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Since one of our favorite activities is lunch, it's not surprising that among our best clients are famous chefs. But when they dabble in the art world, some can find themselves in a jam — and that's where we come in.

Coco is a well-known baker with a taste for 1960s Pop art. She called us after a customer tried to convince her to try "the best thing since lo-cal cobbler": a tax-free swap of art through a so-called Section 1031 like-kind exchange. Coco was fired up about the idea of trading her **Warhol** silkscreen for a friend's Roy Lichtenstein sculpture — and paying no tax on the trade. We worried she might get burned.

Although we aren't tax specialists, we are quite familiar with Section 1031s. Americans understand that they must pay federal and state tax when they sell works at a profit. However, if they meet the requirements of Section 1031 of the Internal Revenue Code, they can postpone paying tax on the gain by reinvesting the proceeds in "like-kind" property. As we explained to Coco, this is easier said than done.

First some background. Section 1031 was enacted in 1921 by the federal government on the theory that capital gains should be lightly taxed and the tax system should promote economic growth. According to the Second Circuit Court of Appeals in the 1959 case *Jordan Marsh Co. v. Commissioner*, in passing the like-kind-exchange provision, Congress "was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort."

The volume of like-kind exchanges has grown recently, with published estimates putting the annual number in the hundreds of thousands. Although most such transactions involve the transfer of real property, the IRS code does permit the deferral of gain on "collectibles," defined as any art, rug or antique, metal or gem, stamp or coin, alcoholic beverage or other property specified by the agency.

These exchanges are simple in theory, but doing them right in practice is no piece of cake. Coco's proposal, for example, seemed to us a recipe for disaster.

The first problem was that Section 1031 applies only to exchanges of like-kind property "held for productive use in a trade or business or for investment." Both the relinquished asset (the old property) and the replacement asset (the new property) must satisfy this test. Artworks owned by individuals and displayed on their walls usually don't qualify, since the pieces are held mostly for personal use, not primarily for investment.

"But art is a great investment," Coco protested, "and I always buy with the thought that if it goes up, I'll sell it. Is the term *investor* defined in Section 1031?"

Unfortunately, no. However, the 1970 Court of Claims case *Wrightsman v. United States* suggests just how difficult it is for collectors to prove they are investors. In that suit, the noted collector Charles Wrightsman insisted that his works were primarily for investment and that his expenses relating to the investment were deductible. The court declined to allow the deductions and established a test for whether he held the works for investment. Among the criteria were whether he could establish that the investment purpose was "of first importance," whether he intended to hold the works for investment, whether he consulted with experts on purchases and whether he kept businesslike records. Some tax specialists might take a different position, but in our view, under *Wrightsman* merely holding a work with the thought of a future sale — as Coco was doing — was insufficient to qualify for Section 1031 treatment.

"What about dealers?" asked Coco. "Do they usually qualify?" Again, the answer is no. According to Section 1031, nonrecognition does not apply to inventory, and art dealers typically hold art as inventory.

Tax specialist Charlie Wagner, for one, believes that like-kind exchanges actually have very limited use in the art world. He acknowledges, however, that a collector might succeed if "the acquisition of the work is carefully structured so that it is clearly held for investment." For instance, an investor could enter into a partnership with an art professional as the general partner, and the art could be owned by the partnership. "The trick," Wagner says, "is that the art must spend most of its time in a warehouse rather than hanging on the investor's wall."

Art adviser Josh Baer counters that he has many happy clients who "have saved a bundle using 1031s correctly," although he notes that they are "scrupulous in crossing their ts — and have attorney and intermediary bills to show for it." Given today's sluggish economy, perhaps it's no wonder that the pace of 1031s has picked up among collectors who want to defer capital gains taxes.

A second problem for Coco was that her Warhol silkscreen and the Lichtenstein sculpture for which she wanted to exchange it probably weren't sufficiently similar to constitute "like-kind property," as defined by the IRS in a different but analogous context. In a 1981 private-letter ruling involving lithographs that were destroyed in a fire that a taxpayer sought to replace with oil paintings, watercolors and sculptures, the IRS stated that it "will not consider as property similar or related in service or use artwork in one medium, destroyed in whole or in part, replaced with artwork in another medium."

Another half-baked aspect of Coco's plan was that she wanted the two halves of the swap to take place at different times — she would receive the sculpture in the spring but would hand over the silkscreen a year later. Like-kind exchanges don't have to occur simultaneously, but the transfer won't qualify under Section 1031 unless two important deadlines are met: First, the taxpayer must identify one or more potential replacements within 45 days from the date the relinquished property is sold; second, the taxpayer must receive the replacement property and complete the exchange no later than either 180 days after the sale or by the due date (including extensions) of the income tax return for the tax year when the sale took place. And the taxpayer must report a like-kind exchange to the IRS (on Form 8824) and file it with her tax return in the year when the exchange occurred. The 1031 deadlines are absolute — a fact that even some tax professionals don't realize.

It is important to note that gains on like-kind exchanges are not tax-free but merely tax-deferred. When the taxpayer ultimately sells the replacement property, the original deferred gain, plus any additional gain realized since the purchase of the replacement property, is taxable. In addition, even if a 1031 exchange is not taxable for federal income tax purposes, it may still be subject to state or local sales taxes.

IRS officials know that taxpayers have been taking liberties with 1031 exchanges, and in 2007 the U.S. Treasury Department issued a report noting that such exchanges should be more heavily scrutinized. There have been repeated efforts to repeal the provision; in 2007, the House passed, and the Senate Finance Committee killed, a bill that would have eliminated like-kind-exchange treatment for collectibles.

Those who wish to proceed with like-kind exchanges involving artworks held for investment should not only keep careful documentation from the moment they acquire the pieces to substantiate the exchanges but should also consult a tax or art law attorney. If they fail to satisfy the requirements imposed under section 1031, they risk paying significant interest and penalties, in addition to the tax due on the gain associated with the exchange. And that's tough for anyone to swallow.

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