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## Sales and Use Tax Issues Relating to the Purchase and Sale of Works of Art

As art prices reach record highs, collectors and advisers increasingly are focused on planning to minimize sales and use taxes when art is bought and sold. In most states, the sale or purchase of a work of art may be subject to a statewide sales tax, a local sales tax, or both, depending on the location of the sale and any applicable exemptions. In some areas, the combined state and local tax rate can exceed 10 percent, a significant cost when applied to art valued in the millions or tens of millions of dollars. For collectors who purchase high-end art—and who have family members, residences, or business or family offices in multiple states—navigating the sales and use tax rules that apply in different jurisdictions can be challenging but may also provide opportunities for tax savings.

### Sales and use taxes

Most people understand that a sales tax is imposed by a state on the sale of tangible personal property (works of art, automobiles, jewelry and furniture, for example) within that state. The use tax, which is more obscure, generally is assessed when a purchaser buys tangible personal property in one state, without paying sales tax (or paying sales tax at a lower rate), with the intent to bring the property into another state (usually the purchaser's "home" state). The use tax is a complement to the sales tax. For example, without the use tax, a person could avoid sales tax in her home state by purchasing a car in another state that has no sales tax. Under the typical sales and use

tax structure, when the buyer brings the car into her home state, she must pay a use tax if she paid no sales tax (or a lower sales tax) in the state where the car was purchased. If she paid sales tax in the state where the car was purchased, the buyer generally gets a credit against the use tax liability in her home state.

Only three states—Delaware, New Hampshire and Oregon—do not have statewide or local sales and use tax laws. (Montana and Alaska have no statewide, but do have local, sales and use taxes.) All states that have sales and use taxes have various exemptions to the imposition of the taxes. Knowing the nuances of both the state in which the property was purchased and the state in which the property will be used will enable sellers and purchasers to minimize the tax to the extent possible.

### Sales of art

The seller of tangible personal property generally is responsible for paying sales tax in the state in which the sale occurs and typically collects the sales tax from the purchaser as part of the purchase. If a seller of a work of art sells through a dealer or an auction house, the dealer or auction house will collect the sales tax from the purchaser. All standard auction contracts with reputable auction companies obligate the auction company to collect sales tax and indemnify the seller against imposition of the tax. A

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seller who sells through a dealer should make certain that the contract obligates the dealer to collect sales tax and indemnifies the seller against the tax.

In a private sale transaction not involving a dealer or an auction house, the seller should collect sales tax from the purchaser and remit the sales tax to the appropriate taxing authorities in the state, unless an exemption applies. For example, California has four common exemptions:

1. The sale is to a dealer or someone else who provides the purchaser a valid resale certificate.
2. The sale qualifies as an “occasional sale,” which applies when a seller who is not engaged in the business of selling tangible personal property makes fewer than three sales in a 12-month period.
3. The sold item is shipped out of California via common carrier, and the contract of sale requires the shipment out of state via common carrier. While most states have a similar exemption, California and Illinois are unusual in that the contract of sale must require the shipment via common carrier; most other states (including New York) just require the shipment to occur.
4. The purchase is for a museum.

New York (but not California or Illinois) has what is sometimes referred to as the “trade-in” exemption. If a collector transfers a work of art to a New York dealer as partial or complete payment for the purchase of a different work of art from the dealer, and the dealer intends to hold the traded work of art for resale, a sales tax credit is allowed to the collector for the value of the traded work. If the value of the traded work is equal to the value of the purchased work, then no sales tax is due because the net sales price, taking into account the credit for the traded work, is zero. The credit does not apply if the transaction occurs between collectors; the collector must exchange the work of art with a dealer.

Note that a trade of a work of art for another work of art no longer qualifies as a “like-kind” exchange under Internal Revenue Code §1031. The Tax Cuts and Jobs Act of 2018 eliminated like-kind exchanges for tangible personal property; like-kind exchanges can be made only for real property. Accordingly, in the two trade-in examples above, the collector will owe income tax on the transfer if the collector’s income tax basis in the work of art given up is less than the fair market value of the work of art that was acquired. The dealer who transfers the dealer’s work of art to the collector will pay income tax on the difference between the dealer’s income tax basis in the work of art given up and the fair market value of the acquired work of art.

### Purchases of art

While the seller has to consider only whether he has an obligation to collect sales tax from the purchaser, the purchaser has to consider whether a sales tax (for property purchased within a state) or use tax (for property purchased outside the state with the intent to bring it into the state) is payable as a result of the transaction.

Some states, including California, have been very aggressive in tracking purchases of art to determine whether a use tax is applicable. California’s Franchise Tax Board has an office in New York that tracks transactions involving art. Under New York’s sales and use tax law, if a work of art is purchased in New York but is shipped out of New York via common carrier, there is no New York sales tax obligation. If the purchaser is a California resident, however, and the work is shipped to California for use in the state, the purchaser must pay California use tax. By checking auction records, bills of lading, export and import documents, and other similar documentation, the California Franchise Tax Board’s office in New York can determine whether works of art purchased in or coming into the United States from abroad are destined for California and whether the purchaser has a use tax obligation. California residents also have

an affirmative use tax reporting obligation, and the California income tax return has a question that asks whether the taxpayer owes California use tax for the taxable year.

Unless an exemption applies, a purchaser of a work of art must pay sales tax in the jurisdiction in which the sale occurs. By taking advantage of the disparity in state sales and use tax laws, however, a purchaser may be able legally to reduce sales and use taxes or even to avoid them entirely. For example, a New York or Illinois collector may wish to purchase a work of art in her home state for display in a vacation home or a family office located in another state. If the other state is one that has a lower use tax (such as Florida, Maine or Colorado) or no use tax (such as New Hampshire), the tax cost can be reduced or eliminated by having the work shipped via common carrier to the vacation home or office. The purchaser should make sure that the shipping arrangements are made by the dealer or auction house; if the purchaser arranges for shipping, the purchaser may be deemed to have taken possession of the work and be required to pay sales tax in her home state.

If a California resident purchases a work of art in New York and ships it from New York via common carrier, she owes no New York sales tax. If the work of art is shipped to a state without a use tax for use within that state (i.e., Delaware, New Hampshire or Oregon), no California use tax may be payable even if the purchaser ultimately brings the work of art into California. Under California law, if tangible personal property (including a work of art) is first used outside California for a period of at least 90 days, the presumption is that the property was not purchased for use within California. California law is not clear on the meaning of “use” in this context, however. California law provides that use of property means use for the purposes for which it was designed. While storage out of state clearly is not a use under this definition, a loan of art for use out of state should be a “use.” For example, if a California purchaser lends

a work of art to a museum in a state that does not have a use tax for at least 90 days and then brings the work into California, the transaction should not be subject to California use tax. The result should be the same if the California purchaser lends a work of art to a family member or family entity for use in another state for the requisite period of time. For example, the California purchaser could lend the work of art to an out-of-state relative for temporary display in the relative’s home or to a family business office in another state.

These types of art loan transactions—whether they involve museums, family entities or individuals—have not been legally tested and may be subject to challenge. The California 90-day rule creates only a presumption that the property was not purchased for use within California. The Franchise Tax Board may take the position that, based on all of the facts, the property was purchased for use in California and the interim loan should be disregarded. In states without such a rule (including New York and Illinois), a loan to a museum or other entity or individual in a no-sales-or-use-tax state may not relieve the purchaser of a use tax obligation when the property is brought into the purchaser’s home state.

Because most states allow shipment out of state to avoid the state sales tax for purchases within the state, shipping a work of art to a state that has a use tax and lending it to a museum (or other entity or individual) in that state in order to avoid the sales tax likely will not relieve the purchaser of liability for the use tax. While many states are not as aggressive as California in enforcing their use tax, the tax obligation exists nonetheless. Whether a use tax will be due when the work of art ultimately is brought into the purchaser’s home state depends on that state’s law.

Delaware has created an art storage facility that is designed to be a “free port,” a carved-out portion of a jurisdiction in which no taxation occurs. The free port is analogous to the grounds of an embassy that are located within a country but actually belong to the

country owning the embassy. Transactions involving art, primarily purchases and sales, can occur within the facility without the imposition of Delaware's income tax and without sales tax in the home state of the purchaser and seller as long as the work remains in the facility.

For U.S. citizens and U.S. income tax residents, transacting purchases and sales within the free port may defer or eliminate sales or use tax but has no impact on the obligation of the seller to pay income tax on any gains. While there may be no income tax liability in Delaware, the seller still is obligated to pay federal income and most likely state income tax even though the sale transaction takes place outside the seller's home state. With respect to use tax, if the purchaser brings the work into the purchaser's home state, absent an exemption in the home state, the purchaser will be liable for use tax. In states including California that have the 90-day first-use rule, storage in a free port is not deemed a use, so the California resident who brings the work into California will be liable for use tax. If the purchaser resells the work while it is still in storage in the free port and ships it directly to the buyer in another state, the original purchaser will have avoided the use tax entirely. This strategy is attractive to purchasers who acquire works of art purely as an investment, with no intention to take possession in the home state prior to resale.

Non-U.S. taxpayers may achieve certain tax benefits by transacting business within a free port, depending on the income tax status of the purchaser or seller.

### Personal property tax

Many states impose a personal property tax on items of tangible personal property located within the jurisdiction on a certain date during the year, which is generally referred to as the "lien date." Items of tangible personal property that are classified as "household goods" or "personal effects" usually are exempt from the imposition of the tax. A work of art not used in a trade or business is usually considered a personal effect that is exempt from the tax, but if

the work is loaned to a museum in the collector's state or in another jurisdiction, its characterization may change. While virtually every state with a significant number of museums has enacted laws exempting loans of art from their personal property tax, collectors should consider the personal property tax considerations when purchasing or lending works of art.

### Resale royalty

California is unique among the states in imposing a royalty of 5 percent on the resale of a work of art. Virtually every European country has a similar law, called "droit de suite." Under the California statute, the royalty is payable if the seller resides in California or the sale takes place in California. A recent federal appellate court case, however, found the statute invalid, except perhaps for sales occurring in 1977, before the federal Copyright Act pre-empted the California statute. The case may be appealed to the United States Supreme Court, but it is unlikely that the Court will agree to hear the case. The most likely result is that the appellate court's decision will stand and no royalties will be payable under the California statute.

### Conclusion

Sales, use and personal property taxes are key considerations for collectors selling or purchasing works of art. Through proper planning and careful adherence to the provisions of applicable state laws, collectors may be able to achieve significant tax savings.

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