

ART AND COLLECTIBLES:

THE PERILS OF 1031 EXCHANGES

BY JUDITH L. PEARSON



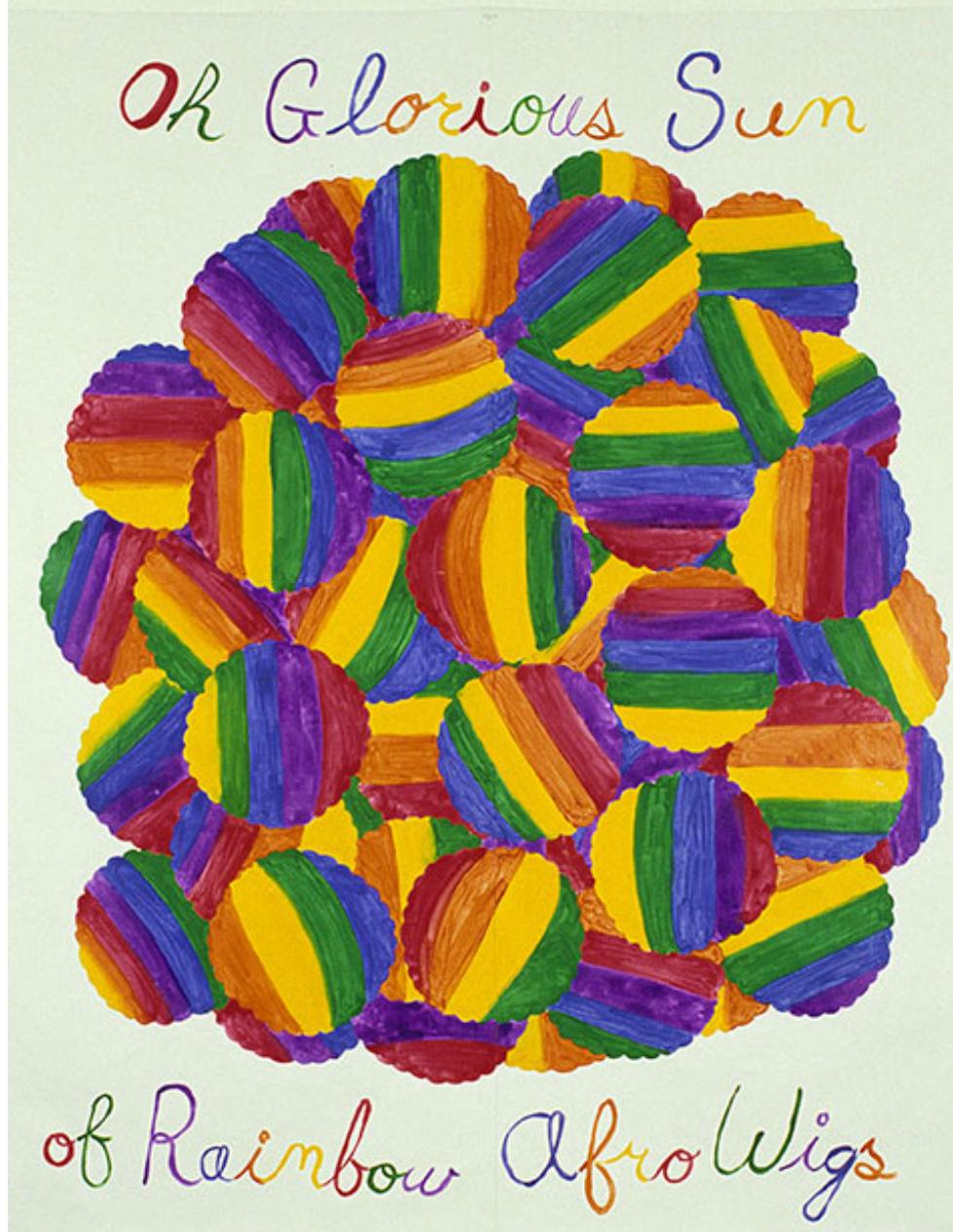
WELL-KNOWN ART COLLECTOR and Andy Warhol-muse Jane Holzer, also known as “Baby Jane,” sued Stephan Stoyanov and his Manhattan gallery in New York state court for allegedly derailing her like-kind art exchange. Mr. Stoyanov was engaged to act as Ms. Holzer’s Qualified Intermediary (QI) in a 1031 exchange. Mr. Stoyanov was to sell two of Ms. Holzer’s contemporary artworks and buy with the sales proceeds plus additional cash, two Richard Prince works which Ms. Holzer identified as the “replacement artworks.” However, Mr. Stoyanov did not escrow Ms. Holzer’s funds and his check to another gallery to buy the replacement works bounced. In short, Mr. Stoyanov failed to complete the replacement part of the exchange.

Like-kind exchanges, known as Section 1031 Internal Revenue Code (IRC) exchanges, allow deferral of federal capital gains tax when investors sell appreciated property and purchase like-kind property of the same or greater value within the defined time period. Exchanges are subject to stringent restrictions outlined with varying degrees of guidance in the IRC including a requirement that the art investor appoint an independent agent to serve as a QI. Experts suggest that 1031 exchanges for art and collectibles is a rapidly growing area of the tax code because of current high valuations for art and precious objects and the 2013 increase in the capital gains tax; however, to take advantage of

this benefit, taxpayers must follow the strict requirements and tread carefully. Given the opaque and unregulated nature of both the QI and the art industry, it is also easy to see how the Holzer-Stoyanov 1031 exchange got off track. The Holzer attempted exchange highlights several issues. First, Ms. Holzer transferred title of her relinquished works to Mr. Stoyanov rather than directly to the buyer(s), perhaps to keep the name of the seller (Ms. Holzer) confidential. Second, aside from the fact that Mr. Stoyanov did not complete the would-be exchange by allegedly violating the exchange agreement (by selling Ms. Holzer's relinquished property and bouncing his check for the replacement property), the failed exchange left Ms. Holzer without her artworks and her money.

In addition, the type of 1031 involved—a dealer or gallery acting as a QI structure—which by all industry accounts is designed to save sales and use tax, tends to support significant “fees” including document creation, transactional fees and commission to the dealer acting as the QI in the form of “overages,” fees that would otherwise not apply in an industry-standard 1031 transaction. Although the Holzer-type 1031 structure may be technically within the IRC guidelines, it pushes the boundaries in the following ways:

- Generally QIs take title to the tax interest not title to the exchange and replacement properties.
- Allowing the dealer to keep the price “overage” is very close to commission as is the \$1,500 fee for each sale and purchase, factors which stretch the constraints of the taxpayer-QI agency relationship and put the taxpayer at risk by creating a possibility for a disqualification of the QI.
- The gallery or dealer QI does not have a legal structure for separate accounts or third party escrow and puts the taxpayer at risk for gallery malfeasance and bankruptcy.
- In the 9 states that regulate QIs, the regulation mandates approved funding, prudent fund management (escrows), and a fidelity bond that



This page: Mike Kelley's 1985 acrylic "Rainbow Coalition," valued at \$240,000, one of the pieces involved in Jane Holzer's lawsuit. **Opposite page:** Judith L. Pearson, author of this piece and president of ARIS Title Insurance Corporation.

covers the potential malfeasance of the QI. There are no similar regulatory statutes or insurance requirements for an art dealer or gallery in the opaque art market.

To benefit from like-kind exchanges, art investors such as Ms. Holzer should follow the structural and due diligence standards which investors exhibit when transacting other assets such as real estate to ensure that title passes properly, creates finality to the transaction, and does not jeopardize the tax strategy. Art 1031 exchanges should be completed with the assistance of knowledgeable, experienced accountants or tax attorneys and professional QIs whose

role is to assure that art exchange transactions are conducted with transactional transparency including closing the art sales in escrow and with title insurance. The use of title insurance in like-kind exchanges confirms clear legal title of both the relinquished and replacement property ensuring finality of the 1031 tax transaction. Use of the title insurance also substantially supports the IRC requirement that the taxpayer is an art investor, who treats her artworks as financial assets, as opposed to just a collector. ♦

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