

Art Galleries - Audit Technique Guide

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Chapter 1 Introduction

Introduction To Art Industry

The creative process of the artist is constantly expanding the definition of what is a piece of artwork. The medium through which an artist works is likewise expanding.

An artist's work, during their life and later, may sell numerous times and be seen in galleries more than once. The sales value can vary from a small sum to millions of dollars such as with the work of Picasso, Van Gogh, etc. An artist may achieve notoriety during their life or may never achieve it; however, their works are of no less importance.

An artist may conduct their craft as their occupation as a for profit trade or business or as a not for profit activity. Income would be taxed as ordinary income and generally expenses would fall under IRC § 162, however for the activity deemed not for profit under IRC § 183 expense deductibility is limited to gross income. Refer to the [IRC § 183 Activities Not Engaged in for Profit Audit Technique Guide](#) for more information.

Once the artwork leaves the hands of the artist, it generally goes to one of four categories of persons, each of which have different tax considerations. They are the investor, hobbyist, business collector and dealer. Which category a taxpayer falls into would depend on the facts and circumstances of that taxpayer's case. The line between the above categories of holders of art for tax purposes is not always clear therefore there has been much litigation in the courts such as the distinction between investor and dealer or between an investor and a hobbyist. In addition, a taxpayer might hold art in different categories. For example, a dealer might hold specific pieces of art in their trade or business and other pieces of art as an individual investor. Additionally various expenses and losses in each category may or may not be deductible and likewise depends on the facts and circumstances. A taxpayer should consult with their tax advisor to determine the category they fall into and if any expense or loss is deductible and if needed, the examiner should consult with their subject matter expert. Following is a brief introduction to the four categories.

An investor is a person who buys sells and collects art solely as an investment with the hope the asset will appreciate to enable sale at a profit. For an investor, generally the art investment when sold is taxable as a capital gain unless it falls outside the definition of capital asset. IRC § 1221 defines capital asset to include all assets except (1) stock in trade or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business (2) property used in a taxpayer's trade or business that is subject to the allowance for depreciation or (3) an artistic composition held by the creator or a person in whose hands the basis of such artistic composition is determined by reference to the basis of the creator. A gift from an artist to anyone would fall under category (3) and be taxable as ordinary income property. A capital loss is available to an investor under IRC § 165(c)(2) if the intent test of entering into the transaction for profit can be proved; the taxpayer must prove the purchase and the sale of the artwork was a transaction entered into for profit. Many factors are looked at based on the facts and circumstances of the taxpayer's case however, the taxpayer's personal use and enjoyment of the artwork will generally be a critical factor showing the intent was not entered into for profit. The

expenses of the investments fall under IRC § 212 with respect to deductibility if an investor's primary intent was to hold the art for the production of income can be proved. The intent is established through facts and circumstances that various court cases have established. Like the loss issue, a critical factor is personal use and enjoyment. Not all expenses would be allowed under IRC § 212 such as expenses to prolong the life or increase the value of the work of art, selling expenses, etc. If IRC § 183(d) applies the activity is presumed to be for profit if the gross income exceeds the deductions in 3 or more years in a 5 year period. If not, then IRC § 183 may apply limiting the deduction of expenses if the activity is deemed not for profit activity. For more information on IRC § 183 refer to the [IRC § 183 Activities Not Engaged in for Profit Audit Technique Guide](#). An investor can be classified as a dealer or a hobbyist instead of an investor based on the facts and circumstances in their case. Sometimes investors want to be classified as dealers when they have losses to be able to deduct the loss as ordinary income rather than as a capital loss.

A hobbyist is a collector who buys art without considering whether it will ever be a profitable investment. The hobbyist rarely sells a work, which if sold generally is a capital asset in which gains are recognized but losses are not allowed (IRC §§ 1221 and 165(c) respectively). Expenses attributed to maintaining the collection are generally not deductible per IRC § 262 however IRC § 183 may allow some deductions up to the amount of gross income generated by the activity following the ordering rules of the IRC § 183. For more information on IRC § 183 refer to the [IRC § 183 Activities Not Engaged in for Profit Audit Technique Guide](#). Because of the tax disadvantage of being a hobbyist, the hobbyist tries to be classified as an investor.

A business collector does not buy the art for resale but rather for purposes such as office display or decoration in the ordinary course of trade or business. Art because the useful life is not determinable is generally not subject to depreciation. In addition, many businesses buy art for investment that can place them in the category of investor or hobbyist. The art investment can be of such a nature that they cross the line into being a dealer. Again, facts and circumstances need to be reviewed in each individual case to determine the categorization of the activity.

The dealer is one who buys and sells art as a trade or business. An art gallery is one of the types of dealers. Art dealers are taxed in the same way as any other retail operation. As such all income including income from the sale of art is taxed as ordinary income (IRC §§ 61, 64). Expenses if ordinary and necessary are deductible under IRC § 162. Dealers sometimes want to be classified as investors because of the favorable capital gains rates versus being taxed on said gains as ordinary income. Additionally dealers including gallery owners often wear the hat of investor in art as well as dealer in art keeping the two as separate activities. There are many court cases dealing with this issue such as *Williford v. Commissioner*, T.C. Memo. 1992-450.

An issue which many times creates problems for all the categories is the charitable contributions of art therefore under Chapter 3 Issues there is a special section highlighting resources and potential issues with respect to charitable contributions of art.

The remainder of this audit technique guides provides guidance on the examination of an art gallery.

Introduction on Art Galleries

The Art Gallery industry is very diverse. The term itself, gallery, conjures up a wide range of ideas to different people. To some it merely includes paintings, while to others it encompasses architecture, pottery, rugs, jewelry and more. As artwork and the media used is expanding by the creative nature of the artist, what is included in a gallery is likewise expanding.

An "**art gallery**" is one of the medium or outlet through which the works of art are marketed. It is the wholesale or retail establishment through which one can acquire ownership of an item of art either for personal enjoyment or resale. The art gallery has a physical location.

Galleries cater to the various types of works available. They may range from pure painting galleries showing only impressionist paintings to galleries that offer a wide range of products. Therefore, it is difficult to categorize galleries by art form.

Galleries also vary greatly in size. They range from having gross receipts of \$50,000 to over \$60 million. Some galleries hold vast inventories of over \$40 million, while others only take works of art on consignment, where the gallery sells the art for a commission but ownership remains with the artist until sold. Depending on the size of the gallery and dollar amount of the items sold, the activity of the galleries varies. Some galleries sell large amounts of low priced items, while other sell few, but high priced items.

Galleries have the ability to make the "unknown" artists popular in the industry. Galleries that represent the most popular and skilled artists have been able to reap the economic rewards without tying up large amounts of capital investment in inventory by selling on consignment.

Gallery owners are the key to the business. Some are experienced artists themselves, while others are collectors turned salespeople, or merely entrepreneurs seeking profits. However, the more knowledgeable the gallery owner is about the artwork, the clientele, and the market, the better the business will function. Galleries with similar art, prices, and location will succeed or fail, and the determining factor appears to be the owner of the business and his or her working knowledge of the industry. This one factor seems to determine the overall strength of the gallery.

It is difficult to monitor compliance with the tax laws by artists because art galleries are not required to report sales via information returns (Form 1099) whether they sell the art on a consignment basis, or carry inventory because as a retail establishment they are exempt from the reporting requirements of IRC § 2041 for property. Additionally, some artists prefer to use cash for personal living expenses and often deal in cash that makes gross income probes of artists challenging for any examiner. The examination of an art gallery will often provide related cases for unreported income of an artist on their return.

Common Potential Audit Issues of Art Galleries

The following are a few audit issues that may be found in the examination of an art gallery:

- Unreported income through cashed checks from galleries to the artists leading to related returns to be examined;
- Barter transactions between artists and others in the art field;
- Taxability and inventory valuation issues for trades amongst gallery owners and artists;
- Avoidance of state sales taxes by using certain schemes devised by art brokers to market the art in other states;
- Treatment of ordinary income as capital gains by mischaracterizing inventory as investments;
- Identification of sources who failed to file/report transactions through "cost of goods sold" by analyzing cancelled checks and payment/transaction records;
- Framing costs not properly capitalized;
- History of losses or very high travel and entertainment costs with low gross receipts indicative of potential Activity Not Engaged in for Profit pursuant to I.R.C. § 183;
- Sales of artwork disguised as "loans" secured by art as collateral and possible "money laundering";
- Other "financial status" indicators when an artist's or gallery owner's reported income is incompatible to his or her lifestyle;
- Potential issue on Non Resident Alien Artist, Art Galleries, Dealers and Brokers (International Referral Required);
- Artwork being deducted as a charitable contribution at fair market value rather than adjusted cost basis and/or not being taken out of cost of sales;
- Business use of the home.

Chapter 2 Examination Techniques for Art Galleries

Pre-Audit Considerations

There are several pre-audit steps involved when auditing an art gallery. The first is to determine if the gallery sells on consignment, from its own inventory, or both.

Galleries acquire artwork in many ways:

- The gallery's artworks may be on consignment. Consignment is popular because galleries need not spend any money acquiring artwork. If the artwork does not sell, then the gallery will return it to the artist and get a new piece. Since art is expensive, galleries do not want to invest their funds purchasing art. The gallery agrees to show the artist's work in exchange for a percentage of the purchase price. Usually, profits are split 50/50 so that both the artist and the gallery receive 50 percent of the gross. However, profits may be split as low as 70/30. Generally, the artist will not take less than 50 percent. Where the split is not equal, the gallery will earn the lower amount. The reason for the differing percentages may be the artist's choice, or the high cost to produce the work of art, which requires more funding. For example, a bronze sculpture is very expensive to cast. Therefore, the artist's costs are greater. The consignment method usually works well with living artists. The gallery will market the artist's work, pay for any local art guidebooks, and incur any show opening expenses. An art gallery's consignment receipt includes the terms of consignment, the actual agreement, the art objects on consignment, and is signed by both the consignor and the gallery.
- Artwork may also be owned by the gallery. The owner or buyer for the gallery will travel locally, regionally, or nationally to find art pieces at auctions, estate sales, private collections, and even other galleries. Many of these works of art are of deceased artists, so they must be purchased before resale. Other galleries specialize in certain types of artwork requiring them to own the pieces. Additionally, some living artists have enough influence to require the gallery to purchase their artwork.

When inspecting a tax return, consider cost of goods sold, inventory, and sales. Does the taxpayer have inventory? Is the inventory amount low in comparison to the cost of sales? Is there a consignment expense on the return? If so, then the gallery probably sells on consignment. Is the inventory amount high? Do purchases exceed the cost of sales? If so, then the taxpayer probably purchases the inventory. The gallery can have a combination of both consigned and purchased pieces. However, it is important to ascertain the type of gallery so that the right information is asked during the initial interview.

Be alert for I.R.C. § 1031 exchange (trade) issues. Section 1031 exchanges are not available for inventory or if personally created. Refer to Trades in Chapter 3 for more information.

A deduction for charitable contributions of art may be present on the return. Since art is an inventory item, the charitable contribution is limited to the lower of the fair market value on date of the donation or the adjusted basis. Inspection of the owner's individual return may show a charitable contribution of art, which is actually inventory of the gallery or a gift to the owner from the artist. In both cases, the donation would be limited again to the lower of fair market value on the date of donation or the adjusted basis. Additionally, there are strict appraisal and substantiation requirements with respect to charitable contribution of art. Refer to Charitable Contributions in Chapter 3 for more information.

An art gallery like any business that has a history of losses should be reviewed to determine if the business is an activity not engaged in for profit under I.R.C. § 183, which limits deductions. For guidance on this issue, please refer to the [I.R.C. § 183 Not for Profit Audit Technique Guide](#). [Appendix A](#) of said guide discusses in detail the factors stated in the regulations which are evaluated based on facts to help make the determination if IRC § 183 applies. [Appendix B](#) of the Guide includes interview questions with respect to each factor.

Other expenses and financial status for the gallery owner require review. There are basic questions that should be considered. Do the expenses fit with the type of gallery? If the gallery sells consigned goods, are travel expenses high, and why? Travel is normally associated with purchasing inventory. If there are no employees and the car and truck expenses are high, the reason should be ascertained. Again, this could mean travel to purchase inventory. Lastly, how does the gallery owner pay his living expenses if he receives no salary? Does he or she have another source of income?

An internet search on the gallery may provide information about the type of art the gallery exhibits and sells. This may help you tailor your interview questions.

Review the IRP (Information Reporting Program) report on the art gallery and its owner. Cash transactions are not uncommon in this industry therefore it is important to review the IRP report for FinCEN Form 104, Cash Transaction Report (CTR) and IRS-FinCEN Treasury Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business. If either is on the IRP, more information should be obtained from the Web Currency and Banking Retrieval System (WEBCBRS) if it is not already included in the case file. A CTR is used to report cash transactions (deposits and withdrawals) greater than \$10,000 involving various financial institutions. Financial institutions, including banks, savings and loans, credit unions and other non-bank financial institutions such as check cashers, and wire transfer companies, file the CTR. The CTR identifies the individual making the transaction, the person or organization for which the transaction was conducted, the financial institution involved in the transaction, and the amount of money involved. Form 8300 is a report of cash payments over \$10,000 (U.S. dollars or foreign currency equivalent) received in a trade or business. This form is filed by the business receiving funds, which includes retailers or businesses selling large ticket items, bulk inventory, and luxury goods. Form 8300 identifies the customer, provides a description of the transaction and goods, and also lists the method of payment.

Find other appropriate items for pre audit consideration on the [Internal Revenue Manual \(IRM\) 4.10.2](#), which is summarized on RGS Lead Sheet 110.

Initial Interview

Since the initial interview is one of the most important aspects of the audit, the interview should be held at the gallery. This provides an opportunity to tour the gallery and note the type of art on display. It is also important to have the owner of the gallery present during the interview. Almost all gallery owners have a "hands on" attitude and know their business well. They are familiar with the different types of artwork and the artists themselves. In some instances, owners may maintain the books and records themselves. Otherwise, it is common for a spouse, an employee, or an independent bookkeeper to prepare the books.

Exhibit 2-1 contains a sample Initial Interview. Since all galleries are different, it is important to tailor the interview to the type of gallery under audit, so use your own criterion in asking questions. Since the audit is at its starting point, it is the best opportunity to gain knowledge about the operation of the gallery and the gallery owner.

Information Document Request

The information document request (IDR) is the examiner's first and best opportunity to gather necessary information. Your initial IDR should include not only the usual request for books and records, but also a request for all records for consigned art received, returned, and sold during the taxable year. In addition, request all shipping records for the taxable year, and ask for canceled checks, especially those payable to artists. Examination of these checks will reveal if checks were deposited or cashed. If cashed, obtain copies of these checks (front and back) for possible research into the artist's return.

Obtain documentation to verify that purchased inventory is being properly valued, is deducted only in the period in which it is sold, and the full sales price is being reported.

Exhibit 2-2 contains examples of IDRs for galleries operating as sole proprietorships, corporations, and partnerships.

Typical Books and Records

The books and records found in galleries are the basic ones found in any industry since galleries use general ledgers and general journals. Large galleries will probably have all records, such as journals, ledgers, inventory records, and check disbursements in computerized form. Some of the smaller galleries may still use manual systems. There are several specialized computer programs available to art galleries that include an extensive inventory management module. Inventory management modules may include pictures of artwork, the piece's history, and information about the artist, among other things. Furthermore, inventory management modules may tie to web databases for potential buyers to review a gallery's inventory and make purchases.

Some items require careful consideration. The first item is inventory. If the gallery purchases its inventory, there should be a very detailed inventory listing showing the purchase date, the purchase price, any restoration and framing costs, the sales date, and price. Restoration and

framing costs are often times recorded separately. This expense is usually small in comparison to cost of goods sold. The inventory should be detailed enough for the auditor to follow any purchase from start to finish. However, inventory costs are not always properly recorded, and the accountant or bookkeeper may have adjusted the books to compensate for it. Additionally, the art gallery may attempt to write down their inventory to the lower of cost or market, which is only permitted in some cases, depending on the type of inventory and other considerations. Below is a more detailed discussion of inventory issues.

If the gallery sells on consignment, there will be a system in place to track consigned items. This system will generally contain the artist's name, his or her address, a description of artwork, the date on which the artwork was received by the gallery, the asking price by the artist, and any other specific terms. It also indicates the date the piece was sold, the sales price, and terms of the sale. Generally, the artist establishes the sales price. Oftentimes galleries sell items on an installment plan, which consists of a 25 percent down payment and three more payments, each of 25 percent of the sales price. When the full sales price is received by the gallery, the artwork is released to the buyer and final payment is made to the artist. Sometimes the artist will demand full payment at the time of sale even if the gallery has not yet received 100 percent of the sales price. This, however, is unusual and normally, the artist is paid when the gallery receives the full payment.

Some galleries have large amounts of cash on hand. If the gallery specializes in local art, many purchases will be from local or regional residents. Some artists do not have bank accounts and prefer to be paid in cash for any items sold to the galleries. Since cash can be easily mishandled, there should be good internal control over the cash drawer. There should be receipts or some other form of documentation for expenditures paid from the cash drawer. If there are any unusual expenses, or little to no documentation, there should be a more in-depth inquiry into the cash purchases.

Galleries usually issue numbered invoices prepared in duplicate or triplicate form. The invoice will reflect the buyer's name, address, date of sale, amount paid (if not fully paid), terms of any installment plan, sales tax, shipping charges, and framing charges if it is the type of artwork that would require framing.

Generally, artists provide galleries with unframed pieces. Galleries will have the option of using a local framing shop or doing the work internally, should they decide to frame the piece to enhance the sales price. However, it is usually noted on sales tags that the frame increases the purchase price.

Since sales to tourists and out of town customers often represent a sizable portion of a gallery's business, shipping costs can be quite substantial. This is normal, but since these costs are passed on the customer, it is important to verify that all shipping charges reimbursements (charges) paid by the customer are included in gross receipts. One method to test gross receipts is to randomly pull shipping bills and trace them to sales. Sometimes when a particular piece on consignment has not been sold and the gallery does not feel it will sell it, the piece will be returned to the artist, as gallery space is limited and expensive. Unsold pieces are typically shipped back at the gallery's expense or the artist will personally pick it up.

Package Audit

The package audit process in the artists and art gallery industry is very similar to that of any other audit. Examiners must inspect related returns, employment tax returns, as well as prior and subsequent year returns. There are a few items to particularly note.

- **Corporate officers are employees:** The first item to note is whether the corporation is paying its officers as employees or as independent contractors. Sections 3121(d)(1), 3306(i), and 3401(c) state that any officer in a corporation is an employee. If an officer is being treated as an independent contractor, an adjustment should be made to convert officers to employees and assess the applicable taxes against the corporation. Corporations engage in this conduct to solve cash flow problems. For example, if a corporation's cash flow is poor, it is financially beneficial for an employer not to pay its officers' Federal Insurance Contributions Act ("FICA") taxes and have the officer file a Schedule C on his or her individual income tax return.
- **Self Rented Property and Passive Activity Losses, PAL:** Net rental income from self-rented property is recharacterized as nonpassive per Regulation 1.469-2(f)(6). If a taxpayer rents property owned personally or by a flow-through entity, to a business in which he materially participates, net rental income is nonpassive and should not be reflected on Form 8582 triggering the allowance of otherwise nondeductible passive losses. Any net rental losses from self-rented property remain passive—they are not recharacterized as nonpassive.
- **Consideration of the sale of artwork by the gallery owner as an investment** that is recorded as a capital asset sale on the Schedule D of their individual return should be reviewed to determine if the characterization of the asset is correct and is being reported in the proper location on their return. The art may not be an investment but may be an inventory item from the gallery they own or an artwork that was gifted by the artist, both of which would be ordinary income property and not a capital asset. This action may be motivated to offset capital losses, avoid paying additional self-employment taxes, and use capital gains income to offset more investment interest expense. Examiners must be aware of the purchase date, the holding period, and the amount of sale. Especially in the case of corporations, gallery owners may be operating a second business on the side so it is important to verify where the artwork was kept. Was it immediately put up for sale? Was it an investment, or was it the purchase of inventory? Was it a gift from the artist?

Audit Procedure

Three items to consider are income, inventory, cost of goods sold, and expenses.

Income

Because art is not a homogenous product, the sale of artwork is a specific item business. Tracing specific item sales to their source is easier than for non-specific items. Income and cost of goods sold can be verified together. Generally, reported income will match the gallery's receipts since

except for the rare occasion where there is a mistake; income usually flows from the books to the return. While looking into income, the examiner should be aware of any odd or unusual items.

Trades are a common income issue. Trades are when a gallery or artist trades inventory with another gallery or individual and they are taxable events. More information on Trades is found in Chapter 3 Issues.

The [Internal Revenue Manual Section 4.10.4.3](#), Minimum Requirement for Examination of Income, which is summarized on RGS Lead Sheet 400, should be consulted.

Inventory of Art Galleries

Inventory is usually the single largest item on the balance sheet and it absorbs the majority of a business' operating capital. Usually, a complete and accurate record of inventory is kept. However, this is not always the case. For example, precise records may not be available when there has been a purchase for a large amount of artwork at one time from one person, and when no actual controls are placed on the purchase, and therefore, there is no actual assignment of cost per item. Normally this will be evident from unbalanced books at year end. Since an item's exact cost is unknown, galleries may assign it to high or too low a cost. It is reasonable to assume that the gallery will not underestimate its cost. When ending inventory is understated because of this method, an opposite account, such as an income account, will be understated, resulting in a need to have an adjustment to both accounts to correct the understatement.

Another method used by taxpayers to account for inventory is to attribute to it a percentage of items sold during the year. The percentage is usually determined by the previous years' cost of sales percentage. As items are sold during the year cost of goods sold is booked at that percentage. At year-end, when ending inventory is physically calculated, an adjustment is made to the cost of sales ("COS"). Since total purchases, as well as the audit year's beginning and ending balances for inventory are known, the adjustment to COS will be accurate. This is a good method for accountants or bookkeepers to use. Although somewhat confusing at first, this method renders accurate results.

Unfortunately, since examiners are not physically present at the audit year's inventory verification, they have limited courses of action if there is an inventory problem. A possible solution is to disallow adjustments that affect current year book balances. Since most errors would stem from prior period adjustments, if there is a tax effect, it would occur in a prior year.

Some gallery owners value their inventories using the lower of cost or market ("LCM") method. Under the LCM method, the market value of an inventory item is its replacement cost, or the price the gallery owner would have to pay on the market to repurchase the item at the date of inventory. See Treas. Reg. 1.471-4(a)(1); *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 534 (1979).

Additionally, for items where there is no active or open market, gallery owners may use the fair market price. However, gallery owners must substantiate estimates of fair market prices made in good faith by providing objective evidence, such as specific purchases or sales of the item in a

reasonable volume. Where gallery owners, in the regular course of business, have offered the item for sale at a price lower than the current market price, the inventory may be valued at such a price, less the direct cost of disposition. The correctness of estimated fair market price is determined by reference to actual sales of the item by the gallery owner for a reasonable period before and after the date of the inventory. *See Treas. Reg. 1.471-4(b); Thor Power Tool Co.*, 439 U.S. at 434-35.

Thus, in cases where an open market exists, such as in cases involving mass produced works, gallery owners may establish the market price of an inventory item through its replacement cost. In cases where there is no open market or where quotations are nominal due to inactive market conditions, such as in the case of "limited edition" work, gallery owners may establish a market price with the use of objective evidence. This evidence should stem from specific purchases or sales of the work by gallery owners or others. However, in cases involving a unique work of art, it will be extremely difficult for gallery owners to establish a market price with objective evidence. For example, gallery owners must offer the art piece for sale in the ordinary course of business and support the correctness of the fair market price by an actual sale within a reasonable period after the date of the inventory. Absent such objective evidence, the proposed fair market price is disregarded.

If the trade or business involves unique works of art, the last in, first out ("LIFO") method of inventory would not be appropriate.

Cost of Goods Sold

Costs of goods sold is probably going to be the most significant adjustment to gross income. While looking at cost of goods sold, trace items back to the time of purchase to determine what was bought and at what price. Most galleries pay for large purchases by check, facilitating the verification process. The examiner should be alert for items that disappear from the inventory record since these may be items that are sold but that remain unreported as income. This verification process requires a significant amount of time so it should only be done if it appears to be necessary.

For sales of consignment items, a different approach is taken. Since artists are not offering a service, galleries are not required to complete a Form 1099 for the payments made. However, artists should receive a consignment check either monthly, at the time of sale, or at a time specified in an agreement between the artist and the gallery. It is, thus important to consider what the artist does with the check. Is the amount cashed or signed over to a third party? Canceled checks should be inspected for signature and deposit marks. Cashing checks has been a good indication that the artist may not be reporting all sales as income. This review process has been an excellent source of "leads" for unreported income cases which might have indication of fraud.

A problem that may arise is locating the artist. In this situation, the first step is to obtain the information the gallery may have on the artist, such as their full name, mailing address, phone number, and SSN, if possible. If the gallery does not have the artist's SSN, then research Integrated Data Retrieval System, IDRS. Also verify IDRS to determine if the artist filed a tax return, and if they did, if the sale was reported on their individual tax return. If there are

indications of substantial unreported income, and the artist is in your local area, consider opening the artist's return for examination. If the artist is outside your area, prepare a referral to the Planning and Special Programs, PSP, in the artist's area attaching any proof of the unreported income such as the copy of a cancelled check.

One last item to review in cost of sales is whether a gallery owner personally sells any items. It is possible that the owner may have sold a piece and not reported it on his or her own tax return, or reported it as a capital gain item on his return when it forms part of the gallery's inventory and should be reported as ordinary income property of the business.

Expenses

The expenses will vary significantly between galleries depending on their source of supply and on whether they aggressively market through various art shows, exhibitions, and private showings. Travel may be a large expense item and the scope of the audit would depend on the examiner's assessment of the gallery owner's overall operations. More information on gift, travel, transportation, and meals and entertainment expenses are found in IRC §§ 162, 274, Treasury Regulation 1.275-5T, [Publication 463 \(Travel, Entertainment, Gifts and Car Expenses\)](#) and [Publication 946 \(Depreciation - section on Listed Property\)](#). Additionally [Revenue Procedure 2010-51](#) provides rules for the use of standard mileage rates and mileage allowances for reimbursement of an employee's ordinary and necessary expenses traveling locally and away from the home and [Revenue Procedure 2010-47](#) provides rules for the use of per diem rates.

Other significant expenses could include framing and restoration costs. These should be capitalized not expensed when they become part of the sellable product (inventory).

Art brokers/agents may be paid commissions by gallery owners for securing various items of inventory or by artists for marketing their works. In any event, this expense can be found on the tax return of the gallery as an expense and on the broker/agent's return as income.

Exhibit 2-1 Sample Initial Interview –Art Galleries

The initial interview should be tailored to the particular taxpayer under examination. No pro-forma style of interview or "check sheet" approach is recommended or even suggested in this guide. Below are some suggested sample interview questions that can be included in the examiner's own interview format for art galleries.

General Questions

- What type of art items do you sell?
- How many locations do you sell from?
- Do you have any special sales events away from the store?
- What is the average price of a piece of your artwork? What is your price range?
- Do you keep a record of inventory?
- What form of payment do you receive: cash, check, or credit card?
- Do you sell on credit? What are the typical credit terms?

- Do you have a customer mailing list?
- Do you engage in any trades or exchanges of merchandise?
- If so, what are the terms and conditions of such trades?
- How often did trades take place during the year(s) under examination?
- How are trades transactions recorded in your books and records?
- Can you provide a sample of a typical trade transaction, including book entries recording the exchange?
- Do you sell on the installment basis or through layaway sales?
- When and how are layaway and/or installment sales recorded?
- How many artists do you represent/showcase in the gallery?
- Do you know of any other galleries that represent the same artists? If so, can you supply the names/locations of these galleries and the artists they represent?
- Do you ever host exclusive showings or hangings for artists who consign their work to your gallery?
- How are exclusive events handled?
- Who is responsible for travel, facilities, and other related expenses?
- Do you own art as a personal investment? If so, do you have any of your personal collection or individual pieces on display in your gallery?
- Are personal items for sale and do you price them yourself or does someone else price them?
- How do you keep personal items separate from your regular inventory of gallery owned or consigned merchandise?

Consignment Questions

- Do you sell on a consignment basis?
- What are the terms and conditions of payment upon sale?
- Who sets the prices on each item of consigned merchandise?
- If you sell on consignment, what artists do you represent and how are profits split?
- How do you pay the consignor for the merchandise? Cash, check, or other form of payment?
- When do you pay the consignor for the merchandise?
- When do you pay for art that is sold: at the moment of sale, when sales proceeds received, or some other time?
- If you pay in cash, what record is kept of the transactions?
- Do you have any particular artists who insist on being paid in cash and how do you handle these artists' requests?

Purchased Inventory

- If you purchase artwork, who are the artists? Can you provide a list of the artists for the year (state examination year)
- Do you travel to find artwork? If so, where: statewide, regionally, nationally, internationally?
- Do you purchase from collectors? If so, do you have their names and addresses?
- Do you attend to auctions?

- Do you purchase items such as jewelry or pottery from walk in vendors? If so, do you pay in cash or check? How do you keep a record of cash purchases?
- Do you keep an accurate inventory of all goods held for sale?
- What inventory method do you use? Specific Item, FIFO, LIFO, LCM or a hybrid method.
- What type of records do you keep of your inventory of goods held for sale?

Framing Costs:

- Who frames your art pieces?
- Do you primarily use one framing company?
- How do you record your framing costs?
- If a customer wants an item custom framed, do you supply the framing? How is the cost of framing recorded if done separately from the purchase price?
- Is the framing cost shown on your sales invoice?
- What is your policy on shipping merchandise?
- Do you use one or more shippers (UPS, Fed Express, etc.)?
- Who pays for shipping costs, the gallery or the customer?
- How are shipping charges recorded?

Exhibit 2-2 Sample Information Document Request Items

For Partnership Return (Form 1065)

- Partnership Agreement
- Workpapers used in preparing the tax return.
- Books and records, such as ledgers and journals for sales and/or purchases
- Information showing beginning and year end balances for loans receivable and other amounts owed you.
- Information showing beginning and year end balances for all outstanding liabilities.
- Records to substantiate all accounts receivable and accounts payable at the beginning and end of the year.
- Bank statements, canceled checks, and deposit slips for all accounts for the year under audit and the months preceding and subsequent.
- Copies of Form 1065 for all years under audit.
- Copies of Forms 940, 941, and W-4 for all years under audit.
- Copies of Excise tax returns filed, e.g., Forms 720, 2290, etc.
- Copies of general partners' returns for all years under audit.
- Pension-Trust Forms 550, a copy of the gallery's plan, and determination letters, if applicable.
- Worksheets used to reconcile the books to the Gallery's tax return.
- Detailed depreciation worksheets.
- Accountant's Workpapers regarding:
 - Year-end worksheet reconciling books to return,
 - Year-end adjusting journal entries and closing entries,
 - Cost of goods sold,

- Beginning and ending inventory valuations,
- Copies of financial statements prepared for internal use,
- Any accounts analyzed by the gallery at year-end or for certified financial statements
- Contracts relating to guaranteed payments.
- List of names, addresses, and SSNs (if applicable) of all artists the gallery has purchased inventory from or made consignment payments to during the years under audit.
- All sales and purchase records including invoices and receipts for the years under audit.
- State sales tax returns for the years under audit.
- Substantiation, such as canceled checks or receipts for the following expenses deducted on your tax return:

For S Corporation Return (Form 1120)

- Corporate minute book/stock records book.
- General ledger and subsidiary ledgers, if applicable, i.e., sales, purchases, accounts receivable, accounts payable, etc.
- Chart of Accounts
- Cash receipts and disbursements journals, i.e., check register.
- List of beginning and ending balances for accounts payable and accounts receivable for the years under audit.
- Detailed depreciation sheets.
- Accountant's workpapers regarding:
 - Year-end worksheets reconciling books to return,
 - Year-end adjusting journal entries and closing entries,
 - Year-end bank reconciliations,
 - Cost of goods sold,
 - Beginning and ending inventory valuations,
 - Copies of financial statements prepared for internal use
 - Any accounts analyzed by the gallery at year-end or for certified financial statements
- Copies of prior and subsequent year tax returns
- Copies of all officers and shareholders' federal individual tax returns for the years under audit.
- Bank statements and canceled checks for the year under audit plus the month immediately preceding and subsequent.
- Forms 940, 941, W-2, and 1099 for the years under audit
- Any excise returns required to be filed.
- Pension-Trust Forms 5500, a copy of the gallery's plan and determination letters of applicable.
- Worksheets utilized to reconcile the books to your tax return.
- Records of all loans and repayments including loans to and from shareholders and also accounts receivable, if applicable.
- List of names, addresses, and SSN's (if applicable) for all artists the gallery has purchased inventory from or made consignment payments to during the years under audit.
- All sales and purchase records including invoices and receipts for the years under audit.

- Copies of state sales tax returns for the years under audit.
- Substantiation, such as canceled checks or receipts for the following expenses deducted on tax return:

For Individual Return (Form 1040)

- Copies of federal income tax returns for the years under audit.
- The following employment tax returns for the years under audit, if applicable: Forms 940 and 941; Form W-4 for all employees.
- Information returns (Form 1099) you were required to file for the year under audit, if applicable.
- Returns for any partnership, corporation, or trust in which you are a partner, shareholder, or beneficiary for the years under audit.
- All records used to determine income on the income tax return for the year under audit, such as Forms 1099 and W-2 received and books and records used to record income.
- Substantiation, such as a canceled checks or receipts for the following expenses deducted on your tax return:
- All bank statements, canceled checks, and deposit slips for the taxable years under audit. (This includes checking and savings accounts, both business and personal, for both spouses.)
- All sales and purchase records including invoices and receipts for the years under audit.
- All inventory records for the years under audit
- State sales tax returns for the years under audit.
- List of names, addresses, and SSN's (if available) for all artists the gallery has purchased inventory from or made consignment payments to during the years under audit.
- Access to all invoices.
- Information regarding nontaxable income received in the year under audit (Please include the amount received and the source of the income.)
- Invoices for all assets purchased during the year under audit.
- Information about outstanding loans for the year under audit. (Copies of notes, amounts paid, and amounts received on notes.)

Chapter 3 Issues

Trades

Trades are a common income issue. Trades are when a gallery, dealer, or artist trades inventory with another gallery or individual. Trades are treated in one of three ways:

- Recorded on the books as nontaxable. The basis of the new item received is the same as the item given up plus any boot received. Boot received would be reported as income.
- Recorded as a taxable event. The basis of the new item is its fair market value, or cost.
- Hybrid method using parts of both methods.

For the following reasons, the proper treatment of trades is to record them as taxable events:

- Section 61 defines gross income as income from whatever source derived. The regulations state:

Treasury Regulation 1.61-1

Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in case.

- In *James A. Lewis Engineering, Inc. v. Commissioner*, 39 T.C. 482 (1962), aff'd. 339 F.2d 706 (5th Cir. 1964), the court ruled that income includes the fair market value of assets received.
- Section 1031 allows for the tax free exchange of like kind assets. However, I.R.C. § 1031(a)(2)(A) makes an exception for stock in trade held primarily for resale (therefore, it excludes inventory).
- Furthermore, under Treas. Reg. 1.1001-1(a), gain or loss is realized when property is exchanged for other property "differing materially in either kind or extent." In *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), the Supreme Court held that exchanged properties are "materially different" when "their respective possessors enjoy legal entitlements that are different in kind or extent." The owner of a work of art enjoys different legal entitlement than the owner of another work of art. Each owner has a pecuniary interest in and is entitled to sell a unique piece of property. Therefore, trading artwork for other artwork is an exchange of materially different property.

The law then clearly dictates that in the exchange of inventory, income must be recognized up to the amount of the fair market value of the asset received.

Despite clear law on the recognition of income from the exchange of inventory, trades are still often treated as nontaxable events with the industry claiming they have always done it this way and/or that fair market value is hard to determine. Irrespective, an adjustment to a taxable event is required.

Business Use of the Home, I.R.C. § 280A(c)

Most art galleries are located in buildings separate and distinct from the business owner's personal residence. However, for some art galleries, the business use of the home deduction is available just like for any other business. Taxpayers are entitled to an I.R.C. § 280A(c) deduction if they use a part of their home regularly and exclusively:

- As their principal place of business for any trade or business,
- As a place to meet or deal with their clients, or customers in the normal course of their trade or business, or
- In the case of a separate structure not attached to their home, in connection with their trade or business.

The deduction is limited to gross income derived from the business.

Please reference [Publication 587, Business Use of the Home](#), I.R.C. § 280A, Treasury Regulation 1.280A-2, and Proposed Treasury Regulation 1.280A-2 for more a more detailed explanation.

For further guidance, see the following court cases discussing I.R.C. § 280A(c):

Cunningham v. Commissioner, T.C. Memo. 1996-141, affd. 110 F.3d 59 (4th Cir. 1997), defines a dwelling unit. An art gallery occupied the basement and ground level floors of a building, where the second floor was a lawyer's residence. The building contained no permanent partitions or walls that physically or functionally separated the areas. Deductions attributable to the business were limited to the gross income derived from the business.

In *Burkhart v. Commissioner*, T.C. Memo. 1989-417, the Court found that the basement of the building where petitioners resided, which was used as a photography studio, was part of, and not appurtenant to their dwelling unit, within the meaning of I.R.C. § 280A(f)(1). Therefore, deductions attributable to the business were limited to the gross income derived from the business, I.R.C. § 280A(c)(5).

Horton v. Commissioner, T.C. Memo. 1997-572, decided a case where an artist resided on the second floor level of a converted commercial building and had an art/fine art business on the first floor level. The Court ruled that there is no exception to the limitations of I.R.C. § 280A(c)(5) for a building zoned for commercial use and which was formerly exclusively used for commercial purposes.

Charitable Donation Of Artwork Issues

The computation of the amount of a charitable contribution, limitations that affect the amount of the allowable deduction and other aspects of charitable contribution are beyond the scope of this Audit Technique Guide. Please refer to IRC Code 170 and the respective regulations as well as [Publication 526, Charitable Contributions](#) (PDF), [Publication 561, Determining the Value of](#)

[Donated Property](#) (PDF), and [Publication 1771, Charitable Contributions Substantiation and Disclosure Requirements](#) (PDF) for detailed information on charitable contributions.

However, there are issues involving charitable contributions of artwork that the examiner should be aware of. Below is a brief description of these issues.

Charitable Donation of Artwork by Art Galleries, Dealers or the Artist who created the artwork

The charitable contribution deduction for artwork by Art Galleries, Dealers or the Artist who created the artwork is generally limited to the smaller of fair market value on the date of contribution or its adjusted basis. In addition, an adjustment to cost of goods sold must be done to prevent a double deduction.

A charitable contribution deduction under IRC §170(a) is generally based upon the fair market value of the property at the time of the contribution (Treas. Reg. § 1.170A-1(c)(1)). If a sale of donated property would have generated ordinary income or a short term capital gain, the amount otherwise deductible is reduced by the amount of ordinary income or short term capital gain that would have been recognized (IRC § 170(e)(1)(A)). Treas. Reg. § 1.170A-4(b)(1) states: “The term ‘ordinary income property’ means property any portion of the gain on which would not have been long term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization. Such term includes, for example, property held by the donor primarily for sale to customers in the ordinary course of his trade or business, a work of art created by the donor ***”. IRC § 1221(a)(3)(A) excludes from treatment as a capital asset certain property in the hands of the person who created it. For example, art created by an artist is ordinary income property in the artist's hands.

Charitable Donation of Artwork by Investor

Generally, an investor is allowed a charitable contribution deduction for the donation of long-term capital gain property equal to the property's fair market value. Reductions and limitations to the allowable deduction may be required under IRC §170 under various situations. Treas. Reg. § 1.170A-1(c)(2) states that “fair market value” is “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.” Numerous issues arise in this arena.

Where artwork is donated to a charitable organization by an Art Gallery owner or a Dealer in artwork, a possible issue is whether the artwork being donated is actually held as an investment or is it inventory of the owner? The charitable contribution deduction for the long-term capital gain property is generally its fair market value, while the deduction for a contribution of inventory is limited to the lower of cost or fair market value (see discussion of donations by Art Galleries, Dealers or Artists above).

The deduction for artwork that was gifted by the artist who created it to the investor is generally limited to the smaller of the gift basis or the fair market value on the date of the charitable

contribution. Under IRC § 1221(a)(3)(C), the property retains its character of ordinary income property as it would to the artist who gave it. IRC § 1015 states that the basis of property acquired by gift is determined by the basis in the hands of the donor (the artist). IRC § 1221(a)(3)(C) excludes from being a capital asset property held by “a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B).” Subparagraph (A) describes “A taxpayer whose personal efforts created such property.” Therefore, the amount of the charitable contribution deduction follows the rules discussed above under artwork donated by the artist except the basis is the gift tax basis (artist basis adjusted for any gift tax under IRC § 1015(d)). A taxpayer who donates art after obtaining the artwork by inheritance (regardless of whether it was part of the estate of the artist) is generally allowed a deduction for the fair market value of the artwork.

Issues with Respect to Appraisals and Valuations

- All taxpayer cases selected for audit that contain artwork with a claimed value of \$50,000 or more per item must be referred to Art Appraisal Services for review by the Commissioner’s Art Advisory Panel. [IRM 4.48.2](#) provides this mandate and the procedures and information needed to make the referral. Even if the value is under \$50,000, the Art Appraisal Services will assist the examiner upon request.
- A contemporaneous written acknowledgment from the donee is required for donations of \$250 or more. For claimed charitable contributions over \$500 for property donated, Form 8283 must be attached to the return and the taxpayer must maintain certain records. Other substantiation rules can be found in IRC 170(f)(11), Treas. Reg. §§ 1.170A-13(b) and (c), 1.170A-13(f), and Notice 2006-96, 2006-45 I.R.B. 902.
- For a charitable donation of property in excess of \$5,000 the donor has an additional requirement of obtaining a “qualified appraisal” (IRC 170(f)(11)). Form 8283 requires that the appraisal for donated art valued at \$20,000 or more must be attached to the return. For property valued at more than \$5,000, an appraisal summary must be attached to the return. IRC § 170(f)(11)(D) requires that all appraisals in excess of \$500,000 be attached to the return. The specifics of “qualified appraisal” requirements as well as “appraisal summary” and other related requirements can be found in IRC § 170(f)(11), Treas. Reg. § 1.170A-13(b) and (c), and [Notice 2006-96, 2006-45 IRB 902](#).
- A charitable donee is required to file form 8282 if it sells, exchanges, or otherwise disposes of (with or without consideration) charitable deduction property (or any portion) within 3 years after the date the original donee received the property. The form is filed with the IRS and provided to the donor of the property. A third party contact should be considered to determine if the form 8282 was required and not provided.
- In order for a taxpayer to claim a deduction for the full fair market value of tangible property donated to charity the property must be used by the charitable organization in a way that is related to its charitable purpose. See IRC § 170(e)(1)(B)(i) and Treas. Reg. § 1.170A-4(b)(3). Art is generally related use property for an art museum, and perhaps a school, but probably not for a rescue organization. See IRC § 170(e)(7) for capture of the deduction on certain dispositions of exempt use property.
- It is possible to claim a deduction for a donation of a fractional interest in art, but immediately before the donation the property must be wholly owned by the donor or

shared by the donor and the charity. Special valuation rules apply to subsequent fractional gifts. The deduction may be recaptured if the gift is not completed within the earlier of 10 years after the initial fractional gift or the date of the donor's death. IRC § 170(o).

- Section 6695A imposes penalties on appraisers in certain circumstances. Section 6662 provides accuracy related penalties on the donor.

Other Areas

The following areas of concern are not necessarily unique to the art industry:

First, examiners should consider whether corporate officers are unreasonably compensated for the duties performed.

Second, examiners should ensure that expensed travel is not personal in nature. As mentioned in the preaudit section, travel will often be a significant item in the art and art gallery industry. Gallery owners travel to buy, sell, and track art. Examiners must be cognizant that only the owner's travel expenses are deductible, not including the expenses of family members. Additionally, some expenses in trips to vacation locations such as Hawaii, California, Florida, or Colorado have the potential to be personal in nature, and should be disallowed as such.

Non Resident Alien Issue

Non Resident Alien (NRA) income may be

- Fixed determinable, periodic, annual (FDAP) income subject to withholding;
- Effectively connected income which would not be subject to withholding but would be reported and taxed on an income tax return (1040NR); or
- Income exempt from US tax through statutory exceptions or through operations of an income tax treaty.

Taxability and withholding would depend on the manner in which the NRA structures his or her affairs. Examiners should obtain all the information available about the foreign artist/art gallery owner, dealer or broker and prepare a referral to International for assistance.