



*A Formal Program to Identify Artwork  
Donations Reported on Tax Returns Is Not  
Necessary, but Examination Procedures  
Need to Be Strengthened*

**August 22, 2006**

**Reference Number: 2006-30-120**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

1 = Tax Return/Return Information

3(d) = Identifying Information - Other Identifying Information of an Individual or Individuals

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

**DEPARTMENT OF THE TREASURY**

**WASHINGTON, D.C. 20220**

August 22, 2006

**MEMORANDUM FOR** DEPUTY COMMISSIONER FOR SERVICES AND  
ENFORCEMENT  
CHIEF, APPEALS

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary, but Examination  
Procedures Need to Be Strengthened (Audit # 200530014)

This report presents the results of our review of the Internal Revenue Service's (IRS) examination coverage of returns that report the value of transferred artwork. The overall objective of this review was to determine whether transferred artwork as reported on tax returns was properly identified and referred to the Office of Art Appraisal Services (AAS) for review by the Art Advisory Panel of the Commissioner of Internal Revenue (the Panel)<sup>1</sup> and whether the Panel's appraisals were properly used in completing examinations of returns.

The Chairman of the Senate Committee on Finance requested that the Treasury Inspector General for Tax Administration assess whether the IRS provides sufficient audit coverage of returns that involve a transfer of artwork and ensures appropriate cases are referred to the Panel.

**Synopsis**

While the IRS does not systematically screen income tax returns to identify charitable donations of artwork with significant audit potential, we concluded that developing and implementing a special program to identify these returns would not be cost beneficial based on the low occurrence of artwork donations in our samples of individual and corporate income tax returns. Our review of a statistically valid sample of 673 individual and corporate income tax returns

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<sup>1</sup> The Panel was established in 1968 and meets at least two times per year. Its members are appointed by the Internal Revenue Service Commissioner and serve as Special Government Employees without compensation.



***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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found only 17 of 429 (3.96 percent) individual returns and none of the 244 corporate returns claimed artwork as a charitable donation.

In addition, the IRS is proactive in its identification of estate and gift tax returns that require referral to the Office of AAS. Furthermore, the IRS exercises due diligence to prevent conflict of interest situations among members of the Panel and the taxpayers whose artwork they value.

However, the IRS should take appropriate actions to improve the timeliness of requests for artwork valuation assistance and to monitor taxpayer compliance with the prefiling Statement of Value it issues under Revenue Procedure 1996-15.<sup>2</sup>

Requests for Office of AAS valuation assistance were promptly initiated in four of eight cases reviewed. However, in the remaining 4 cases, the artwork valuation issue was not discussed with or formally referred to the Office of AAS from 5 months to 1 year after the case was assigned to the Examination function group or Examination function agent.<sup>3</sup> Because the frequency of Panel meetings is limited to the availability of its volunteer members, prompt referral to the Office of AAS is necessary to reduce the risk of extending the examination period. Unnecessary delays can result in increased interest charges to the taxpayer on any understatement of tax liability or increased interest paid by the Federal Government on any overassessment of tax.

Taxpayers used the IRS valuation determination in reporting the value of transferred artwork on the filed return in three of the five Statement of Value cases we reviewed. However,<sup>1</sup>

### **Recommendations**

We recommended the Directors, Examination and Specialty Programs, Small Business/Self-Employed Division, implement procedures requiring group managers to prioritize assignment of return inventory where identified examination classification issues include artwork. Examination function agents should be required to request valuation assistance from the Office of AAS within a defined time period. In addition, the Internal Revenue Manual or appropriate return classification guidelines should be updated to reflect specific issues to consider when artwork is included in the charitable contribution deduction on income tax returns.

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<sup>2</sup> Rev. Proc. 96-15, 1996-3 I.R.B. 41. An administrative procedure that permits a taxpayer to request the IRS' determination of artwork property value prior to filing the return that reports the value of the transferred artwork.

<sup>3</sup> The term Examination function agent as used in this report refers to either the estate and gift tax attorney or the revenue agent that examines a return.



***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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We recommended the Chief, AAS, establish procedures for notifying the appropriate compliance function when a Statement of Value is issued. The Commissioners, Large and Mid-Size Business Division and Small Business/Self-Employed Division, should implement procedures to monitor compliance with the Statement of Value.

**Response**

IRS management agreed with all of our recommendations. The Director, Specialty Programs, agreed to issue guidance requiring estate and gift managers to distribute cases with identified artwork issues within 45 days of receipt. Estate tax attorneys assigned these cases will be required to contact the Office of AAS within 60 days of receipt from the manager. In addition, classifiers will be required to review Schedules F, G, and H of the United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) and identify artwork issues on the classification folder.

The Director, Examination Policy, agreed to update the Internal Revenue Manual to require referral of artwork of a specified value to the Office of AAS within 30 days of the initial examination appointment or the group manager's concurrence meeting, whichever occurs first. The Director, Examination Planning and Delivery, agreed to update the National Classification Guidelines to include specific guidance when a charitable deduction of artwork is a return issue.

The Chief, Office of AAS, agreed to submit notification of issued Statements of Value to centralized locations within the Examination and Estate and Gift programs. Procedures will be issued requiring actions to monitor the referred Statement of Value, review related tax returns, and refer discrepancies to the appropriate Examination function. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8500.



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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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***Table of Contents***

**Background**.....Page 1

**Results of Review**.....Page 3

A Special Program to Identify Income Tax Returns That Report  
Donations of Artwork Would Not Be Beneficial.....Page 3

Estate and Gift Tax Returns Needing Referral to the Office of  
Art Appraisal Services Are Properly Identified.....Page 5

Due Diligence Is Used to Prevent Conflict of Interest Situations  
Among Art Advisory Panel Members.....Page 5

Opportunities Exist for Improving the Timeliness of Requests for  
Valuation Assistance.....Page 5

Recommendation 1:.....Page 7

The Internal Revenue Service Needs to Monitor Taxpayer  
Compliance With the Statement of Value It Issues Under a  
Prefiling Valuation Procedure.....Page 8

Recommendation 2:.....Page 8

**Appendices**

Appendix I – Detailed Objective, Scope, and Methodology.....Page 10

Appendix II – Major Contributors to This Report.....Page 14

Appendix III – Report Distribution List.....Page 15

Appendix IV – Management’s Response to the Draft Report.....Page 16



***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

---

## ***Background***

Individuals and businesses can claim a deduction for the fair market value of artwork donated to charitable organizations on their Federal income tax returns. A Noncash Charitable Contributions (Form 8283) must be attached to the return when the total deduction exceeds \$500. Executors of large estates use the United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) to report the value of transferred artwork. When artwork is gifted, taxpayers use the United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) to report the value of the gift. When the Internal Revenue Service (IRS) selects for examination a return that includes transferred artwork valued at \$20,000 or more, the Examination function agent is required to request assistance from the Office of Art Appraisal Services (AAS) to value the artwork.

The Appeals function provides valuation assistance to Examination function agents<sup>1</sup> by assisting in the development of the IRS' position on the value of artwork. Within the Appeals function, the Office of AAS evaluates fair market value claims of artwork in income, estate, and gift tax cases under examination. The Office of AAS also administers the activities of the Art Advisory Panel of the Commissioner of Internal Revenue (the Panel),<sup>2</sup> which was formed to promote voluntary compliance with Federal tax laws because reported fair market values of transferred artwork were highly vulnerable to abuse. The Panel consists of prominent art specialists that assist the IRS in determining the authenticity and the fair market value of artwork. Currently, the Panel is comprised of two subgroups, with one specializing in valuations of paintings and sculptures and the other specializing in valuations of decorative arts and antiques. The Office of AAS appraisers make valuation determinations on artwork that does not correspond to the specialty areas of the Panel. The Office of AAS appraisers and the Panel review taxpayers' appraisals and other supporting evidence along with additional research developed by the Office of AAS appraisers before making valuation recommendations. In Calendar Year 2005, the Office of AAS reported the Panel reviewed 105 taxpayer cases having a total claimed artwork value of nearly \$218 million and recommended over \$62 million in adjustments to the values.<sup>3</sup>

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<sup>1</sup> The term Examination function agent as used in this report refers to either the estate and gift tax attorney or the revenue agent that examines a return.

<sup>2</sup> The Panel was established in 1968 and meets at least two times per year. Its members are appointed by the IRS Commissioner and serve as Special Government Employees without compensation.

<sup>3</sup> During the 5-year period ending December 2005, the Office of AAS reported the Panel reviewed 520 taxpayer cases having an aggregate claimed artwork value of nearly \$954 million and recommended over \$341 million in adjustments to the values. The adjusted taxpayer artwork valuation claims included items the IRS determined to be overvalued charitable donations and undervalued estate or gift taxpayer appraisals.



***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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In accordance with procedures established in Revenue Procedure 1996-15,<sup>4</sup> the Office of AAS also makes advance determinations of artwork values for taxpayers that request this service prior to filing their returns. For a fee,<sup>5</sup> the IRS will issue a Statement of Value for artwork appraised at \$50,000 or more and that has been transferred as a charitable contribution or by reason of death or gift.

The Chairman of the Senate Committee on Finance requested that the Treasury Inspector General for Tax Administration perform this review to assess whether the IRS provides sufficient audit coverage of returns that involve a transfer of artwork and ensures appropriate cases are referred to the Panel. This review was performed at the Office of the Chief, Appeals, in Washington, D.C., and the Estate and Gift Department within the Cincinnati Campus Compliance Operations in Covington and Florence, Kentucky, during the period July 2005 through April 2006. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>4</sup> Rev. Proc. 96-15, 1996-3 I.R.B. 41. An administrative procedure that permits a taxpayer to request the IRS' determination of artwork property value prior to filing the return that reports the value of the transferred artwork.

<sup>5</sup> The user fee is \$2,500 for the first 3 items of artwork plus \$250 for each additional item of artwork.



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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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***Results of Review***

***A Special Program to Identify Income Tax Returns That Report  
Donations of Artwork Would Not Be Beneficial***

The IRS does not systematically screen income tax returns to identify charitable donations of artwork with significant audit potential. Instead of a special system to identify artwork donations, the IRS uses the Discriminant Index Function<sup>6</sup> to assign to each income tax return a score that represents its potential for significant tax change if selected for examination. Implementing a special program to identify artwork donations would not be a productive use of resources, based on the low volume of artwork donations in our samples of individual and corporate income tax returns. We sampled 429 returns from the population of 78,907 Tax Year 2002 individual income tax returns that reported noncash charitable donations of \$20,000 or more and identified 17 (3.96 percent) that claimed a donation of artwork. Only 11 (2.56 percent) of the reviewed returns claimed artwork donations actually valued at \$20,000 or more; however, none were audited or screened for examination potential. The value of the artwork donated in these cases ranged from \$25,000 to \$276,000.

We requested that the Office of AAS review the return information of the 11 individual taxpayers claiming artwork donations of \$20,000 or more and provide its assessment of whether the information was sufficient to determine the valuation potential of the artwork donations. The Office of AAS determined<sup>1</sup> of the 11 cases had a high potential for being overstated in value, the potential for overstatement was moderate to low in<sup>1</sup>

<sup>1</sup> The return information was insufficient or incomplete (e.g., no appraisal attached) in the<sup>1</sup> therefore, the Office of AAS did not make a determination about their valuation potential.

During our review, we also captured the other items donated on the returns and determined that the most commonly claimed item valued at \$20,000 or more was stock, followed by real estate and clothes/household items. Figure 1 shows the distribution of specified noncash property valued at \$20,000 or more from our sample of individual returns.

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<sup>6</sup> The Discriminant Index Function is a mathematical formula that assigns a unit of measure to certain return attributes. The sum of the measures for each attribute forms the composite score of a return and is used to rank the return's examination potential.





***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

***Figure 1: Distribution of Noncash Property in  
Sample of Individual Returns***

Noncash Property Greater Than or Equal to \$20,000	Number of Returns in Sample <sup>7</sup>	Percentage of Returns in Sample <sup>8</sup>
Art	11	2.56%
Stock	234	54.55%
Real Estate	65	15.15%
Clothing or Household Items	19	4.43%
Transportation Equipment	18	4.20%
Easements	13	3.03%
Various Other Property	50	11.66%

*Source: Treasury Inspector General for Tax Administration  
analysis of sample results.*

To identify the frequency of artwork donations claimed on business returns, we reviewed a statistical sample of 244 corporate income tax returns that reported charitable donations<sup>9</sup> of \$100,000 or more.<sup>10</sup> We identified no tax returns specifically listing artwork and concluded the population percentage of corporate income tax returns with charitable donations of artwork is very small. Therefore, a special program to specifically identify artwork donations on individual or corporate returns for examination would not be cost beneficial. The details of our sampling methodology for the individual and corporate income tax returns are presented in Appendix I.

<sup>7</sup> In our sample of 429 returns, 406 returns contained noncash property valued at \$20,000 or more. The value of the noncash property on the remaining 23 returns was below \$20,000. The numbers in this column total 410 instead of 406 because 4 returns contained 2 of the specified property categories.

<sup>8</sup> The percentages in this column represent the proportion of returns in the sample of 429 and do not add to 100 percent.

<sup>9</sup> The U.S. Corporation Income Tax Return (Form 1120) does not require itemization of noncash charitable donations as a separate line item.

<sup>10</sup> The \$100,000 threshold was arbitrarily selected by the audit team for purposes of completing this test and does not represent any dollar threshold used by the IRS in reviewing charitable donations.



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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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***Estate and Gift Tax Returns Needing Referral to the Office of Art  
Appraisal Services Are Properly Identified***

The IRS has adequate procedures for identifying estate and gift tax returns that report the value of transferred artwork. Estate tax attorneys or transfer tax technicians at the Cincinnati Campus Compliance Operations screen all estate and gift tax returns. Designated estate tax attorneys from the five IRS estate Territories<sup>11</sup> screen estate and gift tax returns on a weekly rotational basis according to a schedule defined for each Territory. Prescribed return screening procedures included appropriate criteria for identifying returns requiring referral to the Office of AAS. Our limited review of 85 returns in the return screening process found 20 returns selected for examination with artwork values meeting the specified criteria for referral to the Office of AAS were properly identified on the return screening checklist. We did not identify any returns with reported artwork transfers that were improperly accepted as filed.

***Due Diligence Is Used to Prevent Conflict of Interest Situations  
Among Art Advisory Panel Members***

The Panel members serve as Special Government Employees without compensation. They are subject to the IRS' employee clearance procedures and are bound by standards of conduct and the disclosure restrictions of the Internal Revenue Code (I.R.C.).<sup>1,3(d)</sup>

We also concluded the Office of AAS exercises reasonable care to identify and prevent conflict of interest situations among Panel members and the taxpayers whose artwork they value. The Office of AAS routinely performs research for each case and notes cases for which acquired information discloses a conflict (e.g., if a Panel member is employed by the museum that displayed the taxpayer's artwork). The Office of AAS valuation report discloses the name of any Panel member who has been recused from discussions about a taxpayer's artwork. In our review of taxpayer appraisals in 27 cases closed by the Office of AAS, we did not identify any taxpayer appraisers that were concurrently serving on the Panel.

***Opportunities Exist for Improving the Timeliness of Requests for  
Valuation Assistance***

In our review of eight examination cases in which artwork was reviewed by the Office of AAS in Calendar Year 2004, we determined the examination reports and the taxpayers' accounts properly reflected the Office of AAS recommendations in all eight cases. Requests to the Office

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<sup>11</sup> The human resources within the Estate and Gift Tax Program were apportioned into five geographic areas called Territories.



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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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of AAS for valuation assistance were promptly initiated in four of the eight cases reviewed. However, in the remaining 4 cases, the artwork valuation issue was not discussed with or formally referred to the Office of AAS from 5 months to 1 year after the case was assigned to the Examination function group or Examination function agent.

In the four cases for which contact with the Office of AAS was delayed, the examination activity record showed the cases could have been completed from 6 months to 1 year earlier if managerial case assignment action and/or the Examination function agent's request to the Office of AAS for valuation assistance had occurred expeditiously.<sup>1</sup>

The frequency of Panel meetings is limited to the availability of its volunteer members. Therefore, prompt referral to the Office of AAS is necessary to reduce the risk of extending the examination period to await review of the artwork valuation issue by the Panel or the Office of AAS. Unnecessary delays in the examination process can cost taxpayers additional interest on any understatement of tax or the Federal Government additional interest on any overassessment of tax for the period of the delay.

The Internal Revenue Manual requires requests for valuation assistance to be initiated "as early as possible" on all examination cases that involve a transfer of artwork valued at \$20,000 or more, to allow sufficient time for the Office of AAS review. However, current procedures do not require priority assignment of these cases by group managers or set a time standard for completing a formal request for valuation assistance. Although the Internal Revenue Manual provides guidelines to assist classifiers with identifying significant issues on income tax returns in the classification<sup>12</sup> process, the guidelines for screening charitable contributions do not adequately describe relevant issues with respect to donations of noncash property (e.g., artwork). Therefore, classifiers might not recognize and itemize the artwork valuation issue on the classification checksheet.

In addition, we attempted to determine whether Examination function agents imposed the penalty prescribed under I.R.C. Section (§) 6701<sup>13</sup> against persons that assist in the presentation of information that results in an understatement of tax liability. Department of the Treasury regulations interpreting I.R.C. § 6701 had not been issued or proposed before or during the period of our review. In March 2005, the IRS Office of Chief Counsel publicly released a

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<sup>12</sup> Classification is the process of determining whether a return should be selected for examination, what issues should be examined, and how the examination should be conducted.

<sup>13</sup> 26 U.S.C. § 6701 (2003).



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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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memorandum it issued to an IRS appraiser in the Large and Mid-Size Business Division on the subject of I.R.C. § 6701 appraisers. In summation, the memorandum stated:

*To Summarize, the Service [IRS] would be required to show by a preponderance of the evidence, that an appraiser helped prepare or present a document that led to an understatement of tax by a taxpayer, for an appraiser to be held liable for a section 6701 penalty. The Service [IRS] would also need to demonstrate that the appraiser had actual knowledge that the taxpayer would rely on the document that would lead to an understatement.*

The Office of AAS adjustment to the taxpayer's claimed value for artwork was a factor in determining the taxpayer's understatement of the tax liability in five of the eight cases reviewed, but penalties were not imposed against any taxpayer appraiser. However, the burden of proof with respect to the penalty is on the Federal Government, and we concluded that developing the necessary evidence to impose the penalty against the appraisers in the cases we reviewed would be very difficult.

### ***Recommendation***

***Recommendation 1:*** The Directors, Examination and Specialty Programs, Small Business/Self-Employed Division, should implement procedures requiring group managers to prioritize assignment of return inventory where identified examination classification issues include artwork. Examination function agents should be required to request valuation assistance from the Office of AAS within a defined time period. In addition, the Internal Revenue Manual or appropriate return classification guidelines should be updated to reflect specific issues to consider when artwork is included in the charitable contribution deduction on income tax returns.

***Management's Response:*** IRS management agreed with our recommendation. The Director, Specialty Programs, agreed to issue guidance requiring estate and gift managers to distribute cases with identified artwork issues within 45 days of receipt. Estate tax attorneys assigned these cases will be required to contact the Office of AAS within 60 days of receipt from the manager. In addition, classifiers will be required to review Schedules F, G, and H of the United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) and identify artwork issues on the classification folder.

The Director, Examination Policy, agreed to update the Internal Revenue Manual to require referral of artwork of a specified value to the Office of AAS within 30 days of the initial examination appointment or the group manager's concurrence meeting, whichever occurs first. The Director, Examination Planning and Delivery, agreed to update the National Classification Guidelines to include specific guidance when a charitable deduction of artwork is a return issue.



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***A Formal Program to Identify Artwork Donations  
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but Examination Procedures Need to Be Strengthened***

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***The Internal Revenue Service Needs to Monitor Taxpayer Compliance  
With the Statement of Value It Issues Under a Prefiling Valuation  
Procedure***

For Tax Years 2002 through 2004, the IRS issued Statements of Value to 18 taxpayers<sup>14</sup> in response to their requests for an advance determination of artwork value. We reviewed return information for 5 of the 18 taxpayers for whom the claimed value of artwork submitted in the requests for a Statement of Value totaled nearly \$30 million. The IRS' recommended adjustments to the taxpayers' values exceeded \$16 million.<sup>15</sup> Our review of the taxpayers' return information found that three of the five taxpayers adhered to the IRS Statement of Value by claiming the recommended adjusted amount for the artwork valuated. However,<sup>1</sup>

The IRS publicizes the availability of a Statement of Value under its prefilling valuation procedure<sup>16</sup> in publications it issues and on IRS.gov. Although the IRS considers the issuance of a Statement of Value to be in the best interest of efficient tax administration and regards it as substantiation for the artwork value, it does not monitor compliance with the prefilling valuation decision. By not monitoring and measuring the accomplishments of its prefilling valuation procedure, the IRS does not have the information it needs to evaluate whether the procedure is an effective and productive compliance tool. In addition, taxpayers that comply with the Statement of Value are inequitably treated when the IRS does not enforce its prefilling valuation decision or require noncompliant taxpayers to account for discrepancies.

***Recommendation***

***Recommendation 2:*** The Chief, AAS, should establish procedures for notifying the appropriate compliance function when a Statement of Value is issued. The Commissioners, Large and Mid-Size Business Division and Small Business/Self-Employed Division, should implement procedures to monitor compliance with the Statement of Value. The procedures should include monitoring the taxpayer's account for the filed return, screening the return for discrepancies with the Statement of Value, and either enforcing the IRS valuation or requesting

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<sup>14</sup> In combining the number of taxpayers for the 3-year period, we considered each year separately. Taxpayers that submitted requests in more than 1 of the 3 years were distinctly counted in each year of their requests.

<sup>15</sup> The adjusted taxpayer artwork valuation claims included items the IRS determined to be overvalued for income or estate tax purposes.

<sup>16</sup> Revenue Procedure 1996-15.



***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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the taxpayer to provide substantiation for the claimed value to be reconsidered by the Office of AAS.

**Management's Response:** IRS management agreed with our recommendation. The Chief, AAS, agreed to submit notification of issued Statements of Value to centralized locations within the Examination and Estate and Gift programs. Procedures requiring actions to monitor the referred Statement of Value, review related tax returns, and refer discrepancies to the appropriate Examination function will be issued to appropriate operating division directors.



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***A Formal Program to Identify Artwork Donations  
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**Appendix I**

***Detailed Objective, Scope, and Methodology***

The overall objective of this audit was to determine whether transferred artwork as reported on tax returns was properly identified and referred to the Office of Art Appraisal Services (AAS) for review by the Art Advisory Panel of the Commissioner of Internal Revenue (the Panel)<sup>1</sup> and whether the Panel's appraisals were properly used in completing examinations of returns. We performed this audit in response to a request by the Chairman of the Senate Committee on Finance to assess whether the Internal Revenue Service (IRS) provides sufficient audit coverage of returns that involve a transfer of artwork and ensures appropriate cases are referred to the Panel.

To accomplish this objective, we:

- I. Evaluated whether the IRS effectively identifies individual and corporate income tax returns with questionable charitable donations of artwork for referral to the Office of AAS.
  - A. Consulted with a professional statistician who assisted us with the development of a statistically valid sampling plan. We used a statistical sample because we wanted to estimate the population of individual and corporate income tax returns with large charitable contribution deductions that included donations of artwork. Because the IRS had no historical data on the number of returns that have claimed charitable donations of artwork, the statistician recommended selecting a sample size using a table of probable observations for a specified rate of occurrence. We conservatively estimated the rate of occurrence to be 0.25 percent. Using the table of probable observations, we determined a minimum sample of 400 individual and 300 corporate income tax returns would provide a large enough sample that could be reviewed within our resource and time constraints. After we completed our review of the returns, the statistician determined the reliability of the sample results.
  - B. Reviewed a statistical random sample of 429 Tax Year 2002 U.S. Individual Income Tax Returns (Form 1040) with Schedule A-Itemized Deductions (Schedule A&B) Line 16 noncash contributions of \$20,000 or more and captured the type of donated property in a database.<sup>2</sup> To identify the universe of 78,907 returns with noncash

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<sup>1</sup> The Panel was established in 1968 and meets at least two times per year. Its members are appointed by the Internal Revenue Service Commissioner and serve as Special Government Employees without compensation.

<sup>2</sup> Based on our statistical sample results, we are 95 percent confident that the true population percentage of returns reporting artwork donations valued at \$20,000 or more is between 1.07 and 4.06 percent with a precision of plus or minus 1.49 percent.



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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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- contributions, we used the IRS Individual Master File<sup>3</sup> Return Transaction File<sup>4</sup> data for Processing Year 2003. The data were extracted and validated by programmers in our Office of Information Technology using run-to-run balancing. Samples of the data fields were verified through Integrated Data Retrieval System<sup>5</sup> research.
- C. Reviewed a statistical random sample of 244 Tax Year 2002 U.S. Corporation Income Tax Returns (Form 1120) with Line 19 charitable contributions of \$100,000 or more.<sup>6</sup> For each return reviewed, we captured whether the taxpayer listed artwork as a component of the reported contribution. Of the 397 corporate returns we requested from the IRS files, 153 were charged out to an IRS function or otherwise unavailable for our review. To identify the universe of 3,771 returns with charitable contributions, we used the IRS Business Master File Return Transaction File data for Processing Year 2003. The data were extracted and validated by programmers in our Office of Information Technology using run-to-run balancing. Samples of the data fields were verified through Integrated Data Retrieval System research.
- II. Evaluated whether the IRS has adequate procedures for identifying and referring artwork to the Office of AAS when it is claimed on estate and gift tax returns.
- A. Reviewed the return screening procedures and observed the return screening process. We judgmentally selected and reviewed 85 returns from a population of 15,769 estate and gift tax returns that were being screened by estate tax attorneys or transfer tax technicians during our visit in October and November 2005. We used judgmental sampling because within our time and resource constraints there was no viable method of defining the population so each return would have an equal opportunity to be included in the sample. The judgmental sample was sufficient to provide evidence of whether the artwork valuation issue was notated on the return screening checklist when a return selected for examination met the criteria for referral to the Office of AAS or whether a return involving a transfer of artwork was improperly accepted as filed.

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<sup>3</sup> The IRS database that maintains transactions or records of individual tax accounts.

<sup>4</sup> The IRS database that contains line items transcribed from the Individual Master File and Business Master File returns (the IRS database that maintains transactions or records of tax accounts for businesses).

<sup>5</sup> The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

<sup>6</sup> The \$100,000 threshold was arbitrarily selected by the audit team for purposes of completing this test and does not represent any dollar threshold used by the IRS in reviewing charitable donations.





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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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- III. Reviewed IRS tax form instructions and publications and searched IRS.gov to determine whether the IRS publicizes the availability of advance determinations of artwork value under Revenue Procedure 1996-15.<sup>7</sup>
- IV. Reviewed the Office of AAS Statement of Value cases and the related income, estate, or gift tax returns to determine whether discrepancies existed between the value of the artwork as determined by the IRS and the value reported on the taxpayers' returns.
- A. Judgmentally selected 8 taxpayer cases from a population of 18 taxpayer Statement of Value cases for Tax Years 2002 through 2004. We reviewed return information for five of the eight cases requested from IRS files. The return files for the remaining three cases were charged out to an IRS function or otherwise unavailable for our review. We used a judgmental sample to focus on cases where there was a significant difference in the Office of AAS valuation and the appraised value claimed by the taxpayer. The judgmental sample was sufficient to provide evidence of the necessity of controls to identify taxpayers that do not comply with the IRS' prefiling valuation determinations.
- V. Reviewed a sample of eight closed Office of AAS cases to determine whether the Examination function properly adjusted the artwork value. We also evaluated whether administrative actions were effective to prevent delays and conflict of interest situations and to hold appraisers accountable for improper practices.
- A. Randomly selected 10 cases from the population of 119 estate cases reviewed by the Office of AAS in Calendar Year 2004. We judgmentally selected an additional 5 cases from the population of 119 estate cases to focus on cases for which the Office of AAS determined the taxpayer's appraised value to be significantly understated. We reviewed returns and examination workpapers for 6 of the 15 cases requested from IRS files. The return files for the remaining nine cases were charged out to an IRS function or otherwise unavailable for our review. We used random sampling to ensure each case had an equal opportunity to be selected. The judgmental sample was used to provide additional evidence of whether a penalty under Internal Revenue Code Section (§) 6701<sup>8</sup> was being imposed upon appraisers whose appraisals resulted in an understatement of income tax on the taxpayers' returns.
- B. Due to time and resource constraints, judgmentally selected 7 cases from the population of 12 charitable contribution cases reviewed by the Office of AAS in Calendar Year 2004. We reviewed returns and examination workpapers for two of the seven cases requested from IRS files. The return files for the remaining five cases were charged out to an IRS function or otherwise unavailable for our review.

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<sup>7</sup> Rev. Proc. 96-15, 1996-3 I.R.B. 41. An administrative procedure that permits a taxpayer to request the IRS' determination of artwork property value prior to filing the return that reports the value of the transferred artwork.

<sup>8</sup> 26 U.S.C. § 6701 (2003).



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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

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C. Reviewed taxpayer appraisals and other case file documentation for the 30 cases selected in the samples described in Steps IV. and V. We reviewed the information to determine whether any apparent relationship existed between Panel members and taxpayers or the artwork under review. In 3 of the 30 cases, we could not assess whether the taxpayer's appraiser(s) was a member of the Panel because the appraisal company reports did not include the names of individual appraisers.

VI.

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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
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**Appendix II**

***Major Contributors to This Report***

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***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
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**Appendix III**

***Report Distribution List***

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Commissioner, Large and Mid-Size Business Division SE:LM  
Commissioner, Small Business/Self-Employed Division SE:S  
Chief, Art Appraisal Services AP:ART  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Director, Specialty Programs, Small Business/Self-Employed Division SE:S:SP  
Director, Strategy, Research, and Program Planning, Large and Mid-Size Business Division  
SE:LM:SR  
Chief, Estate and Gift Tax Operations, Small Business/Self-Employed Division SE:S:SP:EG  
Director, Examination Policy, Small Business/Self-Employed Division SE:S:E:EP  
Director, Examination Planning and Delivery, Small Business/Self-Employed Division  
SE:S:E:EPD  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaisons:  
Deputy Commissioner for Services and Enforcement SE  
Commissioner, Large and Mid-Size Business Division SE:LM  
Commissioner, Small Business/Self-Employed Division SE:S  
Chief, Appeals AP  
Chief, Communications and Liaison CL



**A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
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Appendix IV

**Management's Response to the Draft Report**



CHIEF, APPEALS

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

AUG 7 2006

RECEIVED  
AUG 11 2006

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX  
ADMINISTRATION

FROM: Sarah Hall Ingram  
Chief, Appeals *Sarah Hall Ingram*

SUBJECT: Response to Draft Report – Audit 2005-30-014  
A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary, but  
Examination Procedures Need to Be Strengthened

I have reviewed the subject draft audit report, and I appreciate your efforts in evaluating the Commissioner's Art Advisory Panel to assess the effectiveness of the program and determine whether the IRS is providing sufficient audit coverage in this area.

We are pleased that the results of your audit found that implementing a special and formal program to identify art donations on tax returns is not necessary, but that we should strengthen our procedures to improve the timeliness of requests for art valuation assistance and monitor taxpayer compliance. We concur with your recommendations and are working with the Small Business/Self Employed (SB/SE) and the Large and Mid-Size Business (LMSB) Divisions to implement corrective actions that will ensure we improve program timeliness, clarify procedures, and monitor taxpayer compliance.

Below are our corrective actions in response to your audit recommendations.

**Recommendation 1**

The Directors, Examination and Specialty Programs, Small Business/Self-Employed Division, should implement procedures requiring group managers to prioritize assignment of return inventory where identified examination classification issues include artwork. Examination function agents should be required to request valuation assistance from the Office of AAS within a defined time period. In addition, the Internal Revenue Manual or appropriate return classification guidelines should be updated to reflect specific issues to consider when artwork is included in the charitable contribution deduction on income tax returns.

**Proposed Corrective Action 1:**

The Director, Specialty Programs will issue guidance to implement the following actions:



***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

2

- The Estate & Gift (E&G) managers will distribute cases with identified art issues within 45 days of receipt.
- Estate Tax Attorneys (ETAs) will contact Art Appraisal Services (AAS) within 60 days of receipt of the case from the manager if the case includes a piece of art with a claimed value of \$20,000 or more.
- Identification of art issues has been added as an item for discussion during the pre-classification conference calls between campus and field classifiers. In addition, classification guidelines have been amended to require identification of art issues on the classification folder, and classifiers are now required to review schedules F, G, and H if time does not allow the review of all schedules included with the return (Form 706).

**Implementation Date:** October 15, 2006

**Responsible Official:** Director, Specialty Programs

**Corrective Action Monitoring Plan:** The Chief, Estate & Gift Tax Program will advise the Director, Specialty Programs of any delay in implementing this corrective action.

**Proposed Corrective Action 2:**

The Director, Examination Policy will update IRM 4.10.2, Pre-Contact Responsibilities, to include specific direction regarding referrals to the AAS involving art or cultural property valued at \$20,000 or more. These guidelines will state that a referral for an object of art and/or cultural property valued at \$20,000 or more should be made to the AAS within 30 days<sup>1</sup> of either the initial appointment or the group manager concurrence meeting, whichever occurs first. In addition, the Director, Examination Planning & Delivery will update the National Classification Guidelines to include specific guidance when a charitable deduction of art work is an issue

**Implementation Date:** January 15, 2007

**Responsible Officials:** Director, Examination Policy and Director, Examination Planning & Delivery

**Corrective Action Monitoring Plan:** The program managers for Examination General Processes and Examination Return Selection will advise the Directors Examination Policy and Examination Planning & Delivery of any corrective action delays.

**Recommendation 2**

The Chief, AAS, should establish procedures for notifying the appropriate compliance function when a Statement of Value is issued. The Commissioners, LMSB and SB/SE, should implement procedures to monitor compliance with the Statement of Value. The procedures should include monitoring the taxpayer's account for the filed return,

<sup>1</sup> The difference in 30 and 60 day referrals to AAS is due to the differences in the functions' work practices. E&G's 60-day notification period is from the date the ETA receives the case from the manager. SBSE examination believes utilizing the taxpayer contact is a better starting point for these AAS cases. This initial contact could in fact be 30 days after the case is received from the manager (close to E & G's 60 days).



***A Formal Program to Identify Artwork Donations  
Reported on Tax Returns Is Not Necessary,  
but Examination Procedures Need to Be Strengthened***

3

screening the return for discrepancies with the Statement of Value, and either enforcing the IRS valuation or requesting the taxpayer to provide substantiation for the claimed value to be reconsidered by the Office of AAS.

**Proposed Corrective Action 1:**

The Chief AAS will establish procedures for the LMSB Division, SB/SE Examination and Estate and Gift Tax (E&G) when a Statement of Value is issued. The procedures will include submitting notification of Statement of Values to two centralized locations. Income tax statements will be submitted to the Ogden PSP<sup>2</sup> unit utilizing Form 5346 (Examination Information Report form) and the estate and gift tax statements will be sent to the E&G Headquarters office, logged by the headquarters staff and then forwarded to the E&G Campus function (Cincinnati/CIRSC) for suspense.

The referrals will be monitored, controlled, and reviewed against tax returns to determine the appropriate course of actions. If discrepancies are detected, the case files will be sent to the appropriate office for possible examination. These procedures will be finalized, implemented and shared through the issuance of a guidance memorandum issued by the Chief, Art Appraisal Services to the pertinent operating division directors by October 15, 2006.

**Implementation Date:** October 15, 2006

**Responsible Official:** Deputy Chief, Appeals

**Corrective Action Monitoring Plan:** The Chief AAS will advise the Deputy, Chief Appeals of any delays in implementing this corrective action.

If you have any questions, please have a member of your staff contact Karen Carolan, Chief, Art Appraisal Services, at (202) 435-5609 or Nancy J. Talajkowski, Program Analyst, at (415) 227-5007.

<sup>2</sup> The LMSB Ogden PSP unit has an established process for working Information Items/reports. This process would work well within the established process for LMSB. Due to the low number of SOV cases, the Ogden unit has agreed to process all the income tax referrals from the other operating divisions.