The Collection
As Investment Property

Maintaining a collection in good condition is expensive; the expenses may include framing, reframing, lighting, air conditioning and humidity controls, cleaning and other maintenance, security devices, publications, and insurance. The collector may incur travel and other buying expenses and fees when he adds to a collection. Those costs have increased substantially in recent years.

This chapter focuses on the income tax issues involving the deductibility of the expenses of maintaining a collection, the tax treatment of gains and losses realized on sale of a collection, certain problems of insurance, and sales tax issues. Identification as a dealer, an investor, or a collector and the tax ramifications of each are discussed. Although the text may often refer to works of art, it is equally
applicable to all collectibles, whether art, coins, stamps, antiques, rugs, cars, or any type of tangible personal property.

May an art owner deduct all, some, or a portion of such collection-related expenses and losses incurred in holding the collection as an investment, or are all those expenses nondeductible personal expenses incurred in a hobby for personal use and enjoyment? If an individual who is otherwise employed purchases ten prints, intending to keep one and sell the others privately on eBay, is he an investor or a dealer or perhaps still a collector? Before these questions can be answered, it is necessary to determine whether the individual in question is a dealer, an investor, or a collector and to examine the general statutory provisions.

It is important to keep in mind that the tax rate and the availability of deductions will differ depending on whether a person is a dealer, investor, or collector. A dealer is taxed on the gain from the sale of property at ordinary income tax rates up to a maximum of 35%. An investor or collector is taxed on the gain from the sale of property held for more than one year at the long-term capital gains rate of 28%. If the property was held for one year or less, the gain is treated as ordinary income up to a maximum of 35%. Whereas long-term capital gain on the sale of securities and real estate is currently taxed at a 15% rate, the recent tax acts have imposed a 28% rate on the long-term gain from the sale of "collectibles." It is this seemingly unfair high tax rate of 28% on long-term capital gains from the sale of collectibles that has stimulated interest in tax planning.

DEFINITIONS

Dealer

A dealer is someone engaged in the trade or business of selling works of art, primarily to customers. Although the term "trade or business" is not specifically defined in the Internal Revenue Code, court cases indicate that it is the pursuit or occupation to which one
contributes a major or substantial part of one’s time for the purpose of livelihood or profit.

In December 1983, the United States Court of Appeals for the Second Circuit held that the determination of whether a taxpayer is engaged in a trade or business is not based on all the facts and circumstances. Instead, the Second Circuit ruled that the following three specific conditions must exist for a trade or business status to be recognized:

1. The taxpayer must be regularly engaged in the activity.
2. The activity must be undertaken with the expectation of making a profit.
3. The taxpayer must hold himself out to others as engaged in the selling of goods and services.

Then, in 1987, in *Commissioner v. Groetzinger*, the United States Supreme Court reaffirmed a facts-and-circumstances test and rejected the Second Circuit’s condition that the taxpayer must hold himself out to others as engaged in the selling of goods and services. The Court stated that a judicial attempt to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Internal Revenue Code.

The Court stated that in order to be engaged in a trade or business the taxpayer must be involved in the activity with continuity and regularity, and the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify. Moreover, mere investment activities do not constitute a trade or business.

### Investor

An investor is someone who buys and sells works of art primarily for investment, rather than for personal use and enjoyment or as a trade or business. The cases in the securities area that distinguish a dealer from an investor should be equally applicable to the art world. The word “primarily” means of first importance. The key is whether
the taxpayer is engaged in the investment activity with the primary objective of making a profit.

In *Thomas B. Drummond*, the taxpayer was a psychologist who devoted an average of fifty-eight hours a week to his psychology practice. During the 1970s, the taxpayer, who had an interest in and enjoyed art, purchased a number of drawings at auction or from private galleries. Having conducted research about the drawings throughout the 1970s and 1980s, he concluded that one of them (*Three Famous Heads* by Michelangelo Anselmi), which he had purchased for $1,300, could be sold for about $100,000. The taxpayer sold the drawings to a museum for $115,000 in 1989. He made no other sales of drawings during the 1980s and through 1994. The taxpayer reported the gain from the sale as ordinary business income on income tax Form 1040, schedule C, not as long-term capital gain on schedule D, since the schedule C business income enabled him to obtain a larger deduction for a contribution to his retirement plan. The court had to decide whether the gain from the sale of the drawings was gain from property held by the taxpayer “primarily for sale to customers in the ordinary course of his trade or business” within the meaning of section 1221(a)(1) of the Internal Revenue Code of 1986. If it was, the gain at issue was ordinary income; otherwise, it was long-term capital gain. As used in section 1221(a)(1), the word “primarily” means “of first importance” or “principally.” The court concluded that the taxpayer was not engaged in a trade or business with respect to his art activities and that the gain on the sale of the drawings was long-term capital gain.

The case contains an excellent summary of the relevant principles, pointing out that the purpose of section 1221(a)(1) is to differentiate between the profits and losses arising from the everyday operation of a business and the realization of appreciation in value accrued over a substantial period of time from an investment. In determining whether a transaction is primarily from the operation of a business or from investment, the courts have examined various factors, including the following:
(1) the purpose for which the property was acquired;
(2) the purpose for which it was held;
(3) the frequency, continuity, and substantiability of sales;
(4) the duration of ownership;
(5) the use of the proceeds from the sale of the property;
(6) the business of the taxpayer; and
(7) the time and effort that the taxpayer devoted to sales activities relating to the asset in question by developing or improving that asset, soliciting customers, and advertising.

No single factor or combination of factors is necessarily controlling, and objective factors carry more weight than the taxpayer's subjective statement of his intent.

Collector

A collector is someone who buys and sells works of art primarily for personal pleasure and is neither a dealer nor an investor; ordinarily, a collector may not deduct expenses and losses.

STATUTORY PROVISIONS

The statutory framework involves the interaction of sections 67, 68, 162, 212, 165, 183, and 262 of the Internal Revenue Code of 1986, as amended.

- Section 67 generally limits miscellaneous deductions to those that exceed 2% of adjusted gross income.
- Section 68 generally limits an individual taxpayer's ability to claim itemized deductions if the taxpayer's adjusted gross income exceeds a specified statutory amount.
- Under section 162, a taxpayer may deduct from gross income all ordinary and necessary expenses incurred in a trade or business.
Under section 212(1) and (2), a taxpayer may deduct expenses incurred in the production or the collection of income.

Section 165 permits the deduction of losses sustained in a trade or business or in a transaction entered into for profit.

Section 183 qualifies the foregoing provisions by specifically disallowing, with certain exceptions, deductions attributable to activities not engaged in for profit.

Section 262 denies a deduction or loss for expenses that are personal in nature.

Therefore, a taxpayer claiming a deduction for an expense under section 162 or section 212 or for a loss under section 165 must be able to demonstrate an associated profit motive in order to avoid the ban of section 183 or section 262.

EXPENSES

Prior Law

Before the Tax Reform Act of 1969 added section 183 to the Internal Revenue Code, collection-related expenses were deductible only by someone who is a dealer—that is, someone engaged in a trade or business—or an investor—that is, someone who holds the collection for the production of income. The Court of Claims dealt with the issue of the deductibility of collection-related expenses in the Wrightsman case.

Charles Wrightsman was an art collector, not a dealer, and he conceded that he had originally purchased some works of art as a hobby and that he did derive pleasure and satisfaction from keeping his collection in his residence. However, he claimed that the property was held primarily for investment and, therefore, that the expenses related to the investment were deductible. The court disallowed the deductions, ruling that the test to be applied is whether, as a factual matter from an objective view of the operative facts and circum-
stances, the taxpayer acquired and held the works of art primarily for investment, rather than for personal use and enjoyment.

In *Wrightsman*, the Court of Claims also established the following guidelines and criteria:

1. The collector must establish that the investment purpose for acquiring and holding the items in the collection was "principal" or "of first importance."

2. Artworks or other items that make up a collection can be the subject matter of investment. (A number of investment funds have been started with the intention of investing only in artworks, including Sovereign American Arts, Collectors Funding, Art Fund, and Fine Arts Fund.)

3. The collector must intend to hold the property for investment. That intent can be shown by an analysis of the art collector's financial position, the collector's investment history, whether the collector believes that works of art are a hedge against inflation, and whether the collector has made personal declarations of investment purpose and intention that are supported by circumstances and conduct evidencing that intention. Other indications of investment intent include the following:
   a. Consulting with experts on purchases
   b. Reading pertinent publications
   c. Participating in collection-related activities
   d. Devoting time to the collection
   e. Making an effort to display the collection publicly, so as to enhance its value
   f. Developing expertise about the collection
   g. Keeping businesslike records and using a businesslike method of accounting for the collection

4. The retention of a collection, without any profitable sales, is not a bar to a showing that the property is held for investment.
5. Even though the collector uses part of the collection to fulfill personal needs, that use does not make the collector’s overall activity a hobby.

6. The fact that pleasure is derived from investment property does not preclude deductions.

7. The fact that there is no substantial relationship between the collector’s principal occupation and his collection activities is of little significance.

8. The proportion of the collection-related expenses that is attributable to the personal use of the collection is not deductible. The proportion attributable to personal use is a close approximation based on all the facts and circumstances.

On the basis of the facts presented in Wrightsman, the report of the trial commissioner of the Court of Claims recommended that the deduction for the art-related expenses be allowed. However, the court did not adopt the trial commissioner’s report and disallowed all the art-related expenses. A dissenting opinion to the decision of the court adopted the conclusion of the trial commissioner and, we believe, should have been the conclusion reached by the court.

Conclusions Under Wrightsman

Under section 162, the dealer who buys and sells works of art can deduct the ordinary and necessary business expenses incurred in the trade or business of being a dealer.

Under section 212(1) or section 212(2), the investor who buys and holds works of art primarily for investment can deduct the ordinary and necessary expenses incurred in connection with property held for the production of income.

Under section 262, the collector cannot deduct art-related expenses in connection with collecting activities, since those expenses are nondeductible personal expenses.

Still, the opinion in Wrightsman indicates that the collector faces an extremely difficult, although not impossible, task to prove that he is an investor. In the past not many collectors were able to show that
they acquired and held the works of art primarily for investment, rather than for personal use and enjoyment. Currently, with ever-increasing prices for top-quality works of art, the drop in interest rates, and the inherent risk in the stock market, more collectors are acquiring works of art as investment property and should be able to carry the burden of proof that they are, in fact, investors in works of art.

Section 183

The Tax Reform Act of 1969 introduced section 183 to the Internal Revenue Code, effective January 1, 1970. Although the section is known as the hobby-loss provision, because it disallows deductions and losses from activities not engaged in for profit, it does permit the deduction of certain collection-related expenses that were not previously deductible. Section 183(a) provides the following:

In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

Section 183(c) defines the term “activity not engaged in for profit” to mean

any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

Therefore, for a collector to avoid the application of section 183, a collection-related expense has to be from an activity engaged in for profit and the expense must be deductible under section 162 or section 212(1) or (2). As previously discussed, the Wrightsman case makes the deduction of collection-related expenses under such sections extremely difficult because of the onerous burden of proof the taxpayer has in proving to the Internal Revenue Service (IRS) that he incurred the expenses in connection with works of art held primarily for investment. A collector can avoid section 183 only if he can prove that
the intent to make a profit was the main motivation for the activity. The question of a collector’s intent is by its nature a subjective inquiry that can be determined only by examining a variety of objective facts. As summarized by the Senate Finance Committee,

the facts and circumstances (without regard to the taxpayer’s subjective intent) would have to indicate that the taxpayer entered upon the activity, or continued the activity with the objective of making a profit.

Regulation section 1.183-2 sets forth a number of factors similar to the indications of investment activity listed in *Wrightsman* to be considered in determining whether or not an activity is engaged in for profit. The factors were promulgated in an effort “to comply with the congressional purpose of establishing objective tests to determine subjective intentions.” While the focus on the determination of profit motive is on the subjective intention of the taxpayer, the objective criteria set forth in Regulation section 1.183-2(b) may be cited to establish the taxpayer’s true intent. Those factors are the following:

1. The manner in which the taxpayer carries on the activity. A businesslike manner with complete and accurate books and records is more likely than not to be profit-motivated. The businesslike operation of the activity is probably the most important factor in indicating a profit motive. It is likewise important to be able to show that the taxpayer changed methods in response to a period of losses or pursuant to professional advice. In *Churchman*, the court found that an artist carried on her artistic activities in a businesslike manner for profit since her work did not stop at the creative stage but went into the marketing phase of the art business, where the recreational element is minimal. For the taxpayer with a collection, the maintenance of businesslike records is essential. A collector who maintains good books and records for his activity is more likely to have the profit intent required to escape section 183. These records should include the purchase or sale details from an art transaction. It would be
helpful in proving profit intent if, prior to the purchase of a work of art, the collector had a written analysis of comparable prices for similar works by the same artist and other relevant financial data. Failure to maintain adequate financial books and records may be viewed as indicating a lack of the necessary profit intent.

2. The expertise of the taxpayer or the taxpayer’s advisers. Preparation for the activity by an extensive study of accepted business, economic, and scientific practices or by consultations with experts may indicate a profit motive. For the taxpayer with a collection, consultation with art experts and subscriptions to auction catalogs and collection magazines indicate a profit motive. Obtaining from time to time a fair market value appraisal by an independent art appraiser for the taxpayer’s collection would be indicative of a profit intent.

3. The time and effort expended by the taxpayer in carrying on the activity. Spending a great deal of time and effort is more likely than not to indicate a profit motive. Although it would be burdensome and inconvenient, a collector who kept a diary of the time devoted to visiting museums, art shows, art fairs, and galleries, reading art magazines, and consulting with auction houses, art dealers, and art experts would have an easier time showing a profit intent than a collector without such records.

4. The expectation that assets used in the activity may appreciate in value. The term “profit” does encompass appreciation in value of the assets, but unrealized appreciation alone may not be sufficient. The taxpayer must show that his primary purpose is ultimately to realize a gain from the appreciation in value of the asset. Since the mere owning of a collection produces no income, a profit can be realized only from future appreciation of the collection. But the expectation of appreciation may be insufficient in and of itself to escape the provisions of section 183.

5. The success of the taxpayer in carrying on other similar or dissimilar activities for a profit. The fact that the taxpayer
TAX TIPS FOR COLLECTORS

has engaged in similar activities in the past and converted them from unprofitable to profitable may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

6. The taxpayer's history of income or losses with respect to the activity. A series of realizations of income may indicate a profit motive. But the realization of income must be reasonable in light of the activity. For example, a collector who spent $5,000 traveling throughout Europe in pursuit of travel photography, but sold only $30 worth of pictures, did not have a profit motive.

7. The amount of occasional profits, if any, that are earned. A taxpayer who generates only infrequent and small profits is not likely to have a profit motive. A sale of an item in a collection at a large gain is clear evidence of a profit motive.

8. The financial status of the taxpayer. The fact that the taxpayer does not have substantial income or capital from sources other than the activity in question may indicate that the activity is engaged in for profit. On the other hand, a taxpayer with substantial income from sources other than the activity in question may not have a profit objective, especially if personal or recreational elements are involved. For the collector of valuable items of property, the presence of other sources of income is a difficult element to overcome. Obviously, this is a catch-22 provision and should be given less weight for the collector, since valuable items cannot be purchased by someone who does not have other sources of income and substantial liquid assets. A taxpayer's wealth, or lack thereof, should not be a major factor in determining a profit motive from a collecting activity.

9. Elements of personal pleasure or recreation. The regulations indicate that the greater the pleasure, the less likely it is that the collector has a profit motive. Although not required by the Internal Revenue Code or Wrightsman, a physical segregation of the art investment property from the taxpayer's personal residence or office generally helps the
taxpayer prove his profit motive. Since a collecting activity generally has strong elements of personal pleasure, it can be expected that the IRS will cast a doubtful eye on anyone claiming that the activity is primarily profit-motivated. However, the regulations indicate that a taxpayer with both profit and nonprofit objectives may satisfy the profit intent requirement. The regulation states: “[T]he fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.”

No one of the above factors is determinative, and the determination of a profit motive is not limited to the above factors. The test is this: Based on all the facts and circumstances, is a profit motive present?

The main objective of section 183 is to disallow deductions attributable to an activity not engaged in for profit. The nine factors listed above present an almost insurmountable barrier for a collector. Therefore, section 183(a) is an effort by the IRS to disallow deductions for all collectors who are not dealers or investors.

**Section 183(b)**

Section 183(b) does offer some help to the collector. The section allows the collector to claim deductions for expenses attributable to an activity not engaged in for profit up to the amount of the gross income derived from the activity, after first deducting those items, such as certain items of interest and taxes, that are allowable without regard to whether an activity is engaged in for profit.

As discussed above, if the taxpayer can satisfy section 212(1) or (2) (the investor purchased and held the works of art primarily for investment), the collection-related expenses are deductible whether or not the taxpayer had any gross income from collection activities since he is classified as an investor. If the taxpayer (as in Wrightsman) cannot satisfy the test of section 212(1) or (2), the taxpayer can claim a
deduction for collection-related expenses under section 183(b) up to the amount of his gross income from collection activities, so long as the collector is carrying on an “activity” within the meaning of section 183 and after first subtracting such items as interest and taxes that are deductible without regard to section 183. The collection-related expenses that are then deductible under section 183(b) are subject to the 2% rule of section 67(a), which limits miscellaneous deductions to amounts that exceed 2% of adjusted gross income. The deductible expenses may be further limited under the provisions of section 68(a), discussed below.

For example, if in Wrightsman there had been gross income derived from the taxpayer’s collection activities, the expenses at issue in that case would have been deductible under section 183(b) up to the amount of that gross income. Under prior law, if the expenses were not deductible under section 212(1) or (2), they could not be offset against any gross income from the activity not engaged in for profit.

The regulations contain detailed provisions on how to calculate the gross income from an activity for purposes of determining the amount available to offset deduction items. For example, the regulations require that capital gains and losses from the collection activity be merged with all other capital gains and losses of the collector from noncollection activity. Therefore, capital gains realized from sales of items in the collection are not available to offset collection expense deductions if the collector had losses on securities transactions that reduce the gains on collection sales to zero.

The Taxpayer Relief Act of 1997 lowered the long-term capital gains tax on the sale of securities to 20% and extended the holding period to eighteen months for long-term treatment. However, for the sale of collectibles the long-term capital gains tax rate was kept at 28% and the holding period was kept at more than one year. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (effective May 6, 2003) further reduced the long-term capital gain rate to 15% for sales of securities and other capital assets and reduced the long-term holding period to more than twelve months but once again maintained the 28% rate on gain from the sale of collectibles held for more than one year. The term “collectible gain” is defined in Code
section 1(h)(5)(A) to mean "gain from the sale or exchange of a collectible (as defined in section 408(m) without regard to paragraph (3) thereof) which is a capital asset held for more than one year but only to the extent such gain is taken into account in computing taxable income." It appears as if all long-term capital transactions (securities and collectibles) have to be netted to see if there is any net collectibles gain before any section 183(b) deduction is allowable.

**Cases Under Section 183**

*Leonard L. Barcus* and *Mary L. Stanley* illustrate the difficulty that a collector has in showing that he was engaged in an activity for profit. In *Barcus*, the court found that a married couple who bought and sold antiques were not profit-motivated; the court recognized that the expectation of profit need not be a reasonable one but ruled that the expectation must be a bona fide one. The court noted that the antiques that were purchased were used as furnishings in the taxpayers' residence before they were sold. In holding that, on the basis of all the facts, the taxpayers' purchase and sale of antiques did not constitute a trade or business or a transaction entered into for profit, the court took into consideration the testimony of the taxpayers that the antiques might some day greatly increase in value and be sold at a large profit. The court stated:

> In reaching our conclusion we have not overlooked petitioners' statements that they owned antiques which they expected in the years to come would greatly increase in value and then could be sold at a very large profit. In our view this speculative hope of a profit at some time in the future is not persuasive that petitioners' intent in the purchase and sale of antiques was to make a profit.

In *Stanley*, the court found that a collector of antique glass novelties and marbles had not carried the burden of proving that her collection activities were primarily for the production of income. The taxpayer in *Stanley* did not claim that she was engaged in a trade or business but only that she acquired glass novelties for investment purposes and that she published her book *A Century of Glass Toys to
enhance the marketability of her glass novelty collection. The court succinctly summarized the relevant legal principles:

The test for determining whether an activity is engaged in for profit is whether the individual engaged in the activity with the primary purpose and intention of making a profit. The taxpayer must have a bona fide expectation of realizing a profit, although such expectation need not be reasonable. Whether petitioners had the requisite intention is a question of fact to be determined on the basis of all the facts and circumstances. The burden of proof is on the petitioners, with greater weight given to objective facts than to the petitioners’ mere statement of their intent. No one factor is conclusive and thus we do not reach our decision herein by merely counting the factors enumerated in section 1.183-2(b), which support each party’s position. [Citations omitted.]

The court observed that there was no doubt that the taxpayer hoped or expected that her glass novelties would appreciate in value over time. However, a potential for appreciation is inherent in many, if not most, of the items that have traditionally been collected as a hobby—stamps, coins, works of art—for the pleasure afforded by the acquisition and possession of the collection itself. The mere fact that a collector is aware that the value of his collection may increase does not mean that he is primarily motivated by an expectation of profit, rather than by the personal satisfaction derived from pursuing a hobby, and a hobby is not thereby converted into an activity engaged in for profit.

The court then commented on the *Wrightsman* case, observing that in that case the taxpayer could not deduct expenses connected with his art collection under section 212, although he had an investment motive in acquiring it, since his primary purpose in collecting works of art was not investment but personal pleasure. Although *Wrightsman* was decided before the enactment of section 183, the court stated that the same standard of primary purpose is relevant under section 183. Therefore, the court concluded that Stanley did not establish that investment was the most prominent purpose for her acquisition and holding of the glass novelties.
However, even though the court found in Stanley that there was no activity for profit, it did permit the deduction of collection-related expenses to the extent of the gross income derived from the collection activities as provided by section 183(b)(2). Under the law before the passage of section 183, those deductions would have been disallowed under section 262.

Maurice C. Dreicer illustrates the application of section 183 and the test a taxpayer must meet to have losses allowed in an amount greater than the income received from an activity. In Dreicer the taxpayer, who received a substantial income from a family trust, had traveled extensively throughout the world for many years. Twenty years before the tax years in question, his book on international dining had been published, but, because it was a commercial failure, he had received only meager royalties. Although he had written a rough draft of a book on a similar topic during the tax years in question, he had abandoned his efforts to have it published after the manuscript had been rejected by two publishers. During the twenty years between the books, he had lectured before various travel organizations, written for a travel magazine, and participated in radio and television programs—all without compensation. The taxpayer claimed his travel and other related expenses as business expenses during the tax years in question, but the IRS disallowed the deduction on the ground that it was a hobby loss.

The Tax Court held that the taxpayer was not entitled to deduct his expenses because he did not have a bona fide expectation of profit from the pursuit of his career as a writer-lecturer. However, the appellate court ruled that although a taxpayer’s expectation of profit is a factor to be considered in determining whether losses are deductible, the legal standard is whether the taxpayer has engaged in the activity with the objective of making a profit. Consequently, the court remanded the case to the Tax Court for reconsideration under the profit-objective standard.

On rehearing, the Tax Court agreed with the appellate court that the correct legal standard to be applied was whether the taxpayer engaged in the activity with the objective of making a profit, not
whether he had a reasonable expectation of making a profit. The Tax Court stated:

The purpose of the standard adopted by the Court of Appeals is to allow deductions where the evidence indicates that the activity is actually engaged in for profit even though it might be argued that there is not a reasonable expectation of profit. See S. Rept. 91-552 (1969), 1969-3 C.B. 423, 489-490. We are in total agreement with the Court of Appeals that this is the proper legal standard under section 183. However, a taxpayer’s declaration of his motive to make a profit is not controlling. His motive is the ultimate question; yet, it must be determined by a careful analysis of all the surrounding objective facts, and greater weight is given to such facts than to his mere statement of intent. Sec. 1.183-2(a) and (b), Income Tax Regs. Thus, although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the actual and honest objective of making a profit.

In Marie L. Johnson, the Tax Court seems to say that the profit requirement of section 183 is not to be applied with the same vigor in a sale-leaseback transaction as it is in a hobby-loss case.

In Dailey, the United States Court of Appeals for the Eighth Circuit affirmed a Tax Court opinion holding that a mere floating expectation of realizing a profit was not sufficient to satisfy section 183. The taxpayers in Dailey intended to purchase and maintain appreciating art and antiques to provide a nest egg for their retirement. However, the court held that they could not deduct as investment expenses the costs of art and antiques magazine subscriptions, a magazine-sponsored trip to Europe, or travel within the United States, since they never took any active steps to sell any items in their collection and their expectations of realizing a profit were vague and uncertain.

In H.D. Mandelbaum, the taxpayer Mandelbaum purchased in 1979 an art-master package consisting of copyrights and reproduction rights to Water Carrier by Chaim Goldberg from Jackie Fine Arts for approximately $190,000. Mandelbaum gave Jackie Fine Arts
$7,500 in cash and executed three nonnegotiable nonrecourse notes; most of the debt on those notes was not due until January 1991. Mandelbaum knew that the values claimed by Jackie Fine Arts were, in his own words, “vastly overblown” and that the investment was “a dog.” He received two appraisals valuing *Water Carrier* at between $190,000 and $195,000, but neither appraisal justified its figures or explained how they were determined.

Between 1979 and 1983, Mandelbaum claimed more than $115,000 in depreciation expense. In 1979, he also claimed a $17,000 investment tax credit. By 1989, Jackie Fine Arts was out of business and had forgotten about the notes that were due in 1991. The Tax Court, relying on previous opinions, concluded that Mandelbaum’s acquisition of the art-master package was primarily, if not exclusively, motivated by tax considerations. Therefore, the court sustained the IRS’s determination of deficiencies, additions to tax, and additional interest for tax-motivated transactions. The deduction for depreciation and the investment tax credits claimed were disallowed by the court because the art-master package transaction lacked economic substance. Noting Mandelbaum’s failure to comply with orders issued by the court that were intended to facilitate closing the art-master cases, his failure to offer evidence or present a meritorious case, and his belated concession of other issues, the court awarded the government $10,000 in penalties under section 6673.

In *S.P. Barr*, an attorney engaged in an art-publishing enterprise, but the court found that he had no intention of making a profit. No documentary evidence was provided to corroborate his testimony that he carried on the activity in a businesslike manner. There was no evidence that he received qualified advice, and his attempts at the mail-order marketing of prints were minimal.

In *J.F. Moore*, the court allowed an attorney to deduct the ordinary and necessary expenses incurred in connection with certain bona fide sales of gemstones, but he could not deduct certain distributorship fees purportedly paid or incurred to acquire an exclusive territorial franchise for the sale of the gemstones.
In *J.A. Harmon*, expenses from the taxpayers’ ceramics and quilting activities were allowable only to the extent of the gross income earned from those activities.

Full-time schoolteachers in *L.W. Paxton* were not permitted to deduct expenses related to the sales of their homemade craft items at craft shows in an amount exceeding the gross income derived from the activity, because they failed to demonstrate that their work was an activity engaged in for profit. The schoolteachers had net losses for the five years in question and failed to take any steps to limit the losses.

Deductions were disallowed in *M. Reali*, in which a surgeon and the owner of a private sanitation company were found not to have the requisite profit motive, under the criteria of regulation section 1.1832(b), in connection with their lithograph-purchasing activities.

In *Stella Waitzkin*, a painter was allowed to deduct expenses as an artist engaged in artistic activities, since, on the basis of all the facts and circumstances, she had the requisite objective of making a profit, notwithstanding ten years of net losses from her artistic activities. The court recognized the personal satisfaction achieved by the taxpayer through her artistic endeavors and national gallery showings. It also recognized that the taxpayer was well-off financially and had used the long history of tax losses to offset income from other sources. Yet the taxpayer was able to dispel the characterization of her artistic activity as a hobby by showing a businesslike approach to the activity, by demonstrating her full-time commitment to it, and by convincing the court that she had achieved some commercial success and acceptance. She demonstrated a history of sales of her paintings, adequate business records, an impressive résumé of gallery showings nationwide, growing commercial recognition, and a potential for appreciation in value of a large existing inventory of her artwork. Therefore, in a case involving an activity that could be primarily characterized as, and is commonly thought of as, providing the taxpayer with personal pleasure or satisfaction, the taxpayer nevertheless overcame a profit-motive challenge.

In *Richard A. Stasewich*, an accountant claimed he was also an artist and entitled to deduct the losses from his artistic activities.
Stasewich claimed that he was conducting his accounting practice only to enable him to establish himself as an artist. The question for the court was whether the artist activity was “not engaged in for profit” within the meaning of section 183(c). Whether the required profit objective exists is to be determined on the basis of all the facts and circumstances of each case. The court recited the nine factors of regulation section 1.183-2 and found particularly significant the fact that Stasewich failed to keep adequate books and records and failed to implement a business plan to reverse his continued losses. In denying the losses, the court concluded that Stasewich was motivated more by satisfaction, pride, and prestige than by the objective of earning a profit. However, the court did allow Stasewich to offset any artist-activity-related expenses to the extent of the gross income from the activity.

In Deborah Joyce Windisch, an account clerk who worked full-time at a health services agency was denied loss deductions from her photographic activities. The taxpayer maintained meticulous records, but that was not in and of itself enough to overcome the un-businesslike manner in which she carried on her photography activities. Most of her clients were family members or office-related friends, she set her prices too low to make a profit, she failed to pursue people who owed her money, and she had, the court thought, strong elements of personal pleasure and recreation in her photographic activities.

In Wilbur Kenneth Griesmer, a retired factory worker was denied any deductions related to his meteorite and pyrite collection activities. The taxpayer combed the beaches of Lake Erie searching for what he considered to be meteorites, and in particular Martian meteorites, which he believed were quite valuable. The court looked at the factors under section 183 and found that none of factors indicated that the taxpayer carried on his meteorite collecting activity with the requisite profit objective. In particular, the court noted that the collecting activity was not carried on in a businesslike manner, there were no books and records of income and expenses, and no part of the collection was ever offered for sale.
In *Tony L. Zidar*, an individual spent more than $100,000 to build a stock car for the American Speed Association’s 1992 racing season. To make a profit from his stock car activity, Zidar needed to obtain large sponsors. He could not rely on prize winnings to make a profit because he needed to hire drivers, and drivers take a significant portion of any prize winnings. He had no business plan for his stock car activity, nor did he speak with any consultants about how to operate a profitable stock car business. In 1992, Zidar was able to obtain only $5,571 in sponsorships. Unfortunately, while the stock car was being driven around the speedway between qualifying runs for a race, it collided with another race car and was destroyed. Zidar had no insurance on the stock car. The Tax Court disallowed all of Zidar’s deductions relative to his stock car activity in excess of the $5,571 of income generated by the sponsorships, finding that he failed to demonstrate that he entered into the stock car activity with a good faith expectation of making a profit. The case contains a detailed analysis of the nine nonexclusive factors to be considered in determining whether an activity is engaged in for profit. In reaching its conclusion, the Tax Court placed the greatest weight on the manner of carrying on the activity, noting that the taxpayer had no separate bank account for his stock car activity, retained no business and financial adviser to aid him with his racing activities, participated in no special exhibitions to attract financial sponsorship of large companies, and never actually raced his vehicle (except in the ill-fated qualifying round).

In *Leonard Rabinowitz*, the taxpayer, who owned a clothing business, purchased an aircraft and chartered it to his business and to others at competitive rates. Despite twelve years of consistent losses, the Tax Court found that the charter aircraft business was a for-profit activity and allowed the losses. The Tax Court analyzed the facts under the nine criteria of the section 183 regulations and found particularly relevant that the taxpayer maintained complete and accurate books and records and carried on the activity in a businesslike manner, that is, a manner substantially similar to comparable businesses that are profitable. The Tax Court took particular note that the taxpayer made changes to the jet charter activity to try to make the business
profitable. It was also observed that safety problems with the aircraft and resulting negative publicity hampered the taxpayer’s ability to obtain third-party charters. The court found the taxpayer’s testimony reliable and credible and concluded that the “nine nonexclusive factors and the facts and circumstances of this case lead us to conclude that petitioners engaged in the jet charter activity with the primary, predominate and principal purpose and intent of realizing an economic profit independent of tax savings during the relevant years.”

**Section 68**

If a taxpayer can carry the burden of proof that his art activities are engaged in for profit, the art-related expenses are deductible under section 212(1) or (2). Those expenses, if deductible, can be claimed as a miscellaneous expense on IRS Form 1040, schedule A. Section 67(a) limits the deduction for such expenses to amounts that exceed 2% of the taxpayer’s adjusted gross income. The amount of the deduction for such expenses can be further limited by section 68(a).

For tax years beginning after 1990, an individual whose adjusted gross income exceeds a specified threshold amount is required to reduce the amount allowable for itemized deductions by the smaller of (1) 3% of the excess of adjusted gross income over the threshold amount or (2) 80% of the total amount of the otherwise allowable itemized deductions. The threshold amount for calendar year 1991 was $100,000, and the amount must be indexed for inflation for the tax years after 1991. For 2004, the threshold amount was $142,700; for 2005, the threshold amount is $145,950. The provision is scheduled to be phased out over a five-year period beginning in 2006 pursuant to the 2001 Tax Relief Act. The overall limitation on itemized deductions imposed by section 68(a) will be reduced by one-third in tax years 2006 and 2007, and by two-thirds in tax years beginning in 2008 and 2009. The limitation is completely repealed for tax years beginning after December 31, 2009. The 3% overall limitation on itemized deductions applies only after applying other limitations on itemized deductions, such as the 2% floor on miscellaneous itemized
deductions. That provision may have the effect of further limiting the amount of deductible art-activities expenses.

**LOSSES**

**Losses on Sales**

An individual can deduct a loss on a sale incurred in a trade or business or in a transaction that is not connected with a trade or business but that is entered into for profit. Generally, unless a collector can come within the requirements of section 183(b), as discussed above, a loss by a collector on the sale of a collection is not deductible.

A collector is someone who is not an investor and is not engaged in a trade or business under section 165(c)(1). An individual in the trade or business of buying and selling works of art is a dealer and realizes ordinary income on sales that realize a gain and has ordinary losses under section 165(c)(1) on sales that realize a loss.

The United States Supreme Court has held, in *Higgins v. Commissioner*, that investment activities do not constitute a trade or business. Therefore, a collector can buy and sell items and not be considered a dealer engaged in a trade or business. It must then be decided if the collector is an investor to determine whether the loss can be deducted under section 165(c)(2).

The test for deductibility under section 165(c)(2) of a loss incurred in any “transaction entered into for profit, though not connected with a trade or business,” is a stricter test than that required for the deduction of expenses under section 212, under which the requirement is that an expenditure must be on property “held for the production of income.” Therefore, satisfying section 212 does not guarantee that a loss on a sale of a collection will be deductible under section 165(c)(2). The taxpayer-collector bears the burden of proving that the transaction was entered into for profit; what is necessary is evidence that at the time of purchase the taxpayer acquired the collection with a profit motive.
In George F. Tyler, the taxpayer showed that from the outset he undertook stamp collecting as an investment; all purchases were made in consultation with a stamp expert. The court held that the purchase of the stamps was a transaction entered into for profit, and the loss incurred on the sale of the stamps was deductible under what is now section 165(c)(2). The case is unusual in the clarity of the fact that the taxpayer was able to offer convincing evidence of investment procedures from the outset.

Reacting to the Tyler case, the IRS issued Revenue Ruling 54-268, which held that a loss sustained from the sale of a collection of stamps accumulated as a hobby does not represent a loss incurred in a trade or business or in a transaction entered into for profit within the meaning of section 165(c)(1) or (2). Accordingly, the ruling holds that such a loss is not deductible for federal income tax purposes.

In Eugene G. Feistman, the issue was whether the losses from the taxpayer’s activity known as “Feistman Stamps, Coins and Accessories” were incurred in an activity engaged in for profit. The losses resulted from expenses exceeding income and the court had to decide if the expenses were deductible under sections 162(a) or 212(1) or were nondeductible as mere hobby expenses. The taxpayer had litigated the issue in prior years and the tax court had held that the taxpayer’s activities were a hobby and he did not have a bona fide profit motive. The court examined the current activities of the taxpayer and found that what may have started as a hobby had changed into a profit-motivated activity and that the taxpayer had an “actual and honest objective of making a profit.”

An individual collector can deduct losses on sales as capital losses if it is proved that the collector is, in fact, an investor. However, the allowance of such a loss is extremely rare, since the taxpayer has the burden of proving that the loss-generating activity was a transaction entered into for profit and not merely a hobby.

Section 183(b) once again offers help to the collector who cannot meet the requirement of section 165(c)(2) that he entered into a transaction for profit. If the collector can prove that the collection is an “activity” within the meaning of section 183, capital losses are deductible under section 183(b) up to the amount of the gross income
derived from the collection during the taxable year, after first subtracting such items as interest and taxes that are otherwise deductible without regard to section 183. Therefore, capital losses from the collection activity can be used to offset capital gains from the collection activity under section 183(b). Before the passage of section 183, the gains would have been taxable, but the losses would have been non-deductible personal losses if section 165(c)(2) was not satisfied.

The burden of proving that the collector is engaged in a trade or business or that purchases made by the collector were made in transactions entered into for profit or in the production or the collection of income is extremely difficult. The collector should try to satisfy as many of the factual elements of regulation section 1.183-2(b) as possible. Even if the collector cannot prove a profit motive, the collector should keep adequate records to show that he is engaged in an activity for purposes of section 183, so that losses up to the amount of the gross income from that activity can be claimed as a deduction.

**Losses on Inherited Property**

If a collection is inherited and is immediately offered for sale and is sold at a loss, the loss is capital in nature and may be deductible under section 165(c)(2). However, the collection must not first be converted to personal use and thereafter offered for sale. In that situation, it becomes more difficult to show that the transaction was entered into for profit.

**Casualty Losses**

A collector may want to become a self-insurer because of the high cost of insurance for the collection. The idea behind self-insuring is that the deduction allowed for a loss from fire, theft, or other casualty may save a high-bracket taxpayer more in taxes than the cost of insurance. However, self-insuring may not be the best decision since the allowable casualty-loss deduction is limited to the amount that exceeds 10% of the taxpayer’s adjusted gross income.
Before applying the limitation, the collector must first determine the amount of the loss. The amount of the loss from a casualty is the lower of (1) the fair market value of the property immediately before the casualty, reduced by the fair market value of the property immediately after the casualty (zero in the case of a theft), or (2) the property's adjusted basis.

From that lower amount, the collector must subtract $100 for each casualty and then subtract 10% of his adjusted gross income. Only the amount of loss that exceeds the above limitations can be claimed as a casualty loss.

For example, a collector purchased a painting for $10,000. Ten years later, when it had a fair market value of $50,000, it was stolen. There was no insurance, the taxpayer's adjusted gross income in the year of the theft was $100,000, and the theft took place during the year 2005. The casualty loss deduction is calculated as follows:

<table>
<thead>
<tr>
<th>Amount of loss</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>(lower of fair market value or basis)</td>
<td></td>
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<table>
<thead>
<tr>
<th>Limitations</th>
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<tbody>
<tr>
<td>casualty ($100 per casualty)</td>
</tr>
<tr>
<td>adjusted gross income (10% × 100,000)</td>
</tr>
</tbody>
</table>
| $10,100 | <10,100>

<table>
<thead>
<tr>
<th>Amount deductible</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
</tr>
</tbody>
</table>

If an item in a collection is purchased and later discovered to be a forgery and hence, almost worthless, it produces a deductible loss if the transaction amounted to a “theft” as defined by local law. For it to constitute a theft, the taxpayer must bear the burden of proving that the item was sold to him with an intent to defraud.
Involuntary Conversions

Any amount of casualty loss is further reduced by any insurance recovery. If the collector receives insurance proceeds greater than the cost basis, the collector has a taxable gain unless he can come within the exception of section 1033(a)(2). Under section 1033(a)(2), a gain from an involuntary conversion of property into money is not recognized if the insurance proceeds were used to purchase similar property (similar to the items collected) within two years after the close of the first taxable year in which any part of the gain on conversion was realized.

In the above casualty-loss example, if the collector has a $50,000 insurance recovery on the painting, he has a realized taxable gain of $40,000, unless he reinvests the insurance proceeds in similar property within the applicable time period of section 1033(a)(2).

The question of what is similar property for a collector was dealt with in Private Letter Ruling 81-27-089. A fire had caused extensive damage to a collector's lithographs and other art items. The collector had difficulty in replacing the lithographs and wanted to use part of the insurance proceeds to purchase artwork in other artistic media. The IRS ruled that artwork in one medium that is destroyed in whole or in part and that is replaced with artwork in another medium will not be considered property similar or related in service or use. The Private Letter Ruling appears to be unduly narrow in its interpretation of the statute.

EXCHANGES

It is a common practice for collectors to exchange items, each intending to improve his collection. Dealers often encourage collectors to trade in works of art purchased from them in exchange for other works of art. Section 1031(a) allows certain “like-kind” exchanges to be made tax-free. The statute limits such exchanges to property held for productive use in a trade or business or for investment that is exchanged solely for property of a like kind to be held
The Collection As Investment Property

for productive use in a trade or business or for investment. Accordingly, there are four requirements for a like-kind exchange to be tax-free under section 1031(a):

1. there must be an exchange;
2. the exchange must be of property of a type that qualifies under section 1031(a);
3. the replacement property must be of like kind to the property relinquished; and
4. both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment.

Section 1031(a)(2) provides that the properties involved in a like-kind exchange may not be stock in trade or other property held primarily for sale (inventory); stocks, bonds, or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action. Therefore, an exchange between an art dealer and a collector, if all requirements are satisfied, may be tax-free to the collector-investor but will be taxable to the art dealer.

The general rule of section 1031(a) requires that qualifying property must be exchanged solely for other qualifying property. If an exchange would otherwise be eligible for tax-free treatment under section 1031(a) but for the receipt of cash (boot), any gain realized on the exchange is recognized to the extent of the boot received.

In the usual case, a collector is engaged in a hobby, not a business. The collector may argue that he is an “investor” and held the property for investment. The term “investment” is not defined in section 1031. In light of Wrightsman and sections 162, 165, 212, and 183, the term most likely means property held primarily for profit. The burden of proof for the collector who wants to be an investor may be difficult because of the lack of authorities and because of differences in terminology. With the increases in values for top-quality works of art and dissatisfaction with the stock market, many individuals are investing substantial sums in works of art. When a collector pays $1 million, $5 million, or $10 million for a work of art, it is only
logical to assume that there is some investment objective when the acquisition is made and that the work of art is being held for investment. Regulation section 1.1031(a)-1(b) indicates that unproductive real estate that is held by a nondealer for future use or future realization of the increase in value is property held for investment. The test is applied at the time of the exchange without regard to the taxpayer’s motive before the exchange. With the present long-term capital gain rate at 28% for gain from the sale of collectibles, there is increased motivation for collectors to come within the tax-free exchange provisions of section 1031(a). For the collector, the difference between the fair market value of the property received and the basis of the property given up results in a taxable gain. The investor, however, may be able to avoid any taxable gain under the umbrella of section 1031(a).

Even if a taxpayer can carry the difficult burden of proof of being an investor, the exchange may still have the problem of what constitutes like-kind property. The IRS has ruled, for purposes of section 1033 (the provision pertaining to involuntary conversions), that lithographs may not be replaced with artworks in “other artistic media” such as oil paintings, watercolors, sculpture, or other graphic forms of art. The ruling seems unduly narrow and there is no indication whether the same result would apply under section 1031(a). Under section 1031(a) the words “like-kind” refer to the nature or character of the property and not to its grade or quality. One work of art should be able to be exchanged for another work of art, even in a different medium, since the nature or character of the properties as “works of art” is the same.

Initially, section 1031 was designed to apply to simultaneous transfers of like-kind property between two persons. The rules have evolved to allow multiparty exchanges and deferred exchanges. In a multiparty exchange, an exchange agent facilitates the exchange. For example, Collector A owns painting X and wants to acquire painting Y owned by Collector B. Collector B does not want painting X; Collector B wants cash. So Collector A transfers title to painting X (the relinquished property) to exchange agent C. Exchange agent C sells painting X and uses the proceeds to buy painting Y (the replacement property) from Collector B and then transfers title to painting Y to
Collector A in payment for painting X. This type of exchange is sometimes referred to as a Starker transaction after Starker v. United States, where the court sanctioned the taxpayer’s transfer of property in exchange for a promise by the recipient to convey like-kind property chosen by the taxpayer at a later date. Following the decision in Starker, Congress enacted section 1031(a)(3), which allows the transferor of the relinquished property up to forty-five days to identify the replacement property and 180 days to close on the acquisition of the replacement property. The taxpayer may identify as replacement property any three properties or multiple properties with a fair market value not in excess of 200% of the fair market value of the relinquished property.

The regulations under section 1031(a)(3) set forth detailed guidance concerning how a taxpayer can comply with the tax-free like-kind deferred exchange requirements, including four “safe harbors” that taxpayers can rely on to avoid constructive receipt of the proceeds from the sale of the relinquished property. Each of the safe harbor regulations contains highly technical and complex provisions, made more so since they were promulgated in anticipation of the exchange of real property and not collectibles. For example, under the third safe harbor, the taxpayer’s transferee must be a “qualified intermediary.” A qualified intermediary is a person who is not the taxpayer or a “disqualified person” and who enters into an exchange agreement with the taxpayer and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

A “disqualified person” is

(1) a person who is the agent of the taxpayer at the time of the transaction,

(2) a person who is related to the taxpayer as described in either section 267(b) or section 707(b), or

(3) a person who is related to the person described in (1) by the relationship described in (2) of this sentence.
Persons who acted as the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker during the two-year period immediately preceding the taxpayer’s transfer of the relinquished property are treated as agents of the taxpayer at the time of the transaction. Again, the regulations and rulings are complex and technical as to who is or is not an agent of the taxpayer under the safe harbor provision. Although there is no specific authority, it appears that an art dealer can act as a qualified intermediary and not be a disqualified person. Because of the uncertainty involved, it is important that title to the relinquished property be transferred to the art dealer at a specific stated value and that the art dealer have the freedom to sell the relinquished property in order to use the proceeds to acquire the replacement property. Any amount received by the art dealer on the sale of the relinquished property in excess of the stated value should belong to the art dealer. It is preferable to use an art dealer who has not acted as the taxpayer’s agent through a consignment of a collectible during the two years prior to the contemplated exchange transaction.

No recent cases or IRS rulings have shed light on the meaning of the terms in section 1031(a). Generally, a collector has some difficulty in carrying the burden of proof under section 1031, since he must prove that a painting, say, was held for investment and was exchanged for a painting that was held for investment. Accordingly, many exchanges of appreciated works of art are taxable. However, if the investment objective can be satisfied, there is no reason why the collector cannot take advantage of a section 1031(a) tax-free exchange. The technical requirements and potential pitfalls are numerous and a full description is well beyond the scope of this book. One important development is the requirement that a taxpayer who enters into a like-kind exchange must file IRS Form 8824. The form reveals to the IRS all the details about the exchange and calls attention to exchanges that heretofore may have gone unnoticed by the IRS. A copy of the form appears at the end of this chapter (Appendix 1-1).

Whether an exchange is a taxable or a nontaxable transaction for federal income tax purposes, it is treated as a sale for sales tax purposes, and a sales tax may be payable on the exchange. Generally, if
the exchange is between two collectors, each of them should collect and pay over the sales tax. If the exchange is between a dealer and a collector, the dealer should collect and pay over the sales tax to the extent of the cash required from the collector to complete the exchange. The sales tax provisions are explained in more detail later in this chapter.

RECORD KEEPING

In planning a collector’s estate, an attorney must have the collector maintain adequate records. If both a husband and a wife participate in the collecting activity, careful records should indicate who is the owner of each item, and any insurance policies should be consistent with those ownership records. Further, the date of purchase and the cost of each purchase are necessary to determine the gain or loss on the sale of the collection.

CARRYOVER BASIS RULES

One of the most important tax consequences of death is that property included in a decedent’s gross estate for federal estate tax purposes, subject to certain exceptions, acquires a “step-up” in basis for income tax purposes equal to its federal estate tax value pursuant to section 1014. In other words, if a collector purchased a painting for $10,000 and when he dies the painting is valued at $100,000 for federal estate tax purposes, for income tax purposes the painting acquires a “step-up” in basis equal to $100,000. The Economic Growth and Tax Relief Reconciliation Act of 2001 terminates this step-up in basis for property included in a decedent’s estate for a decedent dying after December 31, 2009, which is when the federal estate tax is scheduled to be repealed. If the repeal comes into effect, a new modified carryover basis system will apply under new section 1022. Under the new system, the basis for certain property treated as transferred on the death of a property owner after 2009
will equal the lower of the asset’s fair market value at the decedent’s death or the decedent’s adjusted basis in the asset. In other words, the basis for income tax purposes may remain at the original cost of the property purchased. There are a number of adjustments that allow some step-up in basis. For example, the executor may increase the basis of carryover basis property in the aggregate by up to $1.3 million. That is, the amount of $1.3 million may be added to the decedent’s cost basis prior to his death. A full discussion of this new provision is beyond the scope of this chapter. As with all other provisions of the 2001 Tax Act, the modified carryover basis system expires on January 1, 2011, and the existing rule for step-up in basis under section 1014 will be reinstated. Therefore, unless there are additional Congressional changes to the Internal Revenue Code, the modified carryover basis rules will only apply to decedents dying in calendar year 2010.

As this book goes to press, it is too early to predict what may happen to the estate tax and income tax laws. However, the lesson is clear: Complete and detailed records as to the date of acquisition and the cost of acquisition of collectibles will be important if the carryover basis rules are ever in effect in any form.

A carryover basis system was previously introduced by the Tax Reform Act of 1976 and modified by the Revenue Act of 1978. Those carryover basis provisions proved to be unworkable and were repealed four years after their enactment by the Crude Oil Windfall Profit Tax Bill of 1980.

**SELF-DIRECTED RETIREMENT PLANS**

Before January 1, 1982, an individual could purchase artworks or other collectibles in an individual retirement account (IRA) or a qualified retirement plan. After discovering that people were purchasing collectibles in their retirement plans and making personal use of those items, the IRS urged Congress to change the law. Section 408(m) was added to the Internal Revenue Code by the Economic Recovery Tax Act (ERTA) of 1981. That section penalizes an indi-
individual who directs his IRA or any self-directed retirement plan to invest in collectibles. The term “collectibles” includes works of art.

Section 408(m) treats any acquisition of a collectible by an IRA or a self-directed retirement plan as a distribution of the value of that collectible from the IRA or retirement plan to the participant. That treatment means that the participant has taxable ordinary income equal to the value of the amount treated as a distribution. That interpretation has the practical effect of making it prohibitive for an IRA or a self-directed retirement plan to acquire collectibles.

The statute provides that section 408(m) is effective for property acquired in taxable years ending after December 31, 1981. The IRS explained, in part, the section 408(m) rules pertaining to collectibles as follows:

Q. What is the effect of the new requirement on collectibles that were acquired on or before December 31, 1981?

A. Since the new provision is not applicable to collectibles that were acquired on or before December 31, 1981, the retention of a collectible acquired prior to January 1, 1982, by an IRA or an individually-directed account is not treated as a distribution.

A question remains, however, as to whether a transfer or rollover after December 31, 1981, of works of art acquired before January 1, 1982, is considered an acquisition by the IRA after December 31, 1981, and would now be treated as a distribution.

A rollover is a transfer of assets from one retirement plan to another. Generally, such a transfer is not regarded as a distribution from the plan from which the assets are transferred and is not regarded as a contribution to the plan to which the assets are transferred. That is, the distribution is tax-free, and the contribution is not deductible or subject to any of the various limitations imposed on contributions to retirement plans. A rollover is merely the shifting of the pension assets from one holding vehicle to another and, as long as the requirements of section 402(a)(5) are met, the Internal Revenue Code provides that such transfers are tax-free.
On January 23, 1984, the IRS issued proposed regulations (still not finally adopted) under section 408(m) dealing with investments in collectibles. Proposed regulation section 1.408-10(d) defines the term “acquisition” for the purpose of section 408(m) as follows:

For purposes of this section, the term acquisition includes purchase, exchange, contribution, or any method by which an individual retirement account or individually-directed account may directly or indirectly acquire a collectible.

That is an extremely broad definition and appears to include any method by which an IRA acquired a collectible after December 31, 1981. The IRS could take the position that such a broad definition includes a rollover of a collectible acquired before January 1, 1982. However, notwithstanding the language of the proposed regulation, IRS Notice 82-3 indicates that collectibles acquired before January 1, 1982, may be retained in an IRA. Therefore, the broad language of the proposed regulation was probably intended to encompass in the broadest terms all acquisitions of collectibles if the collectibles were, in fact, purchased after December 31, 1981. Since a rollover is a mere shifting of assets from one retirement vehicle to another, such a transfer should not constitute an “acquisition of a collectible” after December 31, 1981, as long as the collectibles were, in fact, acquired before that date. However, there is no specific authority for the foregoing interpretation, and the IRS could take the position that a rollover is a taxable distribution.

The Tax Reform Act of 1986 amended section 408(m) to allow the purchases, after January 1, 1987, of gold and silver coins minted in the United States after October 1, 1986, as long as the coins were held in an IRA in the name of a trustee. The Taxpayer Relief Act of 1997 further amended section 408(m) to include in the exception from the definition of “collectible” a platinum coin and certain gold, silver, platinum, or palladium bullion transactions. The definition under section 408(m) has taken on increased importance under the act since the long-term capital gain rate on the sale of a collectible (not in an IRA account) is currently taxed at a 28% rate rather than the 15% rate on the long-term sale of a security. However, an invest-
ment by an IRA in a coin that has been made into jewelry is still considered an investment in a collectible and is treated as a distribution.

**INSURANCE**

Insurance is a significant consideration for collectors, artists, and dealers. It is the insurance policy that covers the risk of loss that may result from any number of causes. If, for example, the collector maintains a collection in his home, the collection should be insured against fire, theft, flood, earthquake, and all other risks attendant to the maintenance of artwork in the home.

As with any other contract, the insurance policy should be examined in detail to make sure that all risks that the collector wants covered are, in fact, covered. The examination should include a thorough review of the policy's exclusions. For instance, the policy may not cover mysterious disappearances or theft by dishonest employees who have been admitted to the residence.

In addition, the policy should cover appreciation in value. Therefore, a new appraisal for insurance purposes is needed from time to time in order to update the policy. The collector should maintain precise inventory records, appraisals, photographs, invoices, and other documentation so that the existence and the ownership of the insured items can be proved.

Further, the insurance policy should cover what happens if the collector suffers a loss, such as the theft of a painting, and the insurance company pays the collector for the then-insured value. If the painting is recovered years later, when it has greatly appreciated in value, what happens? If the collector is able to reclaim title and is not barred by the statute of limitations, he still has a problem because technically, the insurance company is the true owner of the painting, having taken the collector’s rights by subrogation when it paid the collector after the theft of the painting. To cover such a situation, the collector should require the insurance policy to give him the option to acquire title to the painting from the insurance company for the amount paid to the collector by the insurance company at the time of
The loss. Such a provision is crucial, because the current fair market value of the painting may be many times the amount of the insurance payment that was received by the collector. The insurance company sometimes requires that an interest factor be added before agreeing to such a provision.

If the collector is selling artwork on consignment through a dealer, the collector should require the dealer to insure that artwork from the time it leaves the collector's premises. The collector should make sure that the dealer's policy covers all risks and provides that the collector-consignor will be paid in full, regardless of the loss that may occur. The collector should always require that the dealer furnish a copy of the insurance policy proving such coverage to the collector.

Like the collector, the artist also wants to make sure that works of art consigned for sale are fully covered by the dealer's policy. The artist should also have his own insurance policy covering the works of art when they are on the artist's premises. Insurance policies can be intimidating since they consist of numerous pages of fine print. An artist must engage an insurance agent who can explain the policy, the risks involved, and precisely what is being insured.

**SALES AND USE TAXES**

Dealers—those individuals who, on the basis of all the facts and circumstances, are engaged in the trade or business of buying and selling works of art—must register with the state sales tax department and obtain a resale certificate and number from the state in which the dealer is doing business. With a resale number, the dealer is not required to pay a sales tax on works of art purchased in any state, since the works purchased are being bought for resale. When the dealer sells the works purchased, the dealer then collects the sales tax from his customer—that is, the sales tax is paid by the ultimate consumer, who is usually the investor or the collector. The sales tax is a transaction tax, liability for which occurs when the transaction takes place.

A use tax is designed to complement the sales tax, and imposes a tax on the use within a state of works of art (or other items of tan-
The Collection As Investment Property

gible personal property) that would have been subject to the sales tax if they were purchased within the state. This means that an investor or collector who resides in one state, and buys an artwork in another state for delivery in the state where he resides, will owe a use tax to the state in which he is a resident. In this situation, a sales tax would not be due in the state where the purchase was made.

Sometimes the investor or the collector of artworks who may buy and sell a work from time to time attempts to avoid paying the sales or use tax by registering for a resale certificate and number, either in his own name or in the name of a corporation set up for that purpose. Doing so is usually a big mistake since, at best, the artworks purchased will be ordinary-income property that will produce ordinary income and not capital gain if sold, and a deduction will be limited to the artwork's cost if donated to charity. At worst, the investor or collector could face possible criminal charges. The Manhattan District Attorney's office has been conducting an intense investigation of art dealers and collectors who may be in violation of the New York State Sales and Compensating Use Tax Law. The continuing investigation has raised millions of dollars for New York State and has caught the attention of other states that are now focusing on the payment of the sales and use tax due in their states.

Although an analysis of the sales tax law in every state is beyond the scope of this chapter, a review of the law as it applies in New York State can serve as a guide for dealers, investors, and collectors in all states. The references below are to the New York State sales tax statute and regulations thereunder.

Sale of Art

The New York State sales tax must be paid by the buyer and collected by the seller on the sale of tangible personal property in the state unless (1) the property is sold to a buyer for delivery out of the state of New York or (2) it is purchased by a dealer exclusively for resale.


**Delivery Out of State**

The New York State sales tax law does not provide any specific exemption from the New York State sales tax for sales of tangible personal property delivered to purchasers outside New York State. However, such transactions are exempt from the sales tax for constitutional reasons pursuant to the Commerce Clause of the United States Constitution, provided that the out-of-state purchaser does not take delivery in the state of New York.

The sales tax is a transactional tax that is based on the situs where a delivery is made or possession is transferred from the seller to the purchaser. Section 525.2(a)(3) of the sales tax regulation provides:

> [T]he sales tax is a “destination tax.” The point of delivery or point at which possession is transferred by the vendor to the purchaser, or the purchaser’s designee, controls both the tax incidence and the tax rate.

Thus, the sales tax applies only to sales in which delivery takes place within New York State.

Section 526.7(e)(1) provides the following:

> [A] sale is taxable at the place where the tangible personal property or service is delivered, or the point at which possession is transferred by the vendor to the purchaser or his designee.

If the selling art dealer ships a work of art by common carrier to the purchaser, the sale (the taxable event) occurs where delivery is made to the purchaser. In Advisory Opinion TSB-A-89, the seller of audio-video equipment shipped its merchandise by common carrier from the seller’s location directly to the customer in Florida. The customer was billed for the equipment and, presumably, for the shipping cost. The opinion holds that the New York sales tax does not apply. In *Matter of the Petition of Richard L. Feigen & Co., Inc.*, there are five examples of sales of art that were not subject to the New York State sales tax. The decision specifically covers works of art that were delivered by common carrier to an out-of-state purchaser that were not, under various fact situations, subject to the New York sales tax.
The decision is not completely clear as to whether it is necessary for the dealer to be the person who hires and pays the common-carrier fees.

In order to avoid collecting the New York State sales tax, an art gallery is required to deliver the work of art to the purchaser out of New York State. The clearest case is one in which the art gallery delivers the work by a common carrier hired by the gallery and the common-carrier invoice is rendered to the gallery. The art gallery can seek reimbursement from the out-of-state purchaser. It also appears that the New York State sales tax should not apply, even if the purchaser selects the common carrier and is invoiced directly for the costs, so long as it is the art gallery that delivers the work to the common carrier. In the latter case, the art gallery is still required to have documented proof that it shipped the work by common carrier to the out-of-state purchaser. Therefore, if the purchaser wants to select the common carrier, it is always best if the art gallery is the entity that retains the common carrier at the request of the purchaser, even if the cost is to be paid by the purchaser.

Art galleries, among other entities, have been targeted by the New York State sales tax department for specific investigation for sales taxes due. In the course of a sales tax audit, the agents check invoices and points of delivery, look to see if the bill of lading includes the weight of the item delivered, and take other steps to verify the interstate elements of the transaction.

If a purchaser has an item shipped to an out-of-state location, that individual may have a use tax liability in the state of delivery. Under certain circumstances, if that individual later brings the item back into New York State, it is possible that New York State could impose a use tax. Those situations do not involve the responsibility of the art gallery unless it can be shown that the art gallery conspired in some way to assist the purchaser in avoiding the New York State sales tax.
Purchase Exclusively for Resale

Robert Guccione, well-known as the publisher of Penthouse magazine, found out how stringently the sales tax provisions can be applied in the case of P-H Fine Arts, Ltd. Guccione pursued his interest in art with the purchase of works by Pablo Picasso, Edgar Degas, Marc Chagall, Amedeo Modigliani, Pierre-Auguste Renoir, Chaim Soutine, Salvador Dalí, and other great artists. He incorporated P-H Fine Arts, Ltd. as a wholly owned subsidiary of Penthouse magazine for the purpose of buying and selling fine art. The works of art were hung in Guccione’s town house for the purpose of creating a certain image in the eyes of corporate clients until the paintings could be sold. The town house was not open to the public, there was no price list, and Guccione never told anyone that the artwork was for sale. Furthermore, he kept no general ledger or sales journal, since the accountants for Guccione said that such records were unnecessary, because there were so few transactions. Therefore, after an audit the New York State Tax Commission took the position that the art was not purchased for resale. The unique defense put forth by Guccione was that by not telling anyone that the paintings were for sale, a great desire to own the paintings was created in the persons who had the opportunity to see them. Guccione testified as follows:

He wants it [a painting] more now that he knows it is not for sale, and now, knowing how good it is and hearing from Ron who is an expert as well—he is really interested.

Surprisingly, the court found that P-H Fine Arts proved that the artwork was purchased for resale. However, the court said that was not the end of the analysis. The court’s interpretation of the sales tax law was that P-H Fine Arts had to prove that the intention of reselling the artworks was the only purpose for which the artworks were acquired. Therefore, the court concluded that P-H Fine Arts intended to use the artwork for a purpose other than resale: to allow the artwork to be displayed in a setting where it served the business interests of Penthouse and Guccione. At the time the artworks were purchased, Guccione had at least two purposes for the acquisition:
resale and use by him and Penthouse; therefore, the artworks were not purchased *exclusively* for resale. As a result, Guccione was required to pay more than $500,000 in sales tax.

**Trade-In Credit**

The federal income tax provisions related to tax-free like-kind exchanges under section 1031(a) were discussed earlier in this chapter. Even if a collector fails to satisfy the technical provisions of section 1031(a) so that the gain on the exchange is taxable, there will be a savings on the sales tax payable if the collector exchanges the artwork with a dealer. The New York State sales tax law provides that any allowance or credit for tangible personal property accepted in part payment by a vendor on the purchase of tangible personal property or services and intended for resale by the vendor is to be excluded when arriving at the receipt subject to the sales tax. For example, a collector owns painting *A* that cost $10,000 and is now worth $50,000. The collector goes to an art dealer who is willing to allow the collector a $50,000 trade-in credit against the collector’s purchase of painting *B* worth $100,000. The art dealer agrees to accept painting *A* as a trade-in and intends to resell painting *A* at a future date. The New York sales tax is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Painting <em>B</em> sold to collector</td>
<td>$100,000.00</td>
</tr>
<tr>
<td><em>less</em> trade-in credit for painting <em>A</em></td>
<td>&lt;$50,000.00&gt;</td>
</tr>
<tr>
<td>Net amount due art dealer</td>
<td>$50,000.00</td>
</tr>
<tr>
<td>New York City tax (8.375%) on $50,000</td>
<td>$4,187.50</td>
</tr>
</tbody>
</table>

If there were no trade-in credit, the sales tax would be based on $100,000 and would be $8,375—the New York City sales tax rate being 8.375%, effective June 1, 2005. The sales tax rate will vary from county to county in New York State, and the applicable tax rate should always be checked, since it changes from time to time. If the trade-in qualified as an exchange under section 1031(a), there would
be no federal income tax on the difference between the collector's cost of painting A ($10,000) and the trade-in credit or current value of painting A ($50,000). If the trade-in failed to qualify under section 1031(a), the collector would owe an income tax on the difference between his cost for painting A of $10,000 and the trade-in credit for painting A of $50,000. The ideal situation for the collector is to satisfy both the section 1031(a) provisions for federal income tax purposes and the trade-in credit rule for New York State sales tax purposes. The availability of the state trade-in credit should always be checked since it is not available in every state. For example, there is no trade-in credit in California or Massachusetts.

The above result does not work if two collectors exchange paintings, since only a vendor who accepts property as a trade-in with the intent to resell it can allow a trade-in credit free of the New York sales tax.

Advice on Purchase or Sale

Interior decorating and design services are subject to the New York sales tax, but an art adviser's service of consulting with a client solely for the purpose of recommending whether the client should purchase certain works of art from an investment-potential perspective is not a taxable interior decorating and design service. It is not always clear where the line is drawn between art-advisory services that are subject to the sales tax and those that are not taxable.

When the art adviser advises a private collector within New York regarding quality and investment potential of art acquisitions with respect to specific artists and artworks, the art adviser is considered to be performing a consulting service. When the art adviser advises the client on the proper framing of an artwork and on the restoration procedure for such artwork without performing or arranging for the actual framing or restoration service, the art adviser is also considered to be performing a consulting service. The receipts from charges billed to the client for such consulting services are not subject to New York sales tax.
However, when the art adviser supervises the installation of the artwork in the client’s home, the art adviser is considered to be performing interior decorating and design services, and the total charges to the client, including charges for the above-noted consulting services, are subject to the New York sales tax.

**Purchase at Auction**

When a work of art is purchased at Sotheby’s or Christie’s or most other auction houses, the buyer pays a fee over and above the hammer price known as the buyer’s premium. Publishing mogul Samuel D. Newhouse, Jr., argued that the 10% buyer’s premium ($1,550,000) on his purchase at auction of Jasper Johns’s *False Start* for $15.5 million was not subject to the New York sales tax, since it was not part of the purchase price but a fee paid for a separate service. In *In re Newhouse* the court decided otherwise, holding that the buyer’s premium was an integral aspect of Newhouse’s purchase of the painting. The court agreed with the position of the New York sales tax department that at the auction all charges actually paid by the purchaser as a result of the sale of tangible personal property or the rendition of a service are subject to tax. The court stated:

There can be little doubt that [Newhouse’s] purchase of *False Start* at a Sotheby’s auction lends his purchase a special distinction given Sotheby’s history, founded in 1744, and well-known name in fine arts. Therefore, the 10 percent “buyer's premium” may reasonably be viewed as the cost incurred by petitioner to purchase the painting at Sotheby’s . . . which added luster and value to the transaction. Therefore, the “buyer’s premium” is an integral aspect of petitioner’s purchase of the painting and was not a separate service arising from a different transaction.