

THE RE-EMERGENCE OF ART MARKET TAX INVESTIGATIONS AND THE DOMESTIC FREEPORT AS A TAX SAFE HAVEN

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INTRODUCTION

On May 12, 2006, Manhattan District Attorney (DA) Robert M. Morgenthau announced that L. Dennis Kozlowski, former CEO of Tyco International, would pay US\$3.2 million to settle charges of avoiding sales tax on 12 paintings he purchased from art dealers in Manhattan and London. While the amount of Mr. Kozlowski's settlement is staggering, his story is not unique.

In the years leading up to Mr. Kozlowski's settlement, the Manhattan DA's Office undertook a broad investigation of galleries that had failed to collect, and buyers who had failed to pay, the required state sales and use taxes. As home to lofty and media-garnering public auction prices and to one of the nation's highest sales and use taxes, New York City had become a hotbed of art market-related tax fraud and, consequently, tax fraud investigations.

Recently, New York law enforcement agencies have renewed their interest in art-related tax evasion by putting buyers under the microscope. Individuals and companies involved in art purchases and other art-related transactions are now well-advised to proactively educate themselves on this reemerging area of scrutiny. This article will provide an overview of the history and current scope of law enforcement's interest in art-related taxation, including recurring areas of focus. This article will then recommend a course of action to ensure that those transacting in the art market are protected from unwarranted tax scrutiny and liability.

HISTORICAL INVESTIGATIONS BY THE DA'S OFFICE AND OTHER STATE LAW ENFORCEMENT

In 2003, the Manhattan DA's Office launched an investigation into fine art galleries, dealers, and private collectors violating New York State and City sales tax regulations. The probe focused on high-end art sellers who skirted charging their New York customers sales tax by shipping empty containers to out-of-state locations such as New Jersey and Connecticut. See "Art-World Crime Wave?", *Artnet News* (July 25, 2003).

During this investigation, the State of New York subpoenaed over 20 art dealers' records, assessed over US\$37.5 million in fines and tax restitution, criminally charged nearly a dozen galleries and 300 purchasers, and secured numerous felony guilty pleas. See Thomas C. Danziger and Georges G. Lederman, "New York DA Launches Secret Art Sales Tax Investigation", *Artnet News* (January 22, 2015); Graham Bowley and Robin Pogrebin,

"Galleries' Records Are Subpoenaed", *N.Y. Times* (February 4, 2015); Anemona Hartocollis, "Ex-Tyco Chief to Settle Tax Evasion Charges", *N.Y. Times* (May 13, 2006).

As a result of the investigation, many galleries were hit with significant fines. For example, Berry-Hill Galleries paid US\$750,000 as part of a plea with the Manhattan DA's Office for felony failure to collect sales tax and falsifying related business records. See Carol Vogel, "Gallery Under Legal Fire Declares Bankruptcy", *N.Y. Times* (December 22, 2005). For similar transgressions, gallery Otto Naumann Ltd. paid US\$500,000 in fines (see Carol Vogel, "Manhattan Art Gallery Admits Tax Charge", *N.Y. Times* (June 20, 2003)), Bob P. Haboldt & Co., Inc. paid US\$400,000 (see Susan Saulny, "Art Gallery Admits Tax Violation", *N.Y. Times* (July 3, 2003)), and Art Advisory Services, Inc. paid US\$250,000 (see "Westreich in Multiple Tax Pleas", *Artnet News* (July 27, 2004)).

RECENT ART-RELATED TAXATION INVESTIGATIONS

At the time, many in the art world thought the DA's investigation had reached its culmination, but, in fact, it was not over. In 2015, New York law enforcement again took up the investigation, this time with a particular interest in purchasers who claim an intent to resell a work but are in fact displaying (or have in the interim displayed) the art work for personal enjoyment. In early 2015, the Major Economic Crimes Bureau of the Manhattan DA's Office issued subpoenas requesting the sales and shipping records of several art galleries and dealers.

This iteration of the investigation was met with varied responses from art market players. Art dealers seem nonplussed, having assumed that buyers and sellers learned their lessons 12 years before. Attorneys to those in the industry, by contrast, considered recent sky-high public sale prices at Sotheby's and Christie's auction houses an easy red flag to law enforcement because "[w]hen big sales get publicized, the tax authorities' ears prick up." Graham Bowley and Robin Pogrebin, "Galleries' Records Are Subpoenaed", *N.Y. Times* (February 4, 2015).

In May 2016, New York Attorney General Eric Schneiderman announced that Manhattan real estate developer Aby Rosen had agreed to pay US\$7 million to settle a claim of unpaid sales and use taxes on 200 pieces of fine art. Rosen had avoided paying taxes on over US\$80 million of artwork he had purchased or commissioned through two companies since 2002 by claiming the art was purchased for resale. Schneiderman, on the other hand, alleged that the artworks were actually for Rosen's personal enjoyment or to enhance his development properties and, therefore, subject to sales and use taxes.

Rosen, known in art market circles as an astute blue-chip collector and reseller of contemporary art, has in the past displayed works by artists such as Pablo Picasso and Andy Warhol in his Manhattan property holdings, including midtown Manhattan's Seagram Building and Lever House. The State of New York adopted the position that, even if an art purchaser intends to resell an artwork, exhibiting the work in the home or office in the meantime subjects the purchaser to sales and/or use taxes.

Most recently, in July 2016, powerhouse Gagosian Gallery agreed to a US\$4.28 million settlement for its California affiliate gallery, Pre-War Art, Inc., having sold and shipped art worth approximately US\$40 million to New York buyers without collecting state and local sales taxes. Attorney General Schneiderman again iterated that fine art industry transactions are no exception to general tax obligations: "There is one set of tax rules for all, and that includes art dealers and collectors." Katya Kazakina, "Gagosian Gallery to Pay \$4.28 Million in Tax Settlement", *Bloomberg.com* (July 19, 2016).

PROTECTING THE PURCHASER: DOMESTIC FREEPORTS AS A MEANS TO ENSURE TAX COMPLIANCE

The New York Attorney General has publicly asserted that his office is "committed to rooting out tax abuses wherever [they] find them, especially in the art world, where the difference can be hundreds of thousands — if not millions — of dollars in lost tax revenue per sale." Rebecca Spalding, et al., "Art Buyers Face Scrutiny As New York Kicks Off Tax Probe", Bloomberg (May 3, 2016, 8:51 p.m.). This commitment reflects the Attorney General's focus on holding buyers accountable for their use and enjoyment of artwork. "When art collectors don't pay their fair share, law abiding New Yorkers should not be stuck footing the bill," Schneiderman commented. *Id.* The New York State Department of Taxation and Finance has similarly affirmed that it "takes tax evasion very seriously and has a rigorous audit program to ensure that all taxpayers pay their fair share of taxes — in relation to art and all other taxable items and enterprises." Graham Bowley, "Art Collectors Find Safe Harbor in Delaware's Tax Laws", *N.Y. Times* (October 25, 2015).

In light of such public assertions, it is incumbent on art purchasers to be well-versed in effective methods to protect against detrimental allegations of tax fraud. Availing oneself of domestic freeports is one such method.

Overview of Domestic Freeports

A freeport is a storage location or facility in a jurisdiction that does not impose sales and use tax on property while held in that jurisdiction. Foreign freeports have long been popular among American art collectors who were able to make purchases free from domestic sales and use taxes by immediately shipping artwork to overseas warehouses in Monaco, Geneva, or Luxembourg. Now, New York art buyers can plan to ship their purchase 140 miles south to Delaware, home of several domestic freeports for American art purchasers, via an approved "common carrier" as arranged by the seller on behalf of a purchaser. See Eileen Kinsella, "New Delaware Freeport Offers New York Collectors an Art Tax Haven Close to Home", *Artnet News* (October 16, 2015).

Touted as "a safe haven for art," the Delaware Freeport, for example, is one of a handful of privately owned storage facilities designed to provide the benefit of a no-sales/use-tax state to art buyers from high-tax jurisdictions. The Delaware Freeport is described as a 36,000 square foot temperature-controlled art storage facility catering to art purchasers with a suite of services including crating and handling, customs and import facilitation, and regular shuttle services to and from the nearby Amtrak Wilmington stop and New Castle Airport.^[1]

Other businesses, both art-specific storage and general shipping companies, have similarly taken notice of New York buyers' desire for safe haven. Crozier Fine Art, Atelier, and Bayshore, for instance, have each established Delaware storage facilities. Four other states offer zero state-level sales and use tax — Alaska, Oregon, New Hampshire, and Montana — but none is in close proximity to New York. Therefore, Delaware offers the most convenient option to New York buyers. As Fritz Dietl, founder of the Delaware Freeport, remarked, "[t]here really is no reason for an art investor and international art collector — or a New York collector or investor who has no plans for using the work in his apartment or personal use — to have to ship something to Switzerland." Eileen Kinsella, "New Delaware Freeport Offers New York Collectors an Art Tax Haven Close to Home", *Artnet News* (October 16, 2015). As the pinnacle of the national art market and host to one of the highest combined state sales and use tax in the country, New York — and New York buyers — are the domestic freeport's natural target, though purchasers from around the country may take advantage of the benefits.

Using a Domestic Freeport for Art Storage and Resale

Domestic freeports can be ideal for a prospective buyer who intends to purchase art solely for investment or resale purposes (pursuant to a commercial resale certificate, for example). As a professionally administered facility, in addition to the suite of services noted above, the domestic freeport can also provide the buyer with clear documentation of when the artwork was delivered inside the no-tax state, and the fact that the work remains in the freeport, which the buyer may then use, if needed, as evidence that the purchase was appropriately not taxed.^[2]

As an additional advantage to storing work in a freeport, an owner may avail herself of the freeport's viewing rooms. That is, an owner seeking to resell a work can arrange to have the prospective buyer view the work in person in a gallery-like environment offered as one of the freeport's services. See, e.g., www.DelawareFreeport.com/what-we-do/. The entire transaction can take place without moving the art work, which is a significant benefit because moving the art might trigger potential tax implications for the owner and/or cause potential damage from transport and display. This also ensures that storing work in a freeport does not place one at a disadvantage with respect to investment and resale opportunities.

Corresponding Best Practices for Art Purchasers

In addition to relying upon the freeport's record-keeping as needed, as part of best practices by the purchaser, it is important to work with experienced art law counsel to develop an accurate and personal record of the purchase history and use of any work. Specifically, a purchaser should meticulously maintain and preserve all transactional materials to facilitate a swift and thorough response through counsel to any subpoena should an investigation be initiated, and to prophylactically build a record of tax code compliance in defense to any future allegation of wrongdoing. Key transactional materials include correspondence with the seller, correspondence with the buyer, resale certificates, invoices, bills of sale, shipping agreements and records of shipping logistics, freeport documentation, and general receipts.

Moreover, the art purchaser who has not been charged sales and use tax by the commercial seller must not do anything at any point resembling personal use of the artwork, such as displaying or storing the work in the home or any location owned by the purchaser. Rather, the artwork should be shipped directly to the designated freeport, with arrangements for shipping made by the gallery or auction house where the painting was purchased, and should remain there until it is resold. Likewise, if the work is requested or offered for a public exhibition (a potentially attractive option as increasing the work's exhibition history may increase the work's value), the artwork may be removed from its storage place and placed on display publicly without incurring use tax in New York, for example, provided it is returned to its freeport storage thereafter.^[3]

CONCLUSION

In the art market, attention-grabbing transactions among well-known players at sky-high values do not go unnoticed by taxing authorities. Local law enforcement has dedicated significant resources to investigating this market for sellers and buyers who fail to comply with tax obligations.

In light of the Manhattan DA's Office's renewed investigation into instances of tax fraud, those involved in art transactions must be diligent in complying with New York State and City tax law. Indeed, even more broadly, as a

fine art purchaser or seller in any jurisdiction, it is important to work with experienced art law counsel to develop a thorough understanding of local and other taxation schemes so as to ensure compliance at every turn, whether the art work is being purchased for personal enjoyment, as an investment, or otherwise.

Interested in learning more on this topic? Look for an interactive panel discussion on the implications of art-purchases, freeports, and more, hosted by K&L Gates in New York City in early 2017.

NOTES:

[1] Similar Delaware facilities are discussed below and include the 50,000 square foot complex run by art storage company, Atelier; a 40,000 square foot warehouse maintained by art shipper, Crozier Fine Arts; and a 50,000 square foot art-specific facility maintained by general storage company, Bayshore.

[2] In light of the New York Department of Taxation and Finance's emphasis that tax is predicated on the point of delivery, the domestic freeport is a useful tool, then, to substantiate that the artwork was indisputably *delivered* to a no-tax jurisdiction. See New York State Dept. of Taxation and Finance, "Delivery Rules for New York State Sales Tax", (Aug. 6, 2015).

[3] Collectors of notable works of art have also immediately shipped artwork purchased in a state with a high sales and use tax to nonprofit fine art museums in states with no such tax, such as the Portland Art Museum in Oregon, the Hood Museum of Art at Dartmouth College in Hanover, New Hampshire, and the Delaware Art Museum in Wilmington, Delaware. For states that focus on the "first use" of the property for tax purposes, a loan for temporary public exhibition of at least 90 days, or the receiving state's statutorily required "first use" period, may allow collectors in some instances to purchase art without being required to pay the selling state's use tax. See, e.g., "Graham Bowley and Patricia Cohen, Buyers Find Tax Break on Art: Let It Hang Awhile in Oregon", *N.Y. Times* (April 12, 2014). To accomplish this type of loan transaction within the bounds of both relevant state and federal law, the guidance and counsel of an attorney must be sought.

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