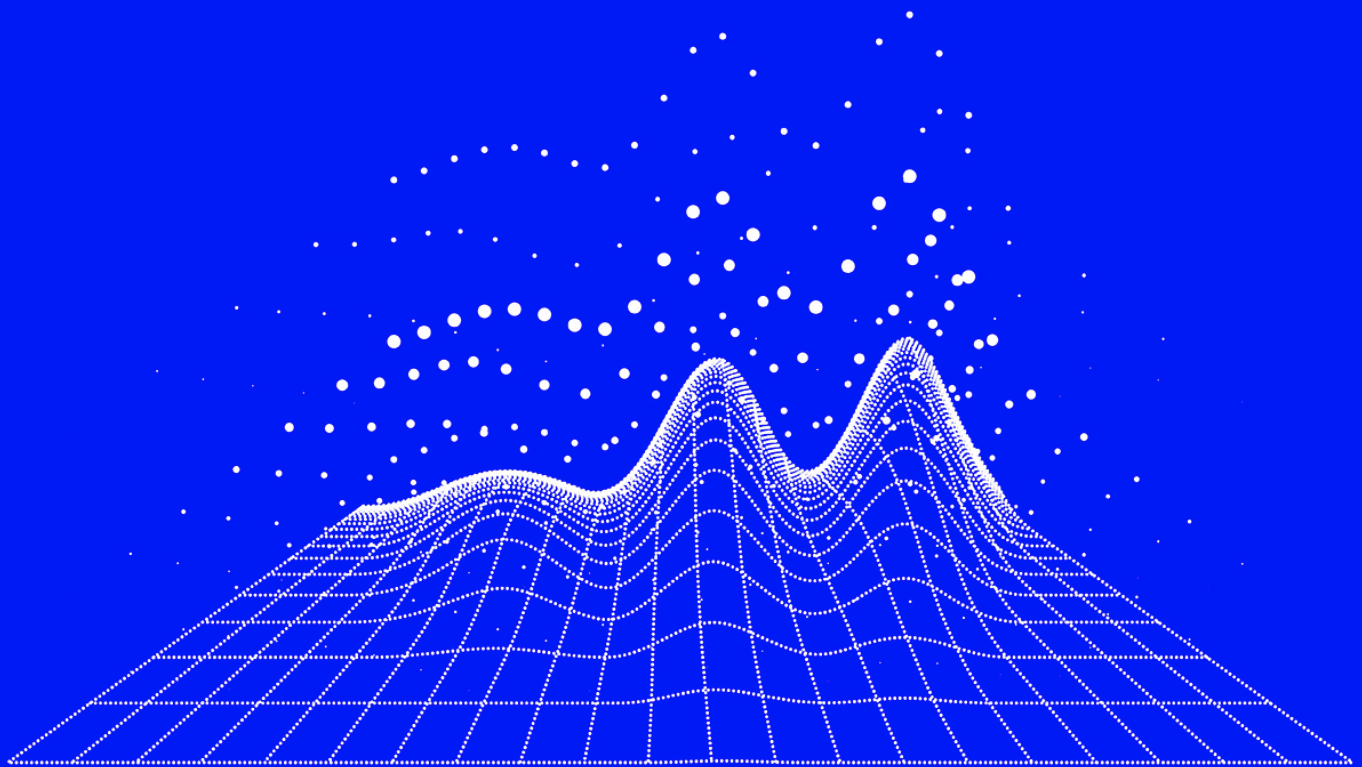


# The Tax Cuts and Jobs Act (H.R.1) Eliminates 1031 Exchanges for Art and Collectibles.

## What Advisors Need to Know.




**Collector**<sup>*IQ*</sup>

**Proposed changes in tax regulations that prohibit the use of a popular tax-deferral strategy for fine art and collectibles, could result in accelerating transaction activity through year-end as owners seek to utilize pre-tax dollars to re-invest in higher value objects. Advisors would be well served to alert clients about the change and to review appreciated, high value holdings where deferring capital gains tax obligations delivers the greatest benefit. For those clients wishing to take advantage of this closing window to defer tax obligations, we've reprinted our 1031 primer below.**

## IRC Section 1031.

Taxable investors of all stripes have long employed strategies designed to minimize taxes paid on gains. For example, holding stocks for longer than one year enables the investor to qualify for the lower tax rate on long-term capital gains whereas short-term gains are generally taxed at ordinary income rates. A strategy most commonly employed by real estate investors is the 1031 or like-kind exchange of real property. Originally conceived in the 1920's as a way for farmers to exchange property in order to straighten out property lines, Section 1031 of the Internal Revenue Code enables owners to defer taxes on appreciated assets and utilize the full pre-tax proceeds from the sale to invest in another, "like-kind" property.

Given the substantial appreciation of art and other collectible assets over the past 15-20 years, many investors hold works with large embedded gains, potentially creating a significant tax liability. These gains can be effectively deferred and the full pre-tax proceeds utilized to purchase higher value, like-kind works. The benefits are particularly acute given the higher tax rates applied to collectibles relative to financial assets (28% versus 20% at the Federal level), as the following chart illustrates:

	<b>Pierre-Auguste Renoir</b> <i>Femme nue a sa toilette</i> 1913	<b>Exchange</b>	<b>Sale</b>
	<b>Cost Basis</b>	<b>\$1,500,000</b>	<b>\$1,500,000</b>
	<b>Sale Price</b>	<b>\$5,550,000</b>	<b>\$5,550,000</b>
	<b>Capital Gains Tax (31.8%)</b>	<b>\$0</b>	<b>\$1,287,900</b>
	<b>Available to Reinvest</b>	<b>\$5,550,000</b>	<b>\$4,262,200</b>

In order to employ this strategy, several conditions must be met:

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## Investment Use Requirement.

In order to qualify for a 1031-related tax deferral, the art or collectible must be purchased for investment rather than for personal use. While the IRS has not promulgated specific criteria defining this distinction, supporting factors could include: (a) regular appraisals to determine value, (b) the maintenance of accurate records detailing costs and expenses associated with upkeep of the collection and (c) the use of a collection management system documenting gains and losses.

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## Like-Kind Requirement.

As the term implies, 1031 exchanges are permissible if the assets exchanged are similar in nature or character. The IRS specifically states that grade or quality do not figure into defining what is alike or unlike but has ruled that mediums are defining characteristics. In other words, to be safe, exchange a painting for a painting and not for a sculpture. Nor does the IRS limit the number of works that can be exchanged. For example, the owner of a \$20 million Christopher Wool painting might decide to diversify by purchasing ten \$2 million paintings.

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## Exchange Requirement.

To qualify for preferential tax treatment, the transaction must be an asset exchange; the owner must receive art or other collectible in return, not cash. But that doesn't mean that the sale and purchase transactions must take place simultaneously. By designating a qualified intermediary (QI), to hold proceeds from a sale transaction, the seller effectively avoids receiving cash while identifying a like-kind asset to complete the transaction. The process can also be effected in reverse with the purchase of the replacement work occurring first with the subsequent sale funding the purchase price.

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## Time Requirement.

IRS regulations regarding timing to complete both the sale and purchase of assets subject to a 1031 exchange are strict. Sellers have 45 days to identify the replacement asset and 180 days to close the entire transaction; during this period, the qualified intermediary holds sale proceeds in order to meet the Exchange Requirement set forth above.

Like-kind exchanges can be an extremely useful tax management strategy for active collectors. However, the strategy has come under persistent attack by advocates of tax reform. To the extent that reforms are enacted as currently written, collectibles will be ineligible for tax deferral resulting in reduced turnover and longer holdings periods.

For further information on on tax strategies, appraisals, qualified intermediary services and liquidity alternatives, please contact us at [advice@collectoriq.com](mailto:advice@collectoriq.com). ↗