Taxation of Player Contract Trades—The IRS Reaches the Correct Result

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The IRS should be congratulated on reaching the correct result in a difficult area of law.

In Rev. Proc. 2019-18 (the Revenue Procedure), the IRS addressed the tax consequences of "player trades" in the professional sports context. This guidance was necessitated by the uncertainty caused by the narrowing of Section 1031 to exchanges of real estate as part of the Tax Cuts and Jobs Act of 2017 (TCJA). The IRS concluded that trades of player contracts could be treated as nontaxable in certain situations.

This guidance could be viewed as favorable to the wealthy individuals who own professional sports franchises, but in fact the result reached by the IRS was likely best for all concerned. Treating such trades as taxable would have opened up the possibility of tax rate arbitrage and would have created major compliance, valuation, and auditing issues. Moreover, a close review of the underlying authorities indicates that there are several lines of reasoning under which such trades should not be viewed as taxable. Thus, the IRS should be congratulated on reaching the correct result in a difficult area of law.

Background

Although the press regularly reports on "player trades" in the professional sports arena, there is no such thing as a trade of individual players—people are not property which can be traded (blatantly unconstitutional). However, sports fran-

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chises can trade the underlying contracts between the teams and the underlying players, provided that there is a clause in such contracts which permits them to be transferred—which is the case for all major sports leagues, although some players will have "no trade" clauses inserted into their contracts. Furthermore, in some instances there will be trades involving draft picks or trades of player contracts for current or future draft picks.

For decades, these trades have not been treated as taxable pursuant to Section 1031, which previously provided that no gain or loss is recognized when property used in a trade or business (or held for investment) is traded for like-kind property used in a trade or business (or held for investment). Indeed, in Rev. Rul. 71-137, 1971-1 C.B. 104, the IRS addressed trades of the standard football player contract in use at the time of the ruling.[1] By virtue of the renewal clause found in such contracts, the IRS characterized the contract as an asset that had a useful life extending beyond the taxable year of acquisition. The cost of such a player contract to be capitalized and depreciated, according to the IRS, included only (a) amounts paid or incurred upon the purchase of a contract, and (b) signing bonuses. The IRS concluded that, as property used in the trade or business of a character subject to depreciation, such contracts were assets described in Section 1231(b). Accordingly, the IRS stated that recognized gains from the sale or exchange of such contracts would be treated as gains under Section 1231(a), subject to the recapture provisions of Section 1245. Furthermore, the IRS concluded that trades of player contracts would be considered exchanges of like-kind property within the purview of Section 1031(a), and as such, gain would be recognized only to the extent that "boot" as described in Section 1031(b) was received. The IRS issued similar revenue rulings regarding baseball player contracts in Rev. Rul. 67-379, 1967-2 CB 127, and Rev. Rul. 67-380, 1967-2 CB 291.

However, the TCJA substantially revised Section 1031, limiting its application to exchanges of real estate, meaning that it no longer applied to trades of player contracts. There was an immediate concern that such trades would be taxable events, and within a matter of months several consulting firms were formed to advise teams concerning the "value" of player contracts. Indeed, several firms immediately began to contact every team in every professional sports league, offering to perform regular valuations of every player contract entered into by the team—for a fee, of course.

In response, the various leagues contacted the IRS to seek guidance concerning the tax treatment of trades of player contracts. The teams were, of course, concerned about the valuation issue that arises when player contracts are traded. Although the press frequently refers to player trades as involving large dollars, those amounts are invariably the salaries (future compensation) owed to the players who were traded and do not relate to the economic value of the contracts, which is the excess of the value received from the player over the amount that must be paid to the player. There is no objective method to place a value on a player contract; simply referring to the compensation paid in the future to the player does not relate to the value of the contract, only the future amount of deductible compensatory payments. A single player's contributions are nearly impossible to break apart from the larger enterprise and quantify. The value becomes even more speculative when the trade involves a draft pick, which by definition is uncertain in its value; the drafted player might never sign a contract or play a single game. The valuation issues would be a nightmare for everyone concerned (although consultants certainly would be happy to "advise" on this topic).

The IRS looked at the issue and quickly understood the valuation issues. The IRS also realized that treating such trades as nontaxable could potentially benefit the fisc. Specifically, if a trade were taxable, the individual owners of the teams engaging in the trade would recognize gain which would be treated as capital gain under Section 1231, because the contracts are an amortizable asset used in a trade or business. As a result, the teams involved in the trade would have a basis in the contracts received in the trade, and this basis would be amortizable over the life of the contract. Assuming that the "received" contract was of average duration (2 or 3 years, often much less), this would create spectacular tax arbitrage for the team owner because there would be ordinary deductions over a short useful life for the contract (deductible today at a 37% rate) versus a capital gain taxable at 20% (and that could be offset by capital losses).

The Revenue Procedure

In Rev. Proc. 2019-18, the IRS recognized that professional sports teams generally engage the services of players and staff members, such as managers and coaches, through the use of employment contracts that provide agreed-upon compensation to the employed individual in return for future performance of specified services for a defined period of time, usually longer than one year (a personnel contract). During the term of a personnel contract, the value of that contract may fluctuate based on a variety of factors, including player performance, the changing needs of the team, the changing needs of other teams, a player's effect on fan attendance, and the number of years until a player becomes a free agent and is able to sign a contract to play for any team in a league. Other considerations affecting the value of a player contract include the size of the team's market (whether a smaller city or a major urban population), the cost of player development, and the impact of injuries and slumps on player performance.

Players may underperform or outperform the expectations of their teams, and the performance of other players on the team or future prospects, which may cause the team to develop a different

[1] The contract was for one year with an option to renew for 75% of the player's previous year's salary. However, by mutual agreement between the team and the player the salary would be invariably renegotiated based substantially upon the player's performance of the previous season. If such an agreement could not be reached, the player would be bound by the option and could not enter into a contract with another team unless he would be released by the team owning his contract.

view as to the value of the player and the contract. In addition to these unique factors, the market in which personnel contracts are traded is small and private. From time to time, teams trade one or more personnel contracts to other teams in exchange for one or more personnel contracts for the services of other personnel. Trades may include the transfer of a right to draft players in the league's player draft (a draft pick) or a cash payment. Some trades involve only draft picks.

In general, a team does not agree to a trade of one personnel contract (or set of personnel contracts) or a draft pick (or set of draft picks) unless the team believes that it is receiving something of equal or greater value to what it is giving up in light of the team's circumstances and priorities at the time. The exact value that a team places on the future performance of services by the personnel it is receiving in a trade is highly subjective and may be influenced by the team's specific needs at the time, rather than by whether the compensation provided for under the contract may be viewed as at market value, over market value, or under market value. In addition, for the reasons stated above, judgments as to whether the amount of compensation agreed to in the personnel contract is at, above, or below what a willing third party would pay at a particular point in time to the player or staff member for services to be performed in the future are highly subjective.

Indeed, these judgments may fluctuate often depending on the performance of a player or staff member and the circumstances under which each individual team in a league is operating. The subjective needs of each team will differ for particular players at different points in time throughout a league's season and is highly dependent on the particular needs of each team. Financial considerations, including league rules and regulations, and the market in which a personnel contract may be traded may impact the valuation of a personnel contract. As a result, although each team may believe it is receiving something of equal or greater value to what it is giving up in a trade of personnel contracts or draft picks, in light of its particular circumstances and priorities at the time, it is difficult to assign an objective monetary value to personnel contracts or draft picks.

In order to avoid highly subjective, complex, lengthy, and expensive disputes between professional sports teams and the IRS regarding the value of personnel contracts and draft picks for the purpose of determining the proper amount of gain or loss to be recognized for federal income tax purposes on the trade of one or more personnel contracts or draft picks, the IRS issued the Revenue Procedure to provide a safe harbor permitting teams to treat the value of traded personnel contracts and draft picks as zero if certain conditions are satisfied.

Section 3 of the Revenue Procedure provides that it applies to trades of personnel contracts and draft picks by professional sports teams that meet all of the following requirements:

> .01 All parties to trade must use safe harbor. The parties to the trade that are subject to federal income tax in the United States must treat the trade on their respective federal income tax returns consistent with the Revenue Procedure;
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> .02 Only personnel contracts, draft picks, and cash. Each team that is a party to the trade must transfer and receive a personnel contract or draft pick. In the trade, no team may transfer property other than a personnel contract, draft pick, or cash;
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> .03 No amortizable section 197 intangibles. In the trade, no personnel contract or draft pick may be an amortizable section 197 intangible; and
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> .04 Accounting treatment. The financial statements of teams that are parties to the trade must not reflect assets or liabilities resulting from the trade other than cash.

If the foregoing requirements are satisfied, Section 4 of the Revenue Procedure provides as follows:

> (1) No gain or loss on a trade. Except as provided in paragraph (5), below, for a professional sports team making a trade of a personnel contract or draft pick within the scope of this revenue procedure, because the contract value of each personnel contract or draft pick is treated as zero for purposes of this revenue procedure, no gain or loss is recognized on the trade for federal income tax purposes.
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> (2) Receipt of cash in a trade, computing amount realized. Under § 1001, a team receiving cash in a trade includes in amount realized the cash the team receives from another team in the trade. Under this revenue procedure, because the contract value of each personnel contract or draft pick is treated as zero for purposes of this revenue procedure, a team that does not receive cash in a trade has an amount realized of zero.
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> (3) Providing cash in a trade, computing basis. Under § 1012, a team providing cash to another team in a trade has a basis in the personnel contract or draft pick received equal to the cash the team provides in the trade. Under this revenue procedure, because the contract value of each personnel contract or draft pick is treated as zero for purposes of this revenue procedure, a team that provides no cash in the trade has a zero basis in the personnel contract or draft pick received in the trade.
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> (4) Providing cash in a trade for multiple personnel contracts or draft picks, allocating basis. A team providing cash to another team in a trade for two or more personnel contracts or draft picks must allocate its basis to each personnel contract or draft pick received from such team in the trade by dividing the basis by the number of personnel contracts or draft picks received from the team.
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> (5) Trades of personnel contracts or draft picks, determining gain or loss. Under § § 1001 and 1.167(a)-8, a team making a trade of a personnel contract or draft pick recognizes gain to the extent of the excess of the amount realized over the unrecovered basis (if any) of the personnel contract or draft pick traded, subject to the rules of § § 1231 and 1245. Under § § 1001, 165, and 1.167(a)-8, a team making a trade of a personnel contract or draft pick recognizes a loss to the extent of the excess of the unrecovered basis of the personnel contract or draft pick traded, over the amount realized, subject to the rules of § 1231. A team's unrecovered basis in a personnel contract or draft pick is the team's basis in such contract or draft pick as determined under § 167(c).

The IRS clarified in Section 4.03 of the Revenue Procedure that it applies only to trades of personnel contracts or draft picks among teams in professional sports leagues and has no application to transactions not described in the Revenue Procedure. In addition, the Revenue Procedure does not apply to trades of a team for another team or a sale of a team.

Teams making trades to which the Revenue Procedure applies must retain books and records to substantiate that all requirements of the Revenue Procedure have been met. Teams making trades to which the Revenue Procedure applies also must make available to the IRS, upon request, all documentation substantiating compliance with the Revenue Procedure. Under Section 4.04 of the Revenue Procedure, no inference is intended with respect to the federal income tax treatment of transactions similar to, but outside the scope of, those described in the Revenue Procedure.

The Revenue Procedure contains several examples which illustrate its application. In the first example, a trade with no cash, in 2018, Team A trades Player Contract 1 to Team B for Player Contract 2. The teams apply the safe harbor, so neither Team A nor Team B has an amount realized or gain on the trade because neither team received cash in the trade. Team A has a $0 basis in Player Contract 2, and Team B has a $0 basis in Player Contract 1.

In the second example, the facts are the same as in the first example, except Team A trades Player Contract 1 and $10x to Team B for Player Contract 2. Team A has no amount realized or gain on the trade because Team A did not receive cash in the trade. Team B has a $10x amount realized on the trade because Team B received $10x from Team A in the trade. Therefore, Team B must recognize $10x of gain, the excess of Team B's $10x amount realized over its $0 basis in the Player Contract 2 it traded. Team B's $10x gain is subject to the rules of Sections 1231 and 1245. Team A has a $10x basis in Player Contract 2, the amount of cash Team A provided to Team B in the trade. Team A's $10x basis is recovered through depreciation under Reg. 1.167(a)-3(a) over the life of Player Contract 2. Team B has a $0 basis in Player Contract 1 because Team B provided no cash to Team A in the trade.

The more difficult situation involves player contracts in which a team has amortizable basis. The third example in the Revenue Procedure addresses how the "safe harbor" works in this situation:

> (i) In 2019, Team C signs Player 3 to a contract (Player Contract 3) for 5 years. Under the terms of Player Contract 3, Team C pays Player 3 a $25x signing bonus in 2019. In each of 2019 and 2020, Team C takes a depreciation deduction under § 1.167(a)-3(a) of $5x for the $25x it paid to Player 3. In 2021, Team C trades Player Contract 3 to Team D for Player Contract 4, and the teams apply the safe harbor in this revenue procedure.
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> (ii) Neither Team C nor Team D has an amount realized or gain on the trade because neither team received cash in the trade. Because neither team provided cash in the trade, each team has a $0 basis in the contract it received in the trade. Team C may deduct in 2021 a $15x loss under § § 165 and 1.167(a)-8, the excess of its unrecovered basis in Player Contract 3 over its amount realized of $0. Team C's $15x loss is subject to the rules of § 1231.

What if there is cash involved in the trade? The fourth example in the Revenue Procedure addresses this situation in the context of the prior example, except Team D trades Player Contract 4 and $20x to Team C for Player Contract 3. Team C has a $20x amount realized on the trade because Team C received $20x from Team D in the trade. Team D has no amount realized or gain on the trade because Team D did not receive cash in the trade. Team C must recognize $5x of gain, the excess of Team C's $20x amount realized over its $15x basis in the Player Contract 3 it traded. Team C's $5x gain is subject to the rules of Sections 1231 and 1245. Team C has a $0 basis in Player Contract 4 because Team C provided no cash to Team D in the trade. Team D has a $20x basis in Player Contract 3, the amount of cash Team D provided to Team C in the trade. Team D's $20x basis is recovered through depreciation under Reg. 1.167(a)-3(a) over the life of Player Contract 3.

The final example in the Revenue Procedure illustrates how teams should allocate basis if multiple contracts are involved in a player trade. The tax basis resulting from the cash provided to the other team in the trade was allocated to the contracts equally to each contract without regard to the "value" of each such contract.

The Revenue Procedure has an effective date for trades of personnel contracts or draft picks entered into by professional sports teams after April 10, 2019, its date of issuance. However, a team may choose to apply the Revenue Procedure to any open taxable year, which means that team owners could apply it with respect to their personal tax returns for 2018.

Subsequent to the release of the Revenue Procedure, as a result of questions and comments received from the tax community, it was suggested that the IRS potentially may be re-evaluating certain limited aspects of the safe harbor restrictions concerning amortizable Section 197 intangibles and accounting treatment.[2] Initial comments indicated that there may be certain forthcoming clarification or easing of such restrictions, because the currently formulated safe harbor may be inadvertently excluding certain taxpayers from its application in situations where it should apply.

Recent comments by IRS counsel have clarified that merely putting a guaranteed contract on a team's books as a liability reflecting the present value of the obligation to pay the contract (rather than the value of the actual contract) should not trip up the accounting treatment prong of the safe harbor and prohibit its application.[3] "In terms of the financial statement limitation . . . what [the IRS was] talking about and what the [revenue procedure] requires not having is an asset booked for the contract itself, not for the underlying compensation agreement," according to a statement made by IRS counsel.[4]

Amortizable intangibles were excluded from the safe harbor to avoid a conflict between the Revenue Procedure and the Section 197(f)(1) loss disallowance rules which would arise if trades were made after a club is sold. Upon a

sale of a club, player contracts become Section 197 intangibles which are precluded from being written off in the manner illustrated in the third example of the Revenue Procedure (instead, any remaining basis must be allocated to the other retained amortizable intangibles). Later comments by IRS counsel have indicated that the IRS has no plans to issue further formal guidance on the Revenue Procedure.[5]

Analysis

The Revenue Procedure reached the correct conclusion because the valuation issues for player contracts—let alone draft picks—are virtually insoluble. The only people who would have benefitted if such trades were taxable would have been the consultants providing valuations, since the resulting tax benefits to the team owners from depreciation deductions would likely have outweighed the tax benefit to the government from treating the trade itself as a taxable event.

Moreover, there was a solid legal basis for treating such trades as nontaxable, even in the absence of the Revenue Procedure. Although the IRS had long treated such trades as nontaxable under Rev. Rul. 71-137, that was not the only legal authority supporting the argument that such trades should not be treated as taxable events.

First, there was a good argument that trades of player contracts should not be taxable under the "open transaction" doctrine. Under U.S. Supreme Court precedent in *Burnet v. Logan*, 283 U.S. 404 (1931) and *United States v. Davis*, 370 U.S. 65 (1962), the "open transaction" doctrine provides that, if both parties to an exchange receive consideration with no ascertainable fair market value, the transaction remains open for tax purposes. In *Burnet*, the Court held that an exchange of stock for payments contingent on the amount of ore subsequently extracted was an open transaction not taxed until payments were actually received. In *Davis*, the Court narrowed the application of the open transaction doctrine from those cases in which the value of property received in an exchange, if otherwise difficult to determine, can be inferred from the value of the property given up.[6]

Player contracts are like the promises in *Burnet*, which were similarly "wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty." This is even more applicable in the instant case, as the net cash flowing from a player contract is even more uncertain than the promises of future variable money payments in *Burnet*. Moreover, the future performance of a football player is not directly quantifiable in an amount of dollars, unlike the payment obligation in *Burnet*. In addition, professional player contracts are usually subject to termination by either the club or the player at any time. The executory nature of the contracts at issue, and the myriad of uncertainties involved, bring further doubt to the value of a player contract, and further support that a contract trade is a unique transaction that remains "open" for tax purposes.

The regulations under Section 1001 provide that the fair market value of property received in determining an amount realized is a question of fact. These regulations also contemplate the potential for "rare and extraordinary cases" in which certain property may "be considered to have no fair market value." Courts that have addressed similar language in prior iterations of such legal authority have tended to focus on restrictions and regulations imposed on the applicable property (and the lack of a secondary market) which limited the ability to reasonably ascertain a fair market value.

A professional player contract is arguably such a "rare and extraordinary case" in which it is nearly or essentially impossible to ascertain the fair market value of the consideration exchanged. Since player contracts are traded almost exclusively for other player contracts and/or future draft picks, player contract trades are not excluded from open transaction doctrine treatment under *Davis* because the value of the players and/or draft picks received cannot be inferred from the value of the players and/or draft picks given up. In light of the particular factual circumstances of contract trades, the valuation of a player contract or future draft pick would involve the "mere estimates, assumptions, and speculation" that the Supreme Court found in *Burnet* not to constitute realized gains or losses for tax purposes. Accordingly, open transaction treatment may be appropriately applied to player contract trades. In tandem, a taxpayer could take the position that a professional player contract is sufficiently speculative and subject to restrictions to be one of those rare and extraordinary cases recognized by Reg. 1001-1(a) in which the contracts and/or draft picks exchanged may be considered to have no fair market value for tax purposes in computing gain or loss realized.

Second, an argument could be made that a trade of player contracts is not a "disposition" if the teams' rights to engage in such trade is part of the contract. In *Centennial Savings Bank FSB*, 499 U.S. 573 (1991), which was the companion case to *Cottage Savings*, 499 U.S. 554 (1991), the U.S. Supreme Court held that when a debtor pays an amount that is already agreed to under a contract, there is no discharge of indebtedness income. Thus, *Centennial* stands for the principle that the exercise of a contractual right is not a taxable event.

Most player contracts in professional sports leagues contain a specific provision that allows for trades. For example, the standard contracts in one league provide that a "Club may assign this

NOTES

[3] See Tax Notes, Kristen A. Parillo: "IRS Might Tweak Sports Valuation Safe Harbor" (posted on 5/7/2019).

[3] See Tax Notes, Kristen A. Parillo: "Restrictions in Sports Trade Safe Harbor Clarified" (posted on 5/14/2019).

[4] See Tax Notes, Nathan J. Richman: "IRS Explains Sports Trade Safe Harbor Decisions" (posted on 5/13/2019).

[5] See Tax Notes, Kristen A. Parillo: "Restrictions in Sports Trade Safe Harbor Clarified" (posted on 5/14/2019).

[6] See also Warren Jones Co., 524 F.2d 788 (CA-9, 1975) in which the Ninth Circuit held that a real estate contract had an ascertainable fair market value where the contract could readily be sold to an institutional buyer for cash. This was not a "rare and extraordinary" situation in which it is impossible to ascertain the fair market value of the consideration. In McShain, 71 TC 998 (1979), the taxpayer sold an interest in a hotel for consideration that included a $3 million nonrecourse note secured by a second leasehold mortgage. The Tax Court held that the note had no ascertainable fair market value and the transaction remained open because of the "speculative nature of the underlying collateral" and the "absence of a market for the note."

contract and the Player's services under this contract to . . . any Club in the League. Player will report to the assignee Club promptly upon being informed of the assignment of his contract and will faithfully perform his services under the contract." Professional sports clubs often have the pre-existing standardized contractual right and ability to cross-assign to another club what is arguably merely contingent future obligations to pay compensation for services, if and when rendered by the player to the club. Thus, although not without potential factual distinction, there is an argument that in trading player contracts, the club is not making a taxable disposition, but rather exercising an option in the standard player contract which arguably does not give rise under *Centennial* to a taxable event.

A third potential line of reasoning is that trading player contacts is not an exchange for other property "differing materially either in kind or in extent" under Section 1001 because all leagues utilize standardized player contracts. Every contract arguably involves the same thing, which is performing services in exchange for cash payment, in each case subject to the same league rules. A player contract trade only changes the identity of a player's employer and not the legal rights of the player or the team.

In *Cottage Savings*, a savings and loan association exchanged its interest in a group of residential mortgages for other participation interests in groups of residential mortgages held by other savings and loan associations. The Supreme Court found that the interests exchanged embodied "legally distinct entitlements" because they were derived from loans made to different obligors and secured by different homes and, therefore, differed materially for tax recognition purposes.

Under *Cottage Savings*, each player arguably could be viewed as being unique for these purposes, like a different home. On the other hand, the holding in *Cottage Savings* turned on the fact there was a different obligor and distinct underlying collateral. Although the obligor to the player has changed [a different team], it could be argued that all teams within a league are essentially fungible because of collective bargaining agreements, so that the facts relating to player trades are different from the facts which resulted in a taxable event in *Cottage Savings*.

The foregoing highlights some of the reasons why a trade of player contracts should not be a taxable event. Fortunately, the IRS reached a similar conclusion (or at least a safe harbor providing for such result) based on the difficulty in valuing such contracts and draft picks—an approach which was clearly the correct answer.

The legal issues and analysis, and the promulgation of a safe harbor by the IRS, is similar to the situation of partnership profits interests. The courts had found that the profits interest received had speculative or no determinable value at the time of receipt. In Rev. Proc. 93-27, 1993-2 CB 343, the IRS addressed the receipt of a partnership profits interest by a person for the provision of services to or for the benefit of such partnership. The IRS set forth a safe harbor, subject to certain restrictions, in which the IRS would not treat the receipt of a profits interest as a taxable event for the partner or the partnership. Today, most profits interests in a partnership are routinely structured to fall within such safe harbor. It can be anticipated that going forward, most teams will likely fall within and apply the "safe harbor" set forth in the Revenue Procedure.

Will any teams elect out or structure trades outside of the safe harbor (such as, e.g., solely for cash), potentially to explore the "rate arbitrage" which will arise if they do so? It is premature to predict what will happen in the sports industry, but because of the uncertainty which will occur in that case, the various leagues may want to consider adopting rules which will require their members to agree to treat such trades as nontaxable to the extent permitted under the Revenue Procedure.