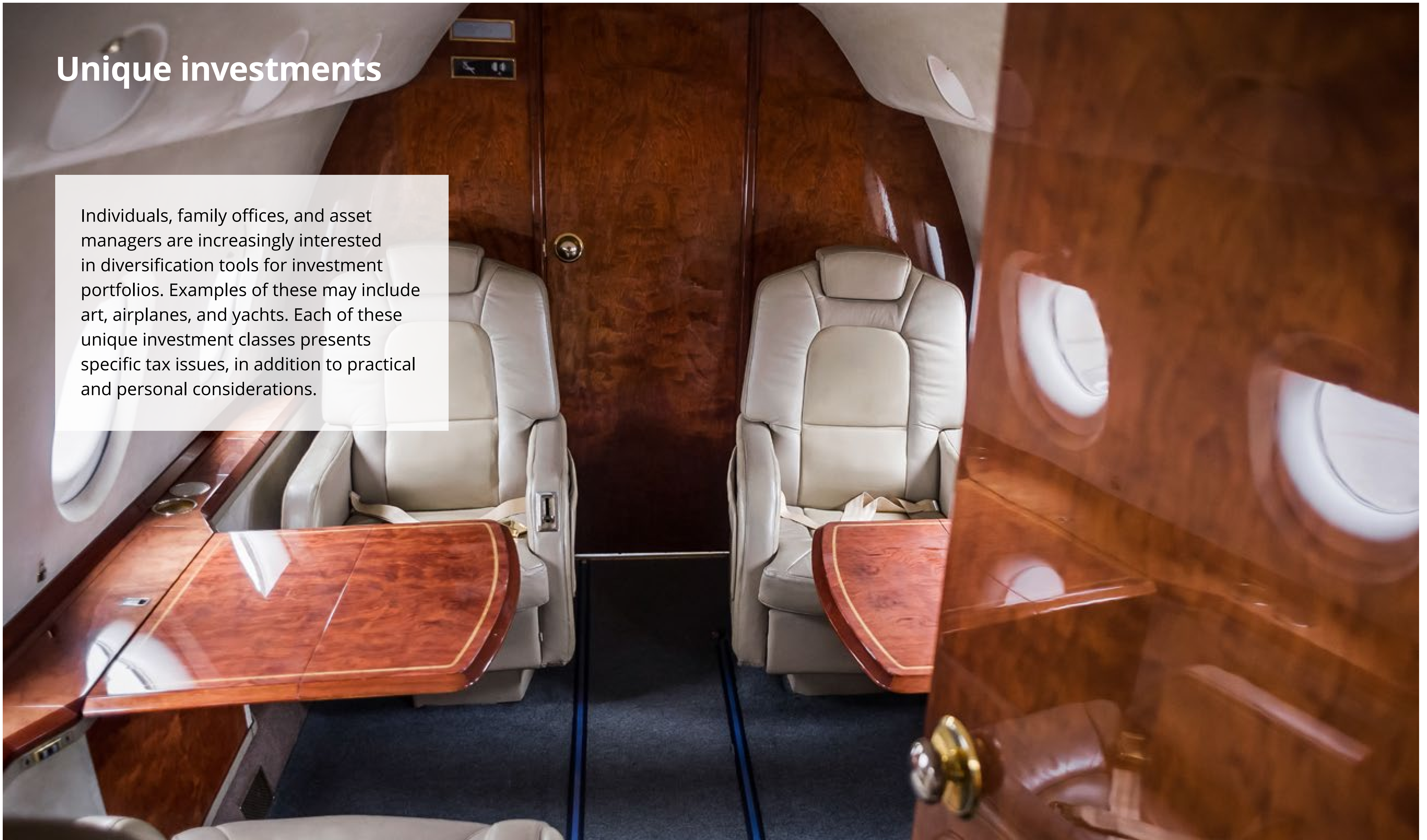

Unique investments

Individuals, family offices, and asset managers are increasingly interested in diversification tools for investment portfolios. Examples of these may include art, airplanes, and yachts. Each of these unique investment classes presents specific tax issues, in addition to practical and personal considerations.

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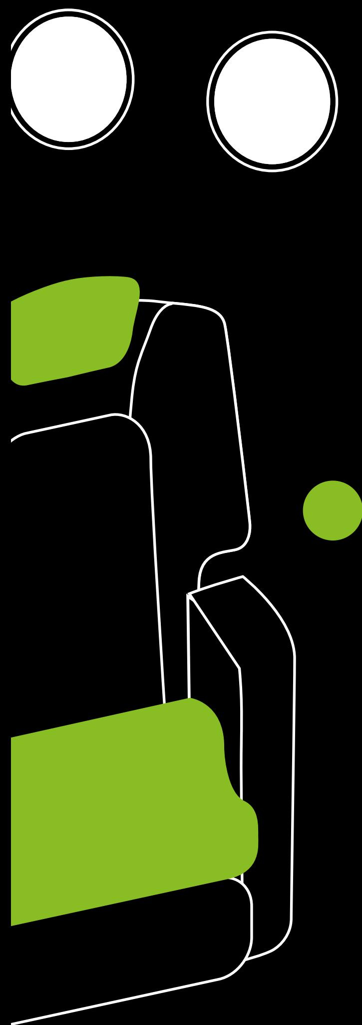


Unique investments

Art

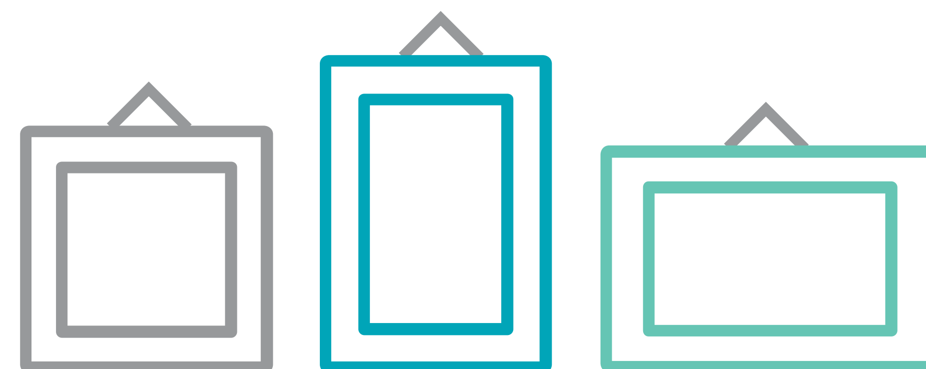
Gift and estate tax planning

For individuals and families who maintain an art collection as a substantial portion of their wealth, gift and estate tax planning can be particularly important. The illiquid and hard-to-value nature of artwork makes it a special asset for planning purposes. Examples of considerations include structuring lifetime gifts or bequests at death. These transfers may occur in specialized situations, from simple transfers to heirs to more complex transactions, including partnerships, dynasty trusts, and split-interest trusts. If the decedent transfers these assets to family members upon death, the estate plan should consider how the taxes attributable to the art collection will be paid, given the illiquid nature of the assets.

Philanthropy and charitable planning

Individual donors may be able to take advantage of significant income, estate, and gift tax deductions for charitable donations of art to cultural institutions. It is important to analyze and implement appropriate donation strategies, consult on related-use requirements, and review appraisal requirements for income and transfer tax returns. Additional considerations for charitably inclined taxpayers may include more complex gifts, including fractional donations and charitable remainder trusts.

For art and other tangible personal property with a long-term holding period, the charitable deduction is the asset's fair market value only if the property will be put to a use related to the exempt purpose of the donee charity. If the art is not used by the charity in its exempt function (*i.e.*, related use) for three years after donation, then the donor must recognize income equal to the difference between the fair market value deduction taken and the basis of the property at the time of donation. This recapture can be avoided if the donor obtains a letter from the charity stating that the property was in fact used in the exempt function, how it was used, and certifies that such use has become impossible or infeasible. There is a special penalty of $10,000 imposed on charities who inappropriately and fraudulently certify property as being "related-use property."



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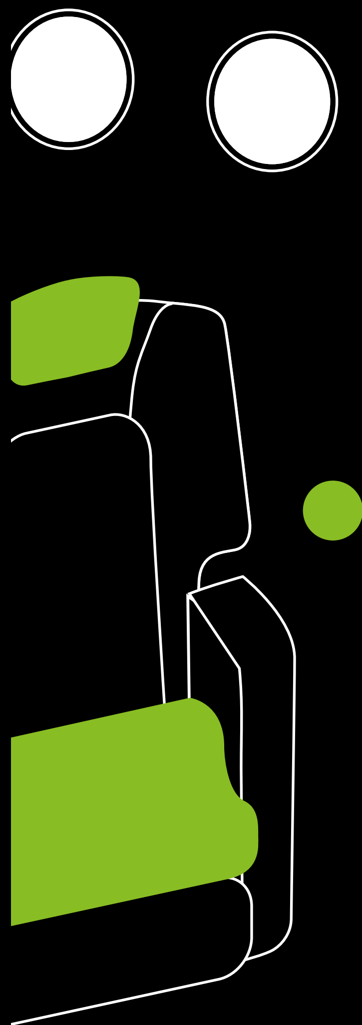


Unique investments

Art

Fractional gifts of art

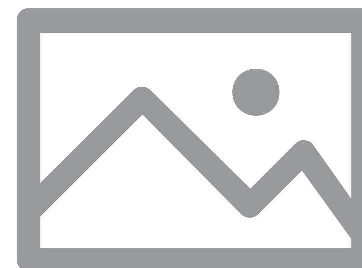
Taxpayers should also be aware of the tax issues related to fractional gifts of art. Prior to the Tax Reform Act of 1969, it was possible to donate artwork to a museum, retain the life estate, and receive an immediate income tax deduction. Congress was concerned that art donors were benefiting from the increase in value as the art was on display in a museum setting. As the value increased, donors would donate additional, more valuable fractions with the hope that the value of the deduction would increase over time. The Pension Protection Act of 2006 established two restrictions as follows:

- **Time limitation:** Art must be completely donated by the earlier of 10 years or the death of the donor, or the income tax deduction will be recaptured and a 10 percent penalty tax will be imposed
- **Value limitation:** Value of subsequent fractional gifts based on the value on the date of the first fractional donation (only subsequent depreciation, not appreciation, is considered)

Fractional donations of art are still a very attractive charitable planning alternative, allowing one to spread a gift over a number of years to reduce the limitations on the charitable deduction allowed. However, taxpayers should be aware that there is no longer an enhanced income tax deduction for subsequent donations.

Valuation considerations

If an executor is tasked with selling a collection through a private sale or public auction, then the executor must plan for the income and transfer tax implications. In any estate or gift-planning situation, valuation will be an important consideration, as will auxiliary costs of insurance, storage, and shipping. Very rarely will clients leave a bequest to sell their art and distribute the proceeds to their children. An executor's biggest worry is getting the art into the right auction, at the right auction house to maximize proceeds. The Internal Revenue Service (IRS) is likely to accept the selling prices as the value for the estate tax return and the selling costs will be allowed as an estate tax deduction. Most clients will leave their art to their heirs—valuation is likely to be the major issue between the IRS and the executor. The IRS can challenge deductions for insurance, storage, and shipping if it appears the expenses were for the convenience of the heirs, rather than falling clearly within estate administration costs.



The IRS has established the Art Advisory Panel, which includes up to 25 renowned art experts. If a taxpayer's individual, gift, or estate tax return is audited and the value of the art reported on the return exceeds $50,000, the IRS will refer the case to its Art Appraisal Services Group. This group will then leverage the Art Advisory Panel to review and assess the valuation used to determine the value reported on the return. Alternatively, taxpayers can proactively request that the IRS review the appraisal prior to filing an income, gift, or estate tax return. Following the review, the IRS will issue a statement of value and the taxpayer can report the agreed-upon value on the return to avoid possible penalties from being assessed on gift and estate tax returns.

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The bottom line is that if the art is expensive, or the estate is that of the actual artist, the estate should retain the foremost valuation expert in the particular artist. There is a strong likelihood that the IRS will review the values claimed for the art on the income, gift, or estate tax return, and the IRS may challenge the values reported if the taxpayer does not obtain a statement of value.

Import and export considerations

In some instances, obtaining artwork, collector's pieces, antiques, or cultural property may involve exporting the item from one country and importing it into another. In such cases, it is important to consider both the departure and arrival countries' export and import laws and restrictions prior to acquiring and transporting the item across borders. For example, certain types of art, artifacts, and antiquities may be restricted or prohibited from export and/or import based on cultural property laws, international agreements, restrictions on materials, formalities on documentation, and other complexities. The assessment of customs duties depends on the proper tariff classification of the item, as determined by factors, such as the detailed characteristics of the item, its age, the circumstances of how it was made, and/or whether the item is a functional object or a collectible as defined by the customs authorities. In some cases, items may be eligible for duty-free treatment. Finally, the proper valuation of the item for export and import purposes must be considered.

The investor must analyze these issues and effectively navigate the complex, global import and export regulations that govern the cross-border movement of artwork, collector's pieces, antiques, and cultural property to identify possible duty reduction planning.

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Art

Value added tax (VAT) and goods and services tax (GST)

There are potential VAT/GST consequences to consider where art is sold, purchased, leased, donated, or simply moved across borders in today's increasingly globalized economy. More than 150 countries in the world have some kind of VAT/GST system. With VAT/GST rates ranging up to 27 percent, it is important to fully understand the applicable rules in order to take steps to manage VAT/GST to limit significant additional costs. In the art world, in particular, there are often special tax regimes and complex VAT rules that can apply where goods are sold by auction or donated/loaned to institutions, making it even more important to plan in advance and take steps to correctly understand the position. Consideration should be given to navigating the complex VAT/GST world to mitigate the risk of unnecessary VAT costs to the investor personally or to a business.

US sales and use tax

In the United States, 45 states and the District of Columbia impose some sort of sales or use tax with differing exemptions and procedures. As a result, owners, dealers, and collectors will need to consider the potential sales or use tax consequences on purchases and/or delivery within the continental United States.

Tax planning, tax compliance, and tax controversy services related to purchases or interstate movement of artwork and other collectibles are all important considerations. With each state—and with certain cities within those states—having unique tax laws, factors, such as origin, status of seller, initial delivery locations, storage, and final destination of the artwork, all impact the tax planning and compliance process. It is important to identify potential issues and tax-saving considerations up front and before the transactions have occurred, so sales and use taxes do not become an unwanted additional expense or surprise.

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Airplanes

Every private flyer is looking for the most efficient way to fly at the best possible price. Whether you are a wealthy individual, a closely-held business owner, an entrepreneur, or any other type of aircraft user, the issues involved in flying private are complex.

The decision to purchase

In situations where it is difficult to predict usage, it usually makes sense to start out by chartering an aircraft or purchasing a flight card until you have a better understanding of how often, how far, and how many people will be flying with you. Especially, if passenger loads will tend to vary widely from trip to trip, the flexibility of charter and flight cards may be advantageous, as they allow you to size the aircraft to meet each flight's requirements.

You may not need to actually buy a plane to fly private. The truth is that the costs and responsibilities of such a large purchase may not match the investment. For the majority of those who need private aircraft, there are attractive partial ownership options.

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Airplanes

Option	Description	How many passengers per trip	Advantages	Disadvantages
Full ownership	You or your entity owns the plane	Your choice, within your aircraft's seating capacity limits	• Full control over every aspect of the plane: crew, maintenance, inspections, hours flown, and passengers • Depreciation benefits	• Full liability • Equipment wear and tear, which affects residual value • Variable operating costs • Bears direct cost of repositioning the plane
Fractional ownership	You or your entity typically owns 1/16 to 1/2 of an aircraft through a third party (a fractional share provider)	Can be scaled to the specific trip needs	• Lower up-front capital outlay • Guaranteed plane availability • Depreciation benefits • Choice of plane size • Planes are professionally managed and maintained • No charges (generally) for deadheading or repositioning costs • Possibility of guaranteed plane buyback	• Can be relatively expensive to use per hour • Planes are used more heavily • There are limits on peak flying dates • Liability could be high, depending on whether the owner or operator is in operational control
Joint ownership	You sign an FAA-sanctioned agreement to share the cost of operating an aircraft	Limited to the size of the plane purchased specifically by the joint owners	• More cost effective per hour than fractional ownership • Depreciation benefits	• Less flexible • Finding a responsible partner • Aircraft availability
Chartering	You contract for services on a trip-by-trip basis or use the services of a charter broker	Can be scaled to the specific trip needs	• Flexible • Cost effective • Less liability • Ideal when flight usage is sporadic or difficult to predict	• Inconsistency in service experience and costs • Less convenient or less consistent as other choices • Additional advanced notice needed to schedule flights • Competition for peak usage periods • Fuel surcharges, pilot wait charges, landing fees and deadhead hour charges
Flight cards	You purchase either a block of flight hours or a specific dollar balance	Can be scaled to the specific trip needs	• Price competitive with charters • Allows family members to fly to multiple destinations at the same time using different aircraft	• No benefits of depreciation • More expensive per flight hour than fractional ownership hours

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Airplanes

Ownership structure

Understanding the tax implications of flying private can help you choose the ownership structure that appropriately addresses your specific needs and circumstances. The immediate instinct of most aircraft buyers is to put the plane in a separate legal entity instead of placing it directly in an operating business in order to protect the owners from legal liability. Unfortunately, this can create significant tax problems. Payments between related entities can attract federal excise taxes, which are imposed on "air transportation." It also may create a captive charter company, which may subject it to certain Federal Aviation Administration rules applicable to operators that "carry passengers for hire." Generally, providing air transportation and carrying passengers for hire occurs when there is a single payment to one entity for both the provision of the aircraft itself as well as the provision of pilots. Individuals and families should always consult competent legal counsel and tax professionals when structuring the ownership of an aircraft.

Sales and use taxes on aircraft purchases

Many states provide exemptions from sales and use tax for the purchase of an aircraft, such as an exemption for aircraft used in interstate commerce and an exemption for leased aircraft (although the future lease payments may be subject to sales/use tax). It is important, however, to understand if one of these exceptions is met (and continues to be met for the period of the aircraft's use). The determining factor in concluding which state's taxability rules to apply is the principal hanger location for the aircraft and/or where the aircraft will be located. Individuals who are considering the acquisition of private aircraft should assess whether any sales and use tax exemptions apply prior to taking possession of the aircraft so that the proper paperwork is executed in a timely manner.

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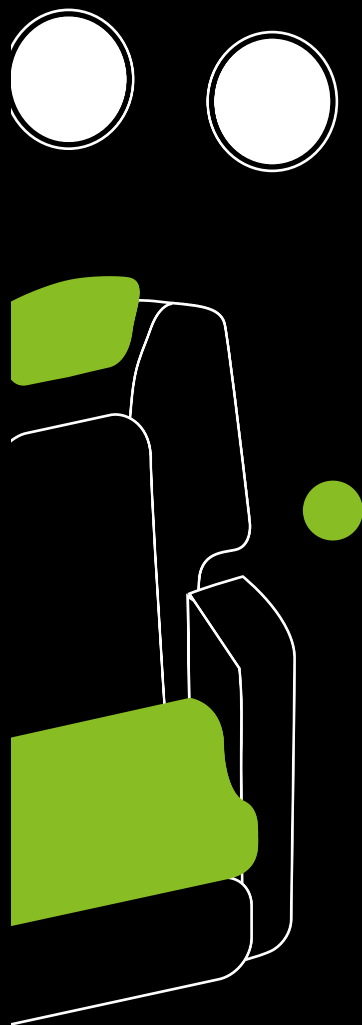


Unique investments

Airplanes

Deductible business expenses

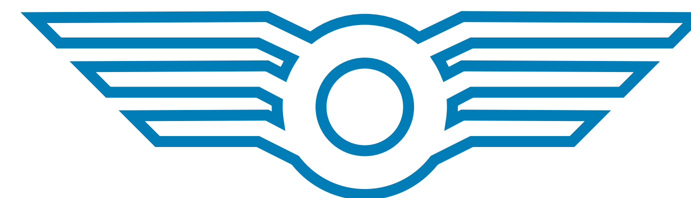
One of the most important questions that must be addressed is when the cost of private aviation is considered an ordinary and necessary business expense. If business is typically conducted locally or business travel is between major cities that are regularly served by the major airlines, it may be difficult to justify the cost of private air travel as an ordinary and necessary expense of the business. A better argument exists when the business requires flights to out-of-the-way locations without ready commercial air service, the timing and duration of business flights is unpredictable, or personal security is a significant concern.

Once the ordinary and necessary requirement is met, the next issue is to determine which costs are deductible and which are not. If the aircraft is owned by an entity (other than a single member limited liability company (SMLLC) owned by an individual), costs need to be apportioned to each passenger on each flight and then allocated between business and personal (which includes personal nonentertainment and personal entertainment). If the aircraft is owned by an individual or through a SMLLC, there is a different allocation methodology to determine any expenses that may not be deductible. For purposes of determining the expenses allocated to entertainment air travel of a specified individual, a taxpayer must use either the occupied seat hours or miles, or the flight-by-flight method. A taxpayer must use the chosen method for all flights of all aircraft for the taxable year. Taxpayers should quantify the deductible costs under all allowed methodologies each year to identify the maximum business deductions allowed.

Personal travel using private aircraft

Many people start out believing they will use a private aircraft strictly for business. Once they try it for personal travel, however, they often increase personal usage steadily. This change creates tax effects that are important to understand. The American Jobs Creation Act of 2004 and its related subsequent regulations have put limitations on the deductibility of aircraft use.

Taxpayers should quantify the deductible costs under all allowed methodologies each year to identify the maximum business deductions allowed.



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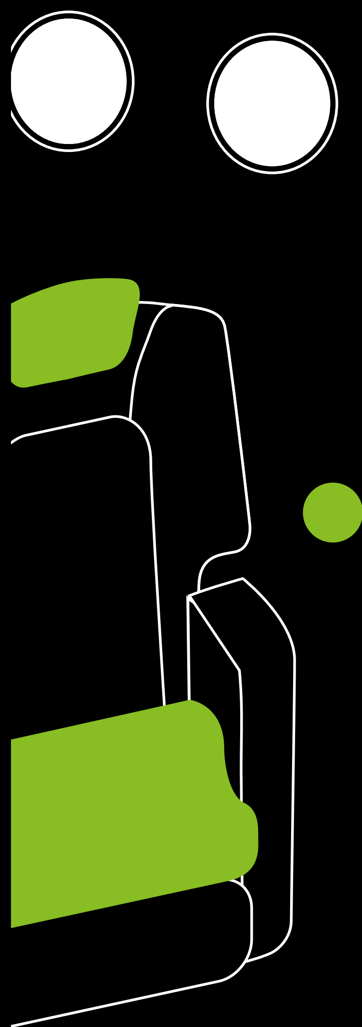

Unique investments

Airplanes

Generally speaking, aircraft use is deductible for business purposes, but it may not be deductible when flown for personal use, depending on the category of the flight. Personal aircraft usage breaks down into two categories—personal nonentertainment and personal entertainment.

Personal travel is also considered a fringe benefit provided to the employee or owner in which income needs to be imputed to the individual, or reimbursed, for use of the aircraft. Most companies, when imputing income to an executive for personal use of an aircraft, utilize the Standard Industry Fare Level (SIFL) tables. SIFL tables can require an amount of income to be imputed to the individual that is less than the actual cost of operating the aircraft. As long as the executive has compensation imputed to him or her for the flight, or reimburses the company an appropriate amount, personal nonentertainment flights can generally be fully deductible by the company.

For example, commuting is considered personal nonentertainment, but is not specifically defined in current guidance. Generally speaking, travel constitutes commuting any time you are traveling from a personal residence (defined as a residence used personally more than 10 percent of the time or for more than 14 days per annum) to your principal place of business. Accordingly, a regular pattern of travel between your place of employment and a personal residence can constitute commuting, making it a personal nonentertainment flight, allowing the company to deduct the entire cost as long as there is proper imputation of income to the individual.

If a specified individual (generally defined as an owner, shareholder, or officer of a company) flies for personal entertainment purposes, the cost of the flight is only deductible to the extent compensation has been imputed to the individual for the flight or the specified individual reimbursed the company for the cost of the flight. Personal entertainment is broadly defined and generally includes all personal travel that is not otherwise categorized as personal nonentertainment.

Additionally, spousal travel is not deductible, unless the spouse is an employee of the company and is also traveling for business purposes. However, if the spouse's travel can be considered personal nonentertainment travel (*i.e.*, they are traveling as a companion to a business event where spouses are expected/encouraged to attend), income related to the spouse's travel would be imputed to the executive, which could then (in limited circumstances) make the full cost of the travel deductible.

Selling your aircraft

Gain or loss on a disposition of an aircraft can be difficult to calculate, as there are differing methodologies for calculating basis on a disposition. The applicable methodology for calculating basis not only affects taxable dispositions of aircraft, but also affects the results of like-kind exchanges. It is important that taxpayers understand the various authorities regarding how basis of an aircraft is affected by personal use before finalizing the gain/loss calculations on a disposition of an aircraft.

It is important that taxpayers understand the various authorities regarding how basis of an aircraft is affected by personal use before finalizing the gain/loss calculations on a disposition of an aircraft.

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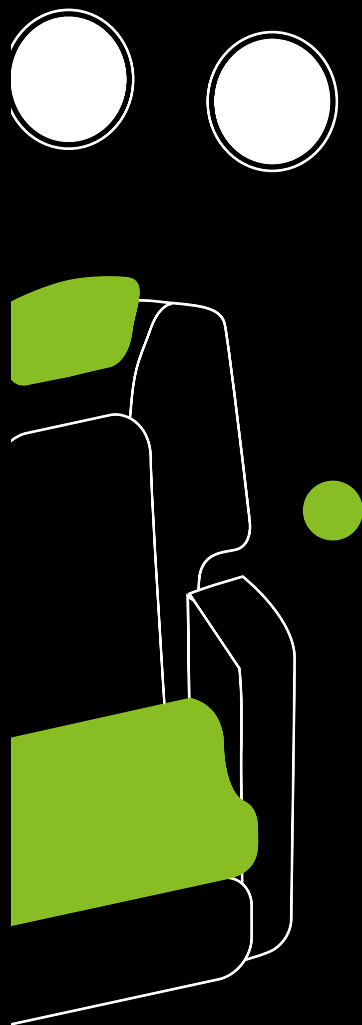

Unique investments

Yachts

Another asset which presents unique tax consideration is a yacht.

Yacht financing

Many of the yachts built in the United States are constructed in Louisiana and Mississippi. Yacht construction resembles home construction in some regard, but there are income tax issues related to construction loan interest that should be considered.

Generally, interest on personal use property is not capitalized. A yacht may qualify as the taxpayer's personal residence and the loan may be secured by the yacht itself. If so, the interest on a construction loan of a personal residence can be mortgage interest for up to 24 months of the construction phase. In that case, interest deductibility is limited to the same personal residence limitations and is nondeductible for alternative minimum tax purposes.

State tax issues

Title to a yacht transfers when it is delivered to a taxpayer after construction is complete and the yacht passes "sea trials." The seller of the yacht has nexus for state sales and use tax in the state(s) where it has physical presence. However, many "yacht-friendly" states have sales and use tax exemptions for sales of vessels with certain load displacements (*e.g.*, 50 tons or more). Although the "selling state" may have an exemption, if the yacht were to cruise in US waters, other states could impose a use tax at their ports if one had not yet been imposed. One possible approach, assuming the taxpayer properly qualifies, is to register the yacht in a state with a low tax to reduce a challenge to impose a sales or use tax by another state. An alternative solution is to become a foreign-flagged vessel (FFV) with a US cruising license.

FFVs

There are advantages and disadvantages to becoming a FFV with a US cruising license. Some believe that they may be safer in international waters by not flying the US flag. Also, it may allow for insulation against sales and use taxes imposed by other states. However, care should be given in selecting the proper jurisdiction (for example, Cayman Islands, Panama, Bahamas, etc.). Taxpayers should understand the initial and annual maintenance fees of a foreign registry, which may include registration fees, tonnage fees, company formation, document recording, inspection tariffs, etc. Additionally, it may be seen as detrimental that in order to enter and operate in US waters for pleasure, an FFV must obtain a cruising license and important restrictions will apply.

Operating costs

Yacht operation is typically handled through a management company. For a fee, the management company will handle the crew, maintenance, books and records, and compliance with applicable rules and laws. Yacht operating costs are significant with annual operating costs typically running 10 percent or more of the acquisition cost.

Chartering activities

Chartering may become a very appealing option to offset the costs of owning a yacht. Chartering income typically may be offset by a portion of operating and maintenance costs, as well as depreciation. The management company would handle the details, but it would also take a commission. For an FFV, the yacht can only be chartered and operated outside of US waters.

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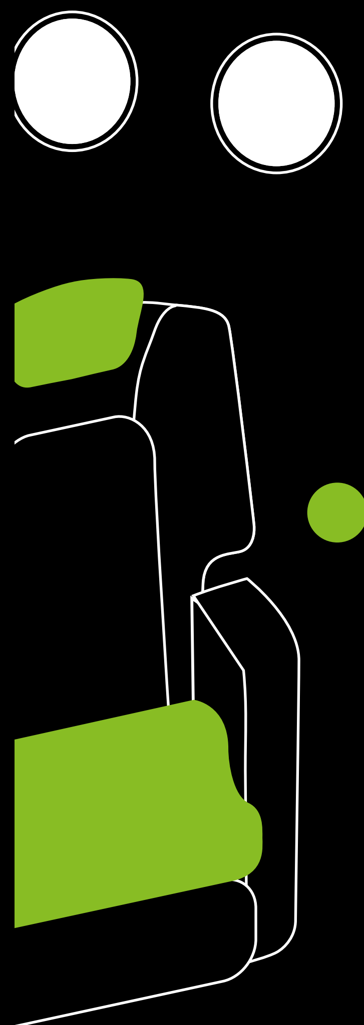


Yachts

Finally, there are special considerations for the income tax treatment of a yacht that is operated for both personal and charter purposes ("mixed use property"). Determining the portion of yacht expenses that are deductible is a complicated calculation. The taxpayer should engage tax advisors familiar with these rules to reduce the potential challenges by the IRS of the deductibility of costs.

Dispositions of yachts

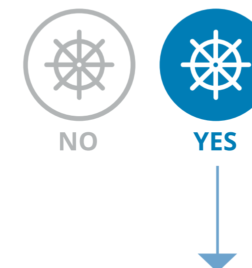
Ultimately, if the investor chooses to dispose of the yacht, then there are additional unique income tax considerations. If the yacht is chartered, a portion of the related gain, if applicable, is ordinary income to the extent of prior depreciation allowed or allowable. Also, based upon the extent of historical personal use, any prior suspended losses may not be utilized to offset any gain upon sale and are lost. Additionally, any loss realized on the sale of the yacht cannot be recognized. If the restrictions for a personal use vessel do not apply, then any passive losses may be "freed up" upon disposition of the activity. It should be noted that an FFV cannot be offered for sale in the United States.

Yacht operation—income tax treatment of mixed use property

Chartering

Does the high net worth individual charter the yacht to unrelated persons?

Multiple courts have treated yachts as an "entertainment facility" under section 274. As such, expenses are non-deductible.

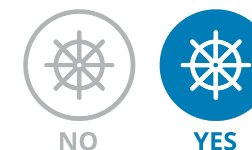


Exception applies for "operating a pleasure cruise ship as a business". Treas. Reg. § 1.274-2(f)(2)(ix). Chartering will permit an allocable share of expenses to be deductible.

Personal Use

Does the high net worth individual use the yacht for the greater of 14 days or 10% of the days chartered?

Chartering activity is a section 162 activity but could be subject to the passive activity loss rules under section 469 and may be susceptible to the hobby loss rules under section 183.



Yacht classified as section 280(A) property. Allocable expenses ***in excess*** of charter income not deductible—carried forward to offset income in future years.

Resources

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Individual income tax planning	Private wealth tax controversies: Deep experience navigating interactions with taxing authorities US Estate and gift tax rules for resident and nonresident aliens
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