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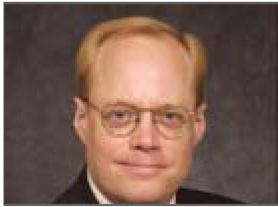

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Donald Sterling's Last Laugh: Tax-Free $2 Billion Clippers Sale

L.A. Clippers owner Donald Sterling seems to be sitting pretty. Sure, he endured bad press and probably would not have sold the team were it not for the NBA action. He may not even get to do his own negotiating, since the NBA stepped in. But a $2 billion sale to Microsoft's Steve Ballmer isn't half bad.

Still, taxes could eat a big piece of his outsize profit. With these high numbers and Sterling's advanced age, income and estate taxes look bleak, but are they? First, let's take income tax.

Mr. Sterling only paid $12.5 million for the Clippers in 1981. The Clippers are apparently a corporation, but is it a C or an S corporation? C corporations pay corporate taxes, S corporations don't. The legal owner is the Sterling Family Trust, though that trust could just be a living trust that avoids probate but is not taxable.

Since Mr. Sterling is probably well advised, the corporation is likely an S corporation. That means whether Mr. Ballmer buys stock or assets, there should be no corporate tax. If the corporation had to pay tax on the $2 billion sale, corporate taxes alone could be $700 million! Then Mr. Sterling would have to pay tax himself when the remaining $1.4 billion was distributed! The two taxes combined could be over 50%.

Donald Sterling

Assuming the S corporation structure, though, Mr. Sterling and his wife Rochelle would just pay taxes on the deal personally. With a federal long-term capital gain rate of 20%, that's approximately $397.5 million. It seems unlikely that Mr. Sterling will pay the Obamacare 3.8% net investment income tax. If the Sterlings spent over 500 hours per year on team-related management activities, it should mean the 3.8% tax wouldn't apply.

What about California taxes? Unless the Sterlings try to quickly move to Nevada, Texas, or another no-tax state, California will collect nicely. The Golden State's top rate rose from 10.3% to 13.3% in 2012. That makes the California income tax on the sale over $264 million. Notably, California doesn't give any break to long-term capital gain.

Some say that's the worst part of the state's tax law, making California capital gain taxed among the highest in any state—or country—in the world. See Killing Golden Goose, California Taxes Capital Gains As Ordinary Income. It is one reason California is constantly pursuing people who exit right before making a sale.

In all, federal and California income taxes total about $662 million, about a third of the $2 billion sale price. Estate taxes are another matter. It is likely that the Sterlings have an estate plan, and it may in part rely on the team structure. Such things can materially reduce an estate tax bill. But cash is harder, and the sale could be a big hit to the Sterlings' estate plan.

If the sale nets $2 billion, and the Sterlings pay $662 million in income tax, that leaves $1,338,000,000. Upon their deaths, Mr. and Mrs. Sterling will each be able to transfer only $5.34 million tax-free, leaving estate tax of over $500 million. Maybe. After all, it's likely that Mr. Sterling has good tax advisers, so don't look for this check to be written just yet.

First, recall that he is suing the league and claiming $1 billion in damages. That could be an offset. He might even try to report his gain on sale as capital gain, but deduct losses as ordinary! Yet latest reports say Mr. Sterling is dropping his suit, agreeing to the sale.

That could mean Mr. Sterling will try to roll over his gain into other investments. How is that possible? Section 1033 of the tax code allows you to defer taxes when your property is taken involuntarily, like eminent domain. Mr. Sterling can argue the Clippers sale was forced on him by the NBA.

What's more, Mr. Sterling wouldn't have to buy another team, as long as within 2 years, he invests the money in similar or related investments. Those standards are pretty loose, allowing him to diversify his investments.

Incredibly, Mr. Sterling might even do some estate planning at the same time. Assuming his basis in the Clippers is only the $12.5 million he paid, it would also be his basis in the replacement investments. Upon death, there's a step up in basis to market value. That could mean that by dying, his $662 million income tax bill just goes away!

Sure, he might face estate taxes, but the basis step up prevents paying income taxes and estate taxes at the same time. Mr. Sterling's age could give his cadre of advisers big reasons to try Section 1033 treatment. Other ideas might be a structured sale or installment sale deal that would stretch out payments over time. That can work well but may not be ideal for someone of advanced years.

In that sense, the Section 1033 involuntary conversion idea could be a bonanza. If successful, it could eliminate not only the federal income taxes, but California's painful taxes as well. That's right, California replicates Section 1033. Sure, the IRS or the California Franchise Tax Board could disagree. Sure, he or his estate might have to go to court. But Mr. Sterling might enjoy that and there's plenty at stake.

Bottom line? The NBA may be doing Mr. Sterling a big favor.

You can reach me at Wood@WoodLLP.com. *This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*