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Like-Kind Exchanges

Sports Team Trades: An Unexpected Casualty of the New Tax Law

Sports teams may face higher upfront taxes on player trades as a result of the GOP's tax overhaul—an unexpected consequence of restrictions imposed by the new law.

Trades are a frequent occurrence in professional sports leagues. In the first three months of 2018, there have been several high-profile trades, including a three-team, three-person exchange in which the MLB's New York Yankees picked up infielder/outfielder Brandon Drury. Around the same time, the NFL's Kansas City Chiefs traded quarterback Alex Smith to the Washington Redskins for a third-round pick and cornerback Kendall Fuller.

In player-for-player trades, professional sports teams now have to recognize gain and pay tax on a traded player's contract. The better the player has performed since signing with the team—especially if that person signed at a relatively low salary—the higher the potential tax bill.

''By imposing U.S. federal income tax on player trades, the Act may have inadvertently impacted the professional sports landscape,'' attorneys at Seward & Kissel LLP said in a recent memo to clients.

The 2017 tax act restricts the use of like-kind exchanges under tax code Section 1031—which taxpayers can use to postpone paying tax on the gain of a sale if the proceeds are reinvested in similar property—to real property, such as land or buildings.

The Internal Revenue Service historically took the stance that two teams trading players were actually trading those players' contracts, which are like-kind property, the Seward & Kissel attorneys said. Previously, when teams exchanged contracts they could apply the like-kind exchange exception, and the trading teams didn't have to recognize gain or loss for federal tax purposes, excepting cash, the attorneys said.

To the extent that the new law makes player trades more expensive, it could lead to fewer trades overall, fewer player-for-player trades, more cash-for-player or player-for-draft pick deals, or spur the development of alternative trading procedures that accomplish a trade without triggering adverse tax consequences, the attorneys said in their memo.

These impacts may only be felt on the margins, because while tax is a factor, there are other, perhaps stronger, drivers for player trades, two of the memo's New York-based authors, Jon P. Brose, a partner in the law firm's Tax Group, and Brett Cotler, an associate in the Tax Group, told Bloomberg Tax.

Valuation—how to value player contracts and how to determine the amount of gain or loss to report to the IRS—is a bigger issue that teams are grappling with, said Carl D. Fortner, a partner at Foley & Lardner LLP in Milwaukee and member of the firm's Taxation Practice and the Sports Industry Team.

More Attention to Value In some situations where teams exchange player contracts, one side will supplement its offer with cash, knowing that the value it is bringing to the table is less than what the other team is offering. This suggests that teams already have a way to value their players' contracts even if they previously didn't have to report that to the IRS, Brose said.

The new tax law may prompt teams to play closer attention to the value they are ascribing to players and whether that value is accurate, Adam Handler, a principal in the Federal Tax Services group of the Washington National Tax Services practice at PricewaterhouseCoopers LLP, told Bloomberg Tax.

The elimination of like-kind exchanges for player trades raises several valuation questions teams may want to consider, Handler said. One is whether a contract—under which a player is being paid at a fair market rate—has value on the day it is entered into, he said.

''One way of looking at that contract is to say that you're paying them market value so that contract itself has no value,'' he said. However, it could be argued that the fact that the player is under contract at a set price over a certain time frame creates value, Handler said.

Fortner said if a just-signed contract has a value it's likely negative because contracts can extend far into the future, and the likelihood is that a player will be less productive—and therefore worth less—later in his playing career.

Assigning a negative or positive value to a player contract becomes easier as the contract runs its course, Handler said.

For example, if a team signs a player for $1 million per year over five years, and two years into the contract the fair market value of the player rises to $1.5 million, that contract now has a positive value and the team may have to recognize gain if it trades the player, he said.

Opening Door for IRS? The new tax law could lead to more litigation with the IRS if teams trading players value the contracts differently, Brose said.

''Do both sides have to agree on it so they both have consistent tax reporting?'' he said. ''That's not legally required, but if both sides agreed, it would certainly support the valuation.''

In a situation where there's a disagreement and one side is valuing a player's contract at $20 million while the other side is valuing it at $10 million, ''the IRS then has some room to come in and tell the other side, 'Hey you only valued this at $10 million. The other side valued it at $20 million. Pay us some more tax.' ''

Fortner said it could be advantageous for teams to consider consulting each other about the values they report to the IRS, to avoid this issue.

Trickle-Down Effect To the extent that the elimination of like-kind exchanges results in owners having to pay more tax, those costs could trickle down to the players or fans, through lower salaries or higher ticket prices, Handler said.

A higher cost of trading naturally means fewer trades, John Karaffa, president of ProSport CPA PLLC, told Bloomberg Tax in an email. Anything that constricts the tradability of players would eventually hurt them financially because fewer trades equates to less flexibility for owners and lower mobility of players, he said.

However, the cost of losing like-kind exchanges may be relatively small, especially when considered on a net basis, Fortner said. ''If you do have to recognize gain on a player contract, you get a tax basis in that player contract and you can amortize over the life of the contract.''

While there's a greater upfront cost, the team gets a deduction later, he said. The true cost to teams relates to the time value of money—the idea that money available at the present time is worth more than the same amount in the future due to its potential earning capacity—and whether that changes how they do business, he said.

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