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AMORTIZATION AND VALUATION OF INTANGIBLES: THE TAX EFFECT UPON SPORTS FRANCHISES

I. INTRODUCTION

One need only consider the content of weekend television programming to realize that professional sports are enjoying unprecedented popularity. This increased popularity has brought about a dramatic increase in sports leagues and teams,¹ resulting in an increase in the ownership of sports franchises.² And while the purchase of a sports franchise may include certain tangibles,³ the bulk of the acquisition is the numerous intangible⁴ property rights⁵ which, for tax purposes, must be assigned values.⁶ The extent to which these intangibles can be valued and written off⁷ as a reduction of future income has a significant

1. See Comment, *The Professional Sports Team as a Tax Shelter - A Case Study: the Utah Stars*, 1974 UTAH L. REV. 556, 557 n.9 [hereinafter cited as *Utah Stars*], citing Libby, *A Look at Professional Sports*, Salt Lake Tribune, Sept. 1, 1974, at D-3, Col. 6. In 1959 there were only 42 professional sports teams in the five major leagues of baseball, basketball, football and hockey. In 1974 the same sports had 114 teams and eight leagues. *Id.*

2. Sports teams are actually franchise rights in which the owners or franchisees are granted exclusive authority to present sporting events in a given geographical area. See note 5 *infra*.

3. Many times the purchase of a franchise includes sports equipment which is usually a minor tangible asset.

4. The Treasury Department has not defined the term "intangible." It merely states or assumes that certain property is intangible. See, e.g., Treas. Reg. § 1.167(a)-3, T.D. 6500, 25 Fed. Reg. 11402. BLACK'S LAW DICTIONARY 946 (Rev. 4th ed. 1968) defines intangible property as "property . . . [which] has no intrinsic and marketable value, but is merely the representative or evidence of value, such as . . . franchises."

5. Such rights include: (1) the exclusive right to exhibit a particular sport within a given area, (2) the right to participate in the college draft and the waiver system, (3) the benefit of league administrative services including preparation of game schedules, organization of college drafts, resolution of disputes among member clubs and others, (4) the benefit of league rules and regulations restricting business competition among the member clubs, (5) television rights, and (6) player contracts. See *Laird v. United States*, 391 F. Supp. 656, 660-61 (N.D. Ga. 1975), *aff'd*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978).

6. When a franchise is transferred, both the purchaser and the seller must allocate the consideration paid or received among the various assets transferred. See *Williams v. McGowan*, 152 F.2d 570, 572 (2d Cir. 1945).

7. I.R.C. § 167(a) provides:

(a) General Rule.

There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or
(2) of property held for the production of income.

impact on the tax aspects of a given franchise. By definition, however, the nature of an intangible is such that it has "no intrinsic and marketable value, but is merely the representative or evidence of value."⁸

In the past, because of the lack of intrinsic value and favorable tax laws, franchise ownership was considered a healthy tax shelter.⁹ Recently, however, franchise owners have been subject to attack by both Congress and the Internal Revenue Service (IRS). Specifically, the Tax Reform Act of 1976¹⁰ eliminates many favorable tax laws for franchise owners. In addition, the Fifth Circuit's decision in *Laird v. United States*¹¹ suggests that the IRS may be able to restrict the valuation and amortization of these intangible property rights in the future.

This comment will analyze selected tax aspects of professional sports franchise ownership. It will begin by examining the tax considerations in the ownership of such enterprises, and progress through the recent changes which affect ownership, with specific emphasis on the *Laird* decision.

II. THE ORGANIZATIONAL STRUCTURE OF PROFESSIONAL SPORTS

The structure of professional sports resembles a typical corporate structure. The "league" or "conference" is the governing entity¹² and is headed by a commissioner and bound by a constitution, bylaws, and specific rules.¹³ The teams in each league are actually franchise contracts which the league has issued to specific purchasers. Such franchises grant the purchasers exclusive authority to present specific

Amortization is the commonly accepted way of referring to depreciation of intangible property. Amortization of intangible property as well as depreciation of tangible property is deductible under § 167. See Klinger, *Professional Sports Teams: Tax Factors in Buying, Owning and Selling Them*, 39 J. TAX 276 (1973) [hereinafter cited as Klinger].

8. BLACK'S LAW DICTIONARY 946 (Rev. 4th ed. 1968).

9. An arrangement is typically considered a "tax shelter" when it generates tax deductions at a more rapid rate than actual cash expenditures. In the sports franchise area, it occurs most often when the franchise is purchased with a larger percentage of long-term notes, the bulk of the purchase price is allocated to player contracts, and the player contracts are amortized over a short useful life.

10. Pub. L. No. 94-455, § 212, 90 Stat. 1520 (1976).

11. 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978).

12. Zaritsky, *Taxation of Professional Sports Teams After 1976: A Whole New Ballgame*, 18 WM. & MARY L. REV. 679, 680 n.6 [hereinafter cited as *Zaritsky*], citing STAFF OF THE HOUSE SELECT COMM. ON PROFESSIONAL SPORTS, 94TH CONG., 2D SESS., PROFESSIONAL SPORTS AND THE LAW 8 (Comm. Print 1976). "The location of all major decision-making authority in the league, rather than in the teams, has been attributed to the 'unique economics of professional sports.'" *Id.* League decisions include "geographic division of the market area, rules of practice limiting competition and the selling of the industry, and distribution of admissions revenues, broadcasting revenues, and franchise rights." *Id.*

13. *Id.* at 681.

sporting events in a given geographical area.¹⁴ The purchase price of the franchise includes many rights,¹⁵ in addition to the monopoly over a given geographical area; however, only the rights to player contracts are not considered part of the basic granted franchise.¹⁶ A franchise may be acquired either directly from the league or from another franchisee and the owner may organize his franchise under any type of business arrangement.¹⁷

The tax benefits or consequences that inure to the owner of the franchise depend primarily upon the allocations of purchase and sales price among the different franchise assets.

III. TAX ASPECTS BEFORE 1976

The entire tax future of a team can depend upon the allocation of the franchise purchase cost among the various assets acquired. Certain types of assets may be amortized and used to reduce current income, while other assets allow no cost recovery whatsoever.

In order for an intangible asset to be amortizable, it must have a limited useful life which can be estimated with reasonable accuracy.¹⁸ Due to the great cost of sports franchises today,¹⁹ different allocations of cost can effect significant dollar amounts of tax deductions.

The basic franchise rights are treated as capital assets²⁰ which are not amortizable because they do not have limited useful lives which can be estimated with reasonable accuracy.²¹ Therefore, all of the cost allocated to the basic franchise is tied up until the franchise is sold, and

14. 391 F. Supp. at 660.

15. See note 5 *supra*.

16. In other words, the acquisition of a team franchise consists of two distinct types of rights: (1) basic franchise rights which are non-amortizable, and (2) rights such as player contracts which are amortizable.

17. Since nearly 40% of the pro sports franchises show losses, it seems the most prudent tax advantages would be gained by organizing the franchise as a sole proprietorship, partnership, or Subchapter S corporation. In these situations, the teams net operating losses are available to the owners to offset their personal or other business income. See, e.g., *Upheaval in Pro Sports*, U.S. NEWS AND WORLD REPORT, August 12, 1974 at 51 [hereinafter cited as *Upheaval in Pro Sports*].

18. "If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance." Treas. Reg. § 1.167(a)-3, T.D. 6500, 25 Fed. Reg. 11402.

19. See, e.g., *A Quarterback for Tax Shelters*, BUSINESS WEEK, January 12, 1974 at 63. In 1974 National Football League franchises cost up to \$20 million.

20. Rev. Rul. 123, 1971 - 1 C.B. 227.

21. See note 18 *supra*. A franchise in professional sport is granted for an indefinite period of time.

there is no deduction to reduce current tax liabilities.²² Thus, the general practice is for the purchaser to avoid, as much as possible, the allocation of cost to the franchise itself.²³

The owner's better tax strategy is to allocate as much cost as possible to player contracts.²⁴ Such contracts have a limited useful life which can be reasonably estimated and, therefore, their cost can be recovered in the form of a tax deduction.

The position of the IRS with regard to player contracts has changed considerably over the years. Originally, it was held that player contracts had a maximum useful life of one year; thus, they could be expensed²⁵ (deducted in full during that year) rather than capitalized.²⁶ The IRS then changed its position and held that such contracts had a useful life beyond one year and would have to be capitalized and amortized.²⁷

22. If no tax deductions are allowed to reduce income, there is no recovery of the initial cost of the franchise and, hence, no reduction of basis. The initial cost of the franchise cannot be recovered until the franchise is sold and the adjusted basis (cost) is taken into account when computing gain or loss. *See* I.R.C. § 1001(a).

23. A general rule of tax planning is to defer the payment of taxes for as long as is legally possible. The theory behind the rule is that the taxpayer is eventually going to have to pay a set amount of tax anyway; hence, if he can hold on to this otherwise committed cash (to earn other income) he will be better off in the short-run and the long-run. An exception to this general rule would be when the owner expects a great appreciation in franchise market value over a short period of time. In this case, the savings by application of long-term capital gain rates may exceed the benefits of tax deferral.

As will be seen below, this was not a concern prior to passage of the Tax Reform Act of 1976.

24. The terms "salaries" and "player contracts" have completely different meanings. Salaries refer to amounts to be expensed in the current year for a player's performance. Player contracts are expenditures which have to be made simply to acquire the contract to pay the player his salary. The cost of acquiring player contracts can only be taken over the limited useful life of the contract.

"The cost of a player contract . . . includes (a) amounts paid or incurred upon the purchase of a player contract [previously negotiated with another team] and (b) bonuses paid to players for signing player contracts, but does not include working agreement development costs." Rev. Rul. 67-379, 1967-2 C.B. 127, 129.

25. Expenditures made to produce income are to be deducted in the period benefited. An "expense" is an expenditure which only benefits the current period. When an expenditure benefits more than one period, it is capitalized and a portion of it is deducted in each period benefited (amortization).

26. Rev. Rul. 441, 1954-2 C.B. 101.

27. Rev. Rul. 379, 1967-2 C.B. 127. The IRS ruled that because of league rules and the reserve clause, baseball contracts (though only for one year terms) had the effect of binding a player to one team for his entire career and therefore had a useful life beyond one year. *See also* Rev. Rul. 137, 1971-1 C.B. 104, using similar rationale for football contracts. It is assumed that these rulings also apply to other professional sports.

Player contracts are the most valuable assets of the team.²⁸ Some owners have been successful in allocating up to ninety-eight percent²⁹ of the franchise purchase price to player contracts, but it is estimated that the average allocation is between seventy-five and eighty percent.³⁰ The result is that after a few years the owner has recovered approximately three-fourths of the initial investment by way of tax deductions.

As a result of this commonly followed practice, most teams show a large book loss in their first years of operation. Even the most profitable team has difficulty offsetting the large amortization deduction. It is very possible that a successful team will have a positive cash flow, but still show a book loss. This is the best of both worlds for the owner because more cash comes in than goes out, and the franchise has a net operating loss which can be applied to other income which would otherwise generate taxes. In other words, the owner can generate income in his other business endeavors equal to the team's net loss without paying any tax.

What if the owner decides to sell the franchise? In such a case, that portion of the sales price attributable to previously depreciated player contracts falls under section 1245 of the Internal Revenue Code and is treated as ordinary gain.³¹ However, any portion of the sales price attributable to a gain in the basic franchise right is taxed at capital gains rates which are equivalent to fifty percent of the owner's marginal tax rate.³²

These general tax principles indicate that the concerns of the buyer are adverse to the concerns of the seller. The buyer would like to allocate as much of the purchase price as possible to player contracts in order to have an asset which can be written off. Conversely, the seller wants to allocate as much of the sales price as possible to the actual franchise rights. This eliminates recapture of previous amortization as

28. See S. REP. NO. 938, 94th Cong. 2d Sess. 88, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3439, 3524.

29. In basketball franchise transfers, allocations to player contracts of over eighty percent are not uncommon. See Comment, *The Effect of the 1976 Tax Reform Act on the Ownership of Professional Sports Franchises*, 1 COM/ENT. 227, 235. Detailed figures from other sports are not as readily available, but it has been reported that baseball contract allocations have exceeded ninety-eight percent. See *Hearings on H.R. 10612, Before the Senate Committee on Finance*, 94th Cong., 2d Sess. 637 n.22 (1976).

30. See *Hearings on H.R. 10612, Before the Senate Committee on Finance*, 94th Cong. 2d Sess. 637 n.22 (1976).

31. Section 1245 designates which portion of the gain on the sale of depreciable property is to be treated as ordinary income. The remaining gain, if any, is treated as capital gain. See I.R.C. § 1245(a)(1).

32. I.R.C. §§ 1201, 1202.

ordinary income and any gain is treated as capital gain taxed at a preferred rate.

Before the 1976 Tax Reform Act, the allocation of cost to player contracts was subject only to the limitation of reasonableness.³³ Team owners, as taxpayers, were free to allocate independent values,³⁴ and their only burden on being questioned by the IRS was to show the allocation's reasonableness. However, the IRS rarely questioned the independent allocations.³⁵ This ability of both parties to make independent allocations was criticized as a "whipsaw" of the government.³⁶

This tax situation clearly demonstrates how franchise owners were given tax advantages not available to other taxpayers. Franchise owners had the ability to recover most of their capital outlay in a few years without having to tie their money up until the sale of the franchise. Also, the seller of a franchise had the ability to convert otherwise ordinary gain into capital gain.

The fact that makes these benefits all the more advantageous is that player contracts have a "zero replacement cost."³⁷ Unlike most businesses where depreciable assets wear out and must be replaced if the business is to continue to operate, professional sports teams obtain the rights to new player contracts each year through the league draft.³⁸ The result is that an owner can deduct the original cost of player contracts, and never have to make a capital expenditure for the new player contracts which replace the original contracts.

The first few years of ownership provide the greatest benefits to the owner if he has outside income with which to offset his paper losses. After the player contracts are fully amortized, the tax shelter loses its vitality until the franchise is sold. Owners with large outside income are the ones who most benefit from the tax shelter, so it is arguable that since the team is not relied upon as a source of income, the owner devotes less time to its operation.

33. I.R.C. § 167(a) states, "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)"

34. Both buyer and seller could allocate a different value on their own books to the same asset.

35. See Okner, *Taxation and Sports Enterprises*, GOVERNMENT AND THE SPORTS BUSINESS 159, 166 (R. Noll ed. 1974). Between the years 1967 and 1971 the IRS audited only one professional basketball franchise.

36. See, *Final Report of the Special Committee on Whipsaw, Section of Taxation, American Bar Association*, 30 TAX. LAW. 127 (1976). See also Zaritsky, *supra* note 12 at 689 n.48.

37. See *Utah Stars*, *supra* note 1, at 561.

38. See note 5 *supra*.

A. The Mass Asset Theory

Where a bundle of contracts or other types of intangibles have been purchased in the acquisition of a going business, the IRS has, at times, argued that the bundle constitutes one "mass asset" (with an indeterminate life or inseparable value) which is not depreciable.³⁹ The Service has had limited success⁴⁰ with this theory and, until 1975,⁴¹ had never attempted to argue it in the area of sports franchises. The theory's rationale is that the value of a "mass asset" does not lie in its individual components, but the real value is in the whole. The individual assets are considered to be in the nature of goodwill⁴² which has an indefinite useful life and cannot be amortized.

The Fifth Circuit clarified many of the separate holdings of other courts regarding the "mass asset" theory in *Houston Chronicle Publishing Co. v. United States*.⁴³ The Houston Chronicle had acquired a competitor newspaper for the price of \$4,500,000, but the sales contract did not specifically allocate cost among the assets acquired. One such asset was the subscription lists of the competitor. The Houston Chronicle assigned a value and a useful life to the list and proceeded to write it off over five years. At trial, the jury found that the subscription lists had a reasonably ascertainable useful life of five years and assigned them a value. The government appealed on the ground that the subscription lists were nonamortizable as a matter of law.⁴⁴

39. See *Klinger*, *supra* note 7, at 277; Jones, *Amortization and Nonamortization of Intangibles in the Sports World*, 53 TAXES 777, 779-80 (1975).

40. Only a few courts have accepted the theory. See, e.g., *Boe v. Commissioner*, 307 F.2d 339 (9th Cir. 1962); *Golden State Towel & Linen Serv., Ltd. v. United States*, 373 F.2d 938 (Ct. Cl. 1967); *Westinghouse Broadcasting Co.*, 36 T.C. 912 (1961), *aff'd on other grounds*, 309 F.2d 279 (3d Cir.), *cert. denied*, 372 U.S. 935 (1962).

41. *Laird v. United States*, 391 F. Supp. 656 (N.D. Ga. 1975), *aff'd*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978). The case will be analyzed in detail below.

42. "[T]he nature of good will . . . [is the expectancy] that 'the old customers will resort to the old place'." *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963). "[T]he essence of good will is the expectancy of continued patronage, for whatever reason." *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). As a matter of law, good will is non-amortizable. Treas. Reg. § 1.167(a)-3 states in pertinent part: "No deduction for depreciation is allowable with respect to good will." There is actually little, if any, difference between the government's contention that certain assets are indivisible (one mass asset) or actually part of the goodwill of a business. The Ninth Circuit has held:

The rationale and purpose of the "indivisible asset" rule is to prevent taxpayers from increasing the value of depreciable property to offset the amount paid in excess of book value of assets purchased. This doctrine makes it possible to strike down depreciation deductions for amounts which should properly be allocated to good will.

Commissioner v. Seaboard Fin. Co., 367 F.2d 646, 652 (9th Cir. 1966).

43. 481 F.2d 1240 (5th Cir.), *cert. denied*, 414 U.S. 1129 (1973).

44. See, e.g., Treas. Reg. § 1.167(a)-3 (1960); note 45, *infra*.

The court held that subscription lists were not as a matter of law inseparable from goodwill. It characterized the "mass asset" cases as involving evidentiary failures⁴⁵ on the part of the taxpayer, at least to the extent that the "mass asset" is separable from goodwill. In order to take an amortization deduction, the taxpayer had the "dual burden of proving that the intangible asset: (1) [had] an ascertainable value separate and distinct from goodwill, and (2) [had] a limited useful life, the duration of which [could] be ascertained with reasonable accuracy."⁴⁶

The Court of Claims expressed its general agreement with the above approach in *Richard S. Miller & Sons v. United States*,⁴⁷ and is likely to rely on it in the future. The court's decision clearly indicates that if the IRS contests a cost allocation to player contracts, the issue will be a question of fact and therefore no general rule will apply. As a result, teamowners will likely be able to avoid falling victim to IRS challenges by supporting any sale or transfer of a franchise with sufficient data to substantiate the allocations made.

B. Theory Behind Tax Incentives

There is no escaping the fact that Congress singled out professional sports for tax breaks before 1976. This was most clearly evidenced by a specific exemption which allowed franchises engaged in "professional football, basketball, baseball, or other professional sport" not to recognize ordinary income on certain sales or exchanges.⁴⁸

Apparently, Congress believed the tax incentives were beneficial to society and the economy.⁴⁹ There are also facts which indicate that Congress thought of the sports industry not so much as a business, but

45. Our view—that amortizability for tax purposes must turn on factual bases—is more in accord with the realities of modern business technology The burden to prove that an asset qualifies for tax amortizability is cast upon the taxpayer, and this taxpayer has manfully carried that heavy load as weighed by the jury.

481 F.2d at 1253-4.

46. *Id.* at 1250.

47. 537 F.2d 446 (Ct. Cl. 1976) (plaintiffs entitled to a depreciation deduction because they established that the indivisible assets represented by lists of insurance expirations were, as a factual matter, separate from the other elements of goodwill which concurrently were acquired as part of a going concern).

48. Similar to other types of capital assets, the gain from the sale or exchange of a franchise was treated as long term capital gain if the franchise was held for a minimum period. I.R.C. § 1222(3). Thereafter, Congress enacted a new provision which provided that if a franchisee retained significant powers, rights, or continuing interests in the transferred franchise, the gain from the sale or exchange would be ordinary income. I.R.C. § 1253(a). However, I.R.C. section 1253(e) provides the following exception: "This section shall not apply to the transfer of a franchise to engage in professional football, baseball, or other professional sport."

49. See *Utah Stars*, *supra* note 1, at 568 n.85. Senator Sam Ervin gave the following

as a sport.⁵⁰ Since large amounts of time and money are required to make a team even marginally profitable, it was believed that few taxpayers were likely to invest in a new sports franchise without some type of financial assistance or tax relief.

Apparently, Congress changed its attitude toward the sports industry as economic pressures appeared to reach the point of crisis. Teams and leagues were multiplying. Team ownerships were changing hands at an increased rate. Football players were striking. Franchise prices and player salaries were skyrocketing even though nearly half the professional franchises showed losses.⁵¹ On the whole, there was public discontent with the sports industry, and it seemed as though the tax laws may have been the key to this economic quandry.

IV. THE TAX REFORM ACT OF 1976

The first significant change in the tax treatment of sports franchises came with the passage of the Tax Reform Act of 1976.⁵² Although this legislation had an indirect effect on franchise ownership,⁵³ its major effects were caused by its provisions dealing directly with sports franchises. The new provisions concern the problems of recapture of

explanation of the purposes of the capital gains and depreciation provisions of the Internal Revenue Code, as they apply to professional sports:

I agree with the capital gains thing because I think it is one of the great things that make our free enterprise system work, because men are not inclined to make investments, short of adventuresome investments, and otherwise they would take and invest their things in stocks already on the market and make no new industries. I defend both aspects of the tax policy [capital gains and depreciation] as incentives to make our free enterprise system work.

Hearings on S. 2373 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 92d Cong., 2d Sess., pt. 2 at 864 (1971).

50. See Zaritsky, *supra* note 12, at 679 n.1. When Dr. Lawrence Woodworth, then the Chief of Staff of the Joint Committee on Taxation, was asked why sports franchises were given special treatment, he responded:

I think that when this treatment was provided in 1969, the exception was made for sports enterprises, primarily because of uncertainty as to what its effect would be on the sports industry. If I recall correctly, it was the desire or feeling which I think was generally prevalent then in the Congress, that the sports industry should probably get a little special treatment relative to other industries, in part because it was thought of as not so much as business but a sport. Whether that treatment should continue or not is a question.

Inquiry Into Professional Sports: Hearings Before the House Select Committee on Professional Sports, 94th Cong., 2d Sess., pt. 2, at 341-42 (1976).

51. See *Upheaval in Pro Sports*, *supra* note 17, at 51.

52. Actually, the *Laird* case was heard in District Court in 1975, but its impact was not fully realized until the Fifth Circuit ruled on the appeal in 1977. See note 11 *supra*.

53. For example, I.R.C. § 1222(3) was amended to extend the holding period for long term capital gains from six months to nine months in 1977 and to one year after 1977.

depreciation (amortization) on player contracts, unreasonable allocations of acquisition costs to player contracts, and "whipsaw" effects.

A. Section 1245 Recapture

I.R.C. section 1245(a)(4) is a special recapture rule which applies only to player contracts of sports enterprises. Its ultimate effect is to convert what would otherwise be capital gains into ordinary income.

Under the former law, ordinary income was recognized to the extent of post-1972 amortization. The new provision treats as ordinary income an amount equal to the greater of recaptured amortization on the player contracts actually transferred, or amortization on the contracts initially acquired with the franchise (even though no longer held by the owner).⁵⁴ Therefore, if a player is cut or retires, the owner must still take into account that player's contract on the sale of the franchise because it was a contract initially acquired with the franchise.⁵⁵

The effect of this provision extends to all teams—even to those where there is no later sale of player contracts. This result occurs because every owner will be required to maintain records of amortization and loss deductions taken on every contract ever held by the franchise.

B. Section 1056

There are three new provisions of section 1056 which directly affect sports franchises. Subsection (a)⁵⁶ provides that when a franchise is

54. Generally, the amount of recapture increases as the recomputed basis increases. Therefore, because the new law increases the recomputed basis in certain situations, recapture as ordinary income is more likely. See I.R.C. § 1245(a)(4)(A), which provides:

For purposes of this section, if a franchise to conduct any sports enterprise is sold or exchanged, and if, in connection with such sale or exchange, there is a transfer of any player contracts, the recomputed basis of such player contracts in the hands of the transferor shall be the adjusted basis of such contracts increased by the greater of—

- (i) the previously unrecaptured depreciation with respect to player contracts acquired by the transferor at the time of acquisition of such franchise, or
- (ii) the previously unrecaptured depreciation with respect to the player contracts involved in such transfer.

55. Under the prior law, owners were able to write off the value of such contracts as a loss and reduce the total basis of the franchise.

56. I.R.C. § 1056(a) provides:

If a franchise to conduct any sports enterprise is sold or exchanged, and if, in connection with such sale or exchange, there is a transfer of a contract for the services of an athlete, the basis of such contract in the hands of the transferee shall not exceed the sum of—

- (1) the adjusted basis of such contract in the hands of the transferor immediately before the transfer, plus

sold or exchanged, the allocation of cost to the transferee's player contracts cannot exceed the adjusted basis of the contracts in the hands of the transferor immediately before the sale, plus any gain recognized by the transferor on the sale or exchange of the franchise. Thus, independent allocation (whipsaw) of the sales price is no longer allowed. The franchise purchaser takes a carryover basis from the seller.

Subsection (c)⁵⁷ requires the transferor of a franchise to file a statement noting the basis claimed in the player contract and any gain recognized by the transferor with both the IRS and the transferee. Subsequent modification of the basis or gain must also be filed. This section further prevents any "whipsaw" of the government because the statement is binding upon both the transferor and the transferee.

Subsection (d)⁵⁸ has been strongly opposed by team owners, team attorneys and league officials.⁵⁹ It provides a rebuttable presumption that not more than fifty percent of the team's acquisition cost is to be allocated to player contracts. In other words, it is presumed that not more than fifty percent of the total consideration paid by the owner is properly allocable to player contracts unless it is established to the satisfaction of the IRS that a larger allocation is proper. However, allocation of less than fifty percent to player contracts will not automatically

(2) the gain (if any) recognized by the transferor on the transfer of such contract. For purposes of this section, gain realized by the transferor on the transfer of such contract, but not recognized by reason of section 337(a), shall be treated as recognized to the extent recognized by the transferor's shareholders.

57. I.R.C. § 1056(c) provides:

Under regulations prescribed by the Secretary, the transfer shall, at the times and in the manner provided in such regulations, furnish to the Secretary and to the transferee the following information:

(1) the amount which the transferor believes to be the adjusted basis referred to in paragraph (1) of subsection (a),

(2) the amount which the transferor believes to be the gain referred to in paragraph (2) of subsection (a), and

(3) any subsequent modification of either such amount.

To the extent provided in such regulations, the amounts furnished pursuant to the preceding sentence shall be binding on the transferor and on the transferee.

58. I.R.C. § 1056(d) provides:

In the case of any sale or exchange described in subsection (a), it shall be presumed that not more than 50 percent of the consideration is allocable to contracts for the services of athletes unless it is established to the satisfaction of the Secretary that a specified amount in excess of 50 percent is properly allocable to such contracts. Nothing in the preceding sentence shall give rise to a presumption that an allocation of less than 50 percent of the consideration to contracts for the services of athletes is a proper allocation.

59. They argue that I.R.C. § 1056(d) is too broad that it does not account for the differences in sports and that the IRS is perfectly capable of handling contract valuation problems on a case-by-case basis. See Comment, *The Effect of the 1976 Tax Reform Act on the Ownership of Professional Sports Franchises*, 1 COM/ENT. 227, 244 n.71 (1977), citing *Hearings on H.R. 10612 Before the Senate Committee on Finance*, 94th Cong. 2d Sess. 637 (1976).

be permitted. The IRS can still apply the test of "reasonableness" in determining the proper allocation.⁶⁰ In light of the allocations previously permitted franchise owners, section 1056 reflects a major shift in policy.

V. THE IRS CHANGE IN POSITION.

The 1976 Tax Reform Act clearly resolved many of the tax problems involved with the ownership of sports franchises. However, the new law did not clarify the question of how player contracts and franchise rights are to be valued for tax purposes.⁶¹ The fifty percent presumption⁶² provides one possible limitation on the value to be allocated to player contracts, but in no way solves the real problem of valuation. As previously stated, the IRS has rarely contested an owner's allocation of cost to player contracts;⁶³ therefore, until recently, there were very few guidelines in this area. However, in *Laird v. United States*⁶⁴ the IRS clearly indicated that owner valuations may be contested even if below the fifty percent presumption.⁶⁵

A. *The Facts of Laird*

In 1966, plaintiff and other investors entered into an agreement with the National Football League to purchase a football franchise in Atlanta, Georgia (the Atlanta Falcons). The investors formed Five Smiths, Inc. as a Subchapter S corporation⁶⁶ and agreed to pay a total consideration of \$8.5 million to the NFL over five years. The corporate owner allocated \$50,000 to the cost of the franchise assets, \$727,086 to deferred interest, and \$7,722,914 to the cost of the forty-two player contracts acquired. The shareholders then took an amortization deduction on the contracts computed on a cost basis of the latter figure. The IRS disputed the allocation, contending that only \$1,050,000 should have been allocated to player contracts, and that the remaining balance, \$6,722,914 was actually the cost of franchise rights.⁶⁷

60. See I.R.C. § 167(a).

61. See notes 29-30 *supra* and accompanying text.

62. I.R.C. § 1056(d).

63. See notes 35-36 *supra* and accompanying text.

64. 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978).

65. Originally, the IRS contested the owners ninety percent allocation to player contracts. The district court settled on a valuation of 34% and the IRS appealed.

66. See I.R.C. §§ 1371-79. Subchapter S corporations are taxed similarly to partnerships.

67. These rights included: (1) the exclusive right to provide professional football in the Atlanta area; (2) the right to participate equally in any single network television contract executed by the league; (3) the right to receive additional income from radio broadcasts, gate receipts, NFL Properties, Inc., and NFL Films, Inc., and program advertising and sales; (4)

The main issue in the *Laird* case was whether the claimed amount reflected with reasonable accuracy the acquisition costs of the contracts, or whether that sum was arbitrarily selected for tax purposes. At trial the Government abandoned its earlier allocation of \$1,050,000 and utilized the "mass asset" theory as its main argument.⁶⁸ It contended that the player contracts were part of a bundle of inextricably related assets acquired with the franchise. None of these assets were capable of independent valuation or separate identity and, therefore, could not be amortized.⁶⁹

An alternative issue was whether Five Smiths' right to participate in network television contracts was an amortizable intangible asset. The IRS argued it was nonamortizable because it had an indeterminable useful life.

The district court held that the player contracts did have an independent value, which invalidated the "mass asset" theory, but found the allocation of costs by the taxpayer to be incorrect. The court's approach to valuation of the different rights took a unique twist. First, the court found a value of \$4,277,043 for the team's right to participate in the revenues from league television contracts.⁷⁰ This value was arrived at by discounting the projected minimum gross receipts the team could expect over the initial four year term of the contract. The court then arrived at its valuation for player contracts by comparing the remaining unallocated value to the amount suggested by the parties.⁷¹

the right to obtain players through the college draft, waiver system and free agents; (5) the right to share in benefits of NFL membership and (6) the possible tax shelter aspect of acquiring a franchise. Weill, *Depreciation of Player Contracts—The Government is Ahead at the Half*, 53 TAXES 581, 584-88 (1975).

The IRS disallowed the corporation's depreciation deduction to the extent of \$1,271,031. This resulted in taxable income to Five Smiths, and plaintiff Laird was denied his proportionate share of the corporation's claimed losses. This resulted in an underpayment by plaintiff of \$48,219 which is the amount sought in this refund suit, the tax deficiency already having been paid.

68. See notes 39-47 *supra* and accompanying text.

69. 556 F.2d at 1231. This was the first time the IRS made this argument in the context of sports taxation.

70. 391 F.Supp. at 664-65.

71. The computation is illustrated in the following chart (based on a similar chart at 556 F.2d 1230):

Finally, the court accepted a valuation for player contracts after the taxpayer filed a supplemental brief asserting a minimum valuation for the player contracts.⁷²

So, while the court did not hold that the useful life and value of the player contracts were inseverable from other franchise rights, it did hold that the television rights were so inextricably linked with the franchise that they had no ascertainable useful life and were not amortizable. Both the taxpayer and the Government appealed the decision to the Fifth Circuit.

The Fifth Circuit affirmed the district court on all issues of valuation and amortizability, but it disagreed with the subtraction method utilized by the lower court in reaching the valuation of the player contracts.⁷³ However, the facts were such that the Fifth Circuit found that the lower court's approach to valuation was not so erroneous as to be reversible.⁷⁴

TOTAL CONSIDERATION PAID		\$8,500,000
BY FIVE SMITHS		
MINUS:	Items not in dispute—	
	(a) Membership Fee	\$ 50,000
	(b) Interest	<u>727,086</u>
		<u>777,086</u>
EQUALS:	Total Amount in Dispute	\$7,722,914
MINUS:	Minimum Present Value of Television Rights	<u>\$4,277,043</u>
EQUALS:	Remainder of Purchase Price Available for Allocation to Remaining Assets Acquired	\$3,445,871
MINUS:	Amount Allocated to Player Contracts	<u>\$3,035,000</u>
EQUALS:	Remainder to be Allocated To the Franchise	<u>\$ 410,871</u>

72. 391 F. Supp. at 666.

73. 556 F.2d at 1226.

74. *Id.* at 1237.

B. Analysis of Laird Decision.

The *Laird* decision is worthy of detailed analysis because the issue of valuation of franchise assets remains the area with the fewest guidelines and the greatest possibility for an unpredictable attack by the IRS. An owner may follow all the guidelines of the 1976 Tax Reform Act, to the letter and the IRS can still contest the valuation process.

Laird contains two unique problems which must be recognized before the case can be fully understood. First, the court had to determine proper valuation methods for intangible assets, assets with no physical presence. Second, the court was presented with a situation where the possible valuations of the assets acquired might exceed the actual cost paid by the purchasers. The court's solution to the first problem was to use different valuation methods for different assets; its solution to the second was to only accept valuations which would total \$8.5 million (the purchase price) or less, no matter how reasonable the other valuations may actually have been.⁷⁵

1. The "Mass Asset" Contention

The court reiterated that a dual burden of proof was on the taxpayer⁷⁶ and stated that under such a test "the mass asset theory does not prevent a deduction in the present case for the players' contracts."⁷⁷ The plaintiff's evidence supported a separate valuation for player contracts and the limited useful life of such contracts was not contested.

It did not matter that the player contracts had economic usefulness only in the context of a professional football team franchise. In order to defeat the applicability of the mass asset rule, the important point to be proven by the taxpayer was that the contracts "represented independent and uniquely valuable assets to the taxpayer."⁷⁸

This opinion seems to lay to rest the "mass asset" theory as it relates to sports franchises because "[player] contracts represent independent and uniquely valuable assets to the taxpayer, ensuring through their non-competition clauses that the individuals under contract will not use their skills with any competing organization."⁷⁹

It does not matter for purposes of amortization if individual assets only have economic significance in the context of an integrated transac-

75. See notes 88-93 *infra* and accompanying text.

76. See note 49 *supra* and accompanying text.

77. 556 F.2d at 1233.

78. *Id.* (quoting *KFOX, Inc. v. United States*, 510 F.2d 1365, 1378 (Ct. Cl. 1975)).

79. *Id.* at 1233-34.

tion involving the sale of a number of assets.⁸⁰

2. The Valuation of Television Rights

Even though the television contract in question was only for a four-year period, the evidence showed⁸¹ that Five Smiths would be able to participate in television contracts as long as its team remained a member of the NFL. Under these facts, there could be no useful life to the television rights, because the right to receive such proceeds did not expire with the contract.

The court approved of the valuation of the television rights. By discounting the future gross cash receipts of the four-year contract the court arrived at a figure of \$4,277,043.⁸² This aspect of the decision is significant because the court used a different valuation method than it did for player contracts.⁸³ The combination of different types of valuation methods presents the risk of some assets being counted twice. For example, a complete earning power approach, which was not pursued by the court, would require estimating the future earnings of a business—that is, future revenues less future expenses (including, for example, amortization of the cost of player contracts)—and then deciding how much the contract was worth to prospective purchasers.⁸⁴ Since

80. In September 1978, the Tax Court decided *First N.W. Indus. of America, Inc. v. Commissioner*, [1978] 9 Fed. Tax Rep. (CCH) 35, 385, the only case confronting these issues since the *Laird* decision.

In *First Northwest*, the Seattle Supersonics basketball franchise was acquired by the taxpayer for \$1,750,000. The taxpayer allocated \$1,600,000 (91%) to the right to participate in the expansion and college drafts, and the remaining costs to franchise assets.

In a deficiency notice, the Commissioner asserted that only \$450,000 was allocable to depreciable assets. By amended answer and at trial, the IRS contended that the taxpayer acquired a "mass of indivisible intangible assets" for a lump sum price of \$1,750,000, and no part was properly allocable to amortizable rights.

In accordance with the *Laird* decision, the Tax Court held that the mass asset theory was inappropriate because "a significant portion of the rights . . . could in fact be separately identified as to life and value and were not inextricably intertwined with goodwill." *Id.* at 35, 386.

81. 556 F.2d at 1235. Both the letter of understanding and the formal agreement contained wording to the effect that Five Smiths would receive a pro rata share of the proceeds of any television contract made as long as it retained its franchise.

82. The minimum amount Five Smiths could reasonably expect to receive over the four-year contract was discounted at a prime rate of five percent. 391 F. Supp. at 664.

83. See Blum, *Valuing Intangibles: What are the Choices for Valuing Professional Sports Teams?* 45 J. TAX. 286, 287 (1976). The court used an "asset valuation" approach for player contracts. This approach considers the fair market value of each of the assets of a business, valued individually. The valuations usually proceed either by reference to sales of comparable assets, if such are available, or by reference to replacement cost of the asset.

84. *Id.* There seems to be no question that the television revenues should be reduced by the expenses incurred to create them. For the franchise to continue as a member of the NFL

such expenses were not taken into account by the court, the present value of the four-year television contract was overvalued.⁸⁵ If the court had taken the expenses into account, there is a good possibility that there would have been no problem with asset values exceeding the purchase price.

The court also stated that, "[d]etermining a valuation for the four-year CBS contract is unnecessary to our decision, since we hold that Five Smiths' television rights at issue have an unlimited useful life, and thus cannot be amortized."⁸⁶ But according to later court reasoning, the valuation was necessary because the value of the player contracts was dependent upon the previous valuation assigned to the television rights.⁸⁷

3. Valuation of the Player Contracts

The taxpayer presented the expert testimony of two general managers from other NFL teams as to the value of the player contracts.⁸⁸ This testimony was to a large extent left uncontroverted.⁸⁹ Yet the district court disregarded this testimony for a compromise valuation later submitted by the taxpayer.⁹⁰ Each expert gave testimony that the player contracts were worth approximately \$7,000,000. The district court rejected the experts' valuations for two reasons.⁹¹ First, the valuation figures greatly exceeded the \$3,445,871,⁹² which the district court

it had to play football. Therefore, the team had to incur all of the expenses of playing football before it could be entitled to receive the television proceeds. This includes the cost of player contracts which, if taken into account, would reduce the amount of television revenue and the present value of the four-year contract significantly.

85. The courts valuation of the television rights is subject to further criticism. Since the television rights had an indefinite useful life, why was only the initial four-year term of the contract taken into account? Would the court have utilized the same valuation method if the network contract were for only one year? This would significantly reduce its value further.

The author feels that the more reasonable approach would be to discount projected future net income by the average holding period of an NFL franchise.

86. 556 F.2d at 1236.

87. See note 70 *supra*.

88. Texas E. Schramm, President and General Manager of the Dallas Cowboys, testified that the player contracts had a fair market value of \$7,300,000. James Finks, General Manager of the Chicago Bears and former General Manager of the Minnesota Vikings, arrived at a valuation of \$6,825,000. 556 F.2d at 1238. These valuations were based on personal knowledge of the players and an assumption that veterans were generally more valuable than college rookies because they had already proven they could make a professional club.

Id.

89. *Id.*

90. *Id.* at 1238-39 n.23.

91. *Id.* at 1238.

92. See note 70 *supra*.

had determined was available for allocation to player contracts. Second, the district court disapproved of a valuation based on the comparison between rookie college players and proven veterans.

Ultimately, the lower court relied on a compromise approach even though "both of said experts [were] men of unquestioned integrity and they must have been sincere in making their estimates of valuation."⁹³

Since the valuation of assets is a factual finding, the trial judge is given reasonable flexibility in discounting the testimony of experts. But, in this case, both reasons given by the trial judge for discounting the expert testimony were disapproved by the Fifth Circuit.⁹⁴ Since the expert testimony was uncontested, since the trial court believed the experts were sincere, and since the trial court discounted expert testimony for incorrect reasons, it is most likely that the expert valuations were reasonable and should have been accepted.

If the court had reduced the receipts for television rights by the expenses applicable to those rights and accepted the expert valuation of player contracts at \$7 million, it is most likely that the entire valuation would have been below the \$8.5 million consideration paid.

4. The Subtraction Approach

The Fifth Circuit properly rejected the subtraction approach followed by the district court. Under such an approach, if the value of the assets received exceeds the amount paid, the ultimate allocation of value depends upon which assets are valued first. By the time the final assets are valued, the earlier assets have already used up a disproportionate amount of the value available to be allocated and the final assets are forced to take the remaining value (even if worth more than that value).

Although the subtraction method was rejected by the Fifth Circuit, it did not require a pro rata allocation, either.⁹⁵ It merely recognized one subjective player contract valuation as being more compelling and per-

93. 391 F.Supp. at 666.

94. In regard to the subtraction method used by the lower court, the Fifth Circuit said, "we do not agree with the district court's subtraction, or residual, method of allocation . . ." 556 F.2d at 1237, and "we have, of course, rejected the subtraction approach taken below and for reasons we have expressed." *Id.* at 1242. Regarding the method of valuation used by the experts and rejected by the lower court, the Fifth Circuit stated that "the various comparisons between veteran and rookie players provided a reasonably reliable measure of the value of the expansion draftees." *Id.* at 1239.

95. Treas. Reg. § 1.167(a)-5 (1978) provides:

In the case of the acquisition . . . of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the

suasive than another. As such, it found the lower court's valuation was not so erroneous as to be reversible.

By accepting the lower court's valuation of player contracts at \$3 million the court never had to face the problem of pro rata allocation. However, the court indicated that if it were accepted that the value of the assets acquired exceeded the consideration paid, the pro rata valuation would have been correct.⁹⁶

The *Laird* approach to valuation exemplifies the many problems of valuation of intangible assets in the area of professional sports. There were so many variables to consider before arriving at a reasonable valuation, that the court ultimately decided the case by drawing a compromise between the two major contentions.⁹⁷ In an area such as this, general rules cannot be implemented without sufficient flexibility due to the fact that most valuations will have to be made on a case-by-case basis.⁹⁸

The only general rule in this area is the fifty percent rebuttable presumption of section 1056(d).⁹⁹ The reasonableness of this section in effecting tax reform will depend upon how difficult it will be for a purchaser to establish "to the satisfaction of the Secretary" that an allocation to player contracts in excess of fifty percent of the purchase price is proper. If the IRS is adamant in adhering to the fifty percent rule for every franchise purchase, without regard to the factual determinations

value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. . . .

Apparently the Fifth Circuit did not utilize this allocation method because it believed that the total value of the asset did not exceed the purchase price. 556 F.2d at 1242.

96. *Id.*

97. The taxpayer's main contention was that the player contracts were worth \$7,000,000 and the government argued they were worth nothing. The district court eventually came up with a value of \$3,000,000 which is approximately halfway between the two contentions. The court stated:

The fact that the valuation method adopted by the district court arrived at what was, in essence, a compromise figure—roughly midway between the positions of the parties—in no way diminishes the validity of that valuation. The district court was called upon to measure the worth of men, not machinery, a task of no small proportions. In a situation like the one at bar, arriving at a compromise figure was an acceptable valuation solution.

Id. at 1241.

98. See note 80 *supra*. In *First Northwest Industries of America v. Commissioner*, *supra* note 80, the court's valuation of player contracts had a similar compromise result. The taxpayer allocated \$1,600,000 to amortizable player contracts and the IRS claimed that none of the assets acquired were amortizable. The Tax Court held that \$750,000 (nearly midway between the two figures) was attributable to amortizable rights.

99. See notes 59-61 *supra* and accompanying text. Because the purchase by Five Smiths took place before December 31, 1975, the 1976 Tax Reform Act did not apply to the *Laird* case.

of taxpayers, the presumption will constitute an arbitrary and unduly harsh attack on sports franchise ownership, with the possible effect of curtailing future investment.¹⁰⁰

VI. CONCLUSION

The tax aspects of sports franchise ownership have undergone considerable change over the last few years. The new treatment given sports franchises reflects a change in attitude, to the effect that tax incentives are not needed to spur investment in professional sports. More stringent tax rules do not seem to have adversely affected the industry. If anything, they have tended to weed out owners whose only concern is with tax advantages. The effect has been to create a more stable market. Owners are now more concerned with successful team operations than with tax write-offs. This increases the quality of professional sports and benefits public enjoyment and entertainment. We no longer have the upheaval in professional sports we had a few years ago and the change in the tax laws may be one reason why.

The area of intangible valuation contains many unanswered questions. There is certain to be further litigation on this issue until Congress enacts more definitive guidelines, or until the courts implement some type of common valuation techniques. However, the more probable result is that valuation will occur on a case by case basis because of the wide range of factual situations which may have a significant impact on asset valuation.

Joseph Mona

100. Comment, *The Effect of the 1976 Tax Reform Act on the Ownership of Professional Sports Franchises*, 1 COM/ENT. 227, 250 (1977).