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PERSONAL PROPERTY TAXATION

Artistic licence

Is HMRC looking for better returns on artworks let under chattel licences? **Charles Cochrane** reflects

Our practice as agents involves three principle processes: buying, selling and planning with works of art. We are not dealers – we hold no stock – and we are not tied to auction as a method of sale. We are therefore able to offer independent advice and approach the market in the best way for our client.

This approach informs our planning and collection management work and we work with clients and their advisors to implement tax and succession planning for art. This might include offering a work of art in lieu of inheritance tax, a conditional exemption or a chattel licence.

Loaning art

A chattel licence allows someone other than the owner to use and benefit from the chattels in question. Think of it as a lease, with the user or custodian being the tenant. The terms of the licence will include: a description of the artwork; the duration of the arrangement; insurance; security; maintenance; transport; environment; inspection rights; termination; and so on. It may also involve a rental clause with a review mechanism.

The overwhelming majority of these arrangements are made between private owners of important works of art and museums and galleries, or between museums. These are usually referred to as loans, and can be made on a short-term basis for a specific exhibition, or a long-term one for a significant work that a museum includes as part of its permanent hang.

The next time you are in a museum, have a look at the text accompanying a work to see who the owner is. There will be an agreement signed by both sides, with the museum providing safe custody and insurance – for instance, in the form of a government indemnity in the UK – but usually nothing more. The owner has the benefit of their art being in a museum, giving it an important cultural endorsement.

> “There is always the inheritance tax risk to consider

There are plenty of loans of art outside the institutional arena as well, such as in: furnished lets; loans to members' clubs and hotels; from commercial galleries to offices and businesses; and within National Trust properties. Quite often, the owner simply has nowhere to store the art or does not want to pay for storage, insurance and care. Again, the basic terms are for the user or custodian to accept these costs and save the owner's storage fees.

Inheritance tax

Our story of private client chattel licences starts in the 1980s. The traditional model was for the parents to give all the chattels in their house to their children. The parents don't want to live in an empty house, however, so the children lease back the chattels with care and custody obligations placed on the parents until death. Provided the donor lives for seven years, the value of the gift falls out of the donor's liability for inheritance tax. The gift itself might trigger capital gains tax, but that is another story.

In 1986 the Gift with Reservation of Benefit (GROB) rules were introduced, which would render invalid the attempt to use the above gift for inheritance tax purposes, unless the parents paid a full consideration in money or money's worth for the use of the gifted chattels. A year later, practice rules were introduced by the Law Society stating that the terms of a chattel licence in these circumstances should be negotiated, within the commercial context by parties independent of the donor and recipient.

A practice subsequently grew up where a valuation using auction estimates would be agreed and a licence would be offered by the owner, asking the user to accept all care and custody obligations. These would be negotiated, and in addition a rent was introduced, often at around 0.1% of aggregate mid-estimate value. The only case that gave guidance is IRC v Macpherson [1967] STC 73 in which the court accepted that a peppercorn rent with self-insurance – a money's-worth obligation – and security were commercial terms. This case is still the only guidance we have, although it does not relate to the GROB regime.

Tax risks

One problem with all chattel licences under the GROB regime is that they are only tested in probate when it is too late to change the costs and rent. If HMRC can show that a benefit was reserved because the consideration – in terms of rent, if any, and costs – was too low given the commercial market, the entire value of the chattels is liable for inheritance tax.

Although there are plenty of commercial examples of the terms habitually agreed when inheritance tax is not at stake, there was sufficient uncertainty and risk that in the 1990s a benchmark position was adopted by practitioners and, eventually, by HMRC. This stated that in the absence of commercial evidence, a composite consideration – costs and rent – of 1% of mid-estimate value would be seen as being commercial. In 2009, this was changed by HMRC when it announced that the general benchmark was 1% rent with costs to be paid in addition.

> “Museum loans do not equate to year-round, exclusive access to a work of art

In summary, we can see a tenfold increase in the rents being paid when there seem to have been no commercial changes to justify it. The gulf between this rate and what might be obtained from anyone other than the donor is based, we believe, on a recognition of an inheritance tax risk, and the fact that the donor, even though independently represented, might be seen to be in a special position.

It is fair to say that museum loans do not equate to year-round, exclusive access to a work of art, which a chattel licence would in contrast allow. On the other hand, chattel licences often include very short notice periods, and museums are thus a comparable the negotiators should consider. Having said that, there are plenty of domestic licences to look at, such as National Trust properties let with contemporary chattels, which carry no extra rent but do incur some extra costs for the tenant.

US models

This brings us up to the October 2016 and 2017 Fiscal Forum meetings, in which HMRC announced that it would no longer recognise the previous 1% benchmark. While the benchmark was arbitrary, it did at least offer certainty. I believe the reason HMRC no longer wishes to abide by the protocol is that it considers much higher returns are possible for certain works of art. The evidence for this is from a New York business that appears to rent art in the same way chattel licences do under the GROB regime in the UK.

The company is called Artemus, and it has two broad offerings. For our purposes only the art leasing is relevant. The art it handles is largely Impressionist, Modern, Post-War and Contemporary works with a value between $1m and $100m.

Leasing tends to involve property developers that can't afford to buy the art they want, but which they can rent for, say, the atrium of one of their developments to help sell that building. Artemus can in turn either buy and rent or lease an artwork to the developer, and often charges 10% per annum for doing so. If the art is lent, the owner must agree to give the tenant an option to purchase to get the 10% return, which is split equally, with the owners and Artemus. The tenant can deduct the rent as an operating cost, and Artemus can register the transaction on the Uniform Commercial Code, which is not available outside New York city. The tenant takes the artwork off the market via the option, and can buy it later. If there is no option to purchase, the rent plummets before being split, assuming a tenant can be found.

Take care

HMRC has given no guidance on how to set suitable considerations, except that there must be a full negotiation assessing all possibilities in the commercial context, and any reliance on the former benchmark will not be regarded favourably. In a sense, we have returned to the 1987 Law Society practice note.

Parties to existing arrangements are therefore advised to check the commercial awareness of their negotiators and ask them to negotiate afresh. Clearly there is an argument from the tenant's point of view that lower rents could be settled, but there is always the inheritance tax risk to consider, given HMRC's new expectations based on the situation in the Big Apple. Parties to chattels licences involving high-value and low-volume 20th-century art should be particularly cautious.

The uncertainty created by HMRC's rejection of the 1% benchmark is unsettling and in the interim all negotiators can do is look to the commercial market, such as that is, and negotiate. This is after all what HMRC has asked for. One way to bring some certainty is via the courts, provided a probate estate is prepared to litigate.

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