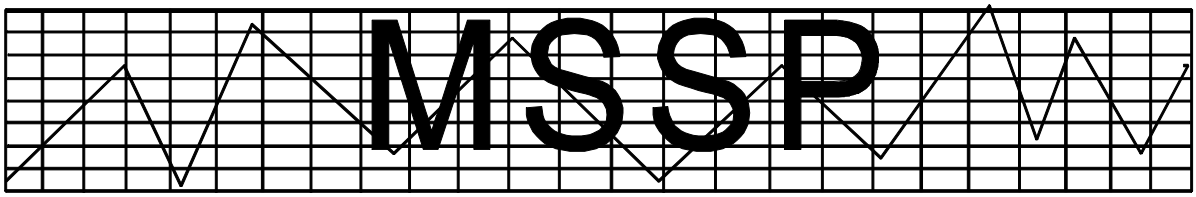

Market Segment Specialization Program

Artists and Art Galleries

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in Webster's Dictionary or from a list of names of counties in the United States as listed in the United States Government Printing Office Style Manual.

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ARTISTS AND ART GALLERIES

TABLE OF CONTENTS

Page

Chapter 1, Introduction

General Description of the Industry 1-1
Industry Description and Characteristics 1-2
Common Characteristics of the Industry 1-3

Chapter 2, Methodology

Artists 2-1
Art Galleries 2-3

Chapter 3, Examination Techniques

Background 3-1
Pre-Audit Considerations 3-1
Initial Interview 3-2
Information Document Request 3-2
Typical Books and Records 3-3
Required Filing Checks 3-4
Audit Procedures 3-5
Income 3-5
Cost of Goods Sold 3-5
Expenses 3-5

Chapter 4, Audit Issues

Trades 4-1
Inventory 4-2
Other Areas 4-4
"Trading Posts" Acquisitions of Inventory 4-4
Emerging Issue 4-5
Art Advisory Panel - IRM 42(16)4.1. 4-6

Glossary G-1

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Chapter 1

INTRODUCTION

GENERAL DESCRIPTION OF THE INDUSTRY

The Art Gallery industry is a wide and diverse creature. To merely mention the term gallery conjures up many different thoughts to different people. To some it is merely paintings, to others it is architecture, pottery, rugs, and even jewelry. The term art is a wide and varied term.

The industry can be broken down into several categories.

General -- Paintings, Sculpture, other framed art work. There are many different subcategories in each of the above which will not be discussed at this time. See the Exhibit 1-1 for a listing of the different types of paintings.

Ethnic Art -- This is as varied as the "General category." It ranges from Mexican, African, South American, Asian, and local items. Local items will vary depending the area of the United States. Ethnic is also varied and different depending on the originating cultures.

Prints -- This type of work is different from paintings as it is a produced item. There are several different methods used to produce a print such as offset, serigraph, lithograph, and photography.

Other -- As mentioned previously, the art world is a diverse industry. To merely list the above and classify all items within these categories cannot be done. Also included in the art world are jewelry, wood carvings, pottery and ceramic items, antiques, furniture, and a myriad of other items.

The term "artist" itself is important. There are two types of artists, living and deceased. "Living artists" are those who sell their art works either as a hobby or as their occupation. These art works can be worth very little or maybe worth hundreds of thousands of dollars. The living artists may even have their art work sold a second and third time. After the work is bought the first time, it may find its way back into the gallery again or at an auction house for sale. The "deceased artist" may or may not be famous. Artists such as Picasso, Van Gogh, or Norman Rockwell are famous deceased artists. However, there are many deceased artists who do not have the notoriety of these artists. Their works are of no less importance though. These works of art have usually been sold at least once. They can range in price anywhere

from thousands of dollars to millions of dollars.

The galleries cater to the various types of works available. Galleries would sell pottery, baskets, rugs, and jewelry. The gallery may be a pure painting gallery showing only impressionist paintings. Another gallery may sell a little bit of everything. Therefore, it is difficult to make a list of art galleries that offer only one type of art.

The galleries themselves vary in size. They range from having gross receipts of $50,000 to over $60 million. They may only take works of art on consignment or may have inventory over $40 million. Depending on the size of the gallery and dollar amount of the items sold, the activity of the galleries vary. Some galleries sell a large amount of small dollar items, while some sell fewer, but higher priced items.

Gallery owners are the key to the business. Are they experienced artists themselves, collectors turned salesmen, or merely entrepreneurs trying to make a profit? The more knowledgeable the gallery owner is about the art work, the clientele, and the market, the better the business will function. While looking at the industry, there were many galleries that were competing side by side with nearly the same type of art, at about the same prices, and one would fail and one would succeed. The difference 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 business.

INDUSTRY DESCRIPTION AND CHARACTERISTICS

An **"artist"** can be defined as almost anyone who creates a work of art, possesses the talents and abilities to master certain techniques when applied to production of a specific item (whether a painting, sculpture, jewelry, etc.), and produces art in whatever form that has intrinsic value to the "market" for which it was produced.

An **"art gallery"** (defined again later) is 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.

Art objects are bringing extremely high returns. The galleries have the ability to make the "unknowns" popular in the industry. The galleries representing the more popular skilled artists have been able to reap the economic rewards without tying up large amounts of capital investment in inventory by selling on consignment.

It is difficult to monitor compliance by artists because galleries selling art works on consignment are not required to report the sales via information returns (Forms

1099). Additionally, some artists generally prefer the use of "cash" for personal living expenses and often deal in cash which makes gross income probes of artists a challenge for any examiner. This MSSP Guide concentrates on the use of "third party" contacts in proving income since the use of cash can be an integral part of the artist's life-style.

COMMON CHARACTERISTICS OF THE INDUSTRY

The following are a few of the common characteristics and audit issues discovered in this market segment:

1. Unreported income from cashed checks from galleries to the consigning artists

2. Inventory valuation problems for "trades" between the artists and the gallery owner and between gallery owners

3. Diversion of income by sale of credit card business to related or other entities

4. Avoidance of state sales taxes on art sales by using certain schemes devised by art brokers to market the art in other states

5. Capital gains vs ordinary income from sales by gallery owners as investments vs inventory

6. Identification of sources through "cost of goods sold" who failed to file/report transactions by analysis of canceled checks and payment/transaction records

7. Framing costs not properly capitalized

8. Very high travel and entertainment costs with low gross receipts indicative of potential "hobby" vs business loss

9. Sales of art works disguised as "loans" secured by art as collateral and possible "money laundering"

10. Other "financial status" indicators with artists'/gallery owners' life-styles being considered against reported income

11. Potential issue on foreign artists who consign to galleries (International Referral Required)

12. Art work being deducted as a charitable contribution, while not being taken out of cost of sales.

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DEFINITIONS

TYPES OF PAINTING STYLES

Realism

Treats all facets of daily life in a style that shows frank enjoyment of the natural shapes, textures, and colors of things and a delight in the manipulation of the paint itself.

Impressionism

Depicts the natural appearances of objects by means of dabs or strokes of primary unmixed colors in order to stimulate actual reflected light.

Post Impressionist

Revolt against impressionism, stresses variously volume, picture, structure, or expressionism.

Abstract

Art in which the artist attempts to convey his or her attitudes and emotions through nonrepresentational means.

Cubism

Sought to reduce nature to its basic geometric shapes, often viewing objects from several sides simultaneously.

Pop Art

Art and Mass Media.

Surrealist

Producing fantastic or incongruous imagery of affects by means of juxtaposition and combinations.

Western Art

Depicts life of Western America through cowboys, Indians, landscapes, and images of western life. The medium can be either painting or sculpture.

Acrylic

A clear plastic used as a vehicle in paints and as a casting material in sculpture. Noted for its quick drying and luminosity.

Oil

A paint which is a drying oil is the vehicle. Oil color is more easily mixed than acrylic color.

Pastel

A combination of pure pigment and binder forming permanent colored sticks; noted for colors which go from soft to brilliant. When ground is completely covered with pigment, the work is considered pastel painting: leaving much of the ground exposed produces a pastel sketch.

Watercolor

A painting compound of water-soluble pigment.

TYPES OF PRINTS

Offset Printing

A process in which an inked plate is used to make an impression on the rubber surface of a roller which transfers it to paper.

Lithograph

The process of printing from a small stone or metal plate on which the image to be printed is ink-receptive and the blank area is ink repellant. The artist or other print maker, under the artist's supervision, then covers the plate with a sheet of paper and

runs both through a press under light pressure. The resultant "original print" is of considerably greater intrinsic worth than the commercially reproduced poster which is mechanically printed on an offset press.

Serigraph

A form of print making which utilizes stencils attached to porous screens that support delicate areas of the cut design. Most often issued in signed and numbered editions.

Artist Proof

One of a small group of prints set aside from the edition for the artist's use.

Edition

A set of identical prints, sometimes numbered and signed, pulled by, or under the supervision of the artist. The edition may either be open (unlimited) or limited.

SCULPTURE

Lost Wax Process

A method of casting metal sculpture requiring a wax version of the original model. The wax form is encased in a heat-resistant molding material. Baking the mold causes the wax to melt and run out leaving a cavity in its place. The cavity is filled with molten metal which solidifies to become the sculpture when the mold has been broken.

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Chapter 2

METHODOLOGY

ARTISTS

A review of the industry was made in the following manner:

Initially PIA codes were to be used to identify the industry. However, the market segment was not easily identified using prescribed PIA codes. Some of the common PIA codes used are as follows:

Form 1040: 5884 - Other Retail
4671 - Jewelry Store
1883 - Other Manufacturing
6882 - Other Personal Services
1073 - Fabricated Metal Products
7880 - Other Business Services

Form 1120: 3490 - Misc. Fabricated Metal Products
5995 - Other Retail Stores
8980 - Miscellaneous Services.

Since PIA codes were not the best source, other means were necessary to identify the market segment. The first method used was to refer to the local yellow pages under "Art Galleries, Dealers & Consultants." This listing will generally list most dealers and galleries located in a specific area. The advertisement will usually list the type of art the dealer/gallery carries or specializes in, for example, Southwest, rugs, paintings, sculptures, etc. A dealer in art is generally a person who owns or operates an art gallery, that is, a retail establishment with such overhead items as rent, utilities, wages, insurance, etc. A broker is generally someone who works on a commission basis for the artist and finds distribution points (galleries) in which to show and sell the artist's works. A broker generally has little overhead, except for travel to various galleries that may be prospective customers. Many times big-name artists will have galleries all over the country showing their art works and a broker is the one who coordinates which galleries will show particular pieces. Generally a living artist's work will only be shown in one gallery in a specific area (city). Therefore, two galleries in a city showing the same artist's works is very rare.

Another method used to identify galleries was to visit the area and obtain one of the art brochures/pamphlets. In Arizona there is a publication called **Art Life** that is used by the galleries to advertise the type of art work, artist, business location, and

hours of operation. The Chamber of Commerce in a specific city is a good place to acquire some of these brochures. These brochures will generally go into more detail than the yellow pages, sometimes even listing specific artists' names that they represent.

Another way galleries were identified was to simply walk around the area where the galleries were located. Most areas that cater to this type of industry are located in small, expensive towns or small areas of larger cities. They are generally located in "clusters" and visiting quite a few in a small amount of time is not difficult. While walking around these areas, take time to note the names, addresses, and locations of the specific galleries. Collect any business cards for future reference. Note the types of art in the galleries and their price ranges.

The next step was to perform the necessary research to identify the specific sample cases for examination. Where necessary, local personnel were consulted for updated research to identify specific characteristics desired in the sample.

During the examination of various art galleries the names of artists who consigned their works of art with the gallery were discovered. The names that developed into "leads" for other examinations were primarily those who "cashed" their checks from the gallery and did a predominant business with one gallery. Resulting research proved that a number of the artists identified lived outside the district and, thus, files were built and information transmitted via "Information Reports" to those districts. This can be a time consuming effort and use resources which otherwise could be applied elsewhere.

After examining several art galleries, efforts were focused on the artists. Research similar to that which was done on the art galleries was performed on artists. The location problems, PIA codes, and no requirements to file Forms 1099 were some of the considerations which the team faced as the project progressed.

Later examinations turned to the "trading posts," which will be described further in Chapter 4. The resulting emphasis was on the **cost of goods sold** sections in identifying and isolating certain **wholesalers** who sell jewelry and other forms of art work to these establishments. The "trading posts" are normally located on the major traveled arteries (interstate highways) and those traversing the Indian reservations between New Mexico and Arizona. Many of these examinations resulted in leads to a group of wholesalers who were furnishing merchandise to the trading posts. Some were found to be non-filers and many had substantial unreported income. The examination process led to several criminal and civil fraud referrals on such taxpayers. See Chapter 3, on Examination Techniques.

ART GALLERIES

The use of PIA codes is not an effective means of identifying the art gallery market segment. The galleries tend to use incorrect PIA codes and often the codes used are not indicative of their business activities. For example, the most commonly used PIA code for Forms 1040 is 5884 "Other Retail" and for Forms 1120 is 5995 "Other Retail."

The initial method to learn about the market was to visit galleries and obtain literature, business cards, and other industry information. From these tours of the galleries, EIN's and SSN's were secured from IDRS where possible. The galleries often conduct business under a different name than the owner. The corporate name may be the owner's name and not the gallery name. If the gallery is operated by an individual living in another part of the country, cross district research may be necessary. Returns were grouped based on an analysis of common characteristics and selections were made for examinations.

Another method of developing industry information was to look at advertising publications. In New Mexico the publication is called **The Collectors Guide**. In Arizona it is called **ArtLife**. These guide books are used by galleries to advertise the type of art work, artist, business location, and hours of operation. Since it is expensive to advertise in these guide books, not all galleries are listed. The guide books also contain maps and other advertising literature on the galleries. Use of this information is particularly effective in identifying a particular type of gallery.

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Chapter 3

EXAMINATION TECHNIQUES

BACKGROUND

All of the audit techniques described in this chapter relate to art galleries. This is due to the fact that the major issue involving artists is unreported income. Information to develop this issue is found in the books and records of 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 or its own inventory or both.

Galleries acquire the art work by two methods:

1. The gallery's art works may be on consignment. The reason consignment is so popular, is that the gallery does not have to expend any money to acquire the art work. If the art work does not sell, then the gallery will return it to the artist and get a new work of art. Since art is expensive, galleries do not want to be out of pocket for the purchase of art. The gallery and the artist agree for the gallery to show the artist's work. In exchange, the gallery charges the artist a percentage of the purchase price. The usual split is 50/50. The artist gets 50 percent of the gross and the gallery gets 50 percent. The split can vary and may be as low as 70/30. Generally, the artist will not take less than 50 percent; however, this is not always the case. Where the split is not equal, the gallery will take the lower amount. The reason for the differing percentages may be the artist's choice, or the cost to produce the work of art is high and requires more funding. For example, a bronze sculpture is very expensive to cast. Therefore, the artist's cost are greater. This method usually works well with living artists. The gallery will market the art for the artist, pay for the local art guide book, and incur any show opening expenses. See Exhibit 3-1 for a sample of an art gallery consignment receipt.

2. The gallery's art work may be owned by the gallery. The owner or buyer for the gallery will travel around the local area, the region, or across the country to find the art work. Many of these works of art are of deceased artists. Therefore, they must purchase the art work to resell. The owners or buyers travel to auctions, estate sales, other collectors, or even galleries. Some galleries specialize in certain types of art work. Therefore, they must own the art work. There are

certain occasions that a living artist has enough clout to require the gallery to purchase their art work.

When inspecting the return, consider the 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 works. However, it is important to know the type of gallery so you can ask for the right information during the initial interview.

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

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 what type of art is 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 exactly what is going on in their business. They are familiar with the different types of art work and the artists themselves. They may or may not maintain the books and records themselves. If they don't, a spouse, employee, or independent bookkeeper will prepare the books.

Exhibit 3-2 is 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 imagination in asking questions. Since the audit is just starting, this 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 get the needed information. Your initial IDR should include the normal request for books and records but should also include all records for consigned art received, returned, and sold during the tax year. Acquire ALL shipping records for the tax

year. Ask for canceled checks, especially those to artists. Examination of these checks will reveal if the 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 all of the sales price is reported. Exhibit 3-3 are examples of IDR's for galleries operating as sole proprietorships, corporations, and partnerships.

TYPICAL BOOKS AND RECORDS

The books and records that are normally found in a gallery are the basic ones found in any industry. There does not appear to be any specialized computer program set up to handle the books of an art gallery. The galleries have general ledgers and general journals. The larger gallery will probably have all records on computer such as journals, ledgers, inventory records, and check disbursements. Some of the smaller galleries may still use manual systems.

There are some specialized areas that require careful consideration. The first item is inventory. If the gallery purchases its inventory, there should be a very detailed inventory listing. It should show date purchased, purchase price, any restoration and framing costs, date sold, and price. Restoration and framing cost many times are broken out separately. This expense is usually small in comparison to cost of goods sold as a whole. The inventory should be detailed enough for the auditor to follow any purchase from start to finish. However, the inventory cost may not be properly recorded, and the accountant may have adjusted the books to compensate for it. This is discussed further in Chapter 4, Audit Issues.

If the gallery sells on consignment, there will be a system in place to track consigned items. This system will generally identify the artist's name, address, description of art work, date the art work 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, sales price, and terms of the sale. Generally the artist sets the sales price. Many times galleries sell items on an installment plan, that is, 25 percent down and three more payments of 25 percent. When the full sales price is received by the gallery, the art work is released to the buyer and final payment is made to the artist. Sometimes the artist will require full payment from the gallery at the time of sale although the gallery has not received 100 percent of the sales price. This is rare and usually the artist is paid when the gallery is fully paid even when installments are made.

The gallery may keep large amounts of cash on hand. If the gallery specializes in local art, many purchases will be from the local or regional residents. Some of the artists do not have bank accounts. Therefore, they want to be paid in cash for any items purchased by 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 the expenditures from this drawer. If there are any unusual or odd amounts, or little to no documentation, there should be a more in-depth inquiry into the cash purchases.

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

Generally, when artists provide pieces to the gallery, they are not framed. The gallery will have the option of using a local framing shop or doing the work internally, should they decide to frame the piece to enhance sales. However, it is usually noted on the sales ticket that is attached to the piece displayed in the gallery that the frame is an extra cost to the purchaser.

Since sales of art to tourists and out of town customers often represents a sizable portion of the gallery's receipts, shipping costs are quite substantial for a gallery. This is normal, but since these costs are passed on the customer, verify that all shipping charges 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 has not been sold and the gallery does not feel it will sell, it will be returned to the artist as their space is limited and very expensive. They will either ship it to the artist at the expense of the gallery or the artist will personally come in and pick it up.

REQUIRED FILING CHECKS

Inspect related returns, employment tax returns, and prior and subsequent year returns. There are a few items to particularly note. The first item is whether or not the corporation is paying its officers as employees or independent contractors. IRC sections 3121(d)(1), 3306(i), and 3401(c) provide that any officer of a corporation is an employee. The adjustment would be to convert the officers to employees and assess the applicable taxes against the corporation. The reason a corporation does this is to solve a cash flow problem. If the corporation cash flow is poor, it would be financially beneficial to not pay its officer's FICA and let the officer file a Schedule C on his or her individual income tax return.

Since most galleries are privately owned, there may be an issue of the corporation renting property from the shareholder. There could be a passive loss issue if the rent is used to offset other passive losses. There is also an issue if the owner of the gallery is selling art work individually. The items are recorded on Schedule D. This may be done for several reasons. One is to offset a capital loss. Another reason is to avoid paying additional self-employment tax. The taxpayer may also be able to use the capital gain income to offset more investment interest. The examiner must be

aware of the date of purchase, the length held, and the amount of sale. The gallery owner, especially if the gallery is a corporation, may be operating another business on the side. Also verify where the art work was kept. Was it put immediately up for sale? Was it truly an investment, or was it the purchase of inventory?

AUDIT PROCEDURES

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

Income

The sale of art work is a specific item business. Art is not a homogeneous product. Therefore, it should be easier to tie into specific item sales and trace them to the source. The income check and cost of goods sold can be verified together. Income will almost always match the receipts. Except for the rare occasion where there is a mistake, income usually ties from the books to the return. While looking into income, the examiner should be aware of any odd or unusual items. An example is where an item appears in inventory, but there is no sale.

Cost of Goods Sold

The cost of goods sold/purchases is probably going to be the most significant adjustment to gross income. While looking at cost of goods sold, trace purchases back to the time of purchase. Determine what was bought and for how much. Most galleries pay for large purchases by check, so the verification should be relatively easy. The examiner should be alert for items disappearing from the inventory record. The item may be sold and the income not be reported. This requires time and should only be done if there appears to be a problem.

For sales of consignment items, a different approach is taken. The artist should be receiving a consignment check. This payment may be monthly, at the time of sale, or according to other arrangements made between the artist and the gallery. What does the artist do with the check? Is the amount cashed or signed over to a third party? The canceled checks should be inspected for signature and deposit marks. The gallery is not required to give the artist a Form 1099 for the payments made, since there is no service being offered by the artist. It is important to determine if the artist is cashing the checks. This is a good indication that the artist may not be reporting the sales as income. This has been an excellent source of "leads" for unreported income and fraud cases. A problem that may be encountered is locating the artist. The first step is to get the information the gallery has 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, research IDRS. If you have problems locating the artist's SSN on IDRS, contact your local AIMS Coordinator for assistance. The artist may live outside your region and the SSN may not be found on IDRS. With the new

advances on IDRS, it may soon be possible to find the individual's SSN, even if they live outside your region. Again, if IDRS for the other regions is not available contact your AIMS Coordinator for assistance. Prepare a Form 5348, Information Report, on any unusual items noted. Include copies of the checks to assist with the other district's audit. As an added note, there may be times when a piece of art work is purchased and the check is cashed. Take all the same steps to make sure the sale is being reported by the seller of the art work.

One last item to review in cost of sales is whether the 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.

Expenses

The expenses will significantly vary between galleries depending on the extent of their source of supply and whether they are aggressively marketing the product at 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. Other significant expenses could be framing costs and restoration costs. These should be capitalized not expensed when they become part of the saleable product (inventory).

Art brokers/agents may be paid commissions by the gallery owner for securing various items of inventory or by the artist for marketing his works. In any event, this expense can be found on both returns.

SAMPLE ART GALLERY CONSIGNMENT RECEIPT

The attached consignment receipt records the name, address, and phone number of the consignee artist, describes the item(s) being consigned, prices set by the artist, the date negotiated, and the signatures of the consignor and consignee. This type of document is somewhat typical of a consignment agreement in the industry which sets forth the terms and conditions of the consignment transaction between the artist and the gallery.

CONSIGNMENT RECEIPT

Date: 2-2-92

TERMS: 50% to artist
50% to gallery

FROM: _____ PHONE: _____

WORK: _____

	TITLE	SIZE	MEDIUM	PRICE
	small herd of horses		wood	300.00
	horses w/ jockeys		"	1000.00
	buffalo		"	300.00
	shoulder to shoulder (horses)		"	300.00
	holsteins		"	300.00
	Mayfair Wood / one piece			

CONSIGNMENT AGREEMENT: In consideration of the acceptance of the above terms, it is agreed: 1) The Artist appoints _____, Inc. an Arizona Corporation, as his/her sole and exclusive agent for the sale, trade (if any), and exhibition of all the Artist's work in Northern Arizona: that is, those counties north of Maricopy County, whether or not said work is listed in the Schedule of Work. The items are consigned to _____ consignee, title remaining in Consignor, with the right of Consignee to sell one or more of the same at the above price 2) Consignment is at Consignor's sole risk of loss or damage unless otherwise agreed in writing in advance. 3) Insurance, if any, is the sole responsibility of Consignor, 4) Consignor agrees to pay Consignee the above stated commission on sale of the items, all agreed upon or customary charges with respect to the sale, 5) This consignment may be terminated by either party on 90 days notice, however, Consignee may terminate on seven (7) days notice due to space and/or other problems. Consignee's right to sell the items shall remain in effect in the period subsequent to notice and prior to termination.

ACCEPTED: _____ _____ INC.
Consignor

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SAMPLE INITIAL INTERVIEW - ARTISTS/ART GALLERIES

The initial interview should be structured to the particular taxpayer under examination. No pro-forma style of interview "check sheet" approach is recommended or even suggested in this MSSP Guide. What follows are only suggested sample interview questions which can be included in the examiner's own interview format for artists and art galleries.

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 art work?
What is your price range?

Do you keep a inventory record?

What form of payment do you receive, cash, check, or credit card?

Do you have credit terms?

Do you have a customer mailing list?

Do you engage in any "trades" of merchandise?

If so, what are the terms and conditions of such trades?

How often did such transactions take place during the year(s) under examination?

How are these transactions recorded in your books and records?

Can you provide a sample of such transactions and provide the book entries which record a "typical" trade transaction?

Do you sell on the installment basis or do lay away sales?

When and how are they recorded?

Do you represent primarily only a few or many artists in your gallery?

Do you know of other galleries in the area or outside the local area where these same artists are represented? If so, can you supply the names/locations of these galleries and the artists they represent?

Do you ever do exclusive "showings" or "hangings" for artists who consign to your gallery? How are these events handled?

Who pays the costs of travel, facilities, and other related costs?

Do you own art work as a personal investment? If so, do you have any of your personal collection or individual pieces on display here in your gallery?

Are these items for sale and do you price them yourself or does someone else price them?

How do you keep these 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, who are the artists and what is the 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?

Do you pay at the time the goods are sold, when you received actual payment, 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 the art work, who are the artists? Do you have it for 19XX?

Do you travel to find the art work? If so, around state, region, country, international?

Do you purchase from collectors? If so, do you have their names and addresses?

Do you go to auctions?

Do you purchase items such as jewelry or pottery from walk- in vendors? If so, do you pay cash or check? How do you keep a record of the cash purchases?

Do you keep an accurate inventory of all goods held for sale?

How are the inventory records costed?

What type of records do you keep of your inventory of goods held for sale?

Framing Costs:

Who does your framing for you?

Do you use primarily one framing company?

How do you record your framing costs?

If a customer wants an item framed differently or in a custom frame, do you supply the framing, send it out, and how is the framing cost recorded if done separately from the painting sale?

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 the costs, you or the customer?

How are shipping charges recorded?

ARTIST

Do you contract out your artistic services to any particular business, group, organization, or other entity? If so, how?

How many galleries do you show your art with?

What towns are these galleries located in?

Do you ever sell directly to a customer, bypassing a gallery?

What is your split with the galleries?

Do you pay for any of the show opening expenses or advertising expenses that the gallery incurs?

How do you record your sales?

Do you ever cash your consignment checks?

Do you ever get paid with cash?

Do you ever receive anything other than cash for you consignment payments?

Have you ever been "commissioned" to produce a work of art for a specific purpose (such as for a memorial, museum, or recognition of artistic value to a community, a city, state, county, or other governmental or non-profit organization?) If so, what were the terms, conditions, work performed, and how were you paid?

Did you do any such work in the years under examination?

Exhibit 3-3 (1 of 3)

SAMPLE INFORMATION DOCUMENT REQUESTS (IDR'S)

FOR AN ART GALLERY FILING FORM 1065

Form 4564 **Rev. 6/88**	**Department of the Treasury** **Internal Revenue Service** **INFORMATION DOCUMENT REQUEST**	**Request Number**
TO: Name of Taxpayer and Co. Div. or Branch **Please return Part 2 with listed documents to requester identified below.**		**Subject** -Audit of Form 1065 for the year ending _____ **SAIN No.** | **Submitted to:** | | _____|_____ **Dates of Previous Requests**

1. Partnership Agreement.
2. Work papers used in preparing the return.
3. Books and records, such as Ledgers and Journals for Sales, Purchases
4. Information to show the balances at the beginning and end of the year for loans receivable and other amounts owed you.
5. Information to show the balances at the beginning and end of the year for all loans and other amounts you owe.
6. Records to substantiate all accounts receivable and accounts payable at the beginning and end of the year.
7. Bank statements, canceled checks, and deposit slips for all accounts for the year under audit plus the months before and after.
8. Copies of your Forms 1065 for years ending_____.
9. Copies of Forms 940, 941, and W-4 for the years ending _____.
10. Copies of Excise tax returns filed, e.g., Forms 720, 2290, etc.
11. Copies of the general partner's returns for the year ending _____.
12. Pension-Trust Forms 550, a copy of your plan, and determination letters, if applicable.
13. Worksheets utilized to reconcile the "books" to your return;
14. Detailed depreciation worksheets.
15. Accountant's Work papers regarding:
    a. Year end worksheet reconciling books to return
    b. Year end Adjusting Journal Entries and closing entries
    d. Cost of goods sold
    e. Beginning and ending Inventory Valuations
    f. Copies of financial statement prepared for you
    g. Any accounts analyzed by them at year end or for certification.
16. Contracts relating to guaranteed payments.
17. List of names, addresses, & SSN's (if applicable) of all artists in which you have made payments to in the years _____ for inventory.
18. All sales and purchase records/invoices/receipts for _____.
19. State sales tax returns for _____.
20. Substantiation, such as canceled checks or receipts for the following expenses deducted on your tax return:

Information Due By_____ At Next Appointment [ ] Mail In [ ]

	Name and Title of Requester	**Date**
FROM:	**Office Location**	

Exhibit 3-3 (2 of 3)

SAMPLE INFORMATION DOCUMENT REQUESTS (IDR'S)

FOR AN ART GALLERY FILING FORM 1120

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: Name of Taxpayer and Co. Div. or Branch **Please return Part 2 with listed documents to requester identified below.**		**Subject** - Audit of Form 1120 for the year ending _____ **SAIN No.** | **Submitted to:** _____ | _____ **Dates of Previous Requests**

1. Corporate Minute Book/Stock Record Book.
2. General Ledger and subsidiary ledgers, if applicable, i.e., sales, purchases, accounts receivable, accounts payable, etc.
4. Chart of Accounts
5. Cash Receipts and Disbursements Journals, i.e., Check Register
6. Listings of Beginning and Ending Accounts Payable and Accounts Receivable
7. Detailed Depreciation Sheets
8. Accountant's work papers regarding:
   a. Year end worksheets reconciling books to return
   b. Year end Adjusting Journal Entries and Closing Entries
   c. Year end Bank Reconciliations
   d. Cost of Goods Sold
   e. Beginning and Ending Inventory Valuations
   f. Copies of financial statements prepared for you
   g. Any accounts analyzed by them at yearend or for certification
9. Copies of prior and subsequent tax returns
10. Copies of all Officers and Shareholders' personal tax returns - Federal for the years ended _____.
11. Bank Statements and canceled checks for the year under audit plus the month immediately proceeding and following.
12. Forms 940, 941, W-2, and 1099 for the years _____.
13. Any excise returns required to be filed
14. Pension-Trust Forms 5500, a copy of your plan and determination letters of applicable.
15. Worksheets utilized to reconcile the "books" to your tax return.
16. Records of all loans and repayments including loans to and from shareholders and also Accounts receivable, if applicable.
17. List of names, addresses, and SSN's (if applicable) for ALL artists in which you have made payments to in the years _____ for inventory purchases or consignment payments.
18. All purchase records/invoices/receipts for _____.
19. All sales records/invoices/receipts for _____.
20. Copies of State sales tax returns for _____.
21. Substantiation, such as canceled checks or receipts for the following expenses deducted on tax return:

Information Due By_____ At Next Appointment [ ] Mail In [ ]		
FROM:	**Name and Title of Requester**	**Date**
	Office Location	

SAMPLE INFORMATION DOCUMENT REQUESTS (IDR'S)

FOR AN ART GALLERY FILING FORM 1040

Form 4564 **Rev. 6/88**	**Department of the Treasury** **Internal Revenue Service** **INFORMATION DOCUMENT REQUEST**	**Request Number**
TO: Name of Taxpayer and Co. Div. or Branch **Please return Part 2 with listed documents to requester identified below.**		**Subject** - Audit of your ____ Form 1040 **SAIN No.** | **Submitted to:** **Dates of Previous Requests**

1. Copies of Federal Income Tax Returns for the years _____.
2. The following Employment Tax returns for the year under examination.
   If applicable: Forms 940 and 941
   Forms W-4 for all employees.
3. Information returns (form 1099) you were required to file for the year under examination, if applicable.
4. Partnership, Corporate, or Trust returns for years _____ in which you are a partner, shareholder or beneficiary of
5. **ALL RECORDS** used to determine income on the return for the year under examination, such as Forms 1099 and W-2 received and books and records used to record income.
6. Substantiation, such as a canceled checks or receipts for the following expenses deducted on your tax return:
7. **ALL BANK STATEMENTS**, canceled checks and deposit ships for the months of December ____ through January ____ . (This includes CHECKING, SAVINGS, both BUSINESS AND PERSONAL, and accounts of BOTH SPOUSES.)
8. All sales records/invoices/receipts for _____.
9. All purchase records/invoices/receipts for _____.
10. All Inventory Records for _____.
11. State sales tax returns for _____.
12. List of names, addresses, and SSN's (if available) for ALL artists to whom you have made payments in the years _____ for inventory purchases or consignment payments
13. Access to ALL invoices
14. Information regarding nontaxable income received in the year under examinatin. (Please include the amount received and the source of the income.)
15. Invoices for ALL asset purchased in the year under examination.
16. Information about outstanding loans for the year under examination. (copies of notes, amounts paid, and amounts received on notes.)

Information Due By_____ At Next Appointment [ ] Mail In [ ]		
FROM:	**Name and Title of Requester**	**Date**
	Office Location	

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Chapter 4

AUDIT ISSUES

TRADES

An issue arose as to the treatment of trades. It was found when a gallery would trade its inventory to another gallery or individual for another piece of work, the trades are treated in one of three ways:

1. 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.

2. Recorded as a taxable event. The basis of the new item is the fair market value, that is, cost.

3. Hybrid method using parts of both methods.

The proper way to treat the trade is number 2. The reasons are set forth as follows:

1. IRC section 61 defines income from whatever source derived. The regulations state:

   Extract

   Treas. Reg. section 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 cash.***

   * * * * * * *

2. In **James A. Engineering, Inc**., 39 T.C. 482 (1962), **aff'd.** 339 F.2d 706 (5th Circuit 1964), the court ruled that income includes the FMV of assets received.

3. IRC section 1031 allows for the tax free exchange of like kind assets. However, IRC section 1031(a)(2)(A) makes an exception for stock in trade held primarily for resale (that is, excludes inventory).

4. Furthermore, under Treas. Reg. section 1.001-1(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 possessor of a work of art enjoys different legal entitlement than the possessor of another work of art. Each owner has a pecuniary interest in and is entitled to sell a unique piece of property. Therefore, trading art work for other art work is an exchange of materially different property.

The law then clearly sets forth that the amount received in exchange for inventory is income, up to the amount of the FMV of the asset received.

If the law is so clear, why is there a problem? One reason the galleries gave is that they have always done it this way. Their argument is that since they are being consistent in their treatment, they should be allowed to continue this way. They further argue that when the traded item is sold, the proper amount of income is reported.

However, the main reason given by the galleries is that FMV is difficult to determine. FMV is defined as the price to which a willing buyer and a willing seller will agree. Rather than determine FMV, the galleries would prefer to report no gain on the transaction other than boot received. This would defer all gain on the item until a later date. The issue, then, is timing.

One can surmise that an item would not be traded for less than that received if the item were sold. According to the gallery owners, this logical assumption is not always true. Sometimes they trade for an item and miscalculate what it is worth, resulting in a loss when they sell the new item. For example, an art gallery trades an item with a sales price of $100,000, cost of $50,000, for another piece of art. The newly acquired piece of art is valued at $100,000. The art gallery must report a gain of $50,000. However, the new piece of art may sell for only $80,000. Because its basis would be $100,000, the gallery has a loss of $20,000, which is reported when the sale takes place. The gallery cannot treat the trade and the later sale as one transaction and only recognize gain, in excess of boot received, when the sale takes place.

INVENTORY

Inventory is usually the single largest item on the balance sheet. It takes up the majority of operating capital of the business. Most of the time a complete and accurate inventory is kept. However, this is not always the case. Variations are a result of purchasing a large amount of art work at one time from one person. No actual controls are placed on the purchase and therefore, no actual assignment of a cost per item. Normally this will show up by the books not tying out at year end. Since the cost per item in unknown, the gallery may pull too much cost or too little cost. It is a reasonable assumption that

the gallery will not write off too little. Since inventory is off, then something must be adjusted to correct the error. Many times it involves an income item.

Another way is for the taxpayer to place a percentage on the items sold during the year. The percentage is usually determined by the previous years cost of sales percentage. During the year, as items are sold, the costs are booked at that percentage. At year end when inventory is calculated, an adjustment is made to the COS. Since opening inventory, ending inventory, and purchases are known, the adjustment made to COS will be accurate. This is a good method for the accountant to use. It is a bit confusing at first, but in the end it does work itself out.

Unfortunately, since the examiner is not there to count inventory, he or she may be limited as to what can be done if there is an inventory problem. One way of solving an inventory problem is by not allowing an adjustment to affect the current year books. Most errors would be a prior period adjustment. If there is a tax effect, it would occur in a prior year.

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

A gallery owner also may establish a "fair market price" for an item in inventory where no open market exists or where quotations are nominal, due to inactive market conditions. The gallery owner must substantiate this fair market price by providing objective evidence, such as specific purchases or sales of the item by the gallery owner or others in a reasonable volume and made in good faith. Where the gallery owner, in the regular course of business, has offered for sale the item at a price lower than the current price, the inventory may be valued at such a price, less the direct cost of disposition. The correctness of this 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. section 1.471-4(b); **Thor Power**, at 434-35.

Thus, in cases involving an open market, such as cases involving mass produced works, the gallery owner may establish the market price of an inventory item with a replacement cost. In cases where there is no open market or where quotations are nominal, due to inactive market conditions, such as "limited edition" works, the gallery owner may establish a market price for the work with objective evidence. This evidence should be specific purchases or sales of the work by the gallery owner or others. However, in cases involving a unique work of art, it will be extremely difficult for the gallery owner to establish a market price with objective evidence. For example, the gallery owner must offer the work 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.

Some art galleries donate art work which they own. The galleries will take a deduction for the amount donated. There are two concerns regarding this. The first is that the gallery should adjust cost of sales for the donation. If they don't, the art gallery will double deduct the item. The second area is the amount deducted as a charitable contribution. The amount deducted is equal to the basis of the art work not the FMV of the piece. This is true for both corporations and individuals. (However, if a dealer makes a charitable gift of artwork from a personal collection held for investment purposes, the dealer may deduct the fair market value of the piece. See, for example, **Williford v. Commissioner**, T.C. Memo, 1992-450.)

OTHER AREAS

The areas below are not necessarily unique to the art industry but appeared while the project was being conducted.

Corporate officers may be paid unreasonable compensation for the duties performed.

Another issue is personal travel. As mentioned in the pre-audit section, travel will often be a significant item. The gallery owners will have buying trips, selling trips, and art hunting trips. Be careful to note that only the owners, and not their family members expenses are deducted. These trips may be to vacation places such as Hawaii, California, Florida, or Colorado. As such, there is a potential that some of the expenses could be personal in nature.

"TRADING POST" ACQUISITIONS OF INVENTORY

Often "trading post" owners acquired merchandise from wholesalers. While tracing the purchases from costs of goods sold to the source payment documents (canceled checks) it was found the majority of the checks were cashed by the wholesalers. Further research of these taxpayers indicated no record of filing returns in some cases, and in others substantial unreported income was discovered from these transactions.

A "pattern" of unreported income developed. Commonly, these taxpayers were dealing with many of the trading posts located near the interstate highway system. There have been several civil fraud referrals developed from this approach.

EMERGING ISSUE

While the project was being developed, an issue emerged that may have substantial impact on the art world. This issue deals with nonresidents consigning goods in the United States. The goods are sold and the money is either sent back to the nonresident or to another third party. The question arose as to whether the gallery should withhold income tax on the nonresident artist. After research and consultation with the National Office, it was decided that this issue would not be pursued at this time. However, there is still an issue with the foreign artist. The income earned may be taxable. The examiner should obtain all the information available about the foreign artist and prepare a referral to International for assistance.

ART ADVISORY PANEL - IRM 42(16)4.1

The Commissioner maintains an Art Advisory Panel of nationally prominent art museum directors, curators, and art dealers to systematically aid the Service in the review of Service-selected cases involving taxpayer valuations on major art objects, principally - American and European paintings and sculpture.

The Art Valuation Group in the Engineering and Valuation Branch provides the staff support and coordination of the Panel's functions.

If the panel members, after individual study of the taxpayer's photography and other documentation, and after panel discussion, question the taxpayer's value, they will so indicate and typically recommend a specific valuation. Such recommendations are advisory only. However, after review by the National Office Art Valuation Group staff, such recommendations become the position of the Service.

For more information regarding referrals to this panel, please refer to the procedures outlined in IRM 42(16)4.1.

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GLOSSARY

Art Dealer -- A person who regularly deals in works of art either for their own account or for other artists usually on a commission basis where they agree to market the merchandise to others. An art dealer could be considered a "middleman" in the process of the disposition of a work of art from production by the artist to ultimate sale to the purchaser.

Art Gallery -- A room, series of rooms, a building, or other structure devoted to the exhibition of works of art. The type of art gallery referred to herein would be a retail or wholesale business establishment where works of art are placed for sale to customers in the ordinary course of a trade or business.

Artist -- A person who practices one of the fine arts, esp. painter or a sculptor. One who exhibits art in his work or makes art his employment. An artist is a person having superior skill(s) or ability or capable of a superior kind of workmanship. **The American College Dictionary**.

Consignment -- The act of placing an item with another for the purpose of resale for a profit. The artist or art collector will consign the art work to the gallery owner or trading post owner for resale. The artist does not pass title or receive payment usually until the item is sold or otherwise disposed of in the normal course of business. The usual consignment consists of an agreement (verbal or written) to "split" the proceeds on a 60-40 percent or 50-50 percent basis with the artist receiving the larger percentage.

Lay Away -- The process of selling an article and not passing title or giving up the merchandise until another payment is made or series of payments made over a period of time for the merchandise. Typically, an art gallery may lay away an item of art for a customer receiving a down payment (perhaps 25 percent of the purchase price) and holding the item until the balance of the purchase price is paid at some future agreed upon date and payment schedule.

Studio -- A place where an artist works in the process of creating a particular piece of artwork (painting, sculpture, etc.) This can be a leased facility, an apartment, a portion of the artists' residence, etc.)

Trade -- The process of giving up an item and receiving another or different item in exchange. In this situation, a trade is usually referring to the exchange between a gallery owner and a customer, dealer, or wholesaler who wants to exchange an item of art work for something the gallery owner has for sale in his gallery (such as a painting for a painting, a sculpture for a sculpture, a painting for a sculpture, etc.)

Trading Post -- A store for carrying on trade in an unsettled or thinly settled area. The typical trading posts are usually located on or near an Indian reservation or on the major traveled interstates or arteries that traverse a reservation. The store carries everything from staples to those hand crafted items which are the artistic creations of the Native American Indian (as found in Arizona and New Mexico).