

ART AND ANTIQUE ESTATES: A GUIDE TO PLANNING FOR LIFE AND DEATH

Comment

*by Michael Campbell**

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I. INTRODUCTION

Whether it is fine art, antique furniture, classic movie posters, or baseball cards, nearly everyone collects something. But what does this mean in terms of

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estate planning? When art and collectables are not properly handled, the potential for loss is proliferated.¹ Many collectors do not view themselves as collectors and most estate planners are not particularly well versed in art succession planning.² Often times, for lack of better classification, unsuspecting planners simply lump such collections into the “personal effects” category.³ Art is a special asset and includes many different legal aspects: title, valuation, provenance, restoration, insurance, taxes, and several others.⁴ In addition, art tends to hold a special place in the heart of its owner, making planning for art succession an even more important and more personal issue than planning for mere stocks and bonds.⁵

This comment will explore three broad topics: the current art market; art as an investment while a client is still living; and estate planning for a client’s art estate.⁶ Part II will provide an overview of the art market as of 2011, espousing the viability of the market as a prudent investment vehicle.⁷ This section will also address the issues associated with the current lack of art-specific estate planning.⁸ Specifically, Part II will address common fallacies that estate planning practitioners are likely to run into.⁹ Part III will look at the options available to clients who wish to maximize the value of their collections for benefits while they are still living.¹⁰ However, much of this discussion will carry over to Part IV.¹¹ Part IV will set out a framework to adequately plan for succession of a client’s art estate.¹² This section will address the basic taxation issues that a client may face, but it will not provide any specific calculations, as the tax code is ever in flux, tending to change year by year.¹³

II. THE CURRENT ART MARKET AND THE IMPORTANCE OF PLANNING

“The alchemy of what’s selling, or not, can swing wildly in any given season depending on what turns up in the marketplace[.]”¹⁴ However, despite

1. See The Complex Estate, *What Every Serious Collector Needs to Know About Art Succession Planning*, INKNOWVISION 1 (May 8, 2012), <http://thecomplexestate.files.wordpress.com/2012/05/what-every-serious-collector-needs-to-know-white-paper.pdf> (“The problem is that collectors and their families can lose, at minimum, as much as 75% in the value of the collection if upon death items are sold through traditional means.”).

2. See *id.* at 1–2.

3. *Id.*

4. See *id.* at 2.

5. *Id.* at 2–3.

6. See *infra* Parts II–IV.

7. See *infra* Part II.

8. See *infra* Part II.

9. See *infra* Part II.

10. See *infra* Part III.

11. See *infra* Part IV.

12. See *infra* Part IV.

13. See *infra* Part IV.

14. Kelly Crow, *How Strong is the Art Market*, WALL ST. J. (Oct. 4, 2012), <http://online.wsj.com/news/articles/SB10000872396390444004704578032260118484392>.

the current economic climate, the art market is on the rise, and the importance of proper care and planning cannot be overstated.¹⁵

A. The Current Market

Though the American and European markets have slowed over the past few years, countries like Brazil, Russia, India, China, and South Africa (BRICS) have continued to see strong economic growth, as some of these emerging economies are beginning to see the enormous economic potential of art.¹⁶ Nowhere has the growth in the art market been more prevalent than in China and other Asian markets.¹⁷ “This growth has been driven by the emergence of new and very wealthy collectors and a growing number of art investment funds. As a result, the Asian art market has become the most high-end area of the entire globe.”¹⁸ In 2011, there was \$11.5 billion in total global art auction revenue.¹⁹ This “total [revenue] exceeded \$10 billion for the first time ever, and grew 21% versus 2010.”²⁰ “In fact, for 2011, the Mei Moses World All Art Index (which tracks art sales across several categories) returned 10.2% while the S&P 500 Index returned 0%.”²¹ Overall, 2011 was a remarkable year for the art market, reflecting its viability as a prudent investment, especially in troubling economic times.²²

B. The Importance of Planning

The nature of art succession requires intensive planning to yield the most effective outcome.²³ Despite this requirement, “data intake questionnaires of several of the top estate planning law firms in the United States [indicate that], without exception, there has not been a line item inquiring about art, antiques,

15. See Thierry Ehrmann, *Art Market Report 2011*, ARTPRICE.COM 1, 6 (Feb. 27, 2012), http://www.meadcarney.com/user/documents/market_data/download_url/5/art-market-report-2011.pdf. “The debt crisis coupled with the turmoil on financial markets has driven numerous investors to fall back on art[,] which has once again played its historical role as a value haven.” *Id.* at 6. “In 2011, the global art auction market generated 21% more than in 2010[,] and there is not a single segment of the art market that did not progress in terms of turnover.” *Id.* at 3–4.

16. See *id.* at 3.

17. See *id.*

18. *Id.* “Asia, which accounted for 43% of the global art market, sold 19% of its auction lots for more than \$100,000.” *Id.* at 21.

19. See *id.* at 20.

20. *Id.*

21. K. Eli Akhavan, *Artfully Deferring Taxes*, 26 PROB. & PROP. 59, 59 (July/Aug. 2012).

22. See Ehrmann, *supra* note 15, at 20. The global unsold rate dropped below 35% for the first time since 2008. See *id.* Approximately 1,688 pieces sold at above \$1 million, representing a 33% increase over 2010. See *id.* at 21.

23. See Randall Willette, *Art Succession Planning*, 17 STEP J. 47, 47 (2009) (“[T]oday’s art investors require a comprehensive art succession plan tailored to their private collection, which will preserve and protect the value of their art assets for future generations.”).

or collectables.”²⁴ This problem is further compounded by the fact that many collectors do not even consider themselves collectors, so they fail to mention their collections to their estate planners.²⁵ “A study by a leading financial services firm shows that 50% of families worth in excess of \$10 million may not call themselves ‘collectors,’ but have lots of ‘stuff’ surrounding them in their homes.”²⁶ Your client need not have a multimillion-dollar net worth and an assortment of classic works of art to possess a collection worthy of proper planning.²⁷ For example, over the years, your client may simply amass a valuable collection of baseball cards, stamps, or classic toys that now demands a proper accounting.²⁸

1. The Empty Hook Syndrome

Another fallacy that can keep collectors from discussing their collections with their advisors is known as the “empty hook” syndrome.²⁹ The idea behind empty hook syndrome is that, after owners die, their heirs will remove works of art from their walls and will hang these works in their own homes, leaving in place, an empty hook.³⁰ Practicing empty hook succession can lead to a myriad of problems: no record of provenance, a diminished value due to lack of a paper trail, and harsh income tax consequences.³¹ Taking art off of the walls may fool some of the more dense relatives and friends, but the Internal Revenue Service (IRS) is a little more hard-nosed: “When art is sold and the funds are deposited into a financial institution and subsequently throw off interest and dividends, the IRS may inquire as to the source of the funds and then how the art was acquired.”³² This fact is even more troubling once your client realizes that estate tax fraud carries no statute of limitations.³³

2. The Problem with Children

Many collectors simply decide to leave their collections to their children to divide, convincing themselves that their children have the same interest in the

24. MICHAEL MENDELSON & PAIGE STOVER HAGUE, *LIFE IS SHORT, ART IS LONG: MAXIMIZING ESTATE PLANNING STRATEGIES FOR COLLECTORS OF ART, ANTIQUES, AND COLLECTABLES* 243 (Wealth Mgmt. Press ed. 2007).

25. *See id.* at 244.

26. *Id.* at 243–44.

27. *See id.* at 242.

28. *See id.*

29. *See id.* at 244.

30. Christopher Hann, *You Can't Take It With You: Here's What You Should Consider When Bequeathing Your Collection*, ART & ANTIQUES, Oct. 2007, at 148, available at <http://www.hannwriting.com/PDF/Estate%20Planning.pdf>.

31. *See id.*

32. MENDELSON & HAGUE, *supra* note 24, at 250.

33. *See* I.R.C. § 6501(c)(3) (West 2012) (“In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.”).

collection as they do.³⁴ However, this leads to two problems: (1) a collector's heirs may not want the collection, and (2) in the event that a collector's children do want the collection, "if the transfer is made as an outright bequest in the will or passes under the residuary clause, the kids may have to sell or liquidate all of the assets in order to pay the estate taxes due on the collection."³⁵

III. ART AS AN INVESTMENT WHILE YOUR CLIENT IS LIVING

Of course, your client's greatest benefit from their collection is likely the pride and enjoyment they receive from their ownership, but who would not mind making or saving some extra money? In addition to planning for art succession, there are several things collectors can do to increase the value of their collections and to save money during the estate planning process.³⁶

A. Deductions

For purposes of tax deductions, owners of art collections who are not artists can be categorized into three groups: dealers, investors, and collectors.³⁷ For the purposes of this comment, the focus will be on investors and collectors.

First, it is important to understand the difference between an investor and a collector.³⁸ "An investor is someone who buys and sells works of art primarily for investment, rather than for personal use and enjoyment or as a trade or business."³⁹ Conversely, "[a] collector is someone who buys and sells works of art primarily for personal pleasure and is neither a dealer nor an investor; ordinarily, a collector may not deduct expenses and losses."⁴⁰ While these definitions seem simple enough, the distinction between investor and collector is not as clear as it might appear.⁴¹

Wrightsmen v. United States involved collectors who indicated on subsequent income tax returns that their interest in collecting certain works of art was primarily investment-motivated, rather than for personal pleasure.⁴² The collectors regularly bought paintings, the invoices for which were sent directly to their business office for approval and recording—the exact same process by which Mr. Wrightsmen handled his oil and gas investments.⁴³ All of the information on the paintings and purchases were meticulously catalogued

34. See MENDELSON & HAGUE, *supra* note 24, at 255.

35. *Id.*

36. See *infra* Part III.A–C.

37. See 1 RALPH E. LERNER & JUDITH BRESLER, *ART LAW: THE GUIDE FOR COLLECTORS, INVESTORS, DEALERS AND ARTISTS* 1424 (3d ed. 2005).

38. See *infra* text accompanying notes 39–53.

39. LERNER & BRESLER, *supra* note 37, at 1425.

40. *Id.* at 1426.

41. See *supra* text accompanying notes 39–40; see also *infra* text accompanying notes 42–53.

42. See *Wrightsmen v. United States*, 428 F.2d 1316, 1317–19 (Ct. Cl. 1970).

43. See *id.* at 1318–19.

and earmarked for capitalization.⁴⁴ However, the court found that the collectors' practices did not rise to the level of investment required to qualify for a deduction under § 212 of the Internal Revenue Code (IRC), which allows deductions for "ordinary and necessary expenses paid or incurred during the taxable year . . . (1) for the production or collection of income; [or] (2) for the management, conservation, or maintenance of property held for the production of income[.]"⁴⁵

Wrightsmen and other cases create a laundry list of requirements to qualify as an art investor; for example, investors must establish that the principle purpose of their collection is for investment, and investors "must intend to hold the property for investment."⁴⁶ Investors can prove this intent by addressing their financial position, investment history, personal declarations as to intent, and actions reflecting investment purposes.⁴⁷ Holding a collection, even without profitable sales, does not preclude a holding for investment purposes.⁴⁸ Additionally, personal enjoyment derived from the collection does not make the collection a hobby, nor does it exclude it from investment classification; however, the proportion of the expenses associated with personal use is not deductible.⁴⁹ Though the criteria may be arduous, investor qualification is not an impossible test to meet, especially considering the current art market, the drop in interest rates, and the overall poor performance of traditional investments.⁵⁰

Under §§ 212(1) and (2) of the IRC, collectors who qualify as investors will be able to deduct costs associated with their art collections; however, under § 262 of the IRC, collectors who do not qualify as investors may not deduct these expenses, as they will be considered personal in nature.⁵¹

Even if your client does not qualify as an investor, not all hope is lost. Section 183 of the IRC, which is known as the hobby-loss prevention, normally does not allow deductions for activities not engaged in for profit, but § 183(b) provides a small exception.⁵² Specifically, § 183(b) permits a collector to deduct "expenses attributable to an activity not engaged in for profit up to the amount of the gross income derived from the activity, after first deducting those items, such as certain items of interest and taxes, that are allowable without regard to whether an activity is engaged in for profit."⁵³ However, this

44. *See id.* at 1319.

45. *Id.* at 1319–20 (quoting I.R.C. § 212 (West 2012)).

46. LERNER & BRESLER, *supra* note 37, at 1428.

47. *See id.*

48. *See id.*

49. *See id.*

50. *See id.* at 1430.

51. *See* I.R.C. §§ 212(1)–(2), 262 (West 2012).

52. *See* I.R.C. § 183; *see also* William P. Barrert, *IRS Seeking to Tax Your Hobby*, FORBES (July 10, 2009, 5:30 PM), <http://www.forbes.com/2009/07/10/irs-taxes-hobbies-personal-finance-hobby.html>.

53. LERNER & BRESLER, *supra* note 37, at 1435.

provision does not create a windfall, and other provisions of the IRC may further limit deductions.⁵⁴

Another small deduction bears mentioning: § 165(c)(2) of the IRC allows a deduction for inherited property that is immediately turned over for sale and incurs a loss.⁵⁵ However, for this provision to apply, at all times, the property must never be used for personal use.⁵⁶

B. 1031 Exchanges

One of the greatest pleasures of collecting art, or anything for that matter, is the joy of acquiring new additions to your collection.⁵⁷ “Applying a technique that is generally used by real estate investors, an art investor may be able to sell an artwork the investor owns, purchase another artwork, and defer the tax liability on the gain.”⁵⁸ Usually, if your clients were to sell or exchange pieces in their collection, they would have to report their gains and pay the subsequent taxes.⁵⁹ However, § 1031 of the IRC provides an exception to this rule—a “1031 Exchange.”⁶⁰ A 1031 Exchange allows investors to exchange their property for property of “like-kind” and postpone the tax that would normally be associated with any gain from such an exchange.⁶¹

To qualify for a 1031 Exchange, four requirements must be met:

1. [T]here must be an exchange; 2. the exchange must be property that qualifies under IRC § 1031(a); 3. the replacement property must be of like-kind to the property relinquished; and 4. both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment.⁶²

54. *See id.* (“The collection-related expenses that are then deductible under section 183(b) are subject to the 2% rule of section 67(a) for deductions claimed on or after January 1, 1987. The deductible expenses may be further limited under the provisions of section 68(a), effective January 1, 1991.”); *see also* I.R.C. § 68(a); Treas. Reg. § 1.67-1T(a)(1)(iv). Section 68 limits an individual taxpayer’s ability to claim an itemized deduction if the taxpayer’s adjusted gross income exceeds a specified statutory amount. *See* LERNER & BRESLER, *supra* note 37, at 1444. Under § 68, all otherwise allowable itemized deductions are reduced by the lesser of (1) 3% of the amount by which the taxpayer’s adjusted gross income exceeds the statutory amount; or (2) 80% of the itemized deductions. *See id.*

55. I.R.C. § 165(c)(2).

56. *See* LERNER & BRESLER, *supra* note 37, at 1447.

57. *See, e.g.,* Anthony Petullo, *A Collector’s Perspective*, ANTHONY PETULLO COLLECTION OF SELF-TAUGHT & OUTSIDER ART, http://www.petulloartcollection.org/the_collection/collectors_perspective.cfm (last modified June 2009).

58. Akhavan, *supra* note 21, at 59.

59. *See id.*

60. *See id.*; *see also* I.R.C. § 1031.

61. *See* Akhavan, *supra* note 21, at 59–60.

62. *Id.* at 60

Section 1031 sets out two specific requirements: an investor must carry out the exchange, and the property must be of like-kind—sculptures for sculptures, oil paintings for oil paintings, lithographs for lithographs.⁶³

The following anecdote best explains how a 1031 Exchange could benefit clients:

[A]n art investor purchases a rare Old Master painting for \$1 million. After 10 years, the value of the piece has increased to \$2 million, and the investor wants to sell it. In addition, the investor's wife has been insisting that they purchase another painting she saw at a local art gallery for \$2 million. Without the 1031 Exchange, the investor would sell the painting for \$2 million and pay federal income tax at the rate of 28% (almost twice as much as the 15% rate for most other capital assets) on the \$1 million gain. The result is a \$280,000 tax liability, leaving the investor with only \$1.72 million to purchase the new painting to make his wife happy.⁶⁴

However, with a 1031 Exchange, the investor could have exchanged the Old Master painting for the new painting and deferred the \$280,000 in taxes to when he decides to sell the new painting.⁶⁵

Investors can use a 1031 Exchange for more than just a simple one-for-one exchange.⁶⁶ Through a reverse exchange, investors can purchase new pieces before they have even sold their old ones; then, investors have 180 days in which to sell the original.⁶⁷ Perhaps instead, your client has an oil painting worth \$2 million but would rather have four other paintings, each worth \$500,000; under a 1031 Exchange, this is possible—the number of pieces exchanged does not matter.⁶⁸ Investors can even use a 1031 Exchange at an art auction, provided they have made the appropriate arrangements, in advance, with the auction house.⁶⁹

C. Buying and Selling

Sales tax is an important consideration one must always make in the purchase of any good; however, as is apparent throughout this comment, art has some peculiarities.⁷⁰ In the purchase of art, a special consideration is the use tax.⁷¹ “A use tax is designed to complement the sales tax, and imposes a tax on the use within a state of works of art (or other items of tangible personal property) that would have been subject to the sales tax if they were purchased

63. *See id.* at 60–61.

64. *Id.* at 60.

65. *Id.*

66. *See id.*

67. *See id.* at 61.

68. *See id.*

69. *See id.*

70. *See infra* text accompanying notes 71–74.

71. *See LERNER & BRESLER, supra* note 37, at 1459.

within the state.”⁷² A piece of art purchased out of state for delivery to the investor’s home state will be subject to a use tax in the investor’s home state.⁷³ An investor may try to avoid this penalty by applying for a resale certificate and number; however, this is usually a foolish move, as it is likely that the return will be negligible, or worse—the investor could face criminal charges for misuse of the resale exception.⁷⁴ The idiosyncrasies of sales tax differ from state to state, and to fully address the issues associated with sales tax, estate planners must take an in depth look at the sales tax provisions of the state in which their particular client is located.

IV. TAX AND ESTATE PLANNING: A GUIDE TO PLANNING FOR YOUR CLIENT’S ART ESTATE

This section addresses the specific steps for estate planners to take to ensure the best plan for their clients’ art collections: establishing provenance; looking at valuation and tax issues; and outlining some options that might be available to your client.⁷⁵

A. Establishing Provenance

Establishing provenance is the first step practitioners should take in planning for art succession.⁷⁶ Provenance is the history of ownership of a piece.⁷⁷ One of the first steps in establishing provenance is creating an inventory of your client’s collection.⁷⁸ A good inventory is important for many reasons: (1) to have an actual working knowledge of your client’s collection, organized in a catalog, complete with a history of each piece in the collection; (2) to establish valid title when authenticating the collection; (3) to help with the process of valuation when the collection is appraised; (4) to establish a paper trail to aid in insuring the collection; and (5) to keep track of any pieces your client may have on loan.⁷⁹

1. Cataloguing

First, it is important to have a documented catalogue of your client’s collection.⁸⁰ Your clients can do this themselves, or if the collection is rather substantial, either in size or in value, the use of a professional service may be a

72. *Id.*

73. *Id.* at 1460.

74. *Id.*

75. *See infra* Part IV.A–D.

76. *See* The Complex Estate, *supra* note 1, at 3.

77. *See id.*

78. *See id.*

79. *See* MENDELSON & HAGUE, *supra* note 24, at 177–78.

80. *See id.* at 178.

valuable asset.⁸¹ “Inventory records document the story of the collection—information on the artist or maker, the history of ownership and exhibition, conveyance and appraisal documentation, insurance records, and any other information that is relevant to the history or value of the piece.”⁸² Every piece in your client’s collection should be accounted for, and specific information should be provided: what medium the piece is—oil painting, lithograph, coin; identifying information—the name of the artist or creator, size of the piece, or any specific identifying marks; information relating to the acquisition of the piece—the bill of sale, receipts, mode of acquisition; any information documenting any times the piece has been shown or referenced in any books, magazines, or other publications; where the piece is kept; and whether or not the piece has been promised as a gift to anyone.⁸³

2. Authentication

When establishing provenance, authentication is an integral step.⁸⁴ The ideal time to authenticate a piece is before purchase; however, this may have been a step your client missed.⁸⁵ It is important to determine the authenticity of all of the pieces in a collection to determine whether they are originals or reproductions.⁸⁶

In addition to authenticating the work, it is important to research the pieces to make sure none of them have been reported as lost or stolen.⁸⁷ Throughout history, there have been many cases in which large amounts of art have been stolen, and then, they later found their way into the hands of owners who were none the wiser.⁸⁸ “It is well-settled that no one can acquire a *good title* from a thief, yet this rule is not as protective as one might think.”⁸⁹ For instance, cases involving art and antiques acquired by members of the Soviet government found that, because a recognized government had nationalized the pieces, the original owners no longer had title to the works and thus no claim of theft.⁹⁰ However, this is distinguishable from cases involving art that was looted by the Nazis during the Second World War; because the Nazi party was never recognized as a legitimate government in the territories it occupied, it was held that title remained with the original owner.⁹¹

81. *See id.*

82. *Id.* at 179.

83. *See id.* at 179–80.

84. *See* The Complex Estate, *supra* note 1, at 3.

85. *See generally* LEONARD D. DUBOFF, THE ANTIQUE AND ART COLLECTOR’S LEGAL GUIDE: YOUR HANDBOOK TO BECOMING A SAVVY BUYER 27 (2003) (explaining the importance of determining authenticity and transferability before purchasing art).

86. *See* The Complex Estate, *supra* note 1, at 3.

87. *See id.*

88. *See id.*; *see also* DUBOFF, *supra* note 85, at 27.

89. DUBOFF, *supra* note 85, at 27.

90. *See id.*

91. *See id.*

Despite a client's best efforts and due diligence, it is still possible for that client to acquire a forged or stolen piece.⁹² If "the authenticity is in doubt[,] [it] acts as a depressant on value."⁹³ This may be easily reconciled by requesting a refund from the dealer—a reputable dealer should have no problem issuing such a refund; however, if there is a problem, the Uniform Commercial Code (UCC) may provide ample protection.⁹⁴ Warranties, both express and implied, under the UCC work to ensure that purchasers are entitled to the benefit of their bargains.⁹⁵ "If [you come to] suspect[] that an artwork may be stolen, [you] should check with the Art Loss Register [and] other relevant registers to see whether it has been reported missing."⁹⁶

3. Valuation

Valuation is incredibly important for the following reasons: (1) "income tax purposes if the collection is transferred during life to a charitable donee"⁹⁷; (2) "gift tax purposes if the property is transferred during life to a noncharitable donee"⁹⁸; (3) "estate tax purposes if the property is owned at death"⁹⁹; and (4) "insurance purposes if the property is maintained during life (because insurance companies require an appraisal in order to determine the premiums for coverage)."¹⁰⁰ In addition, there are two major reasons to appraise a collection: for insurance purposes and for estate planning purposes.¹⁰¹

92. *See id.* at 28.

93. *Peters v. Comm'r*, 36 T.C.M. (CCH) 552 (1977).

94. DUBOFF, *supra* note 85, at 28.

95. *See id.* at 29.

For instance, say you paid \$10,000 for a certain work, knowing that if everything the seller warranted was true, it was actually worth \$20,000. Later you discover that the work is a forgery, worth only \$500. You might think you could recover only \$9,500, but under the UCC, you could recover \$19,500 (\$20,000, the value of an authentic work minus \$500, the current value).

Id. Unfortunately, the UCC does not allow the injured party to recover any attorney fees associated with the suit; under the UCC, each party must pay for their own fees. *See id.*

96. Steven Mark Levy, *Authentication and Appraisal of Artwork*, in ART LAW HANDBOOK 829, 861 (Roy S. Kaufman ed., 2000) ("The Art Loss Register, created in 1991 is the largest private database of stolen and missing works of art in the world, and has an office at 666 Fifth Avenue, New York, N.Y. 10103, telephone (212) 262-4831.").

97. LERNER & BRESLER, *supra* note 37, at 1507 (citing Treas. Reg. §§ 1.170A-1(a)(2)(ii), (c), 1.170A-13 (2008)).

98. *Id.* (citing Treas. Reg. § 25.2512-1 (1992)).

99. *Id.* (citing Treas. Reg. § 20.2031-6 (1986)).

100. *Id.* at 1507.

101. MENDELSON & HAGUE, *supra* note 24, at 216.

While the IRS does have the right to request copies of insurance policies, it is common knowledge that fair market value differs from replacement value. If you only submit your insurance appraisal to the IRS, the IRS will happily rely on the higher values to estimate taxes. By submitting a properly prepared estate appraisal, the IRS will at least consider the fair market values submitted rather than using the replacement market to determine taxes owed, considerably lightening the estate's tax burden. While the IRS may disagree with fair market valuations submitted by the appraiser, the values in question can usually be negotiated to a point that is fair to both the estate and the IRS agent.

For estate planning purposes, appraisal “gives individuals the opportunity to have control over the division of their estate with full knowledge of the fair market value of their property.”¹⁰² An appraisal is also needed “to place assets within trusts, partnerships, and other entities that serve to lessen the estate’s tax burden.”¹⁰³ To embark on a comprehensive estate tax plan, practitioners will require the assistance of a professional appraisal, especially when contributing to a charity.¹⁰⁴ “For example, by IRS guidelines, any gifts you structure estimated at \$5,000 or more require a qualified appraisal.”¹⁰⁵ A qualified appraisal is defined as “an appraisal prepared by a qualified appraiser not more than sixty days before the date of the contribution of the appraised property.”¹⁰⁶ The IRS defines a qualified appraiser as:

[A]n individual who 1. holds himself out to the public as an appraiser or performs appraisals regularly; 2. is qualified by background, experience, education, and professional appraisal association memberships to make appraisals of the type of property being valued; and 3. understands that a false or fraudulent overstatement of the property’s value may subject the appraiser to a civil penalty and may result in future appraisals being disregarded by the IRS.¹⁰⁷

Additionally, appraisers are not allowed to have a vested interest in the items they are appraising.¹⁰⁸ For example, an appraiser’s fee cannot be based on a percentage of the appraised value.¹⁰⁹

Due to the highly esoteric nature of art and collectables, the IRS appointed a special Art Advisory Panel to deal with audits of substantial art estates.¹¹⁰

Id. at 229.

102. *Id.* at 228.

103. *Id.*

104. *See id.* at 225.

105. *Id.*

106. LERNER & BRESLER, *supra* note 37, at 1516 (citing Tax Reform Act of 1984 § 155(a)(2); Treas. Reg. § 1.170A-13(c)(3)(i) (2008)). A qualified appraisal requires the following information:

1) a detailed description of the property, 2) the physical condition of the property, 3) the date or expected date of the contribution, 4) the terms of any agreement or understanding entered into or expected to be entered into by or on behalf of the donor that relates to the use, sale, or other disposition of the property contributed, 5) the name, address, and taxpayer identification number of the appraiser, 6) a detailed description of the appraiser’s background and qualifications, 7) a statement that the appraisal was prepared for income tax purposes, 8) the date on which the property was valued, 9) the appraised fair market value of the property, 10) the method of valuation used to determine fair market value, 11) the specific basis for the valuation, such as any specific comparable sales transactions, and 12) a description of the fee arrangement between [the] donor and the appraiser.

Id. at 1516.

107. Levy, *supra* note 96, at 866 (citing Treas. Reg. § 1.170A-13(c)(5)(i) (2008)).

108. MENDELSON & HAGUE, *supra* note 24, at 219.

109. *See id.* (citing Treas. Reg. § 1.170A-13(c)(6)(i) (2008)).

110. *See* ART ADVISORY PANEL OF THE COMMISSIONER OF INTERNAL REVENUE, DEP’T OF TREASURY, ANNUAL SUMMARY REPORT FOR FISCAL YEAR 2011, at 2, available at <http://www.irs.gov/pub/irs-utl/annrep2011.pdf>.

“Created in 1968, the Art Advisory Panel of the Commissioner of Internal Revenue (the Panel) provides advice and makes recommendations to the Art Appraisal Services (AAS) unit in the Office of Appeals for the Internal Revenue Service (IRS).”¹¹¹

Any time that an audit involves a piece of art or other cultural property with a value of \$50,000 or more, the auditor must refer the item to the AAS; subsequently, AAS works with the Panel to determine and recommend the fair value of the piece.¹¹² The Panel works to cost-effectively alleviate possible misrepresentations in value in this highly abused area.¹¹³ “The AAS appraisers review appraisals by researching public information; the Panel [members] provide[] additional knowledge of private sales based on their personal experience as dealers, scholars, and museum curators, and from information obtained from other members of their relatively small industry.”¹¹⁴

The AAS combines its own research with the information provided by the taxpayer and sends it to the Panel for review.¹¹⁵ Therefore, it is extremely important for valuation information to be as thorough and irreproachable as possible.¹¹⁶ Theoretically, the reports that the Panel issues are only advisory; however, many local IRS offices have considered them to be binding on the case.¹¹⁷ But not all hope is lost; it is possible to request a reappraisal through an appellate conference if a party feels that the Panel did not adequately and fairly review the work.¹¹⁸ Unfortunately, the appeals process can take anywhere from six months to a year, so the more precise the documentation, the better.¹¹⁹

4. Insurance

Your clients love their collections, but are they adequately prepared for and protected from calamity? When considering insurance, there are three factors that should be analyzed: (1) what is the value of the property to be insured?; (2) what are the chances that something will happen to the property?; and (3) what is the cost of insuring the property?¹²⁰ Even a small collection can end up being quite valuable; however, a good rule of thumb is that a client’s piece is worth insuring if the client could be harmed by its loss.¹²¹

There are three basic methods for insuring art and antiques: (1) “[i]nsuring the pieces in [the] collection as part of the contents of [the] home”;

111. *Id.*

112. *See id.*

113. *See id.*

114. *Id.*

115. *See id.*

116. *See LERNER & BRESLER, supra note 37, at 1523.*

117. *See id.*

118. *See id.*

119. *See id.*

120. DUBOFF, *supra* note 85, at 50.

121. *See id.*

- (2) “[i]nsuring the pieces in [the] collection as ‘scheduled items’”; and
 (3) “[i]nsuring [the] collection through blanket coverage.”¹²²

By far the easiest, and likely the least expensive, option is to insure the collection as part of the contents of the house, without ever scheduling them.¹²³ However, when it comes to providing coverage, this method is the least thorough.¹²⁴ It is likely that, under this plan, items will only be replaced at functional value.¹²⁵ For example, a sixteenth century desk will be settled at the price of a brand new reproduction.¹²⁶ This coverage will also likely exclude damages from natural disasters.¹²⁷

With a bit more work, clients can also schedule their own items.¹²⁸ Scheduling requires each item to be appraised and listed separately, but it provides much greater insurance protection.¹²⁹ With this approach, property is protected from natural disasters, as well as other coverage that is not found elsewhere, such as changes in value and replacement cost protection.¹³⁰ Change in value protection is incredibly important, as any damage to a piece of art, though repaired or restored, may significantly reduce its value—this is especially true with contemporary art.¹³¹ Replacement cost protection is particularly important for art that is subject to rapid appreciation.¹³² Replacement cost protection essentially protects the market value of the piece, and under this protection, “the insurance company will pay up to 150% of the agreed value of the item.”¹³³

A third option is blanket coverage, which is most useful if your client frequently buys and sells or has a large collection that consists of relatively low-value items.¹³⁴ Blanket coverage skips individual appraising entirely, which not only allows the collector to determine the overall value of the collection, but it also allows the collector to obtain the right amount of blanket coverage to protect the collection as a whole.¹³⁵ However, because none of the items are specifically evaluated, it is imperative that the collector keeps good records of all of the items in the collection.¹³⁶

122. MENDELSON & HAGUE, *supra* note 24, at 197.

123. *See id.*

124. *See id.*

125. *See id.*

126. *See id.* at 197–98.

127. *See id.* at 198.

128. *See id.*

129. *See id.*

130. *See id.* at 198–99.

131. *See id.* at 199.

132. *See id.*

133. *Id.*

134. *See id.* at 200.

135. *See id.*

136. *See id.*

While no one thinks it will happen to them, theft is a serious concern for collectors.¹³⁷ However, following a few basic guidelines will help guard against this frightening possibility.¹³⁸ Anonymity is a collector's best friend; the best thing collectors can do is to keep knowledge of their collections close to their chest and avoid publishing personal data to the public.¹³⁹ It is also a good idea to suggest your clients have an alarm system installed.¹⁴⁰

B. Appointing an Art Executor

Upon the death of your client, disposition of the estate by sale is common. Although laymen, such as the decedent's spouse or children, can handle most belongings, they may not have the requisite knowledge or expertise to successfully take care of your client's art estate.¹⁴¹ Due to this fact, it is advantageous to appoint an art executor.¹⁴² An art executor can assist in developing, exhibiting, marketing, and promoting the estate for sale.¹⁴³ The executor could also give insight into deciding which pieces should be sold and when, as well as which pieces should be held to generate interest.¹⁴⁴ An art executor should have the right to sell and transfer all of the collection, the ability to consider how separating the collection will effect the overall value, the right to negotiate showings and loans of the pieces, and the ability to collect insurance for any pieces lost or damaged while on loan.¹⁴⁵ If your client elects to appoint an art executor, it is important that the client clarifies that the person is an actual executor and not just an advisor.¹⁴⁶ It is also important that the executor, as a fiduciary, "has the power to act in his or her sole and absolute discretion with respect to the property at issue, even if over the objections of the other fiduciaries."¹⁴⁷

137. See Jane C.H. Jacob, *Stolen Art—How to Keep it Out of Your Collection: Part 1*, CHUBB COLLECTORS (Sept. 3, 2002), <http://www.chubbcollectors.com/Vacnews/index.jsp?form=2&ArticleId=85> ("Today, the trade in stolen art . . . is a six billion dollar a year business, and the second largest crime in the world, exceeded only by drug and gun trafficking.").

138. See *infra* notes 139–40 and accompanying text.

139. See Lori Verderame, *Tips by Dr. Lori: Preventing Property Theft*, DRLORIV.COM, <http://www.drloriv.com/Tips/ID/246/Preventing-Property-Theft> (last visited Feb. 1, 2014) (referencing the well known war time mantra, "loose lips, sink ships").

140. See DUBOFF, *supra* note 85, at 62.

141. See Joshua J. Kaufman & Sarah M. Johnson, *Art is Long, Life is Short: Estate Planning for the Artist and the Art Collector*, AM. B. ASS'N, SECTION OF TAXATION MEETING 25 (May 11, 2012), <https://meetings.abanet.org/meeting/tax/MAY12/media/est-gift-art-johnson-paper.pdf>

142. See *id.*

143. See *id.*

144. See *id.*

145. See *id.*; see also generally *In re Estate of Warhol*, 629 N.Y.S.2d 621, 625 (N.Y. Sur. Ct. 1995) (recognizing that executors require great latitude when making decisions to preserve the value of an estate).

146. See Kaufman & Johnson, *supra* note 141, at 25.

147. *Id.*

Paying the executor is the next step to consider.¹⁴⁸ “Because the commissions from sales of art typically are not netted from the value of the art for estate tax purposes, an [a]rt [e]xecutor could be particularly helpful in this regard.”¹⁴⁹ If the art executor is just the client’s art dealer, then the estate can skip a standard commission agreement and simply pay “a commission that is reasonable or permissible under state law.”¹⁵⁰ However, when clients choose to use their art dealer, conflicts of interests must be addressed in the agreement.¹⁵¹ If your client completely trusts the executor, then conflicts of interest can be circumvented; however, clients should be cautious in appointing art dealers or other artists as executors.¹⁵²

C. Two Things Are Certain in Life: Death and Taxes

Entire books exist on estate taxes and other taxes and how such taxes interact with art collections and estate planning.¹⁵³ Your client’s estate may be subject to a number of taxes: federal estate taxes; state estate taxes; and a litany of other transfer taxes, depending on the disposition of the estate.¹⁵⁴

The biggest problem that collectors encounter is the unintended outcome created by leaving their heirs pieces of their collections, as gifts; with the federal estate tax rate as high as 35%, this may create a gift that their heirs cannot afford to receive.¹⁵⁵ Without proper planning, the estate may not have enough liquidity to pay the tax, and if the estate cannot pay, then the burden falls to the recipient, which will likely force a sale of the piece.¹⁵⁶ It is

148. See *id.* at 25–26.

149. *Id.* at 26.

150. *Id.*

151. See *id.*

152. See *id.* The following scenario from *In re Rothko* warns against the use of art dealers or other artists as executors:

Mark Rothko’s will appointed three executors: One was his dealer and the owner of the prominent Marlborough Gallery, one was a struggling artist friend of Rothko’s, and one was a friend and professor of anthropology at Fordham. The dealer acted quickly and within one month had contracted to sell 798 works of art by Rothko to a corporation controlled by him. For going along with the plan, the struggling artist was offered a show of his work and representation by Marlborough Gallery. The professor orally objected to the proposed sales and hired his own attorney.

All three were fined and removed as executors. The professor was fined \$6M because it was not enough to “close his eyes . . . in the fact of the obvious loss to be visited upon the estate . . . and then shelter himself behind the claimed counsel of an attorney.”

Id. (citing *In re Rothko*, 372 N.E.2d 291 (N.Y. 1977)).

153. See, e.g., MENDELSON & HAGUE, *supra* note 24. This comment will only provide an overview of some of the tax issues and point out some of the important things to anticipate.

154. See *id.* at 271. The federal estate tax exclusion rate for 2013, when adjusted for inflation, came out to \$5,250,000. See Rev. Proc. 2013-15, 2013-5 I.R.B. 444.

155. See MENDELSON & HAGUE, *supra* note 24, at 271 (citing I.R.C. § 2001(c) (West 2012)).

156. See *id.* at 275.

important to advise clients of all the possible tax implications they face when disposing of their estate.¹⁵⁷

1. Gift Tax

The gift tax is a tax on property given as a gift during the taxable year; however, the gift tax is riddled with exceptions.¹⁵⁸ An individual may transfer up to \$14,000 (\$28,000 per couple, treating the gift as if each individual contributed \$14,000) to any individual tax-free during the calendar year.¹⁵⁹ Any gifts made in excess of this figure will require a gift tax return—IRS Form 709—and the excess amount will count against the \$5.25 million lifetime limit.¹⁶⁰ However, there is an exception to this limit; there is no limit on the amount that one spouse can transfer to the other, as long as the receiving spouse is a United States citizen.¹⁶¹

The gift tax also contains an exception for transfers of life insurance policies.¹⁶² The exemption only applies to transfers with cash values under \$12,000, made at least three years before the death of the donor.¹⁶³ If the donor dies within three years of the transfer, the value will still be included in the estate for tax purposes.¹⁶⁴

2. Federal Estate Tax

The federal estate tax is based on the sum total of assets transferred upon the death of the taxpayer.¹⁶⁵ In contrast to an inheritance tax, the estate tax is paid out of the estate prior to the transfer of the property.¹⁶⁶ The estate tax applies even if a trust is established and probate is avoided entirely.¹⁶⁷ In addition to the federal estate tax, many states have state death taxes that must be considered as well.¹⁶⁸

The gross estate, which is the amount by which estate tax is determined, is made up of the entire fair market value of all assets and property at the time of

157. *See id.* at 276.

158. *See* I.R.C. § 2501(a).

159. *See* Marsha A. Goetting & Joel Schumacher, *Gifting: A Property Transfer Tool of Estate Planning*, MONT. STATE UNIV. EXTENSION, <http://msuextension.org/publications/FamilyFinancialManagement/MT199105HR.pdf> (last modified June 2013); *see also* I.R.C. § 2503.

160. *See* Goetting & Schumacher, *supra* note 159; *see also* MENDELSON & HAGUE, *supra* note 24, at 277 (citing I.R.C. § 2505).

161. *See* MENDELSON & HAGUE, *supra* note 24, at 277–78 (citing I.R.C. § 2523(a)). The limit for noncitizen spouses is \$100,000. *See id.* (citing I.R.C. § 2523(h)(i)(2)).

162. *See id.* at 278 (citing I.R.C. § 2035).

163. *See id.* (citing I.R.C. § 2035).

164. *See id.* (citing I.R.C. § 2035).

165. *See id.*

166. *See id.*

167. *See id.*

168. *See id.* at 281.

death.¹⁶⁹ The gross estate includes the following: (1) all tangible, intangible, and real property exclusively owned at the time of death; (2) insurance owned at death; (3) any annuities that do not terminate at death; (4) property in which the taxpayer retains a life estate; and (5) 50% of community property.¹⁷⁰

Much like the gift tax, the estate tax is also subject to deductions.¹⁷¹ The marital deduction lets the taxpayer leave an uncapped amount to the spouse, tax-free.¹⁷² There is also a deduction for transfers for public, charitable, and religious uses, allowing transfers for qualified entities, free of the estate tax.¹⁷³

3. Capital Gains Tax

A tax on capital gains is a tax placed on profits from the sale of investments.¹⁷⁴ This can include the appreciated value of art and collectables.¹⁷⁵ Currently, the capital gains tax rate is 28% on the difference between the cost basis and the selling price.¹⁷⁶ However, taxpayers' capital gains can be offset by their capital losses for that year, reducing the amount they owe in capital gains tax.¹⁷⁷

The most important aspect of the capital gains tax is determining the cost basis.¹⁷⁸ The cost basis will depend on how your client obtained the asset: by purchase; as a gift; or through inheritance.¹⁷⁹ If the asset was purchased, then the cost basis will simply be the purchase price of the item.¹⁸⁰ Receiving the asset as a gift, however, is slightly more complicated.¹⁸¹

If your client sells a gift asset at a gain, then your client's cost basis will be the same as that of the donor.¹⁸² The same is true if your client receives the gift at a gain but then sells it for a loss.¹⁸³ Alternatively, if the asset was gifted at a loss and then sold for a loss, the cost basis will be the fair market value of the item at the time of the gift.¹⁸⁴ Finally, if your client received the gift directly

169. *See id.* at 278.

170. *See* I.R.C. §§ 2031, 2033–2046.

171. *See* MENDELSON & HAGUE, *supra* note 24, at 279.

172. *See* I.R.C. § 2056.

173. *See* I.R.C. § 2055.

174. *See* Topic 409 – Capital Gains and Losses, INTERNAL REVENUE SERV., <http://www.irs.gov/taxtopics/tc409.html> (last updated Dec. 12, 2013) [hereinafter *Capital Gains and Losses*].

175. *See* MENDELSON & HAGUE, *supra* note 24, at 282.

176. *See* *Capital Gains and Losses*, *supra* note 174.

177. *See id.*

178. *See id.*

179. *See* MENDELSON & HAGUE, *supra* note 24, at 271.

180. *See id.* (noting that the purchase price includes any commissions provided for in the purchase agreement).

181. *See id.* at 283–84.

182. *See id.* at 283.

183. *See id.*

184. *See id.*

from the artist, the cost basis will only be the cost of materials.¹⁸⁵ However, in this scenario, the gain is only taxed as ordinary income, not as a capital gain.¹⁸⁶

Inheriting an asset triggers what is known as the “stepped-up basis” for determining the cost basis.¹⁸⁷ This means that the cost basis will be the fair market value of the item at the time the decedent dies.¹⁸⁸ Therefore, when the asset is inherited and then sold, there is a much smaller tax burden on the asset than there would be had the asset been gifted during the donor’s life.¹⁸⁹

D. Possible Options for Your Client

The following discussion will provide an overview of two common options for handling the disposition of a client’s art estate: an irrevocable life insurance trust and a charitable remainder trust.¹⁹⁰ This discussion will only cover abstracts of each of these plans; thus, before deciding which of these options is best for your client, further research will need to be conducted to learn more about the specifics of each of these plans.¹⁹¹

1. Irrevocable Life Insurance Trusts

An irrevocable life insurance trust (ILIT) provides a means by which individuals can “transfer large sums of wealth to [their] heirs, . . . free of gift and estate taxes.”¹⁹² An ILIT is an excellent device because it can provide the means to pay for estate taxes on larger estates that surpass the estate tax credit threshold.¹⁹³ A life insurance policy covers the life of the policyholder, and by placing such policy into a special trust, the policyholder can create an ILIT.¹⁹⁴ The trust owns the life insurance policy; accordingly, the beneficiaries of the trust are also the beneficiaries of the policy.¹⁹⁵ The trust, usually through funds provided by the creator of the policy, then pays premiums on the policy to comply with estate and gift tax laws.¹⁹⁶

The ownership of the life insurance policy is an important aspect of the ILIT.¹⁹⁷ If your client—but not the trust—is the owner of the insurance policy, then all of the death benefits will be added to you client’s estate; these benefits

185. *See id.* at 284.

186. *See id.*

187. *See id.*

188. *See id.*

189. *See id.*

190. *See infra* Part IV.D.1–2.

191. *See infra* Part IV.D.1–2.

192. Jane K. Penhaligen, *Life Insurance Trust*, LAW OFFICE OF JANE K. PENHALIGEN, <http://jpenhaligenlaw.com/life-insurance-trust> (last visited Feb. 1, 2014).

193. *See id.*

194. *See id.*

195. *See id.*

196. *See id.*

197. *See id.*

could push the value of your client's estate over the estate tax exemption limit.¹⁹⁸ Even if your client's estate is already over the threshold for estate tax exemptions, an ILIT is helpful because it provides liquid assets to pay the estate tax on the inheritance, avoiding forced liquidation of the assets to cover those costs.¹⁹⁹

2. Charitable Remainder Trusts

A charitable remainder trust is a trust specifically designed to include qualified charities as beneficiaries, with at least one non-charitable beneficiary.²⁰⁰ The trust requires payment of a specified distribution "annually for life or for a term of years," while also maintaining an irrevocable remainder interest for the benefit of one or more qualified charities.²⁰¹

The specified distribution must be either a sum certain, which is not less than five percent and not more than fifty percent of the initial net fair market value of all property placed in trust . . . or a fixed percentage, which is not less than five percent and not more than fifty percent, of the net fair market value of the trust assets, valued annually.²⁰²

Any gifts made to a charity through a charitable remainder trust count as unlimited estate and gift tax deductions, based on the present value of the retained income interest.²⁰³

V. CONCLUSION

Even in this uncertain market, art and collectables continue to hold their value.²⁰⁴ It appears that hard economic times are not enough to shake the love that art collectors have for their passions.²⁰⁵ However, to protect these collections, estate planners must be just as passionate about their roles in helping their clients plan for their art estates as collectors are about their own estates; art estate planning requires a complex and comprehensive approach, as well as strategic and open communication between the entire estate planning team.²⁰⁶

198. *See id.*

199. *See id.*

200. *See* Marc Hoffman, *Charitable Remainder Trusts*, PLANNED GIVING DESIGN CTR., <http://www.pgdc.com/pgdc/charitable-remainder-trusts> (last updated Sept. 18, 2012).

201. *Id.*

202. *Id.*

203. *See id.*

204. *See supra* Part II.

205. *See supra* Part II.

206. *See supra* Parts II–IV; *see also* Willette, *supra* note 23, at 47.

When working with a client, end of life planning is not the only thing you can assist with.²⁰⁷ With the right information, estate planners can make their clients' collections work for them.²⁰⁸ A well-managed estate can provide a source of income, or it can even be used to expand the collection.²⁰⁹ Collectors collect because they love what they do.²¹⁰ Why not help them get the absolute most from their collection?

Art estate planning takes commitment, but commitment that can pay off exponentially.²¹¹ By establishing provenance and carefully planning, your clients will not only have a better understanding of the value of their collections, but they will also know, with certainty, that their wishes will be fulfilled at death.²¹² After a careful examination of the tax consequences, estate planners and their clients can discuss the litany of different investment strategies to ultimately determine which one works best for their clients' specific estate planning goals.²¹³ Whether your client wishes to leave a collection to a beloved heir or leave a legacy in the form of a charity, with your assistance, careful research, and tactical application, your client's wishes can become a reality.²¹⁴

207. See Willette, *supra* note 23, at 47, 49.

208. See *supra* Part III.

209. See *supra* Part III; see also Willette, *supra* note 23, at 47, 49.

210. See Willette, *supra* note 23 at 47, 49.

211. See Willette, *supra* note 23, at 47.

212. See *supra* Part IV.

213. See *supra* Part IV.

214. See *supra* Part IV.