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KD, AD, Kawhi, Uncle Drew, and Uncle Sam: the Tax Consequences of Player Contract Trades

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INTRODUCTION

Those who follow the National Basketball Association were astonished by the flurry of player trades in a recent two-week period as superstar players, including Kevin (KD) Durant, Anthony (AD) Davis, Kawhi (the ''former King of the North'') Leonard, and Kyrie (Uncle Drew) Irving, moved from one team to another in exchange for other players and draft picks. Another flurry of player trades (albeit few involving franchise-altering talents) occurred at the recent expiration of Major League Baseball's trade deadline. NBA and MLB fans no doubt will argue for years about which teams got the better of these trades.

Prior to the issuance of recent guidance from the Internal Revenue Service, it also appeared that sports team owners and the IRS might be arguing for years about the tax consequences of these and other player contract trades. (Although the media typically describes these transactions as a team trading one player for another, for tax and legal purposes it is actually a player's contract rights that are traded — i.e., the right to the player's future services — and not the player himself or herself. That is because the Tax Cuts and Jobs Act of 2017 (TCJA) changed the tax rules governing such trades in a manner that many team owners feared would result in significant capital gain recognition. This article describes that change in the law and also discusses recently issued guidance from the IRS that likely will allay the fears of team owners and fans alike that the new tax rules will inhibit player movement. Lastly, the article points out some issues raised by the IRS guidance that (to borrow a phrase from the sports world) might merit ''further review.''

Before the TCJA, trades of contracts for professional sports players and other related personnel contracts (collectively, ''player contracts'') qualified as tax-deferred like-kind exchanges under §1031.[1] This generally allowed team owners to avoid the cumbersome and inexact process of valuing player contracts or draft picks in determining the amount of taxable gain or loss incurred in a trade. (In a number of Revenue Rulings, the IRS confirmed that player contracts satisfied the ''like-kind'' test regardless of the ''quality or grade'' of the contracts being traded.) As noted above, however, the TCJA changed the rules of the game for trades commenced after December 31, 2017, by amending §1031 to limit non-recognition treatment to exchanges of real property only. Responding to the concerns of team owners, the IRS in Revenue Procedure 2019-18, (issued on April 11, 2019) introduced, as a rule of administrative convenience, a ''safe harbor'' under which sports franchises may value player contracts and draft picks acquired in a trade at ''zero value'' for determining gain or loss, thus restoring a semblance of the tax treatment teams enjoyed under prior law and, in some cases, producing a more favorable result for the team owner.

REV. PROC. 2019-18 TO THE RESCUE

The purpose of Rev. Proc. 2019-18 is to avoid highly subjective, complex, lengthy, and expensive disputes between professional sports teams and the IRS regarding the value of player contracts and draft picks in determining gain or loss for federal income tax purposes. At the outset, Rev. Proc. 2019-18, §2.02 identifies a variety of unpredictable factors that affect the value a team might assign to a player contract, in-

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[1] All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

cluding: player performance (players frequently outperform or underperform their team's expectations based on their age, injuries, and other factors); the changing needs of the team and other teams (for instance, a baseball team with an outstanding young minor league shortstop may not value the contract rights to that prospect as highly as other teams might if the team owning the prospect's contract already had a young all-star shortstop on its major league roster); and league rules and regulations (for example, some professional sports leagues have salary caps and so-called ''luxury taxes'' to prevent or dissuade wealthier, big market teams from signing or trading for all the best players).

Rev. Proc. 2019-18, §2.03 sets forth the general ''safe harbor'' rule under which a team may treat the value of ''traded personnel contracts and draft picks'' as zero if certain conditions are satisfied. (Rev. Proc. 2019-18, §3.03 provides that the safe harbor is not applicable to trades of one team for another team or a sale of a team for cash.) Accordingly, a team may recognize gain or loss on a player contract trade by treating only the amount of cash (if any) received in the trade in its amount realized for purposes of §1001. Notably, Rev. Proc. 2019-18 is not the first instance in which the IRS cited administrative convenience as a reason for assigning a zero value to a difficult-to-value intangible asset. For example, Rev. Proc. 2007-23 allows taxpayers engaging in ''qualified patent cross licensing arrangements'' to assign a zero value to the exchanged patent rights and treat only cash received in the arrangement as income for §1442 withholding purposes and as the amount subject to capitalization under §263(a) or §263A. On the other hand, those who have watched the celebrations of the owners, employees, and fans of teams that have gained the top pick in the NBA draft lottery would be hard pressed to say that pick has zero value because such jubilation is proof positive that other teams would pay a great deal of money for that pick.

CONDITIONS FOR APPLYING THE SAFE HARBOR

Rev. Proc. 2019-18, §3 provides that a team may use the zero value safe harbor for traded personnel contracts or draft picks if the following conditions are met:

1. **Consistent Tax Reporting Rule:** All parties to the trade that are subject to U.S. federal income tax must agree to file their federal income tax returns consistent with Rev. Proc. 2019-18 (thus, if a U.S. professional soccer team traded player contracts with a European team that does not conduct a U.S. trade or business, the Consistent Tax Reporting Rule would not apply.)
2. **Cash Boot Only Rule:** In the trade, each team must transfer and receive at least one player contract or draft pick, and no team may transfer any property other than personnel contracts, draft picks, and cash.
3. **No §197 Intangible Rule:** In the trade, no personnel contract or draft pick (apparently for any team) may be an amortizable §197 intangible (a ''§197 intangible'' — i.e., an asset which, by its very nature, must be amortized over a 15-year useful life).
4. **Financial Statement Consistency Rule:** No team participating in the trade may reflect assets or liabilities (other than cash) resulting from the trade on its financial statements. Rev. Proc. 2007-23 has a similar financial statement consistency requirement for qualified patent cross licensing arrangements to meet its zero value safe harbor.

Rev. Proc. 2019-18 §4.03 and §4.04 provide that, in a transaction where **a team pays cash** to another team as part of a safe harbor trade, the cash-paying team (1) if it acquires only one player contract or draft pick, will take a basis in that player contract or draft pick equal to the amount of cash paid and (2) if it acquires multiple player contracts or draft picks, must allocate its basis to each player contract or draft pick by dividing such basis by the number of player contracts and draft picks received. If **a team pays no cash** in a safe harbor trade, it will take a zero basis in all player contracts and draft picks received. If both teams in a trade qualify for the safe harbor, then (1) a team that has no basis in a contract will recognize no gain or loss on a trade provided it receives no cash in the deal; (2) a team that has basis in a contract (as a result of remaining unamortized basis arising from a bonus payment) will recognize a taxable loss on a trade provided its receives no cash in the deal; and (3) a team that receives cash, as well as one or more personnel contracts or drafts picks in a trade, will determine its amount realized, and therefore its gain or loss on the trade, based only on the cash received.

QUESTIONS ABOUT THE SAFE HARBOR RULES

''Upon further review'' of Rev. Proc. 2019-18, there was little controversy or concern regarding the Consistent Tax Reporting Requirement or the Cash Boot Only Rule. However, questions quickly arose regarding the No §197 Intangible Rule and the Financial Statement Consistency Rule.

The No §197 Intangibles Rule

Under §197(d)(1)(c)(i), a player contract will be treated as a §197 intangible if it is acquired in con-

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nection with a purchase of a team. Accordingly, if an owner acquired a team within the 15-year period preceding a particular player trade (and the traded player was still on the team's roster under his or her original contract), then the team may not take advantage of Rev. Proc. 2019-18's ''zero value'' safe harbor under the No §197 Intangible Rule.

Although this limitation on the safe harbor appears puzzling at first, it makes sense in the context of §197(f)(3). That section precludes a taxpayer from recognizing a loss on the disposition of a single §197 intangible asset if the taxpayer acquired that intangible (together with other §197 intangibles) in a single transaction (or series of related transactions) and the taxpayer retains one or more of such other acquired §197 intangibles. Rather than recognizing the loss, the taxpayer must add the unamortized basis in the transferred §197 intangible to the basis of the retained §197 intangibles. Absent the No §197 Intangible Rule, a team owner holding a player contract as a §197 intangible could recognize a loss on a trade, which loss §197(f)(3) otherwise would disallow on any other disposition of that contract.

At a meeting of the ABA Tax Section's Committee on Sales, Exchanges and Basis in Washington, D.C. on May 11, 2019, two of the authors of Rev. Proc. 2019-18 in the IRS Office of Associate Chief Counsel (Income Tax and Accounting) confirmed that the No §197 Intangible Rule was intended to prevent teams from circumventing §197(f)(3). It is not clear, however, why the No §197 Intangibles Rule applies to all teams in a trade if only one team involved in the trade holds a player contract as a §197 intangible. Alternatively, Rev. Proc. 2019-18 simply could have confirmed that §197(f)(3) will deny a current loss deduction if the relinquished player contract is a §197 intangible. In addition to team owners who hold a player contract as a §197 intangible as a result of acquiring a team, a team owner who inherits a team (assuming the team is a sole proprietorship or a tax partnership with a §754 election in place) also could hold certain player contracts as §197 intangibles.

The Financial Statement Consistency Rule

The rationale for the Financial Statement Consistency Rule is more obvious. If a team can value a player contract for financial reporting purposes, then it cannot plausibly claim that valuation is too difficult and complicated a task. However, Rev. Proc. 2019-18, §3.04 goes further, and provides that a team's financial statements ''must not reflect assets **or liabilities** resulting from the trade other than cash'' (emphasis added). Because a team's balance sheet generally will record guaranteed contractual obligations as a liability, there was a concern that the exception to the Rev. Proc. 2019-18 zero value safe harbor under the Financial Statement Consistency Rule could swallow the general rule. At the May 2019 ABA Section of Taxation Meeting, however, two of the IRS authors of Rev. Proc. 2019-18 explained that the Financial Statement Consistency Rule was not intended to cover recording of future contractual liabilities. (Of course, a statement by an IRS official at a tax seminar represents that official's view only and is not binding on the IRS.) Rather, the rule was intended to prevent teams from utilizing the safe harbor if its books show a loss on its balance sheet for the trade.

CONCLUSION

Rev. Proc. 2019-18 likely will be a boon to billionaire sports team owners. The IRS requires the valuation of many other difficult-to-value assets (e.g., art work, closely held companies, other §197 intangibles) for federal income tax and estate tax purposes. While a player contract that pays a player fair market value should have a zero value, reams of analytical data maintained by teams likely can pinpoint which players are outperforming their contracts and which players are underperforming. Indeed, Rev. Proc. 2019-18 will lead to more favorable results (by way of a timing benefit) than the prior §1031 regime in that team owners who qualify for the safe harbor will recognize no gains but may recognize losses on player trades. Those concerned that the new tax regime might raise taxes on billionaires or inhibit the type of player movement recently seen in the NBA and MLB should worry no longer.

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