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Tax Deferred Exchanges of Artwork: Maximizing Profits for Art Funds

By Suzanne Goldstein Baker

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Believe it or not, the Internal Revenue Code, in Section 1031, provides one of the best tax strategies available for preserving the value of an artwork investment portfolio. While §1031 tax-deferred exchanges are frequently used by real estate investors, this generous tax tool is too often overlooked in the realm of art collecting.

Benefits

Using a §1031 exchange, an art investment fund can diversify, modify, or upgrade a portfolio of artwork into quality suitable for museum loans and other significant exhibitions as the portfolio's value increases, without recognizing any gain on the sale of the unwanted artworks. As long as they are replaced with like-kind artworks, all of the capital gains tax that ordinarily would have been incurred upon the sale of the assets will be deferred. The fund can restructure the artwork portfolio to better suit the needs of intended purchasers at fund termination, such as museums and other collectors, without eroding the value of the portfolio through capital gains tax. Just as important, §1031 allows the art investment fund to exchange out of artwork for which appreciation has plateaued, into pieces with a greater upside potential, to preserve and maximize the profitability of the art fund without paying capital gains tax on the sale of the no longer appreciating assets.

The benefits of a tax-deferred exchange are significant, particularly in light of the 28% capital gains tax rate for collectables. Tax dollars deferred result in additional buying power for reinvestment in replacement property. Consider the art fund that sells a painting for $10 million (originally purchased for $6 million) and acquires a group of paintings from the bankruptcy estate of a corporate collector having an aggregate value of $10 million.

	Exchange	Sale
Fair Market Value of Sold Painting	$10,000,000	$10,000,000
Basis	$ 6,000,000	$ 6,000,000
Gain Recognized on Sale	$ -0-	$ 4,000,000
Capital Gains Tax	$ -0-	$ 1,120,000
Equity Available to Reinvest	***$10,000,000***	***$ 8,880,000***

The result? By structuring this transaction as a §1031 exchange, the art fund defers at least $1,120,000 in taxes, and is able to purchase replacement property of equal value without having to seek additional capital contributions to make up for the tax cost of more than a million dollars. The tax deferral could be even more substantial, depending upon local and state tax treatment. Bottom line, $10 million dollars is still worth $10 million dollars for the tax-deferred exchanger, but it is only worth, at most, $8.88 million in a taxable sale.

Like-Kind

To qualify for tax-deferral, the relinquished and the replacement properties must be qualified "like-kind" properties and the transaction must be structured as a §1031 exchange. To be considered like-kind, the artwork being sold must be of the same nature and character as that of the artwork being purchased. Differences of grade or quality are ignored. For example, an Andy Warhol painting could be exchanged for a Georgia O'Keefe painting, but not for a piece of Bauhaus furniture, even though both might be found in an art museum.

Differences of artists, style, medium, age and value are considered to be related to grade or quality. Thus, one could exchange an abstract painting for an impressionist painting, an oil for a watercolor, a old masterpiece for a painting by an emerging contemporary artist. Although there is very little published guidance, conventional wisdom is that a painting is like-kind to another painting but not to a sculpture or a photograph. Similarly, sculptures may be exchanged for other sculptures, but not for paintings, lithographs or photographs.

Qualified Use

The properties to be exchanged must be held for investment or used productively in a trade or business by the taxpayer. Artworks held in an art investment fund would certainly meet the qualified use test. Artworks used or held in the United States may not be exchanged for artworks to be held outside of the U.S. It doesn't matter where the artwork is actually sold; the determination of domestic or foreign is based solely upon the use in the hands of the taxpayer. An art fund with a U.S. based collection can exchange an artwork for a piece by a contemporary Chinese artist that will be acquired at auction in London, as long as the replacement artwork will be held in the United States by the exchanging art fund.

Qualified Intermediary

The tax rules for properly accomplishing a tax-deferred exchange are complicated, particularly for artwork and other collectable assets. To obtain the most benefit from this valuable tax strategy, the art investment fund should engage the services of a reputable, professional institutional Qualified Intermediary that has expertise in artwork and collectables exchanges to work with the fund and its tax advisor. A competent Qualified Intermediary will provide an Exchange Agreement and other necessary documentation required by tax rules and will help navigate the technical traps for the unwary. Since the taxpayer is prohibited from holding the exchange funds (the proceeds of sale of the relinquished artworks) during the pendency of the exchange, it is critically important to retain a Qualified Intermediary that is financially strong, and holds funds from each exchange in a segregated bank account set up for the benefit of the named taxpayer.

Summary

For all of the technical requirements, Section 1031 is quite generous. The art fund can sell and buy from different parties or auctions, can take up to 45 days to identify potential replacement artwork, and can take up to 180 days to actually complete the exchange with the purchase of new artwork. It is even possible to acquire the replacement artwork prior to selling the relinquished artwork in a structure called a “reverse exchange.” Strategic financial management of the art fund should always include consideration of the powerful tax benefits afforded by IRC §1031.

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