to accept a valuation with which he disagrees.[90]

The IRS states, "Unless the item being evaluated is minor, your deduction should be supported by one or more written appraisals."[91] Despite the fact that there is only one instance where an appraisal is specifically required to be filed with the return,[92] appraisals are often filed in support of claimed valuations in excess of $200.

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[83] 1978 Annual Report, *supra* note 56, at 2.

[84] *See, e.g.*, Furstenberg v. United States, 41 A.F.T.R.2d (P-H) 78-909 (Ct. Cl. 1978) (trial judge's opinion).

[85] *National Office Coordination*, II INTERNAL REVENUE MAN. (CCH) § 42(16) 4.4 (Oct. 23, 1980).

[86] O'Connell, *Defending Art Valuations for Tax Purposes*, 115 TR. & EST. 604, 605 (Sept. 1976).

[87] *Art Advisory Panel*, II INTERNAL REVENUE MAN. (CCH) § 42(16) 4.1 (Oct. 23, 1980).

[88] O'Connell, *supra* note 86, at 606.

[89] *See* I.R.C. § 7517 (1982).

[90] O'Connell, *supra* note 86, at 606.

[91] *Publication* 561, *supra* note 46, at 7.

[92] *See supra* note 56.

In the vast majority of cases, the valuation issue raised involves an appraisal that falls well short of the ideal. An ideal appraisal should contain:

1. A summary of the appraiser's qualifications to evaluate the particular work of art involved.[93] The taxpayer should be sure that the appraisers chosen are reputable and of recognized competency;[94]

2. A statement of the work's value and an explanation of the method used to determine that amount;[95]

3. The cost, date and manner of acquisition;[96]

4. A good quality photograph, preferably an 8″ x 10″ or larger print;[97]

5. A complete description of the work of art,[98] indicating:

(a) dimension;[99]

(b) medium;[100]

(c) subject matter[101] and, if the work is a portrait, the steps taken or research performed to insure that the work is a portrait of the subject indicated;[102]

(d) title;[103]

(e) the approximate dates of creation;[104]

(f) any marks, symbols or labels on the work;[105]

(g) the support used, for example, a strainer or stretcher;[106]

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[93] Rev. Proc. 66-49 1966-2 C.B. 1258; *Publication* 561, *supra* note 46, at 6; Treas. Reg. § 20.2031-6(d) (1958).

[94] Treas. Reg. § 20.2031-6(d) (1958).

[95] Treas. Reg. §§ 1.170A-1(a)(2)(ii)(e), 20.2031-6(a) (1982); *Publication* 561, *supra* note 46, at 6; Rev. Proc. 66-49, 1966-2 C.B. 1258-59.

[96] Rev. Proc. 66-49, 1966-2 C.B. 1259; *Requests for Assistance*, II INTERNAL REVENUE MAN. (CCH) § 42(16) 4.3 (Oct. 23, 1980); *Publication* 561, *supra* note 46, at 6; Treas. Reg. § 1.170A-1(a)(2)(ii)(d)(f) (1982).

[97] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(a); Rev. Proc. 66-49, 1966-2 C.B. 1259.

[98] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(b); Rev. Proc. 66-49, 1966-2 C.B. 1259.

[99] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(b)(1); Rev. Proc. 66-49, 1966-2 C.B. 1259; *Publication* 561, *supra* note 46, at 6.

[100] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 33(2)(b)(3); Rev. Proc. 66-49, 1966-2 C.B. 1259; *Publication* 561, *supra* note 46 at 6.

[101] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(b)(3); Rev. Proc. 66-49, 1966-2 C.B. 1259; *Publication* 561, *supra* note 46, at 6.

[102] *See* Mathias v. Commissioner, 50 T.C. 994 (1968).

[103] Posner v. Commissioner, 35 T.C.M. (CCH) 943, 946 (1976).

[104] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(b)(5); Rev. Proc. 66-49, 1966-2 C.B. 1259; *Publication* 561, *supra* note 46, at 6.

[105] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(b)(6).

[106] R. LERNER, REPRESENTING ARTISTS, COLLECTORS AND DEALERS 297 (1979).

(h) the physical condition of the work;[107] and

(i) the nature and degree of any restoration.[108]

6. The name of the artist together with a statement about his standing in the profession and the particular school or time period in which he worked;[109]

7. The present location of the work should an inspection be necessary;[110]

8. The provenance of the work;[111]

9. A record of exhibitions at which the work was displayed;[112]

10. A list of any publications in which the work is mentioned;[113]

11. A certificate of authentication;[114]

12. A discussion of collateral items that tend to support the valuation claimed, such as:

(a) the value at which the taxpayer insured the work;

(b) personal property or use tax assessments;

(c) the degree of care that the taxpayer took in the safekeeping of the work; for example, how it was stored or exhibited;

(d) the degree of care or respect given the work by the donee institution;[115]

13. A summary of collateral sales data supporting the claimed fair market value, such as:

(a) sales of other works by the same artist, particularly on or around the valuation date;[116]

(b) quoted prices of the artist's work in dealers' catalogues;

(c) sales or quoted prices for artists of comparable stature;[117]

14. An assessment of the art market's economic state at or around the time of valuation, particularly with respect to the work or artist;[118]

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[107] Treas. Reg. § 1.170A-1(a)(2)(ii)(c) (1982).

[108] *See* Furstenberg v. United States, 41 A.F.T.R. 2d 78-909 (Ct. Cl. 1978).

[109] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(b)(4); Rev. Proc. 66-49, 1966-2 C.B. 1259; *Publication* 561, *supra* note 46, at 6-7.

[110] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(e).

[111] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(f); Rev. Proc. 66-49, 1966-2 C.B. 1259; *Publication* 561, *supra* note 46, at 6.

[112] INTERNAL REVENUE MAN., *supra* note 96, § 42(16) 4.3(2)(g); Rev. Proc. 66-49, 1966-2 C.B. 1259.

[113] *See* Farber v. Commissioner, 33 T.C.M.(CCH) 673, 675 (1974).

[114] Rev. Proc. 66-49, 1966-2 C.B. 1259; *Publication* 561, *supra* note 46, at 6.

[115] *See* Vander Hook v. Commissioner, 36 T.C.M. (CCH) 1394, 1396 (Sept. 29, 1977).

[116] Rev. Proc. 66-49, 1966-2 C.B. 1259.

[117] Rev. Proc. 66-49, 1966-2 C.B. 1257-58.

[118] Rev. Proc. 66-49, 1966-2 C.B. 1257.

15. A statement of the interest donated, if fractional;[119]

16. An explanation of any restrictions, understandings or covenants limiting the use or disposition of the property valued;[120]

17. The date the property was valued, the signature of the appraiser and the date of writing the appraisal.[121]

Very few appraisals are or need to be this detailed. Appraisals are generally challenged by the IRS on account of significant deficiencies or for violations of what one author has termed the "cardinal rules of valuation."[122] These violations include failure to adhere to the fair market value, "willing buyer-seller" rule;[123] failure of the taxpayer to consider all relevant facts bearing on valuation; failure of the taxpayer to carry the burden of proof; one or more material omissions from the appraisal report; the use of an appraiser unfamiliar with the type of property being valued; and the failure of the appraiser to support his opinion with a factual base.

Parties rarely win valuation cases; the other side loses them. Cases that reach the courts generally involve clear over-reaching, as well as violations of the "cardinal rules of valuation," either by the taxpayer or the IRS. The following cases illustrate the various reasons taxpayers lose valuation cases.

In *Cukor v. Commissioner*,[124] the taxpayer donated a Georges Braque still life to U.C.L.A. The taxpayer offered two expert witnesses. One witness used a method of valuation which the court found not to be commonly accepted. The other witness was found to be unfamiliar with the willing buyer-seller rule. The court rejected the taxpayer's valuation and accepted the IRS's which was based on comparable sales prices.[125]

In *Farber v. Commissioner*,[126] the taxpayer donated Tintoretto's "Susanna" to Hofstra College. The court was dissatisfied with the testimony of experts of both sides, stating at one point, "the primary guideline for presentation of this case by both parties was that the less, rather than the more, the court knew, the better."[127] The court refused to be guided by the taxpayer's comparable sales figures because they were based on works by different artists, of different

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[119] *Publication* 561, *supra* note 46, at 6.
[120] Rev. Proc. 66-49, 1966-2 C.B. 1258.
[121] *Id.*
[122] R. LERNER, *supra* note 106, at 145.
[123] *See supra* note 36 and accompanying text.
[124] 27 T.C.M. (CCH) 89 (1968).
[125] *Id.*
[126] 33 T.C.M. (CCH) 673 (1974).
[127] *Id.* at 675.

schools and periods. Furthermore, many of the works used for comparison were masterpieces, whereas the work in question admittedly was not. The court also found that there was some question of authenticity. The piece was in poor condition and there was neither provenance for the work nor any mention of the work in art literature or catalogues.[128]

Hartwell v. Commissioner[129] involved paintings by Gilbert Stuart and Sir M.A. Shee. The IRS expert based his testimony on photographs of the paintings only. Nevertheless, the court was impressed with the expert's knowledge of the value of works of art and accepted his evaluation. The taxpayer committed a fatal error by not calling an expert witness on his behalf. Instead, he relied on his own testimony to which the court refused to give credence even though the taxpayer had been engaged in the business of buying and selling paintings for several years.[130]

In *Mathias v. Commissioner*,[131] the taxpayer only offered appraisal reports and no expert testimony. The IRS offered expert testimony consisting of comparable sales prices from auctions. The taxpayer argued that auction sales were poor evidence of value. The court refused to accept this proposition, finding instead that auction sales have considerable significance in the art field. In addition, the taxpayer failed to authenticate the work's subject and author. The court deemed that this failure tended to depress the work's value.[132]

Rebay v. Commissioner[133] offers an example of the effect an appearance of a conflict of interest can have on a valuation. The case involved the valuation of paintings created by the taxpayer, a professional artist. The taxpayer offered one expert witness, the IRS offered three. The taxpayer's expert based his opinion of value upon the highest price ever paid for one of the taxpayer's paintings—$15,000. However, the $15,000 painting had been purchased by a man who had been associated with taxpayer's counsel in various business ventures. Consequently, the court disregarded that sale and the valuations submitted by the taxpayer's expert.[134]

In *Silverman v. Commissioner*,[135] the taxpayer donated 148 paintings to various institutions, claiming a total value of $100,525.

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[128] *Id.*
[129] 24 T.C.M. (CCH) 278 (1965).
[130] *Id.*
[131] 50 T.C. 2858 (1968).
[132] *Id.*
[133] 22 T.C.M. (CCH) 181 (1963).
[134] *Id.*
[135] 27 T.C.M. (CCH) 1066 (1968).

For the most part, the paintings were the work of living French artists. The IRS responded with a valuation of $13,587 which, in essence, represented the taxpayer's cost basis in the paintings. In this case the taxpayer committed every possible error. The court found his first expert witness to be "a cynical person with flexible scruples,"[136] and his second expert's valuations to be unreliable. It further appeared that the donee institution had sold some of the donated paintings at "Tent" and "Treasure" sales.[137] On many occasions the taxpayer had given similar paintings to his children. None of the gift paintings had ever been valued in excess of $6,000, the point at which a gift tax would have been due. In spite of these discrepancies, the court allowed some appreciation. The court noted that although cost figures are a significant starting point in determining value, the paintings had been purchased in France, where the market was generally lower than in the United States. Thus, the court gave the taxpayer the benefit of having purchased in a lower market.[138]

There are several interesting aspects to *Vander Hook v. Commissioner*[139] which involved the donation of fractional interests in six paintings to Pepperdine University. As in *Silverman* the treatment of the paintings by the donee institution was an important factor—two had been lost and one stolen. The court also considered the treatment of the paintings by the person who had first sold them to the taxpayer, noting that the seller had casually stored the paintings and had not insured them.

Authenticity of the paintings was a pivotal issue. The taxpayer lost in the battle of the experts. The court dismissed the testimony of the taxpayer's expert. Because the expert had valued the paintings for the person who sold them to the taxpayer, the court found that the expert had a vested interest in a high value outcome. On the other hand, the court was impressed with the IRS expert, and noted that at trial he had carefully compared one of the subject paintings with an authentic painting by the same artist so that "even a layman could tell the difference."[140] The credibility of the IRS witness was further bolstered by the fact that he was the Director of the Los Angeles County Art Museum.

Weil v. Commissioner[141] involved the donation of Frederick Ede's "The Mill" to the University of Maine. Even though the IRS

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[136] *Id.* at 1073.
[137] *Id.* at 1075.
[138] *Id.* at 1074.
[139] 36 T.C.M. (CCH) 1394 (1977).
[140] *Id.* at 1396.
[141] 26 T.C.M. (CCH) 388 (1967).

failed to offer expert testimony, the taxpayer lost due to his failure to carry the burden of proof. The court found that the taxpayer's expert, an appraiser and art dealer for thirty-seven years and a member of the American Society of Appraisers, did not know the artist's nationality, usual subject matter, or of any gallery that had exhibited the artist's work. The expert could not describe the painting nor did he have any prospective purchaser in mind when he made the appraisal. The court stated that the expert's unfamiliarity with the paintings, the artist, and his other works allowed it to assign no weight to the expert's opinion.[142]

The IRS, however, also loses valuation cases. For example, *Blaffer v. Phinney*[143] indicates that in some instances the taxpayer ought to consider taking the issue before a jury. The case involved the donation of a fifteenth century triptych which the taxpayer had purchased for $300,000 in 1959 and valued at $425,000 when he donated it one year later. The jury found for the taxpayer, having no problem with one year's appreciation of $125,000.[144]

Crocker Nat'l Bank v. United States[145] is a case in which the credentials and demeanor of a witness carried the day. Plaintiff-bank, as co-executor, had brought suit against the IRS. The case involved two paintings by Jean Francois Millet, "The Wine Carrier" and "The Milkmaid," which had been donated by the bank's decedent to the University of Minnesota. Upon the advice of the Art Advisory Panel, the IRS had lowered the claimed valuation considerably. The court, however, found the IRS value to be unreasonable and erroneous.[146] The court was impressed by the taxpayer's expert, Christopher Burge of Christie, Manson & Woods, and found that his opinion was more amply supported than those of the IRS witnesses.[147]

Kuderna v. Commissioner[148] illustrates the hazards of going to court without an expert witness. The court found that the testimony of two qualified art appraisers established a prima facie case for the taxpayer. The IRS did not offer any expert testimony and failed to rebut that presumption.

In cases where there is no clear overreaching, the courts have tended to split the difference between the taxpayer and the IRS valua-

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[142] *Id.* at 390.
[143] 67-1 U.S. TAX CAS. (CCH) ¶ 9327 (W.D. Tex. 1967).
[144] *Id.*
[145] 39 A.F.T.R.2d (P-H) ¶77-434 (C.D. Cal. 1977).
[146] *Id.* at 77-780.
[147] *Id.*
[148] 24 T.C.M. (CCH) 749 (1965).

tions.[149] These cases best illustrate the problems inherent in the valuation process. In such cases the courts seem to be attempting to achieve equity, without heavy reliance on mechanical rules, the Code or the Regulations.

In *Furstenberg v. United States*,[150] the court, in one of the finest judicial opinions written on the issue of valuation of works of art, substituted its own opinion of value for that of the experts. That case involved the donation of Corot's "La Meditation." The experts wildly disagreed on the value of the painting. The court discounted the low valuation placed on the painting by one of the IRS witnesses, noting that he was a member of the Art Advisory Panel on whose advice the IRS had lowered the valuation. Similarly, the court dismissed a high valuation by the taxpayer's expert witness, noting that he was a friend of the taxpayer. The remaining witness testified for the IRS. The court noted that although he was probably impartial, he had nonetheless failed to take into account the effect of a recent Corot "breakthrough"[151] sale at Sotheby Parke Bernet which had caused the entire Corot market to rise. The court arrived at its own valuation by taking the work's auction price and discounting it for various factors including the condition and restoration of the painting.[152]

It has been observed that:

> [T]oo often in valuation disputes the parties have convinced themselves of the unalterable correctness of their positions and have consequently failed successfully to conclude settlement negotiation. . . . The result is an overzealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement.[153]

It should be remembered that the valuation of art is an imprecise effort at best. Therefore, many factors must be considered in order to arrive at fair valuations.[154]

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[149] *See* May v. Commissioner, 24 T.C.M. (CCH) 205 (1965) (court split the difference where there was a good faith dispute regarding architectural drawings for which there was no established market); Gordon v. Commissioner, 35 T.C.M. (CCH) 1227 (1976) (court arrived at its own valuation after rejecting polar positions taken by expert witnesses).

[150] 41 A.F.T.R.2d (P-H) ¶ 78-487 (Ct. Cl. 1978) (trial judge's opinion).

[151] *Id.* at 78-911.

[152] *Id.* at 78-912.

[153] Messing v. Commissioner, 48 T.C. 502, 512 (1967).

[154] For additional factors that should be considered, see, e.g., Posner v. Commissioner, 35 T.C.M. (CCH) 943 (1976); Rupke v. Commissioner, 32 T.C.M. (CCH) 1098 (1973); Jarre v. Commissioner, 64 T.C. 183 (1975); Mauldin v. Commissioner, 60 T.C. 749 (1973); Estate of Smith v. Commissioner, 57 T.C. 650 (1972), *aff'd on other issues*, 510 F.2d 479 (2d Cir. 1975).

III. Collectors and Dealers

Once a work of art has left the magic world of creation, its exemption from the laws of commerce is lost. Although it may seem unfortunate that art and artists do not exist in a creative vacuum where the mechanics of business cannot intrude, the reality of the situation, and one the artist cannot afford to ignore, is that works of art are commercial commodities. Tax considerations are pervasive in the commerce of art. From initial sale to final disposition, tax laws touch upon almost every aspect of the life of a work of art.

A work of art does not assume one unalterable character for tax purposes. Instead, the work's tax character is defined by the context in which it is traded. For this reason, one must define the various capacities in which persons might buy or sell art. For tax purposes, these capacities fall into four categories of persons. The first of these is the investor: a person who buys, sells and collects art with an eye solely on investment. Some persons invest with the mere hope that a purchase will appreciate to enable sale at a profit. The more serious investor is interested only in capital appreciation. The second category is the hobbyist: a collector who buys art without considering whether the purchase will ever amount to a profitable investment. Hobbyists rarely, if ever, sell a work. The penultimate category is the business collector: a business, other than a corporation,[155] that buys art for use in its trade or business. The business collector does not buy art for resale, but rather for purposes such as office display or decoration. The last category is the dealer: one who buys and sells art as a trade or business.

A. *The Investor*

The transactions of the investor are the most difficult to classify. This is due to the variety of investment activities open to the investor as well as the varying investment "tests" set forth in the Internal Revenue Code.[156] The tax treatment of the gain aspect of art investment is relatively simple. The expense and loss aspects, however, are much more complex. Determining what expenses, deductions and losses the investor may take is a complicated task. The gain aspect will be considered first.

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[155] Corporations that collect art would be subject to the tax rules applicable to corporations.

[156] These investment tests examine objective factors along with the taxpayer's subjective intent. *See infra* notes 189-204 and accompanying text.

Sale at a gain is a taxable event under section 61(a).[157] In virtually all cases such income will be taxable gain. If the investor is not deemed a dealer, profits from the sales of capital assets will be classified as capital gains.

The term "capital asset" includes all property held by the taxpayer except: (1) stock in trade or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; (2) property used in a taxpayer's trade or business that is subject to the allowance for depreciation; or, (3) an artistic composition held by the creator or a person in whose hands the basis of such artistic composition is determined by reference to the basis of the creator.[158] A work of art will be a capital asset in the hands of the taxpayer unless it falls within one of the exceptions specified by section 1221.[159]

It would be the extreme case where an investor would have problems with the first exception. The stock in trade or inventory clause is rarely problematic; the investor would almost never carry stock in trade or inventory.[160] The second part of the exception, regarding property held primarily for sale in the ordinary course of a trade or business, is more difficult to interpret.

In *Malat v. Riddell*,[161] the Supreme Court held that the word "primarily," as used in the phrase "primarily for sale to customers in the ordinary course of a trade or business," means "of first importance" or "principally."[162] Thus, an investor would have to cross the line into dealer status (i.e., be holding the work of art "principally" for sale to customers) in order to be denied capital gain treatment.

In *Hollis v. United States*,[163] the taxpayer was found to have crossed the line. The taxpayer formed a syndicate for the purpose of acquiring a limited number of oriental art objects as an investment. The syndicate was to sell the pieces when their potential increase in

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[157] I.R.C. § 61(a)(1981) provides that "gross income means all income from whatever source derived, including . . . (3) gains derived from dealings in property." *See* Treas. Reg. § 1.1001-1(a) (1972).

[158] *See* I.R.C. § 1221(1)-(3) (1981).

[159] *Treas. Reg.* § 1.1221-1(a) (1975).

[160] The investor would rarely conduct his investment activities like a retail operation and carry stock in trade or maintain an inventory. It is true that art dealers are often collectors and investors as well; however, activities conducted outside of the dealer's business capacity can be afforded separate tax treatment. *See infra* notes 276-91 and accompanying text.

[161] 383 U.S. 569 (1966).

[162] *Id.* at 572.

[163] 121 F. Supp. 191 (N.D. Ohio 1954).

value was realized and economic trends warranted.[164] The court found the issue to be one of fact, or at most, a mixed question of fact and law. The court stated as a matter of fact that the taxpayer held the property for sale in the ordinary course of business, and it emphasized that the special treatment afforded capital gains should only be accorded to transactions with characteristics which set them apart from transactions resulting in ordinary income.[165]

Several factors should be considered in determining whether a particular transaction or course of transactions should be construed as the activity of a dealer or that of an investor. These factors include the purpose for which the property is acquired; the uses, if any, to which the property is put by the taxpayer; the number and frequency of sales; and the period of time the property is held by the taxpayer before it is sold.[166] Ordinarily, the art investor will not be considered to be carrying on a trade or business if investment is the sole activity performed in this area.

It should be emphasized that the exception requires that dealers hold "primarily" for sale to customers *and* that such sale be in the ordinary course of a trade or business. Although the key element to a determination of trade or business is the state of mind or intent of the taxpayer,[167] courts have generally found that trade or business status requires more than investment intent. In *Whipple v. Commissioner*,[168] the Court stressed that every profit-making activity could not be considered to be a trade or business. The Court further emphasized that when the only return to the taxpayer is that of an investor, the taxpayer is not engaged in a trade or business, because investment is a distinctly different activity.[169] Furthermore, even if investment-type activities are coupled with the management of those activities, it will not constitute the carrying on of a trade or business.[170]

The line between dealer and non-dealer status may be elusive, and may be dependent upon whether the focus is on the requirement of holding "primarily" for sale to customers or on the trade or business requirement. The essential difference between dealer and non-dealer status, however, seems to be that the dealer buys specifically for resale, while the investor buys with the expectation of resale only after the work's value has appreciated, and does not rely on the wholesale-

[164] *Id.* at 192.
[165] *Id.* at 195-96.
[166] Koch v. United States, 457 F.2d 230 (7th Cir. 1972).
[167] *See* Demler v. Commissioner, 25 T.C.M. (CCH) 620 (1966).
[168] 373 U.S. 193 (1963).
[169] *Id.* at 202.
[170] *See* Higgins v. Commissioner, 312 U.S. 212 (1941).

retail "spread" for his source of income.[171] The ordinary art investor should have little trouble avoiding dealer status and the first exception to the capital asset provision.

Property used in a trade or business that is subject to the allowance for depreciation,[172] so-called "section 1231 property,"[173] is also exempted from capital gains treatment. This exception has two parts: the property must be used in a trade or business *and* must be subject to the allowance for depreciation. As noted above, the investor ordinarily will not be considered to be carrying on a trade or business by virtue of his investment activities. The second part of this exception is avoidable on two grounds. First, art is generally not depreciable. Second, even if art were depreciable, it must have been used in a trade or business to come within this exception. Hence, because ordinary art investors are not considered dealers and since art is usually not depreciable, the second exception should not preclude capital gain treatment.

The third exception excludes from capital gain treatment an artistic composition whose basis is determined by reference to the basis of the work in the hands of the creator.[174] This exception refers primarily to gifts. A work of art can never be a capital asset of the artist who created it.[175] However, if the artist gives a work of art he has created to an investor, the investor's basis will be determined by reference to the artist's basis.[176] In such a case the work of art would not be a capital asset in the hands of the investor, and sale by the

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[171] *See* Nehring v. Commissioner, 16 T.C.M. (CCH) 224 (1957).

[172] *See supra* note 158 and accompanying text.

[173] I.R.C. § 1231(b)(1981) provides:

For the purposes of this section—

(1) General Rule. The term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,

(C) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221, or

(D) a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (6) of section 1221.

[174] *See supra* note 158 and accompanying text.

[175] *See, e.g.*, I.R.C. § 1221(3)(A) (1981).

[176] *See* I.R.C. §§ 1221(3)(C), 1015(a) (1981).

investor of the work would result in ordinary income. With the relatively rare exception of art with a "carry-over basis," virtually all works of art will be capital assets in the hands of the art investor.[177]

As previously noted, the expense and loss aspects of art investments are considerably more complicated than the gain aspect. Whether or not an investor will be allowed to take an expense, deduction or loss depends upon the investor's subjective intent upon entering into the transaction. The Internal Revenue Code contains four investment intent tests: section 165(c)(2)[178] speaks of a "transaction entered into for profit"; section 212(2)[179] refers to "property held for the production of income"; section 183[180] covers activities not engaged in for profit; and section 1031 limits the benefits of tax deferred exchanges to "property held for investment."[181]

In order to justify the taking of a loss, an investor would have to rely on one of two provisions. Section 165(c)(1) provides for the taking of losses "incurred in a trade or business," and section 165(c)(2) for losses "incurred in any transaction entered into for profit, though not connected with a trade or business." Generally, an investor would have to rely on the latter provision in order to take a loss since art investment normally is not considered a trade or business.[182]

A taxpayer must rely on either section 162(a)[183] or section 212(2)[184] to justify the taking of expense deductions. The former section provides for the deduction of "ordinary and necessary expenses . . . paid in carrying on a trade or business," and the latter for the deduction of expenses paid for "the management, conservation or maintenance of property held for the production of income." Section 212(2) is the provision upon which the art investor must rely, because art investment normally is not considered a trade or business. Therefore, sections 165(c)(2) and 212(2) are the provisions that authorize the taking of loss and expense deductions if the investor falls within their definitions.

It would be a simple proposition if the intent tests under these two sections were the same, but they are not. A "transaction entered

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[177] The characterization of art as capital assets in the hands of the investor provides an ever-increasing benefit to investors. *See* Internal Revenue Act of 1978 §§ 402, 441, which increase capital gain deductions.

[178] I.R.C. § 165(c)(2) (1974).

[179] I.R.C. § 212(2) (1954).

[180] I.R.C. § 183 (1976).

[181] *Id.* Courts have examined various objective factors when determining an investor's subjective intent upon entering a transaction. *See infra* notes 189-204 and accompanying text.

[182] *See supra* note 160 and accompanying text.

[183] I.R.C. § 162(a) (1981).

[184] I.R.C. § 212(2) (1954).

into for profit" is the key to taking a loss under section 165(c)(2), and property "held for the production of income" is the key to taking expense deductions under section 212(2). The reported court decisions construing these two sections are somewhat ambiguous. The tests are often used interchangeably either because of a lack of precision or because of confusion. Although most commentators[185] are in agreement that the test under section 165(c)(2) is stricter than the test of section 212(2), identifying the practical differences between the two is more difficult. The tendency of courts and litigants to blur the distinctions between the two tests is illustrated by the Trial Commissioner's statement in *Wrightsman v. United States*[186] that the Internal Revenue Service conceded that if it was determined that plaintiffs were investors in their art they could claim a capital loss on a sale.[187]

One court has acknowledged the conceptual difficulties of maintaining the distinctions between the two tests and has indicated a desire to re-examine their differences.[188]

Before proceeding with a more detailed examination of sections 165(c)(2) and 212(2), it may be helpful to summarize the issues. If an investor sells a work of art at a loss and wishes to deduct that loss from his income taxes, he must prove that the purchase and sale of such work was a "transaction entered into for profit"—the test under section 165(c)(2). If an investor incurs expenses related to his art collection that he wishes to deduct from his income taxes, he must prove that the collection was acquired, or is held, "for the production of income"—the test under section 212(2). These tests are sometimes referred to as "intent tests." Whether a taxpayer falls within either of the sections depends upon his subjective intent as exhibited by the various factors discussed below.

1. Capital Losses Under Section 165(c)(2)—Transactions Entered Into for Profit

Losses allowed the investor under section 165(c)(2) would be capital losses.[189] The investor's capital losses are limited by section 165(f), which allows capital losses only to the extent provided by sections 1211 and 1212. Section 1211 provides that "[L]osses from sales

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[185] *See* R. LERNER, REPRESENTING ARTISTS, COLLECTORS AND DEALERS 21 (1979).

[186] 428 F.2d 1316 (Ct. Cl. 1970).

[187] *Id.* at 1317 n.2.

[188] Cowles v. Commissioner, 29 T.C.M. (CCH) 884 (1970).

[189] Investors would not be allowed ordinary losses under I.R.C. § 165(c)(1) (1981) because an investor is not in the business of buying and selling art. *See supra* notes 160, 182 and accompanying text.

or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges" plus a limited set-off against ordinary income as provided in section 1211(b)(1).[190] To sustain the loss, the investor must bear the burden of proving that the transaction was, in fact, entered into for profit.[191]

Tatt v. Commissioner[192] involved losses sustained by the taxpayer in the operation of a twenty-acre farm. The taxpayer's primary trade or business had been the operation of a retail produce store. The IRS challenged losses taken by the taxpayer on the ground that the produce farm was not an enterprise entered into for profit. The Court of Appeals stated that the intention of the taxpayer is the dominant factor in determining whether an enterprise is entered into for profit or pleasure. In this instance, the court found the taxpayer's testimony regarding his intent to make a profit to be reasonable and uncontradicted by other testimony.[193]

In *Reynolds v. Commissioner*[194] the court allowed the taxpayer's claimed capital loss. The taxpayer had inherited jewelry which he promptly placed for sale with Cartier, Inc. The court gave particular weight to the taxpayer's testimony indicating that he had always intended to make a profit from the jewelry, and had no intention of using the pieces personally. The court found that the taxpayer's intent had always been to dispose of the jewelry at the best possible price, and it stressed that had the taxpayer made or intended to make personal use of the jewelry, such "*use or intent* would put the transaction in a different category."[195]

Reynolds emphasizes that the taxpayer's personal use and enjoyment can be the most critical factor in determining a taxpayer's success or failure in sustaining a loss. The taxpayer-investor must prove that the transaction was entered into for profit. Courts have been reluctant to accept taxpayers' arguments where the taxpayers have made personal use of, or derived enjoyment from, the objects upon which a loss is claimed. Taxpayers that have prevailed have been able to demonstrate that personal use and enjoyment were not significant in their acquisition and holding of the asset in question.[196]

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[190] I.R.C. § 1211(b)(1) (1981); Treas. Reg. §§ 1.165-1(c)(3), 1.165-1(e) (1980); § 1.1211(b)(2) (1981).

[191] I.R.C. § 183 (1982).

[192] 166 F.2d 697 (5th Cir. 1948).

[193] *Id.* at 699.

[194] 4 T.C.M. (CCH) 837 (1945), *aff'd*, 155 F.2d 620 (1st Cir. 1946).

[195] *Id.* at 841 (emphasis added).

[196] *See* Marx v. Commissioner, 5 T.C. 173 (1945); Cecil v. Commissioner, 100 F.2d 896 (4th Cir. 1939).

The taxpayer in *Hamilton v. Commissioner*[197] was unable to sustain a deduction for a loss resulting from the sale of a Thomas Gainsborough painting acquired by bequest from the taxpayer's deceased father. The Board sustained the IRS disallowance of the loss relying on several factors. The taxpayer had inherited the painting and, thus, could not form an intent upon acquisition. Also, she had kept the painting in her home for ten years and had derived personal enjoyment from it. In addition, she finally sold the painting for less than its value on the date of acquisition.[198]

In *Barcus v. Commissioner*[199] the taxpayer lost due to facts similar to those in *Hamilton*. *Barcus* involved husband and wife "antique hunters." The Tax Court disallowed their capital loss deductions on the basis of three factors: the taxpayers had used the antiques as furnishings in their own home; had held the antiques over long periods of time; and had made a disproportionate number of purchases to sales. The court construed these factors to mean that the taxpayers received personal pleasure and enjoyment from the purchase and sale of antiques. The court also distinguished the taxpayers' interest in keeping pieces which they considered valuable from a definite intention to make a profit from the purchase and sale of antiques.[200]

Tyler v. Commissioner[201] is often cited by taxpayers in support of claimed capital losses. Although many commentators[202] have suggested that *Tyler* is unique and limited to its facts, it nonetheless indicates what an investor may have to do in order to insure the deductibility of losses.

Tyler involved the loss sustained by the taxpayer upon the sale of his stamp collection. The taxpayer began stamp collecting purely as an investment, consummating all purchases through a professional philatelist and purchasing stamps only on a philatelist's recommendation. In addition, the taxpayer exhibited scant knowledge or interest in stamps and testified that he did not enjoy collecting stamps or participating in activities generally associated with stamp hobbyists. Furthermore, he made no personal use of his collection, although he did derive some personal pleasure and satisfaction from its ownership.

The *Tyler* court emphasized that the derivation of pleasure was not necessarily excluded by the statutory language of I.R.C. section

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[197] 25 B.T.A. 1317 (1932).
[198] *Id.* at 1320.
[199] 32 T.C.M. (CCH) 660 (1973).
[200] *Id.* at 664.
[201] 6 T.C.M. (CCH) 275 (1947).
[202] *See, e.g.*, Lerner, *Planning the Collector's Estate*, P.L.I., COURSE HANDBOOK SERIES, No. 98, REPRESENTING ARTISTS, COLLECTORS AND DEALERS (1981).

23(e)(2), but that the profit aim had to be the principal motivation. The court found the taxpayer had the "requisite greed" as his main intention for entering into the enterprise, and thus allowed loss deductions.[203]

The IRS responded to *Tyler* with *Revenue Ruling* 1954-2[204] which states, "[a] loss sustained from the sale of a collection of stamps accumulated as a hobby does not represent a loss incurred . . . in a transaction entered into for profit . . . . Such a loss is not deductible for federal income tax purposes." It is doubtful that this ruling affected taxpayers in Tyler's situation because it added nothing to existing law or the understanding of it. The precise holding of *Tyler* was limited to the specific facts of the case.

It is difficult to arrive at a standardized interpretation of a "transaction entered into for profit." The cases do little more than indicate a few things that the investor should or should not do, the most important of these being the avoidance of personal use and enjoyment. *Tyler*, however, provides the best guide. Although *Tyler* involved a stamp collection, it could just as easily have involved an art collection. If the works in a collection are hung in the investor's home, he must be prepared to convince a court that under the circumstances the home is the best location for storage and that no personal use or enjoyment is being derived. Safety, preservation and conservation may be compelling reasons for storage at home.

The only solace to the investor is that, in inflationary times, sales at a loss are relatively rare.

2. Expense Deduction Under Section 212(2)—Expenses Paid for the Management, Conservation or Maintenance of Property Held for the Production of Income

The art investor must rely upon section 212(2) for the deduction of expenses.[205] The problem would be less complicated if the requirements under the investor's expense deduction section were the same as the requirements under the investor's loss section, but this is not the case. At least one court decision has acknowledged the distinction between the requirements of the two sections.[206] Moreover, several

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[203] 6 T.C.M. (CCH) 275, 280 (1947).

[204] Rev. Rul. 54-268, 1954-2 C.B. 88 (citing I.R.C. § 23(e) which was re-enacted as I.R.C. § 165 in 1954).

[205] *See supra* notes 183-88 and accompanying text.

[206] Cowles v. Commissioner, 29 T.C.M. (CCH) 884 (1970).

cases have disallowed the section 165(c)(2) loss deduction while allowing deduction of expenses under section 212(2).[207]

The practical differences between the two sections are elusive. The Regulations under section 212 provide in pertinent part:

> The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.[208]

In *Bumgardner v. Commissioner*,[209] the tax court listed some additional factors to be considered when determining investment intent. The case involved a practicing orthodontist who established a kennel to raise dogs. The court considered: whether there was a thorough preliminary exploration of the field and the possibility of profit; whether experts were consulted and qualified help hired; whether there was considerable personal attention given the enterprise; and whether a businesslike method of accounting was employed, along with a demonstrated concern for the economic well-being of the operation.[210] After examining the facts and determining that the taxpayer had met the above qualifications, the court found that the requisite investment intent was proven and allowed the taxpayer's deduction.

In *Wrightsman v. United States*,[211] however, the taxpayers' meticulous attention to the *Bumgardner* factors was their undoing. *Wrightsman* is the case most often cited as precedent for denial of art investors' claimed expense deductions. It is a very curious case.

The Wrightsmans' acquisition of works of art commenced in 1947 when their activities were in the nature of a hobby. In the mid-

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[207] *See, e.g.*, Reynolds v. Commissioner, 4 T.C.M. (CCH) 837, 840-41 (1945) (citing I.R.C. § 23(e)(2) which was re-enacted as I.R.C. § 165(c)(2) in 1954); McAuley v. Commissioner, 35 T.C.M. (CCH) 1236, 1238-40 (1976); Horrmann v. Commissioner, 17 T.C. 903, 908-09 (1951) (citing I.R.C. §§ 23(a)(2), 23(c) which were changed to I.R.C. §§ 212, 165(c)(2) respectively in 1954).

[208] Treas. Reg. § 1.212-1(c) (1954).

[209] 13 T.C.M. (CCH) 128 (1954).

[210] *Id.* at 130-31.

[211] 428 F.2d 1316 (Ct. Cl. 1970).

1950's, the Wrightsmans became convinced that works of art were an excellent hedge against inflation and devaluation of currencies. Thereafter the taxpayers abandoned the hobby nature of their collecting and began acquiring 18th century French art for investment purposes.

The court found that the taxpayers' "personal lives revolve[d] around their art collection and related collecting activities"[212] and that they were socially involved principally with people knowledgeable and interested in the field of art. The taxpayers were also found to have diligently pursued a course of self-education in the field, which involved extensive study of works of art, reading leading art periodicals, auction catalogues and price lists, and discussions with recognized art experts. In addition, the taxpayers had installed air conditioning and humidity controls to protect their art and had performed meticulous bookkeeping.[213]

After noting the taxpayers' efforts, the court rejected the recommended opinion of the Trial Commissioner who had held in the Wrightsmans' favor.[214] The court focused on the word "primarily" as used in the Regulations under section 212.[215] Using the construction adopted in *Malat v. Riddell*,[216] the court found that although there was clearly *an* investment intent, the taxpayers had not proven that such intent was "principal" or "of first importance." The court further found that all of the taxpayers' activities were done for personal pleasure rather than for prudent investment.[217]

There was, however, one small victory for the taxpayers in *Wrightsman*. The IRS had urged the court to find absolutely and in all cases that personal use precluded a finding of investment intent and that taxpayers in such situations be required to prove actions inconsistent with the holding of their collections for pleasure. Although the court found that there was extensive personal use of the collection and that the Wrightsmans derived considerable personal pleasure from collecting, it refused to rule that in all cases these factors would preclude a finding of investment intent.[218]

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[212] *Id.* at 1321.

[213] *Id.*

[214] *Id.* at 1317.

[215] Treas. Reg. § 1.212-1(c) (1954).

[216] *See supra* note 161 and accompanying text.

[217] Judge Collins, in a rather vigorous dissent, stated that the circumstances the majority found to support the conclusion that the Wrightsmans were engaged in the collection of art primarily for pleasure, could just as easily support a finding of investment intent. 428 F.2d at 1323 (Collins, J., dissenting).

[218] *Id.* at 1319-23.

Thus, somewhere between *Tyler* and *Wrightsman* are points at which losses and expenses will be disallowed. These exact points, however, are indeterminable. From the foregoing it is relatively easy to identify the salient factors which, apparently, are more or less common to both the investor's loss section[219] and the investor's expense section.[220] The problem, as pointed out in the *Wrightsman* dissent,[221] is that under certain circumstances these factors can militate against, rather than for, the taxpayer. Perhaps the most that can be said is that to be reasonably sure of taking proper expense deductions the investor must show:

(A) a clear investment intent;
(B) lack of personal use;
(C) lack of conduct inconsistent with investment intent;
(D) relatively long holding periods for works in the collection;
(E) more gains than losses upon ultimate sales;
(F) a relatively even ratio of purchases to sales;
(G) lack of pleasure or satisfaction derived from the enterprise;
(H) use of professional advisors;
(I) a knowledge of and interest in the business aspects of the enterprise;
(J) lack of engagement in activities associated with the subject matter that are common to hobbyists;
(K) a "requisite greed," or that profit making is the principal motivation;
(L) prior investigation of the activity's profit potential;
(M) personal attention to the activity; and,
(N) a business-like method of accounting.

If the investor can prove all or a major portion of these factors, the next problem encountered is determining what is deductible. The determination of deductibility will revolve around two primary issues: whether the expenditure is a deductible expense or a non-allowable capital expenditure; and whether the expenditure is "ordinary and necessary" as the term is used in section 212.[222]

I.R.C. section 263 disallows deductions for amounts paid out for permanent improvements made to increase the value of a property.[223]

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[219] I.R.C. § 165(c)(2) (1982).

[220] *Id.* § 212(2) (1982).

[221] 428 F.2d at 1323 (Collins, J., dissenting).

[222] There has been much litigation concerning the interpretation of the phrase "ordinary and necessary." *See, e.g.*, Commissioner v. Tellier, 383 U.S. 687 (1966); Deputy v. DuPont, 308 U.S. 488 (1939); Welch v. Helvering, 290 U.S. 111 (1933); Greenspan v. Commissioner, 229 F.2d 947 (8th Cir. 1956); Friedman v. Delaney, 171 F.2d 269 (1st Cir. 1948), *cert. denied*, 366 U.S. 936 (1949).

[223] I.R.C. § 263(a)(1) (1982).

The Regulations construe this section as also disallowing deductions for any amounts expended in restoring property for which a deduction for depreciation has been allowed.[224] The Regulations further provide, however, that amounts paid or incurred for incidental repairs and maintenance that neither materially add to the value of a property, nor appreciably prolong its life are not capital expenditures.[225]

In the case of works of art, these rules mean that amounts spent either to increase the value of a work, or to prolong its life, might not be deductible. The determination of whether or not expenses fall within the former category is made on a factual basis. It must be decided whether the expenditures increase the value of a work, or do no more than keep the work in an "ordinarily efficient operating condition."[226] Conservation, maintenance and preservation expenses would be examined in this light. Some procedures do no more than preserve the status quo, other procedures may increase the value of a work one to tenfold or more.[227] Thus, any expense that significantly increases the value of a work is not deductible.

The second category, involving amounts spent to prolong the life of a work, is aimed at preventing double deductions; the situation where the taxpayer attempts to take depreciation deductions *and* deductions for those expenses incurred to extend the life of the depreciated asset. Since works of art are generally not depreciable,[228] this category of prohibited expense deductions should not apply unless the taxpayer has successfully taken depreciation. If the taxpayer has taken depreciation, expenses for life-prolonging procedures would not be allowed.

The costs of acquisition of equipment, furniture, fixtures and other similar property having a useful life substantially beyond the taxable year are also non-deductible capital expenditures.[229] Deaccession costs, or selling expenses, are also capital expenditures that cannot be deducted. The general rule with respect to most capital assets is that selling expenses merely reduce the amount realized, thus decreasing the amount of gain or increasing the amount of loss. The Regulations cite only one example of selling expenses,[230] but there is no reason

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[224] Treas. Reg. § 1.263(a)-1(a)(2) (1954).

[225] Treas. Reg. § 1.263(a)-1(b) (1954); § 1.162-4 (1960).

[226] Treas. Reg. § 1.162-4 (1960).

[227] Restoration of a work of art is one procedure that might increase its value.

[228] *See infra* notes 314-18 and accompanying text. *See generally infra* text accompanying notes 313-19, 387-440 (discussion of depreciation).

[229] Treas. Reg. § 1.263(a)-2(a) (1954).

[230] Treas. Reg. § 1.263(a)-2(e) (1954) (commissions paid in selling securities).

to believe that the sale of works of art would fall outside the general rule.

The costs of frames and framing present a much more difficult capital expenditure problem. Framing can be for cosmetic and/or conservation purposes. A frame may be in place when the work is purchased or the investor may have had the work framed or reframed. For all practical purposes, frames which are in place when a work is purchased are not distinguished from the work itself. If a frame is otherwise deductible,[231] however, an investor might do well to allocate a portion of the purchase price to the frame and take a current deduction.

The deductibility of post-purchase framing revolves around whether the frame is primarily for cosmetic or for conservation purposes. A current deduction for a cosmetic frame would not be allowed; the frame would be considered a capital asset, and the cost of the frame a capital expenditure.[232] Conservation framing is arguably different. Certainly a conservation frame does not increase the value of a work; the type of frame does not appear to affect auction and sales prices. I.R.C. section 212[233] refers to conservation as a deductible expense; and, even though such a frame would have a useful life in excess of one year, it would not seem to fall within the letter or spirit of section 263 capital expenditure prohibitions.[234]

After determining that the requisite investment intent is present and that the expense is not a capital expenditure, there is one hurdle left for the investor. In order for a deduction to be allowed, the expense must be "ordinary and necessary."[235] Ordinary and necessary refers to the type of expenditure rather than the amount. With rare exceptions,[236] the reasonableness of the expenditure is not an issue.[237] The I.R.C. contains virtually no requirement with regard to the reasonableness of the amount of expenses.[238]

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[231] I.R.C. § 212(2) (1982) allows a deduction for expenses incurred for the conservation of property held for the production of income. A frame placed on a painting by a purchaser for conservation purposes will be deductible under this section.

[232] I.R.C. § 1221-1 (1982); Treas. Reg. § 1.1221-1(a) (1954).

[233] I.R.C. § 212(2) (1982).

[234] Treas. Reg. § 1.263(a)-1 (1954) (capital expenditures in general); Treas. Reg. § 1.263(a)-2 (1954) (examples of capital expenditures).

[235] *See supra* note 222.

[236] *See, e.g.*, Lincoln Elec. Co. v. Commissioner, 444 F.2d 491 (6th Cir. 1971).

[237] Imerman v. Commissioner, 7 T.C. 1030, 1037 (1946) (cites I.R.C. § 23(a)(c) which was reenacted as I.R.C. § 263 in 1954).

[238] The requirement of reasonableness does arise in the employment compensation area. *See* I.R.C. § 162(a)(1) (1982).

The usual type of expenses that an art investor incurs are likely to be deemed ordinary and necessary. If the requisite investment intent is present, the expenses for insurance, reasonable repair and conservation measures, reasonable security devices, costs of storage and, perhaps, even the purchase of a few art periodicals would be deductible.[239] Many other business deductions would also be available, for example, the costs of safe deposit boxes and consultation with experts, attorneys and accountants.

As pointed out above, courts closely scrutinize the "businesslike manner" in which taxpayers conduct investment activities.[240] Reasonable expenses under section 212(2) are indicia of the businesslike conduct of investment activity.

The problems in this area arise when taxpayers begin to stretch or probe the outer limits of allowability, deducting every manner of expense. The term "ordinary and necessary" refers to the types of expenses for which deductions may be taken. The term is in itself an expression of a reasonableness standard and is colorable and flexible.[241] It has been defined as that which is appropriate and helpful, as opposed to essential or indispensable.[242] Courts are inclined to give taxpayers the benefit of the doubt[243] and not penalize taxpayers for unwise, as opposed to unreasonable, expenditures.[244] The line between the type of expense which will convince a court that the taxpayer is conducting a businesslike investment activity, as opposed to attempting pure tax avoidance, is difficult to draw. Decisions may go either way depending on the circumstances. Common sense and the exercise of a little restraint may be as good a guide as any for the taxpayer.

The investor's losses and expenses are in many respects an unsettled area of tax law, as analysis of the issues involved depends upon subtle gradations of subjective intent. It is impossible to state with any certainty that in a particular case losses and expenses will or will not be allowed. This uncertainty apparently has prompted most commentators to come to the conclusion that expenses and losses on the holding of collectibles as an investment will not be allowed in most family

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[239] *See, e.g.*, Higgins v. United States, 75 F. Supp. 252 (Ct. Cl. 1948); Horrmann v. Commissioner, 17 T.C. 903, 908 (1951); McAuley v. Commissioner, 45 T.C.M. (CCH) 1214-76 (1976).

[240] *See supra* notes 209-22 and accompanying text.

[241] *See* Wilson v. Commissioner, 49 T.C. 406, 412 (1968).

[242] Welch v. Helvering, 290 U.S. 111 (1933).

[243] *Id.*

[244] Fumigators, Inc. v. Commissioner, 31 T.C.M. (CCH) 29-32 (1972).

collection situations.[245] I.R.C. section 267[246] provides that no deduction will be allowed for losses incurred from the sale or exchange of property, directly or indirectly between various prohibited parties. The extended family, various business entities with fifty percent common ownership, and fiduciaries fall within this prohibited class.[247]

3. Tax Deferred Exchanges Under Section 1031—Property Held for Investment

There is one other section of particular interest to the investor. I.R.C. section 1031[248] provides that neither gain nor loss shall be recognized where property held for productive use in a trade or business or for investment is exchanged solely for "like kind" property. In the case of an investor, section 1031 would generally come into play in a "trade-up" where the investor trades a work of art plus cash for a better work.

To qualify for the benefits of nonrecognition of gain, the investor must meet another investment test; the work of art must be "held for investment."[249] The investment test under section 1031 is perhaps less strict but just as difficult to define as the investment tests examined in the two preceding sections.

Courts have consistently held that the purpose of section 1031 is to afford nonrecognition where "in the popular and economic sense there has been a mere change in form of ownership."[250] The "mere change in form" test would seem to readily apply to most art investment situations. However, the provisions of section 1031 are to be

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[245] Darling, *Estate Planning: Planning for the Exotic Assets*, 35 INST. ON FED. TAX'N 1227 (1977).

If looking for a rule of thumb, however, one could do worse than follow the advice of Morton Shulman:

> The only difficulty the investor is likely to run into is that involved in convincing the government that he is an art investor and not just a collector . . . . [A]ll you need to *show is that your primary purpose is investment and not personal enjoyment. You* can do this by showing that (1) a significant proportion of your capital is invested in art as compared to other forms of investment; (2) you have complete records of your purchases and sales; (3) much of your art is not on display in your home; and (4) you have received the advice of experts in your buying.

M. SHULMAN, ANYONE CAN MAKE BIG MONEY BUYING ART 94 (1977).

[246] I.R.C. § 267(a)(1) (1982).

[247] I.R.C. § 267(b) (1982).

[248] I.R.C. § 1031(a), (c) (1982).

[249] I.R.C. § 1031(a) (1982).

[250] *See, e.g.*, Trenton Cotton Oil Co. v. Commissioner, 148 F.2d 208, 209 (6th Cir. 1945) (citing I.R.C. § 23(e) which was reenacted as I.R.C. § 165 in 1954); Helvering v. New Haven & S.L.R. Co., 121 F.2d 985 (2d Cir. 1941) (citing I.R.C. § 112(b) which was reenacted as I.R.C. § 1031 in 1954).

strictly construed: "[t]he exchange must be germane to, and a necessary incident of, the investment or enterprise in hand."[251]

Virtually all reported cases involving section 1031 concern real property and the section's "stock in trade" exception.[252] Most personal property exchange cases do not come to be litigated. There are no reporting requirements for exchanges of personal property, thus, these transactions are rarely subject to IRS scrutiny.

The polar points are personal use property on the one hand and pure investment property on the other. Property held strictly for investment would meet the investment test of section 1031. Property held solely for personal use, however, would not qualify for the benefits of the section.[253]

It is between these extremes that ambiguity lies. Although not a definition per se, perhaps the most appropriate phrase appears in *Burkhard Inv. Co. v. United States*,[254] where the court spoke in terms of a "property purchased with surplus funds and held for realization of increase in value . . . ." The art investor may feel more comfortable under this standard than under the more exacting standards of sections 165(c)(2)[255] and 212(2).[256] Except for the hobbyist, almost all art is purchased with the expectation that it will increase in value and with the intent to, someday, convert that increase to cash.

B. *The Hobbyist*

The hobbyist is a collector who buys art without considering whether the purchases will ever amount to a profitable investment. The hobbyist rarely, if ever, sells a work. Perhaps the majority of art collectors fall within this classification.[257]

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[251] Treas. Reg. § 1.1002-1(b) (1982).

[252] I.R.C. § 1031(a) (1982).

[253] Rev. Rul. 59-229, 1959-2 C.B. 180. *See also* Starker v. United States, 602 F.2d 1341 (9th Cir. 1979), in which it was stated:

> It has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment. Losses on the sale or exchange of such property cannot be deducted for this reason, despite the general rule that losses from transactions involving trade or investment properties are deductible. . . . A similar rule must obtain in construing the term 'held for investment' in section 1031.

Id. at 1350.

[254] 100 F.2d 642, 645 (9th Cir. 1938).

[255] *See supra* note 182 and accompanying text.

[256] *See supra* note 184 and accompanying text.

[257] I.R.C. §§ 165(c), 1221 (1982). DEPARTMENT OF THE TREASURY, YOUR FEDERAL INCOME TAXES 111 (rev. ed. 1978) (works of art are not capital assets if held by a taxpayer whose personal efforts created the work, or if held by a taxpayer in whose hands the basis is determined by reference to the basis of the work in the hands of its creator).

For the hobbyist, works of art generally are capital assets. Sale at a profit results in a capital gain. Deductions are not allowed for sales at a loss.[258] Similarly, expenses attributable to maintaining the collection are not deductible.[259] In addition, section 1031 nonrecognition treatment probably is not available.[260] The gains of the hobbyist and the investor are treated the same way.[261] Thus, there are no tax advantages to being classified as a hobbyist.

There are, however, disadvantages arising from the unavailability of loss and expense deductions. This is why collectors often seek to be classified as investors rather than as hobbyists. The hobbyist could not meet the investment tests discussed in the preceding section. If it were not for the enactment of section 183, entitled "Activities Not Engaged in For Profit,"[262] there would be an absolute, all or nothing, distinction between the two categories.

1. Expenses

With respect to expenses, the primary difference between the investor and the hobbyist is that the investor may deduct expenses without being limited to the gross income from the activity. The general rule is that no expense deductions will be allowed the hobbyist. Section 183, however, creates a limited exception to this rule. Expenses equal to the difference between otherwise allowable deductions attributable to the activity and the gross income from the activity may be deducted. The otherwise allowable deductions are the itemized deductions and capital gains deductions that all taxpayers are allowed to take regardless of the activities in which they engage.[263]

As pointed out in the preceding section, the investor must meet the investment intent test of section 212 in order to deduct expenses. The art-investing activity must be carried on with a sufficient profit motive in order for the taxpayer to take expense deductions. Although this is also true in relation to the hobbyist, section 183 alters the order of inquiry. The Regulations provide that the issue of whether an activity has been entered into for profit is determined under section

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[258] I.R.C. § 165(c) (1982).

[259] I.R.C. § 262 (1981).

[260] The hobbyist would be unable to meet the investment test of I.R.C. § 1031 (1982). *See supra* notes 248-56 and accompanying text.

[261] *See supra* notes 157-77 and accompanying text.

[262] I.R.C. § 183 (1982) (effective as to taxable years beginning after December 31, 1969).

[263] I.R.C. §§ 161-219, 1202 (1982).

212(1) and (2) except insofar as section 183 creates a presumption to that effect.[264] When section 212(1) and (2) do not allow deductions, the rules of section 183(d) apply.[265]

Thus, the investor would first look to section 183(d) to determine whether or not the benefit of the presumption of profitability is available. If the presumption applies, the investor's investment intent need not be examined under section 212; expenses will automatically be deductible. If the presumption does not apply, the investor must prove investment intent under section 212.

The presumption of profitability applies "if the gross income derived from an activity for 2 or more of the taxable years in the period of 5 consecutive taxable years . . . exceeds the deductions attributable to such activity."[266] If the taxpayer is unable to claim the benefit of the presumption, section 183 also affects the inquiry under section 212. The Regulations provide that no deductions are available under section 212 for activities which are carried on primarily as a sport, hobby, or for recreation.[267] The taxpayer must, therefore, prove that the activity is engaged in for profit rather than falling into one of those three categories. This determination is made by reference to objective criteria, taking into account the circumstances of each case.[268] The following factors will be considered: 1) the manner in which the taxpayer carries on the activity, including the time and effort expended and the personal pleasure derived; 2) the taxpayer's financial status and the success of the taxpayer in both similar and dissimilar activities; 3) the taxpayer's history of income or losses with respect to the activity and the amount of occasional profits earned; 4) the expectation that assets used in the undertaking may appreciate in value; and 5) the expertise of the taxpayer and his advisors.[269]

Assuming that the presumption is inapplicable, and that under the section 183 standards, the taxpayer still cannot prove investment intent under section 212, he will be classified as a hobbyist. A taxpayer classified as a hobbyist will only be allowed expense deductions to the extent allowed by section 183.[270]

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[264] I.R.C. §§ 183(d), 1202 (1982).

[265] Treas. Reg. § 1.183-1(a) (1972).

[266] *See supra* note 264. Gross income includes capital gains. Treas. Reg. § 1.183-1(b)(4) (1972).

[267] Treas. Reg. § 1.183-2(a) (1972).

[268] *Id.*

[269] *Id.* § 1.183-2(b)(1)-(9).

[270] *See, e.g., id.* §§ 1.183(b)(3), 1.183-1(b)(1)(i), (4).

2. Capital Gains and Losses

The sale of a work of art by the hobbyist is treated the same as the sale of any other item of personal property; sale at a gain results in capital gains and is taxed as such.[271] With respect to capital losses, the investor has a major advantage over the hobbyist. As a rule, the investor is allowed to deduct capital losses while the hobbyist is not.[272] Unlike the case of expense deductions, section 183 creates no exception to this general rule. In addition, the hobbyist's capital gains deduction must be allocated among the various activities which produced the gain.[273] The portion allocated to art collecting is added to the otherwise allowable deductions under Chapter I of the Code.[274] The net result further reduces the amount of other expenses the hobbyist may deduct.

C. *The Dealer*

The dealer is on the opposite end of the spectrum from the hobbyist, with the investor occupying the middle ground. The term "art dealer" can include situations ranging from the vest-pocket dealer working out of his home to the multi-branch commercial gallery. All art dealers are involved in the buying and selling of art as a trade or business. For the most part, art dealers are taxed the same way as any other retail operation. While a complete examination of the taxation of retail enterprises is beyond the scope of this Article, a few highlights are worth examining.

I.R.C. section 61(a)(3)[275] provides that gross income includes gains derived from dealings in property. Section 64[276] provides that gain from the sale of property which is neither a capital asset nor a section 1231 asset[277] is ordinary income. Section 1221 excludes from the definition of capital assets stock in trade and property which would be included in the inventory of the taxpayer.[278] In addition, section 1231(b)[279] excludes from its coverage property which would be included in inventory, and property held by the taxpayer primarily

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[271] I.R.C. §§ 1202, 1221 (1982).
[272] *Id.* § 183(b); Treas. Reg. § 1.183-1(b)(4)(ii) (1972).
[273] Treas. Reg. § 1.183-1(b)(4)(iii) (1972).
[274] I.R.C. § 183 (1982); Treas. Reg. § 1.183-1(b)(4)(iv) (1972).
[275] I.R.C. § 61(a)(3) (1982).
[276] *Id.* § 64.
[277] *Id.* § 1231 (property used in the trade or business and involuntary conversions).
[278] *Id.* § 1221(1).
[279] *Id.* § 1231(b)(1)(A), (B).

for sale to customers in the ordinary course of his trade or business. Section 65[280] provides that any loss from the sale of property which is not a capital asset is ordinary loss. Thus, gains and losses from dealings in art by the dealer are ordinary gains and ordinary losses.

We have seen that there is often a hazy definitional line between the investor and the hobbyist. This is also the case with dealers and investors. Dealers sometimes want to be taxed as investors to take advantage of favorable capital gains rates, and investors sometimes want to be taxed as dealers in order to take advantage of ordinary losses. The problems arise in attempting to determine, upon the particular facts of a case, whether the participant is a dealer or an investor. In this regard, much of the discussion in the investor section of this Article is pertinent.[281]

Disputes generally revolve around definitional contests over the meaning of such terms as "trade or business,"[282] "inventory,"[283] and "primarily for sale to customers."[284] With respect to the "trade or business" definition, the character of the retail art gallery is rather firmly fixed. Anything less structured, however, is open to interpretation. The "trade or business" characterizations range from that expressed in *Whipple v. Commissioner*,[285] which defines the concept as falling "far short of reaching every income or profit-making activity," to that expressed in *Snow v. Commissioner*,[286] where it was stated that the term is not to be so narrowly construed "as to mean only an activity that involves holding one's self out to others as engaged in the selling of goods or services."[287]

In *Snow*, the court pointed out that the term "trade or business" is used in approximately sixty different Internal Revenue Code sections with different shades of context and meaning.[288] A taxpayer may be involved in more than one trade or business.[289] The trade or business determination is primarily factual, with the courts weighing factors such as those found in *Hollis v. United States* and *Barcus v. Commissioner*.[290] The primary focus, however, is on whether the

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[280] *Id.* § 65.
[281] *See supra* notes 155-259 and accompanying text.
[282] I.R.C. §§ 1221(1), 1231(b)(1)(B) (1982).
[283] *Id.* §§ 1221(1), 1231(b)(1)(A).
[284] *Id.* §§ 1221(1), 1231(b)(1)(B).
[285] 373 U.S. 193, 201 (1963).
[286] 416 U.S. 500 (1974).
[287] *Id.* at 503.
[288] *Id.*
[289] Snyder v. Commissioner, 295 U.S. 134, 138 (1935).
[290] *See supra* notes 163, 199 and accompanying text.

taxpayer functions like a dealer or an investor. When making this determination one should consider whether the taxpayer performs an underwriting function. Another consideration is whether the taxpayer buys wholesale and sells retail, relying on the wholesale/retail spread.

The lessons of any number of cases[291] is that the IRS and the courts do not tend to rely on labels, but rather are inclined to scrutinize transactions to determine their essential nature. The IRS and the courts focus on several factors, including whether a receipt or expenditure is a substitute for an ordinary income or expense item; whether an item of income or expense is related to items taxed in prior years in a way that implies particular treatment in later years; whether a lump sum payment or receipt is merely an anticipation of, or a substitute for, ordinary income or expense; and on the functional equivalent between the transaction at issue and another one whose character is fixed.[292]

These considerations come into play primarily in two factual settings. The first of these is when a dealer, other than an established commercial art gallery, is consistently operating at a loss. The other occurs when a dealer has made a large sum of money in one or a series of art transactions. In the former case, the dealer may resemble an investor or hobbyist, but desires the benefits of ordinary loss deductions. In the latter instance, the dealer may desire capital gains.

The dealer, like the investor, must meet the requirements of section 183.[293] In several respects, the dealer generally is in a better position relative to section 183 than the investor. The dealer usually operates in a more "businesslike" manner and is therefore better prepared to sustain the profitability standards.[294] In many cases, art dealing may be the sole source of income; the dealer cannot afford several years of losses. More importantly, the dealer has no other sources of income against which he may write off losses and expenses generated by his art dealing business. Because there is no adverse revenue impact, the dealer does not come under the section 183 challenge by the IRS.

The dealer desiring capital gains treatment often generates a more spirited debate. In order to receive the benefits of capital gains treatment, the dealer must prove that art sold in a transaction was

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[291] *See, e.g.*, Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Corn Prod. Refining Co. v. Commissioner, 350 U.S. 46 (1955); Arrowsmith v. Commissioner, 344 U.S. 6 (1952); Hort v. Commissioner, 313 U.S. 28 (1941); Mitchell v. Commissioner, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971).

[292] J. McNULTY, FEDERAL INCOME TAXATION OF INDIVIDUALS 354 (2d ed. 1978).

[293] *See supra* note 181 and accompanying text.

[294] *See supra* notes 268-69 and accompanying text.

held for investment rather than as "inventory" or "primarily for sale to customers."[295] Many disputes arise in this area. Art dealers are inveterate art collectors. With the possible exceptions of real estate and stockbrokers, there is perhaps no other area of endeavor in which dealers invest so heavily in the product they also sell at retail. If a dealer purchases one or several works for investment and later sells at a gain, he has the right to have the gains treated as capital gains. In the securities area, the Internal Revenue Code recognizes the propensity of stockbrokers to invest in that which they sell, and special provisions are made to identify investment stock.[296] There are no special provisions for art dealers and, therefore, analysis of the situation can only be done by analogy.

Reasoning that has been applied to cotton dealers seems applicable to the situation of the art dealer buying for investment purposes. In *Williamson v. Bowers*,[297] for example, the taxpayer operated a cotton gin and warehouse. In anticipation of World War II, he purchased 250 bales of cotton as an investment. The court reasoned that "the true intent and motive of the taxpayer"[298] should govern. The court found the requisite investment intent based upon the fact that each bale was separately marked and was neither merged nor consolidated with the taxpayer's general merchandise. The taxpayer was granted capital gains treatment upon sale of the cotton.

In *United States v. Bondurant*,[299] the taxpayer's business was the purchase and sale of cotton. At one point he acquired, and later sold at a gain, a quantity of "investment" cotton. Although he purchased the investment cotton and his inventory cotton from the same broker, the investment cotton was stored in a different city, was never displayed or offered for sale, was held and sold in the same lots as purchased, and was identified as investment cotton in the taxpayer's records. The court granted capital gains treatment, noting that taxpayers have the legal right to separately conduct a number of businesses with the resulting tax consequences for each undertaking.[300]

From cases like *Williamson* and *Bondurant* it is possible to identify the characteristics of a dealer investment in art where the dealer will be granted capital gains treatment upon sale. One must determine whether: (1) the investment art is segregated from the dealer's

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[295] I.R.C. § 1221(1) (1982).
[296] *Id.* § 1236.
[297] 120 F. Supp. 704 (E.D.S.C. 1950).
[298] *Id.* at 706.
[299] 245 F.2d 265 (6th Cir. 1957).
[300] *Id.* at 268.

inventory;[301] (2) the investment art is neither displayed nor offered for sale;[302] (3) the investment art is held and sold in the same lots as purchased;[303] (4) a relatively small amount of time and effort is devoted to the investment activity in relation to the dealer's general business activities;[304] (5) there is relatively limited sales activity (e.g., little or no advertising of the investment art);[305] (6) there are isolated or relatively few transactions;[306] (7) there is initial and continued investment intent;[307] (8) there are separate financial and insurance records maintained for the investment art;[308] and (9) there has been consistent treatment relative to local taxes (e.g., sales tax paid, personal property or inventory tax not paid).

Thus, dealers have certain advantages and disadvantages in relation to the investor and the hobbyist. The primary advantages are the unlimited deductions for expenses[309] and losses.[310] The primary disadvantage is that income, unless from an investment transaction, is taxed as ordinary income as opposed to the investor's and hobbyist's capital gains.[311]

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[301] *See* 120 F. Supp. at 704-5; 245 F.2d at 265; Nehring v. Commissioner, 16 T.C.M. (CCH) 224 (1957). In Browning v. Commissioner, 9 T.C.M. (CCH) 1061 (1950), the taxpayer lost due to lack of segregation.

[302] 245 F.2d at 266.

[303] *Id.*

[304] Patterson v. Hightower, 245 F.2d 765 (5th Cir. 1957).

[305] 16 T.C.M. at 228, 233.

[306] 245 F.2d at 767; 16 T.C.M. at 233.

[307] 16 T.C.M. at 232.

[308] 245 F.2d at 266; 120 F. Supp. at 707; 16 T.C.M. at 231.

[309] I.R.C. § 162(a) (1982).

[310] I.R.C. § 165(c)(1) (1982). The dealer's expense and loss deductions are more liberal than the hobbyist's or the investor's. They are not, however, unlimited. Dealer's deductions have become encrusted with the following limitations: (1) § 274 limits taking of entertainment expenses; (2) § 263 forbids deductions for capital expenditures; (3) § 275 forbids the deduction of certain taxes; (4) § 276 forbids the deduction of indirect contributions to political parties; (5) § 269 disallows deductions for acquisitions made to evade taxes; (6) § 267 forbids deductions for losses, expenses, and interest resulting from transactions with related taxpayers; (7) § 265 denies deductions for expenses incurred with respect to tax-exempt income; (8) § 280(A) disallows deductions for certain expenses arising from the business use of a home and rental of a vacation home; (9) § 262 prohibits a deduction for personal expenses; (10) § 266 disallows a deduction for carrying charges; (11) § 273 denies a deduction for a decrease in value of life or terminable interests; and (12) § 162 excludes deductions for charitable contributions in excess of the amount allowed under § 170, bribes and kickbacks, lobbying, fines and penalties.

[311] There are other disadvantages. Dealer status brings with it the self-employment tax. Section 1402(a) provides that "net earnings from self-employment" include income derived from any trade or business including sale of stock in trade and property held primarily for sale to customers in the ordinary course of trade or business.

D. *The Business Collector*

Businesses are buying increasingly large amounts of art, both for office decoration and for investment. The business collector includes businesses other than corporations that buy art for use, but not for resale, in the ordinary course of trade or business. With some variations, business collectors are governed by the same rules as the other categories. In fact, a business collector may be a hobbyist or investor. In some cases there may be activity sufficient to place the business collector in the dealer category with the art buying and selling activity constituting a separate and additional trade or business.

Most of the variations in treatment are minor. For example, reviewing the profitability standards of section 183,[312] it is apparent that the business collector is in a good position to make a case for the requisite profit motive. Other variations may be major depending upon whether the art, in the hands of the business collector, is subject to depreciation. Although the depreciation issue is treated at greater length in the last section of this Article,[313] one consequence of depreciation should be discussed here.

We have seen that section 1221 excludes from the definition of capital assets "property used in a trade or business of a character which is subject to the allowance for depreciation."[314] This exclusion refers to so-called "section 1231 property." Section 1231 property is accorded hybrid tax treatment. If in any year, realized gains on section 1231 property exceed realized losses, all the section 1231 gains and losses are treated as capital gains and losses.[315] If losses on such property exceed gains, all section 1231 gains and losses are treated as ordinary gains and losses.[316] For our purposes, section 1231 property is depreciable property used in the taxpayer's trade or business and held for a period in excess of one year. Thus, for the business collector, if works of art are "of a character which is subject to the allowance for depreciation," gains and losses may be capital or ordinary.[317] There exists the potential for radically different treatment depending upon how works of art are classified.

The phrase "of a character which is subject to the allowance for depreciation" is less than precise and is not defined in the Code or

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[312] *See supra* notes 265-70 and accompanying text.
[313] *See infra* text accompanying notes 387-440.
[314] *See supra* note 158 and accompanying text.
[315] I.R.C. § 1231(a) (1982).
[316] *Id.*
[317] *Id.*

Regulations. The problem is that works of art, even though not depreciable, may nevertheless be of a *character* which is subject to depreciation (i.e., tangible personal property used in the taxpayer's trade or business). The problem is semantic and the only solution is by analogy. Works of art are generally not depreciable due to the lack of a *determinable useful life.*

Revenue Ruling 68-104[318] concerned the tax treatment of diapers included in the sale of a diaper service company. The ruling stated that since the taxpayer's experience had shown that the average useful life of diapers for rental purposes was less than one year, the diapers were not subject to depreciation and did not qualify as section 1231 property. This ruling is different from the art situation only in degree. The diapers were not section 1231 property because their useful life was less than one year and therefore not subject to depreciation. By analogy, works of art would not be subject to depreciation because they have indeterminate useful lives and therefore would also not be classified as section 1231 property.

E. *Items Common to All Collectors and Dealers*

1. Theft Losses

Section 165[319] provides that art collectors and dealers may deduct losses incurred by theft. The authority for these deductions is derived from different portions of section 165, depending upon whether the loss is sustained in a trade or business,[320] in a transaction entered into for profit,[321] or in a transaction not connected with a trade or business.[322] A theft loss is not considered to be a casualty loss[323] and is governed by its own rules, which generally parallel the rules for casualty losses.[324]

The amount of loss is determined by fair market value of the work of art or the work's loss basis as determined under section 1011,[325] whichever is less. With respect to a fair market value deduction, the deductible loss is determined by reducing the work's fair market value immediately prior to the theft by the work's fair market

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[318] Rev. Rul. 68-104, 1968-1 C.B. 361.
[319] I.R.C. § 165(c)(3) (1982).
[320] *Id.* § 165(c)(1).
[321] *Id.* § 165(c)(2).
[322] *Id.* § 165(c)(3).
[323] Treas. Reg. § 1.165-7(a)(6) (1977).
[324] *See infra* text accompanying notes 346-78.
[325] Treas. Reg. §§ 1.165-7(b)(1), -8(c) (1964); Treas. Reg. § 1.1011-1 (1960); Treas. Reg. § 1.1015-1(a) (1971).

value immediately after. The post-theft value is treated as zero.[326] With the exception of certain dealers, the manner of determining the amount of loss is the same whether the loss has or has not been incurred in connection with a trade or business or in any transaction entered into for profit.[327] Different rules, however, apply to some dealers depending upon whether they are required to maintain inventories. The Regulations[328] provide that 1.165-8 does not apply to "theft losses reflected in the inventories of taxpayers." If the dealer maintains an inventory, the theft losses would be reflected in adjustments to inventory.[329] The amount and timing of the loss would depend upon which inventory method is being employed.[330] The question of whether a dealer is required to maintain an inventory is complex and varies according to the facts of each case. Although authority exists for the proposition that dealers must maintain inventories,[331] in reality many do not.

The hobbyist is allowed to deduct losses according to the general formula mentioned above: the lesser of the fair market value of the work or the work's loss basis as determined under section 1011.[332] The deductible loss with respect to a fair market value deduction is also determined in the same manner as was previously mentioned.[333] The hobbyist, however, may only deduct the amount of the loss that exceeds $100.[334]

Investors, business collectors, and dealers compute their losses in a slightly different manner and are not subject to the $100 limitation.[335] If, immediately prior to the theft, the fair market value of the stolen work is less than its adjusted basis, then the adjusted basis is treated as the amount of the loss.[336]

The question of what constitutes theft is probably more complex in the case of dealings in art than in most other cases. In some instances of art theft it is very difficult to draw the line. Art collectors buy and sell forged works of art and works that have been misrepresented as to authorship, provenance and condition. They also buy and

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[326] Treas. Reg. § 1.165-7(b)(1)(i) (1977); § 1.165-8(c) (1964).

[327] Treas. Reg. § 1.165-7(a)(1) (1977).

[328] *Id.* § 1.165(e).

[329] For the rules applicable to those dealers not required to maintain an inventory see *infra* notes 335-36 and accompanying text.

[330] Treas. Reg. §§ 1.471-3, -4 (1975); § 1.471-8 (1960).

[331] Treas. Reg. § 1.471-1 (1960).

[332] *See supra* text accompanying note 325.

[333] *See supra* text accompanying note 326.

[334] Treas. Reg. §§ 1.165-7(b)(1), -8(c) (1964).

[335] *Id.* § 1.165-8(c).

[336] *Id.* §§ 1.165-7(b)(1)(ii), -8(c).

sell works on the basis of representations that authentication may be obtained, works that have forged authentications, or with authentications that are subsequently withdrawn or revised. In addition, they buy and sell works for many times their value, or for a fraction thereof.

The concept of "outright" theft is fairly simple. The Regulations provide that the term "theft" includes, but is not necessarily limited to, larceny, embezzlement and robbery.[337] Courts have construed the term broadly. The Fifth Circuit has defined theft as "[a] word of general and broad connotation, intended to cover and covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any form of guile."[338] The court also noted that the existence of a theft depends upon the law of the jurisdiction, and the exact nature of the crime does not matter as long as it amounts to theft. The Tax Court has agreed with this view.[339]

The IRS has taken a liberal view and, in some cases, has expanded upon the courts' interpretations. In one case the IRS allowed a theft loss to a taxpayer who loaned money to a corporation based on fraudulent financial statements.[340] In another case, the IRS allowed a theft loss for a kidnap ransom even though the laws of the local jurisdiction made a distinction between extortion and theft.[341] The court stated that the taxpayer need only prove two elements. First, the loss resulted from a taking of property deemed illegal under the laws of the state in which the taking occurred, and second, the taking was done with criminal intent. The court stated, "Congress used the term 'theft' so as to cover any theft or felonious taking of money or property by which a taxpayer sustains a loss."[342]

The laws of the State of Colorado are an example of the "local law" concept; it would appear that a taxpayer could sustain a theft loss under virtually any circumstance involving deceit, criminal misrepresentation, fraud, larceny, embezzlement or robbery. The Colorado theft statute provides: "[a] person commits theft when he knowingly obtains. . .control over anything of value without authorization, or by . . . deception . . . ."[343] This statute covers a

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[337] *Id.* § 1.165-8(d).
[338] Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1957).
[339] Gersetll v. Commissioner, 46 T.C. 161 (1966).
[340] Rev. Rul. 71-381, 1971-2 C.B. 126.
[341] Rev. Rul. 72-112, 1972-2 C.B. 60.
[342] *Id.* at 61.
[343] COLO. REV. STAT. § 18-4-401 (1973).

multitude of sins. Those that are not covered under the theft statute are covered under the criminal simulation statute which provides:

> (1) A person commits a criminal simulation, when: (a) With intent to defraud, he makes, alters, or represents any object in such fashion that it appears to have an antiquity, rarity, source or authorship, ingredient, or composition which it does not in fact have; or (b) With knowledge of its true character and with intent to use to defraud, he utters, misrepresents, or possesses any object made or altered as specified in subsection (1) of this section.[344]

Although there are no cases or revenue rulings involving criminal simulation statutes, it is likely that losses sustained as a result of their violation would be included as theft losses under the liberal interpretations adopted by the courts and the IRS.

Theft losses are generally ordinary losses except in the rare case where the rules of section 1231 would apply.[345]

2. Casualty Losses

The rules pertaining to casualty losses are similar to those of theft losses. Casualty losses to property used in a trade or business are covered by section 165(c)(1).[346] I.R.C. section 165(c)(2) covers casualty losses to property involved in any transaction entered into for profit[347]; and section 165(c)(3) provides for deduction of losses to property not connected with a trade or business if the losses arise "from fire, storm, shipwreck, or other casualty."[348]

The treatment for losses from fire, storm or shipwreck are fairly straightforward. In the art area, however, most casualty losses result from the more nebulous category of "other casualty." What exactly constitutes "other casualty" is largely a question of fact which has resulted in an inordinate amount of litigation. A casualty has been defined as the complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected or unusual nature.[349] Problems arise when applying specific events involving art work loss to this test.

In many respects, works of art are not very durable. Paintings, for example, are subject to deterioration from heat, humidity and

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[344] *Id.* § 18-5-110.
[345] Treas. Reg. § 1.165-8(c) (1964).
[346] I.R.C. § 165(c)(1) (1981).
[347] *Id.* § 165(c)(2).
[348] *Id.* § 165(c)(3).
[349] Rev. Rul. 76-134, 1976-1 C.B. 54; Rev. Rul. 72-592, 1972-2 C.B. 101; Rev. Rul. 66-303, 1966-1 C.B. 55.

dryness. In addition to vandalism, physical damage may occur from dropping, puncturing or scratching a painting as well as from pets and insects. Furthermore, damage can be caused by a restorer, framer or cleaner during their attempts to protect a piece. It must also be noted that damage may not become evident until long after the causal event. For example, a painting might be dropped on its corner, knocking the stretcher slightly out of alignment. No damage may be visible at the time, but later peeling or traction cracking may appear.

Casualty loss from damage to works of art caused by vandalism has been specifically allowed.[350] Gradual deterioration from heat, humidity and dryness, however, would not be allowed as a casualty loss. Deterioration is neither sudden nor unusual. Although deterioration may not be expected, it is foreseeable and an assumed risk of art ownership. Although there are no reported cases dealing with art specifically, there are many cases denying deductions for similar types of loss and damage.[351]

An especially troublesome area is the "accident" category. Although most accident losses occur from sudden and identifiable events, taxpayers may be unable to prove that the losses resulted from accidents in the truest sense of the word. Losses have been granted for a diamond dropped in a garbage disposal[352] and a diamond lost when a car door slammed on a ring finger,[353] but denied for misplacement of jewelry[354] and for rings unintentionally discarded.[355] Losses have been granted for breakage of household goods incurred during a move,[356] but have been denied for personal breakage of household goods.[357] Losses have been denied for property broken by pets,[358] but granted for damage by a sonic boom.[359] Losses have been denied for damage caused by carpet beetles,[360] moths[361] and rats.[362]

There appear to be no hard and fast rules, but from the above examples it seems that deductibility depends on the "true accident"

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[350] United States v. Lattimore, 353 F.2d 379 (9th Cir. 1965).

[351] *See, e.g.*, Hoppe v. Commissioner, 354 F.2d 988 (9th Cir. 1965) (losses due to dry rot denied).

[352] Carpenter v. Commissioner, 25 T.C.M. (CCH) 1186 (1966).

[353] White v. Commissioner, 48 T.C. 430(A) (1967).

[354] James v. Commissioner, 10 T.C.M. 440 (CCH) (1951).

[355] Keenan v. Bowers, 91 F. Supp. 771 (E.D.S.C. 1950).

[356] Abrams v. Commissioner, 256 T.C.M. (CCH) 1546 (1964).

[357] Diggs v. Commissioner, 99 T.C.M. (CCH) 443 (1959), *aff'd*, 281 F.2d 326 (2d Cir. 1960).

[358] *Id.*

[359] Rev. Rul. 329, 1960-2 C.B. 67.

[360] Meersman v. United States, 244 F. Supp. 278 (M.D. Tenn. 1965), *aff'd*, 370 F.2d 109 (6th Cir. 1966).

[361] Rev. Rul. 327, 1955-1 C.B. 25.

[362] Banigan v. Commissioner, 10 T.C.M. 561 (CCH) (1951).

concept. An identifiable, sudden, unexpected, and unusual event must occur for the taxpayer to be able to take a deduction. Perhaps the best way to conceptualize the problem is to draw a clear distinction between section 167 depreciation losses and section 165 casualty losses. Section 167 is designed to deal with losses that are gradual and foreseeable.[363] On the other hand, section 165 is designed to deal with the losses that result from sudden, unexpected and unusual accidents.[364] Since the depreciation deduction is not available to individuals in most cases, it is only natural that they would attempt to bring losses, properly belonging within the purview of section 167, under the umbrella of section 165. When viewed in this light, many of the inconsistencies in the cases seem to dissolve.

Allowance of a casualty loss is not dependent on the presence of investment intent.[365] The amount deductible is the lesser of the fair market value of the property before the casualty, reduced by the fair market value of the property immediately after the casualty, or the adjusted basis of the property.[366] This formula is used by the hobbyist, subject to a $100 limitation.[367] If the property is totally destroyed, the investor and business collector may deduct the amount equal to the adjusted basis of the property.[368]

The Regulations prescribe that casualty losses are to be taken into account in the computation of taxable income under section 63 and therefore are generally considered to be ordinary losses which are unavailable if the individual does not itemize deductions.[369]

As with theft losses, casualty losses must be reduced to the extent that the loss is compensated by insurance or otherwise.[370] The casualty loss rules do not apply to dealers maintaining inventories.[371]

With respect to casualty and theft losses, special attention must be paid to the interrelationship of sections 165 and section 1231.[372] As indicated above, although casualty and theft losses generally result in

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[363] *See* Treas. Reg. § 1.167(a)-2 (1980) which provides that: "The depreciation allowance in the case of tangible personal property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion and obsolescence."

[364] I.R.C. § 165(c)(3) (1982).

[365] Treas. Reg. § 1.165-7(a)(1) (1981).

[366] *Id.* § 1.165-7(b)(1).

[367] *Id.* § 1.165-8(b)(4).

[368] *Id.* § 1.165-7(b)(1).

[369] *Id.* § 1.165-7(a)(1).

[370] *See* I.R.C. § 165(a) (1954).

[371] Treas. Reg. § 1.165-7(a)(4) (1981).

[372] I.R.C. §§ 165, 1231 (1981).

ordinary loss, this presupposes that a netting of gains[373] and losses from thefts and casualties results in a net loss. The netting process involves the following procedure:

(1) included under section 1231 are involuntary conversions resulting from total or partial destruction or theft of capital assets held for more than one year;[374]

(2) the taxpayer's losses resulting from complete or partial destruction or the theft of property are treated as losses upon an involuntary conversion. This holds true whether or not there is a conversion and regardless of insurance considerations;[375]

(3) if the losses from an involuntary conversion resulting from casualty or theft of (a) any property used in a trade or business, or (b) any capital asset held for more than one year, exceed the gains therefrom, section 1231 is inapplicable. In effect, the net loss will be treated as an ordinary loss.[376] In the case of a capital asset held for more than one year, this rule applies whether the property is used in a trade or business, held for the production of income, or is a personal use asset;[377]

(4) in the event that gains exceed losses, theft and casualty losses come under section 1231 and are consolidated with other gains and losses within that section. If the total gains under section 1231 exceed the total losses, the theft and casualty losses will be treated as capital losses.[378]

3. Involuntary Conversions

Section 1033[379] provides that no gain will be recognized if property, as a result of its theft or destruction, is involuntarily converted into other property that is similar or related in service or use to the property so converted. It is further provided that if the destroyed or stolen property is converted into money or property not similar or related in service or use to the converted property, the gain shall be recognized only to the extent that the taxpayer invests the money in property similar or related in service to the converted property.[380]

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[373] This netting of gains refers to gains from involuntary conversions. *See infra* text accompanying notes 379-87.

[374] I.R.C. § 1231(a) (1981).

[375] Treas. Reg. § 1.1231-1(e)(1) (1982).

[376] *Id.* § 1.1231-1(e)(3).

[377] *Id.*

[378] I.R.C. § 1231(a) (1981).

[379] *Id.* § 1033.

[380] *Id.* § 1033(a)(2)(A). This rule would apply to the situation where a taxpayer invests insurance proceeds received as compensation for a stolen or destroyed work of art in a similar work.

The nonrecognition of a gain upon involuntary conversion into similar property is mandatory.[381] As a practical matter, works of art are seldom, if ever, converted into other property. The more typical situation involves the complete or partial destruction or theft of a work coupled with the receipt of insurance proceeds.

Losses on involuntary conversions are deductible or nondeductible regardless of the provisions of section 1033.[382] With respect to works of art, two elements are required to successfully claim a loss resulting from an involuntary conversion: the complete or partial destruction or theft of the work of art; and the receipt of cash, generally insurance proceeds. Unlike casualty losses under section 165, the complete or partial destruction need not be sudden, unexpected or unusual. However, if involuntary conversions are to be taken into account in the initial netting process in order to determine whether section 1231 applies, they must result from casualty or theft.[383]

The taxpayer can elect not to recognize gains upon involuntary conversion by purchasing property similar to, or related in service or use to the converted property.[384] This purchase must be made within a period ending two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.[385] The phrase "similar to or related in service or use" relates to function and character.[386] *With respect to works of art, the only property that* would be similar or related in service or use would be other works of art or, perhaps, other decorative items such as antiques.

The decision to take advantage of the nonrecognition provisions depends upon a number of factors including the taxpayer's other section 1231 gains and losses, the amount of gain involved, and whether suitable replacement property can be found. Whatever deduction treatment the taxpayer elects, he must carefully conform to the reporting requirements contained in the Regulations.[387]

(1) Example 1

A taxpayer acquired a painting in 1975 for $500. In 1979, the painting was stolen. The work was insured for its full fair market value, and the taxpayer received insurance proceeds of $1,200. The

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[381] Treas. Reg. § 1.1033(a)-2(b) (1982).
[382] *See* I.R.C. § 1231(a)(2) (1981).
[383] *Id.* § 1231(a).
[384] *Id.* § 1033(a)(2)(A).
[385] *Id.*
[386] I.R.C. § 1033(a)(1) (1981). *See, e.g.*, Treas. Reg. §§ 1.1033(a)-2(b), -2(c)(9) (1982).
[387] Treas. Reg. § 1.1033(a)-2(c)(2) (1982).

taxpayer has a gain upon involuntary conversion of $700 ($1,200 fair market value less the adjusted basis of $500). The taxpayer may recognize the gain, or elect nonrecognition by purchasing suitable replacement property. If the taxpayer chooses to recognize the gain, section 1231 shall apply since his gains from involuntary conversions exceed his losses (see Example 3).

(2) Example 2

Assume the same facts as those in Example 1 except that in addition to the first painting, the taxpayer had a second painting stolen. The second painting was purchased in 1975 for $400. At the time it was stolen it had a fair market value of $1,500, but was insured for only $400. The taxpayer has a loss on this painting of $1,100 ($1,500 fair market value less $400 insurance proceeds). The taxpayer has a net loss upon involuntary conversion of $400 ($1,100 loss on the second painting less $700 gain on the first painting). Since the losses exceed the gains, section 1231 does not apply, and the taxpayer has a $300 ordinary loss ($400 net loss less $100 limitation).

(3) Example 3

Assume that the taxpayer in Example 1 chooses to recognize the $700 gain and assume in addition that his section 1231 losses exceed his section 1231 gains. In this case the $700 gain would be ordinary income. Remember that under section 1231, if the losses exceed the gains, all gains and losses are treated as ordinary gains and losses.

These examples illustrate that whenever theft, casualty losses or involuntary conversions are encountered, careful tax planning is in order. Through poor planning a taxpayer may wind up with avoidable ordinary gain or lose the benefit of ordinary loss.

IV. Depreciation[388]

The IRS takes the position that works of art are generally not subject to depreciation.[389] The unavailability of the depreciation deduction is arguably the single most important tax benefit denied works

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[388] The discussion in this section is applicable to property placed in service prior to 1981. With respect to property placed in service after 1980 in taxable years ending after 1980 the rules appear to have been changed by the enactment of the Economic Recovery Tax Act of 1981. The effect of this Act on the art/depreciation controversy is discussed in *infra* notes 433-40 and accompanying text.

[389] The IRS position was first stated in A.R.R. 4530, C.B. II-2, -145 (1923), *superseded by* Rev. Rul. 68-232, 1968-1 C.B 79 in which a motion picture director attempted to classify works

of art. While it is impossible to calculate the depressant effect that this has had on the art market, one can assume that it is significant.

It would be one thing if the denial of the depreciation deduction was a clear policy decision made by Congress; however, this is not the case. The denial of the depreciation deduction results from an IRS interpretation that fails to understand both the physical attributes of works of art and the art market as they relate to depreciation concepts.

There are three major misconceptions about art in relation to depreciation that have resulted in the denial of the depreciation deduction. The first misconception is that works of art generally appreciate in value and, thus, are not subject to an allowance for depreciation. *Thompson Co. v. United States*[390] involved the purchase of a restaurant in 1929, which included in the purchase price fifty-seven large oil paintings, five engravings, and two prints, all by nineteenth century artists. In 1962 the premises were condemned. The taxpayer was unable to find a suitable substitute location to display the works, having unsuccessfully attempted to reconstruct the closed restaurant, and so disposed of them. The taxpayer claimed that depreciation should be allowed on the disposed works of art. The court denied any depreciation deduction, finding the logic of A.R.R. 4530[391] "compelling." The court found that the taxpayer was unable to produce evidence of physical wear and tear. The court further found that even if the taxpayer had provided such evidence, the determination of a realistic, useful life or the extent of any depreciation was impossible.

On appeal, the Seventh Circuit[392] echoed the lower court opinion and stated that the loss deduction allowed under section 167[393] is applicable to depreciable property only. The court added, "[e]xcept to the extent that they are subject to physical decay . . . works of art are not depreciable."[394] The above statement reflects the second misconception involving works of art and depreciation; that items are depre-

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of art used to decorate his office as business assets. The committee found that the art works were not properly categorized as business assets, and were not subject to a depreciation from gross income. The committee based its decision on the concept that the value and desirability of works of art generally increase with age.

[390] 338 F. Supp. 770 (N.D. Ill. 1971).

[391] *See supra* note 389.

[392] Thompson Co. v. United States, 477 F.2d 164 (7th Cir. 1973).

[393] I.R.C. § 167(a) allows "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)

(1) of property used in the trade or business, or

(2) of property held for the production of income."

[394] 477 F.2d 164, 169 (7th Cir. 1973).

ciable only to the extent they are subject to physical decay and that works of art are generally not subject to decay.

In 1968, Revenue Ruling 68-232[395] superseded A.R.R. 4530.[396] This ruling denied deductions for depreciation of works of art, finding that "a valuable and treasured art piece does not have a determinable useful life."[397] The court noted that while the physical condition of a work may affect its value, the work's useful life is not determined or limited by this condition. The assertion that valuable art does not have a determinable useful life[398] is the third misconception upon which the depreciation deduction has been denied.

The bases upon which depreciation has been historically denied must be measured against reality to determine whether they have any merit.

A. *Appreciation*

The reference to appreciation in A.R.R. 4530[399] probably stemmed from the difficulty of conceptualizing the depreciation of an asset that might actually increase in value. In fact, as art dealers will confirm, works of art do depreciate.[400] One commentator has noted that "many depreciable items of property appreciate; physical exhaustion, wear and tear should in no way be offset for tax purposes by appreciation in value."[401]

Appreciation in value of art is not now, nor has it ever been, an element in the depreciation equation. Even if it were to be considered a factor, it must be recognized that the overwhelming majority of art does not appreciate. For every work of art created by a well-known artist, there are literally thousands of works created by artists who are neither known nor up-and-coming. The works of such artists are virtually valueless from a monetary standpoint once they leave the art gallery. Works of art have no intrinsic value, nor do they have a "labor" value. The vast majority of works of art have no value other than the pleasure they bring. Thus, they may be the most depreciable of all commodities. This, the largest category of art, is swept along with the more valuable works to which A.R.R. 4530 and its progeny were directed, even though there is no basis for comparison.

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[395] Rev. Rul. 68-232, 1968-1 C.B. 79.
[396] *See supra* note 389.
[397] Rev. Rul., *supra* note 395, at 79.
[398] *See* Potts, Davis & Co. v. Commissioner, 27 T.C.M. (CCH) 1363 n.9 (1968).
[399] A.R.R. 4530, *supra* note 388.
[400] 4 MERTENS, LAW OF FEDERAL INCOME TAXATION 23.09 n.6 (1977).
[401] *Id.*

Although it appears that this basis for denial of depreciation deductions has for the most part been abandoned, there are still references made to it. It is possible the concept plays a subtle role in decisions ostensibly based on other grounds.[402]

B. *Physical Decay*

In the *Thompson* cases,[403] the courts used the "wear and tear" language of section 167[404] as the basis for denial of depreciation. The wear and tear concept relates to the physical life of an object. Both the IRS and the Supreme Court have made clear that depreciation may, but does not necessarily have to, rest on physical life.[405]

To prevent accelerated depreciation, in *Hertz Corp. v. United States*,[406] the IRS successfully forced the taxpayer to calculate a shorter useful life which was more in conformance with the taxpayer's actual business experience. The physical life expectancy and wear and tear on the property of the taxpayer were found by the court to be irrelevant. The important factor was deemed to be the average amount of time that the property was useful to the taxpayer. The average useful life turned out to be considerably shorter than the average physical life. Thus, useful life, the life upon which depreciation is based, is the shorter of the asset's physical life and the asset's economic life to the taxpayer.[407]

In *Thompson Co. v. United States*,[408] the court mistakenly focused on physical life because the works had a shorter economic life to the taxpayer. The court assumed that works of art are not generally subject to wear and tear, or to physical decay. However, the fact of the matter is that most works of art are not as impervious to change as they may seem.[409] In addition, deterioration may not be apparent unless the work of art is examined with x-ray, infrared or ultraviolet lights.[410] The absence of obvious physical decay may account for the general belief that works of art do not deteriorate. Although there

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[402] One such decision was Gudmunsson v. Commissioner, 37 T.C.M. (CCH) 1249 (1978), which involved depreciation claimed by the taxpayers on certain antique furnishings.

[403] *See supra* notes 390, 392.

[404] *See supra* note 393.

[405] *See, e.g.*, IRS *Publication* 534, Tax Information on Depreciation (1978 ed.).

[406] 364 U.S. 122 (1960).

[407] *See, e.g.*, Massey Motors v. United States, 364 U.S. 92, 97 (1960), in which the court stated, "useful life is measured by the use in a taxpayer's business, not by the full abstract economic life of the asset in any business."

[408] *See supra* notes 390, 392.

[409] *See* C. E. KECK, A HANDBOOK ON THE CARE OF PAINTINGS viii (1965).

[410] *Id.*

may be serious deterioration, it may not be apparent unless it takes the form of severe cracking, chipping, or blemishes. It should not be assumed, however, that there is no deterioration just because the damage is not apparent.

C. *Determinable Useful Life*

The issuance of Revenue Ruling 68-232[411] has limited the impact of much of the above. Appreciation and lack of physical decay have a residual effect but are no longer the primary grounds upon which depreciation is denied.

Despite the language in the Ruling concerning physical condition, the essence of the holding is that a work of art will rarely, if ever, have a physical life shorter than its economic life and that the economic life cannot be determined.

Subject to qualification, the first portion of this assertion, that works of art rarely have shorter physical lives than economic lives, may be more true than not. This assertion is the result of the illusion of indestructibility of works of art. However, even when artists were confined to traditional media,[412] it was not a foregone conclusion that the resulting products would be sound and not subject to early deterioration.[413] The issue of whether a particular work could be expected to outlast its economic life would have to be addressed on a case-by-case basis. For the IRS, as a matter of law, to assume otherwise is absurd.

In recent years the situation has become even more pronounced. In the years preceding the issuance of Revenue Ruling 68-232, artists began to experiment with an array of new media.[414] Some of the new materials[415] used render determination of the ultimate value of works

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[411] *See supra* note 395.

[412] Traditional media include tempera, pastel, casein, oil and watercolor.

[413] R. MAYER, THE ARTIST'S HANDBOOK OF MATERIALS AND TECHNIQUES 456 (3rd ed. 1970). The deterioration that occurs to works of art can be compounded by the inability or unwillingness of particular artists to use proper methods or techniques. *See* THE BRITANNICA ENCYCLOPEDIA OF AMERICAN ART 490.

[414] New media that artists have begun experimenting with include: tempera on paper on canvas; oil on hardboard; silk screen on acrylic and aluminum on canvas; oil on canvas with china wash-basin; corrugated paper and enamel; formica on wood; vinyl, kapok, cloth, plexiglass, spray lacquer and stencil on canvas, magna on canvas, aluminum and perspex relief on photo on panel; oil on canvas and toaster; papier-mache and glass; painted bronze; paper; epoxy; fiberglass; paint; plaster figure and illuminated plexiglass; wood, upholstery, paper and lacquers; polyurethane on wood, cellulose on panel; kandy, perl and acrylic on wood relief; painted plaster, wire and cloth; plaster and Coca-Cola bottle; magna on plexiglass; sculpmetal on plaster with mirror; and liquitex, oil and collage on canvas board.

[415] For example, polymer colors, acrylic, synthetic organic pigments and luminescent pigments.

created with these media difficult. This is due to inexperience in ascertaining the best way to apply and manipulate them. Notions that may have existed as to longevity of works of art are now inapplicable in the face of the new materials and techniques available, and the lack of experience in assessing their durability. Ironically, most of the new materials are employed in other products for which the IRS allows the shortest depreciation lives. To maintain that these materials will last longer if employed in a work of art is unreasonable and without any basis in fact.

The second aspect of the Revenue Ruling involves the assertion by the IRS that works of art do not have determinable useful lives. At this point it is appropriate to examine the meaning of the term "useful life." The term first appeared in the Internal Revenue Code of 1954. It has not been defined by statute, but rather by Treasury Regulation:

> [T]he estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) taxpayer's policy as to repairs, renewals and replacements.[416]

This section of the Regulations embodies at least three concepts: (1) and (3) relate to physical life, (2) relates to obsolescence, and (4) relates to economic life, the taxpayer's practices and experience. The Revenue Ruling, in essence, is either stating that none of these factors are ordinarily present in respect to works of art or that none of these factors can be determined.

The question of useful life is a question of fact to be determined on the basis of all the circumstances reasonably known or anticipated at the end of the year for which depreciation is taken.[417] A case can be made that works of art contain any one or all of these factors set forth in the Regulations.

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[416] Treas. Reg. § 1.167(a)-1(b) (1960).
[417] Casey v. Commissioner, 38 T.C. 357 (1962).

1. Physical Life

Works of art are subject to deterioration from natural causes, as well as from climatic and local conditions.[418] For example, the climatic variations in the United States are, as a rule, more extreme than those of the localities where many works of art were originally created. This change in climatic conditions can substantially affect the condition of a work displayed out of doors.[419] Some works kept in storage will be harmed as a result of the absorption of atmospheric moisture.[420] Another example of the effect of climatic conditions on works of art are oil paintings which can lose their elasticity with age and become brittle. This is a result of the cumulative effect of exposure of the paintings to oxygen and the effect of the ultraviolet rays in daylight.[421]

Basevi, Inc. v. Commissioner[422] was a case in which a taxpayer successfully proved that engraved designs, made from photographs of original paintings, have a determinable useful life of less than one year. The court noted the delicate nature of the designs in reaching its determination. That case involved art used in a particular manufacturing process which is not applicable to all other works of art. The differences, however, between this case and the considerations at hand are those of degree, not of kind. The taxpayer was faced with the burden of proving a point of fact and did so. A taxpayer could sustain his burden of proof with respect to any work of art by demonstrating all or a significant number of the following: (1) examination of the work of art under infrared, ultraviolet light or x-ray reveals on-going deterioration; (2) the work of art is by an artist who lacked sound technical knowledge and the work exhibits flaws that have in the past led to serious deterioration; (3) the work is constructed of a new and/or untested material or the result of a new and/or untested technique and the materials are similar to those which, when used in other products, are known to deteriorate; (4) the work of art is obviously constructed in such a manner that it is apparent that it will

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[418] In addition to the effect of external conditions, the discussion above regarding the deterioration of materials used in creating art is relevant to the physical life of a work. *See supra* notes 414-15 and accompanying text.

[419] MAYER, *supra* note 413, at 332. For example, the obelisk in Central Park, which survived for thousands of years in Egypt, had to be protectively coated to halt decay only a few years after its arrival in New York.

[420] *Id.* at 534.

[421] *Id.* at 175.

[422] 5 T.C.M. (CCH) 450 (1946).

deteriorate;[423] (5) the climate of the locale is known to be harmful to the medium in which the work is constructed;[424] (6) the storage or display requirements of the taxpayer are such that the work is subject to inordinate conditions, and; (7) the artist did not construct the work with the intent that it should last.

2. Obsolescence

Section 167(a)[425] includes "a reasonable allowance for obsolescence," reflected in subsection (2) of the portion of the Regulations quoted above. Although it may seem difficult to imagine, many works of art are as trendy and subject to obsolescence as other commodities. The history of art in this country is replete with examples of schools that have fallen into disuse or disfavor.[426]

It may be a necessary requirement of the taxpayer's trade or business that the art displayed be of a current trend or style. An investor may suffer economic loss due to obsolescence of a particular school or style. If so, it is up to the taxpayer to prove such needs or economic loss. In one case[427] a taxpayer successfully supported an obsolescence deduction on the ground that a certain style and type of store fixture was unsuitable for use and display in a new store. The court found that the property was rendered unfit by "reason of the progress of the art,"[428] and had lost its useful value. This opinion demonstrates that obsolescence is not limited to functional obsolescence but, in fact, extends to considerations of style.

3. Taxpayer's Practices and Experiences

Dr. Joseph Judge v. Commissioner[429] is the only case on art depreciation to reach the Tax Court. The case illustrates many propositions, not the least of which is that in this area taxpayers have come to ruin at their own hands. Taxpayers have been as slow as the IRS in

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[423] An example of a work that will tend to deteriorate rapidly would be a work consisting of heavy layers of impasto or thick pigment.

[424] Conditions such as strong sunlight or severe temperature fluctuations, for example, may have an adverse effect on a work of art.

[425] I.R.C. § 167(a) (1982).

[426] Dadaism, The American Scene, Pop Art, Op Art and Minimalism are examples of periods of art in this category. While art historians may disagree about which schools have permanently disappeared from the art scene, most would probably agree that some styles do pass into disuse or disfavor.

[427] Townsend-Veberrhein Clothing v. Crooks, 41 F.2d 66 (W.D. Mo. 1930).

[428] *Id.* at 68.

[429] 45 T.C.M. (P-H) 1242 (1976).

properly conceptualizing the issues. Dr. Judge was a pediatrician who bought twelve paintings of clowns, dogs, birds, children and flowers for $3,000, sight unseen, except for reproductions in a European mail-order catalogue. He hung the paintings in his office, and in time they were defaced by his little patients.[430]

The court found that the paintings were legitimately used in the doctor's business during the relevant tax years, and therefore an appropriate deduction for depreciation could be taken if the useful life and salvage value of the paintings could be shown. The IRS took the position that the two factors were indeterminable. Furthermore, the IRS took the position that the paintings had no determinable useful life. The court in discussing the applicability of Revenue Ruling 68-232 noted "[t]hat the apparent rationale of this ruling is that physical deterioration generally does not cause an end to the useful life of works of art within any determinable period."[431] The Tax Court, however, focused on the first sentence of the Ruling and found that the works in question were not "valuable and treasured" and, thus, not within the Ruling's scope.[432] Dr. Judge, however, still failed to prove the economic useful life of the paintings.

This case provides a guide for those taxpayers seeking depreciation of works of art serving primarily decorative functions. Even if "valued and treasured" works are at issue, the taxpayer may still maintain a strong case by focusing on the Regulations. The taxpayer may prevail if he can prove the actual physical life, the economic useful life, functional or stylistic obsolescence, or a combination of all three.

D. *The Accelerated Cost Recovery System*

This Article was written prior to the enactment of the 1981 Economic Recovery Act.[433] The Act appears to have altered the rules discussed above, with respect to property placed in service after 1980 in taxable years ending after 1980.[434] The Act's Accelerated Cost Recovery System[435] essentially provides for more rapid acceleration of cost recovery deductions. Congress had concluded that the prior laws

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[430] *Id.* at 1250.

[431] *Id.*

[432] The first sentence of this ruling states: "A valuable and treasured art piece does not have a determinable useful life." *Supra* note 359.

[433] Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 2425 (codified as amended in scattered sections of 26 U.S.C.).

[434] I.R.C. § 168(b)(1)(A) (1982).

[435] I.R.C. § 168 (1982).

for determining depreciation allowances needed to be supplanted by a system that would provide greater investment stimulus.[436] Inflation had diminished the real value of depreciation deductions allowed under the prior law.[437] This resulted in diminished profitability of investment and a reluctance on the part of businesses to replace equipment and structures with new, technologically superior fixtures.[438] The ACRS for the most part, abandons the concept of "useful life" upon which Revenue Ruling 68-232[439] relied. However, it should be noted that I.R.C. section 168(c)(1),[440] as amended, defines "recovery property" as "tangible property *of a character subject to depreciation*" (emphasis added). This phrase appears consistently throughout the art/depreciation controversy. Arguably, the IRS will continue to maintain its position that art is not properly "of a character subject to depreciation," and therefore the ACRS rules will be inapplicable to art works. It is more likely than not that the dispute will still be focused on the same issues regarding the depreciable nature of works of art.

V. Conclusion

This Article has outlined some of the unique problems that can occur with respect to the federal taxation of art and artists. Final resolutions of the controversies arising in the areas of valuation of works of art, the tax treatment to be accorded art collectors, and the depreciable nature of works of art are not likely to be readily determined. However, a taxpayer who is aware of the issues involved and who conducts his art-related activities along the lines suggested in this Article, may find his position bolstered in disputes arising with the IRS.

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[436] Joint Comm. on Tax, 97th Cong., 1st Sess., Legislative History of the Economic Recovery Tax Act of 1981, at 1449 (1981).

[437] *Id.*

[438] *Id.*

[439] *See supra* notes 395-97 and accompanying text.

[440] This section defines the applicability of the ACRS.