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Chapter One
Section Four

Tax Aspects of Art and Collectibles

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PART FOUR -- TAX ASPECTS OF ART AND COLLECTIBLES

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I - SALES, USE AND INCOME TAX

There is very little we do in the United States today that is not somehow affected by the tax laws. Buying and selling art and collectibles is no exception. An understanding of basic principles of state and local sales and use tax, income tax, and estate tax will not only assure compliance with the law, but may save you money as well. Of course, although I have tried to accurately present this complicated subject, be warned that tax laws change quite often and that differences in geography, income, and overall portfolio may change considerably the effect of taxes. You should always consult a competent attorney or tax advisor to update yourself and to tailor any tax strategies to your particular situation.

Sales Tax

Some state and local governments impose a sales tax on retailers for the privilege of retailing tangible personal property. The tax is usually a percentage of the gross sale price of the goods, and is remitted by the dealer along with a sales tax return. While the dealer is actually liable for sales tax, a nearly universal practice is to pass the cost of sales taxes on to the retail customer. In a typical over-the-counter sale of art and collectibles, the dealer will add the appropriate sales tax to the invoice price of the coins.

The taxable event for sales tax is an in-state retail sale. This leads to two common exemptions to sales tax. First, sales tax is not due on wholesale (dealer-to-dealer) sales, but only where the buyer holds a valid resale permit or certificate from that state or another state. Second, sales by out-of-state retailers are exempt from sales tax if (1) the customer orders goods directly from the retailer; and (2) the goods are shipped from outside the state and no in-state branch, office, outlet or other place of business of the seller participates in the sale.

In certain states, some sales of rare coins are specifically exempted from sales tax for various reasons. States that do not apply sales tax to the sale of money exempt sales of "coins of the realm", defined as coins that remain legal tender of the United States or a foreign government. Others do not tax investment purchases, and assume that "bulk" purchases of over $1,000 are for investment. However, in most states, unless the sale falls into one of the common exemptions, sales tax will apply.

Dealers occasionally ask buyers of expensive items whether they wish goods to be shipped to a friend or relative in a neighboring state, thereby relieving the dealer of the responsibility to charge sales tax. If the item is actually shipped, a sales tax exemption may apply. *Never* take the item with you and allow an empty package to be shipped out of state. If a dealer wishes to cheat the state, you shouldn't voluntarily participate in the scheme.

Use Tax

Recently, the collectibles marketplace has seen states become much more aggressive in enforcing their right to collect use tax on certain sales. While sales tax is triggered by a dealer's exercise of the privilege of doing retail business in a state, use tax is based entirely on the purchase of property for use in the taxing state. The taxable event is the purchase, not the sale, and the tax is due from the buyer, not the dealer. Use tax is far more difficult to predict than is sales tax. For one thing, the sale need not take place in the taxing state, provided that the buyer resides there. This means that mail order purchases that are clearly exempt from sales tax nevertheless are subject to use tax. States are quite candid in saying that use tax levels the playing field between local dealers who have to pay sales tax and their out-of-state competitors who don't. Generally, states hold dealers responsible for collecting and remitting use tax on behalf of their customers, and for all practical purposes states will not attempt to collect back taxes from individual customers if the dealer itself is solvent. However, the liability is there, and it can continue indefinitely if the unwary buyer does not file a use tax return.

The states with the largest collectibles markets, such as New York and California, are leading the way on use tax. They stipulate that dealers with an in-state office, agent, warehouse or other permanent physical presence have a close enough "nexus" with their states to require collecting use tax on all sales to their residents. But these states have also aggressively audited dealers with no permanent physical presence there, even dealers who just attend local coin shows. For example, in July 1995, California's Board of Equalization announced that attending a single retail coin show in California might create nexus, causing the American Numismatic Association to move its 1996 early Spring fair from Santa Clara to Tucson, Arizona. California subsequently changed the regulations to allow a 14-day “safe harbor”. In June 1995, New York's highest court ruled that Orvis, a Vermont mail order seller of outdoor equipment, acquired "nexus" with New York after Orvis personnel made 12 trips to New York City over a three-year period to monitor product displays at independent stores which carry Orvis products. Orvis's personnel did not attend shows or even make a single sale in New York. Nexus guidelines prepared by the Multistate Tax Commission, an organization created by state taxing authorities, hint that even a short appearance at trade show will trigger nexus. This area of law is likely to change in the future, as states realize the dangers of discouraging out-of-state dealers from doing business there.

Income Tax

Net income from the sale of art and collectibles is taxable, but not until the item is sold or otherwise disposed of for value. For some people, this makes art and collectibles a preferred investment vehicle over stocks, whose dividends are taxed annually even if they are in the form of new stock and not cash. An investor can defer taxable gains until a time of his or her own choosing. However, “collectibles”, which includes art and precious metals, are taxed at a rate higher than that for capital assets such as stocks and real estate, which is a disadvantage. The relative tax advantages of art and collectibles *vis a vis* other forms of investment are beyond the scope of this article, and I recommend specialized advice from financial professionals there.

For purposes of this discussion, the key income tax aspects of purchases and sales of art and collectibles relate to the treatment of expenses and losses, and depend largely upon whether you are a collector, an investor, or a dealer for tax purposes. Sounds simple enough, but many people spend a lot of time and effort arguing with the IRS and state taxing authorities over this characterization, because the tax consequences of each can be quite different.

Collectors, who buy and sell coins primarily for personal pleasure, are the most tax-*disadvantaged* class. They must pay tax on income they earn from their collections, but cannot deduct net losses they might have from collectible sales. They cannot deduct any expenses relating to their collection, such as insurance, security, membership dues for collectors' clubs and subscriptions to relevant periodicals, but can offset these expenses against any net income they declare from the sale of items from their collections. Unfortunately, even this benefit is substantially limited because it comprises a "miscellaneous" itemized deduction on Schedule A subject to the 2% adjusted gross income floor. In other words, unless the collector's total miscellaneous expenses exceed 2% of adjusted gross income, there is no benefit. Collectors are entitled to treat their coins as capital assets after a one-year holding period, but the difference between tax rates for capital gains and ordinary income changes over time, and has been greater and less over the years.

Investors fare slightly better. They can deduct expenses relating to their art and collectibles portfolios, but not net losses from sales. However, the IRS makes it more and more difficult to qualify as an investor, clearly preferring to characterize everyone interested in art and collectibles as a collector. The key is whether the taxpayer is engaged in the activity for profit or for enjoyment. Taxpayers who show a profit from their activities for three of the past five years are presumed to be engaged in those activities for profit, although the IRS has the right to rebut that presumption. Relevant factors are the amount of time the taxpayer spent on the activity, whether the taxpayer relied on advice of experts, and whether losses could be expected in a particular year (such as when the market drops in particular types of art or collectibles).

Finally, taxpayers who can establish that they buy and sell art or collectibles as part of a trade or business may acquire dealer status, enabling them to deduct expenses as well as net losses against their other income. As one might expect, the IRS is loath to treat a collector with other sources of income as a "dealer". However, over the years the regulations in this area have been expanded so that it is not impossible for a serious enthusiast to qualify. The "for profit" determination is similar to that described above for investors. Dealers pay tax at ordinary income rates, and may use losses to offset other ordinary income.

One word about "wash sales". Many retailers offer tax breaks to collectors and investors whose tax basis in their portfolios is higher than their current value. The pitch is for the taxpayer to sell their portfolios to the dealer for a loss, take off the loss against capital gain income in that tax year, and then plow the proceeds of the sale back into more art or collectibles. The sale and tax loss part of the deal is fine. If the assets meet the holding period requirements, the losses can offset income. However, even by taking a small commission on the purchase, most retailers cannot acquire large portfolios without a ready customer. Consequently, I regularly see dealers offering to buy rare coin, stamp or sportscard portfolios which have declined in value, and then sell them back to the customer 30 days later at their current market price, a transaction which the IRS calls a "wash sale." Where the intent of the transaction is simply to generate a loss, the IRS will disallow that loss. Moreover, dealers who offer these deals generally take commissions on both ends, which would not be necessary were the prices fair to begin with.

Like-Kind Exchanges and Barter Transactions

A popular marketing tool for retailers of art and collectibles is the "like-kind" exchange under Section 1031 of the Internal Revenue Code. That Code provision allows investors in art and collectibles to trade items which have appreciated in value for items of the same "nature or character" without recognizing income or capital gains on the transaction. For investors interested in shifting from one area to another, this can be a good tax-avoidance technique. However, it must be carefully done to conform with the Code, and several restrictions limit the availability of the like-kind exchange.

The first limitation on like-kind exchanges involves the parties themselves. Like-kind exchanges between "related parties" such as relatives or controlled corporations or other entities will not receive §1031 treatment. Second, both the items being traded and those received must be held purely for investment purposes, necessitating the types of proofs described above to distinguish investors from collectors. Third, the items must truly be of "like-kind", and the IRS has been difficult there. For example, a trade of gold U.S. rare coins (such as a 1927 $20 gold piece) for gold U.S. bullion coins (such as a 2011 $50 gold piece) will not qualify because the older coin is seen as held as a collectible while the modern coin is seen purely as a precious metal investment. Finally, the exchange does not eliminate the tax, but only defers it.

Barters are trades of property at their market value, without cash changing hands. Where items are clearly not "like-kind", collectors and investors nevertheless attempt to avoid income tax on appreciated value by bartering with one another. While taxable gain on art and collectible items is not recognized until the items are sold, a barter is treated by the IRS as a "sale" because the taxpayer is disposing of the item in exchange for value. The celebrated artist Peter Max was indicted some years ago for failing to report income from the barter of nearly $1 million of artworks for the purchase of two residences.

One last point -- like-kind exchanges and barters are not necessarily exempt from sales or use taxes, and if a dealer is involved it is best to check on this before completing the deal.

Art and Collectibles in IRAs

Until the Reagan 1981 tax law took effect on January 1, 1982, art and collectibles (the IRS lumps them together under the term "collectibles") could be purchased for placement in an IRA or other retirement plan. Since that date, purchase of art or collectibles by a retirement plan was deemed a distribution for tax purposes. This change had a profound effect on the market in rare coins and other investment collectibles, as one of the primary motivations for purchase vanished, literally overnight. The IRS made clear that if such assets were already contained in retirement accounts, they could stay there tax-free. The question remains, however, can taxpayers "roll over" art and collectibles without causing an involuntary distribution? The IRS has not given any clear answer to this question. In any event, in 1986 Congress carved out a small exception to the IRA ban with the introduction of the U.S. Mint American Eagle program. U.S. commemorative gold and silver coins dated 1986 and later may be purchased for retirement accounts. And every year, bills are introduced to expand this exception to include all U.S. legal tender coins. If you are interested, contact a tax or legal professional for the latest information.

Record-keeping Requirements

For various reasons, anyone purchasing a sizable amount of collectibles should keep detailed records regarding such purchases. The prices paid for each item should be detailed as well as the date of purchase, so that if the items are sold the gain (or loss) can be calculated and characterized, *i.e.*, as capital gain, "collectibles" income or ordinary income. In addition, if the taxpayer intends to deduct any expenses relating to these items, those expenses should be paid by check and an invoice or receipt obtained. If necessary, a note should state the purpose of the expense, so that if necessary it can be proven to be within the expenses allowable by law.

Buyers of art or collectibles should realize that dealers also have documentation requirements. Most dealers record every sale, no matter how small, and issue an invoice to the buyer. For cash transactions over $10,000, dealers must file a report to the IRS on Form 8300, and send a copy to the buyer.

When selling items, all relevant records should be kept for at least ten years after the sale. This enables the taxpayer to fulfill all record-keeping requirements for collectors, investors and dealers. If possible, commissions, state and local sales tax and other selling expenses should be itemized and in writing. IRS reporting requirements apply to dealers purchasing certain precious metal coins and bars from collectors and investors beyond established dollar thresholds, meaning that the dealer will issue a Form 1099 notifying the IRS of the date and gross amount of the purchase.

II - ESTATE PLANNING AND CHARITABLE DONATIONS OF ART AND COLLECTIBLES

This is an extremely complicated area of law, and it changes slightly with every major revision of the tax code. However, for three reasons art and collectibles are uniquely difficult assets to deal with in tax planning. First, because art and collectibles can increase greatly in value over time, taxpayers often search for ways to minimize the tax impact of such appreciation when they sell or bequeath their collections. Second, because the study and display of art and collectibles is deemed to be in the public interest, tax-exempt organizations such as museums and universities actively pursue donations of such items. Third, because the values of art and collectibles are so subjective, and may differ for different purposes, there is room for serious argument between taxpayers and the IRS.

Estate Tax

Most taxpayers need not concern themselves with estate tax avoidance. Based on current (2012) estate tax thresholds, only those whose estates are likely to exceed $5,000,000 have any estate tax liability. In addition, the unlimited marital deduction is still in effect, allowing a taxpayer to bequeath his or her entire estate to a spouse tax-free. Nevertheless, these tax thresholds change (2013's will be $1,000,000 unless Congress acts this year) and taxpayers likely to leave substantial estates upon death should work with competent professionals to develop an appropriate estate plan. *All* taxpayers possessing collections of art or collectibles should be aware of the basic rules governing their part in an estate plan.

The decedent's basis in art and collectibles will be stepped-up to the fair market value at time of death. For valuable collections accumulated over time, this can result in surprises, as items for which the decedent paid relatively little are valued much higher. And Congress has had a habit of tinkering with the stepped-up basis rules, such as the $1.3 million limit that applied in 2010. However, stepping up basis can be a huge benefit if proper planning is done. For example, by bequeathing art or collectibles to a spouse, the decedent allows the spouse to acquire items tax-free at fair market value. The spouse can then sell those items without recognizing any gain or income, years worth of appreciation in value going untaxed. Most of these same benefits also accrue to taxpayers with make gifts of art and collectibles to their spouses during their lifetimes, although certain guidelines should be followed when doing this. The stepping-up is also beneficial to non-spouses who receive testamentary gifts of art or collectibles, although in those cases the assets will not be deducted from the decedent's estate. The best approach is often to take advantage both of the marital deduction and the $5,000,000 tax-free allowance by allocating part of the estate to the spouse and part to the decedent's children. This protects the surviving spouse from estate tax at his or her death, when no marital deduction exists. Under current law, however, even that risk is minimal because the $5,000,000 allowance is "portable", i.e., is passed from the original taxpayer to the surviving spouse and then added to the spouse's own allowance (assuming the spouse also dies in 2012 – check with a tax advisor for the latest rules!).

Charitable Gifts of Art or Collectibles

Taxpayers often make lifetime or testamentary gifts of appreciated art and collectibles to charitable organizations. Indeed, many taxpayers *create* charities just to receive, manage, and distribute their collections. The intricacies of using tax-exempt organizations for philanthropic or tax-avoidance purposes is beyond this article, and substantial IRS penalties for overvaluing charitable gifts require some care when donating art or collectibles. What follows are some basic questions when evaluating charitable donations of art or collectibles.

The first question is whether the property being given is long-term capital gain property. If it is, the charitable donor may deduct the full fair market value of the property at the time of the gift, including market appreciation. If not, the donor can deduct only his actual basis in the property, which is generally the amount the donor paid for the property. Generally speaking, art or collectibles held over one year will be considered long-term capital gain property. A major exception, however, applies to artists holding their original works. Because the IRS considers an artist's own works "inventory" or "ordinary income property", artists who donate their works to charity may deduct only the value of the "paint and canvas" incorporated into the work. For collectors or investors who donate property they have held for less than one year, the deduction is also usually limited to the price they paid for the property, because the IRS consider such property short-term capital gain property.

The next question is the use to which the charity puts the donated items. Charities sometimes accept gifts for their own use as part of their regular activities, and in other cases charities sell gift items as part of their fund-raising. According to the Internal Revenue Code, items of tangible personal property which the charity puts to a use "not unrelated" to the charity's tax exempt purpose may be deducted to their full fair market value, but items which the charity uses for "unrelated" purposes may not. Here is the example given by the IRS in Publication 526, entitled "Charitable Deductions":

> "If a painting contributed to an educational institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use. But if the painting is sold and the proceeds are used by the organization for educational purposes, the use is an unrelated use."

The most common "unrelated use" in the art and collectibles field is the charity auction, where collectors donate items to be sold for the benefit of charitable organizations. The IRS's example demonstrates the peculiar nature of the "related-unrelated" distinction. A collector choosing between two organizations to which to donate a particular item might well find that one organization would put the item to a related use while the other would not. If the item is one that has appreciated greatly over time, donating to the former charity might result in a much higher tax deduction.

Quite often, donors are not in a position to know how their gifts of property will be used by charities, and charities do not ordinarily know the donor's tax basis in donated property, or whether the property had been held for more than a year prior to the donation. In other words, neither donor nor charity may be aware of whether or not the gift will result in the maximum tax benefits to the donor. Moreover, what happens when a gift is displayed for a while in the charity's library and *then* sold? The IRS allows donors who believed in good faith that their gifts were to be used for "not unrelated" purposes to take their full fair market value deduction, even if the property is ultimately sold, but only if the charity holds the property for one year. If the charity sells a donated item within two years of acquiring it, however, the charity must file Form 8282 with the IRS giving the donor's name and the amount for which the item was sold. This enables the IRS to check the "fair market value" deduction taken by the donor against the actual value received by the charity when the item was sold.

Third, at the risk of oversimplifying a complicated area, the extent of deductions even for long-term capital gain property put to a related use by the charity depends upon whether the charity is publicly-supported or is a private foundation, and whether the taxpayer wishes to deduct full fair market value in the current year or spread out ("carry over", in IRS parlance) the deduction over up to five years. Taxpayers may deduct gifts to public charities of up to 50% of the taxpayer's adjusted gross income in any given year, while donations to private charities are limited to 30% and, in some cases, to 20%. If you don't know which category a particular charity falls under, the IRS says just ask them: "You may ask any organization whether it is a 50% limit organization, and most will be able to tell you." But gifts of capital gain property are limited to 30% regardless of the recipient, unless the taxpayer elects to deduct only his or her basis, and not any appreciation. Deciding which way to go depends upon the amount of appreciation in the property to be donated, the taxpayer's adjusted gross income for that year and projected into the future, and other charitable gifts that the taxpayer may be contemplating. Be sure to get expert advice here.

Valuations/Qualified Appraisals

Beyond the complexities of charitable deduction law lies the subjectivity of art and collectibles values, which create problems even where everyone agrees on the nature of the gifts or donations themselves. As we have seen, an executor of an estate will want to understate the values of art and collectibles in the taxable estate while at the same time hoping to get away with *overstating* the value of items bequeathed to a spouse. Taxpayers also want high valuations for art and collectibles they donate to charity (for their income tax deductions) and low valuations for gifts to non-spouses (to reduce or eliminate gift tax). The IRS, if it reviews the appraised values, will tend toward the opposite positions in each situation (low valuations for charitable gifts and high valuations in estate situations), and the IRS employs art and collectibles experts who often back up their positions. This is an inherent conflict that shows up quite often in evaluating estate tax returns and charitable deductions of art and collectibles.

We start with the purpose and use of an appraisal. Insurance appraisals have different requirements and can represent different values than estate tax or charitable donation appraisals. Appraisals that will be used for tax purposes require the use of "fair market value". IRS regulations define fair market value as "the price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts." Experts will disagree over what "market" to use in measuring fair market value, as between retail, wholesale, or auction. Substantial differences may exist between these different market levels, and taxpayers may expect the IRS to seek the prices most favorable to their positions.

The IRS also stipulates that "The fair market value of a particular item of property ... is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property ...which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail." Thus a "retail replacement cost" valuation is common used for insurance appraisals and represents the value that one would expect to pay for the same or similar item at retail. When an insured item needs to be replaced in a timely manner, the retail market is often the only place to do so, and an appraiser is entitled to consider differences in prices across the U.S. and around the world in calculating retail replacement cost.

It is important to understand that for estate valuation purposes, an appraisal may result in prices far lower than "retail" prices, because fair market value relates to what a buyer would pay for an item in its usual marketplace, which often translates to a "wholesale" or "auction" value. In other words, many fiduciaries who approach auction houses or dealers with an insurance "retail replacement value" appraisal are surprised that the property is not appraised nearly as highly for purposes of actual sale.

Beyond these broad valuation issues are questions regarding what market information is and is not taken into account when appraising art and collectibles. For example, a common issue when estates include art and collectibles is whether auction prices for comparable sales used to establish value should include the buyer's premium. This 10-25% difference can, of course, be significant. I favor including the buyer's premium because auction buyers generally factor the premium into their bidding calculations. In addition, experts debate the extent to which "blockage", *i.e.*, the loss of value associated with selling a collection as a unit, will affect appraised values for estates or large gifts. A great example of this was the estate of artist Georgia O'Keeffe, in which the IRS and the estate agreed on the total value of some 400 works she bequeathed to various charities and individuals, but were tens of millions of dollars apart on the extent to which blockage and costs of sale reduced their value for tax purposes (a court finally decided upon a 50% reduction).

The best way to minimize valuation problems is to employ a professional appraiser who follows guidelines set forth in IRS Publication 561, "Determining the Value of Donated Property." These guidelines require appraisals to include references to sales of comparable items, such as other works by the same artist, as well as some statement regarding the present market in the type of item being appraised. They also limit who can act as an appraiser in this context. He or she must have earned an appraisal designation from recognized professional appraiser organization, or otherwise must have met certain minimum education and experience requirements, and have demonstrated verifiable education and experience in valuing specific type of property valued. The dealer from whom the collector purchased the item, any expert who derives 50% of his appraisal income from doing appraisals for the collector or the charity, and any family member of such persons cannot perform appraisals for tax purposes. Make sure the appraiser applies USPAP, the Uniform Standards of Professional Appraisal Practice. Under IRS Notice 2006-96, the IRS recognizes this standard, "...The Appraisal will be treated as satisfying generally accepted appraisal standards if, for example, the appraisal is consistent with substance and principles of USPAP." Additionally, the appraiser must also be aware of the extra IRS requirements for charitable contribution appraisal reports that are required in addition to the USPAP requirements.

Acknowledgment and Reporting Requirements

For any donation of over $250 in value, the donor must receive an acknowledgment from the charity at the time of the donation in order to take a charitable deduction on the item(s). This acknowledgment must be in writing, must be signed by an appropriate person within the charity, and must describe in reasonable detail the item being donated. The charity does not value the item, and does not verify the value placed on it by the donor, so in borderline cases the donor and charity should agree that an acknowledgment is due. Note that the acknowledgment is not sent to the IRS by either the donor or the charity.

If the donation exceeds $500 in value, the donor must file IRS Form 8283 with his or her tax return. That form requires information regarding the charity, the date of the gift, a description of the property and the donor's original cost basis in the property.

For donations above $5,000, the donor must get a written appraisal, must summarize the appraisal on Form 8283, and must have the charity sign the Form 8283. Again, by signing the Form 8283 the charity does not agree that the donor's valuation of the item is correct. The donor does not send the appraisal to the IRS, but only a summary.

Finally, when donating art valued at over $20,000, the written appraisal itself must be attached to IRS Form 8283 and filed with the donor's tax return. For items valued at $50,000 or more, the IRS will (for a fee) provide a statement of value from its Art Advisory Panel, which statement can be used in connection with the taxpayer's tax return.