Opportunity Zones Help U.S. Collectors Reduce Taxes on Art Sales

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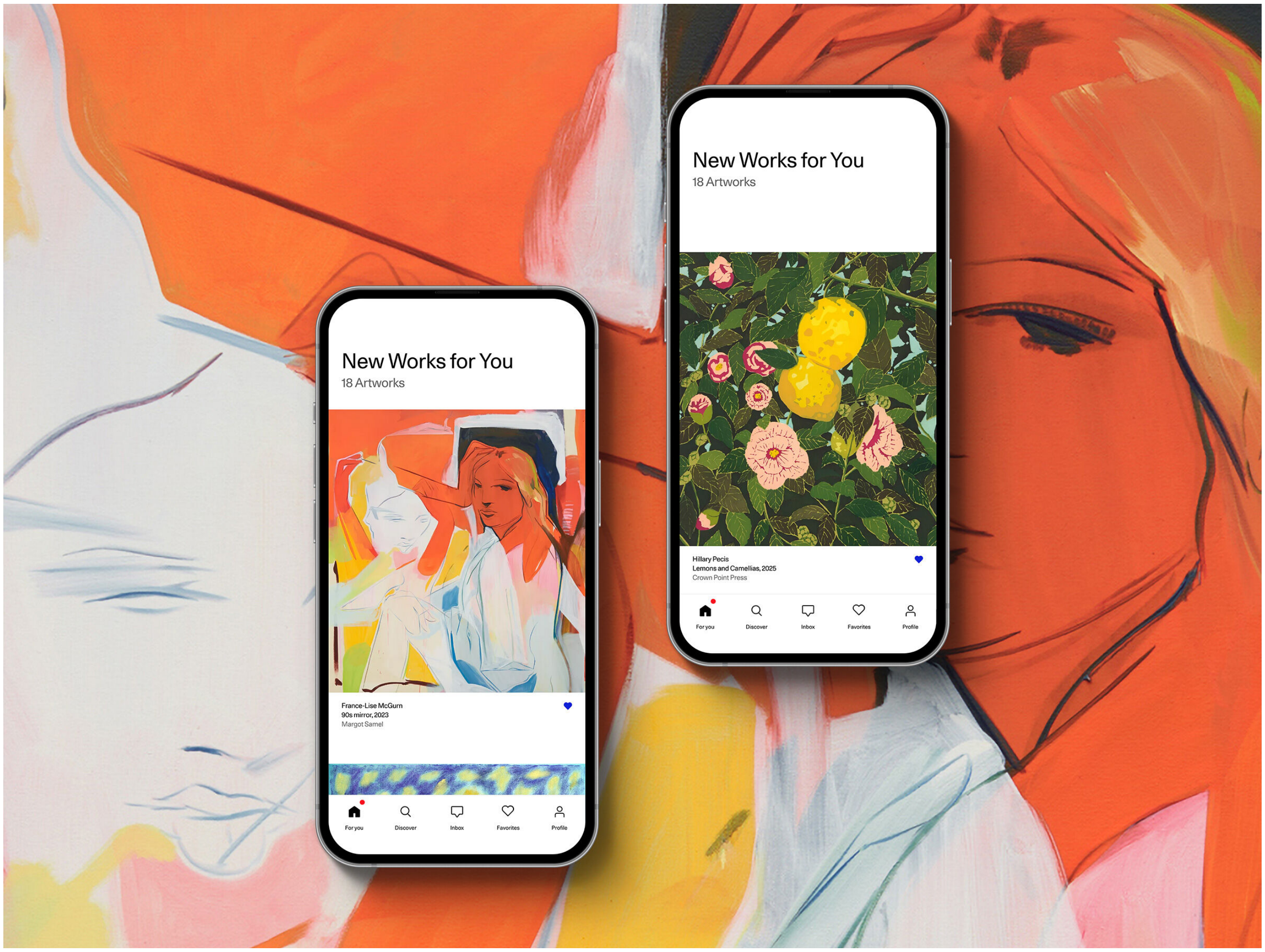

Art Market

Doug Woodham and Anna Louie Sussman

Amy Greenan

And Then We...And Then It, 2014

Susan Eley Fine Art

When the 2017 tax reform took effect last year, art-world watchers feared the elimination of an important tax break for art investors would dent the market. But not only has the U.S. art market held steady, it could benefit from a new tax break for investments in struggling neighborhoods.

In 2018, an estimated $67.4 billion of art changed hands, nearly half of it—$29.9 billion—in the United States, according to UBS and Art Basel's *The Art Market 2019* report. That's despite the loss of what is called a 1031 Exchange, or a "like-kind exchange," a provision in the tax code that allowed U.S. taxpaying art collectors to defer taxes if they sold a valuable work and then used the proceeds to buy more art. In that way, it encouraged both the buying and selling of art. So much so, in fact, that tax lawyer Amanda Rottermund, a New York–based associate in art practice at law firm Withers, recalls she and her colleagues getting calls practically up until New Year's Eve of 2017 from clients hoping to get a few last transactions in before the tax break expired.

The Tax Cuts and Jobs Act of 2017 eliminated that provision for all types of assets except real estate (no prizes for guessing why). But there is a new law whose details are currently being finalized by the Treasury Department. Under this law, the "Investing in Opportunity Act," capital gains taxes on certain assets, including art, can be deferred and potentially reduced if the profits are directed toward neighborhoods known as "opportunity zones." In other words, the lucky art collector who bought a Jean-Michel Basquiat painting in the 1980s, and who will make millions of dollars in profit selling it this year, could get a substantial break from the Internal Revenue Service (IRS) if she channels those millions toward economically disadvantaged communities.

"Opportunity zones are the next opportunity for deferring capital gains tax," said Rottermund, though she warned that it won't have quite the same double-boost as the 1031 exchange. "It's not like the like-kind exchange where you're selling art and [are] able to reacquire and invest back in the art market directly."

Wall Street players are already lining up funds to plough into these zones. For individual art collectors, they also offer an attractive opportunity to save on taxes and potentially stimulate "creative capital," since several opportunity zones in New York State alone are located near burgeoning cultural corridors.

How it works

If a collector sells an artwork, the IRS taxes any profits (known as "capital gains") at 28%. The collector may also have to pay a 3.8% Medicare surtax on this gain, plus applicable state-based capital gains taxes. However, if their profits are invested in an opportunity zone for at least seven years, 15% of the original capital gain can be excluded from federal taxation. What's more, the collector would not owe federal taxes on any gains in her investment in the opportunity zone—say, a building or a business—if it increased in value and was held for at least 10 years. The benefit is particularly useful for art investors, since the 28% tax rate is higher than the 20% tax rate for capital gains from the sale of financial assets such as stocks or bonds.

So for the aforementioned hypothetical collector who bought a Basquiat painting for $100,000 in 1983 and sells it at auction this year for a profit of $10 million, ordinarily, she would have to pay $2.8 million in federal capital gains taxes and $380,000 in Medicare surtaxes. But if she reinvested that $10 million in an opportunity zone and held it there for at least 10 years, she could defer paying these taxes until 2026, reduce the size of the gain subject to federal taxation by 15%, and pay no federal taxes on any appreciation in the value of her $10 million investment. (How these tax benefits work is explained in more detail in a recent research report by Doug Woodham.)

“Investors who are comfortable investing in real estate, a lot of them are also art investors,” said Rottermund. “That kind of group, we’ve seen them be more interested because they’re already comfortable making investments in real estate. For other art investors who don’t have that crossover, they’re kind of still watching to see what happens.”

The opportunity zones were nominated by governors and certified by the Department of the Treasury in April of last year, and received final approval in June. Whether or not an investor is better off directly investing in the zone, such as through starting a business in the area or buying a building, versus investing in one of the many funds that has sprung up, will depend on the final regulations from the IRS, Rottermund added.

“We’re waiting to see what the [regulations] say before really exploring how people can invest directly in those areas,” or through an investment vehicle such as a fund, she said.

A “throughline”

Laura Callanan, founding partner of Upstart Co-Lab and an advocate for what she called “creativity lens investing,” said she anticipates interest from art collectors looking to put their gains to work in a way that aligns with their existing passions.

“We think that there’s a lot of potential in working with art collectors who clearly already care about art and design and culture and creativity, and have lost the 1031 exchange,” Callanan said. “There should be a throughline between folks who love the arts; they have capital gains that they want to defer and shelter, and opportunities to do something positive in the opportunity zones connected to the creative economy.”

Callanan said she is working with partner organizations to identify a pipeline of qualified projects across the country for when investors are ready to dive in. She also pointed to past successes in similar attempts at investments in creative placemaking in low- and middle-income communities, such as those targeted with funds from the Community Reinvestment Act, which she recently highlighted in a report for the Federal Reserve Bank of San Francisco.

For socially minded investors, being able to show a track record is important, especially since this new program of opportunity zones is still untested.

“The story of where their money will go is very, very important,” said Callanan. “It’s not simply a financial transaction, particularly if you’re talking to art folks who…might be less savvy on the real estate investment side. They want to understand the social impact that their money can have, which means you’ve got to have a little bit more clarity about the types of projects you might be investing in.”

Where to invest?

There are 8,700 opportunity zones across the country and in U.S. territories, each of them corresponding to a census tract. According to the Economic Innovation Group, a Washington, D.C.–based think tank that helped develop the Investing in Opportunity Act, “zones have an average poverty rate of nearly 31 percent, well above the 20 percent eligibility threshold, and an average median family income of only 59 percent of its area median, compared to the 80 percent eligibility threshold.”

At least some of these zones lie next to or around existing cultural hotspots. In upstate New York, the Albright-Knox Museum, the recipient of a $42.5 million challenge gift from art collector Jeffrey Gundlach, is one block away from an opportunity zone in the Buffalo area. The opportunity zones program could stimulate incremental investment in the zones located near the museum along the Elmwood Avenue corridor.

Rottermund said she and her colleagues are interested in several zones in New York City, citing a tract in Hell’s Kitchen—not far from Midtown’s Theater District and the new high-end development Hudson Yards—as one potential option. There are also opportunity zones on the Lower East Side and in Chinatown, neighborhoods home to many nonprofit and commercial art spaces.

Leah Hokenson, assistant vice president and estate settlement officer at wealth management firm Fiduciary Trust International, said she anticipates much more interest in creativity-focused opportunity zones once the rules around investment are finalized.

“Although there has not been a race to sell artwork and reinvest triggered capital gains into opportunity zone funds, this tax strategy presents unique opportunities,” Hokenson said. “Once more clarity is released by Treasury, the due diligence and capital deployment into the impact-oriented funds will likely gain even greater momentum.”

Doug Woodham

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