Quarterly Tax Updates: January 2024

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In our latest Tax Quarterly Newsletter, we're covering a number of key tax planning topics, including:

The Unique World of Collectibles

The taxation of collectibles is unique. For example, if a taxpayer has a Mickey Mantle baseball card, what is his/her income tax basis on the card if he bought it for five cents and received six cards and a bad piece of bubble gum? Another example is someone who bought a bottle of A.H. Hirsch bourbon for $125, which he gave to one of his children. The bourbon later became the subject of a book, "The Best Bourbon You Will Never Taste." The bourbon now sells for $5,000 or more. The individual who received the bourbon is considering selling it to help pay for his daughter's college expenses. So, the question is, if he sells it, how will it be taxed?

Many people have collectibles but have not thought about the tax consequences or implications of keeping them until their death or selling them at some point. If you keep them until you die, there is a step-up in tax basis, and, if the decedent's Estate files a Federal and/or State Estate Tax Return, the collectibles should be listed to obtain a date of death basis. You may also need an appraisal to confirm the date of death value.

Here are some tax considerations regarding collectibles:

1. The Internal Revenue Code defines "Collectible" as:
   (A) Any work of art.
   (B) Any rug or antique.
   (C) Any metal or gem (certain gold and silver is permitted as an IRA Investments).
   (D) Any stamp or coin.
   (E) Any alcoholic beverage.
   (F) Any other tangible personal property specified by the Secretary for purposes of this subsection.

   The proposed Treasury Regulations define a Collectible to include "Any historical objects (documents, clothes, etc.)." In addition, the IRS seems to have the discretion to qualify any tangible property as a Collectible, such as a comic book or baseball card. Based on the IRS's definition, bourbon could be considered a Collectible, thus subject to special Tax rules.

2. Long Term Capital gain on Collectibles is taxed at a maximum federal rate of 28%, not 20%. Also, the Net Investment Income Tax can apply, making the marginal rate 3.8% higher. Although a Collectible long-term capital gain is taxed at a

maximum rate of 28%, the actual tax rate may be lower if the taxpayer's federal ordinary marginal income tax rate is less than 28%. Also, for Federal Alternative Minimum Taxes, the tax rate is the same as for regular federal income tax purposes.

3. The Installment Sale rules apply to the gains if the payment(s) from the sale of the Collectible are received in more than one taxable year.

4. Losses from the sale of Collectibles are deductible only if the taxpayer held the Collectible for investment purposes and not for personal purposes. However, the motive for holding onto a Collectible can change, as demonstrated by the bourbon example.

5. In computing Collectible gain for capital gain purposes, gains, but not losses, from sales of pass-through interests (S corporations, partnerships, an LLC taxed as a partnership, and a trust) that hold Collectibles are treated as collectible gain to the extent the pass-through entity holds the Collectible. Sales of gold exchange-traded funds (ETFs) will most likely be considered a sale of a collectible. Gold dealers who hold gold as inventory are not subject to this rule.

6. Generally, Collectibles should not be held in an individual retirement account (IRA), except for certain types of gold, silver, and platinum coins or bouillon. Also, if an IRA owns gold, silver, or platinum, the physical assets should not be stored at home. If it is it is likely to be classified as a taxable distribution.

If you are selling or gifting a collectible, it is important to consult with your Tax Advisor before you sell or gift the collectible.

Jump To Top

The Retirement Corner

Explore key insights into retirement planning as we uncover legal complexities associated with four distinct scenarios.

1. Nothing Personal, Just Business

James Caan who famously played Sonny Corleone in The Godfather, died on July 6, 2022. Before his death, unfortunately for his estate, Caan rejected an offer found in the IRS Rollover Rules, known as the “same property rule.” Essentially, if you receive a cash distribution, you must roll over cash. If you receive a property distribution, you must roll over the same property. A failure to follow the Rollover Rules/same property rule creates a taxable event, i.e. gets you “whacked,” in other words, the distribution is taxable. The United States Tax Court (the Tax Court) decision, ruled that Caan's estate should get whacked. Prior to his death, Caan owned two IRAs. UBS was the custodian of both. One of the IRAs invested in a partnership interest in a hedge fund. UBS, as custodian, was required to report year-end values of “alternative investments.” UBS attempted to obtain a value of the hedge fund investment for the year ending 2014. After multiple attempts, UBS withdrew as custodian in 2015, distributed the hedge fund interest to Caan and valued it at $1.9 million, the 2013-year end value. Caan did not report the $1.9 million as a taxable distribution. In 2017, Caan liquidated the hedge fund and rolled over the cash proceeds into a new IRA. Subsequently, in 20___, the IRS sent Caan a Notice of Deficiency for $780,000 and an Accuracy-Related Penalty of $156,000. In a full Tax Court opinion, the court found that although it was sympathetic to Caan's case, it had no choice but to find in favor of the IRS under the “same property rule.” The IRS and Caan's Estate ultimately agreed that the penalty would be abated.

2. Self-Directed IRAs: Crypto Craze and-A Modern Day Gold Rush

Among the information taught in many grammar school history classes about the California Gold Rush is that most of the people who made money in the gold rush were those who sold picks and other necessary equipment to the gold seekers. There is a new, modern-day “Gold Rush” for mostly self-directed IRAs who invest in Non-Fungible Tokens (NFT). An NFT is a digital file stored on the blockchain in the same manner as cryptocurrency, like Bitcoin. However, unlike cryptocurrency, which is analogous to money, NFTs represent digital files such as pictures, photographs, music, and videos. One can think of

NFTs like collectibles, autographed items, baseball cards, stamps, coins, and artwork. There has been controversy, however, about whether NFTs of trademarked goods violate Trademark Law. In 2023, in Hermes v. Rothschild, Hermes successfully sued Sonny Estival (aka Mason Rothschild) for violating its trademarked “Birkin Bags” when he created NFTs using the name “MetaBirkins.” The court ultimately held that Estival/Rothschild had committed trademark infringement by selling these goods. This relates to IRAs because IRAs are prohibited from investing in “collectibles” defined as:

(A) Any work of art.

(B) Any rug or antique.

(C) Any metal or gem (certain gold and silver is permitted as IRA

Investments).

(D) Any stamp or coin.

(E) Any alcoholic beverage.

(F) Any other tangible personal property specified by the Secretary for purposes of this subsection.

If an IRA invests in a collectible, it is considered a Taxable Distribution.

After the judgment in the Estival case, the IRS issued Notice 2023-27 that held an NFT will be considered a “collectible” if the NFT is associated with a prohibited collectible.

3. Taking RMDs When Your IRA Has Illiquid Assets

Taxpayers may invest in illiquid investments in their traditional IRAs (especially taxpayers who invest through self-directed IRAs). If a taxpayer is required to take a Required Minimum Distribution (RMD), however, it may be difficult or impossible to make the RMD if the IRA has insufficient cash. There are two possible solutions to this problem:

7. If the taxpayer has another traditional IRA with sufficient cash to make the RMD, the IRAs can be aggregated.
8. The taxpayer can make a cash contribution to the illiquid IRA if other conditions are met, for example, the taxpayer has earned income.

4. Transferring a 529 Plan to an IRA

In the first line of his famous short story, The Ransom of Red Chief, O'Henry wrote “It looked like a good thing: but wait till I tell you.” Similarly, converting a 529 Plan to a Roth IRA may have more nooks and crannies than a Thomas' English Muffin so what initially looks possible may not be. The Secure Act 2.0, signed into law on December 29, 2022, permits taxpayers to convert 529 Plan accounts into Roth IRAs under certain circumstances (the Conversion Rules). If you are thinking of making this conversion, please keep the following rules in mind:

9. There is a lifetime limit of $35,000.
10. Any conversion must be aggregated with other Traditional and Roth IRA contributions and cannot exceed the IRA contribution limit for the year.
11. A conversion can only be made from a 529 Plan that has been maintained for at least 15 years at the time of the conversion.
12. Normal IRA and Roth IRA rules apply to distributions.

The Conversion Rules apply to 529 distributions beginning January 1, 2024.

Jump To Top

The Far Side

Usually, we choose one story for the “Far Side” but could not settle on just one, so we chose two.

1. When is “Prepared Food” considered “Prepared”

A recent decision by Donna M. Gardiner, a Judge on the Division of Tax Appeals in New York, explored this issue. In Matter of Neupert, the owner of Tailgate Deli, a delicatessen, (deli) was assessed sales taxes for party platters that his deli sold. The party platters had deli meats, cheeses, bread, condiments, and other usual suspects. The deli owner appealed the assessment and claimed that the party platters were not “prepared food” because individuals had to make their own sandwiches from the items on the party platter. Judge Gardiner rejected the deli owner's argument. In a written decision worthy of U.S. Supreme Court merit Judge Gardiner stated:

“The facts of this case clearly establish that the party platters are ready for immediate consumption. Although petitioner emphasizes that the contents on the platters require further assembly by the ultimate consumer in order to be ready for immediate consumption as a sandwich, this argument ignores the statute and regulations. All the preparation has been completed by petitioner prior to the platters being sold. Another prepared food item that is instructive on this issue is self-service salad bars. Clearly, salads need to be assembled by the ultimate consumer from a variety of salad bar items that are pre-sliced and arranged in a way that is convenient for the customer to create a salad and buy it from the store. Such salads are taxable as prepared foods by the store. Similar to the party platters sold at the Tailgate Deli, the food options on a salad bar are prepared and not sold in their usual form and condition, nor in packaging and quantities as generally sold within the store. It is the preparation of the contents of the salad bar that constitutes the characterization of such salads as prepared food.”

The Court sustained an assessment of more than $12,000 against the deli owner.

2. Chinese Fortune Cookies and Tax Advice

Under the heading, “You can't make this up,” or “Your Tax Dollars at Work,” the IRS recently announced that it has partnered with several fortune cookie companies to include tax advice as part of the paper fortune contained in the cookie. Apparently, the fortunes will include tax deadlines reminders. The IRS did not indicate if fortunes could be cited as legal authority in any administrative or court proceedings.

Jump To Top