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Billionaire Blues

Planning Donald Sterling's Estate

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Harry Truman once made a distinction between a recession, which is when your neighbor loses his job, and a depression, which is when you lose your job. Life hurts the most when it affects you directly, in your own wallet; that's when it becomes real.

When a publicly disgraced billionaire loses his job, it is a surreal spectacle that virtually no one can relate to. It is instant karma, a morality play, and a media feeding frenzy in an explosion of news, sports, and reality entertainment. It's a happening.

I know I messed up badly,
but I am getting screwed,
And now I've got the billionaire blues.

Here, we take an academic look at the tax and legal implications of the forced sale of the Los Angeles Clippers and how the capital gains and estate planning consequences might be addressed by the man of the hour and focal point of this titanic cyclone, Donald Sterling.

Presented With Our Compliments

A Bad Ballclub

The Los Angeles Clippers were basement dwellers of the National Basketball Association for decades. They began as an expansion team in 1970, first in Buffalo, then San Diego, and then settling in Los Angeles in 1984.

The team was awful. It was the punch line of a joke. When purchased by attorney and real estate developer Donald Sterling in 1981 for $12.5 million, the team was averaging attendance of 4,500 per game and was en route to 13 seasons in-a-row of losing records.

Sterling, ever the maverick, moved the team to Los Angeles without permission from the league and was fined $25 million. He sued the league for $100 million. The league and Sterling settled by allowing the move and reducing the fine to $6 million. That tale (courtesy of *Wikipedia*) reveals so many of Sterling's attributes: He's been aggressive, bold, combative, and disrespectful, yet ultimately successful.

Flash-forward 33 years, and Sterling is the longest tenured owner in the NBA, now embroiled in another conflict with the league. A tape recording of Sterling making racist statements was deemed the final straw, and the other owners voted him out; i.e., the team must be sold. Sterling, true to form, is threatening to sue the NBA.

A Great Investment

With 7.18% annual growth, an investment will double every 10 years. Applied to the Clippers, the team would have reached $100 million in 2011. But basketball surged in popularity during the 1980s with the Magic Johnson/Larry Bird rivalry and in the 1990s with Michael Jordan, and it has continued to expand since.

As a result, NBA franchises are extremely valuable properties. In fact, *Forbes* valued the Los Angeles Clippers at $575 million in January 2014 and ranked it 13th in value of NBA franchises, with the New York Knicks in first position at $1.4 billion.

However, as soon as the NBA indicated it would force a sale of the Clippers, there was speculation that the team could sell for about $1 billion and trigger a capital gains tax of $350 million. In fact, a Los Angeles Group that included Grant Hill offered $1.2 billion, another group that included David Geffen and Oprah Winfrey offered $1.6 billion, and former Microsoft CEO Steve Ballmer's bid of $2 billion was accepted by Donald's estranged wife, Shelly Sterling.

For the Sterling Family Trust, this represents a wild investment success, an investment return of 16,000%. The final price is nearly quadruple the $550 million paid for the Milwaukee Bucks earlier in 2014. It is second only to the $2.1 billion paid for the Los Angeles Dodgers in all of American sports franchise history.

As for Steve Ballmer, paying 15 times annual revenues doesn't make financial sense. Observers simply concluded that the 34th wealthiest person on Earth wanted a trophy rather than a future profit. The *Los Angeles Times* quoted Lawrence Mishel, president of the Economic Policy Institute, saying, "This reflects an enormously wealthy person buying a toy."

Legal Fallout

Could Donald Sterling block the sale? According to published reports, the Clippers are now held in a family trust, which Shelly now controls because two qualified neurologists have concluded that Donald Sterling has Alzheimer's and is mentally incapacitated. Sterling could still challenge this diagnosis in the California Probate Court.

Sterling reportedly filed suit in Federal Court against the NBA for $1 billion. Could he win? Can the NBA force an owner to sell, based on a private, illegally recorded statement? Is it appropriate for the NBA to punish Sterling for statements made when he lacked mental capacity? Is the suit made moot by the settlement between the Sterling Family Trust and the league, which was reached prior to the formal termination vote taken by the NBA owners?

Tax Consequences & Options

Being forced to sell at a premium price may not be such a bad punishment, after all. The net proceeds after taxes are going to exceed what the team was thought to be worth in the first place.

For Sterling, with a net worth of about $1.9 billion according to *Forbes* (or $3.3 billion, as the Clippers are actually worth $2 billion), having a forced sale of his team result in $700 million of capital gains being realized, recognized, and paid would be bad, but not the end of wealth. Even if that were followed by a 50% division of wealth with Shelly, Donald Sterling would still walk away with an estate of more than $1 billion.

However, to the extent there are taxes, perhaps some strategy may be applied.

There has been public speculation about a sale of the Clippers for $1 billion resulting in capital gains tax of $350 million, so $700 million may be the tax hit on $2 billion. Some very loose assumptions may have led to those projections.

If Donald Sterling owned 100% of the team outright, and if his cost basis in the team were $0, and if the combined top rate of Federal and California capital gains taxes (20% plus 13.3%) were imposed—along with the Medicare surtax of 3.8%—without any offsets, then perhaps there could be a huge tax exceeding $700 million. However, any net proceeds from the sale that were included in Sterling's estate would then be subject to estate tax at his death.

If Sterling were able to hold the team until his death, he could obtain a stepped-up tax basis and avoid capital gains. But then he would pay a Federal estate tax of 40% or $800 million (still assuming he owned 100% of the team outright and that the team would be worth $2 billion).

However, it is reported that Donald Sterling owns 50% of the team and that the team is held in trust. If the trust is irrevocable and assets were transferred to it as taxable gifts, perhaps there is a higher cost basis than was obvious. As a side note, if the trust was irrevocable, (a) the league might not be able to punish it for Sterling's comments and force a sale; (b) it might have been transferred out of Sterling's estate already; and (c) if the Grantor remained in complete control of the assets, then he might have risked the assets being brought back into his estate.

If the trust is revocable and was set up for administrative purposes during life and ease of estate settlement in lieu of probate at death, the Sterlings might be facing a capital gains tax of about 33% (as discussed below).

Several scenarios might avoid or reduce the capital gains hit. If a sale could be delayed until Donald Sterling's death, i.e., with a transfer of operational interests and an option to buy at death, he could obtain a stepped-up basis (at least for the portion of shares that he owes).

Because the sale is being forced by the NBA, perhaps an argument could be made to apply Section 1033 of the IRS Code for forced sales or conversions. This might not fly, however, because the sale price exceeds the realistic value by about quadruple. Also, the sale appears to be partially voluntary because Shelly Sterling has approved it and settled with the NBA. If the 1033 approach were permitted, then Sterling would have two years to locate a comparable investment for the sale proceeds to effectuate a like-kind exchange. This would defer the recognition of capital gains.

Qualifying for a like-kind exchange under Section 1031 would appear to be the most applicable option, yet the partial ownership inside a trust may interfere with this choice. If Donald Sterling owned the Clippers outright, he could, within the required time (45 days from closing), identify a comparable asset (i.e., another sports franchise or possibly some other asset that meets the requirements) and then acquire that property within the required time (180 days from closing).

Although the 1031 exchange rules have a much shorter time frame than the 1033 exchange, the 1031 industry has now developed many solutions. Specifically, there are tenancies in common that have been established to enable a seller to temporarily park sales proceeds in an investment that qualifies for the like-kind exchange while a more permanent investment is located.

In the current setting, however, it is not clear if the 50% ownership interest of Donald Sterling could be transferred to a comparable asset and meet the 1031 requirements, unless it was done in concert with Shelly Sterling's 50% interest. Like-kind exchanges generally require the same ownership in place before and after the exchange of property. So, the Sterling Family Trust would typically have to exercise the like-kind exchange (the "swap") and then subsequently divide the assets up (the "drop"), if Donald and Shelly Sterling are to go their separate ways.

While gains may be deferred on the current sale, thanks to a 1031 exchange, the newly

Billionaire Blues

Alas, there's no more room for me in the NBA,
I might as well be poison; my welcome's overstayed.
My time is almost over, but I wanted one more day,
I know I had it coming, but this is how the game is played.

I told a doozy to that floozy,
and it made the front-page news,
And now I've got the billionaire blues.

I don't want to be a racist; what a bad scene.
I'd rather trade for Bynum! I'd rather lose my spleen!
The end is coming closer and I'd better find some scheme,
Or Microsoft and Oprah will end up with my team.

I know I messed up badly,
but I am getting screwed,
And now I've got the billionaire blues.

There is no "I" in "team," but it is I who pays the taxes,
I read it every day; my accountants send me faxes.
If Shelly flips the Clippers, they will tax us to the maxus;
They're adding up the gains and sharpening their axes!

In the next life, my ex-wife
Won't cause me to lose,
But now, I've got the billionaire blues.

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acquired assets will retain the lower cost basis of the original asset. So, if a new asset is acquired for $2 billion and then subsequently sold, the old basis of $12.5 million would still be applicable and large capital gains may still result in the future.

California Capital Gains

The stakes are especially high because of the applicable California taxes. There is, however, no straight answer about capital gains in California.

Suffice it to say, the tax is going to be high. There is nominally a tax of 13.3% on long-terms gains for California. When added to the Federal top rate of 20% and the 3.8% Medicare surtax, otherwise known as the Affordable Care Act excise tax, the three add up to 37.1% of tax. However, state income taxes are deductible for Federal tax purposes, so the effective tax rate is about 33%.

However, let's include the Pease, if you please. The American Taxpayer Relief Act of 2012 reinstated the Pease limitations on itemized deductions. When it comes to providing taxpayers with relief, Congress knows that nothing does the job like more Pease.

As a result, when you now add up the top capital gains rate of 20% and the excise tax of 3.8%, instead of 23.8% you get something closer to 25%. At least that's what the Tax Foundation estimates. And if you live in California and your combined 37.1% of taxes just got translated down to 33%, then the Pease factor may push it back up.

Any way you analyze it, the result puts California near the top of the list of high capital gains tax jurisdictions in the United States, as well as internationally. The following lists may not be reliable because it isn't clear which numbers have been adjusted for overlapping deductions or effective rates based on Pease limits, so reader beware.

Top Combined State and Federal Capital Gains Rates in the United States

California	**33.0%**
New York	**31.5%**
Oregon	**30.0%**
Minnesota	**30.9%**
New Jersey	**30.4 %**
Vermont	**30.4%**
Washington, D.C.	**30.4%**
Maryland	**30.3 %**
Maine	**29.8 %**
Idaho	**29.4 %**

Source: Forbes

States With Estate Taxes

New York State recently changed its estate tax exemption to re-couple it with the Federal estate tax exemption. On April 1, 2014, New York's estate tax exemption increased from $1 million to $2,062,500, and the exemption will rise each year until it matches the Federal estate tax exemption in 2019.

Note: New York did not enact a portability provision for spouses. Considering that New York is one of 19 jurisdictions with a state estate tax and had one of the lower estate tax exemptions of $1 million, this is a significant change that will greatly improve its attractiveness as a final state of residence for many people. While retaining any estate tax at all will continue to be a disincentive for wealthy individuals, those residents with estates of $5 million, for example, may now see remaining in New York as viable.

Maryland has recently enacted a similar approach that will cause its exemption to increase annually starting in 2015 until it matches the Federal exemption in 2019. Maryland's exemption will also follow the Federal portability rules for spouses.

Tennessee's estate tax is actually an inheritance tax. It will be phased out by 2016. Ohio and Indiana have eliminated their estate taxes and have dropped off the chart.

2014 State Death Tax Chart

STATE	EXEMPTION	TOP TAX RATE
Connecticut	$2,000,000	12%
Delaware	$5,340,000	16%
District of Columbia	$1,000,000	16%
Hawaii	$5,340,000	16%
Illinois	$4,000,000	16%
Iowa	$25,000	15%
Kentucky	$1,000	16%
Maine	$2,000,000	12%
Maryland*	$1,000,000	16% (10% inheritance)
Massachusetts	$1,000,000 ($0 inherit)	16%
Minnesota	$1,200,000	16%
Nebraska	$40,000	18%
New Jersey*	$675,000 ($25,000 inherit)	16% (16% inheritance)
New York	$1million/$2,062,500	16%
Oregon	$1,000,000	16%
Pennsylvania	$3,500	15% inheritance
Rhode Island	$921,655	16%
Tennessee	$2,000,000	9.5%
Vermont	$2,750,000	16%
Washington	$2,012,000	20%
* Maryland and New Jersey have Estate and Inheritance Tax		