

The Accidental Art Collector: Income and Estate Tax Considerations

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It's not unusual for individuals to inherit valuable artwork without having a genuine interest in art. These "Accidental Art Collectors" often lack awareness of the complex tax, legal, and financial issues involved in owning or transferring high-value pieces. Even a single painting can create significant challenges in estate planning, particularly when its value has appreciated substantially over time.

A Common Scenario

Consider a couple in the mid-70's with a sizeable estate—worth over \$40 million. Despite the fact that they had never created a will, made a taxable gift, or filed Federal gift taxes. Among their assets is a painting valued at approximately \$250,000. The painting was inherited in the 1980's from one of the spouse's father, who had inherited it from his father in the late 1940's. Originally, the artwork was purchased by the grandfather for \$100 from an artist who was unknown at the time. Although the artist passed away in 1990 largely unrecognized, his work has gained significant popularity over the past few decades, becoming well-known, in many art galleries, and frequently sold by art collectors.

The couple plans to leave the painting to a nephew who has expressed interest in the painting. Absent this single painting, it was also evident that they had no interest in art, and did not have an interest in acquiring art. Such owners are often described as "Accidental Art Collectors."

Over many years, it has become apparent that accidental collectors frequently underestimate the complexities a single piece of art can introduce to estate planning. For instance, the painting's value was recorded at \$100 in the previous generation's estate, reflecting its original purchase price. This discrepancy in valuation illustrates just one of the challenges faced by Accidental Art Collector.

Art, like many collectibles, is a mystery to most people. While many recognize that these items may hold unique value, few realize that managing and transferring such assets often requires more business decisions than any other asset in an estate. Several important considerations should be kept in mind.

1. **Keep the Art Until Death or Gift It Now?** Deciding whether to hold onto valuable art until death or to gift it during one's lifetime can be complicated. If the total estate is under \$28 million, the decision would be relatively easy from a Federal Tax standpoint, but not as easy from a state law standpoint. For example, in New Jersey, where this couple lived, when the surviving spouse passes away, the painting's value will be added to the gross estate. If the taxable estate exceeds the unified tax credit (currently \$28 million for a married couple who has never made a taxable gift) there will be Federal Estate Tax liability. Holding the painting until the death of the second spouse will increase the tax basis of the painting to its date of death value. However, unless the unified tax credit increases while either spouse is alive, a death tax will be incurred on the second death. There is no easy answer to this issue. From a New Jersey

standpoint, the nephew is a Class D beneficiary, and the inheritance tax on the first \$700,000 of value transferred to the nephew is 15% and 16% on the value transferred in excess of \$700,000. Thus, depending upon the fair market value of the painting, there could be a significant New Jersey Transfer Inheritance Tax Liability.

2. **Income Tax Consequences.** From an income tax standpoint, the tax basis for the painting is probably \$100, based on the value reported on the previous generation's U.S. Estate Tax Return (Form 706). Gifting the painting now removes future appreciation from the estate and may avoid the New Jersey Inheritance tax. However, it will cause a federal and state income tax problem for the recipient—such as the nephew in this example—if he decides to sell it, since the tax basis of the painting will be \$100. If the painting is sold, the federal tax rate on long-term capital gains is as high as 28%, unlike most long-term capital gains taxed at 20%, plus the net investment income tax of 3.8%. State tax must also be considered.
3. **Sales Tax Obligations.** Should the artwork be sold, the seller may be responsible for collecting state sales tax.
4. **Insurance and Valuation Concerns.** When auditing an estate, the IRS frequently reviews the insurance on assets to help establish value. Often, however, valuable artwork is inadequately insured. Many individuals assume that their general homeowner's policy provides sufficient coverage, a specific personal property floater may be required. Owners of artwork and jewelry should check their insurance policies to make sure that they have secured appropriate coverage for such items.
5. **Documentation and Transfer Requirements.** Any transfer of the painting requires supporting documents confirming the authenticity of the painting, the ownership of the painting, and a seller's warranty. An experienced attorney familiar with the transfer of art should be consulted.
6. **Charitable Contributions.** Donating art to a nonprofit organization can be a meaningful choice, but one with complex rules relating to a gift of property. The donor must obtain a "Qualified Appraisal" by a "Qualified Appraiser" to claim a deduction. Otherwise, the charitable deduction will not be permitted. Also, deductions for a charitable contribution are limited to a percentage of the donor's adjusted gross income, and any contributions in excess of the adjusted gross income limitation are subject to a five-year carryover.

Decisions, Decisions, Decisions. Owning a single piece of valuable artwork may be more than what a taxpayer expects. Tax issues, insurance, valuation, legal documentation, and choices about gifting or selling all require careful planning. What seems like a simple asset can carry significant financial and legal considerations.