Why MLB Clubs Should Care About the New Like Kind Exchange Rules

Answers to Frequently Asked Questions

What has changed and why should MLB clubs be concerned?

On December 22, 2017, the Tax Cut and Jobs Act of 2017 ("Tax Act") was signed into law. The Tax Act became effective on January 1, 2018. One of the significant changes in the law was made to Section 1031 which provides for the nonrecognition of gain or loss from exchanges in kind. In the past, Section 1031 applied to all exchanges of like property including the trading of baseball players. The Tax Act narrowed the type of property eligible to only real property (i.e. real estate) held for productive use.

Any exchange, or trade, of baseball players after January 1, 2018 will result in a taxable gain or loss for both clubs trading players. Last year there were over 130 trades involving almost 400 players. Under the new tax law, a gain or loss will have to be calculated on each of the players traded.

What has the Commissioner's Office been doing to mitigate the impact of the tax changes?

The Commissioner's Office initially sought legislative relief on the basis that player trades were not included in the revenue calculations for the law and therefore their inclusion was unintended. Unable to persuade the legislators to prioritize a correction to the law, the Commissioner's Office approached the IRS seeking a safe harbor for player trades.

A **safe harbor** is a provision in a law or regulation that affords protection for taxpayers from liability or penalty under specific situations or if certain conditions are met. The proposed safe harbor is to value the traded players at zero. It is my understanding that the discussions between the Commissioner's office and the IRS are in the preliminary stages. The timing and approval of any safe harbor is uncertain.

What are the taxable consequences of a player trade?

The new tax rules treat the trade of a player as if the player were sold in a cash sale. The consideration in this theoretical sale is the fair market value of the player, or players, traded.

There are two consequences of this new tax treatment. The first consequence is that each club involved in the trade may have to pay capital gains tax on the sale of their property (i.e. the players traded). The taxable gain (or loss) is calculated by comparing the tax basis of each traded player to the same player's fair market value.

The second consequence is that the trade may require the recapture of any previously deducted amortized player costs (primarily signing bonuses) associated with the traded players. In this way the trade could result in both additional ordinary income and capital gain. Keep in mind that each dollar of recapture reduces the taxable gain by the same amount.

What is Fair Market Value?

Fair Market Value is the valuation standard used by the IRS. Revenue Ruling 59-60 contains the following definition for Fair Market Value:

> The amount at which the property would change hands between a willing buyer and a willing seller, when the former is under no compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

If a Club trades a player(s) for another player(s) even up, why should there be a gain?

Some people have asked why a trade of players between Clubs should generate any gain. After all, both Clubs thought the trade was fair when they made it.

The answer is that the gain is not based on the difference between the value of each side of the trade. The gain comes about because of the new like kind exchange rules. If a taxpayer trades $1.0 million worth of IBM stock for $1.0 million worth of Microsoft stock the trade is balanced, but under the new like kind exchange rules, the taxpayer will still have to recognize a gain, or loss, on the difference between the fair market value of the stock (i.e. $1.0 million) and the taxpayer's tax basis in the stock.

Are there any benefits from the change in the tax law?

While the Tax Act took away the ability to defer gains for many types of like kind exchanges, it does provide the taxpayer with the benefit of stepping up the tax basis in the acquired asset. This can be illustrated by the following example:

Club Red traded two minor league prospects to Club Blue for a veteran pitcher that will become a free agent at the end of the current season. For purposes of the example, assume that both sides of the trade are valued at $2 million. Club Red will have a taxable gain to the extent that the tax basis of the two minor league players is less than $2.0 million, but Club Red will also get tax basis of $2 million in the acquired player which they can amortize.

Are Clubs going to be able to use the new tax law to arbitrage tax rates?

Given that capital gains tax rates are lower than ordinary income tax rates, it is likely that Club owners will enjoy tax rate arbitrage. In the initial years under the new law, the annual capital gains tax may exceed the annual value of the player amortization but it should stabilize into a relatively steady reduction of the owners overall tax rate.

The amount of tax rate arbitrage benefit depends on a number of factors including the amortization period for the newly acquired players and whether there is any recapture tax on the traded players. The Club's level of trade activity and the aggregate value of the traded players will also impact the value of the tax rate arbitrage. Generally, the higher the value of the traded players the greater the amount of tax benefit available to the Club.

Given the opportunity for arbitrage, is there any risk to a Club claiming a zero value for each of their traded players ?

The new law requires that traded players be valued at their fair market value. Claiming that all of the traded players had zero value presents risk to both the taxpayer and their tax preparer. The taxpayer could face substantial valuation misstatement penalties (i.e. incorrectly claiming the value of property resulting in an understatement of tax). These penalties can result in a 20% to 40% increase in the related tax effectively eliminating the opportunity for arbitrage.

Tax preparers signing a tax return indicating a value of zero for traded players could face discipline under IRC Section 6694(b) if it is shown that there is an understatement and any part of the understatement was due to reckless or intentional disregard of the rules. Clubs should seek the counsel of their tax preparer in deciding how to proceed.

How is the stepped up tax basis of the traded player(s) amortized? What is the proper amortization period?

The proper amortization period for player contracts is an area that has been the subject of litigation and several IRS Revenue Rulings. In an IRS memorandum that was issued on September 27, 2013 [Release Number 20133901F], the Office of the Chief Counsel of the IRS indicated that per IRC Section 167(a), a player contract was eligible for amortization over the useful life of the player's contract. The memorandum went on to say that "the taxpayers right to receive…services over a fixed period is amortizable ratably over the period of the right."

The memorandum further states "the useful life for a baseball player's contract generally is the period over which the team controls the player's ability to sign a contract with another team."

Will these tax changes impact the allocation of purchase price when a franchise is sold?

According to IRS Publication 535, “A franchise engaged in professional sports and any intangible assets acquired in connection with acquiring the franchise (including player contracts) is a Section 197 intangible amortizable over a 15-year period.”

The new like kind exchange rules will impact acquired Clubs in an unexpected way. When player trades were considered like kind exchanges and the gain could be deferred indefinitely, Clubs often didn’t bother to individually appraise all of their 200+ major and minor league players. This was done because (1) their subsequent trade didn’t trigger a gain/loss and (2) the pool of intangibles being amortized wasn’t affected. Now that trades are considered sales, Clubs are going to need to know the original value for all of the players they trade so they can properly calculate gains and recapture on future trades. Another impact is that gains on players traded less than one year following the acquisition will be treated as ordinary income rather than capital gains.

How can a players contract have value?

Some people have questioned how a club's rights to a major league baseball player can have value given that their salaries represent a significant liability to the club. How can a free agent that was signed 18 months ago be an asset or have value?

A players contract rights can have value if the player's compensation is less than the compensation required to sign an equivalent substitute player in free agency. Under these conditions the player's contract is favorable in much the same way that a lease or a business contract can be favorable. Take the example of Mike Trout. In 2012 Mike Trout hit 30 home runs, had an OBP of .432, an OPS of .963, was awarded AL Rookie of the Year, came in second in balloting for AL MVP and had a WAR of 10.5. Mike Trout made only $482,500 in 2012, making his contract rights very valuable because an equivalent substitute would have cost tens of millions to sign.

How can a minor league player's contract have value?

The value of a minor league player lies in his future potential and the probability of him making it to the majors. When a club signs a first round pick to a contract with a $7 million signing bonus, they do so because they believe that player has future potential and they believe that the player's probability of making it to the majors offsets the cost of the bonus. Smaller bonuses are paid to players drafted in later rounds because they have a greater probability of failure, which is the inverse of the probability of making it to the majors.

The signing bonuses of International amateurs (predominately from the Dominican Republic, Venezuela, Cuba, etc.) also reflect their future potential.

Once a drafted minor league player begins playing in the minors their value can dramatically increase or decrease based on their performance, their growth as a player, and the perception of whether or not they will make it to the majors and the expectation of what kind player they will be in the majors.

Can a player's contract be a liability rather than an asset? Could the contract have negative value?

In general, assets cannot have negative value. For example, a truck or a patent can be worthless but they can't be worth less than zero. However certain types of intangible assets like leases and contracts can have negative value.

A player contract can be a liability if the player's contractual salary exceeds the cost of a substitute player of equivalent ability. If player A is being paid $12 million per season but plays like a $3 million per season player, his contract has negative value and represents a liability. When this same situation occurs in the NFL the player is asked to take a pay reduction or they are cut from the roster, but in MLB the contracts are guaranteed. The player is not a liability, but their contract is.

Many of the trades that involve cash consideration, or where the trading Club retains a portion of the traded players salary, are the result of a player's contract being a liability rather than asset.

If a player's contract is a liability rather than an asset would its sale result in a capital loss?

If the traded player's contract has negative value than its sale (i.e. trade) would result in a capital loss. A club would recognize a capital loss because they "sold" an asset with a tax basis greater than its fair market value. The liability would then be amortized over the life of the acquired player's contract. The amortization of the liability creates ordinary income.

To the extent that the Club trading the overpaid player agrees to pay a portion of the traded player's salary, the liability and thus the capital loss, can be reduced.

Will the trades always be balanced with equal value on each side of the trade?

Given that both parties to the trade are knowledgeable of the players, motivated by self-interest, and looking to improve their respective clubs, we would expect that most trades would be balanced. When we analyzed some test trades it initially appeared that trades made closer to the trade deadline were not balanced, but closer analyses suggests that the forces of scarcity and demand were causing the trade value of players to increase. This spike in value seems to be driven by clubs in division or wild card races that are determined to add key pieces to their rosters.

While the preponderance of trades will be balanced we expect to find outliers.

How does the inclusion of cash in the trade affect the taxable gain or loss?

The inclusion of cash in a trade affects the recognition of gain for the Club receiving the cash because it increases the value of the consideration they received for the player or players they traded. The team that contributed the cash to the trade has tax basis in the cash so it rolls into the tax basis of the acquired player.

Most trades involving cash are done to neutralize the above market contracts of traded players.

Could the valuations be performed by each Club's GM or other player personnel?

Certainly the GMs are knowledgeable of the players involved in the trades since they made the trade, but they lack independence since they are employees of the taxpayer. Because the GMs personally made the trade, they may also have bias with respect to the value of the players received or given up. GMs are not trained in valuation and lack experience dealing with the IRS on matters of valuation. In Selig vs. United States [52AFTR 2d 834], Chief Judge Reynolds declared that "appraisals made by persons who are not independent [of the Club] may be relied on only to confirm appraisals made by independent persons."

The fair market value of the traded players should be derived by an independent valuation professional using generally accepted valuation methods that are designed to withstand IRS scrutiny.