ART FOR ART

Authors
Nina Krauthamer
Sheryl Shah

Tags
§1031
Artwork
Disposition of Property
Investment Property
Like-Kind Exchange

Taxpayers are usually taxed on net gains from the sale of property. However, tax may be deferred if the transaction is cast as an exchange and certain conditions are met. Code §1031 like-kind exchanges are commonly used in the real estate business to defer taxes arising from the disposition of appreciated property in return for replacement property of similar character and use. Deferral of tax is allowed even when the exchange looks like a sale because it is part of a three-party arrangement where the purchaser provides cash to a qualified intermediary, who is acting on behalf of the transferor, and that intermediary uses the cash to acquire replacement property for the transferor.

Reportedly, art investors are now employing like-kind exchanges to defer tax on gains from the sale of appreciated art. The tax is deferred by exchanging art for art. This article looks at like-kind exchanges and how the stringent requirements have been adapted by art investors.

CODE §1031

Under §1001(a), taxable gain or loss from the sale or disposition of property is defined as the difference between the amount realized from the disposition and the adjusted basis of the property. To constitute a realizable event, the properties exchanged in the transaction must be materially different. The simplest example is an exchange of real estate in return for cash. A more complex example is an exchange of real estate for a sail boat. In both these instances, the properties are materially different and the holder of the property ends up holding assets that are different in kind or extent from the asset transferred.[1]

Section 1031 of the Code provides an exception to the gain recognition rule. Under that provision, no gain or loss is recognized if certain qualifying property is exchanged solely for “like-kind” property. The benefit of the provision is available only if both the properties transferred and received in the exchange are held for productive use in a trade or business or for investment. This does not include stock, bonds, notes, securities, partnership interests, certificates of trust, or beneficial interests.

Qualified Purpose

Property held for a qualified purpose is property used in a trade or business in which the taxpayer is engaged. Although non-business and personal property does not qualify, a minimal amount of personal use generally does not disqualify property from being trade or business, or investment property.[2] Property held for investment

[1] *Cottage Sav. Ass’n v. Commr.*, 499 U.S. 554 (1991).

[2] P.L.R. 8103117.

includes unproductive real estate held for future use or future realization in value at the time of the exchange.[3]

The primary intent of the ownership of the property is considered in a like-kind exchange. To illustrate, a vacation home that is exclusively used for personal purposes does not qualify for the exemption. In contrast, a vacation home that is held solely for rental purposes and not personal use will clearly qualify, since it is being used for business purposes.

Like-Kind Property

In addition to having a qualified purpose, the properties must be similar enough to each other to qualify as like-kind. Like-kind property is property of the same nature, character, or class. Quality or grade does not matter. While most real estate is usually considered like-kind to other real estate, property within the U.S. is not considered to be of like-kind to foreign property. This reflects the scope of U.S. taxing jurisdiction under F.I.R.P.T.A. more so than a rationale for the characterization of the two properties.

Timing and Basis

The exchange may be either simultaneous or deferred. In a deferred exchange, property is disposed of and property qualifying as like-kind is subsequently acquired. The taxpayer has not more than 45 days from the date the relinquished property is sold to identify the potential replacement properties. Because purchasers are generally not interested in finding, purchasing, and selling the replacement property to the seller – all those acts cost money – the purchaser generally transfers the purchase amount to a qualified intermediary. That is the name given to a designated agent who will acquire property in the name of the seller. Since the qualified intermediary is not authorized to perform any act other than the acquisition of the replacement party, it steps into the shoes of the original owner. When a deferred purchase transaction is effected, the like-kind exchange becomes a three-party transaction – the original seller, the original purchaser, and the seller of the replacement property.

The identification of the replacement property must be delivered to the seller or qualified intermediary within the 45-day time period. The purchase of the replacement property must be completed within 180 days of the date of sale of the exchanged property or by the final due date of the income tax return, including extensions, for the year in which the relinquished property was sold.[4]

The basis of the property acquired in a §1031 like-kind exchange is the basis of the property relinquished. The taxpayer does not receive a step-up, fair market value basis in the replacement property since the gain was deferred and not recognized at the time. If the taxpayer receives some cash or non-qualifying property, gain must be recognized to the extent of the cash received and the value of the non-qualifying property. Basis is stepped up to the extent cash is received.

Owners of investment and business property may qualify for like-kind exchanges. This may be an individual, a C-corporation, an S-corporation, a partnership, a limited

---

3 Treas. Regs. §1.1031(a)-1(b).

4 I.R.S. "Like-Kind Exchanges Under IRC Code Section 1031," last modified August 8, 2012

liability company, or any other entity that owns business or investment property. A like-kind exchange must be reported on Form 8824, a form that is filed with the tax return for the taxable year in which the exchange occurs.

LIKE-KIND ART

Like-kind exchanges give the taxpayer the opportunity to reinvest, consolidate, relocate and diversify holdings. Art investors reportedly have applied the tax-free like-kind exchange provision to art, provided that art is held for investment and that purpose can be clearly demonstrated.

> ***"Art investors reportedly have applied the tax-free like-kind exchange provision to art, provided that art is held for investment and that purpose can be clearly demonstrated."***

Qualified Purpose

Under Code §1031, collectibles may be exchanged in a like-kind exchange if they are held primarily for investment rather than for personal use. The burden here is on the taxpayer to prove that the investment intent outweighs the personal enjoyment of the collectible property.

Works of art that are displayed in the taxpayer's home will be considered as being held for personal use.[5] The primary purpose of acquiring the pieces is considered when determining whether the purpose was qualified. Investment cannot be an incidental benefit of owning the artwork. The taxpayer must be able to show that the primary purpose of acquiring the works of art was investment by, for example, holding the pieces in storage in a venue other than the taxpayer's residence.

Other ways of demonstrating a principal investment intent include, but are not limited to, developing an expertise in art, having a history of art investments, obtaining market analyses of the artwork and appropriate insurance, and maintaining detailed records of the investment activity. Without projections of cost of capital and anticipated return on investment performed prior to the time of acquisition, a taxpayer likely has little chance of meeting the burden of proof to demonstrate an investment purpose.

Another sophisticated approach is to own the art through an investment syndicate that provides an investment memorandum at the time funds are raised for the acquisition of art. This begs the following question – from a personal viewpoint, why acquire art if it cannot be viewed other than in a vault? The answer is that the art is an alternative investment and not a thing of beauty.

Like-Kind Property

The exchange must be of like-kind property. The physical properties, nature of the title conveyed, rights of the parties, duration of the interests, and other factors are considered when determining like-kind status of replacement property. Determining whether the properties being exchanged are of like kind is challenging since there is little authority on the matter.

The I.R.S. has ruled that for the purposes of Code §1033, relating to deferral of gain from recoveries for an involuntary conversion, lithographs may not be replaced with artworks in other artistic media such as oil paintings, watercolors, sculptures, or

---

5 *Wrightsman v. U.S.*, 428 F.2d 1316 (1970).

other graphic forms of art.[6] No such result has been reached for purposes of Code §1031(a). Nonetheless, an I.R.S. official is reported to have unofficially indicated that a painting exchanged for a painting would probably qualify under Code §1031, but not a painting exchanged for a sculpture.[7] Vermeers can be exchanged for Warhols but not Berninis.

Whether or not works of art will be considered like-kind is a matter to be decided by the I.R.S. The taxpayer can request a private letter ruling on the question.

Timing and Qualified Intermediaries

The exchange must take place between the prescribed time period if it is not simultaneous. The taxpayer has 45 days in which to identify the replacement work and 180 days to complete the transaction.

A qualified intermediary is a safe harbor provision that can be used to facilitate the transfer. An art dealer, special exchange company, gallery, or auction house may be the qualified intermediary. The intermediary acquires the relinquished and replacement properties and then transfers them to their new owners. A flat fee is usually charged for such a transaction.

CONCLUSION

The Code §1031 like-kind exchange gives investors a chance to reinvest proceeds from sales back into the business and to defer tax on any gains. Traditionally used for investment and business real estate, art investors have now adopted these rules for the exchange of works of art.

If like-kind exchange treatment is granted on the exchange of works of art, the investor is granted the opportunity to refresh its holdings based on the market without incurring taxes. However, the gain will be recognized eventually when the replaced property is sold without a step up in basis.

Like-kind exchange treatment is only available if the exchange fulfills the requirements of Code §1031. The taxpayer has to show that its activities are that of an art investor rather than an art collector. Since there is not much authority on point at the moment, the safest course of action is to acquire art through an investment partnership that keeps beauty locked in a vault until it is exchanged for other items of beauty doomed to a similar fate.

"This begs the following question – from a personal viewpoint, why acquire art if it cannot be viewed other than in a vault?"

6 P.L.R. 8127089 (April 10, 1981).

7 Bloomberg BNA Daily Tax Report, "IRS May Take Liberal View of Bifurcation of Like-Kind Exchanges," November 29, 2012.