[COMMITTEE PRINT]

TAX SHELTERS: PROFESSIONAL SPORTS FRANCHISES

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

SEPTEMBER 11, 1975

U.S. GOVERNMENT PRINTING OFFICE

58-149 WASHINGTON : 1975 JCS-28-75

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GENERAL

The professional sports industry provides entertainment in the form of competitive sporting events, such as baseball, basketball, football, hockey, etc. The industry is organized into various joint associations or leagues consisting of individual teams or franchise members. The league members are subject to various league rules which generally have the effect of restraining economic competition. For example, consent of most of the member teams is normally required to grant a new franchise or approve the move of an existing member team from one city to another.

The assets of a professional sports team may generally be divided into three categories: (1) sports and office equipment; (2) contract rights for services of players and other personnel for a specific period ("player contracts"); and (3) franchise rights granted under the league or association agreement. In certain acquisitions, goodwill may also be involved. The professional sports franchise is a contractual right for an indefinite term which entitles a team to various rights, such as the exclusive territorial right to provide sporting events in a given geographical area, the right to participate in and obtain players through the college draft, the right to participate in receipts from radio and television contracts, and the benefit of league rules and regulations restricting business competition among the member clubs.

Although the operation of many sports teams has not resulted in taxable profits in recent years, the cost of acquiring a sports franchise has increased significantly. In addition, the upward trend in aquisition cost does not appear to have been dampened by those cases where actual economic losses have been sustained.[1] Many feel that this is due in large part, to the various tax provisions that allow owners to shelter income from other sources. These tax provisions provide tax deferral and other tax benefits that often result in profitability from an investment which reflects losses for tax or financial accounting purposes. The major tax benefits in the sports industry are: 1) the deferral of tax payments for one or more years and 2) the conversion of income (and the tax rate) from ordinary income to capital gain.

Tax deferral usually results from the current or rapid deduction of costs from which benefits are derived in later years, i.e., the rapid writeoff does not accurately represent the actual cost of the exhaustion of an asset. Tax deferral is enhanced if the portion of an aggregate purchase price allocable to depreciable assets having a short useful life is maximized. The principal cost that can be deducted rapidly, or before the related income is recognized in the sports industry, is the cost of a player's contract. Conversion occurs where capital and de-

[1] According to an article in *U.S. News and World Report,* at least 10 out of 24 major baseball teams. 25 out of 28 major basketball teams, and 11 out of 14 major hockey teams incurred a taxable loss in 1970. However, all of the 26 major football teams either broke even or made an economic profit. "Pro Sports: A Business Boom in Trouble," *U.S. News and World Report,* Vol. 71 (July 5, 1971), p. 56.

velopment costs have been deducted as depreciation or as a salary expense against ordinary income and then, in a later year, the sports franchise is sold at a capital gain.

The entities most commonly used to maximize tax benefits for an individual investor in the sports industry are partnerships and subchapter S corporations. These two forms of ownership are used since they are conduits which permit an individual to use the losses generated by the franchise to offset other income such as salary or dividends. The various elements peculiar to the sports industry are examined in detail below.

PRESENT LAW

Depreciation and amortization

Under present law, the cost of tangible property used in a taxpayer's trade or business may be depreciated and deducted over the useful life of the property. In general, the use of accelerated methods for computing depreciation are permitted if the asset has a useful life of 3 years or more.

In addition, the cost of certain intangible property used in a taxpayer's trade or business can be amortized and deducted over the useful life of the property if certain conditions are met.[2] To be deductible, the property must have a useful life which is limited in duration and which can be estimated with reasonable accuracy. No deduction is allowed if the useful life of the property is not ascertainable. Unlike tangible property, the use of accelerated methods of depreciation is not permitted for intangible property.

Gains from the sale of both tangible or intangible property are subject to recapture of depreciation as discussed below.

A. Player contracts.

Players' contracts are intangible assets and usually represent one of the important costs of acquiring a sport franchise. While the players' contracts vary with the type of sport involved, the typical contract will provide employment for one year and give the employer (the team) a unilateral option to renew the contract for an additional year at a specified percentage of the player's previous year's salary.[3]

Prior to 1967, the cost of an individual player's contract was deducted as an ordinary and necessary business expense for the taxable year in which paid or incurred depending on the owner's method of

[2] A deduction for the exhaustion of usefulness of an intangible asset used in a trade or business is treated as a depreciation deduction although for financial accounting purposes the deduction may be described as an amortization expense and distinguished from depreciation attributable to tangible property.

[3] Baseball and hockey contracts contain a specific "reserve clause" in which the right to renew the contract is itself renewed. Although the team obligates itself for only one year, the effect of this reserve clause in the contract, and certain league rules, is to bind the player to play only for the team which owns the contract. Under league rules, if the player refuses to sign a new contract or play for an additional year under the terms contained in the original contract, the team can prevent the player from playing for another team. Basketball and football player contracts purport to be less restrictive in that although they provide an option for an additional year's contract, they do not contain a reserve clause per se. Neither the contract nor the league rules prevent the player from "playing out his option" and becoming a "free agent." However, in the case of football, if a player becoming a free agent signs a contract with a different team in the NFL, then unless mutually satisfactory arrangements have been reached between the two league teams. the Commissioner of the NFL can assert the right to award to the former team one or more players (including future draft choices) of the acquiring team. This right is currently being litigated.

accounting. This treatment was based on the theory that individual player's contracts had a useful life of one year or less.[4] However, the bulk purchase of players' contracts was treated by the IRS as an acquisition of one indivisible asset which was to be amortized and depreciated over the useful life of the players. (Rev. Rul. 54–441, 1954–2 C.B. 101.)

In 1967, the Commissioner of Internal Revenue reversed his position with respect to individual baseball contracts and ruled that the cost of a player's contract must be capitalized and depreciated over the player's useful life. (Rev. Rul. 67–379, 1967–2 C.B. 127.) In adopting this position, the IRS noted that by reason of the reserve clause, a player contract has a useful life extending beyond the taxable year in which the contract was acquired. In Rev. Rul. 71–137, 1971–1 C.B. 104, the same result was reached with respect to football contracts by virtue of the option clause under the contract. Although the useful life varies from sport to sport, sports teams typically adopt a maximum life of between three and six years. The cost to be capitalized includes amounts paid or incurred upon purchase of a player contract and bonuses paid to players for signing contracts.

Since franchise rights are not usually depreciable because these rights exist for an unlimited period of time, a purchaser of a sports team will benefit from larger depreciation deductions if he is able to allocate more of the aggregate purchase price to player contracts and less to franchise rights. Under present law, there are no specific statutory rules relating to the manner in which allocation must be made. However, the allocation of an aggregate purchase price among the various assets must reflect the relative value of each asset to the value of the whole.[5]

The depreciable basis of player contracts also affects the current capitalization and depreciation of bonus payments to be made in the future under the terms of the contract. Generally, an accrual basis taxpayer is entitled to deduct an unpaid expense for the taxable year in which all the events have occurred which determine the fact of liability and the amount can be determined with reasonable accuracy (Treas. Reg. § 1.461–1(a)(2)). Under this general rule, accrued salaries would ordinarily be deductible expense for the taxable year in which earned by the employees even if paid in the following taxable year. However, any expenditure which results in the acquisition of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible for the taxable year in which the liability for the expenditure was incurred. This limitation would generally apply to amounts required to be capitalized with respect to a liability for future payments under a player contract.

In addition, another specific limitation would also apply in the case of such a contract if it is treated as a nonqualified deferred compensation plan.

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[4] *Commissioner* v. *Pittsburgh Athletic Co.*, 72 F. 2d 883 (3d Cir. 1934); *Commissioner* v. *Chicago National League Ball Club*, 74 F. 2d 1010 (7th Cir. 1935); and *Helvering* v. *Kansas City American Assn. Baseball Co.*, 75 F. 2d 600 (8th Cir. 1935).

[5] *Harlow N. Davock*, 20 T.C. 1075 (1953). Treasury Regulation section 1.167(a)–5, relating to apportionment of basis, provides that in the case of a lump sum purchase of property the basis for depreciable property cannot exceed an amount which bears the same proportion to the lump sum as the value of depreciable property at the time of acquisition bears to the value of the entire property at that time.

An employer is not entitled to deduct contributions made to or under a nonqualified deferred compensation plan until the taxable year in which an amount attributable to the contribution is includible in the gross income of the employee. (sec. 404(a)(5)). The employee-beneficiary of a nonexempt trust must generally include amounts paid on his behalf in his taxable year in which there is no substantial risk of forfeiture (secs. 83, 402(b), and 403(c)). In addition, the Internal Revenue Service has ruled that if compensation is paid by an employer directly to a former employee, under an unfunded plan, such amounts are deductible when *actually* paid in cash or other property (Rev. Rul. 60–31, 1960–1 C.B. 174). Thus, it would seem that deduction under an unfunded plan before payment would be precluded where the useful life of the player contract is shorter than the actual payout period.[6]

B. Franchises.

A professional sports franchise is an intangible asset. Under present law, however, depreciation or amortization deductions are not allowed since the useful life of the franchise is not of limited duration and cannot be ascertained. The cost or basis of the franchise would be taken into account in determining gain or loss upon sale or other disposition of the franchise.

C. Sports and Office Equipment.

Sports and office equipment are tangible personal property which can be depreciated over their respective useful lives. Unlike player contracts and franchise rights, these assets may qualify for the investment credit.

In the typical case, the cost for equipment represents an insignificant portion of the total cost of a sports franchise.

Capital Gain Treatment

A. Sales of franchises.

In general, in the case of the sale or exchange of a franchise, any recognized gain or loss is treated as capital gain or loss, if the franchise has been held by the taxpayer for more than 6 months (Rev. Rul. 71–123, 1971–1 C.B. 227). Since the franchise is not a depreciable asset, it is not treated as a section 1231 asset (as described below). In addition, an exchange of one franchise for another would be treated as a like-kind exchange under which the recognition of gain is postponed except to the extent "boot" (i.e., money) is received.

Under a special provision (sec. 1253), the sale or exchange of a franchise will not be treated as the sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise. However, a specific exemption is provided for the transfer of a franchise to engage in a professional sport.

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[6] However, one author has suggested that "whether player 'signing' bonuses are correctly treated as an anomaly among the forms of deferred compensation is not clear." (Klinger, "Professional Sports Teams: Tax factors in buying, owning and selling them" 39 J. Tax 276 (Nov. 1973).) On the basis of the Service's ruling that "signing" bonuses are treated as costs of acquiring player contracts (Rev. Rul. 71–137, 1971–1 C.B. 104) and since the contracts are amortizable intangible assets, that author suggests that deduction before payment "seems to be permissible" where the useful life of the contract is shorter than the payment period. Thus, the author suggests that deductions could be generated without cash expenditures.

B. Player Contracts

Under present law, depreciable property that is used in a trade or business is not treated as a capital asset. However, under section 1231, a taxpayer who sells property used in his trade or business obtains special tax treatment. All gains and losses from section 1231 property are aggregated for each taxable year and the gain, if any, is treated as capital gain. If the losses exceed the gains, the loss is treated as an ordinary loss. Thus, gains from the sale of player contracts and sports equipment will be treated as capital gain and subject to the more favorable capital gain rates if the contracts were held for more than 6 months.

Recapture of Depreciation

Before 1962, net gains from the sale of personal property used in a trade or business (with certain exceptions) were taxed as capital gain, and losses were generally treated as ordinary losses. In 1962, section 1245 modified this treatment as to most personal property to "recapture" gain on the sale as ordinary income to the extent of all depreciation taken on that property after December 31, 1962. Accordingly, the Internal Revenue Service has ruled that gains from the disposition of depreciable professional baseball and football player contracts which are owned by teams for more than 6 months are subject to recapture as ordinary income.[7] Further, in the case of an early disposition of sports equipment, there will also be recapture of the investment credit.

Leverage

The amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership (sec. 704(d)), which is reduced by the amount of any deductible losses (sec. 705).

Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership (sec. 722). If a partner assumes liability for part of the partnership debt, this also increases his basis. However, under the regulations, where the partnership incurs a debt and none of the partners have personal liability (a "nonrecourse" loan), then all of the partners are treated as though they shared the liability in proportion to their profits interest in the partnership (Regs. § 1.752-1(e)).

With respect to a subchapter S corporation, losses that may be passed on to a shareholder are limited to the amount of his investment in the stock and any loans he has made to the corporation.

FORM OF OWNERSHIP

The forms of ownership most commonly used to maximize tax benefits in the sports industry are the partnership and the subchapter S corporation. In general, a partnership is not considered a separate entity for tax purposes; rather, the individual partners are taxed currently on their share of the partnership gains and may deduct partnership losses to the extent of their partnership basis. Similarly, the tax incidents of a subchapter S corporation's operations are passed through to its individual shareholders. Both the limited partner and the shareholder may deduct losses of the partnership or subchapter S

[7] Rev. Rul. 67-380, 1967-2 C.B. 291; Rev. Rul. 71-137, 1971-1 C.B. 104.

corporation to the extent of the adjusted basis in the partner's interest or the shareholder's stock.

While the adjusted basis of the shareholder's stock in a subchapter S corporation does not include any portion of the corporation's liabilities (other than loans that an individual shareholder makes to the corporation), it is possible to increase the adjusted basis of the shareholder's stock by making annual loans to the corporation. These forms of ownership allow an individual investor to use the loss generated by the sports team to offset or "shelter" other income of the investor, such as salary or dividends.

PROBLEM

The principal elements involved in the use of a professional sports franchise as a tax shelter are deferral and capital gains treatment upon the sale or disposition of the franchise or the assets. In many cases, these tax benefits combine to transform an otherwise unprofitable investment into a very profitable one. The tax benefits derived from investing in sports franchises have increased the price of franchises and permitted the operation of some marginal teams which might not be in existence but for the tax savings attributable to deferral and conversion allowed by existing law. Because tax losses may be generated which can be used to offset other income, professional sports franchises have become increasingly attractive tax shelter investments for individuals in high marginal tax brackets.

One practice that increases the tax benefits resulting from the operation of a sports team is the allocation of a large part of the amount paid or incurred for the acquisition of a sports team to depreciable player contracts. Typically, a purchaser of a sports team attempts to allocate as much as possible of the aggregate purchase price of the franchise to player contracts because the cost of a player contract may be depreciated over the useful life of the player. Amounts that are allocated to other assets such as the franchise rights or to goodwill cannot be depreciated since these assets have an indeterminate useful life. The effect of allocating a greater amount of the purchase price to player contracts is to decrease the amount of taxable income or increase the amount of tax losses attributable to the operation of the sports team during the early years.[8]

[8] Of the total cash consideration paid for an expansion major league football team, the Atlanta Falcons, the purchaser (a subchapter S corporation) treated $7,722,914 as the cost of player contracts and options. $727,086 as deferred interest and the remaining $50.000 as the cost of the franchise. This resulted in tax losses to the corporation of $506.329 in 1967 and $581,047 in 1968 which was passed through to the shareholders on a proportionate basis. Upon audit, the IRS determined that only $1,050.000 should be allocated to the player contracts and options, and $6,722,914 should be allocated to the nondepreciable cost of the National Football League franchise. The taxpayer paid the additional assessment. submitted a claim for refund, and after its disallowance, filed a suit for refund. The court rejected both the taxpayer's initial allocation of $7,722,914 and the Commissioner's allocation of $1,050,000 and concluded that the amount that should have been allocated to the players' contracts and options was $3,035,000. (*Laird v. U.S.*, — F. Supp. —, 75–1 U.S.T.C. 88,565 (D.C. Ga. 1975)). The court further concluded that $4,277,043 represented the value of the television rights granted to the Atlanta Falcons under a 4-year contract between the NFL and the CBS television network and that this amount was not amortizeable because the useful life of the television rights was for an indefinite period. This case is presently on appeal in the Fifth Circuit.

Questions have been raised as to the method used by the District Court in allocating the purchase price to the various assets acquired in the *Laird* case. First, the court did not appear to allocate the purchase price according to relative fair market values of the assets acquired. Further, although the court held that the right to participate in receipts from television contracts could not be depreciated since it "had no definite limited useful life the duration of which could be ascertained with reasonable accuracy", the court relied upon the existing 4-year contract in valuing this right for purposes of allocating the purchase price. Concern has been expressed as to whether. if the television contract had only 1 year left at the time of acquisition, the court would have determined the contract's value to be the present value of the right to receive television receipts for only 1 year.

The following table illustrates the allocation made of initial team acquisition costs by professional basketball teams:

ALLOCATION OF COST OF TEAMS BETWEEN FRANCHISE AND PLAYER CONTRACTS

[In thousands of dollars]

Club	Total cost	Franchise	Player contracts	Players as percent of total
A1	250	250	0	0
A2	985	100	885	89.8
A3	(1)	(1)	(1)	(1)
A4	295	15	280	94.9
A5	1,550	200	1,350	87.1
A6	452	172	280	61.9
A7	20	20	0	0
A8	606	(1)	(1)	(1)
A9	800	425	373	46.9
A10	255	255	0	0
A11	106	6	100	94.3
ABA total	4,713	1,443	3,270	69.4
N1	500	250	250	50.0
N2	5,600	1,100	4,500	80.4
N3	5,175	1,035	4,140	80.0
N4	3,600	400	3,200	88.9
N5	3,437	400	3,037	88.4
N6	1,250	50	1,200	96.0
N7	1,016	416	600	59.1
N8	678	200	478	70.5
N9	3,635	465	3,170	87.2
N10	1,157	101	1,056	91.3
N11	100	100	0	0
N12	1,907	180	1,727	90.6
N13	3,496	331	3,166	90.5
N14	25	25	0	0
N15	3,040	50	2,990	98.4
N16	23	0	23	100
N17	1,434	150	1,284	89.5
NBA total	36,073	5,253	30,821	85.4

[1] Not available.

Source: Noll and Okner, "The Economics of Professional Basketball" (1971).

This may result in a tax loss in many cases even where the operation of the sports team is generating a positive cash flow. Thus, the depreciation claimed by the owner creates tax losses which can be used to shelter other income from taxation.

On the other hand, the seller attempts to allocate most of the aggregate sales price to franchise rights. In this way, a greater amount of any gain is treated as capital gain and a lesser amount is treated as gain attributable to depreciable assets (e.g., players' contracts) subject to recapture as ordinary income.

With respect to recapture upon sale or disposition of a player contract, an argument might be made that the recapture rules for depreciable personal property do not apply in light of the past treatment of salary contracts by the Internal Revenue Service. Prior to its 1967 ruling, the Service treated payments made under a salary contract as ordinary and necessary business expenses when paid. Further, salary expenses which are not capitalized would not be subject to recapture as ordinary income under the judicial tax benefit rule.

Further, the amount of depreciation taken with respect to player contracts will not be recaptured in many cases since a substantial number of the original players may have retired or been "cut" and replaced by a new player. However, in this case, an abandonment loss would be claimed for the adjusted basis of the contract for the player in the year he retired or was cut.

An additonal problem relates to the useful life that is adopted with respect to the players' contracts. Typically, sports franchises adopt an average useful life of between three to six years for these contracts. The risk of injury to a player is one of the factors that contributes to this short life and is akin to obsolescence or exhaustion of any other asset. However, it is argued that in many cases, the actual life of the more valuable players extends beyond this period. To the extent that a large part of the total amount capitalized with respect to players' contracts is allocated to players who generally tend to have a longer life, the amount allocated is deducted more rapidly than the actual decline in the usefulness of the player.

ALTERNATIVE APPROACHES

Allocation of Purchase Price to Player Contracts in the Case of Sports Enterprises

A. 1974 committee bill

Last year's bill provided that the portion of the amount paid to purchase a team or group of assets which would be allocable to player contracts or sports enterprises must be specified. In addition, the amount allocable to player contracts by a purchaser could not, in any event, exceed the amount of the sales price allocated to these contracts by the seller.

B. Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

Recapture of Depreciation on Player Contracts

A. 1974 committee bill

In the case of player contracts of sports enterprises, last year's bill provided that there would be a complete recapture of all depreciation to the extent of any gain involved at the time of the sale of the player contract or of the sports enterprise.

B. Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

APPENDIX

Example of Sports Shelter

In 1976. Mr. Sport and his 3 partners acquire a professional sports franchise for $10 million ($1 million in cash and $9 million in long-term notes, principal payments beginning in 1980). The assets of the franchise include the franchise rights, players' contracts, sports and office equipment, and a stadium lease, the unexpired term of which is 10 years. The partnership allocates 15 percent of the purchase price to the franchise, 80 percent to the players' contracts. 3 percent to equipment and 2 percent to the stadium lease. A useful life of 5 years is adopted with respect to the players' contracts and a useful life of 10 years is adopted with respect to the equipment. The equipment is depreciated using the straight-line method. Mr. Sport has other personal income of $500,000 in 1976 and has a one-fourth share in the profits and losses of the partnership.

For the taxable year 1976, the partnership has the following income and expenses:

Income:	
Gate receipts	$2,900,000
Television and radio income	1,400,000
Parking and concessions	345,000
Other income	80,000
Total income	4,725,000
Expenses:	
Player salaries	1,700,000
Coaches, scouts, and staff	350,000
Front office administration and overhead	1,050,000
Training	175,000
Interest	900,000
Lease rental	100,000
Total expenses	4,275,000
Net income before depreciation (cash flow)	450,000
Depreciation:	
Player contracts	1,600,000
Equipment	30,000
Lease acquisition cost	20,000
Total depreciation	1,650,000
Net loss for year	1,200,000

Based upon the foregoing assumptions, one-fourth of the net loss from the partnership would have the following effect upon Mr. Sport's tax liability [1] and cash position.

	Without team	With team	Cash benefits
Other taxable income	$500,000	$500,000	
Net loss for team		(300,000)	
Taxable income	500,000	200,000	
Income tax liability	321,000	111,000	
Tax savings			210,000
Cash flow from team			112,500
Total tax savings and cash flow			[2] 322,500

[1] For purposes of this example, the maximum tax on earned income was not used (i.e., none of the $500,000 was earned income).

[2] If another investment opportunity is foregone because of the $250,000 investment in the franchise, the cash benefits attributable to this investment should be adjusted downward to reflect the after-tax income foregone. For example, if Mr. Sport could have invested the $250,000 in taxable securities at a 10 percent yield, the cash benefits attributable to the investment in the franchise would be reduced by $7,500 ($25,000 income less income tax of $17,500).

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