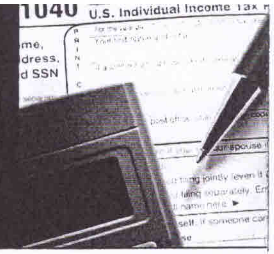

FEATURE:
ESTATE PLANNING & TAXATION

By Diana Wierbicki

Like-Kind Exchanges

Changes in the 2013 federal tax make these an attractive option for art investors

To say that the art market, including public auctions and private sales, has performed very well in the last several years would be an understatement. The press has reported on the record breaking auction sale of Edvard Munch's "The Scream" at Sotheby's and on Christie's historically successful sale of post-war and contemporary art last November, totaling approximately $412 million.[1] These headlines have excited existing art investors and attracted many new ones. Individuals who've been collecting for several decades still have a hard time believing the number of zeros added to art prices these days. During the November 2012 auctions in New York, a Franz Kline work sold for nearly $40.4 million, which is more than quadruple his previous auction record of $9.3 million. However, this pleasant surprise for investors selling their art is often overshadowed by the number of zeros added to their tax bill after a profitable sale.

With increasing art sale prices, art investors generating substantial amounts of gain have been seeking advice on how to best structure their sales. Prior to 2013, the tax rate on gains from the sale of art was 28 percent. In 2013, the additional 3.8 percent tax on investment income has made the search more urgent. As the May 2013 auction season in New York approaches, like-kind exchanges present an attractive option for art investors who wish to defer gain recognition. Art investors are thrilled to hear the tax benefits of a like-kind exchange, but they're usually not as enthusiastic about the rules that must be followed.

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A Changing Landscape

Two Congressional Acts, the 2010 Health Care Reconciliation Act (HCRA) and the American Taxpayer Relief Act of 2012 (ATRA), affect the federal taxation of art sales in 2013.

Beginning in 2013, HCRA imposes a 3.8 percent tax on certain investment income.[2] This surtax for individuals is 3.8 percent of the lesser of: (1) net investment income, or (2) the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 for a married couple filing jointly, $125,000 for a married individual filing separately and $200,000 for all other individuals. Among other things, the definition of net investment income includes the net gain from disposition of property (other than property held in a trade or business). Therefore, this surtax will apply to gain from the sale of art.

ATRA doesn't change the tax rate of gain from art sales. The capital gains rate for collectibles, including art, will remain at 28 percent for 2013.[3] Therefore, in 2013, gains from the sale of art will be taxed at a combined federal rate of up to 31.8 percent.

An Attractive Option

An art investor contemplating selling and purchasing art may consider structuring the sale and purchase as one exchange transaction. This will avoid gain recognition on the sale that would otherwise occur if the sale and purchase were treated as two separate transactions. Recognition of the gain that's realized on the sale will be deferred, and the art that's purchased will acquire a carryover basis from the art that's sold.

Internal Revenue Code Section 1031 and the corresponding Treasury regulations provide guidelines for the non-recognition of gain or loss for certain qualifying property exchanged solely for "like-kind" property. No gain or loss will be recognized on the exchange of