Morgan Stanley

WEALTH MANAGEMENT

Art Resources Team (ART):

Art as an Asset

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EXECUTIVE SUMMARY

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.

SALIENT 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
- Borrowing

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 tax and estate planning with the art and a valuation expert can help to value the art. 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 valuation, tax and legal advisors be familiar with the requirements for appraisals and Internal Revenue Service (IRS) policies and procedures for valuing artwork. The following discussion of tax consequences refers to federal taxes except where state and local taxes are specifically noted.

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 and rules 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

		DESIRED ART RECIPIENT	ENJOY ART DURING LIFE	MAY MITIGATE ESTATE TAX	MAY MITIGATE INCOME TAX
No Planning	During life	No	Yes	No	No
Purchase Life Insurance	During life	No	Yes	Yes	No
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	Possibly
Donate the Art to Charitable Beneficiary	During life	Yes	No	Yes	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 federal estate taxes are due within nine months of the date of death and state estate taxes, if any, are due within a period of time prescribed by each state. 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 help pay the premiums for the life insurance on the collector's life. The trustee can then take cash proceeds from the ILIT and use them to purchase illiquid assets (i.e., the art) from the collector's estate, who in turn may use the cash to pay estate taxes. While a collector can continue to enjoy the art while living, challenges involved with this strategy 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.
- *Sell the Art:* 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 appropriate 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 a federal income tax consequence as the collector will pay a higher capital gains tax rate of 28% for collectibles (versus a maximum 20% long term capital gain rate on other types of assets). This assumes the art qualifies as "long-term capital gain collectible property" with a 28% tax rate as opposed to qualifying as "short-term capital gain property" or "ordinary income property" with a maximum 37% tax rate.

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 the trust is uncertain. In a CRUT, art or other appreciated property is put in a trust, sold and the proceeds reinvested. During the term of the CRUT, distributions will be made at least annually to the non-charitable beneficiaries (typically the collector and/or members of his or her family). The remaining assets in the trust at the end of the trust term are paid to the named charity. The capital gain tax resulting from selling the art is deferred over the lead term of the trust and gets distributed to the non-charitable beneficiaries with the annual unitrust distribution. The collector may be entitled to an income tax charitable deduction on contribution to the CRUT. The deduction will be based on the cost basis (not the fair market value) because the artwork would be sold and therefore fail the related-use test.[1]

If the collector intends for the collection to be sold at death then the collector may enjoy the collection while living however, the collector will not have control over who purchases the art. If the art appreciated during the collector's lifetime, it will have received a step-up in basis to fair market value at the time of the collector's death. This will reduce or eliminate any gains realized on a sale by the beneficiaries. However, this income tax advantage should be weighed against the estate tax cost of including the art in the collector's estate. Some expenses incurred in selling the art during 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) created upon death. At death, the art would be put in the CLAT, sold and the proceeds reinvested. The charity receives an annuity payment from the trust each year of the lead term and the non-charitable beneficiaries receive any remainder at the end of the lead term free of any additional federal transfer taxes. The collector's estate will receive an estate tax deduction equal to the fair market value of the art contributed to the CLAT at the time of death less the present value of the remainder interest.

- *Gift the Art to a Non-Charitable Beneficiary:* 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 $17,000 per beneficiary per year, and their lifetime exclusion of $12.92MM (for 2023) per person. A gift in excess of this amount will be taxed at the top 40% federal gift tax rate. The primary planning reason for gifting art or other assets to beneficiaries during life is to reduce the size of the collector's estate and force any growth to occur 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 may be higher. If the gift is made during life and the recipient of the art eventually sells the piece, in determining any gain on the sale, 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. If the art is transferred at the collector's death, the recipient's cost basis will be equal to the fair market value of the art as of the collector's death. 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 art itself to a beneficiary outright, the collector may transfer art to a Limited Liability Company (LLC) or a Family Limited Partnership (FLP). The LLC or FLP owns the art and can be 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 donor may then gift LLC and FLP interests. The benefit of this structure is it is easier to divide the ownership of an LLC

[1] Ramsay H. Slugg, "Art Collectors and Their Advisors", *ABA Publishing, 2015 (95).*

or FLP amount among multiple recipients than to transfer an interest in the art itself to multiple recipients. Collectors who want to transfer multiple pieces can keep the entirety of the collection together by contributing the whole collection to the FLP or LLC. At death, probate is simplified because the collection is owned by the LLC or FLP and interests in the entity are transferred rather than specific pieces of art.[2]

However, art's lack of liquidity and issues relating to valuation and cash flow do pose significant challenges to estate planning with art, including use of LLCs and FLPs. While the value of illiquid assets can generally be discounted for lack of marketability and, in some cases, lack of control, the IRS closely scrutinizes such discounts on the value of art for gift or estate tax purposes, even where the art is owned by an LLC or FLP. 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 payments to be made back to the grantor/collector may not work well with art because generally art does not generate cash flow to satisfy such payments, and satisfying the payments by transferring an interest in the art itself can necessitate an appraisal of the art for every payment.

Noting the aforementioned challenges, if enough cash flow can be generated from the art, another consideration might be a combination of an 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 considered the same taxpayer for federal income tax purposes and therefore the collector does not incur a taxable 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.[3]

- *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.

  By donating art to a charitable beneficiary at death, the deceased's estate receives an estate tax charitable deduction equal to the fair market 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 U.S. citizen 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 for the predeceased spouse to leave the artwork to the surviving spouse. The surviving spouse can then receive the federal income tax deduction by donating the art before death, but doing so gives up the benefit of keeping the art.[4]

[2] Ramsay H. Slugg, "Art Collectors and Their Advisors", *ABA Publishing, 2015.*
[3] Ramsay H. Slugg, "Art Collectors and Their Advisors", *ABA Publishing, 2015 (75-82).*
[4] Ramsay H. Slugg, "Art Collectors and Their Advisors", *ABA Publishing, 2015 (115).*

If the collector donates art during life, the IRS specifies the following with regard to charitable income tax deductions:[5],[6]

- If ordinary income property (or tangible personal property that will be used in a manner related) to **public charity** then deduct the lesser of fair market value (FMV) or cost basis of the property up to 50% of adjusted gross income (AGI)
- If ordinary income property (or tangible personal property that will be used in a manner related) to **private foundation** then deduct the lesser of FMV or cost basis of property up to 30% of AGI
- If long-term capital gain property (or tangible personal property that will be used in a manner related) to **public charity** then deduct FMV of the property up to 30% of AGI
- If long-term capital gain property (or tangible personal property that will be used in a manner related) to **private foundation** then deduct the lesser of FMV or cost basis of the property up to 20% of AGI
- If tangible personal property that will not be used in a manner related to charity's purpose to a **public charity** then deduct the lesser of FMV or cost basis of the property up to 50% of AGI
- If tangible personal property that will not be used in a manner related to charity's purpose to a **private foundation** then deduct the lesser FMV or cost basis of the property up to 20% AGI

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 no earlier than 60 days before the gift and no later than the date on which the donor's federal income tax return is due (including extensions), and that an appraisal summary (or a copy of the appraisal, if the appraised value is more than $500,000) 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 used in a manner 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 for more than one year is long-term capital gain property and qualifies for deductibility at full fair market value if it meets the related use rule discussed in the prior paragraph 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) the donor is a dealer who held it as inventory for sale

[5] References in this section to private foundations mean private non-operating foundations. Different rules may apply to donations made to private operating foundations.

[6] Classification of art subject to IRS determination. Unrelated use rules only apply to tangible personal property.

to customers in the ordinary course of business, 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 the lesser of fair market value and cost basis only up to a maximum of 50% of AGI, subject to the same five-year carryforward.

While a collector may donate art to any charitable beneficiary, museums are good candidates because they may want the art, the donation can result 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 donation 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 tax-exempt 501(c)(3) organizations. Applying for federal tax-exempt status occurs after the organization is legally incorporated, and the organization may be required to separately apply for tax-exempt status at the state and local level. 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 which channel the art is being sold. While commissions may vary and are negotiable, the combined commissions at auction houses may be more than 20% depending on the 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 and the buyers will often set aside the purchase piece to insure that they are the successful purchaser. While a higher sales price is advantageous to the seller, the federal capital gain tax is 28% on art in contrast to a maximum 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 address issues of 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 had authenticated works in the past, some have now terminated this service due to litigation concerns.

Valid title is more difficult to establish in the art market than with many other assets. The first step in due diligence is generally to check 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, sales 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 that the 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 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 amount of coverage provided by an insurance policy is fixed. An art appraiser can be brought in periodically to re-evaluate the value of the art in order for the collector to maintain the appropriate amount of 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

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.[7] 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".[8] 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 the appraised value is $50,000 or more, the collector can request a Statement of Value from the IRS, and the collector can rely on such value in completing their tax return. Further assumptions for determining 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.[9]

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.[10]

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 determines the value of the artwork and describes how the appraiser determined that value. 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. 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 of art, Congress created the Art Advisory Panel of 25 art experts to assist in reviewing art appraised for $50,000 or more. If a tax return under audit includes an appraisal of a work of art valued at $50,000 or more, then the examining agent is generally required to submit the appraisal to the Office of Art Appraisal Services for potential referral to the panel. The panel consists of auction house representatives, dealers, curators, and other art experts.

Borrowing

Loans secured by art may enable collectors to defer 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 a maximum 20% for financial securities
- State and local taxes can result in a total tax bill of 40% or more on the gain

[7] Ramsay H. Slugg, "Art Collectors and Their Advisors", *ABA Publishing, 2015 (27).*
[8] Cornell University Law School, "Valuation of Property, in general" https://www.law.cornell.edu/cfr/text/26/25.2512-
[9] Branch Banking and Trust Company, "Planning for Art and Collectibles" https://www.bbt.com/wealth/retirement-and-planning/planning-and-guidance/planning-for-art-and-collectibles.page
[10] Venable LLP, "Art is Long, Life is Short: Estate Planning For the Artist and the Art Collector," May 2012.

- 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 may allow the collector to retain ownership of the art for enjoyment purposes as well as retaining the potential future appreciation in value. Finally, borrowing may assist in avoiding a potential public sale thus preserving confidentiality.

ROLE OF 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."[11]

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.

Alternatives to Direct Art Investments

It is not known what portion of global sales of art is attributable to non-financial versus financially motivated collectors. 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 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.

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 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 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.

11 Bloomberg News, "NY Apartments, Art Top Gold as Store of Wealth, BlackRock Chief Says," 21 April 2015, https://www.bloomberg.com/news/articles/2015-04-21/new-york-apartments-art-top-gold-as-stores-of-wealth-says-fink#xj4y7vzkg

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 a 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 publicly realized prices.

One of the earliest and most successful art investment funds was La Peau de l'Ours, or "The Skin of the Bear". The syndicate was arranged in 1904 by businessman, art critic and collector André Level – it has been suggested, inspired by a plan set forth by Henri Matisse – the aim of which was to buy affordable works by emerging and under-appreciated artists over a period of 10 years, then to be sold in one auction. Level was the syndicate's manager and arbiter of taste, responsible (with majority assent of 3 advisory council members, one of whom was Level) for selecting and acquiring paintings by young and under-recognized talents including Raoul Dufy, Matisse, Pablo Picasso, Odilon Redon, Paul Gauguin and Vincent Van Gogh. A public sale of the 145 works was held at Parisian auction house Hôtel Drouot in 1914. It was the first time many 20th century artists including Picasso were tested at auction, whose paintings along with Matisse attracted the highest bids. La Peau de l'Ours had a relatively modest total investment of 27,500 French francs at the time over 10 years, with gross auction results before fees and distributions of 116,545 French francs. The partners were paid an initial distribution of 3.5% of the auction profits, a management payment of 20% was then made to Level, and provisions also stipulated that the artists or their estates would receive a royalty of 20% share of profits (net of expenses). Investors received the remainder in equal proportions.[12]

La Peau de l'Ours presaged the most arguably well-known art fund, the British Rail Pension 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

[12] Forbes, "Artful Art Investment: "The Skin of the Bear", 24 Oct 2017, https://www.forbes.com/sites/claytonpress/2017/10/24/artful-art-investment-the-skin-of-the-bear/?sh=178398de6988

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 limited 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 over 7 years. 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 – some more successfully than others, 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.[13]

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 in 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.

UNDERSTANDING ART AS AN ASSET

Art has become increasingly more accepted as an asset given "art transactions have recently accounted for over $60 billion annually,"[14] 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[15] and it is estimated that over $2[16] 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.

Every collector should be aware not only of the unique qualities of art as an asset but also the responsibility of owning art.

[13] The Economist, "Qatar's Culture Queen", 31 March 2012, *http://www.economist.com/node/21551443.*
[14] Anna Louie Sussman, "Is Art an Object of Passion or an Asset Like Any Other?" https://www.artsy.net/article/artsy-editorial-art-object-passion-asset-other.
[15] Jianping Mei and Michael Moses "Wealth Management for Collectors", *Journal of Investment Consulting Vol. 11, No.,* 12 October 2010 (50-59)
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6. Classification of art subject to IRS determination. Unrelated use rules only apply to tangible personal property.
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