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The Art Of The Tax-Free Exchange

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I apply a multidisciplinary approach to wealth management dovetailed with structured tax planning.

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In the eyes of pop artist Andy Warhol, “Making money is art and working is art and good business is the best art.” It is a profound quote from an artist but it explains why his works explored the relationships between artistic expression and advertising.

But art is also big business.

Actress Baby Jane Holzer, one of Warhol’s film superstars, was an avid art collector. In 2013, it was reported that she wanted to sell two works totaling $740,000 to the Stephan Stoyanov Gallery and use that money to buy two paintings valued at $990,000 from the Gagosian Gallery. It is a simple idea, but with one problem: By selling her paintings, she would incur a hefty capital gains tax in the year of sale. If sold in 2018, net capital gains from the sale of art or other collectibles would be taxed at 28%. If her cost basis was $240,000, a sale at $740,000 would trigger a $500,000 capital gain, and she would owe $140,000 in federal taxes. Who would want to cut that check if it could be legally avoided? Is there an effective way to sell the appreciated artwork to acquire the new paintings *and* avoid the taxes? After all, good business is the best art.

Leveraging Section 1031 of the tax code, she decided to do a like-kind exchange, also known as a 1031 exchange. Holzer engaged Stephan Stayonov to act as a qualified intermediary in the exchange. He was hired to facilitate the sale and transfer of her two contemporary artworks and in turn allocate the sales proceeds to acquire two other qualified paintings identified by Holzer for her benefit as replacement artworks. In the eyes of the IRS, a 1031 exchange allows you to effectively transform one investment into another without triggering a capital gains tax because there is no constructive receipt of the sales proceeds by the seller.

While these specialized exchanges are normally used for investment property, such as land and office buildings, Holzer or her advisor determined that she could also use them for artwork or other collectibles, provided they were held for investment and not for personal use.

A 1031 exchange alone would not get her off the hook from paying the tax. Generally, she would sell the acquired paintings in the future and be taxed at that time. Loosely speaking, if she had a $240,000 cost basis in the original paintings but pays another $250,000 to acquire new ones, her cost basis would increase to $490,000. If she immediately sold the new ones at the current $990,000 market value, she would have had a $500,000 capital gain: exactly the same as if she had sold her original works.

So, 1031 exchanges do not eliminate the taxes associated with the sale of appreciated capital assets, they just defer them. The benefit of deferring tax is that inflation can whittle away the future tax payment -- and the seller can pocket the profits.

There is no limit on how many times a seller can do a 1031 exchange, so she could continue rolling paintings into more valuable ones over time, continue to build her fortune and never pay a penny in taxes. If she were to hold the final paintings until death, and the IRS code remained unchanged, her heirs would receive a step-up in basis, and all capital gain taxes could be avoided. For investors, it serves as a way to keep fortunes in the family -- excluding your Uncle Sam. It’s art in its purest form.

For Holzer, using a 1031 exchange seemed to be a brilliant idea, but it did not go through -- Stoyanov’s check, that is. The bounced check was proof that the intermediary did not hold the money in escrow, as required by law, and that voided the exchange. Holzer went on to demand $585,000 with damages for breach of contract, breach of fiduciary duty and unjust enrichment. It is an important lesson for anyone thinking of doing a 1031 exchange: Good business is art, but like all art, it requires proper perspective.