

Not Considering the Importance of Charitable Giving

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This is Part 10 in a Series of the Top 10 Mistakes Made When Planning for Art and Other Collectibles: A Guide for Professionals and Their Clients.

When a client's family does not wish to inherit a collection or if its inclusion in the estate would create a significant tax burden, it is crucial to explore charitable giving options. Proper planning can help maximize the benefits of a donation while avoiding unintended legal and tax complications.

Ensuring the Charity Will Accept the Gift

While many clients may assume that institutions will welcome their generous donation, not every organization is willing or able to accept a collection. Before naming a charity as a beneficiary in estate planning documents or making a present gift, it is essential to confirm the charity's willingness to accept the donation and any conditions the client wishes to impose on its use. Establishing this agreement in advance can prevent post-mortem disputes and ensure the estate qualifies for the intended tax deductions.

Tax Benefits of Lifetime Charitable Giving

Beyond philanthropy, charitable gifting can provide substantial tax benefits. Clients should be advised on the income tax advantages of donating all or part of their collection during their lifetime.

A charitable income tax deduction is available for contributions of art and collectibles to a public charity, provided the property qualifies as **capital gain property** and meets the **related-use rule** (discussed below). If these conditions are met, the donor can deduct the full fair market value of the collection in the year of transfer, subject to a limit of 30% of their adjusted gross income (AGI). Any excess deduction may be carried forward for five years.

Since the property must qualify as **capital gain property**, a lifetime charitable deduction for the donation of art or collectibles is only available to clients who qualify as **collectors**. As noted in **Mistake #1** of this series, creators and dealers recognize **ordinary income** upon the sale of art and collectibles. Moreover, creators have little incentive to donate their work during their lifetime, as any charitable deduction would be limited to the cost of materials rather than the item's fair market value.

Under the **related-use rule**, the donee charity must use the donated property in a manner that aligns with its exempt purpose under **Internal Revenue Code Section 501**. If the charity's use is unrelated to its mission, the donor's deduction is limited to the property's cost basis rather than its appreciated value. Additional limitations apply under the **Pension Protection Act of 2006** if the charity sells the donated property within three years of receipt unless the organization certifies that the donation was used for its exempt purpose.

For the creator and dealer, it usually makes more sense to consider selling the item and donating the proceeds to charity. Doing so avoids the **related-use rule** and the requirement that the item be **capital gain property**. In such a case, the charitable deduction may offset, most if not all of, the ordinary income realized on the sale.

Public Charities vs. Private Foundations

Clients should also understand the key differences between donating to a public charity versus a private foundation.

- Donations to public charities allow a deduction based on the collection's fair market value, provided the collection is capital gain property and the related-use rule is met.
- Donations to **private foundations**, however, only permit a deduction based on the donor's cost basis, and the deduction is limited to 20% of AGI. Excess amounts may still be carried forward for five years.

Fractional Gifts and Changes Under the Pension Protection Act

One of the biggest challenges in lifetime charitable gifting is persuading clients to part with their collection while they are still alive to enjoy it. Before August 17, 2006, clients could donate a **fractional interest** in tangible personal property, allowing

them to share ownership with a charity while retaining partial possession. However, the **Pension Protection Act** introduced stricter valuation, time, and use limitations that impact the deductibility of fractional gifts.

Under **IRC Section 170(o)**, the deduction for a fractional gift is now limited to the lesser of:

1. The value used to determine the deduction for the initial fractional donation, or
2. The fair market value at the time of subsequent contributions.

Additionally, the donor must fully transfer their interest in the property within 10 years of the initial fractional gift or before their death—whichever comes first. The recipient charity must also take **substantial physical possession** of the item within one year of the initial gift (and within one year of any additional gifts) and satisfy the **related-use rule**. Failure to meet these conditions may result in the recapture of previous deductions, plus interest and an additional 10% penalty.

Charitable Bequests and Estate Tax Benefits

An outright donation of a collection upon death—whether to a public charity or a private foundation—qualifies for an estate tax charitable deduction based on the fair market value at the time of death. Importantly, bequests of tangible personal property generally do **not** trigger the related-use rule, making this a valuable option for clients seeking to preserve their collection's full value for charitable purposes. However, clients planning to donate a collection upon their death should always consult with the intended recipient during life to confirm the organization's willingness to accept the gift. A public charity's acceptance of art and collectibles typically depends on whether the donation aligns with its mission and whether it has the necessary facilities and financial resources to store or display the collection.