

# EXCHANGE ARTWORK AND COLLECTIBLES AND DEFER PAYING CAPITAL GAIN TAXES



## Compliments of

**Kennen S. Cohen**  
**Division Manager**  
**866-601-1031**  
**kennen@apiexchange.com**

Many works of art and collectibles have appreciated significantly in value. Internal Revenue Code (IRC) Section 1031 permits tax deferral on the sale of artwork provided the investor adheres to the Treasury Regulations and IRC rules and timelines. Investors with private art collections held primarily for investment or for use in their trade or business can defer 100% of their capital gain tax liability if they exchange one art collection or a single piece of artwork for another. Examples of qualifying personal property may include many different types of art as long as the investor is able to substantiate that such property was purchased and held primarily for investment purposes or use in a trade or business. This is often the case with fine art and collectibles held for appreciation. The types of personal property that may qualify for a 1031 tax deferred exchange may include: fine art, sculptures, prints, collector coins, precious gems, antiques, classic automobiles and many other collectible investment assets. The obvious benefit of exchanging artwork is that the investor does not have to pay the 28% capital gain tax that would otherwise be due on the sale of appreciated artwork. An investor who displays his collection in his place of business may be able to substantiate that it is held for use in a trade or business.

Assume an investor is selling a Renoir for \$2 million that was purchased for \$500,000 and thus has \$1.5 million of gain. After the investor consults with her tax advisor, she determines she will owe approximately \$420,000 in capital gain taxes based upon the 28% capital gain rate for the sale of the Renoir absent a 1031 exchange. However, if she sets up a 1031 exchange before closing on the Renoir sale, all of the capital gain taxes can be deferred. This leaves the investor with \$2 million of equity and she would have \$2 million to reinvest in other artwork, rather than \$1,580,000 after-taxes, thus maximizing her purchasing power and having the benefit of future appreciation in value on the full \$2 million.



A National IRC §1031 "Qualified Intermediary"

National Headquarters

800-282-1031

Eastern Region Office

866-394-1031

[apiexchange.com](http://apiexchange.com)

[info@apiexchange.com](mailto:info@apiexchange.com)

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	<u>Exchange</u>	<u>Sale</u>
Value of Artwork	\$2,000,000	\$2,000,000
Capital Gain Tax (28%)	\$0	\$420,000
Proceeds to Reinvest	\$2,000,000	\$1,580,000

## THE "LIKE-KIND" REQUIREMENT

A 1031 exchange of artwork or collectibles requires that both the relinquished artwork and the replacement artwork be "like-kind" which means they must be of the same nature or character. Differences in grade or quality do not matter so variances between artists, medium, style and value are considered to be related to grade or quality. There is no solid guidance from Revenue Rulings or Court Rulings defining a "like-kind" standard for artwork and collectibles. However, the IRS in a Private Letter Ruling from 1981, [PLR 8127089](#), provided guidance to a taxpayer regarding replacing lithographs destroyed by fire with replacement lithographs noting they must be "similar or related in service or use" to the property destroyed. The destroyed portfolio contained 99% lithographs and 1% other artwork while the replacement portfolio contained 63% lithographs and 37% other artwork. The "similar or related in service or use" standard is found in [IRC Section 1033](#) and is more restrictive than the "like-kind" standard specified in [IRC Section 1031](#). Although a PLR only provides guidance to a taxpayer's specific facts and circumstances, a PLR does provide useful insights from the IRS even though it does not establish a de facto standard applied to all taxpayers. Some examples of artwork and collectibles that are considered of the same medium and are "like-kind":

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Water color painting	→	Water color painting
Oil painting	→	Oil painting
Lithograph	→	Lithograph
Sculpture	→	Sculpture
Violin	→	Violin (or a musical instrument sharing the same NAICS code)
Antique	→	Antique
Coins	→	Coins

## THE QUALIFIED USE REQUIREMENT

Both the relinquished and replacement property in an exchange must be held for investment or used in the property owner's trade or business. Although an intent to hold for investment does not need to be the *sole* intent, it is certainly beneficial towards establishing investment intent if holding artwork for investment is the *primary* intent. This is often the case with fine art and collectibles as many artwork buyers purchase and hold artwork for long-term appreciation. The intent to hold for investment does not necessarily preclude aesthetic enjoyment or pleasure derived from displaying or viewing artwork or collectibles.

## AN INVESTOR VERSUS A COLLECTOR

Artwork and collectibles may qualify for tax deferral in a 1031 exchange if they are held *primarily* for investment and not for personal use. The Court case, *Wrightsmen v. U.S.*, 192 Ct. Cl. 722 (1970), provides insights on holding artwork with the proper investment intent versus primarily for personal use. The IRS may consider all of the facts and circumstances to determine the primary intent of the owner of artwork including:

- Obtaining the advice of art experts regarding artwork being acquired or sold;
- Developing a reputation locally as being an investment expert in the type of artwork or collectibles the owner researches and studies;
- Maintaining thorough records of all artwork purchases, including documenting the purchase price, date of purchase, keeping a copy of the invoice, showing maintenance expenses and assigning inventory numbers;
- Appraising and reappraising the artwork and collectibles occasionally;
- Seeking to obtain title insurance for artwork and casualty/property insurance ([www.aristitle.com](http://www.aristitle.com) is the only company providing title insurance on artwork).

## PROCEDURES – SETTING UP A 1031 EXCHANGE OF ARTWORK

A 1031 exchange must be set up before closing on the sale of the artwork being relinquished. Contact an established and reputable 1031 exchange qualified intermediary - a neutral third-party like [Asset Preservation, Inc.](http://Asset.Preservation.Inc) who prepares the necessary exchange documents and holds the net proceeds in an exchange. The sales contract should contain an exchange cooperation clause permitting the assignment of rights to the qualified intermediary.



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The qualified intermediary will prepare the necessary documents including the Exchange Agreement, Assignment Agreement and Notice of Assignment. On the sale, the buyer should sign a Notice of Assignment and on the purchase the seller should also sign a Notice of Assignment. In a delayed exchange, once the sale closes, the art investor has 45 calendar days to identify artwork that he may want to acquire in the exchange pursuant to the identification rules. To learn more about the identification rules and requirements, click on [Identification Rules](#). From the date of the relinquished artwork sale, an art investor also has a maximum of 180 days to close on the acquisition of replacement artwork. The net sales proceeds (after commissions and other closing costs like art title insurance) should be sent to the qualified intermediary where it is held on behalf of the investor.

### A REVERSE EXCHANGE OF ARTWORK

Sometimes the art market does not wait and an investor needs to buy a desirable piece of artwork immediately. By utilizing a 'reverse exchange' an investor can purchase the replacement artwork first and sell the artwork that will be relinquished in the exchange up to 180 days later. In this exchange format, either the relinquished artwork or the replacement artwork must be parked with the qualified intermediary during the exchange period, and the arrangement must be carefully documented.

### DEALERS CAN BENEFIT FROM 1031 EXCHANGES

1031 exchange tax deferral does not apply to art dealers holding inventory. However, if an art dealer has a segregated collection of artwork held for investment that he desires to trade, he may also qualify for the tax deferral benefits of a 1031 exchange. A dealer must keep careful records demonstrating that the artwork in question was held primarily for long-term investment rather than for sale purposes. Since many dealers maintain their own private collections, they may have a history of not offering certain pieces for resale which could make the investment artwork eligible for a 1031 exchange.

### MULTIPLE EXCHANGES

The IRS allows an investor to exchange one work of art for multiple works which provides an excellent opportunity for diversification. For example: If 15 years ago a collector bought an oil painting by a then-undiscovered contemporary Chinese artist for \$1 million, she could now sell the painting for its current price of \$10 million and buy ten new oil painting for \$1 million each from ten up-and-coming, undiscovered artists—and pay no capital gain taxes.

Although there are specific rules for identifying potential replacement works of art, the number of works exchanged is not a factor in achieving a successful tax deferral. The determining factor is whether the investor has reinvested the entire net proceeds from the sale (sale price less expenses) in one or more replacement "like-kind" properties. Any remaining equity not reinvested from an exchange will be taxed at normal capital gain rates.

### ART AUCTIONS

A 1031 exchange can be used when selling or purchasing artwork at an auction. The investor should alert the auction company and contact the qualified intermediary before closing on the sale or purchase of artwork at an auction. As always, artwork and collectible investors should always seek the advice of competent tax/legal advisors to discuss any contemplated exchange before closing.



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INCORPORATED

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