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.
Unique investments

Art

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.

Gift and estate tax planning
Whether you are contemplating lifetime gifts or bequests upon death, the illiquid and hard-to-value nature of artwork makes it a special asset for planning purposes. Such 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 eligible for significant income, estate, and gift tax deductions for charitable donations of art to cultural institutions. It is important to analyze and understand the impact of various donation planning considerations, 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, such as 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 its exempt function and how it was used, or certifies that such use has become impossible or infeasible. There is a penalty of $10,000 imposed on charities that inappropriately and fraudulently certify property as being “related-use property.”
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 else the income tax deduction will be recaptured and a 10 percent penalty tax will be imposed.
- **Value limitation:** The value of subsequent fractional gifts is 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 an 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 planning or gift planning situation, valuation will be an important consideration, as will auxiliary costs of insurance, storage, and shipping. Rarely will clients leave a bequest to sell their art and distribute the proceeds to their children, but when they do, an executor’s biggest concern may be getting the art into the right auction and at the right auction house to enhance proceeds. The Internal Revenue Service (IRS) is likely to accept the selling price as the value for the estate tax return, and the selling costs will be allowed as an estate tax deduction. When clients leave their art to heirs, valuation is likely to be a major issue between the IRS and the executor. The IRS can also 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 an established 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.
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If the art is expensive, or the estate is that of the actual artist, the estate should retain the foremost valuation expert on 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 and its age, the circumstances of how it was made, and 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 considerations.
Unique investments

Art

Value-added tax (VAT) and goods and services tax (GST)
There are potential VAT/GST consequences to consider when 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 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. Each state—and with certain cities within those states—having unique tax laws and factors such as origin, status of seller, initial delivery locations, storage, and final destination of the artwork may impact the tax planning and compliance process. It is important to identify potential issues and tax considerations up front and before the transactions have occurred, so sales and use taxes do not become an unwanted additional expense or surprise.
Unique investments

Airplanes

If you’ve made the choice to fly private, then addressing the related financial and regulatory compliance requirements is a critical step.

Ownership structure
Understanding the tax implications of flying private can help you choose the ownership structure to appropriately address 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 considerations. From a tax perspective, typically the entity owning the aircraft does not have a trade or business to allow for a full deduction of the aircraft expenses by the owner. Careful planning should be considered to identify the expenses of the aircraft entity that can be used to offset trade or business income of the business it supports. In addition, there are various elections and “grouping” rules to consider.

Payments between related entities can attract federal excise taxes, which are imposed on “air transportation.” They also may create a captive flight department company, which may subject them to certain Federal Aviation Administration rules applicable to operators that “carry passengers for hire.” Individuals and families should consult competent legal counsel and tax professionals when structuring the ownership of an aircraft.

Under the 2017 Tax Act, aircraft are considered eligible property to qualify for the new 100 percent expensing rules (also referred to as 100 percent bonus depreciation). However, the taxpayer needs to have enough qualified business use of the aircraft in the year of purchase, as well as subsequent years, in order to qualify for the accelerated tax depreciation over the otherwise allowable straight-line method. Additionally, even if there is enough qualified business use to permit the taxpayer to use the 100 percent bonus method, taxpayers should consider examining and limiting personal entertainment usage in the year bonus depreciation is taken to avoid a disallowance of the depreciation expense, along with other fixed and variable expenses of operating the aircraft.

1 An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.
Unique investments

**Airplanes**

**Sales and use tax 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 and use tax). In addition, there are flyaway exemptions in various states for the sales tax if the aircraft is not used there; however, there could be a use tax in a different state based upon the aircraft’s usage.

It is important to understand if one of the above sales tax exceptions is met in the initial year of purchase 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.

**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. Personal flights can further be broken down between personal non-entertainment and personal entertainment.

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.

If the aircraft is owned by an individual or through a SMLLC, there is a different allocation methodology to determine which expenses are deductible. Generally, this results in classifying each trip as primarily personal or primarily business. Many factors are used to determine the appropriate classification.

Historically, costs associated with travel to and from a business entertainment event were fully deductible if certain rules regarding the entertainment event were met. The 2017 Tax Act has implemented new rules governing the deductibility of expenses associated with business entertainment. Depending upon the additional guidance issued to support these new rules, there may be an impact on the tax treatment of travel to and from a business entertainment event.
Unique investments

Airplanes

Personal travel using private aircraft
Aircraft can be a useful tool for business travel, easing security concerns, allowing flexibility for changing schedules and maximizing owners’ and executives’ availability to attend to business matters. However, fairly often the personal usage increases steadily. This 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.

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 non-entertainment and personal entertainment. These categories are only relevant if a regarded tax entity is providing the aircraft to employees, owners, or guests. If the aircraft is being provided from a SMLLC to its owner, the other rules discussed previously will apply.

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 non-entertainment.

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 non-entertainment travel (i.e., they are traveling as a companion to a business event where spouses are expected or 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.

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 or fair market value 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 non-entertainment flights can generally be fully deductible by the company. Again, the income imputation requirement is only found when a non-cash fringe benefit is provided to an employee or owner. If a SMLLC is providing aircraft usage to its sole owner, there is no employer/employee relationship and therefore no fringe benefit applies.

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. 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.

Additionally, the 2017 Tax Act has eliminated the ability to defer gain under the like-kind exchange rules. Therefore, aircraft will be fully taxable when disposed, however, they are eligible for 100 percent bonus depreciation, as discussed previously.
Unique investments

Yachts

A yacht is another asset that presents unique tax considerations.

Yacht financing
Many of the yachts built in the United States are constructed in Louisiana and Mississippi. Yacht construction resembles home construction in some regards, 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. With respect to debt incurred after December 15, 2017, and before January 1, 2026, the reduced limitation on the amount of acquisition indebtedness ($750,000, or $375,000 in the case of married taxpayers filing separately) for the mortgage interest deduction will generally be applicable. Also, the deduction for mortgage interest on home equity indebtedness is suspended for tax years beginning after December 31, 2017, and before January 1, 2026.

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 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.

Foreign-flagged vessel (FFV)
There are advantages and disadvantages to becoming an 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. 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 often 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 an appealing option to offset the costs of owning a yacht. Chartering income 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 cannot be chartered within US waters.

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 deductible portion of yacht expenses is a complicated calculation. The taxpayer should engage tax advisers familiar with these rules to reduce the potential IRS challenges regarding the deductibility of such costs.

Dispositions of yachts
Ultimately, if the investor chooses to dispose of the yacht, then there are additional 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. In addition, 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 generally cannot be offered for sale in the United States.

Yacht operation: Income tax treatment of mixed use property

Chartering

Question: 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 nondeductible.


Chartering will permit an allocable share of expenses to be deductible.

Personal use

Question: Does the high net worth individual use the yacht for the greater of 14 days or 10 percent 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 are not deductible and are carried forward to offset income in future years.