The Art of Taxing Capital Gains

By Giovanna Quattrone

In recent years, a popular tax deferral mechanism has been employed in transactions relating to art and collectibles. The 1031 Exchange, also known as a like-kind exchange,[1] was originally introduced into the tax code in the 1920s to lighten the financial bu den of farmers who sought to trade property. Later, it became a popular tactic for real estate investors seeking to flip p operty, and quite significant within the sector of comme cial real estate. Now, it has developed into a well-known tool for a new class of investors: buyers of expensive art who wish to defer federal taxes when upgrading their Stellas to Pollocks. The use of this mechanism has likely expanded in response to record high art prices and a growing number of discerning investors who believe art to be a tradable commodity. Accordingly, like-kind exchanges are a substantial function of the current marketplace, especially since the last economic downturn in 2009. [2] Section 1031 permits a delay of the lofty 28% capital gains tax on sales of art, as well as other collectibles, including stamps. As a result, the profits f om the first sale can be put towa d the purchase of a similar piece. This has become an attractive tool in estate planning, but only to those who are identified as investors [3] In the world of stocks, bonds, and real estate, no one hesitates to announce that he or she is in the game for the money. However, this is what separates those markets from the art market.

The Internal Revenue Code § 1031 regulates like-kind exchanges, and states that in general, "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment."[4] Some find the language of 1031 troubling, because this represents the singular differentiation between an investor and a collector. The word "investor" is inflammatory in the art world, and participants go to great lengths to avoid this title in great fear of being black-listed from artists and galleries; that is, of course, until the time comes to pay capital gains taxes. This is a sector in which buying is more highly prized than selling, and selling too quickly gets one into trouble. Buyers initially have two choices: they can self-identify as investors and risk dooming themselves to isolation and dislike among players in the art world, or they can buy what is available to them and sell at their leisure, effectively receiving a no interest loan from the government.[5]

Many critics believe that use of a like-kind exchange when purchasing art is a sophisticated scheme, and the tax code is being exploited just so the ultra-wealthy can further transfer their money.[6] If beauty of art is in the eye of the beholder, is the tax code as well? Apparently not, according to the way the issue of actual intent versus expressed intent[7] has been decided in an array of different cases. Courts place quite a heavy burden of proof on those collectors who realize that 1031 suits them much better financiall , so long as they claim to be investing.

In *Wrightsman v. United States*,[8] the United States Court of Claims decided against the full court trial commissioner's satisfaction that the plaintiffs had demonstrated enough evidence to prove that the primary purpose was investment.[9] In this 1970 case, Plaintiffs Charles and Jayne Wrightsman sought to recover alleged overpayments of federal income tax. The couple conceded that they originally purchased some of their world famous nineteenth century French art collection as a hobby, and that they did derive enjoyment and satisfaction from keeping the collection in their home. They also claimed that the property was held primarily for investment, and the related expenses associated with maintaining their collection were thus deductible. Under the facts and circumstances, the court did acknowledge that "an investment purpose" existed. However, the court held that the evidence did not ascertain investment intent "as the most prominent purpose for acquiring and holding works of art."[10]

Two of the government's proposed theories on how the regulatory prerequisites should be met were analyzed.[11] The first theory was denial of ecovery to the plaintiffs because they lacked demonstration of "any action on their part inconsistent with the holding of their collection for pleasure…."[12] The second theory was termed by the court "the physical segregation-pleasure preclusion standard."[13] This theory was the government's attempt at a fixed ule for determining the taxpayer's primary intent. Additionally, the decision to disallow the deductions was based on the application of whether the taxpayer acquired and held the works of art *primarily* for investment rather than for personal use and enjoyment.[14] Here, the court used the primary purpose test to identify whether the plaintiffs were collecting or investing. It was through the application of this test that the Wrightsmans were found to be collectors. The *Wrightsman*[15] standard places the burden of proof on the taxpayers to demonstrate that "as a factual matter, from an objective view of the operative circumstances in suit, they acquired and held works of art during the years here involved primarily for investment rather than for personal use and enjoyment."[16]

Similarly, in *Drummond v. Commissioner,*[17] the primary purpose test was used to decide whether the taxpayer's gain from the 1989 sale of Old Master drawings was ordinary income or long-term capital gain. Here, the same analysis was used to determine whether the plaintiff was

a collector or a dealer. The taxpayer purchased an estimated six drawings at auction and from private sales during the 1970s. After conducting his own market research, the plaintiff determined that one drawing purchased for $1,300, titled "Three Feminine Heads," could be sold for approximately $100,000. Drummond subsequently sold this drawing to the National Gallery for $115,000 in 1989. No other sales during the 1980s and 1990s were conducted, but he reported the gain from the sole sale as ordinary business income on Form 1041 schedule C, and not as long-term capital gain on schedule D.[18]

The issue before the court was whether the gain from the sale of the drawings was from property held by the taxpayer *primarily* for sale to customers in the ordinary course of his trade or business within the meaning of § 1221(a)(1). As used in § 1221(a)(1), the statutory word "primarily" is defined as "of first importance" or "princ pally."[19] The court held that the gain on the sale of drawings was long-term capital gain because Drummond was determined to be a collector and not a dealer.

It is certainly no secret that tax law controls much of human activity, because people make decisions from which they will best benefit [20] The court sent a message to participants in the art world to demonstrate that they cannot dial up their own tax remedy to best benefit past actions, and achieved this by establishing a very high burden of proof, as illustrated in the former cases.

Art collectors are gravitating toward use of this exchange, and as this happens, courts will continue to make the burden of proof more intense. Subsequently, as more of these § 1031 exchanges are challenged, another restraint is likely to be introduced. Instead of buyers and sellers playing fast and loose with the tax law, the government will set concrete numerical criteria for like-kind exchanges. There is pending legislation[21] on §1031 based on various motivations. [22]

As use of these transactions concerning artwork increase, and as the industry garners more attention, the tax code may become riddled with constraints. As this section of the tax code received greater attention from legislation (currently aimed at intent), it will eventually get more attention from the courts. There will likely be polarizing opinions over the concern of actual and expressed intent. Judge Learned Hand articulated the dilemma perfectly when he stated, "[W]hile I should be the last to say that the making of a profit was not in itself a pleasu e, I hope I should also be one of those to agree there were other pleasures than making a profit. [23]

Endnotes

1. 26 I.R.C. § 1031
2. Graham Bowley, "Tax Break Used by Investors in Flipping Art Faces Scrutiny," New York Times, Apr. 26, 2015.
3. Andy Gustafson, "Investor or Collector Impacts 1031 Exchange Eligibility" The 1031 Exchange Blog, June 20, 2011, *available at* http://www.atlas1031.com/blog/1031-exchange/bid/55046/Investor-or-Collector-Impacts-1031-Exchange-Eligibility.
4. 26 I.R.C. § 1031(a)(1).
5. *Supra* note 2.
6. *Id.*
7. "Art Investment Expense Deductions And The Primary Purpose Requirement," Washington and Lee L. Rev., 1, No. 28 (1971): 234.
8. 428 F. 2d 1316 (Ct. Cl. 1970)
9. Wrightsman v. United States, 7 CCH 1969 Stand. Fed. Tax Rep. ¶ 7910.
10. *Id*. at 1322
11. Art Investment Expense Deductions and the Primary Purpose Requirement, 233.
12. 428 F. 2d at 1319.
13. *Id*. at 1320.
14. *Id*. at 1319.
15. *Id*. at 1316.
16. *Id*. at 1320.
17. Thomas B. Drummond v. Commissioner, 73 T.C.M. CCH 1959 (1997).
18. *Id.*
19. Malat v. Riddell, 383 U.S. 569, 572 (1966).
20. Christine Manolakas, "Mixed Use of a Personal Residence: Integration of Conflicting Holding Purposes under I.R.C. Sections 121, 280A, and 1031," Wake Forest J. of Bus. and Intellectual Property L. 14.1 (2013-2014): 62.
21. Section 1031 Repeal Issue Federation of Exchange Accommodators: The Voice of the 1031 Industry, 1031 Tax Reform, accessed February 5, 2016, *available at* http://www.1031taxreform.com/1031repealissue-2/.
22. Diana Wierbicki, "The President's Attack on Like-Kind Exchanges," *Trusts and Estates*, May 2015, *available at* http://wealthmanagement.com/ high-net-worth/presidents-attack-kind-exchanges.
23. Thacher v. Lowe, 288 F. 995 (S.D.N.Y 1922).

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