

Completing the Picture of Wealth: Managing Tangible Assets

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Presentation Overview:

When are valuable objects considered appreciating assets? How does the expanding global art market affect the value of fine art, furniture, wine, silver, jewelry and other collectibles owned by clients? What factors influence the value of objects? During the past several years, fine art and collectible markets have been in a continuous state of evolution expanding into new countries and to new purchasers across the globe. Due to the increased number of international buyers, tastes and desires have broadened. As a result, the value of fine art, jewelry and collectibles have fluctuated tremendously over the past decade due to changes in consumer demand. Many personal collectors remain unaware of the value changes and as a result, their personal assets are not adequately protected.

This presentation will educate the legal community on the state of the art and collectible markets. The legal community will also develop an understanding of the importance of planning for and insuring a client's valuable tangible assets.

A. How the Expanding Global market affects the value of tangible assets? *(Art and Collectibles as a valuable financial asset)*

Many types of fine art and collectibles have appreciated over the past several years. It is important for Attorneys to identify what their clients own and understand whether there are any appreciating assets in a clients' asset in order to appropriate plan for any capital gains issues. Value changes in the fine art and collectible markets may require that attorneys advise clients with a different strategy in the estate plan. Instead of monetization, a client may be better suited toward a philanthropy initiative. Or if assets have depreciated in value, monetization may take place during lifetime. Other choices such as setting up trusts, LLC, foundations may be discussed with the client based on the value of tangible assets as well as appreciation rates.

1. What types of tangible assets are valuable?
 - a. Art, jewelry, wine, furniture, stamps, coins, collectibles, decorative arts, instruments, books and manuscripts, silver, handbags, collector cars
2. How large is the tangible asset market?
 - a. By 2026, UHNWI will have an estimated \$2.7 trillion in tangible assets

3. What factors influence value?

a. Global demand, Scarcity, provenance, condition, artist/maker

4. What are the different types of Value?

a. Standards of value

1.) Retail Replacement Value is used for

- Insurance purposes— A retail replacement cost appraisal is mostly used for insurance purposes and represents the value that one would expect to pay for the same or similar item in a retail setting at the present time.
- Attorneys need to advise clients that retail replacement is used for insurance purposes not necessarily for probate or equitable distribution
- Donation- IRS requires the appraiser to identify the most appropriate market for the object. In some cases there will be a secondary market for the object and the fair market value needs to be used. In other cases if there is not a secondary market then the retail value can be used for donation. If there is not a secondary market for an object, the attorney may advise a donation strategy and receive a retail replacement tax benefit versus monetizing.

2.) Fair Market Value

- Definition: According to the IRS, fair market value (FMV) is the price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.

When Fair Market Value is used:

- Estate Planning/Probate Appraisals
- Divorce
- Equitable Distribution
- Donation
- Gift Tax
- Auction Acquisition Cost
- Rental Value
- Fractional Interest
- Case study—It is important for the attorney to understand that if the wrong value is used for the

scope of work, the client can be audited. Often in a divorce situation, dealers will use retail replacement instead of fair market values and this can impact the outcome of a litigation case.

3.) Marketable Cash Value (MCV)

Definition: Marketable Cash Value is similar to "fair market value," but expenses related to the sale are subtracted. MCV is used for Collateralization. It is important for an attorney to understand the credit requirements for valuing collateral for assets to be leveraged.

b. Methodology of the appraisal (what should be included in the appraisal)

- Description of object
- Color photo and multiple images
- Narrative of the market
- Appropriate value
- Size
- Condition
- Comparables
- Provenance
- Literary references
- Exhibition history

c. Tools for valuation

1.) If the appropriate value is not used for IRS purposes this will result in an IRS audit and possibly implicate the estate to pay more in taxes. It is important to have a justifiable and objective appraisal when determining the tax liability of an estate, donation or gift tax. (any type of IRS appraisal report) The valuation of art and collectibles is not an exact science however, in order to determine the precise tax liability of an estate, appraisers and estate executors must adhere to the Internal Revenue Service guidelines, professional codes of ethics and the legal requirement within the Tax Code to ensure some level of objectivity and consistency.

2.) If the object is valued at \$50,000 or higher for a fair market value for an IRS report, the IRS art panel will review the report. If the report is not completed correctly, such as the comparables are not relevant or missing then the client may be audited.

- Case Study—IRS and why a Coin audit occurred

5. What are the Appraisal Standards and Appraisal Practices

a. Appraiser qualifications

1.) Appraiser Certification (Appraiser should belong to one of these associations-AAA, ISA, ASA)

2.) USPAP compliancy- Every other year, an appraiser should pass the USPAP test which identifies changes in the tax law and other regulatory issues

3.) Expertise-an appraiser should have knowledge and experience in valuing the asset class.

6. Issues with tangible assets

1.) Authenticity—Does the object need to go through a process to authenticate. For example, if client owns a Calder sculpture, has the piece been verified by the Calder foundation and given a number and letter. If not, it can not be considered authentic

2.) Fakes & Forgeries—Discuss the established Knoedler Gallery located in NYC and the sale of fake art to clients

3.) Capital Gains

4.) Clear Title- if the provenance of an object is not discussed/researched, the client may possibly own a stolen object

5.) Conservation/preservation-With new forms of art material, discussions around preservation are important for art. Storage is also important for objects such as wine and autographs. Sunlight can damage an asset and depreciate the value.

6.) Condition (see 5) Also if an object needs to be restored, it is important to find the best qualified restorer for the type of object. If a restorer is used who is not an expert with the asset class, the object may result in depreciation.

B. What are the financial considerations of Tangible assets?

1. Using Art and Collectibles as collateral

a. Describe the types of lenders who will lend against passion assets

b. Discuss the trends in collateralizing art and collectibles

c. The importance of using MCV or FMV to determine the value of the object

2. Monetization strategies

a. Tax implications and strategies of sale

Blockage issues- Blockage discount may be allowed where a large quantity of any one type of art is offered on the market at

one time, and would substantially depress its value. Often blockage is applied to artist estates. A discounted value (or blockage) needs to be applied to a large number of similar objects in a estate. For example, if there are 100 watercolors by the

b. Case study— Lisa de Kooning and blockage discount for estate. In 2017, the estate of Lisa de Kooning filed a petition in the US Tax Court after the IRS increased the value of the de Kooning estate by \$231 million resulting in a \$92 million tax bill. The estate of Lisa de Kooning consisted of a collection of artwork, including 57 paintings, 83 sculptures and 51 drawings by her father, Willem de Kooning. Originally the estate had appraised the collection at \$231.4 million, but when determining the total estate tax owed, the estate discounted the value of the collection by nearly 60% for the paintings and 85% for the sculptures applying the blockage concept. The IRS determined that the estate could not apply blockage discounts to the value of the artwork.

Blockage discounts reflect the economic concept that introducing a large number of art items by the same artist into the market would decrease the value of the individual works. In order to determine the appropriate value of the estate for tax liability purposes, the appraiser would apply a blockage discount to reflect the market economics.

No precise calculation exists for blockage discounts. For the Calder court case, the IRS used the same approach for valuing annuities by considering the rate of liquidation at a uniform rate over a period of time. If an attorney is working with an estate with a large number of art items and a blockage discount is going to be applied, it is important that the blockage discount be carefully evaluated and supported with strong analytics and narrative.

3. Succession plan

a. Discuss Tax implications and risk management strategies

- Are items equitably distributed between heirs?
- Was FMV used for the gift tax valuation?
- Do heirs have appropriate risk management strategy for inherited objects?

4. When does a collection become legally significant?

a. Contested value in estate settlement or donation

- IRS Art panel—What are the issues and concerns regarding appraisal reports? These items should be included:
 - Appropriate comparables
 - Photographs
 - Narrative
 - Quantitative analysis
- Significant asset in matrimonial or bankruptcy proceedings may required that objects have a more detail narrative or quantitative analysis
- Contested value in insurance litigation- depending on the insurance claims terminology, some insurance companies require FMV and others retail replacement. It is important for attorney's to understand the required value to settle the claim.

a. Challenging changes in valuation

- a. Case study –Value change after donation was completed. Understanding market changes and methodology with the IRS guidelines. A Nobel Peace Prize was originally valued for the weight of the gold at \$88,000 because there were no comparables at the date of donation. Within two years after the donation, three Nobel Peace prize medals were auctioned. Under IRS guidelines, a new valuation can be completed up to three years after donation if comparables occur in the market. The new value for the donation had been adjusted to close to \$1mm.

b. Alternative to 1031 Like-Kind Exchange

- a. Instead of reinvesting in art, a client can allocate a capital gain from art to real estate. Opportunity Zones are economically distressed communities where new investments may be eligible for preferred tax treatment. Regulations allow for tax deferral on proceeds from the sale of an appreciated asset. Assume a client purchases artwork for \$9 million and then sells the artwork for \$10 million. Instead of paying tax on the \$1 million, a client can take the \$1 million and invest in an opportunity fund. The gain must be invested within in 180 days of the sale. There is a 10-15% exclusion of the deferred gain.

5. Philanthropy

- a. Benefits of using tangible assets for philanthropic initiative
- b. Understanding appropriate use rule
- c. IRS concerns for donations to an institution
 - 1.) Confirm that institution is interested in the item(s).
 - 2.) Own Object for more than one year.
 - 3.) Be aware of appropriate use rule—IRS requires that donated work be used by the charity in a way that is related to its mission.
 - 4.) Qualified appraisal (IRS requires a formal valuation report for all items with fair market value of \$5,000 or higher). Who is not qualified to appraise?
 - 5.) Charity must agree to hold onto item for 3 years to receive full deduction
 - 6.) Other options for tangible assets including creating trusts, foundations, private museums

6. Protecting Tangible Assets

- a. Case study—Risk Management and Claims scenario
- b. Storage strategies—Protection and tax benefit

Learning Objectives

After completing this course, you will be able to:

- Understand valuation issues, including those specific to individual asset classes, such as art, jewelry, wine and other collectibles.
- Recognize when a collection constitutes a significant asset.
- Better understand the IRS Art panel review process.
- Recognize potential issues of collections that can impact estate planning
- Be acquainted with the various strategies for monetization
- Acknowledge potential philanthropic initiatives using tangible assets for both tax benefit and for improving family dynamic.

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