Considerations in the Art of Tax Planning

Timothy Mertons, Chairman of Sovereign Trust says investing in art can reap good returns but you need to watch out for the pitfalls if it is not planned properly. Sovereign is sponsoring the Cape Town Art Fair (28 Feb-02 March, The Pavilion, V&A Waterfront).

Art is now an increasingly popular asset class for investors at a time when bank interest rates are at record lows, financial markets are under pressure and many countries around the world struggle with sovereign debt.

Collecting art does not suit everyone but for those who have some knowledge of or an appreciation for art could do better than with many of the current alternative investments available, such as hedge funds, private equity funds or even some types of share portfolio.

The wonderful thing about art is that it is tangible and so has more in common with the likes of property investment than shares, other than the fact that of course art is portable. It does not provide any income or rental like a share or property investment would but it could be said that art does pay a dividend in the form of the enjoyment one receives from it, whether it is regarded as an investment or not.

The portability of art means that it can be moved between borders, which make it an attractive store of wealth for the wealthy, especially those living in less stable economies or countries around the world. In South Africa, of course, one would have to obtain Reserve Bank approval in order to transport art cross border but in countries where this is not an issue, there are obvious advantages.

If one considers who the serious art collectors are, they are generally entrepreneurs or investors who make their money not from art itself but from the business they run. They then invest in art that is able to provide them with returns of income. In times of high economic growth when there is hunger for capital, these art collectors are more far more likely to concentrate on their own business ventures than alternative asset classes,, such as art. For this reason, investment in art does not appear to be correlated with equity markets but does suffer from economic cycles. If one looks at this historically, as the global economy accelerated in the 1990s and Russia, China and India entered the global economy; there was a massive injection of capital into infrastructure, manufacturing and creation of new business to soak up the low cost demands from the rest of the world. This meant that art prices and returns were generally low.

This all changed after the boom years from 2002 to 2008, when there was a sudden injection of new money into the art world. Suddenly, there were Asian millionaires and

Russian plutocrats on the scene who were looking for investment opportunities as a result of the huge economic gains in the 1990s and the rise of middle class spending.

However, as global markets deleveraged between 2008 and 2010, the art market suffered again just as it had in the 1990s – and in line with increased demand for capital with the concomitant demands for increased liquidity.

In 2010, the art market again started to boom and returns in art rocketed because large amounts of capital had nowhere else to go, due mostly to concerns over major currencies such as the US Dollar and the Euro and a general suspicion of traditional investment markets.

For those who have invested in art over the years or who are now thinking about it for the first time there are some important considerations. Take for example the buyer of Peter Doig's painting *The Architect's Home in the Ravine*, which took place at auction in 2002 for £314,650. As this is a fairly considerable investment even for a serious collector. At the time, a conversation should have been had about issues such as capital gains tax if the artwork were ever to be sold, potential succession planning and Inheritance Tax in the event of the buyer’s death and other issues such as insurance.

The painting was sold in 2007 and again in 2012 by Christie's for a staggering £7.7m. Had the buyer divested the work into an appropriate tax structure when purchased, there would have been the opportunity to create the huge upside growth in this investment outside the buyer’s estate, thus avoiding inheritance taxes down the line.

Closer to home, consider the work *'Chinese Girl'*, the most iconic work of Vladimir Tretchikoff, the Russian émigré who settled in South Africa. *Chinese Girl* will be on show, thanks to Delaire Graff Wine Estate, at this weekend’s Cape Town Art Fair, sponsored by The Sovereign Group. This painting was estimated to sell for between £300 000 to £500 000 (and bought initially for far less) but it made £982,050 at the Bonhams South African Art sale.

There have also been record prices achieved for works by Pierneef and Stern which demonstrates that art can deliver as an investment class and also, as with any valuable asset in one’s estate, that this should be carefully and properly tax planned. This is not only the case for well-known masters but also applies to works by emerging artists because they can often significantly appreciate in value over time and as the artist becomes better known.

Appreciating that assets also need to be properly documented, described and catalogued - particularly when art collections are to be handed down from generation to generation - means that proper records need to be kept by trustees if the works are settled into trust. If not, then executors should be provided with clear instructions in any last Will so that in the case of large valuable art collections, these are not broken up or sold to cover taxes.

Art and tax planning are unlikely bedfellows. Art is often about passion, personal taste, and creativity, whereas law and tax is a set system of rules that is often inflexible and has to be obeyed.

For those who already have valuable art collections it may still not be too late to consider effective strategies to minimize the sometimes devastating effects of estate duty and capital gains tax. For those who are just starting their art collections, be it for investment purposes or the pure enjoyment art brings them, it would be wise to get proper advice so that any future growth in value can be anticipated and succession and tax plans put into place .

Timothy Mertens is Chairman of Sovereign Trust (SA) Limited, a subsidiary of the world-wide Sovereign Group which is sponsoring the 2014 Cape Town Art Fair.