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By Paul L. B. McKenney and Eric M. Nemeth

The following material served as the basis for a two-part presentation by the authors before the American Bar Association Taxation Section in Los Angeles in 2000 and in Scottsdale in 2001, as well as for a presentation to the IRS Sports Franchise Industry-wide meeting. The full text of the presentation can be found on the Bar Journal*'s website at www.michbar.org/journal.*

This article focuses on the tax issues of greatest concern in the purchase and sale of a sports team. These include the following:

- Player Contracts (a nine-figure item)
- Leases (also including signage, concessions, and parking)
- Local Television/Cable/Radio
- Covenants Not To Compete
- National Television Revenues
- Season Ticket Holders
- Sponsorship Agreements
- Merchandising Rights
- Sky Box Leases

The tax issues for the above components include, among other things, valuation, eligibility for amortization, and tax accounting. The key fact of major league business life is that the club is a sophisticated 24/7/365 marketing machine. Different products are offered to various economic strata. For example, corporate America and high income individuals buy sponsorship packages, season tickets, and sky boxes; the blue collar fans purchase any available single game seats; civil groups buy blocks of "nose bleed" seats (if available); and teenagers buy team apparel.

Given the rising values of American professional franchises, as well as league expansions and more sale transactions, the Internal Revenue Service has taken interest in this growing industry. The service has established a sports franchise office in Plantation, Florida. Unlike years past where a local revenue agent was "star struck" because the taxpayer was the local team, and the agent had no experience in this complicated tax arena, the examination is now quarter-backed by exceedingly competent IRS personnel in Florida who are also knowledgeable about the business and tax issues. In short, the government has greatly enhanced its audit game. In November, a "Sports Franchises" Market Segment Specialization Program (the Sports MSSP) was issued by the Internal Revenue Service.

BASIC TAX BATTLEGROUNDS

The government tends to allocate purchase price first to the franchise and broadcast contracts, which are arguably not amortizable, second, to amortizable items such as the lease, season ticket holders, skybox leases, and third, to player contracts. "Aren't those professional athletes grossly overpaid anyway? How can player contracts

nd Sale

Tax issues and rules

Sports Team

have any value?'' seems to be one school of thought, though of those who have never read a collective bargaining agreement with a player's association. A sports franchise is specifically excluded from ''section 197 intangible'' status. See IRC 197(e)(6).

Club owners are keenly aware, not only that player contracts are amortizable under IRC 1056, but also that each such contract is amortizable over its remaining term rather than the IRC 197(a) 15-year period. Club owners will next allocate what is left after player contracts to the lease, ticket holders, skybox leases, etc., and view the non-amortizable franchise as of little value. There is also a dispute whether television contracts are eligible for amortization.

IRC 1060's residual method of allocation will apply to an asset acquisition. Allocation of the purchase/sale amounts to component assets is obviously of concern for cost basis/amortization purposes and the seller will be concerned about recapture. The IRS is generally not bound by allocation of costs if the allocation does not reflect relative fair market value of asset components or economic reality.

Generally, the parties are bound by the allocation within the agreement. There are, however, exceptions to this principle. The strong proof doctrine provides some cover. The more stringent *Danielson* rule provides that a taxpayer is bound by the contractual allocation unless it can demonstrate that the contract terms are unenforceable because of fraud, duress, or undue influence. This is an

Fast Facts:

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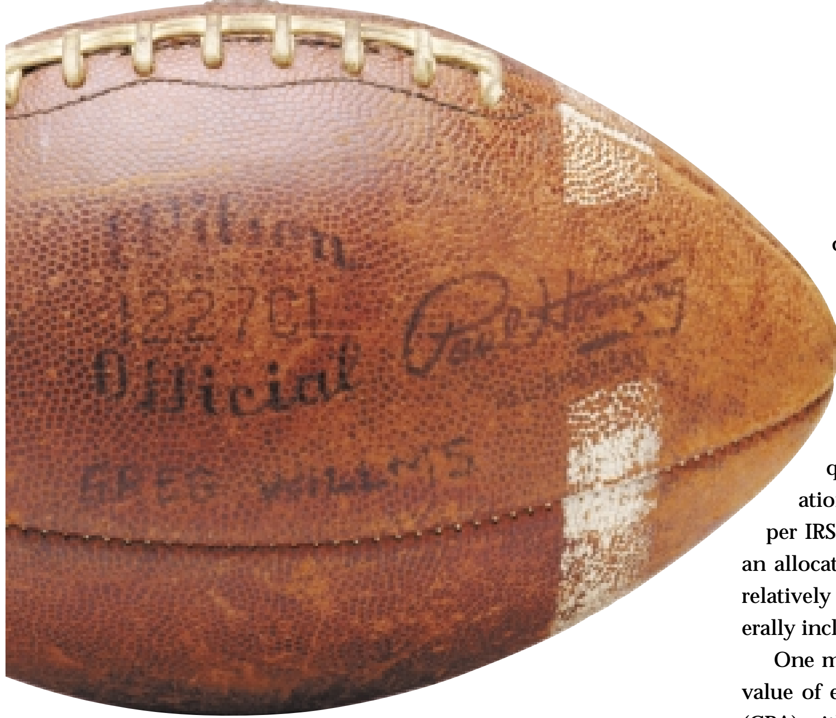
The tax issues of greatest concern in the purchase and sale of a sports team are player contracts, leases, local media broadcasting, covenants not to compete, national television revenues, season ticket holders, sponsorship agreements, merchandising rights, and sky box leases.



extraordinarily heavy burden to meet. Depending on the appropriate circuit, the tax court may apply the ***Danielson*** rule or the strong proof doctrine. This distinction can be critical when the transaction includes purchasers, sellers, and franchisers all in different judicial circuits. In any event, attention to detail in the allocation will be the order of the day.

PLAYER CONTRACTS

Before the 1976 adoption of current IRC 1056, player contracts were allocated among the purchased assets according to fair market value. The purchaser amortized player contracts under IRC 167 prior to adoption of IRC 1056. IRC 167 caselaw had allowed what the government perceived as very generous allocations to player contracts.

IRC 1056 provides the general rule that in connection with a sale or exchange of "a franchise to conduct any sports enterprise" transfer of the contract for services in an athlete shall not exceed the sum of (a) adjusted basis of contract in the hands of the transferor immediately prior to the transfer, plus (b) any gain recognized by the transferor on the transfer. There are exceptions for IRC 1031: like-kind exchange (player trades routinely chronicled in the sports sections of newspapers), as well as property acquired from a decedent within the meaning of IRC 1014(a). The transferor is required to furnish to the purchaser its adjusted basis and the amount the transferor believes to be gaining, as well as any subsequent modifications of either amount.

There is a rebuttable presumption, according to IRC 1056(d), that "not more than 50 percent of the consideration is allocable to contracts for 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 proceeding sentence shall give rise to a presumption that the allocation of less than 50 percent of the consideration to contracts for services of athletes is a proper allocation." The 50 percent presumption has given rise to considerable controversy. However, it is not permissible to arbitrarily allocate up to 50 percent to the player contracts. That may have been done in some situations many years ago, but it will be vigorously challenged today. Competent appraisals are a practical necessity.

Likewise, just because less than 50 percent is allocated to player contracts does not mean that the service either cannot or will not challenge the allocation. Again, competent appraisals are a virtual necessity. A question is "50 percent of what consideration?" If consideration includes a stadium lease, the lease is intangible property per IRS Technical Assistance. See ITA 1997-41 (11/12/97). There is an allocation to each player contract. Player contracts tend to have relatively short lives, usually one to six years. Option years are generally included.

One must consider all facts and circumstances in establishing the value of each player contract. The Collective Bargaining Agreement (CBA) with the players association is perhaps the most influential factor in determining fair market value in the relevant league. Any appraisal by a financial appraiser with the right sets of initials behind his or her name is essentially worthless, unless the appraiser is intimately familiar with the league's CBA.

> **Many fans generalize that major are overpaid young adults While everyone is entitled to in economic terms,**

It is the authors' firm belief that general manager assessments are appropriate to value player contracts. Because of the intangibles involved (leadership ability or lack thereof, a player one can count on at crunch time, understanding of the game, disruptive influence with a group of people who essentially practice and/or play games together for months at a time with only a break for that sport's All Star Game, where they may or may not fit the salary scale, a very candid analysis of physical and game skill strengths and weaknesses), there is only one group of people in the world who take these various types of factors and place a number on them for a living (and have to live with the group they select)—the general managers.

The tax court's concerns, voiced in the Denver Broncos litigation, about the mere summary schedule can be cured by designing packages for general managers with a copy of the contract in effect at the year at issue, career statistics, and most importantly, a form giving them the opportunity in an organized fashion to set down their

thoughts as well as their final valuation. These make for fascinating reading and also for insights in to how various members of the very small group with that knowledge and experience view a given player.

Many fans generalize that major league athletes, as a group, are overpaid young adults often with bad attitudes. While everyone is entitled to their own opinion, in economic terms, they are entertainers.

The Sports MSSP employs minuscule numbers in its player contracts treatment. For example, the player it calls "STAR" in Chapter 9 has a three-year contract with a two-year option that reaches a maximum of $150,000 per season. This contrasts sharply minimum salaries under major league CBAs. Shaq (no last name necessary) signed a three-year, $88.5m contract extension in October, 2000. At $29.5m per season, assuming 100 games with playoffs and assuming no injuries, that equates to $295,000 per night (or about $35,000 per missed free-throw).

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Given the Texas Rangers recent $252m 10-year contract with ARod, what is the value of a long-term contract for a comparable (some says more valuable) player at the same position? Is Derek Jeter's new $18m per season contract a bargain? How about Mark McGwire at $15m per season?

IRC 197 governs many intangible assets in the acquisition and sale of many businesses, but it does not either (a) apply to any item in connection with the sale of a sports franchise or (b) supersede IRC 1056.

IRC 1245(a)(4) applies recapture treatment to gain on the sale or exchange of player contracts. PLR 9617001 suggests the IRC 1056 applies to a new expansion franchise's acquisition of players.

Player trades generally constitute an IRC 1031 like-kind exchange of standard player contracts. Rev. Rul. 67-380, 1967-2 C.B. 291. The Sports MSSP adopts this time-honored approach for trading players under contract. What about trading veteran player A for a draft pick? The Sports MSSP concludes Chapter 12 stating, "It appears that future draft picks of a sports franchise are inseparable from its franchise intangible asset. Accordingly, it appears that future draft picks and existing player contracts do not constitute like kind property for purposes of IRC section 1031." Many tax lawyers simply disagree with the government's interpretation of the statute.

STADIUM LEASE

The lease of the stadium, where the team plays their home games is often assigned as part of the sale of a team, such stadiums being often built solely at taxpayer expense. It is a special use facility expressly designed to comply with the league's specific requirements for playing area, seating capacity, press boxes, parking, etc. The stadium's cost exceeded $200 million dollars. The stadium is owned by the local municipal stadium authority (the Stadium Authority) and the lease was approved by the appropriate governmental body.

Chapter 8 of the Sports MSSP opines that "Numerous cities have proven their willingness to mortgage their futures through taxes and the sale of bonds to attract or keep a sports franchise." In valuing the stadium lease, conventional wisdom would point to a comparison of other leases throughout the league to determine if this lease has any terms that make it more or less favorable to the club than other leases. Unlike most if not all "mere mortal" tenants, at the end of the year this tenant actually receives a check back for a multiple of what was paid in rent.

A new football or basketball facility with state-of-the-art sky boxes and other amenities costs at least $250m. Some stadiums are now in the $350m price range. A modern basketball or hockey custom facility with the now standard amenities represents an expenditure in excess of $200m. In pure economic terms, some leases for other teams in the league are either a little more lucrative or a little less lucrative. We do know that there are no other facilities in the metropolitan area for a given franchise that meet the league requirements for seating and support facilities. The tax court held in *New Orleans Saint Limited Partnership v Commissioner,* 73 T.C.M. 2883, T.C. Memo. 1997-246 that in evaluating a lease on the New Orleans Superdome, any analysis of comparable leases must be limited to the specific location at issue and not to other league cities.

A question of the lease value is a large dollar issue. The MSSP is silent regarding this issue, leaving several questions: Is the value of this lease of a special use facility

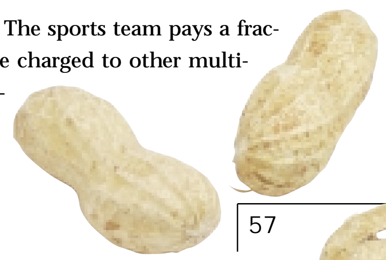
a. The nine-figure replacement cost?

b. Any financially determined value representing a premium over the "league average?" (Note that under this approach a lease could possibly be allocated a negative value.) The service has argued this for years. A simple example illustrated why the tax court rejected this approach in *New Orleans Saints.* Suppose you have a bond that pays you $10m interest per year and your neighbor has another bond from the same borrower that pays $12m annual interest. Does that mean that your bond is worthless? Has a negative value?

c. A very large sum, but less than (a) above?

The tax court stated the proper standard—a stadium lease represents two distinct values that may be calculated using conventional financial analysis models:

a. *Bargain element of the lease.* The sports team pays a fraction of the nightly usage fee charged to other multi-event users, such as the circus, ice shows, etc. That



daily usage savings must be refined to reflect what (or more accurately who) is included. For example, NBA and NHL leases typically require the stadium authority to provide all ushers, ticket takers, security (including both locker rooms), traffic control personnel, first aid, maintenance, and myriad other personnel (even the three statisticians, game clock operator, message board operator, the shot clock operator, etc.) at the landlord's expense. Also, normally, the multi-night user who is not a pro sports team will not receive parking revenues or concessions. Some users bring their own merchandise sellers and retain all associated revenues. Some deals are hybrids.

b. *Revenue streams from signage, concessions, and parking.* With new stadiums there is also revenue from naming rights. Unlike conventional leases for the tenant, net occupancy costs are not expenses, but rather, significant annual revenue streams. This is akin to conventional appraisal of cash flows with appropriate growth factors. Even with probably unrealistically low growth projections, these cash flows typically represent in the aggregate a very large value in the acquisition of any sports franchise.

ECONOMIC ISSUES/INTANGIBLE ASSETS

As the service economy and information age trends continue, the impact and value of intangible assets continues to increase. Most value in the entertainment industry, including the professional sports subset, is intangible in nature. In a typical non-service business, the economics are that the fair market value of the balance sheet assets, net of liabilities, may be $100X. However, the fair market value of the business may be $150X to $200X, as now adjusted for non-balance sheet intangible assets. Many service businesses are worth many times their book value. You should think of a sports team as a marketing operation.

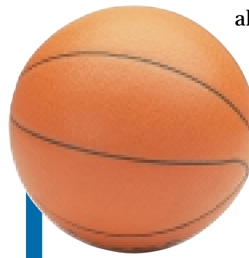
The economic question is: "What does that spread represent and how should the components of that spread be treated for income taxation purposes?" In terms of raw dollars, intangibles disputes are the second biggest area of controversy between taxpayers and the service. The cases inherently focus upon the "facts and circumstances" of a given situation.

Under longstanding Treas. Reg. Sec. 1.167(a)-3, intangible assets, except for going concern value and goodwill value, could be amortized if certain criteria are satisfied. Neither goodwill nor going concern value are amortizable. Goodwill and going concern value are different from each other. The service defines goodwill as follows: "In the final analysis, goodwill is based upon earnings capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets." Rev. Rul. 1959-1 C.B. 237, 59–60, Sec. 4.02(f).

Going concern value, on the other hand, has been described as an ongoing business's ability "to continue to function and generate income without interruption as a consequence of [a] change in ownership." *VGS Corp v Commissioner,* 68 T.C. 563, 592 (1977). In *UFE, Inc, v Commissioner,* the tax court distinguished goodwill from going concern value: "going concern value has been described as related less to business reputation and the strength of customer loyalty, than to the ongoing relationship of assets and personnel in an ongoing business."

If both are present, the purchaser should separately allocate between these two items. Amortization Criteria Prior to IRC 197. Under Treas. Reg. Sec. 1.167(a)(3), an intangible asset cannot be amortized unless it does not represent either goodwill or going concern value and the two following requirements are satisfied: the intangible asset must have an ascertainable cost basis aside from goodwill or going concern value and it must also have had a limited useful life the "length of which can be estimated with reasonable accuracy." The useful life requirement was typically the focal point of disputes between the service and taxpayers.

These tests inevitably resulted in numerous factual controversies and some fine-line distinctions. Some cases have allowed professional baseball and football teams to amortize player contracts over the remaining lives of the respective contracts, while others have consistently refused to allow any amortization of consideration paid for the acquisition of television rights in connection with purchasing professional athletic teams. Such rights are viewed as effectually perpetual, despite the stated term of a given contract. Intangibles assets and other tax advantaged assets commonly encountered are not ordinarily balance sheet items. Accordingly, these frequently valuable assets are sometimes overlooked in smaller transactions.



The "there will always and for more money"

There were two main reasons for a legislative solution. First, under the Treas. Reg. Sec. 1.167-3 and the voluminous reported decisions, every case essentially turned on its own facts and circumstances about what portion of intangible value was represented. There were also numerous disputes as to what identifiable intangibles could be amortized. Second, as the House Conference Report noted, "[T]he purpose of the provision is to simplify the law regarding the amortization of intangibles." The IRS devoted considerable resources to case by case resolutions. These cases represent the second largest dollar value item of disputes between taxpayers and the service. Taxpayers likewise devoted considerable attention, and thus money, to the problem. Also, there was, to put it mildly, a lack of certainty in an acquisition about what, after examination, would be amortizable and over what period of time. Congress held hearings and the result was *IRC 197.*

IRC 197(e)(6) specifically excludes from 15-year amortization "A franchise to engage in professional football, basketball, baseball, or other professional sport, and any item acquired in connection with

such a franchise." Treas. Reg. Sec. 1.197-2(c)(10) specifically excludes from IRC 197 "any item (even though otherwise qualifying as a section 197 intangible) *acquired in connection with such a franchise.*" (Emphasis added.) Previously proposed legislation during the last Congress would have extended the scope of IRC 197 to professional sports franchises. One major league has reacted favorably to this proposal.

BROADCAST RIGHTS

Before the Supreme Court's 1993 *Nework Moring Ledger* decision, the tax court held that no amortization of broadcast rights was permissible under IRC 167(b) since the broadcast contract would continue in perpetuity, the proverbial "link in a continuity chain." *First Northwest Properties v Commissioner,* 70 T.C. 817 Oct. 861 (19-8) rev'd on other grounds 81-1 USTC 919529 (CA 9, 1981).

Do professional sports currently suffer from overexposure in the U.S.? Too many remote control choices? Viewer fatigue? The TV ratings for the most recent World Series, continuing a trend, were the lowest in many, many years. The 2000 NCAA championship basketball game had abysmal viewership. The Sydney Olympics audience

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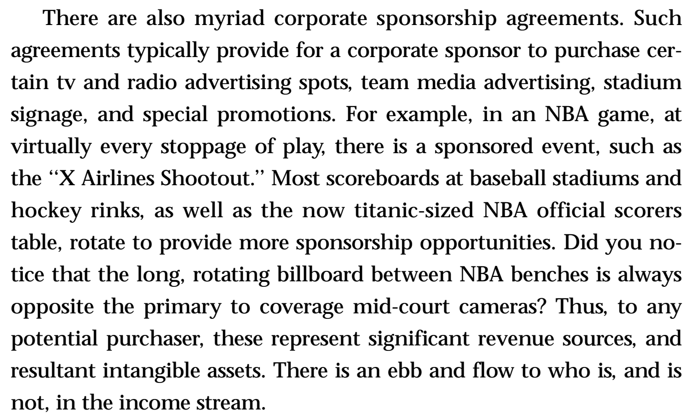
was far below NBC's expectations. The "there will always be a new contract, and for more money" days may well be over. A lengthy article on the front of the "Outlook" section in the February 25, 2001 *Detroit News* was entitled "Are we tired of sports? Early signs suggest fans are losing interest." PA 17.

As that piece noted, "The NBA All-Star Game's viewership fell to a record low." Does this mean we are going to see the first broadcast "renewal" contract for a major league professional sport that is less lucrative than the previous? Probably, yes. If so, what, if any, impact would this have on the government's continuing "link in a chain" rationale?

SEASON TICKET HOLDERS, SKY-BOX LEASES, AND SPONSORSHIPS

A typical factual scenario for an existing team is that there are a substantial number of annually renewable season ticket holders and a lesser number of long-term sky box lessees. These season ticket holders/sky box leases represent critical income streams to any club. They are also the result of a substantial and continuous marketing effort of which the average (and indeed above average) fan has absolutely no idea of the number of people involved in the perpetual, well orchestrated marketing campaigns.



There are also myriad corporate sponsorship agreements. Such agreements typically provide for a corporate sponsor to purchase certain tv and radio advertising spots, team media advertising, stadium signage, and special promotions. For example, in an NBA game, at virtually every stoppage of play, there is a sponsored event, such as the "X Airlines Shootout." Most scoreboards at baseball stadiums and hockey rinks, as well as the now titanic-sized NBA official scorers table, rotate to provide more sponsorship opportunities. Did you notice that the long, rotating billboard between NBA benches is always opposite the primary to coverage mid-court cameras? Thus, to any potential purchaser, these represent significant revenue sources, and resultant intangible assets. There is an ebb and flow to who is, and is not, in the income stream.

Since the burden of proof to substantiate any deduction is always upon the taxpayer, it is imperative that the taxpayer have proper appraisals of these valuable rights, documents the same, and claims and substantiates appropriate deductions. Such appraisals should review factors such as with the annual season ticket renewal rates, is there a waiting list? When do skybox leases expire? At what pricing? Renewal prospects and similar information on major corporate sponsors are likewise important.

COVENANTS NOT TO COMPETE

The 15-year level amortization rule of IRC 197 applies generally to a covenant not to compete or similar arrangement entered into in connection with an acquisition, directly or indirectly, of an interest in a trade or business, or a substantial portion thereof. However, IRC 197 does not apply to any intangible assets acquired in connection with a sports franchise. Thus, the pre-IRC 197 caselaw applies.

The tax question today is both simple and complex. Is the allocation to the covenant reflective of fair market values?

The grantor of the covenant recognizes ordinary income. It has long been established that covenant income is ordinary income to the recipient. Additionally, covenant income is not passive income for the IRC 469 purposes, but rather it is in the nature of compensation income although covenant payments are for doing nothing, rather than providing services. Since in a sports franchise situation IRC 197 is inapplicable, payments should be amortized over the life of the covenant.

It is well recognized that a covenant is separate from the sale of assets. The key question is the amount properly allocable to the covenant. Several factors may be important: (a) the likelihood that the seller will in fact compete is viewed under the economic realities of a given situation (considering the seller's age and health; whether the seller intends to retire, remain in the area, or intends to compete; the seller's legal ability to compete, whether the seller has the financial strength and technical knowledge to compete; whether the

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covenantor has a good reputation in the business, the covenantor's ability to attract customers or clients; and whether, looking at all of the facts and circumstances in a given case, the grantor of the covenant would be a realistic economic threat.

Other considerations are: What was the conduct of parties during the negotiations? Did they discuss a covenant? Are the payments among the various individuals according to their stock holding percentage? Their ability to effectively compete? Did the covenant enter into the price negotiations? Could the negotiations on the covenant be fairly described as vigorous? What does the correspondence between the parties' representatives as well as the various drafts of the documents indicate? Are the parties sophisticated? What are the terms of the covenant itself? Do the payments terminate upon the death of the grantor of the covenant? Are the time and geographic scope restrictions related to effective economic competition? Is the covenant valid under state law? What is the consequence of a breach? Can the payor cease future payments? Does the covenant provide for injunctive relief? Do the percentages of the covenant payments track stock (or LLC) ownership? (If the answer to this question is yes, then the IRS usually wins.) Did the parties made an allocation between recipients of the covenant payments based upon fair market values?

The TRA 1986 Conference Report to IRC 1060 cited the lack of adverse interests as a reason for judicial scrutiny of non-adverse interest transactions. Today there is a substantial difference between ordinary income and capital gain rates for non-corporate taxpayers. Aside from rate differentials, there are other important differences between ordinary income and capital gains. Capital gains, as opposed to ordinary income, grant a basis offset in determining gain. IRC 1001. A seller with a current year capital loss, or with a capital loss carryover, prefers a capital gain to ordinary income regardless of any rate differential. Recapture income is instantly constructively received for installment reporting purposes. See IRC 453(i).

INCOME RECOGNITION—WHICH PARTY? WHEN?

When teams are sold, often between seasons, the seller has already collected prepaid income for items such as season tickets, television, and broadcast rights. There is always extensive work to be done between the execution of a binding purchase agreement and closing. There are myriad third-party approvals that must be obtained, such as assignments of the lease, sponsorship agreements, and numerous other contractual rights, as well as the all-important league investigation of the new owner and approval.

If such revenues are received between seasons by the seller, but the games will be played under the new owner, which party is taxable on the revenues? What does the purchase agreement provide? Even when there is no change of ownership, there are timing issues if prepaid items are received in tax year one, but the games, or some of the games, are not played until tax year two.

The service's position is that the income has to be recognized in the tax year received, rather than when the games are played. Rev. Proc. 71-21, 1971-2 C.B. 549 applies to certain situations in which accrual basis taxpayers can defer income received in year one for services to be performed in year two (and not later). While Rev. Proc. 71-21 is still the governing service interpretation, it was on the IRS business plan to be reviewed. However, that did not happen and it is not currently on the business plan.

The service has opined that television broadcasting revenue was not "services" within the meaning of Rev. Proc. 71-21, but rather, represented consideration for the sale of property rights. See also PLR 8331053 and GCM 39177. This is an important issue for club owners.

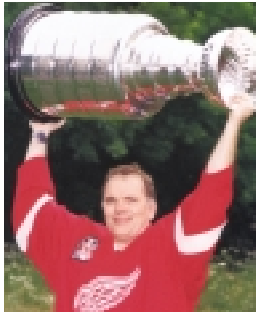
OTHER TAX ISSUES

You should also be aware of the following income tax issues:

1. Consulting Agreements—Is the allocation of purchase price proper?
2. Strike fund payments—*INDOPCO* lives in sports! See Chapter 7 of the Sports MSSP for the government perspective. This will be important to baseball and hockey clubs as work stoppages are expected at the end of their CBAs.
3. Fines and penalties.
4. Sponsorship/Advertising Revenues—Do they fit within Rev. Proc. 71-21? Caselaw treats advertising as a service.
5. Private Seat License (PSL) issues: Can the subscribers deduct the cost of the PSLs? Do the PSLs have a definite life? Indefinite?
6. An expansion team generally pays the existing teams in installments. The existing teams report the revenues as a combination of ordinary income and capital gain items for the player contracts and the sale of other assets. How does the existing team calculate its adjusted bases as offsets to gain?

7. Disability and life insurance payments on key players—Are the premiums deductible to the franchise that would receive any benefits under the policy?
8. Barter income to the club. Often automobiles, airline tickets, etc., are given to the club in exchange for seats, luxury boxes, or special promotions.
9. Relocation inducements by a new city. See Chapter 6 of Sports MSSP for the service's views.
10. Signing bonuses.
11. Application of IRC 1060 allocation regulations.

The glamorous world of professional sports ownership is chuck full of the same everyday valuation, tax, corporate, and contractual issues that permeate many other industries with, dare we say, "a few curve balls." The Sports Franchise Office has definitely stopped the IRS's game. Careful planning is the rule of the day. ✦



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McKenney holds the Red Wings's 1998 Stanley Cup, wearing a sweater that last saw competition on that "glorious June evening against the Washington Capitals."

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