BAIRD

Picasso, St. Gaudens or Lafite: Does Passion Have a Place in Wealth Management?

By Christopher G. Didier

CRITICAL OBSERVATIONS:

- Collections represent sizable assets for many high-net-worth individuals, but are seldom included in wealth management strategies.
- Some collectibles have performed as well as or better than stocks over longer periods.
- Because there can be a low correlation between performances for collectibles and those for stocks and bonds, collectibles can provide important portfolio diversification that may reduce risk.
- Collectibles can also add risk in the form of illiquidity, price volatility, and opportunity costs.
- Creating a precise asset allocation strategy that includes collectibles may be difficult due to poor data for modeling and appraisal pricing.
- To accommodate a collection, advisors can reduce assets with similar types of risk, and make sure their portfolios have adequate cash flow and liquidity.
- While it has become more common to talk about collectibles in terms of investment returns, the IRS may not take the same view.
- By incorporating collections into the estate planning process, advisors can minimize the impact of taxes on collection returns.

Synopsis

What's your passion? Fine art? Coins? Wine? We all know someone who collects something – or are collectors ourselves. This may include collections that started as simple hobbies and quickly built in value to thousands, even millions, of dollars. Collections that become a significant part of an individual's net worth should be considered in any wealth management strategy.

Collectibles often satisfy an emotional need, but, they may also offer benefits similar to those of financial assets. They can be used for diversification and a hedge against inflation. Over time many collectibles have earned higher returns than traditional investments like stocks. However, they also involve unique costs, risks and tax liabilities. So like any financial asset, a sizable collection must find its proper place on a personal balance sheet.

Identifying that place is not an easy matter. It can also be difficult to develop an asset allocation strategy that accommodates collectibles in terms of diversification, volatility and cash flow as this requires a history of accurate valuations or reliable benchmarks that can be used for modeling. And while it may make sense to rebalance a portfolio to achieve an asset mix that suits the investor's goals and appetite for risk, lack of ready liquidity may make this impossible.

It is imperative that sufficient due diligence be undertaken before buying and selling pieces of a collection, along with an assessment of all of the costs involved. Maintaining detailed, up-to-date records and obtaining expert tax and estate planning guidance will ensure that the value of the collection is efficiently transferred to heirs or other beneficiaries.

While people generally start collections for non-financial reasons, treating them like other assets can help collectors follow their passions for years to come while maximizing potential returns.

Introduction

It is said that one in three Americans collects something. Why they collect is a matter of debate. While humans have been collectors since at least the time of the Roman Empire, most research on the subject has been conducted in the last decade or so.[1] In addition, the definition for collectibles can vary widely.

Collecting and Investing in Rare Coins

Paul, the 68-year-old chairman of a public company, began collecting rare gold coins in 2006 as a "diversion" from his business activities. He considers himself a collector/investor – in that he values the historical significance of his coins but expects to make a profit over time.

"I realized I was a collector/investor when I bought my first coin for $60,000," he says. He prefers older coins whose exact supplies are known and conditions have been professionally graded. Paul has developed extensive knowledge about coins but will frequently rely on the opinions of top experts before making any transaction.

Using a common technique among numismatists, Paul holds about 20 coins at a time – the best he can buy. He uses profits from the occasional sale to upgrade his collection with coins of greater rarity. Wishing to keep his collection between 7% and 10% of his net worth, he also sometimes uses his profits to buy other assets that may offer more attractive returns. He routinely discusses his collection in quarterly updates with his financial advisor.

Paul sees his coins as an important part of his investment diversification strategy. In addition to their value as a hard asset and hedge against inflation, gold coins offer potentially strong upside returns. In the last few years, Paul has made more money in gold coins than he has in stocks and is more comfortable investing in his collection. While gold "got hammered" in the fall of 2008, he notes, ultra rare gold coins didn't suffer at all.

"And while gold coins are less liquid than gold bullion, the well-connected collector can always sell a coin when necessary," Paul says. "But I don't want to be a trader. I think you need to commit to a coin for at least three to five years." He sometimes breaks this rule if another coin he really wants comes along, but always considers profit potential as part of his decisions to buy or sell.

As an investor, Paul keeps detailed records. Running his collection like he runs his business, he relies on expert tax and legal advice to make sure he is maximizing the value of his investment while minimizing the tax liability. "The state quarters and other minting programs have dramatically increased the number of people who collect non-rare coins and some of those people are becoming interested in rare coins," Paul adds. "The supply/demand equation is definitely moving in my favor."

When I was 15, collecting beer cans was all the rage. One day, my Dad came home with a six-pack of Billy beer that he found at our local grocery store. It cost him $2.49. I had hit the jack-pot! It was the late 1970s. Rumors were rampant that individual cans bearing the name of Jimmy Carter's infamous brother could fetch as much as a thousand dollars each. If I could just keep them in good shape, their value would surely climb.

Unfortunately, it turned out that millions of Billy beer cans were sold and the rumors of lofty values proved false. Like CB radios and pet rocks, beer can collecting faded quickly. I lost interest, and when I threw away my leisure suit the collection went, too! Thirty years later, eBay lists a few offers for a six-pack of Billy beer at about $25. Assuming a willing buyer, that would imply a respectable 8% return on my Dad's investment had I stuck with my collection.

Many enthusiasts would consider my beer cans – or more recently, Michael Jackson memorabilia – as collectibles. However, most serious collections involve vintage items produced before 1970.[2] Popular collectibles today include fine art, jewelry and watches, comic books, coins, stamps, wine, classic cars, antique furniture, books, musical instruments, and sports or other memorabilia. Demand can be enduring especially for, fine art and coins, or fleeting, as it was for my beer cans.

A few years ago a client who was an avid collector showed me a coin he had just purchased for

[1] Susan M. Pearce, Interpreting Objects and Collections, 1994

[2] Various interviews of collectibles market participants

$500,000. Clearly, this was no beer can collection. It was serious money. And, he expected a serious return on his investment. When the technology bubble burst at the end of the century, many wealthy families looked past stocks and bonds to alternative investments for better returns and risk management. The definition of alternative investments expanded beyond private equity and hedge funds to include commodities (such as gold, oil, corn and timber) as well as real estate and equities from emerging markets, to name just a few.

It is easy to add collectibles to that list. Over time, many collectibles have earned higher returns than traditional investments like stocks. But they also involve unique costs, risks and tax liabilities. So like any financial asset, a sizable collection must find its proper place on a personal balance sheet and be considered in any wealth management strategy.

For many people, their collections are like the homes they live in – becoming investments when their values rise strongly. When values decline, the same collections morph back into simple passions. But by including stamps, art and coins on the asset side of their balance sheets, collectors can work more effectively with their wealth managers to get the right mix of risk, return and liquidity to ensure that they can pursue these passions for years to come.

Beyond Investments of Passion

Collections represent sizable assets for many high-net-worth individuals, but are seldom included in wealth management strategies. This is probably because historically collectibles have been viewed as something other than financial assets. For example, the World Wealth Report recognizes collectibles as “passion investments,” but does not include them as financial assets. It is true that many collectors are fascinated by the history behind a particular stamp, see the social value in encouraging new artists, or enjoy the camaraderie of trading coins with other numismatists. Some, however, are more financially motivated. One school of thought is to divide the market into collectors, collector/investors, and investors each participating in the collectibles market in a different way:

Collectors – Defining collectors is as difficult as understanding why someone collects. There is general agreement that collectors have a passion, or even an obsession, for the objects they collect. They may want to preserve history, or possess objects that no one else has. In any case, the primary objective is to build a collection.[3]

Collector/Investors – Collector/investors have the same drive but want some form of monetary return. They are willing to part with some or all of their collections if the profits

[3] Susan M. Pearce, Interpreting Objects and Collections, 1994

TABLE 1:

Estimates of annual global transaction value[5]

Collectible Category	Estimated Global Annual Market	Source
Wine	$3 Billion	Liv-ex
Art	$8.3 Billion	Artprice
Stamps	$10 Billion	Stanley Gibbons
Coins	$10 Billion	GPA for Coins
Total	$31.3 Billion	

or other benefits (such as a tax deduction) are high enough. They may constantly trade up objects within their collections to improve the profit potential. From time to time they may use parts of their collections to fund investments in other asset classes with superior potential. Collector/investors are also willing to hold objects for long periods of time.

Investors – Investors have no passion for the art, coins or wine they acquire. Holding onto objects represents a cost and satisfies no need, nor does it provide any value. Investors are solely motivated by profit and only buy collectibles for a profit opportunity. Some may even hold shares of collectibles funds – which become available from time to time with limited success.

Under this division, only the pure collector may have trouble viewing a collection in financial terms. Collector/investors and investors in collectibles would do so naturally, and the number of people in these groups may be on the rise. The 2009 Wealth Report noted that, for wealthy individuals, the allocation to fine art has risen since the financial crisis broke at the end of 2008 "as investors sought assets with more enduring value.[4]" It became clear to me that collections have moved beyond investments of passion when CNBC recently started running profiles on a variety of collectibles. The concept of collectibles as a financial asset had gone mainstream!

Still, data on the actual size of investment in collectibles is difficult to come by. Steve Ivey, co-founder of Dallas-based Heritage Auction Galleries, one of the world's largest collectibles auctioneers, estimates that the annual market value for vintage item transactions lies somewhere between $50 and $100 billion. This seems like a lot, but, as Table 1 shows, by combining other estimates of just a few individual collectible categories, it is easy to see the $50 to $100 billion range as reasonable. And that does not account for the many private sales that take place among all sorts of collectibles and never show up in any data. It is safe to say that the annual trade in collectibles is substantial.

Arriving at an accurate estimate of total investment value requires some additional leg work. The total value of collectible art alone has been estimated at more than $3 trillion.[6] The 2009 Wealth Report showed that fine art accounted for 27% of passion investments. Other collectibles – such as coins, wine and antiques – accounted for about 12%. Using $3 trillion as the value of all collectible art, and the Wealth Report's estimates on the percentages held as representative of the actual proportion held, we can back into an

[4] Capgemini & Merrill Lynch, "World Wealth Report", 2009, p18

[5] The estimates in Table 1 were obtained from sources we believe to be reliable but cannot guarantee their accuracy. The reliability of estimates varies as well. For example the estimate for global fine art is based solely on actual auction data and does not include private sales while the estimated market value of rare coins is an estimate of the entire market.

[6] Raya Mamarbachi, Marc Day and Giampiero Fauto, "Art as an Alternative Investment Asset", 2006

estimate of $1.3 trillion in value for other collectibles or a total collectibles value of around $4.3 trillion. If just one-third of the market was represented by collector/investors and investors in collectibles, that would put the value of collectibles viewed as financial assets on par with the $1.9 trillion invested in hedge funds[7] and the $2.5 trillion invested in private equity funds.[8]

An Asset Class of Their Own

Wayne Carini, a master car restorer who worked for collector David Letterman, hosts "Chasing Classic Cars" on the Discovery Channel. In a recent episode, Wayne made the case for classic cars as an investment.

"The economy is in the tank," he said, "but, it doesn't affect the automobile business as far as the collector car end of it. Collector cars are something that everyone wants. It's a place they can put their money and invest properly. You can always go out in the garage, feel it, touch it, sit in it and drive it. You can't do that with your stock portfolio."

Earlier this year, I was standing in a custom-built garage of a collector of b-body classic cars who told me the very same thing. The point is; the collectibles that offer the greatest enjoyment may make great investments as well.

Treating collectibles as an asset class is tricky. Equities and bonds have many widely available indices that can serve as benchmarks and good proxies for modeling how different asset classes can add or subtract potential risk and return to or from a portfolio. Finding reliable data for collectibles can be much more difficult. There are many collectibles pricing guides that list auction results and "expert" opinions on value. There are also indices for some broad collectible categories that can be useful in tracking broad market trends.

Some of these indices have a relatively short history, and it remains to be seen if they will be continued into the future. In October 2008, the Barrett-Jackson Auction Company published the Barrett-Jackson Mini-Index based on prices for seven vintage U.S. and European sports and muscle cars. The index showed an average annual return of 16.4% versus 4% for the S&P 500 Index for the 10 years ending January 2008. That same year, similar data was published by NADAguides.com covering February 2004 to February 2006 that showed an average increase in collector car values of 36% versus 16% for the S&P 500.

Others indices are more established: The Antique Furniture Index, published by the Antique Collector's Club in England, has been calculated annually since 1968 using retail prices from shops, fairs, markets and auctions across England. Over the 40-year period ending December 31, 2008, the index returned 7.5%, on average, annually versus 5.7% on average for the S&P 500 over the same period.

Measuring Risks and Returns

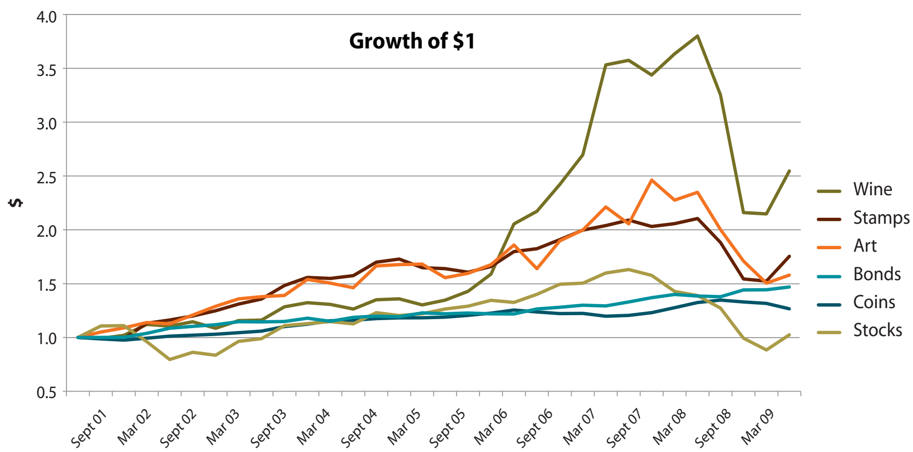
Most research regarding collectibles as investments tends to focus on a single category such as art or rare

[7] Hedge Fund Research, Inc., July 2009

[8] Preqin, December 2008

GRAPH 1:

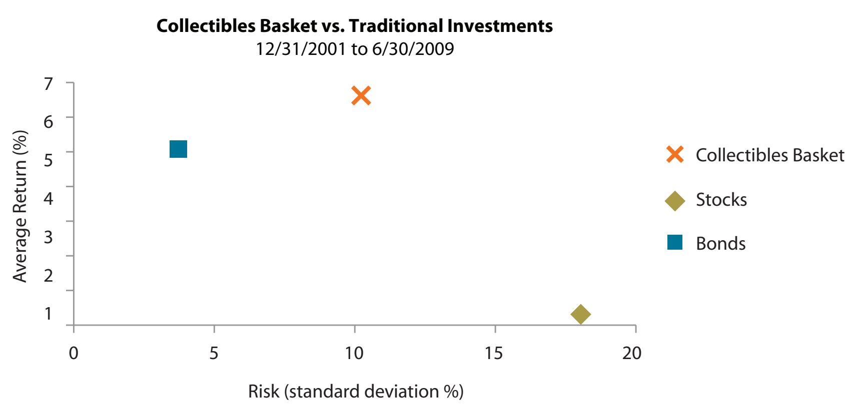
Performance of popular collectibles against stocks and bonds[9]



Graph 1 shows how each of these indices performed against stocks (as measured by the S&P 500 Index) and bonds (as measured by the BarCap US Aggregate Bond Index) from September of 2001 through March of 2009. The indices used are representative of some of the more popular collectibles. Index data for other collectible categories was unfortunately not available. We intentionally selected the broadest indices for each category available, (Art, for example, may include sub-sets such as old masters, contemporary, or U.S.). It is also worth noting that most indices only capture auction prices. As a result, dramatic changes in any one component of an index can dramatically distort its value. Thus, the outsized return in the Liv-ex 100 index of fine wine can be attributed to the extremely strong demand for Lafite Rothschild during the period shown. The indices do prove useful, however, when examining the direction or trends within a broad collectible category.

GRAPH 2:

Performance of the "collectibles basket" against stocks and bonds[10]



Graph 2 shows the collectibles basket performed significantly better than stocks on both a risk and return basis. Risk was defined as volatility as measured by standard deviation. The collectibles basket returned 6.6% on average versus just 0.32% for stocks, and with 55% lower risk. The average return for the collectibles basket was also higher than that for bonds, which returned 5.1%. However, the risk of the collectible basket was 117% higher than bonds, which is significant. Obviously, different results may be found over different periods. Whether these trends hold up over any future period remains to be seen.

coins. Since I was interested in examining some of the trends in price movements for the broad collectibles market versus traditional asset classes and other alternative investment classes, I constructed a "collectibles basket" based on indices representing the recent historical performance of wine, art, coins and stamps (Graph 1). These indices include:

Wine: Liv-ex 100 Fine Wine Index, which is based on the 100 most popular French, German and Italian wines with a secondary market, weighted for scarcity

Art: Artprice Global Art Index, which is based on the Artprice auction database and includes more than 25 million auction results from more than 2,900 auction houses worldwide.

Coins: PCGS 3000 Index, which is based on 3,000 rare copper, silver, nickel and gold U.S. coins.

Stamps: Stanley Gibbons GB30 Rare Stamp Index, which is based on prices for 30 rare British stamps.

Our basket of collectibles was then constructed by weighting the indices, based on estimates of annual global sales, over the available common period (Graph 2). We first compared the performance of our collectibles basket with stocks (the S&P 500 Index) and bonds (the Bar Cap Aggregate Bond Index).

[9] The S&P 500 is a managed stock price index comprising the 500 largest companies in the U.S constructed by Standard and Poor's. The BarCap Aggregate Bond Index is an unmanaged market value weighted performance benchmark for investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities with maturities of at least one year. The index information presented has been obtained from sources we believe to be reliable. We cannot, however, guarantee its accuracy. Past performance is not necessarily indicative of future performance. The stated market indices are unmanaged indices used to measure and repeat performance of the market in general. Direct investment in an index is not possible. The investment results depicted herein represent historical gross performance with no deduction for management fees or transaction costs. Dividends are assumed to be reinvested.

[10] The "collectibles basket" was constructed by weighting 9.1% to the Liv-ex 100, 30.3% to the Artprice Global Art Index, 30.3% to the PCGS 3000 Rare Coin Index and 30.3% to the Stanley Gibbons GB30 Rare Stamp Index. Weightings were based on estimated annual market value of $3 billion, $10 billion (rounded up in an effort to compensate for the conservative weight relative to wine, coins and stamps), $10 billion and $10 billion respectively.

Table 2 shows the correlation of the collectible basket with other traditional and alternative asset classes as well as the U.S. economy and inflation. The collectible basket is positively correlated with all of the other asset classes – with the exception of bonds. This means it is likely the prices of a collection will move in the same direction as these asset classes and in the opposite direction of bonds.

Like the non-bond asset classes, collectibles are positively correlated to the U.S. economy. Bond guru Bill Gross, manager of the $104 billion PIMCO Total Return Fund, came to a similar conclusion and personally turned a $2 million investment in British stamps made between 1998 and 2001 into $9.1 million at auction, as it became clear the economy was headed down.

The correlation between our collectible basket and inflation suggests that collectibles are in fact a good inflation hedge. For the period we examined, which was not a highly inflationary time, the collectible basket was the second best hedge, behind commodities.

Our collectibles basket was most highly correlated to private equity and hedge funds. This may have something to do with the similarities in appraisal methods and the auction nature of pricing for these asset classes. Like real estate, this price mechanism can make these asset classes fairly illiquid at times. The extra return may simply be compensation for not being able to get your money out when you want. This may not be a major concern for high net worth individuals, however, who typically have other ways to get the cash they need.

TABLE 2:

Asset class correlations from 12/31/2001 through 6/30/2009

	Stocks	Bonds	Private Equity	Hedge Funds	Real Estate	Commodities	Emerging Markets	Inflation	U.S. Economy	Collectibles Basket
Stocks	1.00	-0.33	0.76	0.73	0.38	0.28	0.87	0.12	0.47	0.51
Bonds	-0.33	1.00	-0.29	-0.21	-0.16	-0.19	-0.18	-0.42	-0.24	-0.15
Private Equity	0.76	-0.29	1.00	0.81	0.68	0.36	0.70	0.28	0.62	0.66
Hedge Funds	0.73	-0.21	0.81	1.00	0.44	0.52	0.85	0.39	0.60	0.75
Real Estate	0.38	-0.16	0.68	0.44	1.00	0.35	0.24	0.30	0.77	0.49
Commodities	0.28	-0.19	0.36	0.52	0.35	1.00	0.39	0.73	0.51	0.53
Emerging Markets	0.87	-0.18	0.70	0.85	0.24	0.39	1.00	0.14	0.47	0.52
Inflation	0.12	-0.42	0.28	0.39	0.30	0.73	0.14	1.00	0.31	0.45
U.S. Economy	0.47	-0.24	0.62	0.60	0.77	0.51	0.47	0.31	1.00	0.57
Collectibles Basket	0.51	-0.15	0.66	0.75	0.49	0.53	0.52	0.45	0.57	1.00

Defining correlation – In designing an asset allocation strategy, Financial Advisors may chart how a group of assets correlate, or perform against each other over time. If a portfolio is well-balanced, each individual asset class within the portfolio can be expected to vary in performance. Two assets A and B can have a correlation that ranges from -1 to 1. For example, if Asset A is up and Asset B is also up, they are said to be positively correlated. If A is up, but B is down, they are negatively correlated. If they increase together in equal amounts, then they have a correlation of +1. If they move in equal amounts in the opposite direction, they have a correlation of -1.

Know What You're Doing

It goes without saying that collectors should buy what they love. But any collector, especially someone seeking investment returns, should do adequate due diligence before making a purchase.

"There are so many people who are relatively new to wine, who are going around setting themselves up as experts on investment in wine and spreading the complete myth that all fine wine is a safe investment. It's not," Jancis Robinson, a respected wine writer, told CNBC in a recent interview.

Without adequate due diligence, it is often difficult to know what you are buying. This was evident on a cruise I was on with my wife. Drawn to the daily art education series, we were amazed to learn that there would be Picassos, Rembrandts, and Dalis at auction toward the end of the cruise. The gentleman providing the daily lecture was so skilled at building enthusiasm that over $100,000 of art was sold at the subsequent auction.

I'm sure few of the buyers went on the cruise planning to go home with art. But the environment that was set up – the daily lectures, the "high-end" works, and the enthusiastic salesman – all worked to build desire. It was no surprise to me to learn on our return that the auction company on this cruise line received many complaints as buyers realized that their "too good to be true" purchases may have been just that.

Warren Buffett has often said about the stock market: "Risk comes from not knowing what you are doing." This view is seconded by John Albanese, a world renowned numismatist and founder of

(continued)

When the prices of traditional investments tumble, collectors are more likely to sell other assets before their beloved antique cars or vintage wines residing in custom-built garages and cellars.

This was clearly the case when the first car came up for sale at the Amelia Island Concours d'Elegance RM auction held in early 2009. The car was a 1959 Ferrari 250 GT LWB California Spyder with a catalog price of $2.4 to $2.9 million. Bidding began at $2 million and found no takers. After starting over at $1 million, the auctioneer was able to get the price up to $1.85 million before calling a "no-sale" – as the reserve, or price at which the seller would part with car, had not been met.[11]

On the surface, risk and return from our analysis of the data look good for collectibles. However, a collector/investor or an investor in collectibles should be aware that a lack of liquidity may smooth out volatility and make collectibles appear less risky than they actually are. For the 1959 Ferrari, the "market" price was 23% below the low end of the catalog price. But, since there was no sale, there wasn't any price volatility. It is important to understand that the appraisal pricing mechanism for collectibles and some other alternative investments may explain some of the lower volatility readings that we see when comparing these asset classes to more traditional investments.

Additionally, when comparing actual returns for collectibles with those for stocks and other investments, calculations should be net of the costs for purchasing, holding, and selling items in the collection. These costs may include the commissions paid to auction houses or private dealers as well as expenses for insurance, storage, maintenance, titles, condition reports and certificates of authenticity. Taxes paid by the collector should also be considered.

One must also consider the opportunity risk in tying up money that might earn better returns in the equity or fixed income markets – or the risk that a collectible will fall out of favor and earn little, if any, return.

A Place in the Portfolio

Most collectors, of course, are not trying to hedge inflation or diversify their portfolios. They have simply developed a deep connection with antique china, baseball cards or bottles of wine – some may even have inherited a collection from someone with that passion.

That said, it makes sense – when the collection is sizable – to incorporate it into a larger wealth management plan. In a previous paper, we noted that integrating a business into an asset allocation strategy can help assure adequate liquidity and avoid over-exposure to risk. The same is true, even if on a smaller scale, for a collection.

A key question for advisors is whether the collection represents a sizable part of a client's net worth. Research by Ibbottson Associates, for example, sets 10% as the maximum for private equity investments in a well-diversified portfolio. Given that collectibles have similar liquidity and appraisal risk, a 10% upper bound seems to make sense.

[11] "Chasing Classic Cars," Discovery Channel

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Certified Acceptance Corporation, a coin grading service, who said: "You can lose money on coins, even in a good market, if you buy from the wrong person and pay a high markup or don't get the quality you expect." This is good advice for any collector.

Determining specific allocations that include collectibles does not have to be the end game to making collectibles part of a wealth management strategy. The primary goal is ensuring that an investment portfolio has adequate liquidity and reasonable risk – a task that is more art, so to speak, than science.

Since collectible markets generally seem to be sensitive to the economy, albeit with a time lag, it may make sense for an investor with a large collection simply to lighten up on other economically sensitive assets. Given the lack of cash flow from collectibles, it is also important to make sure that sufficient income is available from other sources. There may be a need to rebalance a portfolio that includes other less liquid assets – such as real estate or a family business.

To maintain the appropriate balance, an advisor needs to know when there is a substantial addition to the collection or something of high value is sold. Unlike more traditional investments, such changes will likely involve as much passion as market opportunity, as most collectors would jump at the chance to add a rare stamp that completes a particular niche or sell a painting by an out-of-favor artist to purchase one who's all the rave.

Minimizing Income Taxes

Even those who do not view their collections as investments must follow fairly specific and systematic guidelines to minimize their tax liabilities. There is a significant body of law and case law dealing specifically with collections that make them different from other assets.

Unlike buying shares of stock, the purchase of collectibles through an auction house or private dealer may involve a state sales tax. Although the dealer or broker typically pays the tax, it is usually passed along to the collector. Collectors may also have to pay a use tax on items purchased outside the states where they live. While any short-term gains on the sale of collectibles are treated as ordinary income for tax purposes, long-term gains are taxed at a 28% rate, versus 15% for most other investments.

The IRS takes a fairly hard stance on whether one is an investor or collector in determining the deductibility of costs related to a collection. It requires proof that investment is the primary reason for owning a collectible, rather than enjoyment.

Before you put money into the equity or bond markets, real estate, commodities or other traditional investments, you would generally conduct some research or consult with an expert as to the market outlook, comparable or alternative strategies, how the investment fits into the rest of your portfolio, the investment's potential return versus risk and its effect on your cash flow, liquidity, taxes or any other factors that may influence your purchase decision. In short, you would consider the investment in the context of your overall wealth management strategy.

A collector/investor or investor in collectibles must be able to show a similar profit motive with collectibles to claim any related tax deductions. Accurate record keeping is critical here, along with establishing a pattern of behavior, such as tracking a collection versus its market or other investments. A similar case must be made to use a loss on the sale of collectibles to offset long-term capital gains.

Collectors must also follow specific guidelines to claim deductions for the full market value of a collectible donated to charity. The charity must be a public charity, as opposed to a private foundation, and the donated collectible must qualify as long-term capital gain property. The deduction must be supported by a qualified appraisal from a qualified appraiser.

In addition, the collectible must satisfy the "related-use" rule. This means that the charity receiving the item uses it for purposes related to the charity's core mission. If these guidelines are not followed, a collector will only receive a deduction for the cost of the item, rather than fair market value – a big difference if a collection has appreciated strongly in value.[12]

In the case of a painting, for example, this means that the charity (a museum, perhaps) would have to make the painting available for public display or include it in an educational program for the donor to get the full deduction. Unlike a donation of stocks, the painting could not be sold so that the proceeds could be used to support the charity's mission for at least three years.

In addition, most collectibles cannot be included in an IRA. The exception is a small amount of certain gold, silver, or platinum coins. Under IRS rules, if assets held in an IRA are used to purchase other types of collectibles, the purchase is considered a taxable distribution that may also invoke early-withdrawal penalties.

Thoughtful Estate Planning

The role of collectibles is equally important in estate planning. All collectors must prepare for the possibility that their heirs will not share their passions or, if they do, will appreciate attempts to minimize their tax bills.

The estate-planning process is often the place where collectors realize they have significant assets that they must include in their wealth management plan, says Heather Gray, vice president of trusts and estates at Sotheby's.

When purchasing life insurance to handle potential estate taxes, an advisor should be sure there's enough to cover a collection so that heirs have a choice in deciding whether to liquidate those assets. For large collections, a foundation can determine how the collection is handled and make sure it is well maintained.

This approach helps to avoid conflicts that can arise when some heirs want to sustain a collection and others don't, says Ralph Lerner, counsel in estate planning, tax and art law with Withers Bergman LLC. If it is clear that none of the heirs is particularly interested in the collection, arrangements can be made to give it to a charity with instructions to keep it whole. "You get the tax deduction, but keep control," Lerner says.

[12] Ralph E. Lerner and Judith Bresler, All About Tax Tips For Collectors, 2008

Collectors and their advisors can help heirs make informed decisions about what to do with a collection by educating them in advance about its potential benefits and risks. It also helps to think about how a collection might be divided among family members. "One expensive painting can really skew the division," notes Sotheby's Heather Gray.

It is imperative that any collector seek out expert tax and legal advice as the laws surrounding collections are constantly changing. For example, the Pension Protection Act of 2006 effectively limited the desirability of fractional gifts. As museums saw charitable donations decline significantly, new legislation has been proposed that would bring back a compromised version of the fractional gift. Stay tuned.

Conclusion

Although high-net-worth collectors "will always indulge in their passions" and pay top dollar for unique pieces of high quality, the authors of the Wealth Report expect economic conditions to suppress the overall demand for collectibles in the near term. But, given the positive correlation of collectibles with the economy, we could expect demand to return as the economy improves. It's times like these that make it particularly important for collectors and their financial advisors to recognize the impact of collections on overall risk, liquidity and cash flow.

The wise collector or investor will work with their advisors to ensure that the collection is treated like the invested asset it is. At a minimum, one should:

- Make sure there is a complete, properly appraised inventory that indicates the date items were purchased, their original prices, where they were purchased, and where information on their history or certificates of authenticity are stored. The inventory should be updated any time there is a change in the collection and reappraised every two to three years. Current listings readily available from auction houses can be used for ballpark estimates of broadly held collectibles.
- Keeping the appraisals up to date is imperative to consider the value of the collection's potential benefits and risks versus the collector's overall financial profile as well as for any charitable or estate planning objectives.
- Adjust the investment portfolio to accommodate the collection and, if possible, adjust the collection to accommodate the investment portfolio.
- Seek out expertise to conduct proper due diligence as with any other financial investment.
- Check with an accountant and attorney, who have expertise regarding the tax and estate planning issues associated with collectibles. This should be done early and as the collection grows in value and importance to overall wealth.

By treating the collection like other financial assets, collectors can follow their passions for years to come while considering the likelihood of potential returns and managing their risks.

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