THE ART INSTITUTE OF CHICAGO

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Office of the Vice President, General Counsel
and Secretary

October 31, 2006

Honorable Charles E. Grassley, Chairman
Honorable Max Baucus, Ranking Member
Committee on Finance
U.S. Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Honorable William M. Thomas, Chairman
Honorable Charles B. Rangel, Ranking Member
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: Pension Protection Act of 2006 (H.R. 4)
Section 1218 – Gifts of Fractional Interests

Gentlemen:

We are writing to request that certain corrections be included in the Tax Technical Corrections Act of 2006 (S. 4026 and H.R. 6264). Our requests relate to the provisions on fractional interest gifts found in Section 1218 of the Pension Protection Act of 2006 (the "Act").

Background

The Art Institute is deeply concerned that the fractional gift provisions of the Act will curtail or even end partial interest gifts to museums and will thus deprive the public of the opportunity to see great works of art. Like many American museums, the Art Institute has received significant works as fractional gifts. Objects we have received as partial interest gifts – and that as a result are on public view at the museum – include works by Monet, Picasso, Van Gogh, and Cezanne, among others.

Museums rely on gifts to acquire such works for the public; in today's art market, museums cannot realistically expect to have the funds to purchase such major works on a

regular basis. It is the public that gains when a museum receives gifts of art, since these masterpieces can now be viewed by anyone who visits the museum rather than being passed down in families or being sold to other private owners.

Given the critical importance of gifts of art, including fractional interest gifts, we are seeking the corrections described below.

Requested Corrections

1. Discrepancy Between Tax Liability and Deduction

Under Sections 2031 and 2512 of the Internal Revenue Code of 1986, as amended (the "Code"), estate and gift taxes are based on the fair market value of an object on the date of death or the date of the gift. Under Section 1218 of the Act, however, after a donor makes a gift of a fractional interest in an object, the deduction for all subsequent fractional interest gifts in the same object is limited to the appraised value at the time of the first gift. As a result, if a donor makes a gift of a 30% interest in an object in Year 1, the work appreciates in value, and he then dies in Year 8 with the remaining 70% interest going to the museum at that time, the estate tax will be based on the fair market value of the object in Year 8 but the deduction will be based on the lower appraised value from Year 1. A similar result occurs under the gift tax laws.

This discrepancy does not seem to promote any policy goal and produces a harsh result for individuals who are attempting to make charitable gifts. Not surprisingly, perhaps, donors have already informed us that because of this discrepancy, they will no longer make partial interest gifts. We therefore seek corrections that will eliminate this concern.

2. Gifts in Progress

When museums receive gifts of art, including fractional interests, they take the new work into account in developing exhibition and programming plans. In addition, they adjust their acquisition plans and priorities; having received an interest in a work by a particular artist, which brings with it the right to possess that work for some period and the expectation of eventually receiving full ownership, a museum will focus its acquisition plans on works by other artists or works from other periods. Unfortunately, in light of the uncertainty created by the Act and the new penalties contained in the Act, donors are suspending gifts that were in progress before the new law was enacted. Museums, in turn, are facing disruption to plans and a delay in receiving gifts that donors long intended to give. To avoid this result, the Act should not apply to fractional interest gifts in an object if the donor had made at least one fractional interest gift in the same object before the law was enacted.

3. Recapture Provision

The Act provides for recapture of income and gift tax deductions, plus a penalty, if the remaining interest in a work has not been contributed to the donee "before the earlier of

(I) the date that is 10 years after the date of the initial fractional contribution, or (II) the date of the death of the donor...." One reading of this language is that the final interest has to have been contributed before the date of the donor's death, making it impossible for the gift to be completed upon death by way of a will, trust, or other instrument without recapture. If the donor dies within ten years of making the initial fractional gift, and if the work is in fact transferred to the donee upon the donor's death, recapture and penalties seem inappropriate.

4. Valuation of Subsequent Gifts

We are particularly troubled by the provision of the Act stating that subsequent gifts must be valued based on the lesser of the fair market value at the time of the initial gift or the fair market value at the time of the additional contribution. First, of course, this provision gives rise to the discrepancy discussed above between the deduction and the potential gift and estate tax liability. Second, faced with the likelihood of having to take a deduction in the future that does not represent the actual market value of the gift, donors may choose either not to give the gift at all or to delay and give the object as a bequest at death. From the museum's perspective, even a delay in making a gift poses a risk; a donor may change his mind about making the donation, the work could suffer damage, or the donor's circumstances may change such that he is forced to sell the work.

The concern reflected in this provision appears to be that donors are using inaccurate appraisals. Rather than requiring donors to use out-of-date valuations, however, an approach generally disfavored in other contexts, it would seem more appropriate to focus on assuring that appraisals are accurate. We therefore recommend that donors be permitted to deduct the current fair market value, but in any case in which the work as a whole is valued at $1 million or more, even if the gift in question is just a fractional interest, the appraisal should be reviewed by the IRS Art Advisory Panel.

5. Ten-Year Recapture Period

We also recommend a change to the provision in the Act requiring recapture and imposing penalties if the gift is not completed by the earlier of ten years from the date of the initial contribution or the death of the donor. Donors may wish to spread out a gift over more than ten years for legitimate reasons such as financial planning or personal attachment to the object. A ten-year time limit will likely deter donors from making gifts; a collector who owns an object valued at tens of millions of dollars may feel he simply cannot donate such a work over only ten years, given the contribution limit for gifts of tangible personal property, and thus may not give the work at all, while another collector may wish to have possession of a particularly treasured object for at least some periods throughout his life and therefore may decide simply to keep the object until his death. So long as the museum ultimately ends up with the object and meets the possession requirements during the course of the gift, the period of the gift should not matter. To assure that these goals are met, donees could be required to file information returns with the Internal Revenue Service in the event the gift is not completed or the

possession requirements are not met. If either event occurs, prior income and gift tax deductions could be recaptured.

6. Possession

Under the Act, donors are subject to recapture and penalties if the donee does not have substantial physical possession of the work during the period of the gift. We suggest a clarification that the recapture and penalties do not apply in the event the donor dies before the donee has taken possession. In addition, we recommend the adoption of exceptions to the possession requirement for exceptional circumstances, such as a significant construction project at the museum that requires deinstallation of galleries or because of unique factors relating to the particular work of art in question.

We appreciate your consideration of our suggestions and your attention to the important role that fractional interest gifts play in allowing museums to build art collections for the benefit of the public.

Very truly yours,

James Cuno
President and Eloise W. Martin Director

Julia E. Getzels
Executive Vice President, General Counsel and Secretary