

AAMD TAX PRIMER

Updated February 2014

AAMD Tax Primer

AAMD is not qualified to give legal or accounting advice. While we believe the information below to be correct regarding federal tax law to the best of our knowledge as of the date of issue, it should not be relied upon either by museums or donors; they should consult their own legal and/or tax advisors. The information below, although not exhaustive, is intended to provide basic knowledge about some issues so users may ask informed questions of their professional advisors.

Remember that local or state laws may also apply to some of the issues listed below, so be sure to check with local authorities as well.

Italicized words in sections II and III are found in I. Definitions

I. Definitions

1. **Appreciated property** is property that has increased in value during the time the owner has held it. For example, if a collector purchased or inherited a work of art in 2000, which was valued at \$5,000 (the *cost basis*) and today is worth \$10,000, he owns a work of appreciated property.

2. **Cost basis** or **basis** is the price paid for an object or the value when an object is inherited. If the object appreciates in value, it becomes *appreciated property*.

3. **Cost basis for artists** is the cost to produce a work of art. For example, an artist's basis in creating an oil painting would be the cost of paint, canvas etc.

4. **Exempt purpose** is the reason for which the museum has been granted its tax-exempt status.

5. **In-kind gifts** are gifts of objects, whether works of art or other tangible personal property rather than cash or securities.

6. **Fair-market value** or **market value** is the price a willing buyer will pay to a willing seller in an arms-length transaction.

7. **Related use** is the IRS designation that describes the purpose(s) for which museums have been granted their tax-exempt status. Related use purpose can generally be equated to the museum's mission. (Related use is sometimes referred to as exempt use.)

8. **Related use gifts** or **exempt use gifts** are those given to an institution where they will be used to further the mission of the institution. For example, giving a work of art to a museum is usually a *related use gift* since it furthers the mission of the institution; however, giving a work of art to a soup kitchen is not a *related use*, since the soup kitchen's mission is to serve meals, not display art. *Related use gifts of tangible personal property* will enable the donor (except for artists who donate their own work) to generally take a *fair-market-value* deduction. A gift that is donated in order to be sold is not a *related use gift*.

9. **Tangible personal property** is property other than land or buildings that can be seen or touched including works of art, furniture, books jewelry, paintings and cars. Land and buildings are not tangible property -- they are real property and governed by different tax rules.

10. **Unrelated Business Income Tax (UBIT)** is paid by museums if they earn income from:

- A. A trade or business,
- B. Regularly carried on by the museum, and
- C. Not substantially related to the performance by the museum of its charitable and educational purpose.

The activity must meet all three tests before it is subject to UBIT. There are, however, exceptions, like a museum restaurant or parking garage, which help attract visitors and allow them to devote more time to exhibitions. (See II. 10.)

II. Tax Issues for Museums

1. **Exclusive Corporate Sponsorship** - A museum does not pay UBIT on sponsorship payments provided the museum offers no other inducement for sponsorship payments, for example: advertising or promising specific outcomes like a certain level of attendance or agreeing not to offer a service or product that would compete with those of the exclusive corporate sponsor. Offering such inducements is tantamount to carrying on an unrelated business. For example, if Coca-Cola becomes an exclusive corporate sponsor for an exhibition and the museum agrees not to sell Pepsi products during the run of the exhibition, the Coca-Cola sponsorship payments would be subject to UBIT. (*See Treas. Reg. 1.513-4(a) and (c)*).

2. **Form 990 to Explain Museum Expenses** - Many who examine the Forms 990 from museums, which are posted on the internet, are reporters searching for information. When filing the 990, it is permissible and advisable to explain any expenses that are not apparent from looking at the form. This can be accomplished by adding footnotes or additional pages to further explain the numbers or break them into more meaningful parts.

3. **Form 8282 Disposing of Donated Works of Art in Less than Three Years** - If a museum disposes of (sells, trades, exchanges, destroys or gives away) a donated work of art for which the donor took a deduction of more than \$5,000, in less than three years after receipt, the museum must file IRS Form 8282 reporting to the IRS within 125 days of the disposition; a copy must also be sent to the donor.

A donor is required to recapture and include in income the amount of any deduction in excess of cost basis, if the museum disposes of the property within three (3) years, unless a certification is made by the museum under penalties of perjury certifying that either:

- (A)(i) the use was substantial and related to the mission of the museum, which constitutes the basis for the museum's exemption, and
- (ii) a description of how the property was used and how it furthered the mission of the museum, or
- (B)(i) states the intended use by the museum at the time of the contribution, and
- (ii) certifies that such intended use has become impossible or infeasible to implement.

Whether or not a work is accessioned plays no role in the three-year rule.

A \$10,000 penalty will be imposed for knowingly misidentifying property as related to the mission of the museum.

4. **Quid Pro-quo** - Museums must acknowledge the *market value* of anything given in exchange for a gift. For example, if a donor purchases a ticket for a benefit dinner for \$500 the museum must indicate the portion of the \$500 that represents the *market value* of the meal -- what one would expect to pay in a restaurant (not what the museum might pay for the meal if it gets the meal donated or at cost). Only the amount above that *market value* is tax deductible. There is an exception for "token items" such as key chains or coffee mugs.

5. **Raffles** - Gifts won in museum raffles must be valued at *fair-market value* in order for donors to pay taxes on the winnings. Penalties could accrue to museums for intentionally undervaluing raffle prizes.

For prizes valued over \$600 museums must file Form W-2G with the IRS as well as providing a copy to the prize winner. If the prize is valued over \$5,000 museums must withhold taxes at the rate of 25%. If the winner does not provide a federal ID number, the museum should withhold at a rate of 28%.

(<http://www.irs.gov/pub/irs-pdf/iw2g.pdf>)

Museums must provide winners with form W-9 to collect personal data like social security number, name, address etc. in order to comply with their reporting obligations, as well as their obligation to withhold taxes for prizes valued at more than \$5,000. (For a fuller explanation of requirements for raffles see IRS Notice 1340 at http://www.irs.gov/pub/irs-tege/notice_1340.pdf)

6. **Substantiation** - Museums must acknowledge gifts of over \$250 in writing and indicate whether or not goods or services have been provided in exchange for the gift. (See below III. 13.)

7. **UBIT - 990 T** - Organizations with more than \$1,000 in unrelated business income must file IRS Form 990-T and make the forms available for public inspection. They may delete certain privileged information. The IRS does not release the 990-T to *Guidestar*.

8. **UBIT —Facility Rental** - Facility rentals may be subject to UBIT unless, for example, a private viewing of the collection is included with the rental, in which case it could reasonably be argued that this activity is "substantially related" and therefore not subject to UBIT.

9. **UBIT - Gift Shops and Catalog Sales** - In considering whether revenue from items sold through museum shops or catalogs is subject to UBIT, the IRS examines the merchandise item by item to determine whether it is mission-related. In other words, some of the revenue may be subject to UBIT, and some may not.

The IRS has made legal rulings on most items sold by museums. For example, note cards depicting works of art from the museum's collection, or from other art collections that are identified on the cards, are not subject to UBIT. The IRS has ruled that the cards contribute importantly to the museum's exempt purpose by "stimulating and enhancing the public awareness, interest and appreciation of art". By the same token, books on art would be exempt from UBIT.

However, pencils, tote bags and trinkets that bear an image, name or logo of the museum are subject to UBIT since they do not carry any educational information, nor do they contribute to the mission of the museum; however, if they bear the image of a work of art and are sold with educational literature they would not be subject to UBIT.

The following factors are relevant when considering whether the sale of particular merchandise contributes importantly to the museum's *exempt purposes*:

- A. Examine the *exempt purpose* of the museum to determine whether the merchandise relates to the purpose;
- B. Provide educational information about the merchandise -- a highly important point in establishing the necessary relationship;
- C. Merchandise may be related to a museum's *exempt purpose*, even though it does not represent an item in the museum's own collection;
- D. Merchandise may be related to a museum's *exempt purpose* even though it has a utilitarian purpose or a limited useful life.

(*Treas. Reg. 1.513-1 (d)(2); Rev. Rul. 73-104 and 105; TAM 8326003*).

10. **UBIT - Restaurant** - If the restaurant meets certain conditions the IRS has ruled that the operation, of a restaurant is a service that contributes importantly to the accomplishment of the museum's *exempt purpose* by attracting visitors and allowing the visitors to devote a greater-portion of their time and attention to exhibitions and therefore is not subject to UBIT. The conditions:

- A. Size of the restaurant should be commensurate with the size of the staff and the number of visitors;
- B. Restaurant should be accessible only from the interior of the museum, not from the street;
- C. Restaurant should not directly or indirectly solicit the patronage of the general public;
- D. Profits should be used to further the *exempt purpose* of the museum.

11. **UBIT - Study Tours** - If tours are truly educational, and not travel tours with an incidental education component, they are not subject to UBIT. To be truly educational and therefore not subject to UBIT, it is recommended that tours be structured to include:

Reading list;

- A. Lectures and field trips that should account for approximately two-thirds of the available tour hours of participants;
- B. Educational component represented and treated as mandatory;
- C. Instructors who are recognized experts;
- D. Promotional literature that stresses educational component; not vacation information.

If, as part of the cost of taking the trip, the museum "requires" a donation, that donation would not be tax deductible to the donor (see below III. 12), because it is not freely given. The "donation" would not be subject to UBIT, if the trip itself is not subject to UBIT, but if the trip is subject to UBIT, the "required" donation is also subject to UBIT.

III. Tax Issues for Donors

1. **Auctions/Sales** - Artists or collectors who donate works of art to an auction or sale – even though the proceeds will be used to support the museum's tax *exempt purpose* -- may only deduct their *basis* in the work, not the *fair-market value*.

Fair-market-value deductions can only be taken for works of art donated for the museum's *exempt purpose* and donated by other than artists. Artists can deduct only their *basis* -- the cost of materials. Collectors can deduct only their *cost basis* -- what they paid for the work; neither artists nor collectors can deduct the appreciated value.

The taxpayer who purchases a work of art (or any other good or service) at a charity auction cannot deduct the purchase price from his taxes, unless he paid above the *fair-market value*. For example, if a work being sold at auction is advertised to have a *fair-market value* of \$1,000 and is purchased for \$1,000 the taxpayer deducts nothing. If the \$1,000 work sells for \$2,000 the taxpayer may deduct \$1,000 as a contribution.

2. **Deduction of Museum Membership Fees** - Donors may deduct museum membership dues which are \$75 or less provided the member receives only certain benefits such as free admission, shop discounts, invitations to member events and/or any insubstantial gifts or publications. However, if in return for membership the donor were to receive a framed print valued at \$50, he could only deduct \$25 of his membership fee. (*Treas. Reg. § 1.170A-13(f)(8)*).

If the membership fee is above \$75, that which is deductible is more complicated since the benefits must be estimated and deducted from the membership fee; that which remains after the deduction of benefits is tax deductible.

3. **Deduction of Out-of-pocket Expenses** - Volunteers who incur out-of-pocket expenses may take a deduction for the value of those expenses (not their time). The museum is not obliged to provide substantiation in the event that the taxpayer claims more than \$250; instead the taxpayers' own records and receipts are sufficient. (*Treas. Reg. § 1.170A-1((g))*).

4. **Cash Donations** - Deductions taken by donors who give gifts of cash generally are limited to 50% of the adjusted gross income, but any excess can be carried forward for five years.

5. **Donations of Works of Art** – Deductions for gifts of art are limited to 30% of the adjusted gross income, but any excess can be carried forward for five years.

6. **Fair-market Value Deduction** - Taxpayers who donate *tangible personal property* to a museum -- a work of art -- may take the *fair-market value* deduction. (This rule does not apply to artists who donate their own work.) The work must be related to the *exempt purpose* of the museum. For example, the donation of a rare set of surgical instruments donated to a contemporary art museum would not likely be an allowed deduction since-the contemporary art museum collects and exhibits contemporary art, not surgical instruments.

If the donor claims a tax deduction of over \$5,000 for donated property, a qualified appraisal must be attached to the taxpayers' income tax return, if the donor cannot take the entire deduction in the year the gift is given, it can be carried forward for five years.

Museums should not give appraisal advice except to offer a list of qualified appraisers, if appropriate.

Any taxpayer whose returns are audited -- for whatever reason -- and who has donated a work of art valued at \$50,000 or more will automatically be referred to the IRS Art Advisory Panel which will determine if the art deduction was warranted.

An audit will not be triggered solely on the basis of having donated a work of art; there must be another underlying cause, for example, an off-shore bank account. In which case, as part of the audit of the bank account, if it is found that the taxpayer took a deduction for a donated work of art valued at more than \$50,000, the valuation will be examined.

7. **Fractional Gifts** – Effective August 17, 2006 the provision for making fractional donations of works of art changed.

A donor may now give a museum a fractional interest, e.g. ten percent (10%), in a work of art provided the donor or the donor and museum own 100% immediately before the gift and provided the remainder ownership interest is contributed within 10 years or the donor's death, whichever occurs first. The donor, after receiving a qualified appraisal, takes a charitable deduction for the *fair-market value* of the initial fraction given; he can also carry forward his deduction for five years, but can only deduct an amount up to 30% of his gross adjusted income in any given year. When the donor gives subsequent fractions, after receiving a qualified appraisal, he may only deduct the lesser amount of either, the first appraisal or the current appraisal. As a result, if the work has increased in value, the donor cannot take an increased deduction, however, if the work declines in value: the donor must take a lower deduction.

Donors must file IRS Form 8283 that includes description of property (and percentage interest donated, if a fractional gift) and a qualified appraisal which must be repeated for each additional portion of ownership the donor gives to the museum.

The museum is obligated to take "significant physical possession" of the work and use it for a *related use* within the 10 year period.

If a donor has given a fraction before the effective date of August 17, 2006, a subsequent fraction given after the effective date starts the clock on the new provisions described above. In other words, the first subsequent fraction, after the effective date, is treated like the first fraction -- the donor gets a qualified appraisal and may deduct the fair market value that corresponds to the ownership interest being transferred. From that point forward:

- Gift must be fully given within 10 years or death of the donor.
- Deductions for subsequent fractions are based on the appraised value of the first fractional donation after the effective date. These subsequent donations can be no higher than the first fractional donation after the effective date, but they can be lower if the work has lost value, rather than appreciated.
- Museum must take "significant physical possession" of the gift during the 10 year period.
- Museum must take total possession no later than the end of the 10-year period.

8. **Hold Work One Year Before Donating** - Donors must hold a work for one year after purchase before it can be donated for a *fair-market value* deduction; if the work is

donated less than one year after acquisition, the donor can only deduct his *cost basis* in the work.

9. **IRA Rollover** - Persons 70-1/2 or older may transfer up to \$100,000 from an IRA or a Roth IRA account directly to a charity without including the funds as income, paying taxes and then taking a charitable deduction when the funds are donated. The gift must go from the donor's IRA account directly to the charity. Important note: Congress has approved this provision on a year-by-year basis, sometimes letting it lapse but then renewing it retroactively. The provisions currently lapsed on December 31, 2013. Please check with a tax advisor to see whether Congress has renewed or expanded the IRA Rollover.

10. **Planned Giving Contributions** - individuals may designate a nonprofit to receive property or cash upon their death. All such planned gifts pass tax-free from the decedent's estate to the museum. However, except in connection with certain trusts or annuities, there is no income tax deduction allowed at the time the planned gift is arranged. An estate tax deduction will be available when the gift is made at the time of death.

11. **Raffles** - Winners of museum raffles must pay tax on the winnings which they must report on their tax return. The tax to be paid is based on the *fair-market value* supplied by the museum at the time of the raffle.

12. **Study Tours** - Tour costs are not deductible by the donor. If there is a supplement added to the *fair-market value* of the trip that is to become a donation to the museum, it must be clear that those giving the donation are not obliged to do so in order to take the trip. There should be language indicating that the donation is not required, in which case, the donation is tax deductible to the donor; however, if the donation must be given in order to take the trip, it is not tax deductible to the donor.

13. **Substantiation** - Donors of monetary gifts-cash, check or other monetary gifts - regardless of the amount, are required to maintain a bank record (e.g. cancelled check) or written communication from the museum showing the name of the museum, the date of the contribution and the amount of the contribution.

Association of Art Museum Directors
Washington, DC
December 2013

Anita M. Difanis
Phone 202-638-4250
Email AAMDGOV@aol.com

Andy Finch
Phone 202-638-4530
Email afinch@aamd.org