

Planning Considerations for the **Established** Art Collector

Whether you're hitting Art Basel to discover the hottest new artists or bidding on a piece by one of the Old Masters at auction, as an experienced art collector you probably know how to navigate the art world. What may have once been a daunting arena for you—complete with its own rules and language—is a familiar stomping ground full of likeminded people.

Now that your collection is well established, you might want a more sophisticated approach than when you originally started accumulating art. More and more, investors are looking at art for more than their aesthetic qualities. It can also serve as an important portfolio diversifier beyond traditional asset classes like stocks, bonds and cash.

Art can be used as collateral for loans and help lower your tax burden during your lifetime and for your beneficiaries. Most importantly, it can be a central component of your legacy, both for your family and the public.

Documentation is everything

You'll have the most flexibility about using your art collection for other goals if you take steps now to ensure that your collection has integrity. Proper documentation helps you establish authentication and ownership of your artwork. It also helps an appraiser determine value, a necessary step for insurance, taxes and sales.

Prospective buyers should request a copy of the condition report since condition is an important factor in determining value. You might consider consulting with a third-party expert to ensure that the condition is good, says Danna Kay, Art Collection Management Specialist with AIG's Private Client Group. AIG is an insurer that insures 52% of the ArtNews Top 200 collectors in the United States. If the condition is poor, you will need to decide if you are still comfortable owning the piece or continue to search for artwork in better condition.

Each piece of art you purchase should come with a bill of sale, listing the price you paid and the seller. It should also have a description of the piece, including dimensions, materials, the type of work (a painting versus a sculpture, for example) and its visual elements. In addition, it should state the date the work was created, the artist and a full list of previous owners, which establishes provenance.

"You want to know if there is any documentation of the provenance of a piece and the chain of title; it should show every owner, every time it was lent out, whether it was to a private gallery or if it was shown in a museum," says Susanna Poon, Director of Philanthropy Services at CTC | myCFO serving ultra-high net worth clients of BMO Wealth Management.

Provenance, meaning the origin of the piece, is critical to establishing authenticity. Without it, there is a risk that your art isn't what you believe it to be. And there is also the risk that your own ownership claims might be called into question. How else can you know that the seller was authorized to sell you the piece in the first place if the chain of title isn't clear?

Bear in mind, that many pieces—particularly older ones—lack full documentation. There are likely to be missing links in the chain of title. If that's the case, you or your dealer should make every effort to document past owners to the best of your knowledge. Do a little research to verify that past owners existed at the time they are believed to have owned the work. Consider contacting previous owners—if they are still alive—as they might be able to shed some light on the piece's history.

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A taxing endeavor

As your collection grows, the financial responsibilities of art ownership will also grow and taxes may become a significant consideration.

Art and collectibles are considered capital assets. If you received a painting as a gift during the collector's lifetime, your basis is the collector's cost basis in the art acquisition (purchase price plus any associated fees). If you inherit a painting as a gift your basis is the fair market value of the painting at the time of the collector's death. Your capital gain is the difference between your basis and the sale price.

To determine the new cost basis of inherited art at the collector's death, you'll need an appraisal. Unlike for insurance purposes, this type of appraisal looks only at how much the piece would fetch at auction, not its retail value and any extra needed to cover the true cost of replacing a piece of work.

For collectors, taxes can be steep. Capital gain tax for art owned for more than a year is 28% (significantly higher than the capital gains tax rate for equities and bonds that is 20%). In addition, depending on your income, you may also owe the 3.8% Medicare surtax on unearned income as well as state taxes. In total, your top rate could be 45% in a high-tax state like New York or 44% in California.

If you sell a piece within a year of buying it, the gain will be taxed as ordinary income, which can be as high as 39.6% plus state taxes.

Given the high tax burden on art, it's no wonder that collectors look for ways to alleviate it. In general, expenses related to a hobby are not tax deductible. But highly experienced art collectors can be viewed as art investors or dealers, and have the ability to deduct expenses and losses.

In order to be considered an art investor, you must buy and sell art for profit. Art dealers demonstrate sales activity and the intention to sell when they acquire art.

Investors, dealers and artists themselves may deduct attorneys' fees, brokers' fees, cost of appraisal, cost of insurance and others.

If your art is damaged or stolen while it is in your possession, you may claim a loss of personal property as an itemized deduction on your taxes. Form 4684 lets you figure out how much of a loss you can claim, which you can then report on your Schedule A.

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Art as charitable donation

Donating artwork can also provide big tax savings, particularly for pieces that have appreciated greatly in value. But pay close attention to how you donate, to whom and when.

"There are different tax treatments between donating art work during your lifetime versus donating at death," explains Poon.

By donating artwork during your lifetime, you can employ two important tax strategies. First, you receive a tax deduction (how much depends on the type of charity that gets your donation). The other is that the value of the piece will be removed from your estate, helping to reduce the estate tax burden on your estate. The Internal Revenue Services' Art Advisory Panel may review the appraisals you submit for your donation.

The most favorable tax treatment is realized by donating artwork to a cultural institution that houses similar works. In that case, you can deduct the fair market value of the piece, no matter how much you paid for it.

On the other hand, "if you donate to a charity and they don't make use of the art work, the value of your deduction is your basis," explains James Minich, Managing Director in the Capital Advisory Services group of CTC | myCFO. For example, say you donate a painting to a wildlife rescue organization, but the charity's only interest in the donation is the ability to sell it and use the money for its operations, then your income tax charitable deduction is limited to your basis.

Bear in mind that your annual charitable deduction is capped at a percentage of your adjusted gross income (AGI), as either 20%, 30% or 50%, depending on the nature of the donation and your income.

Not only is selling art taxing, but so too is buying it because sales and use taxes apply, though there are some exceptions. How much depends on where you purchased the pieces and where the pieces are displayed.

Buying art like a pro

Would you buy additional art if you could borrow against your current collection? There's a [growing market for art-secured lending](#) that can help you turn your art into cash without having to sell any works.

"These types of loans are done by private banks and more niche art lenders who tend to look at the art itself and less at the borrower so they can feel confident that the collateral has value," explains Minich.

Many private banks offer art-secured lending, with loans typically ranging from \$1 to \$10 million.

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Loans typically hover around 50% of the appraised value of the work. Lenders, says Minich, often prefer to lend to several pieces at once, rather than one. And they are typically looking for diverse pieces, perhaps a Jackson Pollock, Edward Hopper and Georges Seurat because they represent different styles. If one style is out-of-favor, another might be holding up and can fetch a fair price in the event that it must be sold.

“Selling art to pay off the loan is a last resort,” Minich says. “Lenders don’t want you to have to sell your art.”

When art leaves your collection

At some point, you might want to sell a piece in your collection either because your tastes have changed or you need to raise funds. Decide wisely who you will entrust to manage the sale.

“If you are a well-known collector, you likely have a relationship with other people who may be able to be a private art broker and can arrange for that kind of private sale,” Poon says.

Your ability to negotiate favorable terms from the art dealer or auction house depends on how in-demand your artwork is, says Poon. It never hurts to press for concessions.

“If they really want your piece, they will offer various incentives,” Poon says.

Among the things to ask for is a concession on the seller’s premium, typically 20% to 30% of the sale price. And if your art is particularly hot and likely to generate a high price, dealers may also share the buyer’s premium with you as an added inducement.

“Other things you can negotiate include how the art work will be displayed, how often will the artwork tour before the sale, will it be on the cover of the auction publication?” Poon explains.

If you are unsure whether or not you’re getting the most favorable terms, consider working with an art advisor who can guide you through the process.

All in the family

Art can be an integral part of a family’s legacy, not only because pieces can be passed down from one generation to the next, but also because it can plant the seeds for a lifetime of art collecting in the next generation.

“It’s no different than any other family mission or vision,” says Tina Milligan, Managing Director with CTC | myCFO. “We usually see families start to involve the children in the process and educate them about what they own.”

Involving your children in your collection is an excellent way to educate them about the world of art. Taking them to auction shows and art festivals exposes them to a wide variety of different artists and styles. And explaining the process of how you plan to acquire pieces and what’s involved behind-the-scenes gives them a window on a rarefied experience.

But as much as you might hope that your children will follow in your footsteps and collect alongside you, make room for them to develop their own tastes, cautions Milligan. It may be a hard sell for the selfie generation to get excited about the Dutch Masters.

Some children may turn away from collecting altogether in favor of their own hobbies. That may be disappointing, but try to honor their desire to blaze their own path.

A lasting legacy or a burden?

An extensive art collection can be a prized possession to pass on from one generation to the next. But prepare yourself for the possibility that your children will not be interested.

“You want to have an open conversation about whether or not your children want the art work [after your death],” says Poon. “They may want some pieces but not others. If kids do want specific pieces, they should identify them ahead of time, so the trustee isn’t stuck with the job of trying to split up the pieces.”

Regardless of how much of your collection the next generation keeps, the issue of estate taxes will likely surface.

Remember that each individual receives a \$5.49 million exemption from estate tax and married couples have a combined \$10.98 million exemption, if the surviving spouse elects to carryover deceased spouse’s exemptions (an election which must be made within nine months of death). The fair market value of the art in the collection is added into the estate and estate taxes will be owed on anything above the thresholds.

Give careful thought to how your children will pay estate taxes.

“If the kids are doing the liquidation without the parents being involved, they might be doing a fire sale because they have to raise the money to pay estate tax,” explains Poon. “The parents should be planning for the sale during their lifetime.”

It’s important to identify an attorney and art trustee who will be responsible for selling the work upon death. Established collectors must have those conversations early so that when the time comes, art dealers or auction houses can act fast.

“Most good art collections have auction houses circling them for years,” says Poon.

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However, bear in mind that your estate has nine months to pay the estate tax if any is owed. Is there anything in your collection that might be particularly difficult to liquidate?

Consider the case of the famed art dealer Ileana Sonnabend. When her beneficiaries inherited the Robert Rauschenberg painting, *Canyon*, they soon learned that they would be unable to sell it because it featured a stuffed bald eagle. Selling would violate the 1940 Bald and Golden Eagle Protection Act. The beneficiaries (not to mention three appraisers) therefore assumed the fair market value of the work was zero. The IRS's Art Advisory Panel disagreed and gave the work an estimated value of \$65 million. That sum was included in the estate and the Sonnabend beneficiaries were required to pay estate taxes on the much higher base.

In the end, the family chose to donate the work to the Museum of Modern Art, even though they did not receive the charitable deduction because well, the piece had no market value.

On the other hand, inheriting art work after death has capital gains tax advantages for beneficiaries. The art works receive a step up in basis to the fair market value on the date of the collector's death, so when your beneficiaries sell the art work, the basis is higher than the collector's was if the art work appreciated during the collector's lifetime.

It works like this: Say you bought a piece of art for \$100,000, but it's worth \$500,000 now. If you were to sell it, you would realize a \$400,000 gain and be required to pay capital gains tax on that amount. But if the piece is valued at \$500,000 at the time of your death, your beneficiaries would have a stepped up basis of \$500,000 and pay the difference between the new basis and the future sale price. If your beneficiaries sell the art work shortly after your death at \$500,000, there will be no capital gain taxes. If they hold onto the art and sell it later for \$600,000, then they will owe capital gain on the difference, which in this case is \$100,000.

For the public good

Some collectors have grander plans for their art after their deaths. Their intention is to provide a public benefit.

Take Jerry Perenchio, the former chairman of Univision. A few years prior to his death in May 2017, he planned to gift the bulk of his mostly Impressionist paintings, including important works by Claude Monet, René Magritte and Edouard Manet to the Los Angeles County Museum of Art. The collection was valued at more than \$500 million—the largest bequest ever to the institution.

While most museums never aspire to gifts on the scale of Perenchio's, donations by individuals are their lifeblood. Up to **90% of art in the public trust comes to them through donations**. As a result, these institutions work hard to cultivate relationships with collectors who may wish to donate their collections—or at least a part of them—after their deaths. Donating art can be an exciting opportunity to share the work you've spent a lifetime acquiring with the public.

Leaving a legacy to an institution requires careful planning, though.

If you intend to bequeath art, it's important not to leave this task up to the executor of your estate or the trustee of your trust to carry out. These people are almost certainly going to be much less knowledgeable—not to mention less passionate—about the collection than you. Collections need to find the right home, and that may take time. Institutions are under no obligation to accept a posthumous gift, in which case the work will be returned to your estate, leaving your executor or trustee in the difficult position of dispersing your collection. A better way to do this is by researching and identifying an institution that has an interest in the type of work you collect. A museum director or curator is a good point of contact for these discussions. Do not worry if you are unable to bequeath your entire collection. Many collectors only donate some pieces and sell others for the benefit of their estate.

In making a donation, understand that the needs of museums and cultural institutions are always evolving. While they may be excited to acquire the work of a conceptual artist from the 1990s today, in a few decades it may be less of a focus. With that in mind, you may wish to impose some restrictions on how your donation may be used in the short term (less than 20 years). But aim to give the institution wide latitude in how the work can be displayed in the long-term.

A formal agreement with the institution helps to spell out all the conditions.

Established collectors are no longer getting their feet in the art world. They are working on bigger goals, like expanding their collections, involving the next generation and planning for a legacy. Even experienced collectors understand that art collecting is complicated and there's a lot to know.

Take time to educate yourself on all the issues you might encounter so your art can help you reach those goals.

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