**The Law of Unintended Consequences? US Federal Taxation and the Market for Modern Art in the United States**

As a prelude to considering the consequences of Federal taxation on the market for modern art in the United States, one needs first to note some basics about the relationship between government and arts organisations. This is significantly different to other nations. There is little direct support for the arts. Where Finland tops the list for direct government support of the arts, spending $111.67 per citizen in 2000, with Germany a strong second at $89.52, the United States ranks last, with the government apparently supporting the arts to the tune of only a miserly $5.85 per capita (Heilbrun, 2001, p 139). Philosophically it is a central tenet in the U.S. that arts institutions and organisations should rely upon the philanthropy of wealthy private individuals to supplement earned income; state support should be either indirect or minimal. This ideology supplements concerns about how direct government funding might lead to government meddling in the arts, if not outright control and censorship (Feld et al, 1983, p 179-84).

Secondly, in the United States, the composition and characteristics of the art market system in the 20th century turned out significantly differenlyt to the norm previously identified in Europe: the so-called ‘dealer-critic’ system in Paris (White & White, 1965/1993; Moulin or Gee). In New York, the art market with respect to modern art has been characterised by 3 main constituents: the modern art museum, the dealer-gallery, and the private collector. Of these, the modern art museum came to have an importance quite unlike other art market centres. One hopes to show that this was—if unintentionally—impacted upon by Federal government policy of fostering private support for non-profit charitable undertakings (including art museums) via the Federal Tax Code, rather than supporting arts organisations by direct grants.

The importance of indirect support—which Feld describes as “*like an underground river*” which “*affects the arts profoundly*” and which in 1983 amounted to perhaps 2/3 of all the support the arts received (Feld et al,1983, p 2) —has received relatively little attention outside specialist circles. The few studies there have been of such “indirect aid” tend to focus upon government policies in relation to organisations and institutions chartered as charitable, or upon the relationship between tax policies and philanthropy by the wealthy (Clotfelder et al, 1997; Auten, Clotfelder, Schmalbeck, 1997). What has not been considered is the possibility of such policies might have impacted upon the support system for modern art and the art market.

Indirect Federal support of the arts via the Tax system takes 2 forms: first, tax exemptions for certain classes of organisations and institutions; second, the so-called ‘Charitable Deduction’, whereby Federal government foregoes tax revenues to encourage private philanthropy via the tax system. Both provisions date back to 1917: it was introduced because of concerns that the Federal Income Tax introduced for the first time in 1913 would hurt contributions by the very wealthy (the main subjects of the new income tax) to charity (Clotfelder, 1985, p 31). The first strand—that tax-exempt status was given to all “institutions operated exclusively for religious, charitable, scientific, literary or educational purposes” (Feld, 1991, p 204) meant that such institutions were exempted from Federal or State taxes themselves. Subsequently, privately funded art museums—such as the Museum of Modern Art in New York when founded in 1929—were typically chartered as non-profit educational charities to be tax-exempt. They also benefitted from the other provisions aiming to encourage private philanthropy.

Philosophically, the second strand of the 1917 Act, the ‘Charitable Deduction’ “*may seem like the logical consequence of private giving to a public cause,*” (Feld, 1991, p 196). Pragmatically its importance is how it fostered and facilitated private support for charitable undertakings (Heilbrun, 2001, p 140). Taxpayers who “itemized” their tax deductions (this applied to tax payers in the higher income tax brackets) could set the value of any gifts they made to any recognised charitable institution (Heilbrun, 2001, p 140) against their adjusted gross income (gross income minus business-related expenses) to calculate their individual income tax. The upper limits for the charitable deduction were set at 15% of AGI (Adjusted Gross Income) in 1948, raised to 20% in 1952, 30% in 1954, and 50% in 1969 (Feld, 1991, p 204-6); in the case of married couples the limit could be doubled. With a progressive tax structure, it was possible to reduce one’s tax bracket from higher to lower via the ‘Charitable Deduction’. For instance, if an individual had a taxable income of $60,000 to $70,000 they would be liable to pay 57% on the first $60,000, and tax at 78% on the excess above $60,000; with a taxable income in the next tax bracket down ($50,000 to $60,000), the same individual would be expected to pay only 53% on the first $50,000 and 75% on the excess over $50,000 [see table]. The ‘Charitable Deduction’ meant an individual taxpayer could not only be generous to charity (direct support) but *also* reduce their annual tax liabilities to the extent that government would forgo potential tax revenues (indirect support).

Also of note is the so-called “price of giving.” The higher an individual’s marginal (top) tax rate, the greater their potential tax reduction per $ value of their gift (Clotfelder et al, 1999, p 219), and from mid-century through to the 1970s top rates were consistently high. In 1948 the marginal rate on incomes of $200,000 or more was 82%; in 1951 the combined normal and surtax tax rates rose to 91% for incomes of $300,000 plus; the top rate was lowered to 70% in 1966 though raised somewhat again in 1969 to 77% owing to Vietnam War expenses (Wolff in Clotfelder, 1999, p 216). For a taxpayer with a top marginal rate of 78% the “price of giving” would be 22 c in the $; if the top rate had been 35% then the “price of giving” would be 65 cents (Clotfelder, 2012, p 7 & others). Charitable institutions were quick to pick up on this: Cornell University pointed out in its 1919 endowment drive that “*wealthy individuals would bear only a fraction of the price of gifts they made*” (Clotfelder, 1985, p 31). Under a progressive tax system, for the very wealthiest, donations could—particularly with respect to highly appreciated assets—actually result in a paper *profit* of up to .19 cents in the $ for the donor, raising the issue of possible abuse of the system (F. Lundberg*, The Rich and Super Rich,* 1969, p 685-66; J. K. Lasker, ‘How to Raise Money Painlessly’, *Harper’s Magazine*, Dec. 1947, p 551). And it is with the wealthiest that any study of tax and the art market must be concerned: only a very small percentage of individuals had either the disposable income or assets (probably less than 3% of the population) to contemplate art market activity.

If the concern is with the—unintended—consequences of Federal Tax policies upon the art market, then one art museum—the Museum of Modern Art in New York—needs to be considered, as it played such a seminal role in the support system for modern art in America. One might say that the Modern would not have existed without the tax breaks offered by the 1917 Act. It was founded with no core collection, nor any significant founding endowment. The founding Trustees always intended that the museum would be grown by attracting cash donations or donations of art works from wealthy individuals interested in modern art. Gifts of art works were undoubtedly the most significant means by which MoMA’s collections grew. By 1935, having been gifted its first oil painting in 1930 by trustee Stephen C. Clark (scion of the Singer Sewing Machine family), 73 paintings and 18 sculptures had been donated by 17 donors (A H Barr ‘Chronicle of the Collections, 1929-1967”, p 621-624). In the 1930s, the value of art works donated was $645,260, more than 10x the value of purchases (the latter were made with funds donated for this purpose by a small pool of donors). In the 1950s the ratio of gifts to purchases was approximately 2:1, and MoMA was also promised a substantial number of art works to enter the Museum collections in the subsequent 2 decades. Although most gifts were of single works, MoMA was also promised substantial groups and/or even whole collections e.g. that of Nelson Rockefeller, who eventually left 25 works to the museum (B. Gold “Nelson A Rockefeller Collection: Modern Works at MoMA”, *Arts*, Vol. XLIII, No 7, pp 28-31).

This paper is not the place to detail MoMA’s seminal role as a tastemaker for modernism, a story which has been well rehearsed, but the efforts MoMA played in encouraging a market for modern art are. Its status as a disinterested ‘public’ institution involved in presenting the best in modern art, and its identification with the socio-economic elite, gave it a very special standing within the structure of the market for modern art. It is possible to argue that the taste-making influence it exerted was reinforced by tax provisions which made charitable institutions a focus for the wealthy (Robson, 1988, p 409). Encouraging collectors of modern art—and so ensuring MoMA’s continuance—was a key interest of A H Barr, Director of Collections, from the Modern’s early years. On the one hand this meant publicising the social credentials of already existing trustees and collectors. The social status of Museum connections to Social Register families such as the Rockefellers helped to give social cachet to modern art, by providing the “*provocative spectacle of the thickest pillars of conservative society upholding a distinctly radical artistic cabal, and upholding it not merely with cash but also with vigorous personal effort*” (*Fortune* December 1938, p 127). Social Register families such as the Rockefellers were imbued with attitudes toward private philanthropy identical to those underpinning the 1917 Act. On the other hand, Barr’s aim, as expressed in a 1934 memo, was to promote owning modern art as a financially respectable activity for “sober” businessmen. On the one hand this meant publicising the social credentials of already existing trustees and collectors, for instance via the 1958 show of “Works of Art: Given or Promised.” With the aim of encouraging a market for modern art, as well as attracting collectors to engage with the Modern as donors and patrons, there was regular publicity about details of prices and rising values of works belonging to MoMA’s collection, both in press releases and in the Museum’s own published Bulletins.

Privately, Barr worked to underpin public efforts to encourage a market for modern art. In the MoMA archives is correspondence where Barr gives advice to individual collectors about tax – presumably as a way of encouraging them to think both about buying art works then, and about donating to MoMA in the future. Donating art works to museums was particularly advantageous from a tax perspective. This is because of the so-called “double incentive”: charitable gifts of money were tax deductible at “cost,” but assets with an appreciated value could be deducted at “fair market value” rather than base cost. But this wasn’t all: for most gifts of property no tax was levied on any capital gains (the difference between purchase price and current fair market value). In effect, donors of appreciated assets such as art works got a double tax break: they could use the value of donations to reduce current tax liabilities, and were not liable for any capital gains tax when they gifted the art work. When the “price of giving” was coupled with the “double incentive” it meant that the wealthier the potential donor, the more attractive donating appreciated assets such as art works was (Clotfelder et al, 1999, p 219). For instance, if a collector had paid $10,000 for a work of art in 1950 which by 1980 had a market value of $200,000, if s/he sold the work they would be liable for 25% tax on the capital gains from the sale. However, if the same donor gave the art work to a museum, s/he could claim the $200,000 “fair market value” as a charitable deduction (which could be spread over several years if exceeding the limit for that year), while at the same time avoiding paying capital gains tax. In consequence, as Feld notes: “*the tax provisions render a contribution of appreciated property more attractive to the donor than selling a property and contributing the proceeds to charity*” (Feld et al, 1983, p 45; Clotfelder 1990). Moreover, although charitable bequests are only a small proportion of total charitable giving, they were a “crucial source of art for museums” (in Feldstein, 1991, p 228). (Feld, 1991, p 227-8), There was also further skewing in who donated: the highest value estates not only provided the most charitable bequests, they also gave proportionately more to the arts.

If MoMA’s curatorial staff had the more disinterested ambition of raising public appreciation and understanding of modern art, Federal tax laws which facilitated indirect aid to museums also meant “*the capacity to make large gifts opens the door to forms of philanthropy in which donor control is inherent*” (Auten et al, 1997, p 16). As Clotfelder (2012, p 4) notes: “*American tax law in effect recognizes that donations replace government spending and, by extension, gives legitimacy to the social value of donor’s preferences”* (my underlining). MoMA trustees undoubtedly came from the income bracket where the fiscal advantages of collecting-and gifting-art works to museums was apparent. Some perhaps also hoped to enhance the status of their own taste and of the art in their own collection by having it valorised via public institutions. Few, though, expressed it as bluntly as one of MoMA’s founding trustees in 1930, when he is reported as saying, albeit with respect to a loan exhibition: "*We only want the works of men owned by the Trustees. That’s the only way we can run this Museum*" (Lynes, *Good Old Modern,* p 71). It is undeniable that the growing influence of MoMA upon the art market did indeed enhance the status of certain collectors’ taste, particularly if included in the occasional series of “*Works of Art: Given or Promised*” (see 1958 show, which included collections both of Social Register collectors and noted businessmen). This is not to argue that collectors controlled but that, because of the tax provisions outlined, there was a unique relationship between institution and collector within the wider American support system for modern art.

In life, a prospective donor did not necessarily even have to cede complete possession of any art work gifted: the “life interest” provision meant that a donor could arrange to keep a work for an agreed period, deducting a proportion of the “fair market value” of their donation per a sliding scale set down by the IRS. For instance, as noted by Alfred H. Barr in correspondence with a private collector, the value of a donation of $100,000 by a donor retaining a life interest would be $48,030 if s/he was 50 years old rising to $72,630 if they were aged 70 (AH Barr, letter to Richard S Davis, 17.10.1955; AH Barr Papers, MoMA Archives). Moreover, museums could be most ‘accommodating’ regarding potential “life interest” gifts, allowing a donor to keep a work in his/her own home although the museum had full title to it, and the full ‘Charitable Deduction’ taken (T.B. Sherman, “Art and Taxes”, *Saturday Review of Literature*, 7.7.1956, pp 5,6,26).

Although in large part its efforts to encourage potential collectors of modern art were forced upon MoMA by circumstance, what resulted was a situation where the modern art museum was akey “player” in the market for modern art. Indeed, MoMA’s efforts to stimulate the potential market for modern art in the US/NYC was so successful that by the mid-forties MoMA was cited by many NYC dealers as the single most important influence on the market for modern art in that city (and in effect the country). By the late 1950s its impact on the market for modern art was such that it was regarded , to quote curator Andrew Ritchie, as *“… the Bourse. Everything we did the dealers knew about before we did it, and prices were affected accordingly*” (R. Lynes *Good Old Modern,* p 250). MoMA’s influence on the art market was undoubtedly due to the status which it had built up as a public institution since 1929, coupled with the social cachet of the collectors and donors supporting it, but was, at least in part, because dealer-galleries did not publicise their prices outside their tight circle of potential clients. Commercial galleries in NYC, because of the then norm of only handling art on consignment, did not typically engage in much taste-making. In least in part because of this, auction sales in NYC, which to 21st century eyes would be expected to set price benchmarks, tended to be seen at mid-century as a rather unreliable measure of art market values. As noted by *Fortune* Magazine in 1955 “*the auction price is a very special price and must never be confused with the market price … On the whole the auction price is below the market price* …” and taken by most contemporary commentators as about 1/3 of the asking price in private commercial galleries (Hodgins & Lesley “The Great International Art Market”, *Fortune,* January 1956, pp 122-136). There were few ‘headline’ auction sales in the 1940s and 1950s, and these all came only at the end of the 1950s e.g. the Kirkeby Sale in November 1958. However, as some of the seemingly record prices in this sale were lower than Kirkeby had paid for the work on 57Th Street only a few years earlier auction sales were not necessarily attractive for American collectors of modern art. It was only in the 1980s that auction sales became a key part of the NYC art market as prices of modern art escalated.

If we are considering the issue of “unintended consequences”, it is interesting finally to consider the events of the 1980s. In this decade, the NYC art market funda-mentally changed in nature. Big modern art museums such as MoMA were edged out of their previously pivotal role regarding the art market; prices of modern art achieved a significant price escalation accompanied by headline-making auction sales in New York; and private collectors seemingly assumed a relatively more important role within the art market support system. It is surely no coincidence that such changes paralleled radical changes in Federal taxation.

Changes in the headline rates of income tax came in 2 tranches: 1981 and 1986. The 1981 Revenue Tax Act significantly reduced the top marginal income tax rate from 70% to 50%. The 1986 Tax Reform Act continued the work of the 1981 Act by reducing the top marginal rate for 1988 to 28% (Clotfelder, 1990). However, as Feld notes, such “*Tax changes that work to the advantage of taxpayers by decreasing their taxes work to the disadvantage of charitable institutions*” (Feld et al, 1983, p 181). This reduction in the top marginal rate meant that the “price of giving” $1 in cash thus rose from first 30 to 50 cents in 1981, and then 62 cents in the $ for those in the highest tax bracket in 1986 (Fullerton in Feldstein, 1991, p 206; Clotfelder, 1990, p 4). It was not expected that these changes would necessarily have a negative impact. To some commentators it seemed that some of the proposed changes - particularly the equalisation of personal income tax and capital gains tax rates to 28% - would benefit art museums by encouraging more to consider donating (*New York Times,*  8 June 1987). Moreover, because “*a strong tradition of giving away 30-cent dollars*” had developed during the 1960s and 1970s it seemed plausible that reductions in income tax rates which raised the donor’s “price of giving” would not necessarily mean cutbacks in museum donations (Heilbrun, 2001).

As Wolff (in Clotfelder et al, 1999, p 219) notes, the sensitivity of potential donors in the USA to their tax rates as particularly noticeable among upper-income households. Key provisions of the 1986 Tax Reform Act did have a negative impact upon the behaviour of the wealthy collectors who made up the bulk of donors to arts organisations, and thus upon art museums. The “price of giving” for appreciated assets such as art works nearly trebled from 20 c per $ in 1980 to 58 c per $ in 1988 (Fullerton in Feldstein, 1991, p 208; Clotfelder, 1990, ‘Table 3’). Most significantly, the 1986 Reform Act eliminated the “double incentive”: tax payers could now no longer deduct the “fair market value” of any appreciated asset (art work), they could only deduct the original cost, eliminating the previous forgiveness of capital gains (R N Rosett, in Feldstein, 1991, p 168). This reflected the fact that Congress was anxious that some had used the “double incentive” to pay less tax than they should (Ibid, p 208), a possible abuse which had been evident for some time. Consequences can be seen in the following example: if donating property worth $10,000, that originally cost $8,000, the value of the exemption pre-1986 would have been $5400 ($5000 from the deduction at a 50% marginal tax rate, plus $400 from the forgiveness of capital gains tax at the 20% rate); under the new rules the value of the exemption fell to $3360 ($2800 from the deduction at the 28% top tax rate and $560 or capital gains tax at the 28% rate). The negative potential of the 1986 Act was further increased by the introduction of AMT (Additional Minimum Tax)—targeted at the wealthiest taxpayers—which introduced a particularly unfavourable treatment of donations of appreciated assets such as art works (Auten et al, 1997, p 24) which “*for some potential gifts, … had the effect of virtually wiping out the bulk of the deduction, particularly of artwork*” (Clotfelder, 2012, p 8).

Although one should not generalise too much, as there are always some collectors who remain unconcerned by changes in the tax situation, the consequence of these changes was to depress donations of works of art to museums: between 1986-88 Rosett (in Feldstein, 1991, p 168) notes a fall of 54%; in 1987 the American Association of Museums projected that 162,000 fewer objects had been donated than in the previous year; while a 1989 study by the Association of Art Museum Directors found that “t*he value of donations [to art museums] declined by $161 million, or 63 percent, from 1986 to 1988 for the 116 institutions reporting*” [*New York Times,* 7 May 1989; *Orlando*-*Sentinel,*  18 June 1989) ). The link between the levels of gifts to museums, and the unfavourable AMT treatment of appreciated assets first introduced in 1986 meant that donation levels bounced up and down as this clause was imposed, suspended, re-imposed and finally revoked in 1993. Perhaps more importantly, such changes disrupted what had up to then been a presumption among the very wealthiest collectors: that their collections, either in whole or in part, would be donated to a public institution of choice, memorialising their taste and status as patrons of modern art. Instead, selling key works in their collections became, for the first time, an equally attractive option.

There are several telling proofs of the impact of the 1986 changes. On a more general level one might point to the overall totals raised in NYC auction houses: in 1985-86, before the tax ‘reforms’, modern art auctions at Sotheby’s and Christies’ NYC totalled some $25 million; in 1987-88, after the reforms, and while the new AMT provisions were fully in place, modern art auctions in New York generated nearly $85 million. Some of this must be an escalation of prices caused by wider economic conditions and an increasingly international market for modern art (one driven at least in part by Japanese collectors), but at least some was American collectors who had decided to sell rather than follow the conventional museum and donation route.

In light of being liable for AMT, where the tax benefit “*is based on the original value of the art work, not its appreciated worth*” (*New York Times,* Sept. 3, 1987) art dealer John Whitney Payson decided in 1987 to sell van Gogh’s *Irises*—which he had inherited from his mother, Joan Payson Whitney, in 1975, when it had been valued at $1.8 million—rather than to give it, as previously planned, to Westbrook College in Portland, Maine (where it had been on loan for the previous 10 years together with 27 other works from Joan Whitney Payson’s collection). The painting sold at Sotheby’s in November 1987 for a record-breaking $53.9 million (about 2x the pre-sale estimate). Although attracted to sell by some recent very high auction prices for van Gogh paintings, Payson also noted the significance of the recent tax changes in his decision to sell the painting: pre-1986 a work of art bought for $10,000 and which had increased in value to $100,000 would have brought a $50,000 tax savings if donated to a museum or other charitable institution; in 1987, “that art work would bring a tax benefit of only $2,100” (*Sun-Sentinel,* 5 September 1987). However, Payson, in donating 12.5% of the sale proceeds to establish the ‘Joan Whitney and Charles Shipman Payson Charitable Foundation’ in honour of his parents ``*to support the arts in Maine*” surely used other tax provisions to reduce the capital gains tax on the sale: this donation would have reduced his income tax liabilities (the limit was 50% of AGI donations, but this could be spread over up to 5 tax years). One might argue that Payson’s career as art dealer, and the fact he had inherited the works, might have made him more inclined to sell the paintings, but other cases show how a combination of escalating prices and tax reforms persuaded collectors to sell rather than simply donate.

Conventionally, collecting was for love of art, its social promise, and investment possibilities: American collectors preferred to admit to the first, cultivate the second, and pretend to downplay the last. With the tax reforms of 1986, and more particularly when AMT stripped away the tax advantages of donating appreciated property, then the conventional collector and museum route for the acquisition and donation of paintings seemed doomed. Burton and Emily Tremaine had been long-standing collectors who had started collecting European modernism and post-war American painting in the late 1940s. The Tremaines were actively cultivated by several museums, and had previously given 90 objects to the National Gallery in DC, and 300 smaller pieces to the Wadsworth Athenaeum in Connecticut (which showed 150 works from the collection in 1984) (*New York Times,* 7 June 1991). Also, it seemed increasingly difficult to contemplate giving major works of art to museums considering the ever-escalating prices. There were 2 Tremaine sales – the first in 1988 after Emily’s death; the second in 1991 after Burton’s death. The timing of the first sale at Christie’s was seen as “perfect” (Housley, 2001, p 215) as it occurred at the peak of a strong speculative surge. Price records were set by works such as Jasper John’s *White Flag*, which sold for $7.04 million, although this record was surpassed at another sale the very next evening, when in another sale Johns’ *False Start* sold at Sotheby’s for $10 million. All together the 1988 Tremaine sale totalled $25,824,000, then a record for a sale of post-war art. The second Tremaine sale, in 1991, over 2 nights at Christies New York, was not such a success; the previously frenetic art market of the 1980s was seen to have peaked with the disappearance of the Japanese collectors who had helped drive the 1980s boom. Several paintings were “bought in” and others, although realising 6 figure sums, did not achieve their estimates. The proceeds of the sale still amounted to $ 25,145,000 (Housley, 2001, p 215-17). In selling their collection at auction, however, the Tremaines did not entirely reject the possibility of tax benefits. In 1987, Emily Tremaine had set up a charitable foundation, into which the proceeds of the sales were funnelled. As contributions to private foundations were fully deductible for tax purposes (Auten, Clotfelder & Schmalbeck, 1997, p 9) this resolved any issues with estate taxes.

Hopefully what has become clear is that Federal taxation did have some impact upon the development of the market for modern art in the United States, though the consequences were, for the main part, unintentional, for the Federal government. To assess what impacts Federal tax, and changes to these Codes, might have had since the 1980s is to turn the next page on the narrative presented. When the art market is buoyant American collectors are tempted to sell their collections at public auctions. Post the 1986 Act, there was intensive lobbying for the market-value deduction to be reinstated. This was restored in 1993, and has remained in place hitherto. The sharp fall in donations to museums noted after the tax ‘reforms’ of the 1980s subsequently ameliorated somewhat, though escalating prices of art have continued to make sales attractive to collectors and make donations of highly appreciated art works newly problematic in comparison. What also seems to have become an ever-growing trend however is the founding of private art museums – with the advantage for the collector of retaining more control of the collection, while at the same time reaping the tax benefits of being a charitable tax exempt. What continues to be true, however, is that the issue of tax and the collector continues to be a key issue – whether for museums, collectors or tax advisers!