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The Risk of Tax Avoidance through Charitable Donations in the U.S. Art Market

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Abstract:

Provided in a variety of galleries, local and national museums, art is something that everyone can appreciate. Access to art through these places provides the opportunity for cultural, social and historical enrichment, functioning as an invaluable addition to the academic growth of both individuals and communities; however art is also big money. The fine arts market is one of the most poorly regulated markets in the world, allowing for extensive collusion on prices and sales which ensures that the market prices of art do not decreases. This exclusivity and collusive behavior results in pieces of art that are worth fortunes. So why would anyone willing donate art worth hundreds of thousands if not millions of dollars? Rather than solely out of altruistic motivation individuals also engage in philanthropic activity due to financial incentives found in the U.S. tax code. Using a variety of economic and journalistic sources, we explore the structure of the fine arts market, paying close attention to the pricing practices and relevant U.S. tax code to open the discussion on the value of donated art and provide possible policy changes. The current structure provided through the U.S. tax code fails to address the constant increase of values seen in art and does not provide strict enough guide lines for museum donation criteria. Policies should be implemented that aim to mitigate excessive tax avoidance through the exploitation of charitable donations.

It is safe to assume that most individuals do not want to pay more in taxes than necessary. Most individuals in the United States go to great lengths to ensure that they receive every deduction and tax break that they can. There are negative effects in allowing tax deductions, as it reduces the revenue available to state and federal governments to make improvements to their communities. In 2016 the United States federal revenue was approximately $3.3 trillion, and 47% was from individual income taxes (Malinovskaya 2017). When paying taxes and looking

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for tax deductions individuals are looking to maximize their personal benefit by saving money that they would otherwise pay in taxes. For the majority of American households, these deductions are not significant enough to have a noticeable impact on the coffers of the state and can provide necessary savings to individuals and families. But for the highest income quintile in the United States, whose income tax contribution makes up 69% of all federal income taxes, tax deductions can have a larger impact on government tax revenues (Malinovskaya 2017). These deductions become more and more substantial to the U.S. budget as you move higher up in the U.S. tax brackets. Households with a minimum annual income of $250,000+ are responsible for 51.6% of federal income tax revenues (Desilver 2016). In 2014 the bottom 50% of American households, who make a maximum yearly income of approximately $61,360, paid $38 billion in federal income taxes, or about 2.75% of the total income taxes for that year (Greenberg 2017; Malinovskaya 2017). In the same year the top 1%, who earned above $465,000, paid $543 billion or 39.48% (Greenberg 2017). Moving higher into the top .05% and the .0001%, who include names like Jeff Bezos, Bill Gates, Warren Buffet, each of whose net worth is near or over $80 billion; the progressive U.S. income tax codes ensure that individuals in higher tax brackets contribute significantly more in federal income taxes than the average American household (Forbes 2018). Therefore any deductions they take will have a substantially larger impact on the U.S. collections and budget.

One kind of tax deduction that disproportionally benefits the wealthy are charitable donation deductions. These donations can be extremely valuable to the charities they go to and the communities they serve. But there is a grey area regarding the value of donations given versus benefits received; the monetary value of these donations does not always equal the value that the donated object provides to a community. Here we distinguish between monetary and non-monetary donations. Monetary donations are clear cut as the charity it is donated to receive the amount given by the donor; non-monetary donations, such as donated works of art, have a more subjective worth putting the amount received through a charitable deduction into question. Non-monetary donations raise the issue that tax deductions taken by donors may not be equal to the benefits received by the charities.

We must consider that the United States tax code in regard to charitable donations and tax deductions may be exploited through excessive giving of non-monetary objects with subjective value. In 2017 “the deduction for charitable gifts was claimed by 37% of tax filers with an AGI [adjusted gross income] between $50,000 and $100,000; 68% of tax filers with an AGI between $100,000 and $200,000; and more than 86% of tax filers in each of the income ranges over $200,000” (Lowry 2017). Deductions have a negative effect on the U.S. tax base, in this case total amount of income taxes, which in term means less funding for programs supported by tax revenues. While these statistics include both monetary and non-monetary donations, they show that a substantial number of Americans are using charitable donation deductions to their benefit. The Association of Art Museum Directors of U.S. art museum shows that in 2016 donated art works increased from 69,516 objects to 87,638 over the three year period between 2014 to 2016 (Association 2017).

A key element in this discussion is the United States fine arts market. The United States is the largest art and antiquities trader in the world with the domestic market estimated to be worth $11.66 billion as of 2015 (Pownall 2017). The price range of these art works tends to lean towards the tens of thousands up to tens of millions of dollars. Due to budget constraints, we can assume that lower to medium income American households are not active participants in this market leaving the majority of market activity to the wealthiest of Americans. We define the fine arts market in this discussion to be defined as highest tiers of the art market's galleries and auction houses with art works whose prices that range into the tens of thousands to hundreds of millions of dollars. The participation of individuals in this high cost market is based on their wealth which allows them access to some of the world's most prized historic and cultural artifacts. Though ownership of these art works may be exclusive to the wealthy, seeing and experiencing them is accessible to the public. Within the United States there are 35,000 museums, and in art museums on average 80- to 90% or more of all art works have been donated (Bullard 2014; Anagnos 2017; Association 2017; Reifsneider 2018). To begin our exploration of the art market we must first dive into the logistics and practices that go on behind the buying and selling of art. Let us start with why investors are choosing to opt into the market and then donate their acquisitions.

Investing in Art

Art is a classic demonstration of money and power that has evolved into a careful, modern investment. The main appeal of the market for new investors is its security and positive returns on art in the long run. Within the art market fine art seldom, if ever, decreases in value due to the careful price and resale control of works within the market (Mayyasi 2015; Schranger 2013). Though the market's internal regulatory boards attempt to keep the market's business practices as clean as possible, collusion frequently occurs (Schranger 2013). These collusive practices focus around keeping the market exclusive and the prices high to ensure a profitable resale (Mayyasi 2015; Schranger 2013). Collusion seen in art auctions and private showings results in an asymmetric distribution of information within the market that benefits both buyers and sellers while deterring new investors (Depmster 2017; Mayyasi 2015; Padhi 2016; Seidel 2015). Every player in the market (i.e. buyers, sellers, collectors, galleries, and auction houses) benefits from the increasing value of the items within the market. The methods used in ensuring these prices stay high are strongly influenced by the reputations of pieces and the individuals who own them along with the connected monetary value between pieces (Mayyasi 2015). Each piece in the art market is related to a much larger collection of work, whether it be by the same artist or artistic style. Art market pricing is heavily reliant on trends in buyer preferences and as a result the sale of one piece can have a ripple effects on investments held by distant collectors. The players benefit from keeping the market exclusive and driving out new investors because it ensures that the prices will remain controlled by a select few within the market (Mayyasi 2015; Padhi 2016; Schrager 2013).

Despite the benefits gained by keeping ownership exclusive, visibility and popularity can have major influences on the appraisal and future sales. Take for example the rapid price increase of “Salvador Mundi,” a recently re-discovered painting by Leonardo da Vinci, which saw its price skyrocket from approximately $75 million in 2014 to $450.3 million in 2017 (Reyburn 2014; Helmore 2017). Back in 2014 at its first auction a London- based art dealer named Charles Beddington reflected that the “Salvador Mundi” only sold for $75 million because “It’s worth what you can get for it” (Reyburn 2014). In three years there was a massive increase in the piece’s visibility and its popularity soared resulting in its newly found fame as the most expensive piece ever to be sold at auction (Helmore 2017).

Though it is too early to see any of the ripple effects, the rapid increase in price for this one work of art will have an effect on owners and collectors of similar pieces. The story of “Salvador Mundi” reflects how popularity effects price, but its monetary value also shows that art is worth more than the sum of its parts. Art contains a deeper social, historical, and creative message that makes its value subjective. Back in 2014 “Salvador Mundi” did not sell for $75 million due to sheer luck, but rather from the accumulation of Leonardo da Vinci’s contributions to art and art history, its quality, and historic significance. The subjective nature of art’s monetary value becomes a central variable that art collectors, buyers, and sellers aim to control for within the market. Galleries and appraisers first look at market trends along with current tastes and preferences to determine at what price a specific work of art may sell for (Mayyasi 2015; Schrager 2013; Mei 2002). If it is determined that a work of art would see a decrease in its price, rather than taking a loss on the art work the owners and gallery or auction house may decide not to sell it (Mayyasi 2015). This allows the work to maintain its original sale price and protects other pieces like it in the market.

Collusion between buyers and sellers helps the appreciation rate of fine art prices remain constant overtime, resulting in a relatively safe investment. The appreciation rate of art is determined by the difference in sale and resale price over the duration between sale and resale. In 2002 a study by Jianping Mei and Michael Moses found that between 1875 and 2000 art auction sales from Sotheby’s and Christies appreciated in a similar pattern to that of steady, low risk stock portfolios (Mei 2002). Their findings show that art, while it does appreciate at a lower rate, follows the growth patterns of the S&P 500. While the art market overall has increased in value over this time period they find that changes in tastes and preferences have significant effects on price. We see that older, better known pieces appreciate at a slower rate than newer art. This may be due to reputation along with its long history of sale records making the work more resistant to market shocks and keeping its value growing at a steady rate. Their theory for this discrepancy in value growth lies in the potential earnings of new pieces that may greatly increase as tastes and preferences within the market change (Mei 2002).

Understanding the stability of art as an investment leads us to our next section which is how art is priced for sale. In our example of the "Salvador Mundi" the idea that art is worth what an investor is willing to pay for it becomes more complicated with the addition of appraisals. The appraisal process is an important step in determining not only the resale value but also the possible tax deduction that can be claimed from a charitable donation. Art appraisals give donors an idea of what their art is worth, but even when performed by a trained professional the amount given is an estimate. The Pension Protection Act of 2006 added §170(f)(11)(E), which increased the requirements needed to be qualified as a professional art appraiser, including increasing the standards on certifications, education level, and formal, professional experience (Carney 2016). Art appraisers must specialize in their field and regularly preform appraisals on works under their specialization (Carney 2016). This means that while one appraiser may be specialized in ancient Chinese pottery they are not qualified to appraise impressionist paintings. The estimated price for a piece comes from a variety of variables and specific information about the artist, quality of the painting, how it compares to other paintings by the same artist or paintings of the same genre, age, ownership history, etc. (ArtBusiness). In addition to the appraisers estimate, before receiving the deduction the IRS can either approve the donation or challenge the donation (Carney 2016). Finding a well-qualified appraiser is often considered to be the most important part in the resale and or donation process, as their estimate and thoroughness in appraising the piece can be a deciding factor in the donation being approved or denied.

Once the works are appraised, sellers work together with galleries and auction houses to decide on the prices of individual goods using the appraisers estimate to gauge the works value and expected sale price (Mayyasi 2015; Schrager 2013). A lack of external market regulation has been shown to contribute to unequal participation in auction arenas and inefficient price outcomes due to collusive behavior (Padhi 2015). Art, while being scrutinized, appraised, and collected, is being disassociated with artistic value and being used as a physical stock of wealth. For this argument we must distinguish between the artistic value of art versus its monetary value. The artistic value of art is deeply subjective and varies between individuals and often contains social, cultural and historical value that is difficult to assign a monetary value to. Art's monetary value is its estimated worth and or sale price. In the following section we address why individuals donate art, which may seem counter intuitive to the reasons that individuals buy art. Moving forward we restrict our discussion to the donation of art to art museums, though the tax code states that a charitable donation deduction can be taken from any organization that falls under §170(c)(2)(B) and §501(c)(3). Art museums around the country provide invaluable access to hundreds of thousands of works of art. What we know so far shows that art is a high value, low risk investment with positive payoffs; why do people then choose to give it away?

Art Donations

While individuals choose to donate art for a variety of reasons there is a clear financial incentive to donate art in the United States. When an individual donates a work of art to a museum or other non-profit organization, U.S. tax code dictates that the donor is entitled to a tax deduction of equal value to the purchase price or current market value of the piece.

In 1917 the Unites States introduced §170 to the tax code through the War Income Tax Revenue Act of 1917 (Lindsey 2003). The section outlined in the War Income Tax Revenue Act was intended to encourage private philanthropy near the end of WWI. In the past century §170 has been through a variety of revisions which have slowly raised the maximum donation amounts. In the original law there was a 15% annual income donation ceiling, revisions in the Individual Income Tax Act of 1994 raised it to 15- to 20%, in 1954 it was raised to 20- to 30%, and in 1964 it was raised to 30% along with the addition of a provision that allowed unlimited charitable contribution deductions to those who donated 90% or more of their taxable income for the last year and 8 of 10 of the years prior years (Lindsey 2003). The Tax Reform Act of 1969 implemented many of laws still active in the U.S. tax code today. Within these revisions congress slowly phased out the unlimited deductions provision provided in 1964 and established the maximum 50% AGI [adjusted gross income] donation that can be reduced by short term capital gains (Lindsey 2003). Moving forward we outline current U.S. tax code for both charitable contribution donors and non-profit organizations.

To qualify for charitable contribution donations the organization receiving the donation must fall under section §170(c)(2)(B) and be considered a §501(c)(3), an income tax exempt organization, of the U.S. tax code. Which is "a corporation, trust, or community chest, fund or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes. . ." (§170(c)(2)(B)). Museums, both private and public, fall under this section as they provide an educational service. This tax exempt status allows museums to operate at lower costs which allows for more individuals to visit them and further their mission as a non-profit organization. As a tax exempt organization museums and other non-profits must provide a mission statement that clearly, if not broadly, outlines their educational and or charitable goals that provide a benefit or service to the public. In order to receive a deduction for a donation to one of these organizations the donation must fall under the non-profits mission statement.

We now move on to explain what sections of the tax code can be utilized by donors and the limitations they face when donating to non-profit organizations as of the 2018 U.S. tax code. We propose that the financial structure of U.S. tax code incentivizes donors to give, and, as utility maximizing individuals, they choose to donate up until the point that it is no longer economically advantageous for them to do so. For our argument we define this as being, under the constraints of U.S. charitable donation tax code, that the deduction received by the donor allows them to pay the minimum amount in taxes in a given year with minimal to no additional taxation on the donated object.

There are certain limitations that donors face when applying for tax deductions. When someone decides to donate art it can fall into two categories based on the duration that the individual has had it in their possession. Art, or any object, that has been acquired by another person, or not created by said person, it is considered a capital asset, or something owned by an individual for investment purposes or personal use. If the work of art has been in their possession for over a year it is considered to be long-term capital asset. When donating long-term capital assets the owner has the option to donate it for the fair market value or the property value of the work. The fair market value is the value of the art if they were to go to auction and sell the work; this value is determined by an appraiser. The property value is what the donor originally paid for the art, excluding any appreciation in the works value. If the owner opts into donating the work for the property value they are able to deduct up to 50% of their adjusted gross annual income [AGI] from the donation (§170(b)(1)(C)(iii); §170(b)(A); §170(b)(B)(ii)). If the owner does not choose the property value of the piece for donation, instead choosing to donate the piece for its fair market price, they may donate up to 30% of their adjusted gross income (§170(b)(1)(C)(i)). If the donated piece has a fair market price of over 30% of the donors adjusted income then it is subject to capital gains property tax for the following five years (§170(b)(B)). If a work of art has been in the owner's possession for less than one year then the 50% annual limit applies and is subject to capital gains property tax (§170(b)(A); §170(e)(1)(A)).

The reasoning behind the differences in deduction rates and their determination by the duration of ownership lies in the structure of the U.S. capital gains tax. Capital gains are "profits from the sale of assets, such as stocks, bonds, real estate and antiques. Income tax on capital gains is paid only when the asset is sold" (ITEP 2011; ITEP 2016). Under 2017 tax code, capital gains are divided into short- and long-term or under and over a year of ownership, respectively. The effect of this code is that short-term capital gains are not eligible for the same deduction status as long-term capital gains. In addition to federal tax breaks for long-term capital gains, states can also supply additional tax breaks on long-term gains (ITEP 2011; ITEP 2016). State tax breaks on capital gains income almost exclusively benefits the upper class of any state resulting in substantial losses in tax revenue that would be fed back into the state government (ITEP 2011; ITEP 2016). State tax code is relevant in this situation as it shows signs of a regressive tax deduction policy. The income and or tax deductions received by sold or donated art are unevenly distributed between social classes with the top 0.1 % of Americans with adjusted gross incomes over $2 million received over 60% of capital gains income in 2011 and 49% of all income from capital gains in 2013 (ITEP 2011; ITEP 2016). What this means in the world of art is that a very select few who have standing in both the upper tier of the upper class along with art investments can receive substantial income tax breaks for the resale or donation of art.

When it is time to donate an object to a museum, the donation is evaluated to ensure that it falls under the organizations mission statement. It is in a donor's best interest to try to receive the largest tax deduction they can and in order to qualify for a fair market value tax deduction the donated work must fall under the museums mission statement ((§170(e)(1)(B)(i)(I); (§170(e)(3)(A)(i)). To receive fair market value for a donated work of art means that the donor can receive the full value of the appraised work as a tax deduction. A museum's mission statement is a general goal that the museum hopes to achieve through displaying a genre of art. A mission statement may pertain to anything that the museums and its benefactors deemed to be important such as a historical period, social movement, contemporary art works, a specific artistic movement, and etcetera. Museums may exhibit a various styles, subject matter and mediums of art so long as they are within the mission statement. The fair market value of a piece can only be received if it falls under the mission statement because it ensures that the piece can be used by the museum to benefit the community in a way that corresponds with the museums community outreach and educational goals (§170(e)(1)(B)(i)(I)).

Art can either be rejected or accepted by a museum. Not every work given or donated to a museum is wanted, and museums have the right to turn away donations. But there are two avenues that art can go down if it is accepted. If a work of art is applicable to the museums mission statement the museum may accept the work and actively use it, the donor is able to collect the fair market price of the work in a deduction. This donation falls under the charitable contributions and gifts section of the itemized deductions portion of the U.S. tax code. The tax policy mentioned earlier, where an individual may receive a tax deduction on a donated work so long as the fair market value of the work does not exceed 30% of their gross adjusted income applies (§170(b)(1)(C)(i)). But if a work of art is donated to a museum and does not fit their mission statement the museum may still accept the piece for holding (§170(e)(7)(D)). When this occurs, the museum agrees to take the work of art from the donor and then puts it into storage for a minimum of three years (§170(e)(7)(B)(ii)). The donor receives a deduction equal to the amount that they originally paid for the work so long as it is under 30% of their adjusted annual income (§170(e)(1)(B)). If the value of the work is more than 30 % of their adjusted income property gains tax will be applied.

The museum can then put the donated work up for auction so long as they use the money to benefit the museum. This mainly consists of restoration and maintenance on aging works of art, expansions, and acquiring new works for display that fit the museum's mission statement (Reifsneider 2018). If a museum has a previously donated work of art that they no longer plan to use for its intended purpose, the museum has the right to put the piece up for auction three years after its donation (Gilbert 2018; §170(e)(7)(B)(ii)). However, if the museum decides to sell the piece before the three-year period is over, the donor of the piece has already received the fair market value of the work in a deduction, and the deduction was over $5000, then the donor will be responsible for paying a recapture tax for the work (§170(e)(7); §170(e)(1)(B)(i)(II)). A recapture tax holds the donor responsible for the difference in value between the cost they originally paid for it and the fair market price. If the recapture tax is applied the difference in value is added onto their income for the year that the piece was donated, and they are then responsible to pay taxes on it (§170(e)(7)(A)).

To put these laws into context let us look at five different theoretical scenarios in which an individual wants to donate a work of art for a tax deduction. These scenarios will incorporate individuals from a variety of income levels which differs from the real world trends in art donations, where most donors should fall into the top 20% of the U.S. income bracket. We do this to show the full range of implications that these laws have on individuals looking for deductions through donations. The scenarios are simplified to better show the effects of 2018 U.S. code on charitable donations in a given year. In each scenario a donor wishes to donate a painting to a museum to offset the amount of money they owe in taxes that given year. We assume that some of the paintings fall under the receiving museum's mission statement to show the role of the mission statement in tax deductions. We also assume that each individual is attempting to make themselves financially better off and wants to pay the minimum amount in taxes for the year.

In addition, these scenarios mention the effects of capital gains tax but do not explicitly say how much the tax is because of state differences in capital gains tax rates. The United States as of 2014 had a state capital gains tax average of 27.8% with the highest rates found in California, at 33%, and New York, at 31.5% (Pomerleau 2014). These taxes do not include the federal capital gains tax, which is a progressive tax where the lowest 15% of the population pays no taxes on capital gains where the upper quarter of the population pays approximately 15- to 20% on long term capital gains (Tax Policy Center). Gains received on art and other collectables are considered to be ordinary income and can face a federal tax rate of up to 28% (Tax Policy Center).

Scenarios of Charitable Donation Tax Law

Scenario 1: The 'ideal' donation outcome.

Person X is a new investor in the art market and makes $200,000. She purchased a painting over a year ago at auction for $20,000 and is now looking to donate the painting and use the deduction on the taxes she owes this year of $25,000. The appraiser notifies X that the painting has appreciated in value by $5,000. After finalizing the donation with the appraiser and the museum X is able to deduct $25,000, the full market value of the painting, and pay no money in taxes this year. The full market price, $25,000, is less than 30% of her annual income making it possible for her to deduct the fair market price on her taxes. This is the ideal scenario as it minimizes the amount that X needs to pay in taxes.

Scenario 2: A painting worth more than the taxes of an individual with a lower income. Person W makes $35,000 annually and owes $5,000 in taxes. W has owned a painting of unknown value for several years and after visiting with an appraiser discovers that the painting is worth $15,000. If W decides to go through and donate the painting then he can deduct up to the full worth of his taxes that year, $5,000, and then receive $10,000 in a tax refund because the total property value of the painting is less than 50% of his annual income. W may choose to donate the painting and receive the $10,000 tax refund if the taxes he would pay selling the painting at auction are greater than $5,000.

The following scenarios break the assumption that the painting relates to the museum's mission statement. This adds restrictions to the amount a donor is able to deduct from their taxes on the donation.

Scenario 3: A painting unrelated to a museum's mission statement that was purchased under a year ago. No resale within three-year holding period.

Person Y has an annual income of $400,000 and wants to donate a painting worth $75,000 at time of purchase to help offset their taxes owed of $125,000. Y purchased the painting under a year ago and it has seen a large increase in value due to changes in artist popularity and is appraised at $100,000. The museum he is looking to donate to made it clear that the painting does not relate to their mission statement. Paintings that do not relate to a museum's mission statement can follow two donation paths. Path one is where a donor can receive a deduction based on the original purchasing price of the painting, which would leave Y with $50,000 in taxes that year. On the second path a museum can agree to offer a market price tax deduction of up to 30% of the donor's annual income. The second scenario has a more beneficial effect on Y's financial situation. The value of $100,000 is under 30% of his income, so he will pay $25,000 in taxes from the $125,000 owed. The painting is less than 50% of his AGI and he will pay capital gains property tax on the $25,000 increase in the painting's value because of his less than one year ownership of the painting.

Scenario 4: Museum's decision to take a painting unrelated to its mission statement. Owned for over a year, no resale within three-year holding period.

Person Z is an art collector with an annual income of $150 million and owes $35 million in taxes this year. Z's painting is worth $40 million, has been owned for over a year and was originally purchased for $30 million. The museum agrees to take in Z's painting and Z receives the price she originally paid for it, $30 million, which is less than 30% of her annual income. This leaves her with $5 million in owed taxes. The museum puts this painting into storage and after three years they are able to sell the painting for its full market price. The museum will then be able to take these funds and put them back into the museum for things such as restoration, expansion projects or buying other art.

Scenario 5: If Z's painting related to the mission statement but the museum decides to sell it within three years of its donation.

Taking the situation from scenario 4 and changing the painting's relationship to the museum's mission statement results in a different outcome for the donor. Let's assume that Z receives the full market value of the painting in a tax deduction, $40 million and owes $0 in taxes for that year. However if the museum changes its decision to keep the painting after Z has received their deduction, Z is responsible for recapture taxes on the painting. If the museum sells the painting at auction, within three years of the donation, and sells the painting for $45 million, Z is held accountable for the $5 million increase in its worth. This scenario has a positive effect on the museum but negatively effects Z's financial situation.

Tax Avoidance

In the scenarios above we gain a simplified understanding of how charitable donations are transformed through the tax system into deductions. The greatest simplification in these examples is in the income and owed tax amounts of the donating individuals. As previously stated, the United States on average receives 69% of all federal income tax revenues from the upper 20% of households (Malinovskaya 2017). If we break down the United State income tax even further we see that these top 1% of households contribute 39.48% to the U.S. government each year (Greenberg 2017). In 2014 the average tax deduction for charitable giving for the reported 372,696 individuals taking itemized deductions that were earning over an adjusted gross income of over 1 million dollars was $172, 529 (Lowery 2017). 87% of the 372,696 individuals took an itemized deduction on a charitable donation, which was the largest percentage of any deduction group in that year, closely followed by real estate taxes (86%) and income tax (79%) (Lowery 2017).

To better understand the issues that come from excessive tax deductions, which we will call tax avoidance, we need to explore the incentives that cause individuals to participate in complete tax evasion. In addition to financial incentives for households and individuals to save money through deductions and or evasion, there are also socio-physiological elements to tax evasion that have significant effects on the number of individuals choosing to take part in evasion (Bazart 2014; Hashimzade 2013). Unequal levels of taxation and knowledge of other individual's income and taxation levels have been shown to influence the frequency and severity of evasion (Bazart 2014). Individuals will choose to accurately or inaccurately report their income depending on those around them and their decision to do so. When an individual knows the tax information of others in his or her tax group, they will choose to report their income closer to the group mean (Bazart 2014). This social behavior is prevalent regardless of whether or not an individual is in an advantageous or disadvantageous tax situation (Bazart 2014). Within the context of the art market it implies that an individual is more likely to donate art for a tax deduction when their friends in a similar tax situation do so, and becomes more prevalent when an individual is paying more in taxes than someone in the same tax bracket.

In most cases the idea of saving money on taxes is straight-forward and deductions for charitable donations can benefit more than just the donor. However as a society we need to address the question: is the deduction from non-monetary objects of equal social value and benefit to what their tax money would have contributed too? Because each donated work of art has a subjective value that is assessed by an appraiser and then after a period can be put back into the art market by the museum, art can be caught in a cycle of continuous increasing value, moving between private ownership and museums. When you take into consideration the exclusivity of the market and socio-economic factors that make the market highly responsive to high social standing and influence, which encourages selling art to the most high standing individuals and close business associates, we can see several financial and social results. First, we see that charitable deductions taken from art donations disproportionally benefit the wealthy while providing a benefit of subjective value to the receiving organization. Secondly, the tax deductions taken on these works of art have real world affects in collected U.S. federal income taxes that, while benefitting the wealthy, can negatively affect the U.S. tax base and organizations that receive funding from the government. Wealthy individuals donating art is not inherently insidious, but it can have a larger, more negative effect over time on U.S. tax revenues than deductions taken by the average American household.

One of the most concerning results of the existing U.S. tax code is that art collectors have the ability to own and operate private art museums. These museums can be located on the same properties as the homes of donors, and while they are required to be open to the public, the restricted visiting hours and location often dissuade others from visiting (Cohen 2015). What this allows collectors to do is donate art works to themselves, take the deduction, and then place the painting in a difficult to access public gallery.

The New York Times in 2015 reported on this issue, finding two examples: the Brant Foundation Art Study Center and the Glenstone Museum (Cohen 2015). Both museums are located in the northeast and are owned by private art collectors and are open a few days a week to the public, usually by appointment only. These museums are tax exempt and picturesque examples of a tax havens. The Glenstone Museum is located a short walk away from its founder's home on private property and its assets had a collective estimated worth of $702 million according to its 2002 tax return (Cohen 2015). These museums are being praised by many in the art world who defend their existence as "one of the most exciting developments in the international art world" (Cohen 2015). One of the most extreme examples given by the article is the Hall Art Foundation founded in 2013 by executive bank manager Andrew J. Hall. It is located on his private estate which is closed December through May. Between 2013 and 2015 the museum was visited by 1,500 people and has an estimated worth of $38 million in total assets (Cohen 2015). These museums do provide unique educational experiences for those able to visit, offering rotating collections from around the country. Most of the works donated to these private, estate-located museums are from private donors with some close connection to the museum founders. While museums such as these may be the exception and not the norm in the art world, it does raise red flags about the ethics and legal financial process of charitable donations.

Policy Revisions and Conclusions

Tax deductions can be a valuable source of additional income for some households; others whose annual contribution to the nation tax system are substantially greater than that of the average American household, deductions from charitable acts can be offset by lack of tax revenue. Fine art is a costly and exclusive source of tax deductions that is accessible to the wealthy (top 20%) and super wealthy (top 1% and above) American households. The art market is unlike other sources that contribute to charitable tax deductions due to its high level of internal regulation that lead to steady price increases in objects. Additional measures should be put into place to ensure that art donations are not exploited by the wealthiest within American society that could exploit the law for excessive tax deductions. A lack of participation in the tax system may benefit the individual but is a disservice to the communities and organizations that receive funding from federal sources.

In response to this information steps should be taken to reform the U.S. tax code to mitigate the risk of excessive tax avoidance through charitable donation deductions through stricter requirements on the donors and the receiving organizations. One way this might be done is to introduce a limit on non-monetary donations over a multi-year time period. Limiting the number of art works an individual house can donate for a tax deduction in a period of X years should ensure that a more affluent household is paying a greater portion of federal income tax while still contributing to the artistic community. A time frame that restricts the number of pieces donated should work as a deterrent to those looking to avoid taxation though non-monetary donation. This may incentivize individuals to look for other forms of tax deductions but it would lessen the risk of an excessive deduction due to the subjective value of an object. A policy such as this should allow the art community to prosper and may make the donation process to museums more lucrative as it would ensure that donors were donating paintings that better relate to that museums' mission statement.

Another possible reform to the charitable donations section of the U.S. tax code would be to limit the amount that individuals can deduct as their annual income increases and or increase the duration of the recapture tax period. Rather than a high-income individual being able to deduct up to 30- or 50% of their annual income depending on their situation, it would be beneficial to tax revenues to create a progressive deduction system where the wealthiest of Americans could only deduct 20- to 30%. This suggestion may be more detrimental to the artistic community as charitable donations of non-monetary objects would become less appealing to a donor seeking a deduction. A solution with a less damaging effect on the number of works being donated to museums would be an increase in the recapture tax period. By increasing the duration of the recapture tax, currently set at three years after the donation, donors would be incentivized to donate more relevant artworks to museums to lessen their risk of paying recapture tax in the event that museum decides to sell their donated object. In addition to an increase in mission statement-related work, a longer recapture tax period would provide additional revenue from the resale that would have originally been paid in capital gains tax if the owner had decided to sell the object themselves.

Our final suggestion is less theoretical and strongly recommends a ban on charitable donations to private museums founded and or indirectly owned by the donor. In the event that a donor owns a private museum that is not easily accessed by the public and displays a large number of works donated by the founder of the museum, it is really functioning as a private art gallery and does not meet the needs of a community as a public museum would. Though providing a mission statement with charitable intentions, these museums are a misinterpretation of a charitable organization as they prioritize an individual's financial savings and personal benefit rather than the benefit to a community. This violates §170(c)(2)(C) which stats that a charitable donation can only be given to an organization in which "no part of the net earnings of which insures benefit of any private shareholder or individual" (§170(c)(2)(C)). An alternative to a ban would be increasing the operating requirements of these museums to ensure that they lie within city limits, are open to the public the majority of the week, and if not easily accessible, provide transportation to and from the facility.

In general we see that there must be some steps taken to ensure a more stringent charitable deductions code within the United States that considers more than just the monetary worth of the object but also the donor's financial contributions to U.S. tax revenues and the market that each donated object is taken from. Further research can be done that uses donation information to look at empirical evidence of the effect that art donations has on the U.S. tax revenues, the value of donated art, what communities benefit from art donations. Exploring more into these areas will fill gaps in the lacking body of research that looks into the art market and its impacts on the U.S. economy. Areas of discussion that may be taken from the information we have presented should push individuals to look more critically at high class ‘luxury’ markets and the underlying tax structure that allows them to exist.

The U.S. art market is prosperous not only for the participating individuals who buy and sell art but also for those who are able to view paintings and sculptures in numerous museums around the country. To keep the practice of charitable donations and deductions fair and beneficial to the U.S. revisions must be made to ensure that deductions given to individuals under the name of charity are in fact worth their civic contributions to society.

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