Anchin Alert

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The Art of Tax Planning - Part 1

Fine art is increasingly making headlines as record breaking auction prices steal the attention of collectors, hopeful artists, and art market enthusiasts. At the same time, the perception of a rising art market has brought fine art to the attention of investors around the world, who now consider it an alternative asset class to be evaluated alongside real estate, hedge funds, and other investments. Many collectors have realized tremendous appreciation on their accumulation of emerging and contemporary art, and a select few artists are experiencing strong financial success from their creations. However, unlike traditional investments, fine art can be incredibly illiquid and difficult to manage. A highly appreciated art collection belonging to an art investor, or a body work in the possession of a successful artist, can become a significant liability if not properly planned for prior to the owner's passing.

The federal estate tax can be an unwelcome surprise for the unsuspecting heirs to an art collection. The tax owed on a major collection could even exceed the cash and liquid assets available in the estate, forcing the executors to sell artwork rapidly or in large blocks, reducing the value of the art and harming an artist's long-term reputation. On the other hand, effective planning can ensure that the estate tax is not a major impediment to an artist or art collector's wishes, and perhaps even involve the family in a philanthropic mission that can provide benefits for many years.

<u>Federal Gift and Estate Taxes</u>
Federal gift and estate taxes are two related tax regimes that share a number of similarities, and essentially constitute two sides of a coin: gift taxes are assessed on transfers of wealth during life, and estate taxes are assessed on transfers at death. Under current federal law both taxes have a maximum rate of 40%. The gift tax is imposed on the total of all gifts made during a taxpayer's life in excess of a lifetime exclusion. As of 2014, the exclusion stands at $5.34 million, and increases with inflation, as measured by the Consumer Price Index. The estate tax is imposed on the "taxable estate"—the sum total of the fair market value of all assets owned at death minus debts and expenses —in excess of the same lifetime exclusion of $5.34 million. Many states also impose their own estate taxes, pointedly called "death taxes," and Connecticut even imposes its own gift tax. These state taxes have different rates and exemptions from their federal counterparts.

Transfers to spouses who are United States citizens are free from federal estate and gift taxes (although there are more complex rules for non-U.S. spouses) and the unused portion of one spouse's $5.34 million exclusion may be transferred to the surviving spouse to increase his or her available exclusion. The gift tax and the estate tax both must generally be paid by the transferor (decedent's estate or donor), rather than by the recipient, and the tax may only be paid in money, not in property. As we shall see later, these requirements can become quite onerous for artists and art collectors.

In spite of their similarities, there are a number of important differences between the federal gift and estate taxes. For one, the gift tax regime permits an annual exclusion of $14,000 per recipient per year. Enacted in order to reduce the burden of the gift tax on relatively small transfers during life, this exclusion rises with inflation in similar fashion to the lifetime exclusion. There are further exclusions for medical costs and college tuition, if paid directly to the medical provider or educational institution.

One of the most important differences between the estate and gift taxes with regard to art collections relates to the question of how the inherited or gifted property is treated in the hands of the recipient. In general, the tax basis of assets of a decedent's estate are adjusted ("stepped up") to their value at date of death. This affects the future capital gain when the heir sells the asset. Furthermore, the character of income that an asset produces can change when the asset is inherited under a will and the inheritor has a different use for the property. For example, an art dealer's collection is classified as inventory during his or her life and subjected to ordinary income tax rates when sold. Through inheritance, however, an heir who is not involved in an art dealing business could treat the collection as a capital asset, which has a lower tax rate when sold. Combining the higher inherited basis and the lower tax rates could mean that the heir would pay significantly less tax on a liquidation of the collection than the deceased art dealer would have paid had the art been sold during his or her lifetime.

This is the first installment of an article about tax as it applies to the unique subject of art.

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