

Art-Related Tax Issues

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I. TAX ISSUES FOR ARTISTS SELLING THEIR ARTWORK

A. INCOME TAX

Sales of art work by the artist generates ordinary income, because the work is not a capital asset in the artist's hands. IRC § 1221(a)(3).

An artist cannot trade his or her work for other art work on a tax free basis.

“Qualified creative expenses” may be deducted as business expenses, rather than capitalized. § 263A. Those are expenses paid by individual writers, photographers, and artists in their trade or business. IRC §263A(h)(2). Photographic plates, motion picture films, video tapes or similar items are excluded.

Deductions to charity can only be deducted at the cost of the art to the artist (materials), not at the fair market value of the art. Many efforts to change this are underway legislatively.

B. SALES TAX- www.boe.ca.gov/

1. Obligation to Collect Sales Tax on Sales of Art

Tax does apply to finished art. Finished art is the final artwork prepared for reproduction by photomechanical or other processes, or used for display. It includes electronic artwork, illustrations (e.g. drawings, diagrams, halftones, or color images), photographic images, sculptures, paintings, hand lettering, etc. The measure of tax includes all charges for any rights sold with the finished art (e.g. copyrights or distribution and production rights.) Board Of Equalization Sales and Use Tax Manual, Chapter 11- 1103.15

2. Exemption for Graphic Artists

a) Preliminary Art & Conceptual Services

Tax generally does not apply to charges for preliminary art and conceptual services. Conceptual services are services performed to convey ideas, concept, messages, etc. prior to entering into a contract or obtaining approval for finished art. Preliminary art is tangible personal property prepared solely for the purpose of demonstrating an idea, concept, look or message for acceptance by the client prior to the preparation of finished art. Examples include roughs, visualizations, drawings, sketches, renderings, illustrations, layouts, comprehensives, photographs, negatives, transparencies, prints, copies, states, logotypes, scans, lasergraphics, visual prototypes and electronic imagery. It does not include items used to produce finished art. BOE Sales and Use Tax Manual, Chapter 11- 1103.10

b) Finished Art

Tax does apply to finished art. Finished art is the final artwork prepared for reproduction by photomechanical or other processes, or used for display. It includes electronic artwork, illustrations (e.g. drawings, diagrams, halftones, or color images), photographic images, sculptures, paintings, hand lettering, etc. The measure of tax includes all charges for any rights sold with the finished art (e.g. copyrights or distribution and production rights.) BOE Sales and Use Tax Manual, Chapter 11

C. ESTATE TAX

1. Basic Estate Planning Concepts & Techniques

a) Exemption from Estate Taxes

Current law allows every person an exemption from the federal estate taxes based on the overall value of their estate. The total exemption changes year to year...2004-2005 it is \$1,500,000. No estate tax must be paid on an estate valued at under that amount.

b) What is Taxed

Estate Tax is charged on the value of an estate at death.

Current law is that if you buy an asset for \$1,000.00, your "basis" is \$1,000.00. If you sell it for \$10,000.00, you have a \$9,000.00 capital gain. If you die when the asset is worth \$10,000.00, its basis in the hands of your heirs is \$10,000.00... in other words, the basis is "stepped up" at death. This eliminates or greatly reduced the heirs' capital gains tax.

But that will change in 2010 unless the law is changed before then, so that your basis is "carried over" rather than "stepped up."

c) Repeal Uncertain

2. Special Issues for Artists Estates- Art is a unique type of asset.

a) Management and care of art after artist's death- art trusts

b) Valuation of art's fair market value

FMV is what a willing buyer would pay a willing seller when each of them knows all the relevant facts and neither is forced to buy or sell.

Art is valued at the retail price, even if the artist only get 50% of the gallery's retail price.

Artist's art left in the artists estate is not treated as business inventory, but rather as "household and personal effects."

Cases: *Estates of Smith, O'Keefe, Warhol*- application of various blockage and other discounts to retail value.

II. TAX ISSUES FOR COLLECTORS

A. INCOME TAX ON SALES OF ART

Collectors must be distinguished from dealers and investors.

Dealers hold art primarily for sale to customers in the ordinary course of business. IRC §1221(a)(1), and can deduct their ordinary business expenses.

Investors buy art primarily for investment, with the primary objective of making a profit. Expenses incurred in the production or collection of income are deductible only to the extent the total of them exceeds 2% of the person's income. IRC § 212.

Collectors acquire art primarily for personal pleasure. A collector's expenses are not deductible except in connection with hobby loss rules. IRC § 262(a).

Works of art are generally not depreciable for tax purposes, either. Rev. rul 68-232.

B. CAPITAL GAINS ON SALES OF ART

A collector's losses are not deductible either. IRC § 165(c), But a collector's gains are still subject to tax as capital gains. IRC §1(h)(5).

C. USE TAX & PURCHASES FROM OUT-OF-STATE VENDORS (INTERNET)

1. **GENERALLY**, A collector is required to pay sales tax on art purchased. Can be substantial on very expensive art works.

2. **RESALE**

If art is purchased for the purpose of resale, the item will be exempt from use tax, such exemption taking the form of a tax credit (but note that the item must be bought in full with a lump sum payment). See attached Cal Rev & Tax Code § 6406 (2005).

3. **OUT OF STATE PURCHASES**

The core issue in California use tax is whether the item was purchased "for storage, use, or other consumption in this state." Cal Rev & Tax Code § 6201 (2005).

If so, then the item is subject to the 5% state tax. § 6201.1.

Items will be presumed to have been bought for the above-stated purpose unless otherwise stipulated. See attached Cal Rev & Tax Code § 6247 (2005).

Property that is purchased out of state and functionally used out of state for at least 90 days after purchase is EXEMPT from the use tax. CA RTC regulation 1620 (b)(3).

II. TAX ISSUES FOR NONPROFITS & MUSEUMS

A. NONPROFIT EXEMPTION FROM INCOME TAX

1. Income from the sale of art (deaccession) not taxed if part of the regular business of the museum.
2. Gift Shops and the Unrelated Business Income Tax
 - a) Must be reasonably related to nonprofit mission – include explanation cards with each items.
 - b) If not, then taxable under UBIT

B. NONPROFIT EXEMPTION FROM USE/SALES TAX

Art bought for the purpose of public display in a non-profit museum or gallery is exempt from sales and use tax.. See attached Cal Rev & Tax Code § 217 (2005).