Morgan Stanley

Art as an Asset

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Art and the Collector

This discussion intends to heighten awareness of the significant role art may play in the context of a collector's overall wealth. Generally, a collector may segment wealth between financial assets including stocks, bonds and real estate from other possessions such as art. This separation is sometimes the result of art being considered a personal interest rather than an asset. Additionally, the historical opacity and inaccessibility of the art market may also be contributing factors. However, these factors have and are being alleviated. It is because of this increased transparency that a collector should carefully consider the role of art on a balance sheet in addition to the salient implications of owning art.

The definition of art varies depending on who answers the question. For example, The European Fine Art Foundation (TEFAF) categorizes art as follows: 1. Classical Antiquities and Ancient Art, 2. Antiquities, 3. Old Masters, 19th Century and Impressionists Works, 4. Modern Art, 5. Post-War and Contemporary Art, 6. Prints, Precious Books and Maps, 7. La Haute Joaillerie and 8. Design Objects [1]. For the purposes of this discussion, art is meant to encompass as broad a categorization as possible and may include the following which is by no means a complete list or representation: paintings, sculpture, jewelry, cars, furniture, wine and collectibles.

The Art Market

The art market has evolved from patrons commissioning works of art based on the artist's talent and reputation in the 17th century to the emergence of auction houses in the 18th century and galleries in the 19th century. Later art fairs developed in the 20th century followed by online providers surfacing in the 21st century.

Auction Houses

While there are thousands of auction houses globally, arguably the two oldest and largest are Christie's and Sotheby's.

- Christie's, founded in 1766 by James Christie, has since conducted the greatest and most celebrated auctions through the centuries providing a popular showcase for the unique and the beautiful. Christie's offers around 350 auctions annually in over 80 categories, including all areas of fine and decorative arts, jewelry, photographs, collectibles, wine, and more. Christie's has a global presence in 46 countries, with 12 salerooms around the world including in London, New York, Paris, Geneva, Milan, Amsterdam, Dubai, Zürich, Hong Kong, Shanghai, and Mumbai [2].
- Sotheby's, founded in 1744 by Samuel Baker, is a British multinational corporation headquartered in New York City. One of the world's largest brokers of fine and decorative art, jewelry, real estate and collectibles, Sotheby's operation is divided into three segments: auction, finance, and dealer. The company's services range from corporate art services to private sales [3].

Auctions are open to the public so technically every work of art or lot is available to the largest group of potential buyers. Buying at auction can be a more "democratic" method of acquiring art as auctioneers accept the highest bid via the age-old process of real-time bidding. Auction houses take a buyer's premium and charge a sellers commission on the sold or hammer price. Auction houses efficiently gather thousands of items annually across a broad spectrum of genres, periods and media. Catalogs with descriptions of the art are produced and experts offer bidders guidance about the items on offer.

Works sold at auction, however, are exposed. Should they not sell or sell at a low price, the public sales record for that artist and object are forever altered. Additionally, many auction houses now conduct an increasingly large share of their business as private sales. In other words, collectors can buy or sell privately through traditional auction houses as well as through Gallerists and Dealers.

Dealers and Gallerists

Dealers and Gallerists are perhaps closest to the artist. They arrange shows, sometimes absorb a portion of production costs and occasionally serve as liaison to museums and curators. Through their "brick & mortar" spaces, this part of the market is a critical link between artists and collectors. Dealers typically share profits with the selling artist or consigner and prices are sometimes negotiable to the buyer.

Dealers typically work in either the primary market (selling directly from the studios of working artists or directly from the estates of deceased artists) or in the secondary market (reselling work that has already been in the market at least one time). Dealers in the secondary market tend to buy and sell higher priced work.

Dealers and Gallerists play a significant role beyond the brokering of artwork. They nurture new talent, educate the public and provide advice on maintenance, installation and display.

Art Fairs

Among the many closely watched international fairs is Frieze Art Fair (London), TEFAF (Maastricht), Art Dubai and Art Basel. Using Art Basel as an example, consider the following:

- Art Basel started in 1970 by Basel gallerists Ernst Beyeler, Trudi Bruckner and Balz Hilt. In its inaugural year, the Basel show attracted more than 16,000 visitors who viewed work presented by 90 galleries representing 10 countries. Thirty art publishers also participated.
- By 1975, five years after its founding, the Basel show reached almost 300 exhibitors. The participating galleries came from 21 countries, attracting 37,000 visitors.
- In 2013, Art Basel launched its inaugural show in Hong Kong. Half of the participating

galleries came from Asia and the Asia-Pacific region.

- In 2014, Art Basel partnered with Kickstarter to create a crowdfunding initiative aimed at funding non-profit visual arts organizations worldwide. Together with JRP Ringier, Art Basel publishes Art Basel | Year 44 the first book that covered all three shows [4].

Art Fairs are tremendous social events and a great way to gather information about many facets of the art market. Art Fairs are a major focus for dealers many of whom expect to meet new clients and a majority of whom expect fairs to continue to drive increased sales.

Online

Collectors are increasingly relying on online platforms and digital images to make purchasing decisions. There are a number of platforms dedicated to this type collecting – Artsy & Artspace among them – and traditional auction houses have begun to use online sales for lower value works. Reduced overhead allows these providers to charge a lower commission to buy and sell. Online sales are a democratizing force in the space of art collecting. Additionally, there are numerous websites and providers that offer increasing pricing transparency some of which include:

Artnet.com	Artforum.com
Askart.com	Theartnewspaper.com
Artfact.com	Flashartonline.com
Artprice.com	Frieze.com
Artandauction.com	Gabrius.com
Artbase.com	Kunstmarkt.com

Despite the majority of the art market remaining unregulated and private, there has been increased transparency with regard to medium, price and volume. While auction houses provide price discovery through publicly available information about their sales, Art Fairs assemble large numbers of dealers so potential buyers may better understand the landscape of sellers and the available inventory of art. Additionally, with advances in technology and user adoption, more sales information is being captured and recorded for a broader audience.

Accessing Art

As the art market evolves, so too do the methods of gaining art exposure. To date, the predominant means of accessing art is from direct purchases. However, there are increasingly new ways of indirectly gaining exposure to the value of art via other types of transactions. Direct purchases of art may be accomplished through the previously described auction houses, dealers, art fairs and online purveyors. Indirect methods of accessing art may be accomplished via art securities, financing and funds.

Art Securities

People may gain indirect access to the art market by purchasing art securities. Examples of such securities are equity shares in the below listed companies. By purchasing shares, one gains exposure to art indirectly by becoming a fractional owner of the business. The exposure is not pure however in that the shares reflect the profitability of the business which is partially attributable to the art market and valuations realized but also attributable to the efficacy of the management of the company. Additionally, because these securities trade on exchanges, they are also exposed to exogenous shocks to equity markets that are unrelated to the art market.

Art securities with indirect access to the art market include:

- Sotheby's: listed on the New York Stock Exchange and is one of the aforementioned auction houses [5] .
- Artnet: listed on the Frankfurt Stock Exchange and is an art market website that provides images of works of art with their realized market prices. "Artnet operates an international research and trading platform for the art market …It provides services that promote accessibility allowing users to research art, contact galleries directly and to attain price transparency."[6]
- Artprice: listed on the NYSE Euronext Exchange "claims to be the world's leading online art price database with more than 27 million entries commented by its art historians covering as much as 500,000 artists. Artprice Images allows access to … 108 million images constantly updated from various auction houses."[7]

Art Financing

Indirect access to the art market may also be accomplished through art financing. By providing the funding for an art transaction, one receives interest and future repayment of principal backed by art with a market value subject to market fluctuations. This exposure is not pure however in that the loan also introduces creditor risk unrelated to the value of the art. If the debtor is unable to pay, then one may sell the art subject to market value to repay the loan or one may gain exposure to the art directly by taking possession.

Art financing with indirect access to the art market includes:

- Financing dealers or artists – one may lend money to a dealer to finance the gallery or a particular artist and share in the overall gallery's or the specific artist's profits or losses.
- Financing auction guarantees and bridge financing – one may loan money to an auction house to fund a guarantee against a sale or specific work of art and share in the auction house's success or failure to realize the anticipated valuation of the art.

Another type of debt financing related to art is the issuance of municipal bonds by museums to finance their ongoing operations, renovations and expansions. While the viability of the bonds is not related to art prices, an investor gains exposure to not only the efficacy of the management of the museum but also to the business of maintaining art for public enjoyment and the sentiment of the public toward art.

Art Funds

For decades, there have been numerous art funds launched with mixed results. The demise of many of the funds is largely attributable to the cost and complexities associated with owning art and holding it over time. Holding art is expensive in that it must be purchased, moved, stored, insured and sold, and these expenses would be in addition to the management and performance expenses of the fund itself. Additionally, art valuations are cyclical and oftentimes the funds raise money near the end of cycles as investors are attracted to higher publically realized prices. Arguably, the most well-known and relatively successful art funds include the British Rail Pension Fund and Philip Hoffman's Fine Art Fund.

The rationale for the British Rail Pension Fund to begin investing in works of art in 1974 was to provide diversification and inflation protection against the financial and economic conditions resulting from the OPEC led oil crisis in 1973. At the time, the stock market had fallen dramatically, there had been a sharp fall in the commercial property market, the pound was depreciating strongly against other currencies, rates of inflation were unprecedentedly high and there were no inflation-indexed investments available. Works of art offered the advantage of having international marketability, thereby providing a hedge against the changing fortunes of the UK economy and protection against currency realignments.

The British Rail Pension Fund invested 40 million (of its 1 billion) pounds at the time into approximately 2400 works of art. The pension worked with Sotheby's to purchase art over multiple categories of which approximately 75% of the value was invested in the following collections: Old Master Paintings 19%, Old Master Drawings 11%, Impressionist Art 10%, Chinese Works of Art 10%, Books and Manuscripts 10%, Antiquities 8% and Medieval/Renaissance Works of Art 7%. To alleviate the carrying costs of holding the art which were approximately 2% of book cost, approximately 35% of the value of the art was on loan to museums. This also attributed to the provenance of the works which would likely be beneficial later when they were sold. In 1987, the trustees decided to begin to sell the collection given the advancement of prices in the art market however given the number of pieces to be sold and the later correction in the art market, the last piece was not sold until 2003. Overall, the intention of outpacing inflation was generally achieved across most collecting categories but the predominant significant price realization was concentrated in a small number of pieces. While the inflation protection was achieved, it was not as advantageous as expected given the appreciation in other asset classes over the time of the investment in art.[8]

The Fine Art Group was founded by Philip Hoffman in 2001 as a new endeavor to help clients approach the art market with a view to investing as well as collecting. Philip Hoffman launched his first Fine Art Fund in 2004 which was one of the first of its kind to invest in art. Since then, his company has grown from operating one long-term investment fund to managing subsequent funds of varying size and focus:

- 2004: Fine Art Fund I is launched
- 2006: Fine Art Fund II is launched
- 2009: Fine Art Fund I begins returning capital
- 2010: Fine Art Fund III is launched
- 2012: Fine Art Fund II begins returning capital
- 2013: Fine Art Guarantee Fund is launched.

While there is little public information regarding the funds in particular and their performance, by comparison over this time period there have been dozens of public art fund closures.[9]

There are collectors who collect for passion, those who collect for financial return and those who have both goals in mind. There are still others who see the vast value represented in the art market and wish to participate without actually collecting for which there are a few ways to do so. While these transactions for indirect investment may reduce the illiquidity risk and the holding costs of art, they generally still carry the risk inherent to the art market. As the art market continues to evolve, additional indirect art investments may arise and might include:

- Art futures on one or more art indices to hedge art exposure;
- Securitization of art collections to raise funds and provide broader ownership of art;
- Exchange funds for artists and collectors' art to provide diversification; and
- Bonds to finance museum shows to other museums with interest payments tied to ticket sales.

Art on a Balance Sheet

While a collector's rationale for collecting art may be varied, the significance of art on a collector's balance sheet is increasing. As an example, Larry Fink, the chairman and CEO of BlackRock said "the two greatest stores of wealth internationally today include contemporary art … and I don't mean that as a joke, I mean that as a serious asset class and the other store of wealth today is apartments in Manhattan, Vancouver and London."[10]

Interestingly, the evolution of real estate as a definable and measurable asset provides precedence for art in that real estate and art present similar challenges including the following:

- Each asset is unique
- Valuations can be challenging given few if any direct comparables exist
- There are a myriad of indices with diverse underlying calculations and results
- Both are highly illiquid
- Buying, holding and selling costs are considerable
- Buying and selling is infrequent.

To put these nuances in context, it is first helpful to consider the definition of an asset class as well as how an index might track and measure an asset class over time.

- An asset class is a group of securities with distinct investment characteristics, including the level of risk and potential for delivering returns and performance in different market conditions. [11] Each asset class is homogenous and largely independent of other asset classes. [12] The three main asset classes are equities, fixed income and cash equivalents.
- "An index is a select group of investments whose collective performance can be taken to represent a market as a whole, or at least a clearly defined subset of that market. While some indexes may be recalculated once a day or less, indexes representing large, liquid and active markets are typically recalculated continuously throughout trading periods to reflect up-to-the-moment pricing data and to

indicate the direction and magnitude of the market's price sentiments." Index values can be compared in order to calculate relative performance and to show how the market may have changed over certain time periods.[13]

To address these challenges for real estate, Karl Case, Robert Shiller and Allan Weiss created the Case-Shiller Home Price Indices (now named S&P Case-Shiller) that are calculated from data on repeat sales of single-family homes. [14] Given that repeat sales are the only basis for true apples to apples return comparisons over time, Jianping Mei and Michael Moses utilized a similar process to create the Mei Moses Fine Art Indices (now named Sotheby's Mei Moses). The Mei Moses database has more than 45,000 repeat-sale auction pairs from Christie's and Sotheby's, with approximately 3,000 incremental pairs added each year from recent auction transactions. This information is used to create an art index that dates from 1875 and includes eight collecting category indexes each with various starting dates the earliest of which is the Old Masters/19th century index which starts in 1900.[15] [16] According to Mei and Moses "creating an index for individually unique objects such as art or residential real estate requires an approach different from that used from homogeneous products such as individual stocks, bonds, and commodities. This is because of trading infrequencies and characteristic differences among the objects that come to market from period to period. Thus for art and real estate, indexes based on average prices over a period of time may depend more on the mix of objects that come to market than on changes in the underlying market itself." [17]

As is the case with other assets, there are hundreds of sources of art market data and infinite ways to represent it. Most of these art market data aggregators use public auction records to assess trends of collecting categories or specific artists over time, and most focus on the more liquid parts of the market. Limitations of these indices are that they do not include private sales (at auction or through galleries), thereby only reporting on the public market. Most indices also use only data for artworks that have sold more than once, and do not include artwork offered for public sale that fails to sell thus introducing some measure of selection bias to the data. Examples of other art indices include:

- **ARTPRICE:** Publishes market level and category level data as well as artist-specific indices. The database is comprised of results from 4,500 auction houses (excluding most online sales) and also uses repeat sale methodology.[15]

- **ARTNET:** Monitors the performance of specific collecting categories and of certain artists. It uses data from 1,600 auction houses worldwide, including data from online auctions. Artnet does report data on artworks sold only once and does so separately from data on artworks sold more than once.[15]

Understanding the benefits and shortcomings of art indices, is helpful particularly in appreciating trends relating to a single artist or a category of art. To understand much higher level trends, there are three widely read reports: Deloitte's Annual Art & Finance Report, The European Fine Art Foundation's (TEFAF) Art Market Report and Art Basel's The Art Market 2017. These industry level surveys discuss the art market broadly, versus the performance of any one artist or category.

Implications of Owning Art

There are peculiarities of art as an asset that require extra vigilance and understanding on the part of the collector including:

- Financial stewardship of Art
- Strategic planning considerations for art
- Costs of transacting and holding art
- Complexities of art valuation.

Financial Stewardship of Art

The ultimate challenge facing a collector may be what to do with the collection after the collector's death. Does the collector intend to keep any, a portion or all of the collection together and who will oversee the art. It is prudent to create a strategy so as to not put undue financial or emotional pressure on the surviving family. If there is no plan and the deceased's assets flow to the surviving spouse, will the surviving spouse be able to address and take responsibility for the art during the surviving spouse's lifetime or will the surviving spouse further pass the responsibility onto their children after the second spouse's death?

With a succession plan, the collector may establish legal structures to own and retain the art, appoint art specialists to advise on the art should other family members not have the requisite knowledge, alleviate the emotional association with the art given the collector's death and mitigate the financial burden of imminent or future taxes. The collector may establish a structure that owns the art and affords the collector the flexibility to draft and customize the governing documents to memorialize the collector's intention for the art as well as address the needs of the family and the collection. Specifically, the specialists necessary to advise the family with regard to the art can be identified, appointed and instructed according to the specifications of the collector. This way, financial considerations with regard to maintaining the collection may be addressed and the emotional consequences of being uncertain about decisions concerning the art are mitigated.

When planning for the transfer of art, consider working with a number of specialists who can assist in making a smooth transition. An art executor can help market the works and determine which could be sold for a reasonable price in the short term, which should be held to generate interest and which are less valuable. Similarly, an art attorney can impart legal advice on how to value art for purposes such as tax and estate planning. They can also help navigate the legal issues that arise when executors and trustees are fulfilling their responsibilities for safeguarding, holding and disposing of art. It is important that tax and legal advisors be familiar with the requirements for appraisals and Internal Revenue Service (IRS) policies and procedures for valuing artwork.

The art community abounds with great collectors, all with distinct motivations and definitions of success. The following examples highlight three distinct styles of collecting through three celebrated collectors. Nearly universal among today's top collectors is a connection to a public museum or the use of a private museum space in order to make their collections available to the public.

AN ENCYCLOPEDIC COLLECTION: Sheikha Al Mayassa Al Thani, sister of Qatar's ruling Emir, is one of the most significant collectors in the Middle East and buys both for herself and for the Qatar Museums in Doha, for which she serves as chairperson. Her approach is to buy the finest example of each artist she collects, often only purchasing a single high quality work by a given artist. She has worked with seasoned advisors, many of whom are auction house alumni, to source new works for the collection. [18] She is a serious patron of Islamic art, as well as Western Modernism and a vast array of other categories including painting, photography, sculpture, film, jewelry, weaponry, coins and fossils.[19] A major focus of the Qatar Museums is the local community: local school children visit the Qatar Museums, local artists are encouraged, and future commissions could draw on Qatari talent.[20]

A DEEP COLLECTION: Beginning in the 1970s, Eli and Edythe Broad, major Los Angeles philanthropists, built a collection of some of the most sought after Post-War and Contemporary artists. The couple began collecting Impressionist and Modern works (van Gogh, Miro and Matisse), but quickly shifted to artists of their own generation, with whom they could form personal relationships.[21] The collection is deep in most artists, owning not one or two examples but sometimes more than ten examples of a single artist. Christopher Wool, for example, is represented by 20 works in the Broad Collection. The Broads have worked with art advisor Joanne Heyler to make collecting decisions since the late 1980s. Since 1984, the Broad Art Foundation has run an ambitious lending program, sending the collection works to over 500 museums and galleries around the world, with the mission of improving access to contemporary art. In 2015, the Broads opened the Broad Museum, a 120,000 square foot storage and exhibition space in Los Angeles that houses the 2,000 work collection.[22]

A THEMATIC COLLECTION: Frieder Burda, a German Publisher, has a amassed a collection of more than 1,000 works, which is largely focused on

German Expressionists, Abstract Expressionists and his German Contemporaries (including Sigmar Polke and Gerhard Richter).[23] His collecting style is driven by his fascination with color and the emotion that can be conveyed through painting. [24] Burda does not work with dealers, but often receives advice from art historians. He opened a museum to display his collection, and to host an active, high quality exhibition schedule, mostly of individual artists. The museum is located in Baden-Baden, Germany, and it is a major draw for collectors and art enthusiasts.

Strategic Planning Considerations for Art

For the art collector, art is an important component of their trust, tax and estate planning and may require the same strategic planning as other investments. Given this, it is important to note that tax rates are subject to change and therefore, clients need to consult qualified tax and legal advisors for any related transactions. Additional care and consideration may be necessary as an art collector likely has a personal connection to the art after allocating time and resources over many years. It may therefore be a more involved process to determine how to plan for the eventual disposition and transfer of the art while considering the following options:

- No planning
- Purchase life insurance
- Sell the art
- Gift the art to a non-charitable beneficiary
- Donate the art to a charitable beneficiary.[25]

		Desired Art Recipient	Enjoy Art During Life	May Help Estate Tax	May Help Income Tax
No Planning	During life	No	Yes	No	No
Purchase Life Insurance	During life	No	Yes	Yes	Yes
Sell the Art	During life	Yes	No	No	No
Sell the Art	At death	No	Yes	No	Yes
Gift the Art to Non-Charitable Beneficiary	During life	Yes	No	Possibly	No
Gift the Art to Non-Charitable Beneficiary	At death	Yes	Yes	No	No
Donate the Art to Charitable Beneficiary	During life	Yes	No	Possibly	Yes
Donate the Art to Charitable Beneficiary	At death	Yes	Yes	Yes	No

No Planning: While the collector will continue to enjoy the art during life, this is probably the least desirable option. It is possible that the art will end up under the control of an estate executor and/or distributed to family members who do not share the collector's passion for and understanding of the art. Additionally, the value of the art at death will be included in the collector's taxable estate. It is important to note that without extensions, federal estate taxes are due within nine months of the date of death and state estate taxes are due within several months of the date of death, as may be applicable. Thus, it may be that art will have to be liquidated at an inopportune time in the art market to pay estate taxes.

Purchase Life Insurance: The collector may establish an Irrevocable Life Insurance Trust (ILIT) and fund it with a combination of the collector's lifetime and annual gift tax exclusions which can be used to pay the premiums for the life insurance on the collector's life. The beneficiaries of the life insurance can then collect the income tax and estate tax free proceeds (because of the ILIT) and apply the insurance proceeds to pay the estate tax on the art. While a collector can continue to enjoy the art while living, challenges include matching the life insurance death benefit with the potential future value of the art at the collector's death and aligning the beneficiaries of the art and the beneficiaries of the ILIT proceeds.

<u>Sell the Art:</u> Selling the collection can be done during life or after death. In either case, it is prudent to get a professional assessment of whether it is better to sell the art at an auction, gallery, or private sale. Then it is important to understand which auction house or gallery would be most suitable for the type of art being sold and to then negotiate fair and reasonable terms. An art professional and art attorney may help to negotiate and document the transaction.

If a collector sells the art during their life then the collector will forgo enjoyment of the art while living. However, the collector may control to whom the art is sold. There is an income tax consequence as the collector will pay a higher capital gains tax rate of 28% (versus 20% for financial instruments). This assumes the art qualifies for "capital gain collectible property" with a 28% tax rate as opposed to qualifying for "ordinary income property" with a 35% tax rate.[26]

If the collector intends to sell the art and is confident that it can be sold in a reasonable amount of time, then the collector may consider creating a Charitable Remainder Unitrust (CRUT) to defer the capital gains tax payable from the sale of the art. Funding these types of trusts with artwork requires careful consideration because art is not an income producing property. This characteristic often makes artwork a less desirable choice for funding a CRUT since timing of the sale of artwork by trust is uncertain. In a CRUT, appreciated property or the art is put in a trust, sold and reinvested. Depending on the term of the CRUT, a distribution rate will be specified which determines the annual distribution of income back to the collector. The remaining assets in the trust at the end of the term are paid to the named charity. The capital gain tax resulting from selling the art is deferred over the life of the trust and gets distributed to the collector with the annual distribution of income. Once the art is sold, the collector may be eligible for an income tax deduction but only in the amount of the cost basis of the art because the art in the trust will fail the related use test.[27]

If the collector intends to sell the collection at death then the collector may enjoy the collection while living however, the collector will not have control over who purchases the art. It may be a less costly option with regard to the size of a potential capital gain because the beneficiaries will be the ones to sell the art and the beneficiaries' new cost basis will step up and equal the fair market value as of date of death. However, it is important to note that the art is then included in the estate for estate tax purposes. The collector's estate documents should indicate that some expenses incurred in the administration of the decedent's estate may be deductible if the sale is necessary to pay debts, expenses, taxes or preserve the estate.

To potentially mitigate the estate tax, the collector could arrange to have a Charitable Lead Annuity Trust (CLAT) be created upon death. At death, the art would be put in the CLAT, sold and reinvested. The charity receives the income flow from the trust each year of trust term and the collector's beneficiaries receive the remainder transfer tax free. If set up correctly, the collector's estate may receive an estate tax deduction in the amount of the art contributed to the CLAT at death.[28]

<u>Gift the Art to a Non-Charitable Beneficiary:</u> Collectors may want to gift the art to their children or other non-charitable beneficiary. The process of gifting art to children follows the same rules as most other gifting techniques. As mentioned previously, the funding of certain types of trusts with artwork requires careful consideration because art is not an income producing property. Art collectors may use their annual gift tax exclusion, which is currently $14,000 per beneficiary per year, and their lifetime exclusion of 5,490,000 (for 2017) per person. A gift in excess of this amount will be taxed at the 40% gift tax rate. The primary planning reason for gifting art or other assets to beneficiaries during life is to reduce the future size of the collector's estate as not only the current value of the asset but also any potential appreciation of the asset will be outside the estate. Unlike gifting during life, the benefit of gifting at death would be that the collector retains the art and enjoys it during life. Additionally, the estate planning documents may specify who receives the art at the collector's death. However, the estate tax burden will be higher. If the gift is made during life and the recipient of the art eventually sells the piece, the recipient will assume the collector's original cost basis for the art, which will then be used to calculate the amount of capital gains tax.[29] It is important for

clients in such circumstances to be familiar with the requirements for appraisals and IRS policies and procedures for valuing artwork for gift and estate tax purposes.

In place of gifting to a beneficiary outright, the collector may transfer art into a Limited Liability Company (LLC) or a Family Limited Partnership (FLP). The LLC or FLP owns the art that is controlled by one or more managers appointed by the collector to be responsible for maintaining insurance and storage as well as for making decisions regarding sales. The control feature must be carefully crafted for estate tax reasons. The donor may then gift LLC and FLP interests. The benefit of this structure is it allows the transfer of an intangible partnership interest rather than a tangible piece of the collection to which there may be emotional attachment. It also keeps the entirety of the collection together. At death, probate is simplified because the collection is owned by the LLC or FLP and interests are transferred rather than specific pieces of art. [30]

However, art's lack of liquidity and issues relating to valuation and cash flow do pose significant challenges to the utilizing of LLCs and FLPs. For illiquid assets such as art, the IRS typically does not allow "discounting techniques" for gift or estate tax purposes. Instead, for illiquid assets, a collector may be able to utilize the IRS "valuation discount" due to the art's lack of marketability. For this reason, it is important to note that art can be one of the most expensive assets to transfer during life. Of note, leveraged gifting techniques such as grantor retained annuity trusts (GRATs) and sales to intentionally defective grantor trusts (IDGTs) that require valuation to determine cash flow back to the grantor/collector may not work well because generally art does not generate cash flow and it is not like a financial security that is marked to market.[31]

Noting the aforementioned challenges, if enough cash flow can be generated from the art, another consideration might be a combination of a LLC and an IDGT. In this strategy, the collector funds an IDGT with cash whose value is at least 10% of the value of the art. The collector then sells the LLC interests to the IDGT in exchange for a promissory note. Because the IDGT is a grantor trust, the collector and the trust are the same for income tax purposes and therefore the collector does not incur a capital gain. The cash to pay the interest on the note comes from the cash that originally funded the IDGT as well as potentially from the LLC's cash proceeds from renting or loaning the art (potentially to a museum). Since the IDGT owns the LLC, the cash is available to pay the interest on the note.[32]

Donate the Art to a Charitable Beneficiary: A collector may donate art during the collector's lifetime or at death with the clear distinction being whether the collector will be able to enjoy the art during life. In either case, the collector may specify to which charitable beneficiary the art will be given.[33]

By donating art to a charitable beneficiary at death, the deceased's estate receives an estate tax deduction equal to the value of the art. A downside to gifting to a charitable beneficiary at death is that the collector forgoes the potential income tax deduction during life. This may be mitigated by leaving the collection to the surviving spouse. The unlimited marital deduction from the federal gift and estate tax allows U.S. citizens and their spouses to transfer property to each other free of gift and estate taxes. One way of transferring collectible artwork, which should be reviewed with a trusts and estates attorney regarding specific estate planning techniques, is through basic credit shelter and marital deduction planning. This example would allow both spouses to utilize their estate tax exemption amounts. The surviving spouse can then receive the federal income tax deduction if gifted but gives up the benefit of keeping the art.[34]

If the collector donates art during life, the IRS specifies the following with regard to charitable income tax deductions [35]:

- If ordinary income property to **public charity** then deduct up to 50% of adjusted gross income (AGI) by the lesser of fair market value (FMV) or cost basis
- If ordinary income property to **private charity** then deduct up to 30% of AGI by the lesser FMV or cost basis
- If long-term capital gain property to **public charity** then deduct FMV of art up to 30% of AGI

- If long-term capital gain property to **private charity** then deduct FMV of art up to 20% of AGI if it is publically traded stock otherwise cost basis is used

- If tangible personal property unrelated to charity's purpose to a **public charity** then deduct up to 50% of AGI by the lesser of FMV or cost basis

- If tangible personal property unrelated to charity's purpose to **private charity** then deduct up to 20% of AGI by the lesser FMV or cost basis

IRS regulations state that a gift of property other than cash or marketable securities whose value exceeds $5,000 requires that the donor obtain a qualified appraisal dated within 60 days of the gift and that the appraisal summary be attached to the income tax return.

By donating art to a charitable beneficiary during life, the collector may receive an income tax deduction. In order to obtain a charitable deduction equal to the fair market value of the work of art, the work must be donated to a public charity and the donor must anticipate that the charity's use of the work will be "related" to its exempt purpose. For example, a gift of a painting to a museum would clearly be a related use gift. However, if the work of art is contributed, for example, to the local Society for the Prevention of Cruelty to Animals (SPCA), who in turn just plans to sell the art, the amount of the deduction would be limited to cost basis because the gift would not be related to the organization's exempt purpose. It is important that a collector understand the future use of the artwork because the nuances can affect the amount of the income tax deduction. Collectors in such circumstances should be familiar with the requirements for appraisals and IRS policies and procedures for valuing artwork for gift and estate tax purposes.

It is also important to understand what type of property the artwork will be deemed for tax purposes. Generally, a work of art held by a collector is capital gain property and qualifies for deductibility at full fair market value if it meets the related use rule discussed and is given to a public charity. The contribution is deductible up to 30% of adjusted gross income ("AGI") with any excess contribution deductible over the following five years (limited to 30% AGI) until exhausted.

However, the art will be deemed to be ordinary income property if (i) the donor created it, (ii) the donor received it as a gift from the creator, (iii) it is held as inventory by a dealer, or (iv) its sale would generate short term capital gain because it was held for one year or less. If it is ordinary income property and is given to a public charity, the deduction is for cost basis only up to a maximum of 50% of AGI.

While a collector may gift art to any charitable beneficiary, museums are good candidates because they may want the art, the gift results in a greater income tax benefit for the collector, and a museum may be a more effective and impactful steward of the gift than family members. However, collectors may mistakenly believe their donated art will become a permanent piece in the museum of their choice. They assume that once accepted, their art will be displayed and highlighted, or that their art will become part of the museum's permanent collection and not deaccessioned. These assumptions may prove false. Due to decreased funding, limited storage space and highly selective art acceptance committees, major museums have limited their acceptance of works of art. It is important for the collector to understand the long-term plan for the art and create a realistic strategy. For most people, it may be best not to focus on the largest and most famous museums. Less notable organizations often have more space and additional flexibility. It is extremely important for the client to make the gift pursuant to a written agreement that builds in flexibility, and provides clear terms that could be enforceable at a later date. An attorney or an independent art professional can help negotiate and document the transaction.

For collectors looking for a venue to exhibit their art, preserve the integrity of the collection and also receive tax advantages, consideration should be given to creating a museum. However, a collector needs to take a number of factors into consideration. First and foremost, establishing and maintaining a museum entails relatively high fixed and variable costs. Clients must also understand the legal and tax obligations that come with establishing and running this type of organization. Most museums choose to establish as nonprofit 501(c)(3) organizations. Applying for nonprofit status applies to federal, state and local tax exemptions after the organization is legally incorporated. The process is costly and complex, therefore the client should consult with their legal and tax advisors. In addition, collectors who have families with little interest in the art and its legacy should consider donating to an existing museum that satisfies the collector's requirements of space, location and structure. An existing museum would be able to manage the art without relying on family members.

Costs of Transacting and Holding Art

Preparation and consideration of art transactions can be quite involved particularly in the case of significant valuations. Similar to acquiring real estate, there are numerous additional steps with associated costs in addition to finding, negotiating and paying the purchase price. Art may have high transaction costs depending on through which channel the art is being sold. While commissions may vary and are negotiable working through the private market with dealers, the buyer and seller premiums at auction houses may be as high as 20% depending on the achieved sale price. If an artist has a "thin" market due to few works created or available for sale, it could take months or years to identify a desired work of art at which time buyers often pay up for the piece to make sure they are the successful purchaser. While a higher sales price is advantageous to the seller, the capital gain tax is 28% on art in contrast to 20% for financial securities. The buyer must also pay sales tax on the sum of the purchase price and premium or commission. Finally, buyers should take precautions necessary to alleviate fraud including verifying authenticity, title and documentation.

Authenticity has varying definitions depending on the genre of art. To be deemed authentic, a Matisse painting must have been painted by Matisse and perhaps equally important for the art collector, commercially recognized scholars and experts must concur about its inclusion in the compendium of the artist's body of work. An ancient Egyptian artifact, however, may be deemed authentic without any information about the artist. The best place to begin confirming authenticity is with provenance whereby reviewing the documentation tracing ownership from the creator to the current seller. Also check the object's sales, exhibition and publication history to determine whether experts have deemed the work authentic. For those objects that lack a complete ownership history, you may need to employ an expert in the genre to establish authenticity, perhaps even supplemented by a scientific expert who can date the materials. While many artists' foundations authenticated works in the past, some have terminated the service due to litigation concerns.[36]

Valid title is more difficult to establish in the art market than with many other assets. Begin due diligence by checking the Art Loss Register to see if the work is listed as stolen. If the identity of the seller is known, check for any liens or "lack of authority to sell" claims in state and local registries. Be particularly careful with works that have crossed borders, as they might be considered another country's cultural property or have claims from art looting. Consider art title insurance to protect against the full spectrum of defective title risks.

Proper documentation, as noted above, is indispensable in establishing the authenticity and the right to own the art intended for purchase. A standard invoice or bill of sale typically includes a complete description of the work of art, its purchase price, sale tax, payment instructions and notes about who pays for shipping costs and when title passes to the buyer. The condition of a work of art invariably has a profound impact on its value. Careful measures should be taken to ensure art is well protected and properly insured. Threats to the physical security of art are more likely posed by improper transportation, storage, installation and environmental controls.

- Art may be its most vulnerable when it is moved. Specialist art movers are experts at shipping and handling as well as documenting an audit trail for the chain of custody from point to point.
- Art should be stored art in facilities that have the expertise to handle them properly. Specialist art storage facilities

provide a detailed facility report that includes information about fire detection and suppression, humidity and temperature control.

- The physical and environmental conditions in which the art is housed are critical. On a regular basis, a conservator who specializes in the type of art owned should be consulted.

Art fluctuates in value while the stated coverage value in a policy is fixed. An art appraiser can be brought in periodically to re-evaluate the value of the art so the collector maintains appropriate insurance coverage. Art insurance is a highly specialized field, so both broker and carrier have expertise in insuring fine art and art risk management services.

Complexities of Art Valuation

While the art market is fairly opaque, art is an asset and therefore it is important to ascertain its value. Specifically, the value of art is vital not only when it comes to sale and borrowing but also for:

- Income tax purposes if the art is transferred during life to a charitable beneficiary
- Gift tax purposes if the art is transferred during life to a non-charitable beneficiary
- Estate tax purposes if the art is owned at death
- Insurance purposes if the art is maintained during life

When determining the value of a piece of art there are numerous inputs to consider including the artist, type, image, medium, year, dimensions, condition, presence of markings or signatures, provenance and whether the piece is a standalone item or part of a larger set/collection. The frequency with which art valuations are updated depends on the type of art involved and how stable its valuations are. [37] Typically there are two types of valuations, fair market value and replacement value:

FAIR MARKET VALUE: The fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts". [38] This valuation is required by the Internal Revenue Service (IRS) for estate tax, income tax and gift tax purposes. Additionally, the fair market value serves as the basis for borrowing against art as collateral. If an agreement cannot be reached between the IRS and taxpayer, further assistance may be requested of the IRS Art Panel and the Office of Art Appraisal Services. Further specifications for fair market value include that there is no time constraint on the sale, the transaction takes place in an appropriate marketplace and the buyer's premium, the amount above the successful bid price that is paid as part of the total purchase price at auction, is included.[39]

REPLACEMENT VALUE: The replacement value is the reasonable dollar amount that would be required to replace a piece of art with another of similar quality, age, appearance, provenance and condition on short notice. This valuation is necessary for insurance purposes and can be thought of as retail value.[40]

APPRAISALS: Typically, if the transfer of art occurs shortly after it was purchased, its value is the cost that the seller/transferor paid. However, more often than not, the transfer of art does not occur close to the time the art was purchased and thus it requires an appraisal. An appraisal is a legal document that describes the value of the artwork. For gifts to charity during life of greater than $5,000, a qualified appraisal must be obtained. The donor must receive the appraisal before filing the income tax return.[41] A qualified appraiser can be located through a referral from a specialized art or antique dealer or from a lawyer or other advisors. The qualified appraiser should be affiliated with a major appraisal organization and one should check the appraiser's qualifications.

Due to the uncertainty in the valuation process, Congress created the IRS Art Advisory Panel of 25 art experts to assist in reviewing art appraised for $20,000 or more. The panel consists of auction house representatives, dealers and curators.

The importance of appraisals can be seen through the tax penalties that are imposed in the case of inaccurate valuations:

- For income tax purposes, a "substantial misstatement" occurs if the value is overstated by 150% or more, in which case a penalty of 20% of the underpayment of tax is added to the tax. A "gross valuation misstatement" occurs if the value is overstated by 200% or more, in which case a gross penalty of 40% of the underpayment is imposed. (The higher the value of the art donated, the potential for a higher income tax deduction.)

- For federal estate and gift tax purposes, if the stated value of the art in the estate is 50% or less of the restated value then the penalty is 20% of the tax underpaid. The percentage penalty increases to 40% if the stated value is 25% or less than the restated value. (The lower the value of the art in the estate, the lower the estate tax.) [42]

BORROWING: Loans secured by art may enable collectors to avoid the significant transaction costs and taxes associated with the sale of art. Specifically:

- Long-term federal capital gains tax on art is currently 28% versus 20% for financial securities
- State and local taxes can result in a total tax bill of 40% or more on the gain
- Selling costs, such as an auctioneer's or dealer's commission, may be as high as 20% of the value of the item sold
- Selling in an unstable economic climate may be a less attractive liquidity option, as at a time when prices are falling the percentage of art "bought in" or potentially "burned" at auction increases.

Additionally, borrowing rather than selling allows the collector to retain ownership of the art for enjoyment purposes as well as retaining the potential future appreciation in value. Finally, borrowing assists in avoiding a potential public sale thus preserving confidentiality.

Approximately 53% of collectors who expressed an interest in art secured lending said their motivation would be to buy more art, while 38% said they would use the proceeds to invest in other business activities and 9% said they would use the proceeds to refinance existing loans.[43]

Understanding Art as an Asset

This discussion intends to bring awareness to the significant role art may play in the context of a collector's overall wealth. Generally, a collector may segment wealth between financial assets and other possessions such as art, however, art has become increasingly more accepted as an asset given "art transactions have recently accounted for over $60 billion annually,"[44] art prices have increased 50 to 100 percent over the past 50 years so art originally purchased to decorate a home may now be extremely valuable[45] and it is estimated that over $1 trillion worth of art is held in private hands. It is important for a collector to understand that the size of the art market has increased and the structure of the art market has evolved thus bringing with it more opportunity, information and responsibility. Therefore, it is prudent for a collector to recognize art on a balance sheet and plan accordingly.

The value of global art market sales in 2016 was $56.6 billion, in 2015 it was $63.6 billion and in 2014 it was $68.2 billion. Although 2016 is the second year of declining sale values, representing a 17% decrease from 2014, 2014's $68.2 billion in global art market sales represents a peak that surpassed the previous $66 billion record in 2007.[46] Of the $56.6 billion in 2016 global art market sales, 57% or $32.5 billion was through dealers and 39% or $22.1 billion was through auctions. Art Fairs represented 41% or $13.3 billion of dealers' sales. 43% of total auction sales were from two auction houses: Christie's with $5.4 billion and Sotheby's with $4.1 billion. Total online sales were $4.9 billion and include pure online sales ($2 billion) as well as those attributable to auctions ($300 million) and to dealers ($2.6 billion).[47]

Additionally, of the $56.6 billion in 2016 global art market sales, $22.9 billion or 40% were in the USA, $12 billion or 21% were in the UK and $11.6 billion or 20% were in China leaving the other 19% or $10.1 billion of sales in regions with developing art markets.[48] The regional sales are reflective of the 32.9 million millionaires globally whose net worth approximated $117 trillion in 2016. Of them, 20 million millionaires have been created since 2000, most are from developing countries and approximately 40% of them have been active in the art market in the past two years. Finally, according to the Wealth-X Billionaire Census in 2016, it is estimated that there are approximately 2500 billionaires globally representing approximately $7,500 billion in wealth. Of this billionaire wealth, 33% is in North America, 22% is in Asia and 30% is in Europe. The Asian billionaire wealth saw the largest year over year increase of 20% in 2016.

Art, law, financial and other firms have been making strides and increasing staff in the art advisory area to help collectors evaluate their art and the potential consequences of the exposure. In 2016, there were approximately 310,000 businesses operating in the global art market employing approximately three million people. Additionally, another approximately 300,000 people were employed by businesses providing ancillary art services worth almost $18 billion for the following:

- $3.6 billion for advertising and marketing
- $4.0 billion for Art Fairs
- $1.0 billion for conservation and restoration
- $1.4 billion for insurance and security
- $2.2 billion for packing and shipping
- $1.8 billion for hospitality and travel
- $1.5 billion for professional fees (lawyers, auditors, banks etc.)
- $2.3 billion for information technology [49]

Increasingly more information about the art market has been published. For example, in 2017, Dr. Clare McAndrew published a new report, "The Art Market," in which there are vast amounts of information about the size and structure of the art market based on public and private sales. This publication is in addition to other previously published noteworthy reports: "The European Fine Art Foundation Art Market Report" from Dr. Rachel A.J. Pownall and "The Art and Finance Report" by Deloitte. The generation of these and other art market reports are evidence of heightened curiosity and demand for art market information.

For many collectors, an investment in art is only a byproduct of their collecting. They build their collections based on their own tastes, a theme or even a sense of cultural duty. Most would prefer not to see the value of their collections fall, but they have no specific investment return in mind. Other collectors, perhaps a minority, buy with an expectation of financial return, whether through a young and promising artist at a bargain price or through a well-established artist likely to hold their value. While it is not known what portion of the $56.6 billion sales of art is attributable to non-financial versus financially motivated collectors, in "The Art Market 2017" report by Dr. Clare McAndrew, collectors were asked to rank considerations for purchasing art and they are as follows:

1. Aesthetic and decorative considerations
2. Emotional reasons/passion/expression of personality
3. Support of artists and culture/preserving or promoting cultural values
4. Protecting and maintaining family traditions and heritage
5. Expected financial appreciation/return on investment
6. Social/event-driven reasons
7. Portfolio diversification/risk benefits
8. Hedge against inflation/capital preservation/value maintenance
9. Status/cultural credibility

Irrespective of the consideration for owning art, every collector should be aware not only of the unique qualities of art as an asset but also the responsibility of owning art.

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Alternative investments are often speculative and include a high degree of risk. Investors can lose all of a substantial amount of their investment. They may be highly illiquid, can engage in leverage, short-selling and other speculative practices that may increase volatility and the risk of loss, and may be subject to large investment minimums and initial lock-ups. They may involve complex tax structures, tax inefficient investing and delays in distributing important tax information. They may have higher fees and expenses that traditional investments, and such fees and expenses can lower the returns achieved by investors.

Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss. Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies. Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Funding investments backed by Art are subject to market fluctuations, creditor risks and other risks associated with the management of art institutions and public view.

Added considerations of holding Art can be illiquidity and marketability, carrying costs, insurance costs, liquidity risk, uniqueness and direct comparables limitations, transaction infrequency, selling costs, authenticity as well as other risks inherent to the art market.

Fine Art Indices are limited in that they do not include private sales and only report on public markets and used a repeated sale methodology.

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