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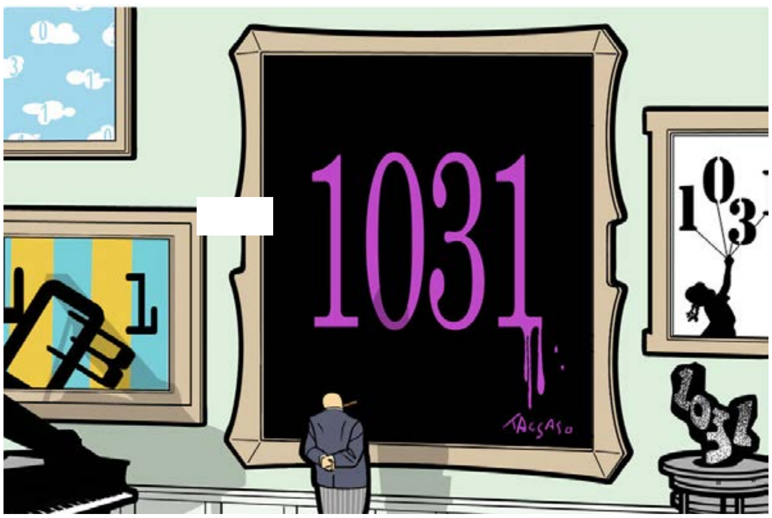
With 1031 Exchanges, Art Investors Avoid Taxes

Tactic Used in Real-Estate Investing Makes Inroads in Art World



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By DANIEL GRANT
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People who Sell valuable works of art are increasingly avoiding capital-gains taxes by applying an Internal Revenue Service rule more commonly used by real-estate investors.

Under the rule, sellers of certain kinds of property can postpone capital-gains taxes if a qualifying exchange structure is used and proceeds from the sale are used to purchase property of "like kind" within 180 days. The Internal Revenue Service then treats the entire transaction as a reinvestment of capital, and so not subject to taxation.

Such postponements can continue as long as qualifying exchanges continue to occur, and as long as the value of the replacement property is equal to or greater than the value of the object being sold. After the owner dies, estate taxes can come into play, but capital-gains taxes will no longer be owed.

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Real-estate investors traditionally have been the most active users of these so-called 1031 exchanges, named for the relevant section of Internal Revenue Code. But now, as prices of art have soared in recent years, art investors increasingly have been getting in on the exchange act.

"We've definitely seen an uptick in the last two or three years," says Mary Cunningham, president of the Federation of Exchange Accommodators, an association of companies that act as qualified intermediaries in the exchanges. There is "an increasing awareness" of the rule, she says.

Many sophisticated investors are active art collectors, adds Andy Augenblick, president of Emigrant Bank Fine Art Finance LLC, and "may have done these types of transactions with other assets they own, such as real estate." Emigrant Bank Art Finance is a subsidiary of New York-based Emigrant Bank.

The IRS Is Watching

To pass IRS scrutiny, the buyer must be able to prove that he or she is an investor in art, not just a collector, and that the principal reason for owning the art is to earn a profit rather than personal enjoyment. Paintings decorating one's home typically can't be labeled investments just because an opportunity arises to sell one work to buy another comes up.

"The IRS frowns on treating artwork as an investment when it is displayed in a personal residence," says Ramsey Slugg, wealth strategist for U.S. Trust/Bank of America. But, he adds, that isn't usually the sole determining factor in determining the tax treatment.

Art Swap

What to keep in mind when considering a 1031 exchange

- Buyer must prove status as an art investor
- Swap typically takes place at art galleries or auction houses
- IRS requires use of a qualified intermediary
- Intermediary fee averages $750 to $1,500
- Swap must take place over a period of 180 days
- IRS private letter ruling fee ranges from $1,000 to $10,000

Source: WSJ reporting

Howard J. Levine, an attorney with Roberts & Holland LLP in Washington, D.C., says investors don't necessarily have to avoid displaying the art in their homes, just "perhaps not in your bedroom, but in a home office or public area where potential buyers or business acquaintances may come see it."

Experts say the IRS looks more favorably on those desiring investor status when they maintain records of purchases and expenses, seek the advice of art experts, have artworks appraised periodically, obtain insurance for the art and present themselves in the industry as an art investor.

Swap Fees

Approved swaps most often take place at art galleries or auction houses. The IRS requires that a qualified intermediary, which could be a bank, an art dealer, or one of the members of the Federation of Exchange Accommodators, receive the sale proceeds and document the exchange to insure that it complies with IRS requirements. The fee for the qualified intermediary for a one-to-one swap averages $750 to $1,500.

The swap needn't be simultaneous. It may take place over a period of 180 days. But the intended replacement property must be identified within the first 45 days.

What constitutes "like-kind" isn't spelled out in IRS regulations. It is not clear, for example, that a lithographic print couldn't be exchanged for an oil painting, or even a painting for a sculpture. Still, says Mr. Levine, "most practitioners believe that exchanging a sculpture for a painting as part of a 1031 is very risky."

But others aren't so sure. As Louis Weller, a lawyer with Bryan Cave in San Francisco, says, "the scope of the 'like-kind' requirement as it applies to art is wholly unexplored territory from a technical tax perspective."

Art investors who seek more certainty as to a prospective like-kind exchange may request a "private letter ruling" from the IRS, which is a pre-ruling by the gency's office of legal counsel. The cost for this legal opinion ranges from $1,000 to $10,000. According to an IRS spokesperson, the cost is determined by the amount of staff time required.

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