

CASTING LIGHT ON THE SHADE: USING SECURITIES LAWS TO DRAW NEW CONTOURS IN ART INVESTMENT REGULATION

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The disparate treatment of art investments under the Internal Revenue Code and the Securities Exchange Act of 1934 poses a problem. This disparity generates inequities among art investors and between art investors and investors in traditional securities markets. The Internal Revenue Code considers both art and traditional securities to be capital assets with no material distinction. For example, prior to the 2017 tax act, art investors could defer the realization of capital gains through like-kind exchanges of works of art under section 1031 of the Internal Revenue Code. Currently, under section 1400Z-2, an addition to the Internal Revenue Code through the 2017 tax act, art investors may defer capital gains taxes in the same manner as traditional investors by investing their gains from the sale of works of art into “Qualified Opportunity Funds.” These funds are utilized to spur economic growth in designated “Opportunity Zones.”

The Securities Exchange Act of 1934, in contrast, does not recognize or regulate art as an investment vehicle with a trading market. As a result of this divergence between two legislative regimes that influence investment decisions, inequitable and unbalanced practices can develop within the secondary art market. Art investors may reap the tax benefits of investing in art without being subject to any modified securities laws or regulations, such as those concerning trading on or tipping material, nonpublic information.

This Note compares the tax treatment of art with the insider trading laws and regulations that apply to traditional securities and explores the potential of adapting those laws and regulations to fit the growing secondary art market. It concludes that increased regulation of the secondary art market would (1) synergize investing practices with the tax benefits of those investments and (2) enhance fairness and equity in the secondary art market.

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INTRODUCTION

Imagine that you have a sizable and impressive private art collection for investment purposes. You are familiar with the tax implications of your art collection, such as paying capital gains taxes when you periodically sell works in your collection. Now, one of New York City's top art museums has invited you to join its board of directors. Through this position, you may

learn which genres and artists will be most prominently featured at the museum over the next few years.¹ You may also acquire special access to top artists and their studios.² How might this insider knowledge impact your investments in the secondary art market,³ recognizing that there are no regulations regarding your use of material, nonpublic information in trading art?

The art market has grown substantially in the twenty-first century, reaching an estimated \$67.4 billion globally in 2018.⁴ In that same year, the United States represented the single largest art market, capturing 44 percent of the global market share.⁵ From a tax perspective, Congress implicitly views this sizable market as a trading market, and art itself as investment property, because the Internal Revenue Code (“the Code”) does not create any material distinction between art and other tradable investment assets.⁶ Though art, as a collectible, may be subject to a different capital gains tax rate than traditional securities,⁷ its classification as a capital asset and the process of its tax assessment remain synonymous with traditional securities.⁸ Art transactions, for example, generate investment gains and losses just like traditional securities.⁹ Despite some changes, the 2017 tax act reinforces this perspective.¹⁰ This tax approach to art demonstrates that although art may provide investors with incalculable personal satisfaction, art also provides investors with satisfying opportunities for capital gains (or dissatisfying losses) in the secondary trading market.

1. See, e.g., Hannah Furness, *Art World Is “Hotbed” of Corruption, Collector Claims*, TELEGRAPH (June 2, 2016), <https://www.telegraph.co.uk/news/2016/06/02/art-world-is-hotbed-of-corruption-collector-claims> [<https://perma.cc/3HAZ-EZRL>].

2. See Robin Pogrebin, Elizabeth A. Harris & Graham Bowley, *New Scrutiny of Museum Boards Takes Aim at World of Wealth and Status*, N.Y. TIMES (Oct. 2, 2019), <https://www.nytimes.com/2019/10/02/arts/design/whitney-art-museums-trustees.html> [<https://perma.cc/B3BE-L53S>].

3. This Note is concerned with transfers in the secondary art market, either at auction or in private sales, rather than initial sales in the primary market. See *infra* Part I.C (defining the primary and secondary art markets).

4. Press Release, Art Basel, *The Art Market 2019: Global Art Market Reaches Its Second Highest Level in 10 Years, Amidst Further Consolidation at the Top End* (Mar. 8, 2019), https://d2u3kfw92fzu7.cloudfront.net/The%20Art%20Market%202019_Press%20Release-2.pdf [<https://perma.cc/KW6R-RWE7>].

5. *Id.*

6. See, e.g., I.R.C. § 1221(a) (2018).

7. See *id.* § 1(h)(5)(A); see also *id.* § 408(m)(2)(A).

8. See *id.* § 1221(a); see also *id.* § 1222.

9. See *id.* § 1222; see also *Estate of Elkins v. Comm’r*, 767 F.3d 443, 453 (5th Cir. 2014) (affirming the tax court’s decision to allow a fractional-ownership discount to assess the taxable value of a decedent’s fractional interests in sixty-four works of art). *Estate of Elkins* indicates the development of art as an “asset class,” rather than an asset that cannot be owned in fractional interests. Moses Luski, *Estate of Elkins v. Commissioner of Internal Revenue: Cautionary Tale and Gem*, INSIGHTS (Shumaker, Loop & Kendrick, LLP, Charlotte, N.C.), Spring 2015, at 1, 2.

10. See Pub. L. No. 115-97, 131 Stat. 2054 (2017) (codified as amended in scattered sections of the U.S.C.). The 2017 tax revisions are commonly known as the Tax Cuts and Jobs Act. To remain technically accurate, this Note will refer to these revisions as the 2017 tax act. See MICHAEL J. GRAETZ ET AL., *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 11 (8th ed. 2018).

In contrast, Congress has not imputed this trading and investment perspective of the secondary art market to the Securities Exchange Act of 1934 (“the Act”) or to the Securities and Exchange Commission (SEC) more broadly.¹¹ The limited scope of the Act impedes the SEC’s ability to regulate the secondary art market. Notwithstanding some important distinctions to be discussed,¹² as art transactions become more prevalent in individual investment portfolios and the secondary art market increasingly resembles trading in traditional securities markets,¹³ this discrepancy should be addressed.

For years, there have been discussions of increasing regulations in various corners of the art market.¹⁴ At the turn of the century, rival auction houses Christie’s and Sotheby’s paid \$512 million to settle a collusion suit¹⁵ and a Sotheby’s executive was criminally convicted of collusion,¹⁶ flagging the art market as an industry in need of increased regulation. More recently, Nouriel Roubini, an economist at New York University, has emphasized that practices within the art market would not be permitted in other financial markets.¹⁷ Others have concurred with Roubini in considering the art market to be an “informal economy.”¹⁸ In December 2019, the *New York Times* published an opinion piece exposing the development of inequitable practices among directors, who are often also art collectors and investors, at American museums.¹⁹ No compelling public policy or economic reasoning justifies the absence of regulation in this arena.

This Note explores the divergence between the tax treatment of art transactions and the absence of any modified securities laws or regulations, particularly those concerning insider trading, in the secondary art market. As the mandates of the Internal Revenue Service (IRS) and the SEC share

11. Compare Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78qq (2018), with I.R.C. §§ 1221(a), 1400Z.

12. See *infra* Part II.D.

13. See, e.g., Press Release, Art Basel, *supra* note 4.

14. See Marc Spiegler, *Time To Reform the Art Market?*, FORBES (May 30, 2005), https://www.forbes.com/2005/05/30/cx_0530conn_ls.html [<https://perma.cc/7BGY-SBRX>] (quoting Greg Allen, a former financier and co-chair of the Junior Associates Board at the Museum of Modern Art, who said “people coming from the finance world into the art market tend to be shocked by the level of opacity and murkiness”); see also John Gapper & Peter Aspden, *Davos 2015: Nouriel Roubini Says Art Market Needs Regulation*, FIN. TIMES (Jan. 22, 2015), <https://www.ft.com/content/992dcf86-a250-11e4-aba2-00144feab7de> [<https://perma.cc/RVE5-CCYK>].

15. Vanessa O’Connell, *Christie’s, Sotheby’s Agree to Pay \$512 Million Collusion Settlement*, WALL ST. J. (Sept. 25, 2000), <https://www.wsj.com/articles/SB969829620926708015> [<https://perma.cc/ZPL6-SKM5>].

16. DOUG WOODHAM, ART COLLECTING TODAY: MARKET INSIGHTS FOR EVERYONE PASSIONATE ABOUT ART 31 (2017).

17. Gapper & Aspden, *supra* note 14.

18. Artsy Editors, *What Actually Happens in the Art Market’s Informal Economy*, ARTSY (Aug. 2, 2017), <https://www.artsy.net/article/artsy-editorial-art-markets-informal-economy> [<https://perma.cc/BQ39-VXDL>].

19. Michael Massing, *Opinion, How the Superrich Took over the Museum World*, N.Y. TIMES (Dec. 14, 2019), <https://www.nytimes.com/2019/12/14/opinion/sunday/modern-art-museum.html> [<https://perma.cc/WKL9-VU3R>].

principles of equity, efficiency, and transparency, this Note finds the practices resulting from this divergence to be particularly alarming.²⁰ The current absence of regulation in the secondary art market makes it difficult to address any specific instance of insider trading in this market. However, this Note takes a proactive approach to resolving a regulatory deficiency in a growing trading and investment markets, which is especially relevant as debates about these principles ripen in public discourse in the context of the 2020 presidential election.²¹

Part I provides essential background information about federal income taxation, securities law, and the art market. Part II uses this background to critique the disparate treatment of the same asset (art) by two different federal agencies (the IRS and the SEC). Part III unveils an integrated resolution by discussing relevant policy considerations and recommends that Congress look to the Code to expand the scope of the Act and subject the secondary art market to modified insider trading regulations. This resolution posits that increased regulation of the secondary art market best acknowledges the market for what it is: a lucrative platform for investment, which generates a strong trading market and is one that is best enhanced by fair and balanced regulation, rather than compromised by its absence.

I. PAINTING THE PICTURE: TAX, SECURITIES, AND THE ART MARKET

To understand the disparate treatment of art investments under the Code and securities laws, an overview of each of these elements is first necessary. Part I.A introduces important tax concepts and provides a brief history of federal income taxation. Part I.B discusses central concepts within securities law. Part I.C defines the art market and its related terms.

A. Tax Concepts and a Brief History of Taxation

Though the background and history of taxation may seem distant from the notion of modifying securities laws and regulations to fit the secondary art market, tradable investment assets, like art, became a source of taxable income under the Code.²² Understanding the Code's treatment of art therefore illuminates a path to inform the Act's application to the secondary art market.

20. See GRAETZ ET AL., *supra* note 10, at 28–30; see also *What We Do*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/Article/whatwedo.html> [https://perma.cc/J3E6-KJF8] (last updated June 10, 2013).

21. See, e.g., Scott Eastman, *Unpacking Biden's Tax Plan for Capital Gains*, TAX FOUND. (July 31, 2019), <https://taxfoundation.org/joe-biden-tax-proposals> [https://perma.cc/J9UE-59HX]; Matt Stevens, *Elizabeth Warren on a Wealth Tax*, N.Y. TIMES (July 30, 2019), <https://www.nytimes.com/2019/07/30/us/politics/elizabeth-warren-wealth-tax.html> [https://perma.cc/NVB7-TL4S].

22. See Nat'l Fed'n of Indep. Bus. v. Sebelius, 567 U.S. 519, 571 (2012) (summarizing the history of how personal property became a source of taxable income).

1. Basic Concepts

The Code comprises the body of federal taxation statutes in the United States. The Code has continuously evolved since its initial implementation in 1939.²³ Though the Department of the Treasury has the statutory authority to administer and enforce the Code, Congress grants the Treasury the authority to delegate its responsibilities.²⁴ The Treasury has, in turn, delegated many of these responsibilities to the IRS.²⁵ As a result of this delegated authority, the IRS prescribes rules and regulations for the administration of the Code, interprets Code provisions, and clarifies the Code's applicability to various situations.²⁶

Under the Code, art is a capital asset.²⁷ A capital asset generates taxable income when the asset is sold or otherwise disposed of at a profit,²⁸ subject to some exceptions.²⁹ A taxpayer realizes a capital gain when the taxpayer's adjusted basis in the asset (the amount that the taxpayer pays for the asset less any depreciation deductions or plus any capital expenditures) is less than the amount realized when the taxpayer sells or disposes of the asset.³⁰

The taxpayer's holding period of the asset affects the rate at which the gain is taxed.³¹ A taxpayer must hold an asset for more than one year to benefit from a preferential long-term capital gains tax rate.³² That long-term capital gains rate hinges on the taxpayer's ordinary income tax bracket.³³ For collectibles such as art, the maximum capital gains tax rate is 28 percent.³⁴

23. See, e.g., Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (amended 2017); Internal Revenue Code of 1954, ch. 736, 68A Stat. 3 (amended 1986); Internal Revenue Code of 1939, ch. 2, 53 Stat. 1 (amended 1954).

24. I.R.C. § 7801(a)(1) (2018).

25. *Id.* § 7803.

26. *Id.*

27. See *id.* § 1221; see also *Capital Gains and Losses—10 Helpful Facts to Know*, INTERNAL REVENUE SERV. (Feb. 22, 2017), <https://www.irs.gov/newsroom/capital-gains-and-losses-10-helpful-facts-to-know-0> [<https://perma.cc/7GAX-QUXS>]; *Topic No. 409 Capital Gains and Losses*, INTERNAL REVENUE SERV., <https://www.irs.gov/taxtopics/tc409> [<https://perma.cc/VQ8P-F7LJ>] (last updated Jan. 3, 2020).

28. See I.R.C. § 63; see also *Merchs.' Loan & Tr. Co. v. Smietanka*, 255 U.S. 509, 516 (1921) (holding that taxation on gains acquired from the sale or disposition of property is constitutional).

29. *Publication 544 (2018), Sales and Other Dispositions of Assets*, INTERNAL REVENUE SERV., <https://www.irs.gov/publications/p544> [<https://perma.cc/2G55-P3DQ>] (last updated Dec. 19, 2019) (describing the difference between ordinary and capital gain or loss).

30. See I.R.C. § 1001.

31. See *id.* § 1223.

32. See *id.* §§ 1222–1223.

33. See *Topic No. 409 Capital Gains and Losses*, *supra* note 27.

34. See I.R.C. § 1(h)(4); see also *Topic No. 409 Capital Gains and Losses*, *supra* note 27. At least one legislative attempt has been made to synchronize capital gains tax rates for art and other investment property. See *Art and Collectibles Capital Gains Tax Treatment Parity Act*, S. 374, 110th Cong. (2007).

In some cases in which a taxpayer's income exceeds a threshold amount, an additional 3.8 percent investment tax also applies to the capital gain.³⁵

These preferential capital gains tax rates are a subject of debate as the 2020 presidential election approaches.³⁶ Those who favor preferential rates may emphasize: (1) the distinction between nonrecurring capital gains and recurring income, such as that from wages and salaries; (2) the fact that preferential capital gains tax rates encourage market transactions, thereby remedying a lock-in effect of taxpayer retention of assets to avoid the otherwise greater tax implications of generating taxable income at ordinary rates; and (3) the various benefits of waiting until a capital gain is realized, such as increased administrative efficiency and taxpayer accessibility to liquid assets to pay the tax.³⁷ Those disfavoring preferential capital gains tax treatment may emphasize that: (1) a gain is a gain regardless of its form; (2) preferential rates increase vertical inequity because those with more income are more likely to have capital assets; and (3) preferential rates complicate the Code's administration.³⁸

Though art remains a capital asset regardless of taxpayer classification, art is taxed differently according to the type of taxpayer.³⁹ Corporations cannot benefit from preferential capital gains tax rates.⁴⁰ Corporate capital gains are instead treated as ordinary income and taxed at a flat rate of 21 percent.⁴¹ Further, 501(c)(3) tax-exempt organizations, which include many public art museums, do not pay capital gains taxes.⁴² As a result, individual income taxes are most relevant to the issues discussed in this Note.

2. History of the Income Tax and the Sixteenth Amendment

Federal income taxes raise revenue to fund government programs.⁴³ Congress's decision to tax a source of income or to grant a deduction or exclusion therefore reflects a policy choice about which sources of income should be targeted to achieve this goal.⁴⁴ In response to these policies,

35. See I.R.C. § 1411; see also *Questions and Answers on the Net Investment Income Tax*, INTERNAL REVENUE SERV., <https://www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax> [<https://perma.cc/7CPK-STG3>] (last updated July 22, 2019).

36. Bruce Brumberg, *Capital Gains Tax Tug-of-War: Democratic Presidential Candidates, Trump's Indexing, and IRS Forms*, FORBES (Aug. 12, 2019), <https://www.forbes.com/sites/brucebrumberg/2019/08/12/capital-gains-tax-tug-of-war-democratic-presidential-candidates-trumps-indexing-and-irs-forms> [<https://perma.cc/P32H-ASG4>].

37. See GRAETZ ET AL., *supra* note 10, at 566–70; see also Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 344–70 (1993).

38. See GRAETZ ET AL., *supra* note 10, at 570–72; see also Ed Dolan, *The Case Against the Capital Gains Tax Break*, MEDIUM (Aug. 1, 2019), <https://medium.com/swlh/the-case-against-the-capital-gains-tax-break-48e9c39ef9a8> [<https://perma.cc/WR7E-LQEB>].

39. Compare I.R.C. § 1, with I.R.C. § 11.

40. See GRAETZ ET AL., *supra* note 10, at 565.

41. See I.R.C. § 11.

42. See *id.* § 501(a).

43. See GRAETZ ET AL., *supra* note 10, at 1.

44. See, e.g., Nat'l Fed'n of Indep. Bus. v. Sebelius, 567 U.S. 519, 537 (2012).

however, taxpayers seek to design transactions to minimize their tax burdens.⁴⁵ A brief overview of case law reveals these competing interests and demonstrates a steady expansion of Congress's pool of taxable sources to keep pace with the multitude of ways in which taxpayers generate income.⁴⁶

Though the Constitution originally laid out Congress's general powers in the realm of taxes, it did not offer contours to shape the tax system, such as the substance and extent of permissible taxes.⁴⁷ Article I, Section 8 grants Congress the broad, undefined power to "lay and collect taxes."⁴⁸ Article I, Section 9 prohibits "capitation, or [any] other direct tax . . . unless in proportion to the Census or Enumeration."⁴⁹ Yet the Fifth Amendment prohibits the deprivation of "life, liberty, or property, without due process of law,"⁵⁰ and the Tenth Amendment reserves any "powers not delegated to the United States by the Constitution" to the states or the people.⁵¹ The subtle tensions between these clauses inevitably made their way into the courts.

Judicial interpretation of the phrase "direct tax" expanded over time to encompass both personal property and real property. In one early case, the U.S. Supreme Court took the position that, because direct taxes concerned real property, a sixteen-dollar tax on carriages was not a direct tax to be apportioned among the states.⁵² President Lincoln later expanded this interpretation when he signed the first official income tax, which was apportioned among the states by population, to finance the Civil War.⁵³ The tax was challenged, but ultimately upheld, in *Springer v. United States*,⁵⁴ where the U.S. Supreme Court reaffirmed that an income tax is not a direct tax, such as a tax on real property, and therefore income taxes need not be apportioned among the states.⁵⁵ This holding, however, was short-lived.⁵⁶ In *Pollock v. Farmers' Loan & Trust Co.*,⁵⁷ the Supreme Court reversed course and held that income taxes did constitute taxes on property and, as such, needed to be apportioned among the states.⁵⁸ The limitations deriving

45. See, e.g., Arthur Acevedo, *Abusive Tax Practices: The 100-Year Onslaught on the Tax Code*, 17 BARRY L. REV. 179, 184 (2012).

46. See *id.*

47. See, e.g., *Hylton v. United States*, 3 U.S. (3 Dall.) 171, 173 (1796) (opinion of Chase, J.).

48. U.S. CONST. art. I, § 8.

49. *Id.* § 9. A direct tax is imposed on property, whether real or personal, "and presumed to be borne by the person on whom it is assessed." *Direct Tax*, BLACK'S LAW DICTIONARY (11th ed. 2019); see also *Nat'l Fed'n of Indep. Bus.*, 567 U.S. at 571–72 (holding that a direct tax includes more than real property).

50. U.S. CONST. amend. V.

51. *Id.* amend. X.

52. See *Hylton*, 3 U.S. at 174–75 (opinion of Chase, J.).

53. See GRAETZ ET AL., *supra* note 10, at 6.

54. 102 U.S. 586 (1880).

55. See *id.* at 593.

56. See *Pollock v. Farmers' Loan & Tr. Co.*, 158 U.S. 601 (1895).

57. 158 U.S. 601 (1895).

58. See *id.* at 618.

from this holding likely motivated the passage of the Sixteenth Amendment in 1913.⁵⁹

The Sixteenth Amendment provides Congress with its modern taxing power, enabling Congress to tax income “from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”⁶⁰ Throughout the twentieth century, the Sixteenth Amendment granted various administrations the power to experiment with different tax policies, reflecting the fluidity and continuous reassessment of equity in the American tax system.⁶¹ As a consistent thread running throughout this fluidity, the Sixteenth Amendment empowers Congress to tax gains derived from sales of personal property, such as art.

3. Recent Changes: The 2017 Tax Act

The 2017 tax act reflects the most recent conception of how income, and specifically capital gains, should be taxed.⁶² Its implementation marked the largest set of revisions to the Code since 1986.⁶³ In accordance with promises made in his 2016 campaign, President Trump used the 2017 tax act to reduce corporate and individual tax rates, increase various deductions and credits, alter corporate taxation on income earned abroad, and double the estate tax exemption, among other changes.⁶⁴ The Joint Committee on Taxation has estimated that these changes may generate a \$1.5 trillion loss in federal revenue.⁶⁵

For the purposes of this Note, there are two especially relevant changes in the 2017 tax act: (1) the elimination of section 1031’s like-kind exchanges for personal property such as art and (2) the implementation of a similar tax advantage for art investors through section 1400Z’s “Opportunity Zones.”⁶⁶ Prior to the 2017 tax act, like-kind exchanges enabled an art investor⁶⁷ to

59. See U.S. CONST. amend. XVI; see also Sheldon D. Pollack, *Origins of the Modern Income Tax, 1894–1913*, 66 TAX LAW. 295, 296 (2013) (discussing a political blunder that may have also contributed to the passage of the Sixteenth Amendment); Benjamin G. Barokh, Note, *The Meaning of ‘Incomes’ in the Sixteenth Amendment*, 15 GEO. J.L. & POL’Y 409, 411 (2017).

60. U.S. CONST. amend. XVI.

61. See, e.g., Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §§ 311–314, 111 Stat. 788, 831–43 (reinstating the preferential capital gains tax rates); Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (amended 2017) (lowering the ordinary income tax rate for the top bracket, increasing the ordinary income tax rate for the lowest bracket, and eliminating preferential capital gains tax rates).

62. See GRAETZ ET AL., *supra* note 10, at 11.

63. Compare Pub. L. No. 115-97, 131 Stat. 2054 (2017) (codified as amended in scattered sections of the U.S.C.), with Alan J. Auerbach & Joel Slemrod, *The Economic Effects of the Tax Reform Act of 1986*, 35 J. ECON. LITERATURE 589, 589 (1997) (discussing how the Tax Reform Act of 1986 was the “most sweeping change in the U.S. federal income tax since it became a tax that applied to most citizens during World War II”).

64. See GRAETZ ET AL., *supra* note 10, at 11.

65. Robert J. Barro & Jason Furman, *Macroeconomic Effects of the 2017 Tax Reform*, BROOKINGS PAPERS ON ECON. ACTIVITY, Spring 2018, at 257, 261, 307.

66. Compare I.R.C. § 1031 (2018), with I.R.C. § 1400Z (2018).

67. The term “art investor” carries implications distinct from those associated with “art collectors,” which will be discussed in Part II.A.

defer paying capital gains tax for the exchange of similar works of art while simultaneously adjusting the art investor's basis in the work of art acquired through the exchange.⁶⁸ Art investors would benefit from this provision if they received property "of a like kind to the property" transferred and both parties had held the original property "for use in a trade or business or for investment."⁶⁹ Legislative motivations for section 1031 included the administrative difficulty of valuing assets in personal property exchanges and the notion that in a like-kind exchange, a taxpayer alters the form but not the substance of the investment and, as such, the taxpayer retains the bulk of his or her economic position.⁷⁰ No matter the legislative motivation, however, this nonrecognition provision demonstrated the Code's treatment of art as a common form of tradable investment property.

Though the 2017 tax act eliminated the tax benefits for like-kind exchanges of art, the act implemented Opportunity Zones, a program that offers similar tax benefits to art investors alongside traditional investors.⁷¹ Opportunity Zones therefore continue to reflect the Code's treatment of art as tradable investment property despite changes in the 2017 tax act. State governors designate, and the Department of the Treasury approves, low-income census tract areas as Opportunity Zones for a period of ten years.⁷² Any area that satisfies the definition of "low-income community" under section 45D(e) of the Code may be nominated.⁷³ Alternatively, contiguous areas that meet exacting criteria may be nominated.⁷⁴ However, no more than 25 percent of tracts of land in low-income communities can be designated as Opportunity Zones.⁷⁵ Once the Treasury approves a tract as an Opportunity Zone, the "economically-distressed community" may "under certain conditions . . . be eligible for preferential tax treatment."⁷⁶

The beneficial tax treatment occurs when art investors reinvest their capital gains acquired from the sale of art into "Qualified Opportunity Funds," which are then utilized as "investment vehicles" to purportedly spur economic

68. Under the 2017 tax act, section 1031 of the Code now only applies to transactions involving real property. *See* I.R.C. § 1031.

69. Bradley T. Borden, *Reverse Like-Kind Exchanges: A Principled Approach*, 20 VA. TAX REV. 659, 661 (2001).

70. *Id.* at 665–67; *see also* *Century Elec. Co. v. Comm'r*, 192 F.2d 155, 159 (8th Cir. 1951).

71. Despite the focus of this Note, any investor who generates capital gains may reinvest those gains in Qualified Opportunity Funds. This is not limited to art investors.

72. *See* I.R.C. § 1400Z-1(b)(1); *see also* *Opportunity Zones*, ECON. INNOVATION GROUP, <https://eig.org/opportunityzones/about> [<https://perma.cc/2EJC-RZ63>] (last updated July 22, 2019).

73. *See* I.R.C. § 45D(e); *see also* Rev. Proc. 2018-16, 2018-9 I.R.B. 383.

74. *See* Rev. Proc. 2018-16, 2018-9 I.R.B. 383.

75. *See* I.R.C. § 1400Z-1.

76. *Opportunity Zones Frequently Asked Questions*, INTERNAL REVENUE SERV., <https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions> [<https://perma.cc/L79L-RQ7P>] (last updated Oct. 22, 2019); *see also* *Opportunity Zone Resources*, COMMUNITY DEV. FIN. INSTITUTIONS FUND, <https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx> [<https://perma.cc/ZPC2-H432>] (last visited Feb. 14, 2020) (providing access to a map and list of all Opportunity Zones).

growth in Opportunity Zones.⁷⁷ Though individuals may participate in these funds, the funds are organized as partnerships or corporations.⁷⁸ For a taxpayer to receive tax benefits through these funds, at least 90 percent of fund assets must be invested in Qualified Opportunity Zone property.⁷⁹ The fund must be used to either create a new use for Opportunity Zone property or to “substantially improve” existing Opportunity Zone property.⁸⁰

Through these funds, art investors can defer, or in some cases nearly eliminate, their capital gains taxes using one of two pathways.⁸¹ First, investors may “defer tax on any prior gain until no later than December 31, 2026, so long as the gain is reinvested in a Qualified Opportunity Fund.”⁸² The tax deferral is worth a 10 percent exclusion of the deferred gain if the investment is held for at least five years, or a 15 percent exclusion of the deferred gain if the investment is held for more than seven years.⁸³ Second, if the investor holds the gain in the Opportunity Fund for at least ten years, the investor may increase the basis of the investment “equal to the fair market value of the investment on the date that it is sold.”⁸⁴ This tax deferral grants art investors a greater time value of money and enables them to reinvest the amount of deferred tax elsewhere.

The Opportunity Zone program aims to improve economic conditions by incentivizing private investment in public spaces.⁸⁵ But it is estimated that the program will generate an annual average tax revenue loss of \$1.6 billion over the next eight years.⁸⁶

Despite the changing mechanisms for receiving preferential tax treatment, this subpart has demonstrated that Congress has consistently aligned art with traditional securities, both before and after the 2017 tax act. The ability of art investors to benefit from this preferential treatment is not new, and to the extent that the legislative history in the tax realm is revealing, this preferential treatment is unlikely to be eliminated any time soon.

77. Joseph Bennett, Note, *Lands of Opportunity: An Analysis of the Effectiveness and Impact of Opportunity Zones in the Tax Cuts and Jobs Act of 2017*, 45 J. LEGIS. 253, 254 (2018); *Opportunity Zones Frequently Asked Questions*, *supra* note 76.

78. See Rev. Proc. 2018-16; see also I.R.C. § 1400Z-2(d)(1).

79. See I.R.C. § 1400Z-2.

80. “Substantial improve[ment]” is defined as improvements alone with a greater cost than the cost basis of the property. See *id.*

81. See *id.*; see also Bennett, *supra* note 77, at 256.

82. Press Release, U.S. Dep’t of the Treasury, Treasury, IRS Announce First Round of Opportunity Zones Designations for 18 States (Apr. 9, 2018), <https://home.treasury.gov/news/press-releases/sm0341> [<https://perma.cc/HM8F-XNPL>].

83. *Opportunity Zones Frequently Asked Questions*, *supra* note 76.

84. Press Release, U.S. Dep’t of the Treasury, *supra* note 82.

85. See Eileen Kinsella, *Explaining ‘Opportunity Zones’: The Trump Administration’s New Tax Break for Art Collectors*, ARTNET NEWS (Jan. 14, 2019), <https://news.artnet.com/art-world/trump-administration-tax-break-collectors-1436485> [<https://perma.cc/ZH9A-GMEY>] (discussing how the 2017 tax act closed one tax loophole but opened another loophole for art investors).

86. THE JOINT COMM. ON TAXATION, JCX-67-17, ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 1, THE “TAX CUTS AND JOBS ACT” 6 (2017), <https://www.jct.gov/publications.html?func=startdown&id=5053> [<https://perma.cc/ZA3D-JU8X>]; Bennett, *supra* note 77, at 258.

B. The Securities Exchange Act of 1934 and Other Securities Law Terms

The second legislative regime relevant to this Note is the Securities Exchange Act of 1934.⁸⁷ Through the Act, Congress created SEC, a federal agency, to enforce the Act's laws, all of which endeavor to enhance market stability and protect investors.⁸⁸ The Act is particularly concerned with regulating corporate securities traded in the "public 'secondary' market."⁸⁹ As state law enforces corporate fiduciary duties, the Act is primarily concerned with disclosures, reporting requirements, fraud, and insider trading.⁹⁰

Congress implemented the Act after the Great Depression to recapture investor confidence in American financial markets.⁹¹ Its regulations impact brokerage firms, transfer agents, clearing agents, and self-regulatory organizations (such as the New York Stock Exchange, Nasdaq, and the Financial Industry Regulatory Authority).⁹² The Act's current scope and statutory language indicate a legislative intent to protect transactions in which individuals rely on external factors in the market for their own economic growth.⁹³

The SEC employs the test developed in *SEC v. W. J. Howey Co.*⁹⁴ to assess whether an asset is properly classified as an investment contract and therefore subject to the securities laws under the Act.⁹⁵ In that case, the U.S. Supreme Court looked to section 2(1) of the Securities Act of 1933, which defined the term "security" to include "commonly known documents traded for speculation or investment," and sought to resolve whether a land sales contract fit this definition.⁹⁶ Answering in the affirmative, the Court held that the SEC regulates "contract[s], transaction[s], or scheme[s] whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."⁹⁷ As SEC Chairman Jay Clayton recently summarized, the test essentially asks, "Am I giving you my money for you to go off in a venture where I'm relying on your efforts and the efforts of your colleagues?"⁹⁸ Part II.B discusses how this test might apply to the secondary art market.

87. 15 U.S.C. §§ 78a–78qq (2018).

88. See WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 617 (5th ed. 2016); see also *What We Do*, *supra* note 20.

89. See 15 U.S.C. § 77b; see also ALLEN & KRAAKMAN, *supra* note 88.

90. See also 15 U.S.C. §§ 78a–78qq.

91. See *What We Do*, *supra* note 88.

92. See *id.*

93. See 15 U.S.C. § 78(b); see also S. REP. NO. 73-1455 (1934).

94. 328 U.S. 293 (1946).

95. *Id.*

96. *Id.* at 297.

97. *Id.* at 293.

98. Kate Rooney, *SEC Chief Says Agency Won't Change Securities Laws to Cater to Cryptocurrencies*, CNBC (June 11, 2018, 9:35 AM), <https://www.cnbc.com/2018/06/06/sec-chairman-clayton-says-agency-wont-change-definition-of-a-security.html> [<https://perma.cc/MBC6-9ZBA>] (including a video interview by Bob Pisani with Jay Clayton, chairman of the SEC).

Once the *Howey* test leads to the determination of an asset as an investment contract, obligations under the Act attach to the practices surrounding that investment contract, such as the fiduciary duty of loyalty. The duty of loyalty requires fiduciaries, such as directors and officers of a corporation, to “exercise their authority in a good-faith attempt to advance corporate purposes.”⁹⁹ Part II.B also discusses how the duty of loyalty might develop in the secondary art market if the *Howey* test applied to works of art.

An individual may breach his or her fiduciary duty of loyalty by trading on the basis of inside information.¹⁰⁰ Insider trading “refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, on the basis of material, nonpublic information about the security.”¹⁰¹ This vague definition, as well as the absence of clearly defined elements of insider trading, has generated blurry applications for quite some time.¹⁰² Recently, members of Congress have proposed a bill to assist in interpretation.¹⁰³ For now, however, insider trading claims are brought under a statute concerning manipulative and deceptive devices.¹⁰⁴ The SEC has also issued a regulation to implement this statute.¹⁰⁵ Together, these rules seek to eliminate fraudulent activities within securities markets by requiring a corporate insider to “disclose to the public the material nonpublic information in his [or her] possession relating to his [or her] corporation’s securities, or refrain from trading based on the information” when the insider has met a series of requirements.¹⁰⁶ At this point in the process, federal common law steps in to fill in the gaps.¹⁰⁷

For example, Congress has left the definition of “insider” largely to the federal courts. Though courts look to the Act and SEC rules to shape this definition, neither text defines the word “insider.”¹⁰⁸ Broadly speaking, however, insiders are persons “under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage.”¹⁰⁹ This duty has traditionally related directly to a publicly traded corporation and its shareholders, but Part II.B discusses other potential

99. ALLEN & KRAAKMAN, *supra* note 88, at 229.

100. See 15 U.S.C. § 78j(b) (2018); see also *Insider Trading*, INVESTOR.GOV, <https://www.investor.gov/additional-resources/general-resources/glossary/insider-trading> [<https://perma.cc/5GY2-L9CG>] (last visited Feb. 14, 2020).

101. *Insider Trading*, *supra* note 100.

102. See, e.g., Thomas Newkirk, Assoc. Dir., Div. of Enf’t, U.S. Sec. & Exch. Comm’n, *Insider Trading—a U.S. Perspective*, Address at Jesus College, Cambridge University (Sept. 19, 1998), <https://www.sec.gov/news/speech/speecharchive/1998/spch221.htm> [<https://perma.cc/4A9A-AKDD>].

103. See generally H.R. 2534, 116th Cong. (2019).

104. See 15 U.S.C. § 78j(b); see also 17 C.F.R. 240.10b-5 (2019).

105. See 17 C.F.R. § 240.10b-5.

106. Laura Palk, *Ignorance Is Bliss: Should Lack of Personal Benefit Knowledge Immunize Insider Trading?*, 13 BERKELEY BUS. L.J. 101, 105–06 (2016).

107. *Id.*

108. See, e.g., *Salman v. United States*, 137 S. Ct. 420, 423 (2016); see also Stephen M. Bainbridge, *The Law and Economics of Insider Trading 2.0*, in *ENCYCLOPEDIA OF LAW AND ECONOMICS* (2d ed. forthcoming 2020) (manuscript at 10) (on file with author).

109. *Salman*, 137 S. Ct. at 423.

contours.¹¹⁰ Lastly, inside corporate information may be defined as “material, nonpublic information,” either about a corporation and its activities or about the larger market.¹¹¹

Scholars debate the proper mechanisms to regulate insider trading.¹¹² While some scholars advocate for the SEC to investigate potential violations, others advocate for state prosecution.¹¹³ No matter the mechanism, however, the proliferation of technology certainly assists the SEC and the Department of Justice in monitoring insider trading.¹¹⁴ Using technology in a market surveillance approach, regulators may track the timing of trades and stock values to investigate insider trading.¹¹⁵ The SEC also sometimes relies on tips and complaints from others to detect insider trading.¹¹⁶

This subpart has demonstrated that as trading markets grow, offering financial benefits to investors, legislators have implemented regulation to ensure equity and transparency in those trading markets. Though the current application of those regulations is limited, its principles may properly apply to other markets as well.

C. The Art Market

Defining art is tricky. As economist and auction house professional Doug Woodham explained, “Unlike a hammer, a chocolate bar, or other objects of daily living, art has no practical value. Its utter uselessness in performing a productive activity is key to its inherent charm and purpose.”¹¹⁷ The IRS took a broad approach to defining art through a revenue procedure,¹¹⁸ which considered art to include “paintings, sculpture, watercolors, prints, drawings, ceramics, antique furniture, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia, and other similar objects.”¹¹⁹ As this Note does not seek to provide a philosophical definition of art, no specific definition of art (whether an expensive painting or a banana duct-taped to a

110. See, e.g., Stephen J. Crimmins, *Insider Trading: Where Is the Line?*, 2013 COLUM. BUS. L. REV. 330, 335.

111. See *United States v. O’Hagan*, 521 U.S. 642, 652 (1997); see also Bainbridge, *supra* note 108 (manuscript at 16).

112. See, e.g., Bainbridge, *supra* note 108 (manuscript at 43).

113. *Id.*

114. See, e.g., Crimmins, *supra* note 110, at 335.

115. Elvis Picardo, *How the SEC Tracks Insider Trading*, INVESTOPEDIA (June 25, 2019), <https://www.investopedia.com/articles/investing/021815/how-sec-tracks-insider-trading.asp> [<https://perma.cc/WJ8F-TMHX>].

116. *Id.*

117. WOODHAM, *supra* note 16, at 1.

118. A revenue procedure is an “official statement of a procedure” that is published and “either affects the rights or duties of taxpayers or other members of the public under [the Code] and related statutes, treaties, and regulations or, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge.” *Revenue Procedures*, INTERNAL REVENUE SERV., <https://www.irs.gov/tax-exempt-bonds/revenue-procedures> [<https://perma.cc/YUK7-V2T7>] (last visited Feb. 14, 2020).

119. Rev. Proc. 96-15, 1996-3 I.R.B. 41.

wall¹²⁰) is as relevant to addressing the concerns of this Note as the means through which the material is traded. In this sense, for the purpose of this Note, art is defined as any visual form that is traded in a secondary market for investment purposes. Though the issues examined in this Note become more relevant in the context of significant art investments because of the higher economic stakes, the issues may similarly apply to smaller-scale art investments.

The art market refers to the economic venue for the exchange of works of art.¹²¹ Initial sales of works of art take place in the primary art market, such as at galleries.¹²² The secondary art market encompasses subsequent resales of works of art, often at auction or in private sales.¹²³ This Note is most concerned with the secondary art market because it constitutes a trading platform and can therefore be aligned with traditional securities markets.¹²⁴

As mentioned above, the global art market has grown substantially in recent years and the United States has retained the greatest market share.¹²⁵ Multiple factors contribute to this continued growth. From a financial perspective, these factors include popularizing strategies to incorporate art into wealth management solutions,¹²⁶ increasing public recognition of art as a valuable asset class,¹²⁷ and evolving perceptions about traditional financial markets.¹²⁸ The rise of “art finance” companies offering art as collateral,¹²⁹ firms offering financial solutions for those interested in art investment

120. Caroline Elbaor, *Buyers of Maurizio Cattelan's \$120,000 Banana Defend the Work as 'the Unicorn of the Art World,' Comparing It to Warhol's Soup Cans*, ARTNET NEWS (Dec. 10, 2019), <https://news.artnet.com/art-world/maurizio-cattelan-banana-collector-1728009> [<https://perma.cc/7MG6-7TCD>].

121. See WOODHAM, *supra* note 16, at 23.

122. *Id.* at 28.

123. Darius A. Spieth, *Art Markets*, OXFORD ART ONLINE, <https://www.oxfordartonline.com/page/art-markets> [<https://perma.cc/YP4Y-5XA9>] (last visited Feb. 14, 2020).

124. See WOODHAM, *supra* note 16, at 31 (suggesting that auction houses are similar to the New York Stock Exchange and Nasdaq).

125. See Press Release, Art Basel, *supra* note 4.

126. See DELOITTE, ART & FINANCE REPORT 2017, at 98–107 (2017), <https://www2.deloitte.com/content/dam/Deloitte/at/Documents/finance/art-and-finance-report-2017.pdf>, [<https://perma.cc/7JTL-QBB5>].

127. See *What You Should Know About Art Investments and Trends*, SOTHEBY'S (Mar. 13, 2018), <https://www.sothebys.com/en/articles/what-you-should-know-about-art-investments-and-trends> [<https://perma.cc/43J2-6TSD>].

128. WOODHAM, *supra* note 16, at 24–25 (discussing how these factors likely contributed to the growth of the art market).

129. Scott Reyburn, *Art as Collateral in a Fickle Market*, N.Y. TIMES (Mar. 9, 2016), <https://www.nytimes.com/2016/03/07/arts/international/art-money-and-collateral-in-a-weak-market.html> [<https://perma.cc/6ZGY-27DZ>].

markets,¹³⁰ and quantitative investment firms concentrating in art assets¹³¹ also exemplifies the growing nexus between art and finance. From an industry perspective, the supply of and demand for an artist's works in the market, the trading behavior of other art investors,¹³² the prevalence of an artist or genre in public discourse,¹³³ and the publicity generated by museum exhibitions and gallery shows also foster market growth.¹³⁴ Despite this market growth and the inclusion of art in investment portfolios, regulatory oversight of the secondary art market has remained remarkably low.

Lastly, individuals can participate in the art market either as investors or collectors. Traditionally, this distinction had profound tax implications, but the 2017 tax act curbed the benefits of the investor classification.¹³⁵ To be considered an "art investor," a taxpayer must engage in art transactions with the purpose of producing income.¹³⁶ Prior to the 2017 tax act, investor status was preferential for taxpayers because it allowed taxpayers to take more deductions for the expenses involved in trading art.¹³⁷ Under current law, however, many deductions are disallowed until January 1, 2026.¹³⁸ In contrast, an "art collector" (also known as a "hobbyist") may occasionally sell a work of art but his or her efforts are directed at building a personal collection. Since the purpose of the collection is personal, expenses involved in building the art collection are not deductible, though preferential capital gains tax rates still apply when a gain is realized because each work of art remains a capital asset.¹³⁹

II. CRITIQUING THE CANVAS: EXPLORING THE DISPARATE TREATMENT OF INVESTMENT PROPERTY

Part I has provided the background information essential to understanding the difference in treatment between the IRS and the SEC in approaching the secondary art market. The tax system includes art investments in its array of

130. See, e.g., ATHENA ART FIN., <https://www.athena-art.com/> [<https://perma.cc/JU6J-P4J4>] (last visited Feb. 14, 2020). Further strengthening this business model's connection to traditional securities, YieldStreet, "a digital wealth management platform," purchased Athena Art Finance in April 2019. See *YieldStreet Acquires Athena Art Finance from the Carlyle Group & Co-Investors*, BUSINESSWIRE (Apr. 10, 2019, 5:55 AM), <https://www.businesswire.com/news/home/20190410005300/en/YieldStreet-Acquires-Athena-Art-Finance-Carlyle-Group> [<https://perma.cc/95T7-SJT9>].

131. See ARTHENA, <https://arthena.com/> [<https://perma.cc/Y296-DFBM>] (last visited Feb. 14, 2020).

132. See Michael Findlay, *The Value of Art: Money, Power, Beauty*, ARTNET NEWS (Nov. 1, 2012), <https://news.artnet.com/market/defining-the-value-of-art-27673> [<https://perma.cc/GP98-RNH6>] (discussing the factors that contribute to the value of art).

133. See *id.*

134. For this reason, many art investors and collectors loan their works to museums as part of exhibitions. See Paul Sullivan, *A Museum's Seal of Approval Can Add to Art's Value*, N.Y. TIMES (Oct. 14, 2016), <https://www.nytimes.com/2016/10/15/your-money/a-museums-seal-of-approval-can-add-to-arts-value.html> [<https://perma.cc/2SSJ-YW98>].

135. 26 C.F.R. § 1.212-1(c) (2019).

136. See *id.*

137. I.R.C. §§ 165(c)(2), 212 (2018).

138. *Id.* § 67(b), 67(g).

139. *Id.* § 262.

taxable assets. The Act's trading regulations, however, have yet to impact the secondary art market.

Part II critiques the canvas that is the preferential tax treatment of art as tradable investment property despite the absence of any modified securities regulations of art. This critique is especially apt in the context of the growing secondary art market in the United States.

A. Tax Implications of Art Investments

Preferential capital gains tax rates, the now-expired like-kind exchanges for personal property, and Opportunity Zones each exemplify the Code's tradition of treating art as a tradable investment asset. The Code does not draw a meaningful distinction between art and traditional securities as it classifies both as capital assets and assesses the resulting taxes through the same process.¹⁴⁰ This Part dives deeper into the technical elements of how that tax treatment works and posits why Congress may have taken this position.

1. General Tax Treatment

As briefly mentioned, until the 2017 tax act, art investors could benefit not only from preferential capital gains tax rates upon selling a work of art but also from deducting the expenses involved in their trading endeavors under section 212 of the Code and taking loss deductions under section 165.¹⁴¹ The IRS, however, imposed strict requirements on the taxpayer before the taxpayer could take advantage of art investor status and deduct these expenses.¹⁴² These requirements likely derived from the fact that art is also personal property and those who trade in art can also engage in personal consumption in such a way that is not readily available when trading in traditional securities.¹⁴³

It is difficult to determine whether someone is an "art investor" for tax purposes. The U.S. Court of Claims held in *Wrightsmen v. United States*¹⁴⁴ that a taxpayer must "establish that [his or her] investment purpose for acquiring and holding works of art was 'principal,' or 'of first importance,'" to be considered an art investor.¹⁴⁵ This involved a fact-intensive inquiry.¹⁴⁶ The Wrightsmen did not satisfy this requirement despite the fact that they: (1) often consulted art experts; (2) maintained investment card records in a manner similar to those records in Mr. Wrightman's oil and gas business; and

140. See, e.g., *id.* § 1221.

141. See *id.* §§ 165, 212; see also 26 C.F.R. § 1.212-1(c).

142. See, e.g., *Wrightsmen v. United States*, 428 F.2d 1316 (Ct. Cl. 1970); *Stanley v. Comm'r*, 40 T.C.M. (CCH) 516 (1980).

143. See Christine Manolakas, *The Taxation of Artists and the Acquirers of Art: The Many Shades of Grey*, 43 AIPLA Q.J. 69, 100 (2015).

144. 428 F.2d 1316 (Ct. Cl. 1970).

145. *Id.* at 1320 (quoting *Malat v. Riddell*, 383 U.S. 569, 572 (1966)).

146. *Id.*

(3) catalogued their works of art.¹⁴⁷ Instead, the court held that the Wrightsmans' primary purpose in collecting art was "personal pleasure or satisfaction."¹⁴⁸ The fact that a large part of the Wrightsmans' collection was kept on view in their personal residences in New York and Florida contributed to this personal consumption.¹⁴⁹ As a result, the Wrightsmans could not deduct expenses involved in their art investing endeavors under section 212.¹⁵⁰ Later case law reinforced that a taxpayer's primary motive must be profit, and the evidence of personal satisfaction must be weak, for the taxpayer to deduct expenses involved in trading art.¹⁵¹ One scholar has diluted these concepts into fourteen factors that courts may consider before classifying a taxpayer as an art investor, which illustrates the burden of proving this status.¹⁵²

The burden of proving art investor status has encouraged individuals to develop other practices to acquire investor status and receive the corresponding tax benefits. For example, free ports, offering tax-free storage to art investors, have become a popular venue for art storage.¹⁵³ When individuals store art in free ports, they may avoid sales taxes and demonstrate that their primary motive for investing in the work was not personal satisfaction, as the works themselves do not hang on the walls of investors' homes, but are instead locked in foreign vaults.¹⁵⁴

Interestingly, Mr. Wrightsman was a skeptic about traditional investments in the stock market.¹⁵⁵ He admitted that a key motivation for the expansion of his art collection was his opinion that art was "an excellent hedge against inflation and devaluation of currencies" and an "appropriate asset[] for investment of a substantial portion of his surplus cash being generated."¹⁵⁶ This perspective provides an early indication of how investors considered the art market to accomplish similar goals as traditional securities markets. It also suggests that some investors looked to the art market to supplement traditional investments, thereby using both types of assets as part of a larger investment strategy.

Under the 2017 tax act, art investors are treated more like art collectors. Section 212 of the Code, which previously offered individuals an itemized deduction for "all the ordinary and necessary expenses" for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income, is currently suspended as a

147. *Id.* at 1318–19.

148. *Id.* at 1322.

149. *See id.* at 1321–22.

150. *See id.*

151. *See Stanley v. Comm'r*, 40 T.C.M. (CCH) 516, 520 (1980).

152. *See Manolakas, supra* note 143, at 99.

153. *See, e.g.,* Graham Bowley & Doreen Carvajal, *One of the World's Greatest Art Collections Hides Behind This Fence*, N.Y. TIMES (May 28, 2016), <https://www.nytimes.com/2016/05/29/arts/design/one-of-the-worlds-greatest-art-collections-hides-behind-this-fence.html> [<https://perma.cc/XR3X-7REM>].

154. *See id.*

155. *See Wrightsman*, 428 F.2d at 1317.

156. *Id.* at 1318.

miscellaneous itemized deduction under section 67(g).¹⁵⁷ However, though art investors are currently treated more like art collectors and are disallowed a deduction for these expenses, both art investors and collectors can still receive beneficial capital gains tax treatment. Furthermore, art investors may deduct a loss for a transaction entered into for profit under section 165(c)(2), but only if the loss results from casualty or theft.¹⁵⁸

In allowing art collectors and investors to take advantage of preferential capital gains tax rates after holding works of art for more than one year, Congress implicitly acknowledges that the income generated from art investments differs from traditional income sources, such as wages and salaries.¹⁵⁹ Rather, the income generated from art investments is more akin to that generated from traditional investments in stocks and bonds. As individuals look to structure transactions that minimize their tax burdens, capital transactions are compelling. Currently, however, an additional factor lingers to render art investments even more compelling than traditional investments in securities: the absence of trading regulations in the secondary art market.¹⁶⁰

2. Special Provisions

Though the 2017 tax act extended the Code's recognition of art as a tradable investment asset, it shifted the focus from the investor classification to the mechanism for receiving preferential tax treatment. There are three main differences in how this treatment works.

First, only capital gains must be invested in Opportunity Zones, whereas the entire value of the trade was considered under a like-kind exchange.¹⁶¹ Second, there is no investor exchange requirement to receive the tax benefit under the new Opportunity Zone program.¹⁶² Entry-level art investors and collectors who may not have other works of art to trade can still benefit from this special tax provision. Third, and perhaps the largest difference in tax treatment between like-kind exchanges and Opportunity Zones, is a new mechanical requirement. Previously, under section 1031, art investors themselves could defer their capital gains tax through like-kind exchanges.¹⁶³ Now, under section 1400Z, a legal entity must be formed before an individual can accrue the capital gains tax benefits.¹⁶⁴

The transition from like-kind exchanges to Opportunity Zones carries four principal implications. First, art investors may be less inclined to put works

157. I.R.C. §§ 67(g), 212 (2018).

158. *See id.* § 165(c)(2); *see also id.* § 67(b)(3).

159. *Compare id.* § 1221, with *id.* § 1.

160. *See* Lawrence M. Kaye & Howard N. Spiegler, *The Art Market: Would More Regulation Spoil All the Fun?*, HERRICK (Oct. 2016), <http://www.herrick.com/publications/the-art-market-would-more-regulation-spoil-all-the-fun/> [<https://perma.cc/6ZP9-UP3W>].

161. Benjamin W. Kennedy, *The Opportunity Zone Program*, NEV. LAW., Sept. 2018, at 19, 19.

162. *Id.*

163. I.R.C. § 1031.

164. *Opportunity Zones Frequently Asked Questions*, *supra* note 76.

of art in the market at all because they have no interest in Opportunity Zone Funds and their ensuing technical requirements.¹⁶⁵ This would reduce taxable transactions and shrink the amount of taxes received through art.¹⁶⁶ Second, some question the effectiveness of the presumed redistribution of wealth and trickle-down economics in Opportunity Zones. Opportunity Zones may not improve distressed communities because the policy fails to include any grassroots elements of economic development.¹⁶⁷ Further, Opportunity Zone investors need not live, work, or have a business in any particular Opportunity Zone to reap the tax benefits.¹⁶⁸ As a result, Opportunity Zones may benefit only investors, often for large-scale real estate development projects.¹⁶⁹ Third, the elimination of the like-kind exchange tax break for art, but not real estate, is an arbitrary distinction. This issue may become more pertinent if the Virtual Value Tax Fix Act of 2019, which would provide capital gains tax breaks for like-kind exchanges of virtual currency, becomes law.¹⁷⁰ Fourth, Opportunity Zones redirect investment opportunities from other places.¹⁷¹ This, in turn, clashes with free market investment notions of public economic growth.¹⁷²

Despite these concerns, Opportunity Zones are not an entirely new concept, and some speak positively about the expected benefits. For example, some scholars point to the fact that the Opportunity Zone program generated benefits after Hurricane Katrina when Congress enacted the Gulf Opportunity Zone Act of 2005.¹⁷³ Further, as Treasury Secretary Steven Mnuchin argued, “Attracting needed private investment into these low-income communities will lead to their economic revitalization, and ensure economic growth is experienced throughout the nation.”¹⁷⁴

Whether one rejects or supports the concept of Opportunity Zones, the novelty and complexity of the federal program has created confusion.¹⁷⁵ For

165. CITI PRIVATE BANK, STATE OF THE ART MARKET 7 (2019), <https://www.privatebank.citibank.com/pdf/State-of-the-Art-Market-Spring-2019.pdf> [<https://perma.cc/T6XB-WW5N>].

166. *Id.*

167. Paul Krugman, Opinion, *The Great Tax Break Heist*, N.Y. TIMES (Sept. 2, 2019), <https://www.nytimes.com/2019/09/02/opinion/trump-tax-opportunity-zones.html> [<https://perma.cc/PUN9-MUZ6>].

168. *Opportunity Zones Frequently Asked Questions*, *supra* note 76.

169. Jesse Drucker & Eric Lipton, *How a Trump Tax Break to Help Poor Communities Became a Windfall for the Rich*, N.Y. TIMES (Aug. 31, 2019), <https://www.nytimes.com/2019/08/31/business/tax-opportunity-zones.html> [<https://perma.cc/4TZG-8A6X>].

170. See H.R. 3963, 116th Cong. (2019).

171. Bennett, *supra* note 77, at 257.

172. *Id.*

173. Brandon N. Mourges & Michael J. March, *Opportunity Zones: The Good, the Bad, and the Yet to Be Defined*, ROSENBERG MARTIN GREENBERG LLP (Jan. 17, 2019), <https://www.rosenbergmartin-tax.com/news/opportunity-zones-the-good-the-bad-and-the-yet-to-be-defined/> [<https://perma.cc/5PCN-BP7W>].

174. Press Release, U.S. Dep’t of the Treasury, *supra* note 82.

175. Howard Gleckman, *Opportunity Zones May Someday Help Poor Communities. They Already Are a Tax-Shelter for High-Income Investors*, FORBES (Sept. 5, 2019), <https://www.forbes.com/sites/howardgleckman/2019/09/05/opportunity-zones-may->

example, the process of investing in Opportunity Zones is technical and may strike the average art investor as unclear.¹⁷⁶ Further, implementation of the program is messy, likely in part because of the rushed manner in which the 2017 tax act was pushed through Congress.¹⁷⁷ Ultimately, it is difficult to measure the success of the program at this early stage, in terms of both investor participation and public economic growth.¹⁷⁸ Nevertheless, the mere establishment of the program continues to align art investments closely with traditional investments in securities.

B. The Securities Exchange Act of 1934 and Insider Trading

As the Act and its insider trading regulations do not currently apply to art investments, this Note cannot discuss the treatment of art or the regulation of the secondary art market under the Act. However, this Note will analyze elements of the Act, particularly its sections concerning insider trading, which may provide an effective and proactive approach to reconciling the Act with the Code and regulating the secondary art market.

Part I.B.1 discussed the basic concepts implicated in insider trading, which are not clearly delineated in the law. The law only provides two broad provisions to prosecute insider trading: 15 U.S.C. § 78(j) (also known as section 10(b) of the Act and criminally enforced by the Department of Justice) and SEC Rule 10b-5 (civilly enforced by the SEC).¹⁷⁹ These rules seek to prevent the use of manipulative and deceptive devices in securities markets. The jump from manipulative and deceptive devices to insider trading seems unnatural given the fact that those who engage in insider trading are not necessarily seeking to manipulate or deceive another individual. This serves as just one example of how insider trading doctrine has become a “doctrinal mess.”¹⁸⁰

Some scholars posit that insider trading should not be regulated at all, in part because it is difficult to prove the direct harms of insider trading.¹⁸¹ Other scholars may even support insider trading, arguing that if securities regulations prioritize efficiency, insider trading can only improve the efficiency of stock prices.¹⁸² At its core, however, a central justification for regulating insider trading is to protect the integrity of markets for the

someday-help-poor-communities-they-already-are-a-tax-shelter-for-high-income-investors/ [https://perma.cc/WFA9-NARZ].

176. John Pantekidis, *Qualified Opportunity Zones: Proceed with Caution*, FORBES (Apr. 16, 2019), <https://www.forbes.com/sites/johnpantekidis/2019/04/16/qualified-opportunity-zones-qoz-caution> [https://perma.cc/GVK9-47HU] (critiquing Qualified Opportunity Zones for their potentially perverse impacts).

177. Bennett, *supra* note 77, at 268–70.

178. Eastman, *supra* note 21.

179. See 15 U.S.C. § 78(j) (2018); see also 17 C.F.R. § 240.10b-5 (2019).

180. Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 935 (2014).

181. See *id.* at 946.

182. See *id.* at 946–47; see also Bainbridge, *supra* note 108.

investing public.¹⁸³ This is a long-held, nearly instinctive notion in American jurisprudence.¹⁸⁴ As early as 1909, the U.S. Supreme Court held that a director of a corporation committed fraud when he bought stock from a shareholder knowing that the value of that stock was about to increase significantly because of a favorable contract.¹⁸⁵ Once Congress implemented the Act, the case law has since revealed a long-term judicial puzzle to determine where the lines should be drawn for insider trading.

1. Section 10(b) of the Act and Rule 10b-5

Section 10(b) of the Act and Rule 10b-5 provide the starting point for insider trading law. Under section 10(b) of the Act, it is unlawful to use “any manipulative or deceptive device or contrivance in contravention” of SEC rules “in connection with the purchase or sale of any security.”¹⁸⁶ Rule 10b-5 added substance to this prohibition. The rule renders three actions unlawful “in connection with the purchase or sale of any security”: (a) the “employ[ment] [of] any device, scheme, or artifice to defraud”; (b) the making of any “untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading”; and (c) the “engage[ment] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”¹⁸⁷ These prohibitions illustrate intent to curb investor attempts to manipulate information for personal benefit.

2. Initial Regulatory Approaches to Insider Trading: *Cady, Roberts & Co.*

In *Cady, Roberts & Co.*,¹⁸⁸ the SEC initially interpreted the Act to impose an “obligation” on individuals to disclose information or abstain from trading when two criteria were satisfied: (1) “a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone” existed and (2) the “inherent unfairness” resulting “where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”¹⁸⁹ This broad approach to insider trading alludes to the SEC’s interest in fairness and the SEC’s protection of equal access to material information as its key approach to fairness.

183. James J. Park, *Insider Trading and the Integrity of Mandatory Disclosure*, 2018 WIS. L. REV. 1133, 1134 (describing this justification and acknowledging the “reality that there will always be significant disparities in the ability and willingness of investors to access and analyze information”).

184. Although, and interestingly, many foreign jurisdictions do not share this view. See Newkirk, *supra* note 102 (comparing U.S. insider trading laws to the European Community).

185. *See id.* *See generally* Strong v. Repide, 213 U.S. 419 (1909).

186. 15 U.S.C. § 78(j)(b) (2018).

187. 17 C.F.R. § 240.10b-5 (2019).

188. 40 S.E.C. 907 (1961).

189. *Id.* at 912.

3. Equal Access Theory: *SEC v. Texas Gulf Sulphur Co.*

In response to Rule 10b-5 and the SEC's ruling in *Cady, Roberts & Co.*, the Second Circuit "initially took the aggressive position that any possession of relevant, material, nonpublic information gives rise to a duty to disclose or abstain from trading."¹⁹⁰ This position is articulated in *SEC v. Texas Gulf Sulphur Co.*,¹⁹¹ a case in which the Second Circuit held that those who transacted in or placed calls on Texas Gulf Sulphur stock after being apprised of a successful drilling discovery in Canada violated section 10(b) and Rule 10b-5.¹⁹² The court emphasized Congress's intent to protect "equal access to the rewards of participation in securities transactions" for all investors and held that the investing public should be subject to "identical market risks."¹⁹³

Texas Gulf Sulphur Co. marks the judicial implementation of the equal access theory, which holds that "all traders owe a duty to the market to disclose or refrain from trading on nonpublic corporate information."¹⁹⁴ This holding contains two important assessments. First, traders owe a duty to the market at large, not to any one constituency, to disclose material, nonpublic information or to abstain from trading on the basis of that information. The imposition of this duty levels the playing field among investors by prohibiting an economic advantage for those with privileged insider positions. Second, the expected value of nonpublic information, or whether that information is likely to impact an investor's decisions, measures the materiality of that information.

In the context of the secondary art market, the equal access theory may apply to anyone trading art who acquires material, nonpublic information, either about a museum, an artist, or even a work of art, because a duty is owed to the art market at large to promote equal access to information.

4. Fiduciary Duty Theory: *Chiarella v. United States* and *Dirks v. SEC*

In *Chiarella v. United States*,¹⁹⁵ the Supreme Court held that the equal access theory imposed too broad of a duty in requiring anyone in possession of material, nonpublic information to either disclose the information or to abstain from trading.¹⁹⁶ To rein in the scope of section 10(b), the Court held that an individual violates section 10(b) only when that individual acquired material, nonpublic information and had a fiduciary duty, arising from a "relation of trust and confidence," to the party without access to that information.¹⁹⁷

190. ALLEN & KRAAKMAN, *supra* note 88, at 630.

191. 401 F.2d 833 (2d Cir. 1968).

192. *Id.* at 852.

193. *Id.* at 851–52.

194. ALLEN & KRAAKMAN, *supra* note 88, at 640.

195. 445 U.S. 222 (1980).

196. *See id.* at 223, 230.

197. *Id.* at 228.

Dirks v. SEC,¹⁹⁸ a case in which the Supreme Court reaffirmed that “a duty to disclose only [arises] where the inside traders [breach] a pre-existing fiduciary duty owed to the person with whom they traded,”¹⁹⁹ advanced the fiduciary duty theory developed in *Chiarella*. In *Dirks*, the Court also clarified that an outsider to the inside information who nevertheless receives a tip of such information may be a “constructive insider” if the outsider has reason to believe that the tipper breached a fiduciary duty in giving the tip.²⁰⁰

Though the fiduciary duty theory may at first seem inapplicable to the secondary art market because the secondary art market does not involve fiduciaries in the traditional sense, this difference can be reconciled.²⁰¹ Museum directors, for example, may be deemed to owe a duty to their respective museums.²⁰² Since museums have the implicit ability to affect prices in the secondary art market, and museums are also affected by prices in the art market, museum directors may in turn become pseudofiduciaries to their institutions, among others.

5. Misappropriation Theory: *United States v. O’Hagan*

The misappropriation theory advanced in *United States v. O’Hagan*²⁰³ covers a different dynamic of insider trading by focusing on outsiders to a corporation who acquire access to inside information.²⁰⁴ The theory “premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.”²⁰⁵ Even though O’Hagan, a partner at a law firm, did not owe a fiduciary duty to the issuer of the security, a client of the firm with material, nonpublic information, O’Hagan did owe a fiduciary duty to the other partners of the firm.²⁰⁶ O’Hagan breached that duty by engaging in a “self-serving use of a principal’s information to purchase or sell securities.”²⁰⁷

As will be discussed further, the misappropriation theory may apply to the secondary art market in the context of gallery or museum employees who may learn inside information from a trading platform, such as an auction house, and seek to make profits on the basis of that inside information.

The case law reflects the evolving distinction between strategic trading and insider trading at any point in time.²⁰⁸ The SEC likely benefits from this evolving distinction because it allows for continuous tweaking of the elements required, which may deter some individuals from engaging in

198. 463 U.S. 646 (1983).

199. Bainbridge, *supra* note 108 (manuscript at 4).

200. *Dirks*, 463 U.S. at 655.

201. *See infra* Part II.C.

202. *See infra* Part III.A.

203. 521 U.S. 642 (1997).

204. *See generally id.*

205. *Id.* at 652.

206. *Id.*

207. *Id.*

208. *See supra* Parts II.A.2–5.

insider trading to begin with because of the unclear scope of the law.²⁰⁹ Most relevant for this Note, however, are the elements that are common to the different theories of insider trading and their potential applicability to new asset classes. The most essential element is the lingering prohibition on investor use of a deceptive device, such as inside information, to generate a personal benefit—financial or otherwise.

C. How This Regulatory Discrepancy Affects Art Investors and Policy Considerations

Part II.A described how federal tax laws treat art as a tradable investment asset without any material distinction from other capital assets, such as traditional securities. Part II.B analyzed the securities laws that apply to traditional securities to protect the integrity of those markets. Since these securities laws do not apply to the secondary art market, this subpart highlights the effects of trading in that art market without comparable restrictions.

First, auction houses are not required to disclose details about guarantees or irrevocable bids on works of art at auction as are trading platforms that deal with traditional securities.²¹⁰ Individuals, however, may know more details about a work of art because of their own social networks in the art world or their special relationships with experts in the field. These individuals may even pay a premium for information precisely because it is “tightly” held in the art market.²¹¹ Current circumstances in the secondary art market foster the monetization of a competitive advantage of inside information.²¹² As a consequence, individuals who cannot access this information may suffer the effects of price manipulation in the secondary art market.²¹³

Second, buyer and seller identities are often unknown in art transactions.²¹⁴ While information about a work of art’s provenance may be available, that information may also be incomplete. Indeed, museums sometimes make active use of incomplete information in designing placards that describe the work of art.²¹⁵ This increases the possibility that an individual may invest in a looted or stolen work of art,²¹⁶ which poses a

209. Kim, *supra* note 180, at 933.

210. See Kaye & Spiegler, *supra* note 160.

211. See *id.*

212. Doug Woodham, *Why Investing in Fine Art Is Different Than Investing in Traditional Asset Classes*, ARTSY (Apr. 9, 2018), <https://www.artsy.net/article/artsy-editorial-investing-fine-art-investing-traditional-asset-classes> [<https://perma.cc/P6AN-XATQ>] (discussing how “trading on non-public information is an important driver of returns” in the art market).

213. See Isaac Kaplan, *Should the Art Market Be More Heavily Regulated?*, ARTSY (May 23, 2016), <https://www.artsy.net/article/artsy-editorial-should-the-art-market-be-more-heavily-regulated> [<https://perma.cc/3TH9-AKR5>].

214. See Kaye & Spiegler, *supra* note 160.

215. See Anne Higonnet, *Afterword: The Social Life of Provenance*, in *PROVENANCE: AN ALTERNATE HISTORY OF ART 195, 195–97* (Gail Feigenbaum & Inge Reist eds., 2013).

216. See Kaye & Spiegler, *supra* note 160.

serious problem in the art market.²¹⁷ Art investors rely almost entirely on the “due diligence of the dealer,” whether at a gallery or an auction house, for information without any regulatory requirements to ensure completeness or accuracy.²¹⁸

Third, and most broadly, individual art investors can make use of any inside information they may acquire for personal financial gain or benefit. Investors may receive this acquired information on an uneven playing field, either as insiders themselves or with insiders selectively sharing information with them. This effectively silos the art market into uneven networks of information, which is becoming particularly problematic at the museum-director level.²¹⁹

The central problem apparent in each of these examples is a lack of transparency in the art market that causes inequities and inefficiencies. This problem, ironically paired with beneficial tax treatment, is not merely ripe for comparison and legal analysis. At its core, this problem cripples the public’s confidence in investing in the secondary art market and heightens the barriers to entry. As the SEC becomes more aggressive in prosecuting insider trading,²²⁰ and courts demonstrate an expansive approach to interpreting the relevant insider trading law,²²¹ the SEC should more aggressively apply securities laws to the growing secondary art market. Insider trading concerns cannot be remediated without a broader understanding of the impact of insider trading on various markets.

D. Important Disclaimers

Before presenting a resolution to this problem, two important disclaimers must be made. First, the IRS and the SEC have different goals. The IRS is incentivized to maximize revenues through taxes and expand its sources of taxable income wherever reasonable.²²² The SEC, in contrast, seeks to protect investors in securities markets and strategically targets its enforcement efforts accordingly.²²³ These different goals require different approaches, and presuming that these agencies should take identical approaches to these assets would oversimplify this argument. The differences between these agencies, however, do not eradicate the relevance of synchronizing the approach to and treatment of an asset when it makes sense to achieve the agencies’ shared goals of equity, efficiency, and transparency.

Second, this Note does not advance the idea that art is synonymous with a stock or a bond. Of course, there are differences in the process through which

217. *See* *Republic of Austria v. Altmann*, 541 U.S. 677 (2004); *see also* Holocaust Expropriated Art Recovery Act of 2016, Pub. L. No. 114-308, 130 Stat. 1524 (codified as amended at 22 U.S.C. § 1621 note (2018)).

218. *Kaye & Spiegler*, *supra* note 160.

219. *See* *Massing*, *supra* note 19.

220. *See generally* *Crimmins*, *supra* note 110.

221. *See, e.g.*, *United States v. Blaszczyk*, 947 F.3d 19 (2d Cir. 2019).

222. *See supra* Part I.A.2.

223. *See supra* Part I.B.1.

each type of asset is exchanged and in the qualities of the assets themselves. In terms of process, art is not a perfect fit for the *Howey* test.²²⁴ Art only fits three of the test's four elements: individuals (1) invest money, (2) expect to earn profits, and (3) rely on external efforts (such as those by museums, galleries, and auction houses) to earn those profits. Contrary to traditional securities markets, however, the money invested in the art market is not invested into a "common enterprise," which constitutes the fourth element of the *Howey* test.²²⁵ There is no single exchange in the art market. Though there is also no single place of exchange for traditional securities, exchanges in the art market occur in a more diffused manner. Further, absent an arrangement between an art investor and an art dealer or consultant of some sort, no individual or entity owes the owner of a work of art a fiduciary duty for future behavior. As a result of these differences between art and traditional securities, art may be less liquid than traditional securities markets,²²⁶ and it may carry greater inefficiencies than traditional securities markets.²²⁷

The art market also differs from traditional securities markets in the substance of and information about the transacted assets. For example, no two individuals typically own the same work of art in the way that two individuals may own an identical share of stock in a corporation. Artists do not usually mass produce the same work as a "fungible commodit[y]."²²⁸ Further, there are no price indexes assessing risks and returns in the art market or audited financials providing information about the value of works of art.²²⁹ The art market instead relies heavily on, for example, auction sales at the nation's two largest auction houses, Christie's and Sotheby's, which function as a "duopoly" in the market.²³⁰ Museums may complicate the matter by keeping much of the market's acquisition data in the dark through private transactions.²³¹ This is changing, however, with the growth of resources such as the Artnet "Price Database."²³² Lastly, forgeries and fakes

224. See *supra* Part I.B.1.

225. See *supra* Part I.B.1.

226. Woodham, *supra* note 212.

227. Gregory Day, *Explaining the Art Market's Thefts, Frauds, and Forgeries (and Why the Art Market Does Not Seem to Care)*, 16 VAND. J. ENT. & TECH. L. 457, 463–65 (2014) (discussing the art industry's refusal to provide answers to pertinent questions about the art market).

228. *Id.* at 466.

229. Woodham, *supra* note 212.

230. See WOODHAM, *supra* note 16, at 31; see also Martin Gammon, *The Often-Ignored Problem with Buying Art as an Investment*, ARTSY (June 24, 2019), <https://www.artsy.net/article/artsy-editorial-often-ignored-problem-buying-art-investment> [<https://perma.cc/9C6H-SEFX>].

231. Gammon, *supra* note 230.

232. See *Price Database*, ARTNET, <https://www.artnet.com/price-database/> [<https://perma.cc/KM3N-SMUB>] (last visited Feb. 14, 2020).

render the art market particularly susceptible to issues involving fraud and restitution.²³³

Though these differences are not irreconcilable, they must be acknowledged before proceeding with this Note's resolution. It is because of these differences that this Note proposes the application of modified securities laws to the secondary art market, rather than the application of securities laws as they presently affect traditional securities.

III. UNVEILING AN INTEGRATED RESOLUTION

This Part unveils an integrated resolution to synchronize the disparate treatment of art under the Code and the Act. It proposes that regulatory efforts should target investor motives and not mere asset classes. As such, insider trading regulations should be modified and adapted to fit the secondary art market. This Part also addresses possible pushback to this resolution.

A. How to Synchronize Disparate Treatment

Despite the admitted differences between the secondary art market and traditional securities markets, investors in both markets share a core interest in generating financial gain. Art investors exchange works of art in the secondary market to increase the value of their works, and the amount of increased value hinges on external factors.²³⁴ Investors in both markets also rely on information networks to achieve financial gain. In the context of traditional securities markets, these are circumstances that have sparked regulation.²³⁵ In the secondary art market, however, these circumstances have yet to receive regulatory scrutiny. Consider the shared investor motives and patterns in both markets, which in turn contour the dynamics of equity and efficiency in each respective market. Efforts to reconcile the regulation of the two markets are worthwhile.

To the extent art investors in a growing market reap the same benefits of preferential capital gains tax rates and other tax deferral opportunities (such as those provided through the investment of gains in Opportunity Zones) as investors in traditional securities,²³⁶ consideration should be given to broadening the scope of insider trading regulations to include the secondary art market, albeit in modified form. The application of modified insider

233. Frederik Balfour, *Billionaire's Secrets on How to Make a Bundle in Art*, BLOOMBERG (May 7, 2018), <https://www.bloomberg.com/news/features/2018-05-07/top-collectors-reveal-the-secrets-of-how-to-invest-in-art> [<https://perma.cc/YM3S-B2SN>].

234. *See supra* Part I.C (discussing factors that contribute to the art market's growth).

235. *See supra* Parts I.B, II.B (discussing activities in traditional securities markets that warrant regulation).

236. As a capital asset, gains from the sale or disposition of art should continue to be taxed at preferential capital gains rates. Under current law, art investors can no longer deduct their expenses for the production or collection of income generated from art investments. *Compare* I.R.C. § 212 (2018), *with* I.R.C. § 67(g) (2018). Whether or not these deductions should be permitted after the current law disallowing the deduction sunsets in 2025 falls outside the scope of this Note.

trading regulations to the secondary art market would increase the equity and fairness of trading within that market, thereby bolstering investor confidence and lowering the barriers to entry.

If the SEC is not willing to expand its definition of securities to art in its regular enforcement work,²³⁷ a new subdivision within the SEC's purview should be formed to tackle these issues. Creating a new division that broadly, but perhaps imperfectly, fits within the scope of the SEC's work is not a novel concept. In June 2018, the SEC created a new advisory position to adapt the SEC to "emerging digital asset technologies and innovations, including Initial Coin Offerings and cryptocurrencies," which are also not identical to traditional securities.²³⁸ Taking a similar approach to the secondary art market would demonstrate the SEC's awareness of that market as the substantial investment vehicle and trading market that it is today. As the following paragraphs describe, modified insider trading regulations could apply to the secondary art market in various forms.

First, a modified fiduciary duty theory can apply to museum, auction house, and gallery directors and officers.²³⁹ Traditionally, the fiduciary relationship arises between corporate directors and officers who have a relationship of trust and confidence with the shareholders of the corporation whose shares are traded.²⁴⁰ Though most directors and officers at museums, auction houses, and galleries do not owe a fiduciary duty in the traditional sense,²⁴¹ these individuals can be deemed to have: (1) a pseudofiduciary duty to their institutions or (2) an indirect relationship of trust and confidence with their customers or other investors in the art market who rely on these institutions to support the market.²⁴² These relationships generate a need to curb insiders in the secondary art market from trading or tipping on the basis of material, nonpublic information acquired through their positions for personal gain and at the expense of others in the market. As a result of this potential deception, coupled with the absence of direct fiduciary relationships at each of these institutions, a modified fiduciary duty theory can take root. In this context, the word "fiduciary" encompasses the more diffused relationships of trust and confidence that exist in the secondary art market. Though this modified theory may evoke elements of the broader equal access

237. Initial SEC reluctance to envelop the art market would not be surprising. *See* Rooney, *supra* note 98 (promoting a formalist definition of the SEC's regulatory scope).

238. Press Release, U.S. Sec. & Exch. Comm'n, SEC Names Valerie A. Szczepanik Senior Advisor for Digital Assets and Innovation (June 4, 2018), <https://www.sec.gov/news/press-release/2018-102> [<https://perma.cc/2JGX-RKCR>].

239. *See supra* Part II.B.

240. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980).

241. Sotheby's was publicly traded before BidFair USA took it private in 2019. *See Sotheby's Announces Definitive Agreement to Be Acquired by Patrick Drahi*, SOTHEBY'S (June 17, 2019), <https://www.sothebys.com/en/articles/sothebys-announces-definitive-agreement-to-be-acquired-by-patrick-drahi> [<https://perma.cc/4YJP-QSHV>].

242. Further still, if an art museum receives public funding, there is a strong argument to be made that its directors and curators have a relationship of trust and confidence with the public to carry out civic nonprofit missions. *See, e.g., Grants for Organizations*, NAT'L ENDOWMENT FOR ARTS, <https://www.arts.gov/grants/apply-grant/grants-organizations> [<https://perma.cc/4EFS-BKLJ>] (last visited Feb. 14, 2020).

theory,²⁴³ there should be less concern for overbroad applications given the uniquely diffused and unequal information networks in this market.

To provide an example of this modified theory at work, suppose a museum director, D, learns that a particular artist, A, will soon be featured in an exhibition at a prominent museum in New York City. The exhibition has the potential to significantly increase the value of A's work, and the museum has not yet disclosed this exhibition to the public. Rather than disclose the information to the public or abstain from trading on the basis of this information, D proceeds to purchase works by A in the secondary market. D also tips a friend and fellow art investor, F, and F also proceeds to buy a work of art by A. After the exhibition, D and F sell their works by A at a much higher price because the exhibition has increased the value of the works.

In using D's insider position as a museum director for D's own personal benefit,²⁴⁴ D harmed the owners of other works by A whom he purchased from before the exhibition became public knowledge.²⁴⁵ F similarly harmed those owners. Together, D and F engaged in manipulation and deception by relying on inside information and artificially affecting the market.²⁴⁶ If the museum later seeks to purchase a work of art by A, perhaps because of the success of the exhibition, then D's manipulation directly affects the institution of which he is a fiduciary as a director. Ultimately, these hypothetical transactions contribute to the existing negative perception of the secondary art market as a murky "network of undue influence."²⁴⁷ Under this Note's proposed resolution, the SEC may prosecute D and F for violations of modified securities laws.

Second, if an individual does not have a strong enough relationship to justify the application of the modified fiduciary duty theory, the misappropriation theory or Rule 10b5-2 can apply to prevent museum, auction house, or gallery employees from improperly acquiring a personal benefit through the use of inside information at art institutions. In other words, even where an employee may not owe a duty to another individual, an individual may still be prohibited from trading without disclosure when engaged in a network of inside information at his or her institution. Under the misappropriation theory, the fiduciary duty is owed to the source of the information that an outsider acquires.²⁴⁸ This could apply in situations where, for example, outside counsel learns inside information when working for an auction house in preparation for a large sale. Further, under Rule 10b5-2, museum, auction house, or gallery employees may be liable for insider

243. See generally *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

244. D receives two benefits here. First, D receives a personal pecuniary gain from his own trades. Second, D benefits by intending to benefit his friend. See *Dirks v. SEC*, 463 U.S. 646, 660 (1983) (delineating the contours of tipper-tippee liability).

245. D also could have benefitted by donating the works by A that D purchased to the museum and taking a charitable contribution deduction. See I.R.C. § 170 (2018).

246. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

247. Francesca Gavin, *The Only Way Is Ethics: The Art World's "Networks of Undue Influence,"* ART NEWSPAPER (June 7, 2019), <https://www.theartnewspaper.com/analysis/the-only-way-is-ethics> [<https://perma.cc/ZR52-8E93>].

248. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

trading if they have agreed to maintain inside information in confidence, yet proceed to share that information with art investors in breach of that confidence.²⁴⁹ Such agreements can often be found in the ethical guidelines of these organizations.²⁵⁰

Aside from adapting elements of insider trading to the art market, scholars and art market experts have proposed other solutions that could support this Note's proposed resolution to improve the murkiness of the secondary art market. First, a more formal registry that tracks price histories of works of art "both at auction and in private sales" could be implemented in the secondary art market.²⁵¹ Second, more efficient uses of financial technology could be incorporated into the secondary art market to provide "access and information to retail investors."²⁵² Together with modifying securities laws and regulations to apply to the secondary art market, these solutions are also effective mechanisms for supporting equity, efficiency, and transparency.

B. Addressing Potential Pushback

As this approach is likely to be met with some pushback, this section responds to anticipated counterarguments.

First, and most broadly, some may argue that the fundamentally distinct goals of the IRS and the SEC cannot be reconciled through a shared approach to the secondary art market. This Note has acknowledged the differences between the IRS and the SEC, and this resolution does not seek to import tax principles into securities laws or vice versa. However, this Note points to the shared purposes of the agencies, especially in promoting equity, efficiency, and transparency. The IRS works to create an even playing field through a progressive tax system,²⁵³ while the SEC works to do the same by protecting investors from unfair and deceptive practices.²⁵⁴ With these shared purposes, this resolution aims to tie up loose ends in the secondary art market and, in doing so, better actualize the purpose of each legislative regime in its own right.

Second, some may argue that insider trading regulations are problematic because they do not "advance" any "important federal policy," yet they are incredibly costly.²⁵⁵ Though this argument may be valid, it does not justify deregulating trading markets altogether. By working to protect the market and regulate insider trading, more people will invest in the market. The more

249. 17 C.F.R. § 240.10b5-2 (2019).

250. See Gavin, *supra* note 247 (discussing the codes of conduct at auction houses).

251. Spiegler, *supra* note 14 (quoting Ian Charles Stewart, a venture capitalist based in London).

252. Brian L. Frye, *New Art for the People: Art Funds & Financial Technology*, 93 CHI.-KENT L. REV. 113, 113–14 (2018).

253. See, e.g., Meredith R. Conway, *Money, It's a Crime. Share It Fairly, but Don't Take a Slice of My Pie!: The Legislative Case for the Progressive Income Tax*, 39 J. LEGIS. 119, 125–29 (2013) (discussing the legislative rationales for the progressive tax system).

254. See, e.g., *Our Goals*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/our-goals> [<https://perma.cc/B5RF-CWCW>] (last updated Oct. 16, 2018).

255. Professor Stephen Bainbridge has discussed these arguments at length. See Bainbridge, *supra* note 108 (manuscript at 64–82).

voluminous the investments in the markets, the greater the opportunities for innovation and economic growth.

Third, some may say let caveat emptor reign, especially in the notoriously convoluted art market. This principle of “buyer beware” was popular as a corporate law concept in the nineteenth century.²⁵⁶ In the twenty-first century, however, equity concerns should trump caveat emptor in situations like these where a viable framework is readily available to remediate and clarify an especially murky market.²⁵⁷

Fourth, art investors may criticize the practical implications of this regulation and wonder where the lines of these regulations should be drawn. Who is an “insider”: a director at a museum? A gallery owner? A customer? An artist? As noted above, however, the fiduciary duty and misappropriation theories provide helpful initial contours here.²⁵⁸ Further, the “material, nonpublic information” in the context of the art market can be understood as information that an entry-level art investor who conducts a reasonable amount of research cannot access on his or her own, such as a museum’s five-year calendar or a gallery owner’s network of information about an artist’s future plans.

Fifth, some may argue that the unregulated distribution of information in the art market contributes to investors’ success in this asset class.²⁵⁹ Surely, some investors’ success in traditional securities markets would also increase in the absence of insider trading regulations. Increasing fairness in the art market does not eradicate, or even significantly impair, individuals’ opportunities for financial gain for those who strategically buy and sell art based on available public information about the works and the market.

Sixth, some may reverse the approach taken in this Note and recommend that preferential tax treatment for art be eliminated in exchange for no regulations of the art market. As this Note considered the recent growth of the art market to be a similarly important factor spurring the need for regulation, removing tax benefits (which would in turn generate greater lock-in effects and disincentivize market transactions) is an underwhelming solution to this problem.

Ultimately, this Note pushes the secondary art market into uncharted territory. If this Note provokes thought and debate on the topic, it will have served its purpose.

C. Increasing Attention to Taxation and the Art Market

In the debates surrounding the 2020 presidential election, discussions about how to increase equity in the tax system have become more relevant, particularly in the context of a growing budget deficit.²⁶⁰ The Congressional

256. ALLEN & KRAAKMAN, *supra* note 88, at 617.

257. *See, e.g.,* Day, *supra* note 227, at 459–60 (discussing market failures and suppressed information in the art market).

258. *See supra* Part II.B.

259. *See* Balfour, *supra* note 233.

260. *See, e.g.,* Eastman, *supra* note 21; Stevens, *supra* note 21.

Budget Office recently assessed that the federal budget deficit will average \$1.2 trillion between 2019 and 2029.²⁶¹ The topics of equity, efficiency, and transparency in trading markets, such as the art market where individuals may also benefit from preferential capital gains tax treatment, are interesting and pertinent angles of this greater discussion. Improving conditions in markets that are traditionally thought to be reserved for wealthier investors may benefit the larger economy at whole.

CONCLUSION

This Note has sought to expose the impact that the disparate treatment of the same asset by two different federal agencies can have on a growing trading and investment market. As the art market continues to grow, modified SEC regulations regarding insider trading should envelop the art market to make it more equitable, efficient, and transparent. Tax benefits should also be paired with greater oversight of the trading market in which those benefits are generated. Though art differs from traditional securities, the similarities that art shares with traditional securities, as well as the motives that art investors share with traditional investors, justify new contours in art investment regulation. An investor motive-based inquiry is central to assessing this need for increased regulation in the secondary art market.

The SEC should either adapt to enforce these modified insider trading regulations within its traditional structure or form a subdivision to specifically address trading issues in the secondary art market. Without cohesive treatment of art as an investment asset, issues of inequity remain, hindering honest and fair transactions within the secondary art market and deterring the entry of new investors.

261. CONG. BUDGET OFFICE, *THE BUDGET AND ECONOMIC OUTLOOK: 2019–2029*, at 7 (2019), https://www.cbo.gov/system/files/2019-08/55551-CBO-outlook-update_0.pdf [<https://perma.cc/MA25-N9V7>].