Folks:

Take-Away: Due to the high capital gains taxes faced by art collectors when they sell artwork, deferring capital gains taxes should be seriously considered using a charitable trust.

Background: The taxation of artwork, i.e., tangible personal property, is complex. It is subject to different tax treatment than other investments or ordinary income. How an individual handles ownership of the collection of artwork often dictates the subsequent income tax treatment when buying or selling tangible personal property assets.

Four Classifications: In general, the IRS recognizes four distinct types of owners of artwork based on their role before a sale transaction: (i) collector; (ii) investor; (iii) business investor; and (iv) dealer. We'll stick with the first two. By default, the IRS will presume that an individual is a *collector* which classification imposes the highest capital gains tax rate [28%] while allowing the fewest tax deductions. An individual may qualify for an *investor's* more favorable tax status, but qualifying as an *investor* is more than just making a self-serving declaration 'I'm an investor;' it requires a well-documented pattern of behavior to fall within the *investor* classification.

Capital Gains Tax: Recall that the tax on capital gains is determined if it is short-term gain, i.e., artwork held for one year or less, and thus generally taxed at the owner's ordinary income tax rate, or long-term capital gains which applies to artwork that was held for more than one year, which is taxed at a lower rate than the short-term rate(s.)

Collector: The long-term capital gains on artwork for a *collector* is

31.8% (28% plus the 3.8% net investment income tax.) In contrast, the current long-term capital gains maximum tax for the sale of real estate, stock and bonds is 23.8% (20% plus the 3.8% net investment income tax.) States can also impose their own state capital gain tax as well on the sale of artwork. Note that here is no tax-free exchange of artwork for a *collector*, unlike real estate investments. [IRC 1031.]

Investor: If the owner qualifies as an *investor* in artwork, then he/she will be subject to the customary long-term capital gains rate [20% plus the 3.8% NIIT.] In addition, an *investor* in artwork can qualify for a like-kind exchange which allows the investor to defer capital gains tax on the sale of an artwork by reinvesting the proceeds from the sale into a similar piece of art within a specific time frame. But, as noted, to qualify for the like-kind exchange, the artwork must be held for investment purposes [determined by the IRS], and both the original artwork and the replacement artwork must meet specific criterial established by the IRS.

Deferral of Tax- CRT: If a *collector* holds appreciated artwork and he/she wants to sell that artwork, he/she might consider using a charitable remainder trust (CRT) as a tax deferral device to avoid the high up-front capital gain tax cost.

Example: Carol owns artwork that is appraised at $1.0 million. Carol decides to transfer the artwork to a charitable remainder annuity trust (CRAT) with a ten-year annuity period. Carol intends to maximize the amount that she will receive from the CRAT over the ten years. The AFR rate for March 2024 is 5.0%. Carol transfers the artwork to the CRAT in March, which then promptly then sells the artwork for $1.0 million. In 2024, Carol will enjoy tax savings of $318,000 by avoiding the federal capital gains tax and NIIT. Carol will receive an annual annuity payment from the CRAT of $116,554.63 for ten years. Carol will also enjoy an immediate federal charitable income tax deduction of $100,000.12.

Deferral of Tax-CLT: Perhaps an even better way to defer taxes on a *collector's* sale of artwork is with a charitable lead trust (CLAT.) A *grantor* CLAT can reduce the negative effect of the limitations on itemized deductions and offset up to 50% of an individual's adjusted gross income for the year. The CLAT can also be sued to eliminate gift and/or estate taxes on transfers to the donor's children [or potentially grandchildren, but the allocation of the donor's GST exemption is delayed until the end of the charity's annuity period, or the ETIP period.] Alternatively, the CLAT could be used to defer income back to the donor in or near his/her retirement years. If the CLAT is created during the donor's lifetime, then the donor will receive an immediate and sizeable federal income tax deduction. In the second and following CLAT years the donor must report the income earned by the CLAT, less the amounts that is actually paid to the charity in the form of the annuity. Thus, one potential advantage of the CLAT is the acceleration of the charitable income tax deduction in the year of the donor's gift to the CLAT, even though the payout is spread over the CLAT term. Another benefit from using the CLAT is that it allows a discounted gift to the donor's children, since the value of the gift to the children is determined at the time the gift is made to the CLAT, when the children are the CLAT remainder beneficiaries. The value of the gift of that remainder interest to the donor's children is discounted since they must wait for the charity's annuity term to expire; consequently, the value of that remainder interest is discounted for the 'time cost of waiting.' When the CLAT assets are transferred to the children in later years, any appreciation in the value of the CLAT's assets is free of either gift or estate taxation.

> **Example:** Carol transfers artwork to a CLAT appraised at $1.0 million. The CLAT plans to sell the artwork this year. Carol is currently in a very high-income tax bracket, but she expects to be in much lower income tax brackets over the next nine years. With this in mind, Carol thinks that funding a CLAT with appreciated artwork this year will help to reduce her taxable income in 2024 knowing that in future years, when her income is much lower, she will have to pick up the CLAT's income and report it on her own tax return. Carol selects a 10-year CLAT. It is projected that the growth in the CLAT

assets over the next 10 years will be at 8%. The annual payout to the charity from the CLAT will be $72,999.47. The remainder assets that pass from the CLAT to Carol's children after the 10-year CLAT term will be $1,016,813, thus saving gift taxes of $400,000.

Conclusion: The tax rules associated with the sale of artwork are highly complex. Qualifying as an *investor* and not a *collector* is important, which is why the individual needs to develop a tax planning strategy, accurate records, and documents consistent with a pattern of being an active art *investor and* being mindful of the ability to defer capital gains taxes when artwork is sold using a CRT or CLAT.

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