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The Taxation of Art and Collectables

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1 Introduction

Art and other collectables, such as wine, jewellery, classic cars and yachts, are often celebrated for their contribution to contemporary culture. Whether they take the modest forms of paintings and boats, or embrace the avant-garde forms of augmented reality and digital video, art and collectables hold cultural value. In addition to their cultural value, what makes art and collectables unique is that they can simultaneously hold financial value. Hence the phrase "luxury assets". This paper will consider the tax issues of acquiring and disposing of luxury assets within the Australian legislative and regulatory framework. It will specifically focus on transactions involving art and cultural objects as the classic luxury asset paradigm.

The paper will firstly give a background overview of the market for acquiring and selling art and cultural objects. It will then consider how art is treated in the eyes of tax regulations. It will discuss issues to consider when looking to acquire and then later dispose of art, including GST and relevant entity structures. Finally, it will consider the legislative framework in place in Australia which governs the gifting of art and cultural property, particularly the Cultural Gifts Program.

2 The Art and Collectables Market(s)

Accurately relaying key statistics and figures about the art and cultural objects market is no easy feat. Indeed, this appears to be the case irrespective of whether one is tasked with doing so at a global level, or when surveying transactions within Australia. The reasons for this are related to the nature of acquiring and selling art itself. Traditionally, the acquisition and sales process is conducted behind closed doors and the terms of the transaction are rarely disclosed beyond those directly involved. Discretion is often a key characteristic of the transaction, usually favoured by both buyer and seller. As Andrew Bailey observed in his recent article for the *Australian Financial Review*, "there is no "standard" art work, transactions are difficult and costly, and market information is chronically poor. It's about as opaque a market as you can find."[2] With that said, the annual Art Basel UBS Report does provide a useful starting point for gaining a basic understanding of the global market for art and cultural objects – that is, a market which is separate from local markets for art and cultural objects, including the Australian art market. Some of the key takeaways from the recent 2018 Report include that the global art market amassed $67.4 billion in sales, growing 6% from 2017 to 2018.[3] The Report also provides that private collectors comprise 68% of that market share, while public museums making up 11% and private institutions another 6%.[4] Intermediaries such as art advisors and dealers make up 14% of that market share. However, each of these statistics are chronically affected by asymmetrical information flows from seller, to buyer and back again.

To this end another important characteristic of the art and collectable(s) market is the division between the "primary" market and the "secondary" market. The "primary" market refers to the first transaction of an item, with the artist being considered the seller. Whereas, the "secondary" market refers to all subsequent transactions of an item, with the seller being a private collector, a public or private institution, or a dealer. Excluding those art and cultural objects which are sold on the "secondary" market through auction on consignment to the auction house, sellers and buyers very rarely make details of sales (including the value of such sales) publicly available. Hence it is that lack of public knowledge of transactions involving art and cultural objects which make these markets for buying and selling particularly unique.

[2] https://www.afr.com/personal-finance/budgeting/thinking-of-investing-in-art-read-this-first-20190415-p51ecq.

[3] Art Basel & UBS Report, *The Art Market 2019*, p. 32, https://www.ubs.com/global/en/about_ubs/art/2019/art-basel.html.

[4] Art Basel & UBS Report, *The Art Market 2019*, p. 78, https://www.ubs.com/global/en/about_ubs/art/2019/art-basel.html. Advisors and other market professionals make up 14%, almost on par with museums and institutions.

3 Trading Stock Versus Collectables

Irrespective of whether any details of a transaction involving art are publicly available are not, tax implications can be triggered through the buying and selling process. Art can be viewed in many guises and in different ways depending on the intention behind acquiring the work. It can be bought as trading stock or bought as a collectable. Artworks in each of these categories are taxed differently.

3.1 Trading Stock

Art is primarily classified as “trading stock” when the art is being bought and sold by art dealers, art galleries and other art market professionals (“**AMP**”).

In most instances where the gallery or art market professional transacts on the primary market and works directly with the artist in the sale of the work, the artist provides their work to the gallery or AMP on consignment. In this case there is usually no outright purchase of art by the gallery or AMP and no transfer of title between the gallery or AMP and the artist. Rather, the gallery or AMP acts as agent for, and sell the work on behalf of the artist. In such instances the proceeds of the sale are owed to the artist. The gallery or AMP charges the artist a commission on the sale (at approximately 30 – 50% +GST depending on the nature of the relationship between the artist and the gallery and whether the gallery has funded the production of the work).

On the primary market, it is rare for galleries and AMP to purchase the work at value from an artist. Whereas, galleries and AMP that transact in the secondary market tend to either sell work on consignment on behalf of the collector owner, or buy it from the collector owner in their own name and then sell it. In the instance that the AMP has purchased the work at value from the artist or bought the work from a collector owner, the artwork is brought to account as stock at the lower of either the cost purchase price or the market value of the work. This is because title has now transferred to the art market professional and normal trading stock rules apply.

In addition, the stock of art is treated as purchases and sales are treated as normal income and the stock on hand is valued at normal valuation rules.

3.2 Collectables

One of the reasons why art is purchased, either on the primary market or on the secondary market, is because of its collectable nature. In addition to the emotional and cultural reasons for why a person may want to acquire an artwork, there may also be financial reasons. Like other forms of collectables, a person may purchase a work with the intention that some capital growth may accrue and with the expectation of a profit at the end of their holding period.

In the recent past we have observed the emergence of three groups of buyers who acquire collectables, particularly art. These are as follows.

a. Speculators

In certain instances, some people have tried to cash in on the rising market popularity of certain artists and have tried to seek large increases in prices over a relatively short period of time. In Australia, we have had periods of inflated prices for some artists, the most recent being from the early 2000s until 2008 – 9 (it is said that the art market(s) tend to suffer a flow on effect after significant market crashes, such as the 2008 GFC).

The term that has been coined for such art market speculators is “flippers”. However, in Australia where the local art market has cooled over the last decade (as opposed to the global international art market for example which has all but recovered from the GFC flow on effect), these folk have very much tapered off in search of the next best thing in which to invest.

b. Investors

Unlike speculators, buyers in the investors category have sought to reap returns from investing in art over the medium to long term (i.e. generally 10 or more years).They have a view of art as a legitimate asset class, particularly within the luxury asset subset, and they may or may not have a great enthusiasm or an in-depth knowledge of art.

c. Collectors

Buyers of art who have a deeply ingrained passion for collecting art, be it art by established artists, emerging artists or somewhere in between. Collectors have all sorts of methods and means for selecting the artworks they acquire, and may limit their holdings to a certain genre, gender, locality, thematic or format. Their motivation is not solely driven by financial factors but rather, arises from their more holistic interest in the cultural value of art per se. Many collectors have, or at least as they go on their collecting journeys they develop, a deep commitment to the arts and culture more generally. They have an art education (whether formal or informal) gleaned from years of immersing themselves in the art world and scholarship about art.

As art is acquired by collectors (as well as the other two categories discussed above), for the purpose of holding for a purpose of realising a profit of eventual sale , it is categorised as being a collectable within the definition of the CGT provisions -

The Australian Taxation Office (“ATO”) refers to collectables as follows:

> “Collectables include the following items used or kept mainly for the personal use or enjoyment of you or your associates:
>
> - paintings, sculptures, drawings, engravings or photographs; reproductions of these items; or property of a similar description or use
> - jewellery
> - antiques
> - coins or medallions
> - rare folios, manuscripts or books
> - postage stamps or first day covers.

A collectable is also:

- an interest in any of the items listed above
- a debt that arises from any of those items
- an option or right to acquire any of those items." [5]

Collectables are taxed under Subdivision 108-B—Collectables of the *Income Tax Assessment Act* 1997 (Cth).

As art is part of the collectables regime, there are certain specific characteristics to be aware of:

a. There is only a capital gains tax event when the cost base of the collectable is greater than $500.

b. Should one incur a capital loss on disposal of *collectables*, this loss can only be offset against a capital gain on *collectables* and not on any other capital gain be it on property or shares.

[5] https://www.ato.gov.au/Forms/Guide-to-CGT-2002-03/?page=17

4 Entity Structures for Acquiring and Disposing of Art

There are advantages and disadvantages to acquiring and disposing of art using various entity structures. We will examine each of the relevant entity structures in turn.

4.1 Individuals and Sole Traders

a. Acquisition of art

An individual sole trader in business can benefit from the acquisition of art by taking advantage of the instant asset write off. The write off has been extended to $30,000 on eligible business assets.

The instant asset write-off now also includes businesses with a turnover from $10 million to less than $50 million. These businesses can claim a deduction of up to $30,000 for the business portion of each asset (new or second hand), purchased and first used or installed ready for use from 7.30pm (AEDT) on 2 April 2019 until 30 June 2020.[6]

Artwork is included in the Commissioner's Effective Life of Depreciable Assets for 2019, albeit at a small rate of 1% pa. This allows eligible businesses that qualify to claim the purchase of art as a 100% deduction providing it is used in business. A legitimate business use for art may be for display, staff amenities or part of an office fit out.

While this may be seen as an incentive for business owners to buy art, it is important to bear in mind that upon sale of the artwork, the tax is paid as ordinary income and there is no ability to access the more concessional capital gains tax provisions (assuming the asset is held for more than 12 months).

b. Disposal of art

For individuals and sole traders that dispose of artwork where the art is either trading stock or used as a business asset under the instant asset write off outlined above under 4.1.a, there is normal tax payable on the proceeds with no reference to the cost base.

For example, assume the cost of an artwork is $10,000 and this work has been purchased in June 2019. Assume also that the sale proceeds are $12,000 in June 2020. In the case of a normal income on revenue account, the taxable income is $12,000. When the work was acquired back in June 2019, there was a deduction of $10,000. The tax is paid at the individual's marginal tax rate.

Should the artwork be held as a collectable then there is tax under the CGT provisions.

Assuming the asset is held for more than 12 months and cost base is more than $500, then the gain is 50% of the difference between the proceeds and the cost base. Should the cost be less than $500, then the gain is disregarded. We also need to be mindful of any prior capital losses on collectables.

[6] https://www.ato.gov.au/Tax-professionals/Newsroom/Your-practice/Instant-asset-write-off-increased-and-extended/

Considering the previous example, in the case of a capital gain as a collectable then the capital gain is ($12,000 - $10,000)/2, the gain is $1,0000 which is the taxable capital gain. The tax is paid at the individual's marginal rate.

4.2 Partnerships

Similar rules as discussed above under 4.1 apply to partnerships. Should the partnership be in business and have the intention of acquiring art for business purposes, then the same instant asset write off provisions apply. This means the partnership can enjoy an immediate tax deduction for art costing less than $30,000 (assuming the particular circumstances are met) and the resulting reduction in net partnership income flows down to the individual partners.

If the partnership is acquiring art as a means to invest medium-long term than the resulting capital gain on collectables is treated in the same way as capital gain on other assets, it is calculated in the individual partner's tax return with reference to the same rules as mentioned above for individuals.

4.3 Companies

As a company's income is taxed at 27.5% and there is no discount available on capital gains, tax is payable at 27.5% on the whole capital gain. This is why companies tend to not be used as a suitable vehicle for investing in art.

Using the previous example provided under 4.2 above, where we assume the cost to purchase the artwork is $10,000 in June 2019 and the sale proceeds are $12,000 in June 2020, the taxable capital gain is $2,000. This would mean the tax paid at the company tax rate of 27.5% is $550.

In addition, if a distribution is made to shareholders, further tax could become payable, as the dividends distributed carry with them a 27.5% franking credit. If the recipient is at the highest marginal rate, a further 17% could be payable, bringing both income and capital gain to a level of 47%.

4.4 Trusts

Trusts have a more favourable tax outcome for capital gains than the company structure. When a capital gain is made and if it is distributed to individuals, the gain is subject to a 50% discount if held for more than 12 months and the cost is more than $500.

If the income is accumulated, tax is payable at the maximum rate of 47% and there is no 50% discount on the capital gain, thus taxing the full gain at maximum rates.

However, if the capital profit is made by a discretionary family trust, subject to complying with the trust deed, and specifically, streaming clauses, the profits could be distributed to beneficiaries who are not at the maximum tax rate, thus reducing the potential tax liability.

4.5 Self-Managed Superannuation Funds

Self-Managed Superannuation Funds ("SMSF"s) are a contentious entity structure to consider for the acquisition and disposal of art. For SMSFs, income is taxed at 15% while capital gains are discounted by 1/3rd and taxed at 10%.

Most income in relation to art is generated from the capital gain made as a result of the sale of the art work. Therefore, the benefits 1/3rd discount to SMSF's traditionally meant that the SMSF was one of the most suitable entity structures for acquiring and disposing art for investment.

However, there are now strict limitations on the ability of SMSFs to acquire works of art. Regulations relating to SMFS's investment in artworks were enacted on the 30 June 2011 under Section 62A of the *Superannuation Industry (Supervision) Act* 1993 ("SIS Regulations").

The SIS Regulations affect all artwork acquired after 1 July 2011. Whilst retaining the sole purpose test and the inhouse asset rule for SMSF's acquiring art, the *Superannuation Industry (Supervision) Regulations* 1994 (Cth), regulation 13.18AA additionally provide that artworks (being artworks within the meaning of "artworks" under section 995.1 of the *Income Tax Assessment Act* 1997 (Cth)):

- Must not be leased to a related party
- Must not be stored in the private residence of a related party
- The Trustees must make a decision relating to the storage of the artwork and record the reason for this decision and keep this record for 10 years.
- The Trustees must insure the artwork within 7 days of acquisition in the name of the Fund.
- Related parties must not "use" the artwork
- The transfer of artworks to related parties, require independent valuations at market values.

Historically, prior to 13.18AA being in force, there had been some ambiguity concerning the "sole purpose test" of the SIS Regulations, which provides that the dominant purpose of a Superannuation Fund is to provide retirement benefits to its members on their retirement. This test was designed to prevent Superannuation Funds from being used for purposes such as, for example, providing benefits to members prior to their retirement or purchasing a holiday home for use by members. It is the responsibility of the trustees of a Superannuation Fund to develop and maintain an investment strategy, which in their view meets the "sole purpose test". Arguably, where the benefit is only incidental to the dominant purpose, such as where a painting is purchased as part of the investment strategy, professional advice has been obtained as to the value and growth potential of the work, then the work being hung on a wall should not affect the investment. However now, with 13.18AA not permitting the asset to be stored in the private residence of a related party, the SMSF entity structure no longer holds the greater tax benefits for the acquisition and disposal of art above any other entity structure.

This has all changed with the newer more restrictive regulations around acquiring any form of collectable for a Superannuation Fund.

5 GST Implications for Acquiring and Disposing of Art

When it comes to art, the rules around GST tend to follow the general principles of GST law. Section 9-5 of subdivision 9-A of the *Goods and Services Tax Act* 1999 (Cth) ("GST Act") provides that you make a taxable supply if:

a. you make the supply for consideration; and

b. the supply is made in the course or furtherance of an enterprise that you carry on; and

c. the supply is connected with the indirect tax zone; and

d. you are registered, or required to be registered.

However, the supply is not a taxable supply to the extent that it is GST-free or input taxed. So, in the case where all the above criterion have been met, then there are GST implications. For example, an art dealer selling art as trading stock, where they meet all the standard above criteria needs to add GST to their selling price.

The same principle applies for creditable acquisitions. Section 9-5 of subdivision 9-A of the GST Act provides that you make a creditable acquisition if:

a. you acquire anything solely or partly for a creditable purpose; and

b. the supply of the thing to you is a taxable supply; and

c. you provide, or are liable to provide, consideration for the supply; and

d. you are registered, or required to be registered.

Therefore, where for example an art dealer purchases an artwork in furtherance of their enterprise, such as where that dealer buys the artwork for the purposes of resale, then they are entitled to an input tax credit.

Further, where a gallery or art market professional sells artwork on consignment, they are subject to agency law as previously mentioned. For the purposes of tax, the artist stands in the shoes of the artist and acts accordingly. If the artist is registered for GST, the GST is charged by the gallery or AMP but if the artist is not registered, then the gallery or AMP have no requirement to charge GST on the sale price.

These rules around creditable acquisitions do not affect the percentage commission that the gallery charges for the sale of the artwork. For example, if the gallery entity is itself registered for GST then they charge GST on their commission (which can as high as 50% +10% X (base rate) =55%).

In the specific case of art sold on the secondary market, there is also a relevant provision in Division 66 of the GST Act. This provision allows a notional input tax credit ("**ITC**") for the purchasing of goods that are second-hand from members of the public. This can be applied where an art dealer buys an artwork on the secondary market and they retain it as trading stock for sale. They are able to claim back 1/11 of the purchase price as a notional ITC, notwithstanding whether the person or entity from whom they bought the good was registered or required to be registered for GST.

Finally, in many cases where art is bought as a collectable and not seen to be held by the purchaser for resale, but as an investment to sell at a later date, there may not be a requirement for GST as arguably they are not carrying on as an enterprise in buying and disposing of the work.

6 Gifting Art and Cultural Objects

When it comes to gifting art, we must first consider when can a gift of artwork or collectable be made, before then considering when a tax deduction be claimed for the gift and how that tax deduction is to be calculated.

6.1 What is a Gift and When is a Gift Accepted?

a. Courts have described a gift as having the following essential characteristics and features:

- there is a transfer of the beneficial interest in property i.e. the goods are delivered;
- the transfer is made voluntarily i.e. it must be the act and will of the giver, and there must be nothing to interfere with or control the exercise of that will;[7]
- the transfer arises by way of benefaction i.e. the receiver of the gift is advantaged without any countervailing detriment arising from the terms of the transfer;[8] and
- no material benefit or advantage is received by the donor by way of return.[9]

It has also been found that ‘mere acknowledgment’ in newsletters, annual reports, on a donor’s board and so on, i.e. public recognition, will generally not be a material benefit to the donor.[10]

Accordingly, as long as the characteristics and features outlined above are present, then the work can be a gift.

b. The Work Must Comply with the Acquisition Policy of the Recipient of the Donation

Whether an institution can accept a gift of the work depends on its acquisition policy. This is where it is important to not only consult the *Income Tax Assessment Act* 1997 (Cth), but also the Acquisition Policy of the institution that the proposed donor intends to gift the work to.

Often, the Acquisition Policy will include such requirements as that the artwork must fit within an identified collecting area, and that the work is selected by the board of the institution based on the significant of the artist and the specific quality of the artwork.

In order to be accepted by the institution the method of acquisition must also comply with its Acquisition Policy. This may include, for example, signing a Deed of Gift, evidencing full transfer of title and possession, and providing the institution with a range of warranties and indemnities and affirming the agreement of both parties to the transfer and acceptance of title and possession of the artwork.

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[7] TR2005/13 at 23.
[8] TR 2005/13 at 27.
[9] It does not matter whether the material benefit or advantage comes from the DGR or another party TR 2005/13 at 37.
[10] TR 2005/13 at 186.

6.2 When Can the Donor Claim a Tax Deduction for the Gift?

a. The Cultural Gifts Program

The Cultural Gifts Program ("**CGP**") exists to encourage Australians to donate items of cultural significance from private collections to public art galleries (as well as museums, libraries and archives).[11]

The principle legal provision for the Program is sub-division 30-A of the *Income Tax Assessment Act 1997* (Cth) ("**ITAA**"). Donors are eligible for certain tax incentives under the Program, including:

- a tax deduction for the market value of the gift (and a tax deduction for the cost of the valuations obtained specifically for the purpose of making the gift, and indeed, for the cost of obtaining this advice from an agent such as a lawyer or accountant (section 25-5 of the 1997 Act));
- the option to elect to spread the deduction over a maximum of five income years; and
- gifts are exempt from CGT.

To participate in the Program, the recipient of the donation must be a public art gallery, museum or library (including archives) which is or is operated by a registered charity or Australian Government Agency (section 30-100, item 12.1.4 of the Act) and be endorsed under Subdivision 30-BA as a Deductible Gift Recipient ("**DGR**") or in the case of a fund, is owned by an entity that is endorsed as a DGR.

To be a registered charity, the entity must be registered with the Australian Charities and Not-For-Profits Commission ("**ACNC**").

b. Gifts to Organisations on the Register of Cultural Organisations

Under Item 1 of Subdivision 30-15 of the ITAA, art and cultural objects (in addition to other types of assets) valued above $5000 by the Commissioner can also be donated to organisations which are on the Register of Cultural Organisations ("**ROCO**"). In practice, when it comes to gifting art and cultural objects, Item 1 is generally only relied upon by a donor where they intend to donate to an organisation which is not a public art gallery, museum or library (including archives), but which is on the ROCO. To that end public art galleries, museums and libraries (including archives) are generally not included on the ROCO on the basis that they are approved recipients under the CGP.

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[11] Department of Communications and the Arts, Cultural Gifts Program Guide, 2013, https://www.arts.gov.au/file/3141/download?token=Fls6G0kY.

c. Gifts to the Commonwealth through the Artbank Program

It is also possible that Item 5 could be relied upon, where the donor wishes to donate the property to the Commonwealth for the Commonwealth's Artbank program. Established in 1980 as a federal government support program, Artbank's two core objectives are to provide direct support to Australian contemporary artists through the acquisition of their work and to promote the value of Australian contemporary art to the broader public. Artbank funds its operations through the leasing of artworks from its collection.

6.3 How Much Can the Donor Claim?

a. Gifts made under CGP and through Artbank

Under Items 4 and 5 of Subdivision 30-15 of the ITAA, if the work is purchased by the donor and donated after 12 months, then the valuation of the gift would be calculated based on the average of two written valuations which represent the GST inclusive market value of the Work on the day the gift was made.

Section 30-200 of the ITAA also provides that the market values must be specified in the written valuations obtained from two (or more) approved valuers under the CGP, who are approved to value the type of property being gifted.

If the Work is purchased by the donor and donated within 12 months, then the valuation of the gift would be calculated based on whichever is lesser of the following:

- the amount you paid for the Work; or
- the average of two written valuations which represent the GST inclusive market value of the Work on the day the gift was made.

If the artwork is purchased by the donor for the purpose of making the donation, or it is purchased by the donor subject to an agreement that it would be gifted, then the calculation of the 'market value' of the work at the time the work is gifted to the gallery would be calculated in the same way i.e. the lesser of the amount you paid and the average of two written valuations. Once this has been calculated, the section 30-220(1) of the ITAA provides that the amount that can be deducted is then to be reduced by a 'reasonable amount' if the gift recipient does not immediate receive custody and control of the property, does not obtain immediate, indefeasible and unencumbered legal and equitable title to the property and the custody, control or use of the property by the recipient is affected by an arrangement entered into in respect of the making of the gift. Further, under section 30-220(2) of the ITAA, in deciding what is a reasonable amount, the effect of the promised gift arrangement on the GST inclusive market value of the gift would need to be considered.

Ultimately, the tax deduction calculations for gifting a work as a promised gift are structured so that the donor should not obtain a tax benefit from retaining ownership and possession of the artwork while having promised to gift it to the gift recipient on a specific date.

b. Gifts made under ROCO

Under Item 1 of Subdivision 30-15 of the ITAA, if the work is purchased by the donor and donated after 12 months, the valuation of the gift is calculated based on the market value of the artwork on the day the donor made the gift, as determined by the Commissioner.

Whereas, if the work is purchased by the donor and donated within 12 months, the valuation of the gift is calculated based on whichever is lesser of the following:

- the amount you paid for the artwork; or
- the market value of the artwork on the day the donor made the gift, as determined by the Commissioner.

Unlike the CGP, section 30-200 does not apply to establishing the market value of the artwork. In other words, it should not strictly be necessary to obtain two written valuations from approved valuers if one is donating an artwork or cultural object under Item 1 to a ROCO.

Like the CGP, the promised gift rules of section 30-220 of the ITAA outlined above apply in calculating the tax deduction.

c. Spreading the Deduction

The donor can also choose to spread the deduction over up to 5 income years. Where the donor chooses to spread the deduction, once a donation has been certified, the donor is also responsible for submitting an Apportionment Election Form to the Department Secretary. However, the deduction cannot add to or create a tax loss. The apportionment must be specified in percentage points and must begin in the income tax year in which the gift was made, being the date of donation on the Certificate of Donation.