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HEADLINE: 1999 TNT 225-9 IRS RELEASES MSSP PAPER ON SPORTS FRANCHISES. (MSSP Audit Guide on Sports Franchises (Training 3123-005 (8-1999))) (Release Date:

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ABSTRACT: The Service has released a Market Segment Specialization Program audit guide that contains examination techniques for sports franchises.

SUMMARY:

The Service has released a Market Segment Specialization Program audit guide that contains examination techniques for sports franchises. Although the guide focuses on major league sports franchises, the examination techniques and issues addressed also apply to minor league sports franchises.

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SPORTS FRANCHISES

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MARKET SEGMENT SPECIALIZATION PROGRAM

THE IRS MISSION

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

MISSION OF EXAMINATION

Examination supports the mission of the Service by maintaining an enforcement presence and encouraging the correct reporting by taxpayers of income, estate, gift, employment, and certain excise taxes in order to instill the highest degree of public confidence in the tax system's integrity, fairness, and efficiency. To accomplish these goals, Examination will:

Measure the degree of voluntary compliance as reflected on filed returns;

Reduce noncompliance by identifying and cost-effectively allocating resources to those returns most in need of examination and taxpayer contact;

Conduct, on a timely basis, quality examinations of tax returns and quality contacts to determine the correct tax liability.

\* \* \* \* \*

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## INTRODUCTION AND LEAGUE INFORMATION

### SOURCES OF INFORMATION AND GUIDE EMPHASIS

[1] The primary source of information for the examination techniques and issues addressed in this guide is North Florida District examinations of major and minor league professional sports franchises. This has been supplemented with networking with examiners in other districts, and sports league information from public sources.

[2] Although this guide focuses on major league sports franchises, the examination techniques and issues addressed also have relevance to the examinations of minor league sports franchises.

### EMERGING ISSUES AND SPORTS FRANCHISE ISP TEAM ISSUE ASSISTANCE

[3] Potential emerging sports franchise issues addressed in this guide are distinguished from established sports franchise issues. Any emerging sports franchise issues are addressed at the end of the applicable issue chapter.

[4] For some emerging sports franchise issues, a position is not taken. Promising emerging issues may receive additional consideration by the Sports Franchise Industry Specialization Program (ISP) team.

[5] Examiners are encouraged to contact the Sports Franchise ISP team, located in the South Florida District, for issue assistance on both established and emerging sports franchise issues addressed in this guide.

### SPORTS LEAGUE ASSOCIATIONS

[6] Each of the major sports leagues is represented by a league association. The primary purpose of the league association is to promote the sport, negotiate national TV broadcast rights, negotiate national sponsorship agreements, and protect the interests of the sports franchise owners and the sports league as a whole.

[7] The individual sports franchises in the league are members of the league association. League associations are operated as tax exempt organizations under IRC section 501(c)(6).

### LEAGUE REVENUE SHARING

[8] Each of the major sports leagues has revenue sharing. The leagues equally divide national television revenues regardless of the sports franchise's number of televised games, winning record, or drawing power among the sports franchises in the league. Merchandise licensed on a national level, such as team logos, are also shared by the sports franchises in the leagues.

[9] Sharing of gate receipts varies among the leagues. For instance, the National Football League (NFL), splits gate receipts 60-40 with the home team receiving the larger amount, whereas in the National Hockey League (NHL), the home team retains the entire gate. In the National Basketball Association (NBA), the home team retains 94 percent of the gate with the league receiving the other 6 percent. In Major League Baseball (MLB), the split with the American league is 80-20, and in the National League, the visiting team receives 42 cents per admission.

[10] Local media revenue is not shared, and the revenue from stadium box seats is generally not shared.

[11] There are significant differences in the relative amount of revenue shared in the different leagues. The NFL has the highest degree of revenue sharing with over 80 percent of league revenues shared. This is because the NFL derives most of its revenue from national media broadcasting contracts. On the other end of the scale, only 5.4 percent of league revenue is shared in the NHL. The NHL derives only a small portion of total revenue from its national media contracts, with the majority of its revenues obtained from gate receipts. The MLB and the NBA fall between these two extremes.

#### THE MAJOR SPORTS LEAGUE TEAMS

[12] The major sports league information furnished below is based on the status of these leagues in 1998. A separate sports franchise owns each of the major league teams listed.

#### The National Basketball Association

[13] The National Basketball Association (NBA) consists of 29 teams divided into the Eastern and Western Conferences. The teams are further divided into four divisions: Atlantic, Central, Midwest and Pacific.

##### Eastern Conference

###### Atlantic Division

Boston Celtics  
Miami Heat  
New Jersey Nets  
New York Knicks  
Orlando Magic

Indiana Pacers Washington Wizards

###### Central Division

Atlanta Hawks  
Charlotte Hornets  
Chicago Bulls  
Cleveland Cavaliers  
Detroit Pistons Philadelphia 76ers  
Milwaukee Bucks  
Toronto Raptors

##### Western Conference

###### Midwest Division

Dallas Mavericks  
Denver Nuggets

Los Angeles Lakers

Antonio Spurs

Sacramento Kings

Minnesota Timberwolves

Portland Trail Blazers

Vancouver Grizzlies

###### Pacific Division

Golden State Warriors

Los Angeles Clippers Houston Rockets

Phoenix Suns San

Utah Jazz

Seattle SuperSonics

[14] Each team plays an 82 game regular season schedule with 41 home games and 41 away games. The winner in each division, plus the next six top finishing teams in the conference, play to determine the conference winner. The two conference winners play in the NBA playoffs to determine the overall NBA champion.

#### The National Football League

[15] The National Football League (NFL) consists of 31 teams divided into the American and National Conferences. Both the American and National Conferences further divide the teams into three divisions: Eastern, Central, and Western.

##### American Conference

###### Eastern Division

Buffalo Bills

Dallas Cowboys Miami Dolphins

##### National Conference

###### Eastern Division

Arizona Cardinals Indianapolis Colts

New York Giants New

England Patriots  
Washington Redskins

Philadelphia Eagles New York Jets

Central Division

Central Division

Cincinnati Bengals  
Baltimore Ravens  
Tennessee Titans  
Minnesota Vikings  
Cleveland Browns

Chicago Bears  
Detroit Lions  
Green Bay Packers  
Jacksonville Jaguars  
Pittsburgh Steelers  
Tampa Bay Buccaneers

Western Division

Western Division

Denver Broncos  
Kansas City Chiefs  
Oakland Raiders  
San Diego Chargers  
Seattle Seahawks

St. Louis Rams  
Atlanta Falcons  
New Orleans Saints  
San Francisco 49ers  
Carolina Panthers

[16] Each team plays a 16 game regular season schedule with 8 home games and 8 away games. The winner in each division, plus the next three top finishing teams in each conference, play to determine the conference champion for their respective conference. The two teams that win their respective conference play against each other for the overall league championship in the Super Bowl.

#### Major League Baseball

[17] Major League Baseball (MLB) includes 30 teams, with the American and National Leagues having 14 and 16 team circuits respectively. The American and National Leagues further divide the teams into three divisions: Eastern, Central, and Western.

National League

American League

Eastern Division

Eastern Division

Atlanta Braves  
Montreal Expos  
Florida Marlins  
New York Mets  
Tampa Bay Devil Rays

New York Yankees  
Baltimore Orioles  
Boston Red Sox  
Toronto Blue Jays Philadelphia Phillies

Central Division

Central Division

St. Louis Cardinals  
Houston Astros  
Detroit Tigers  
Pittsburgh Pirates  
Chicago Cubs

Cleveland Indians  
Chicago White Sox  
Cincinnati Reds  
Minnesota Twins  
Kansas City Royals Milwaukee Brewers

Western Division

Western Division

San Diego Padres  
Los Angeles Dodgers  
Colorado Rockies  
San Francisco Giants  
Arizona Diamondbacks

Texas Rangers  
Seattle Mariners  
Oakland Athletics  
Anaheim Angels

[18] Each team plays a 162 game regular season, with 81 home games and 81 away games. The top four teams in each league, with at least one from each division, play in the post season league championship games. The two teams that emerge as

champions of their respective leagues play in the World Series. The winner of the World Series is the MLB champion.

#### The National Hockey League

[19] The National Hockey League (NHL) consists of 26 teams divided into the Eastern and Western Conferences. The teams are further divided into four divisions: Northeast, Atlantic, Central, and Pacific.

##### Eastern Conference

###### Northeast Division

Boston Bruins

New York Rangers

Hartford Whalers

Tampa Bay Lightning

###### Atlantic Division

Philadelphia Flyers

Montreal Canadiens

Washington Capitals

Ottawa Senators

New York Islanders

Pittsburgh Penguins

Florida Panthers

Buffalo Sabres

New Jersey Devils

##### Western Conference

###### Central Division

Chicago Blackhawks

Calgary Flames

Louis Blues

San Jose Sharks

Avalanche

###### Pacific Division

Mighty Ducks of Anaheim

Dallas Stars

Detroit Redwings

Edmonton Oilers

Los Angeles Kings

Phoenix Coyotes

Toronto Maple Leafs

Vancouver Canucks

Colorado

[20] Each team plays an 82 game regular season schedule, with 41 home games and 41 away games. The top eight teams in each conference play to determine the conference winner. The two conference winners play in the Stanley Cup Playoffs to determine the overall NHL champion.

#### League Expansion

[21] The major sports leagues have added new teams throughout the course of their history, and each league is scheduled for further expansion. Expansion teams added in the major sports leagues in the 1990's are as follows:

##### The National Basketball Association

1994 - Toronto Raptors (started playing in 1995-1996 season) 1994 - Vancouver Grizzlies (started playing in 1995-1996 season)

##### The National Football League

1993 - Carolina Panthers (started playing in 1995 season)

1993 - Jacksonville Jaguars (started playing in 1995 season) 1998 - Cleveland Browns (started playing in 1999)

##### Major League Baseball

1993 - Colorado Rockies (National League)

1993 - Florida Marlins (National League)

1998 - Arizona Diamondbacks (National League)

1998 - Tampa Bay Devil Rays (American League)

##### The National Hockey League



1991 - San Jose Sharks  
1992 - Ottawa Senators  
1992 - Tampa Bay Lightning  
1993 - Mighty Ducks of Anaheim  
1993 - Florida Panthers

## CHAPTER 2

### GENERAL SPORTS FRANCHISE EXAMINATION TECHNIQUES

#### OVERVIEW

[22] This chapter addresses general sports franchise examination techniques. More detailed examination techniques and issue guidance are contained in the specific issue chapters of this guide.

#### GENERAL ACCOUNTING CONSIDERATIONS

[23] Even among sports franchises in the same league, the financial statements for the sports franchise are generally unique. There are often significant differences in accounting for the acquisition of the sports franchise and in the accounting policies for major items such as player contracts and contingencies. There are also varying levels of vertical business integration. The financial statements often reflect significant related party transactions which are common for most sports franchises.

[24] The amortization of player contracts is almost always a material audit issue. Player contracts are typically structured to include signing bonuses and deferred compensation arrangements.

[25] For most sports franchises, ticket revenues and broadcasting rights constitute the majority of revenue. Many teams also have favorable lease arrangements in which the team receives revenue from parking, concessions, and stadium naming rights. Advance sales of upcoming season tickets are typically reflected as deferred revenue on the balance sheet. Generally accepted accounting principles (GAAP) require that gate revenues be recorded in the period in which the fans attend the games so that they are matched against period costs. As with other industries, the GAAP timing of income and expenses for sports franchises often differs from that for tax purposes.

#### RETURN IDENTIFICATION AND ENTITY BACKGROUND INFORMATION

[26] There are usually a limited number of sports franchises located within a specific district. For purposes of an approved district compliance initiative, sports franchise returns can often best be identified through the examiner's personal knowledge of the sports teams located within their district.

[27] The main problem in identifying returns, however, is identifying the owner's entity name under which the tax return is filed, as opposed to the sports franchise's "doing business as" (DBA) name. This can be a difficult and time consuming task in situations in which the entity operates as a partnership.

[28] One way to identify the ownership entity is through the use of the incorporation library (INCORP) on Lexis-Nexis. By accessing the XXBIZ file ( where XX represents the state abbreviation; for example, FLBIZ for Florida) examiners can usually locate the records for the ownership entity by utilizing the DBA name as the search term.

[29] The BIZ file can provide a wealth of information about the entity, including the entity's registered name; the form of the entity, for example,

corporation or partnership; the officers of record; and the federal employer's identification number (EIN). The INCORP records will also indicate whether or not the entity is still active, or if it has been dissolved (voluntary or involuntary). Additionally, historical data is provided which, if applicable, would include name changes or whether a merger had occurred. The BIZ file will often cross reference related entity records.

#### PREPLAN AND ISSUE IDENTIFICATION

[30] The following information is presented to assist in assessing the audit potential of a sports franchise return. It should only be used as supplemental information during the preplanning stage of an examination. Since it is not all inclusive, in no way should it restrict the examiner from identifying other potential return issues that may be present.

#### Intangible Assets

[31] The balance sheet is an integral part of any preplan. Aside from normal preplan audit considerations, a specific review of the allocation among amortizable and non-amortizable intangible assets is especially important in sports franchise examinations. A sports franchise's non-amortizable intangible assets may, upon examination, be determined to be significant. The ratio of non-

amortizable intangible assets (TV broadcast rights, goodwill, going concern value, and franchise costs) to amortizable assets (primarily player contracts)

will depend on how long the franchise has been in existence and the number of marquee players employed by the team.

[32] Form 4562, Depreciation and Amortization, should be viewed to ascertain if amortization has been claimed on non-amortizable intangible assets. An inspection of Form 4562 might also indicate potential problems regarding the amount of the original franchise cost (whether by purchase or by expansion) allocated to player contracts, the useful life assigned to player contracts, and the placed in-service date for these contracts.

#### Deferred Revenue and Deposits

[33] In order to identify deferred revenue and amounts that may have been improperly treated as non-taxable deposits, a detailed review of balance sheet current liabilities and long term liabilities is recommended. The detail attached to the return may identify the make up of any deferred revenue. For example, the detail may state that long term liabilities include deferred broadcast revenue and deferred sponsorship revenue.

[34] Look at long-term liabilities to determine if any deferred revenue is included. Sources of income such as ticket revenue for games which may extend beyond more than one season are often inappropriately deferred.

[35] Amounts treated by the taxpayer as non-taxable deposits, which may in fact be taxable advance payments for services, may be included in long term liabilities or other liabilities. The deposit/advance payment amounts for multiple year season ticket holder agreements (regular season ticket holders, club seats, and skybox or executive suites) can be quite significant. This is especially the case for new sports franchises resulting from league expansion or team relocations and sports franchises that have or are trying to improve or expand the stadiums in which they play their home games.

#### Accrued Expenses

[36] As part of the examination of the balance sheet, large accrued expense items should be considered. Accrued expenses may include such items as accrued bonuses or compensation to related parties to which IRC section 267 or IRC section 482 may apply. Additionally, accrued compensation costs will often fall under the purview of IRC section 404 (deductions for deferred compensation) or IRC section 419 (deductions for contributions to welfare benefit funds). Also, a large accrual of rent for a stadium or an arena should be reviewed to determine whether it qualifies as an IRC section 467 rental agreement, and if so, that the requirements of IRC section 467 are in compliance.

#### Other Deductions

[37] As with any examination, excessive repair expenses claimed may indicate capital improvements are being improperly expensed. The same can be said for excessive professional fees claimed, which may represent fees connected with the acquisition of the sports franchise, a lease agreement, or similar capital asset.

[38] The audited financial statements should reflect any loans to related parties and the terms of the loans. A review of this information may indicate an IRC section 7872 issue involving related party debt having below market interest rates.

#### Schedule M-1

[39] Schedule M-1 should be inspected to determine the sports franchise's differences between taxable income and book income. As with other taxpayers, these differences warrant consideration.

[40] A taxpayer's tax accounting and book accounting are the same for items not reflected in Schedule M-1. Accordingly, awareness of the sports franchise accounting areas for which there are usually differences in tax accounting and book accounting (which raise questions by their absence from Schedule M-1) can assist the examiner in identifying areas of audit risk.

[41] An example is the absence of a Schedule M-1 adjustment for amortization. Generally, a sports franchise's amortization will be less for tax purposes than for book purposes. This is especially the case for new franchises, whether through expansion or purchase.

#### Related Party Transactions

[42] Related party transactions are common for sports franchises. Concession arrangements, local television contracts, and stadium lease arrangements to related entities are common in the industry. It is not uncommon for the owners of the sports franchise to have an interest in these and other businesses that have financial dealings with the sports franchise.

[43] The audited financial statements are a good source of information. Generally accepted accounting principles and more specifically Statement of Financial Accounting Standard 57, Related Party Disclosures, require disclosure of related party transactions in the notes to the financial statements. This includes information on: (1) their affect on the financial statements, (2) the dollar amount of each transaction, and (3) any amounts due to or from related parties along with the terms of the debt arrangement.

[44] Often, the underlying documents will be needed to determine the substance of related party transactions.

#### ISSUE DEVELOPMENT

[45] Issue development is the key to any examination. This means the facts should be fully developed to support the underlying issue, and to the extent possible, the taxpayer should acknowledge agreement with the facts.

[46] Exhibit 2-1 is a sample Form 4564, Information Document Request, that can be tailored to fit the specific needs of the examination. Depending on the issue, the examiner may need to retain a copy of many of the documents and agreements inspected during the examination for the case file workpapers.

[47] Factual development starts with the initial interview. The interview should be conducted with the party having first-hand knowledge, usually the chief financial officer or comptroller.

[48] It is important to develop initial interview questions which fit the particular facts and circumstances of the sports franchise. Exhibit 2-2 is a sample interview questionnaire that can be tailored to the sports franchise's unique facts and circumstances. This sample interview questionnaire contains generic, initial interview questions, as well as questions specific to sports franchise examinations. The questionnaire is by no means all inclusive. Rather, it is meant to be used as only a guideline.

[49] As with most examinations, a key to good issue development is a tour of the business. Regardless of how many stadiums or sports arenas the examiner has visited, each is unique in its own way. Moreover, visiting a stadium or sports arena as a spectator is quite different from touring the facility as an examiner, where one has the opportunity to ask questions about the lives of assets, financing arrangements, and income producing activities.

[50] It is preferable that the examination take place at the sports franchise's place of business. A day-to-day observation of the business operations can lead to a more thorough understanding of the facts, clear up potential misunderstandings, and facilitate obtaining information from the taxpayer in a timely manner. This usually minimizes the time expended on the examination and inconvenience to the taxpayer.

[51] Make specialist referrals as early as possible. Because a Computer Audit Specialist (CAS) referral is mandatory on all cases with Activity Code 219 and above, sports franchises typically require a CAS referral.

[52] Asset valuation issues are usually identified early in the examination. If asset valuation assistance is warranted, make the engineering referral early in the examination.

#### REQUIRED FILING CHECKS

[53] There are usually related entity returns that should be inspected and perhaps examined. This often includes the tax returns of the owners of the sports franchise.

[54] The single largest expense of a professional sports franchise team is its salaries and wages. This is due to ever increasing player costs. It is, therefore, important for examiners to ensure the proper filing of all employment tax returns. In addition, the policies for issuing Forms 1099 should be reviewed in conjunction with a determination that all required Forms 1099 were issued and that employees and subcontractors were properly classified.

[55] Among other things, examiners should ensure that any relocation expenses paid to new players, coaches, etc., are included in the employee's W-2. Additionally, examiners should determine if taxable fringe benefits have been properly handled. For example, if all employees are provided season tickets at no

cost, the value of the tickets given should be included in the employee's W-2, and proper FICA and FUTA paid. If appropriate, the assistance of an Employment Tax Specialist should be requested.

#### Player Personal Service Corporations

[56] A potential issue area is whether the sports franchise's players have formed personal service corporations (PSCs) through which their services are offered to the sports franchise. A PSC may have a tax impact on the individual player under IRC section 269A and IRC section 482. In addition, a PSC is likely to have a major employment tax impact on the sports franchise.

[57] In the case of a sports franchise and a player employed through his PSC, there is no issue as to whether the player is an employee or independent contractor. The issue is whether the player is an employee of the sports franchise or the PSC for employment tax purposes.

[58] An analysis of the evidence generally establishes that a sports franchise controls its players not only as to the result, but also as to the means and methods of accomplishing the result. Under the player contracts, players may not offer their services to any other sports franchise in the league. Additionally, the sports franchise normally pays for the players' expenses when the team is on the road.

[59] Generally, a sports franchise will be determined to be the employer of its players. Accordingly, the sports franchise is usually responsible for FICA and FUTA taxes on the compensation paid for player services even if they are paid to a PSC. See *Leavel v. Commissioner*, 104 T.C. 140 (1995).

#### COMPLIANCE STRATEGIES

[60] If you believe there may be a lack of compliance in your area for one or more of the issues covered in this ATG, you may want to recommend a district compliance initiative. In determining the appropriate compliance initiative strategy, consideration should also be given to taxpayer education, guidance, and assistance.

#### EXHIBIT 2-1

##### Sample Form 4564, Information Document Request

Form: Department of the Treasury -- Internal Revenue Service  
4564: Information Document Request

-----  
To: Subject

SAIN Number: Submitted to:

Dates of Previous Requests

Please have the following records available at the initial appointment:

1. The original partnership agreement and any amendments to the partnership agreement.
2. All contracts, agreements, and other similar documents between the partnership and any of its partners separate and apart from the partnership agreements. These may include, but not be limited to, employment agreements, management contracts, or other similar

transactions.

3. Retained copy of Form 1065, Partnership Income Tax Return, for the years ended \_\_\_\_\_, and \_\_\_\_\_, if filed, for inspection.
4. Copies of income tax returns for those partners who own directly or indirectly 10 percent or more of the partnership for the years ended \_\_\_\_\_, and \_\_\_\_\_, for inspection.
5. Copies of income tax returns for any other entity, regardless of form and regardless of whether taxable or tax-exempt, which is owned or controlled directly or indirectly by the same interests as the partnership for the taxable years \_\_\_\_\_ and \_\_\_\_\_.
6. The general ledger, year end tax workpapers, trial balance sheet, and adjusting journal entries for the taxable year ended \* \* \*. Please include a chart of accounts if the ledger accounts are identified by number only.
7. Bank statements, deposit slips, cancelled checks, credit/debit memoranda for all bank accounts for the taxable year ended \_\_\_\_\_.
8. The complete franchise agreement between the partnership and the league, as well as any other pertinent documents.
9. The complete lease agreement between the partnership and the City regarding the lease of the stadium, as well as any other pertinent documents, including any contracts regarding the renovation to the stadium to which the partnership may be a party.
10. Any agreements, contracts, and other documents with television stations and radio stations regarding rights to broadcast games or other special programming.
11. All agreements, contracts, and other documents regarding corporate sponsors, such as Official Team Bank, Official Team Health Care Provider, etc. which were in effect during \* \* \*. This includes all concession agreements.
12. Sample copy of season ticket agreements (original, as well as any later amendments, or terms in any form) for each category of seat, including club seats. A breakdown of the total number of seats in each category. A listing of season ticket holders, including name, date ticket purchased, total purchase price, date and amount of deposit, subsequent payments (if any), and remaining amount due. Also, a copy of the Payment Plan Agreement for each category of seat, which outlines the various payment options available to ticket holders.
13. Copy of the media package for the sale of sky box seats, as well as a listing of sky box seat holders, the cost of the sky box, the deposits received for the sky box seats (if any), and the remaining amount due from the sky boxes.
14. Sample cover letter to ticket holders transmitting coupon books for those who opted to pay by monthly check. If available, a sample coupon book. Similarly, a sample confirmation letter or signature authorization, if any, sent to those who opted for the automatic monthly withdrawal to pay for their tickets.

15. Listing of ticket holders who requested refunds of their deposits. The list should reflect the date the refund was requested, the date the refund was made, as well as the amount of the refund. Please provide five actual letters requesting a refund, as well as all correspondence from the team to the requestor (interim letter and letter transmitting the refund).

16. Copies of all player contracts negotiated in \_\_\_\_.

_____ Name and Title of Requester	_____ Date
_____ Office Location	_____ Phone

\* \* \* \* \*

SAMPLE INITIAL INTERVIEW QUESTIONS

TAXPAYER: YEAR:	EXAMINER:	DATE:
--------------------	-----------	-------

\_\_\_\_\_  
Interview with:

Time & place:

Other business entity name(s) used:

Address:

Telephone Number:

Power of Attorney:

Taxpayer contact person(s):

Explain all changes in the business organization of the taxpayer, purpose, entities involved, and when they occurred:

TMP address verification for future notices:

TMP's for other partnerships which are partners:

Names/Titles of Officers:

Are officers also involved with other entities?

Any related corporations, partnerships, trusts:

Related party transactions; sales/rentals, etc.:

Loans to or from partners:

What benefits, if any, do partners of the sports franchise receive (reduced sky box cost)?

Future plans: expansion, diversification, etc.:

Number of employees/duties (other than team players and coaches):

Prior audit/results:

Describe all changes in accounting methods:

Has a Form 3115, Request For Change In Method of Accounting, been filed since the filing of the tax return for \_\_\_\_\_ (the first year under examination)?

Amended return(s) filed/planned:

Describe the books and records maintained:

Where are the books and records kept?

Who is responsible for maintaining the general ledger?

Who prepares and who reviews the monthly adjusting journal entries?

Return prepared from what records, how long return preparer involved, etc.:

What types of receipts are received in cash versus by check?

Are all receipts deposited intact into a bank account?

Bank accounts:

Who authorizes expenditures: signs checks, how many signatures, etc.:

Who opens mail, posts receipts, prepares deposit slips, takes to bank, etc.:

Non-taxable sources of funds:

Determination of gross receipts per return:

Petty cash: how accounted, amount, vouchers, etc.; other cash on hand:

Expenses: cash/check, authorization:

Assets owned: real property, autos, etc.:

Vehicles owned/leased: purpose, used by whom, personal use accounting, etc.:

Employee/officer expense policy:

Types of insurance maintained: health, life, disability:

Law Suits: parties involved, when & where filed, nature of suit, and status:

Is there an expense/capitalization policy?

What is interest expense claimed for?

Describe any large or unusual expenses for the tax year:

What shared expenses, if any, does the team have with the league (player pensions, advertising, etc.)?



Are there any agreements between the team and the city, the league, local stations, vendors, etc. that are NOT in written form? Are there any bartering agreements with contractors or other parties?

Explain the sale of the season tickets; deposits & how they are accounted for; identify all refundable deposit or deferred income/revenue accounts:

Additional Questions :

### CHAPTER 3

#### SPONSORSHIP REVENUE

#### INDUSTRY PRACTICE

[61] A major source of revenue generated by a sports franchise is sponsorship revenue. Most sports franchises solicit local sponsors that want to be associated with the sport franchise's team name. Most notably, a sports franchise may have an official team bank, an official team television station, an official team radio station, an official team healthcare provider, etc. Sponsors pay significant sums of money to enter into these contracts, which usually cover multiple years. Unlike other categories of revenue, local area sponsorship revenue is generally not shared with other sports franchises in the league.

[62] The sponsorship agreements entered into, for the most part, represent advertising contracts. The sponsors receive specified advertising spots in radio broadcasts, television broadcasts, and team print media. Additionally, the sponsors usually receive stadium signage.

[63] The sports franchise usually receives significant advance payments from the various sponsors upon signing the contract, with periodic payments to be made during the remainder of the contract term. Often the sports franchise's tax return will reflect less than the total amount received during the initial year as current income. The remaining amount received will usually be reflected as deferred revenue. Depending on the length of the contract and the nature of the advance payment, some portion may be designated as long-term deferred revenue.

[64] Instead of including advance payments on multiple year sponsorship contracts in gross income during the tax year received, sports franchises often report advance payments prorata over the term of the contracts.

[65] Some contracts designate a portion of the advance payment as "exclusivity." This term indicates the vendor is the exclusive sponsor in a particular business segment (such as banking, television, radio, healthcare, etc.). The payment made for exclusivity is usually reported by sports franchises as income over the life of the contract, with the currently recognized portion representing only the current year's prorata share.

#### AUDIT ISSUE

[66] It should be determined whether the sports franchise has improperly deferred the reporting of sponsorship revenue. More specifically, whether the sports franchise is unable to rely on the income deferral provisions of Rev. Proc. 71-21, 1971-2 C.B. 549, because:

1. The sponsorship agreement provides for the provision of services after the end of the sports franchise's tax year following the tax year in which the advance payments are received, and for sponsorship agreements conferring exclusivity rights.

2. The advance payment is for property rights, rather than the provision of services by the sports franchise.

TAX LAW

Prepaid Income

[67] Under IRC section 451(a), "General Rule. The amount of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as from a different period."

[68] Treas. Reg. section 1.451-1(a) provides "\* \* \* Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. \* \* \*"

[69] A fixed right to receive income occurs when: (a) the taxpayer's required performance takes place; (b) payment is due; or (c) payment is received, whichever occurs first. Schlude v. Commissioner, 372 U.S. 128 (1963), and Rev. Rul. 79-195, 1979-1 C.B. 177.

[70] The history behind former IRC section 452 reflects Congressional intent to limit tax deferrals of prepaid income to just those narrow areas specifically provided by Congress (such as IRC sections 455 and 456). Former IRC section 452 permitted the deferral of prepaid income. The purpose of IRC section 452 was to bring tax accounting more in line with accepted business accounting for prepaid income. When IRC sections 452 and 462 (which allowed deductions for reserves for estimated expenses) were enacted with the Internal Revenue Code of 1954, the estimated revenue loss was \$ 45 million. A year later, after the American Institute of Accountants estimated the tax revenue loss resulting from these provisions to be around \$ 500 million, Congress retroactively repealed IRC sections 452 and 462.

Revenue Procedure 71-21

[71] Rev. Proc. 71-21 was published "to implement an administrative decision, made by the Commissioner in the exercise of his discretion under section 446, to allow accrual method taxpayers IN CERTAIN SPECIFIED AND LIMITED CIRCUMSTANCE to defer the inclusion in gross income for Federal income tax purposes of payments received (or amounts due and payable) in one taxable year FOR SERVICES to be performed by the end of the next succeeding taxable year."

Per section 2 of Rev. Proc. 71-21:

In general, tax accounting requires that payments received for services to be performed in the future must be included in gross income in the taxable year of receipt. \* \* \* The purpose of this Revenue Procedure is to reconcile the tax and financial accounting treatment of such payments in a large proportion of these cases without permitting extended deferral in the time of including such payments in gross income for Federal income tax purposes.

Section 3.02 of Rev. Proc. 71-21 provides:

An accrual method taxpayer who, pursuant to an agreement (written or otherwise), receives a payment in one taxable year for services, WHERE ALL OF THE SERVICES under such agreement ARE REQUIRED BY THE AGREEMENT AS IT EXISTS AT THE END OF THE TAXABLE

YEAR OF RECEIPT to be performed by him before the end of the next succeeding taxable year, may include such payments in gross income as earned through the performance of the services, subject to the limitations provided in sections 3.07, 3.08, and 3.11. HOWEVER, IF THE INCLUSION IN GROSS INCOME OF PAYMENTS RECEIVED IS PROPERLY DEFERRED UNDER THE PRECEDING SENTENCE AND FOR MY REASON A PORTION OF SUCH SERVICES IS NOT PERFORMED BY THE END OF THE NEXT SUCCEEDING TAXABLE YEAR, THE AMOUNT ALLOCABLE TO THE SERVICES NOT PERFORMED MUST BE INCLUDED IN GROSS INCOME SUCH SUCCEEDING YEAR, REGARDLESS OF WHEN (IF EVER) SUCH SERVICES ARE PERFORMED.

Section 3.03 provides:

Except as provided in sections 3.04 and 3.05, a payment received by an accrual method taxpayer pursuant to an agreement for the performance by him of services MUST BE INCLUDED IN HIS GROSS INCOME IN THE TAXABLE YEAR OF RECEIPT IF under the terms of the agreement as it exists at the end of such year: (a) ANY PORTION OF THE SERVICES IS TO BE PERFORMED BY HIM AFTER THE END OF THE TAXABLE YEAR IMMEDIATELY SUCCEEDING THE YEAR OF RECEIPT: OR (b) ANY PORTION OF THE SERVICES IS TO BE PERFORMED BY HIM AT AN UNSPECIFIED FUTURE DATE which may be after the end of the taxable year immediately succeeding the year of receipt.

[72] The Tax Court in *T.F.H. Publications, Inc. v. Commissioner*, 72 T.C. 623 (1979), determined that "advertising is considered a service." Thus, amounts received in advance for advertising are considered payments for future services to which Rev. Proc. 71-21 may apply.

[73] Advance payments under television contracts are not services, but are considered a property right -- the right to publicize the taxpayer's games. Accordingly, a taxpayer cannot defer the reporting of the advance payments received for television contracts under Rev. Proc. 71-21. The tax law section in Chapter 4 addresses the case law supporting this conclusion.

#### TAX LAW APPLICATION

[74] Advance payments received on most of a sports franchise's multiple year sponsorship contracts are unlikely to qualify for income deferral under the provisions of Rev. Proc. 71-21. As addressed above, per Rev. Proc. 71-21 sections 3.02 and 3.03, ADVANCE PAYMENT FOR SERVICES IS DEFERRED UNDER REV. PROC. 71-21 ONLY IF THE SERVICES ARE TO BE PROVIDED BY THE CLOSE OF THE NEXT TAXABLE YEAR. Accordingly, Rev. Proc. 71-21 only results in sponsorship income deferral if, under the specific sponsorship contract, the services are to be provided by the close of the sports franchise's tax year following the tax year during which the advance payment is received. This results in most advance payments for multiple year sponsorship contracts being ineligible for deferral under the provisions of Rev. Proc. 71-21.

[75] For advance payments that are not excluded from Rev. Proc. 71-21 deferral due to the requirement that the service be provided by the end of the tax year, following the tax year of receipt, only advance payments for services versus advance payments for property rights qualify for Rev. Proc. 71-21 deferral.

[76] In this guide, "exclusivity rights" are defined as a sponsor's payments to a sports franchise to promote the sponsor's association with the sports franchise as the exclusive sponsor for the specific market segment or industry (banking, television, radio, health provider, etc.).

[77] For advance payment issues on exclusivity rights, the primary argument is that Rev. Proc. 71-21 does not apply because it is an advance payment for property rights versus an advance payment for services, and then, if applicable, an alternative argument that Rev. Proc. 71-21 does not apply because the services are not provided by the end of the subsequent tax year. The distinction between property rights and services is further addressed in Chapter 4.

[78] When the examiner determines a sports franchise is unable to rely on Rev. Proc. 71-21 for income deferral, it is not uncommon for the sports franchise to argue that its sponsorship income is deferred based on the application of general case law on prepaid services. The case law on the taxation of fixed and definite prepaid services is addressed in Chapter 5.

#### EXAMPLE

XYZ, a professional sports franchise, entered into a sponsorship agreement with a local bank to be the official bank of the sport franchise. The contract provided the bank with a specified amount of advertising time during television broadcasts, radio broadcasts, as well as in the team magazine. Additionally, the sports franchise agreed to do all of its banking with the sponsor and would encourage its employees to do the same. The bank had the right to advertise itself as the official bank of the sports franchise.

The contract is for 5 years beginning on January 1, 1994, for a total contract price of \$ 6 million. The bank paid \$ 4.2 million on execution of the contract, which represented a \$ 3.75 million exclusivity rights fee and \$ 450,000 for the first year's advertising. On each anniversary date, the bank is to pay \$ 450,000 until the end of the contract.

On its 1994 calendar year tax return, XYZ included in gross income \$ 1.2 million on the bank sponsorship contract. This included \$ 450,000 for the first year's advertising and \$ 750,000 for the first year's pro rata share of the exclusivity rights fee (which is \$ 3.75 million divided by 5 years equaling \$ 750,000).

XYZ's balance sheet on December 31, 1994, reflected \$ 3 million of deferred revenue (the \$ 3.75 million total exclusivity rights fee less the \$ 750,000 amount reported in 1994). \$ 750,000 of the \$ 3 million was designated as a current liability, and \$ 2.25 million was designated as long term liability.

On its 1995 and 1996 calendar year tax returns, XYZ reported \$ 450,000 for the advertising fee paid in January and \$ 750,000 for the pro rata share of the exclusivity rights fee which had been pre-paid. At year end, XYZ's 1995 balance sheet reflected total deferred revenue of \$ 2.25 million, and XYZ's 1996 balance sheet reflected total deferred revenue of \$ 1.5 million.

The sports franchise's tax reporting of the local bank sponsorship contract is summarized as follows:

Tax Year	Advertising Fee Reported	Pro Rata Exclusivity Fee Reported	Exclusivity Fee Account Balance
1994	\$ 450,000	\$ 750,000	\$ 3,000,000

1995	\$ 450,000	\$ 750,000	\$ 2,250,000
1996	\$ 450,000	\$ 750,000	\$ 1,500,000

During an examination of the sports franchise's 1994-1996 tax returns, the examiner determined the exclusivity rights fee advance payment was an advance payment for property rights. The examiner's primary argument is Rev. Proc. 71-21 does not apply because it is an advance payment for property rights versus an advance payment for services, and, alternatively, that Rev. Proc. 71-21 does not apply because the services are not provided by the end of the tax year following the tax year in which the advance payment was received.

The alternative argument applies, because under the agreement existing at the end of the tax year in which the advance payment was received (the January 1, 1994 contract constituted the terms of the agreement at December 31, 1994), the sports franchise's services (assuming not property rights) are to be provided after December 31, 1995 (the end of the year following the tax year in which the advance payment is received).

The examiner's report adjustments are reflected as follows:

	1994	1995	1996
	_____	_____	_____
IRC section 446 Adjustment	\$ 3,000,000	(\$ 750,000)	(\$ 750,000)
Total Adjustment	\$ 3,000,000	(\$ 750,000)	(\$ 750,000)

The 1994 IRC section 446 adjustment includes in income the revenue improperly deferred to future years in the amount of \$ 3 million. The 1995 and 1996 IRC section 446 adjustments eliminate the \$ 750,000 of income improperly deferred from 1994 that was erroneously reported in each of these years.

Because the examiner's case was closed unagreed, the examiner prepared a Form 5346, Examination Information Report, for the sports franchise's subsequent tax years which were not yet filed or due to be filed when the examiner closed his case.

#### EXAMINATION TECHNIQUES

[79] Documents and information that should be obtained in determining whether you have one or more deferred sponsorship revenue issues include:

1. All agreements, contracts, and other documents regarding corporate sponsors, such as official team bank, official team health care provider, etc., that remain in effect during the tax year under examination. This includes all concession agreements.
2. A breakdown of current versus deferred revenue (both current and long-term deferred revenue) by contract.

[80] The breakdown of current versus deferred revenue should be tied to the income recognized during the current year, as well as the deferred revenue accounts on the return's balance sheet.

[81] The sponsorship contracts provide specific information on what the sports franchise is providing (advertising, game tickets, etc.), as well as the specific

payment, length, renewal, and other contract terms. Additionally, the contracts sometimes call for other up-front fees and should define what the fees cover.

[82] Since a tax distinction is made for advance payments for services and advance payments for property rights, the nature of the advance payments in question needs to be determined. In the context of sports franchises, what is often referred to in contracts as exclusivity rights may, in fact, be property rights.

[83] The precise nature of the payments as advertising or exclusivity rights can be determined by reference to the contracts themselves. Exclusivity rights contracts expressly provide for the sale of the rights to use team logos and name on letterhead, etc., to promote the association with the team. In some instances, the contracts refer to the transaction as a license. In such a circumstance, the contracts may not be in exchange for services, but in exchange for the taxpayer's property interest in the publicity of its enterprise.

[84] Proper application of the law for exclusivity rights would appear to require the examiner to first determine if the advance payment qualifies for Rev. Proc. 71-21 deferral (whether it is an advance payment for services or an advance payment for property rights) and then, only for advance payments for services, determine if the provisions of Rev. Proc. 71-21 are met. However, because the determination of the nature of the payment (services versus property rights) may be less clear and more time consuming than determining the timing of the services, the examiner may want to first determine if the subsequent year rule is met before addressing the nature of the advance payments.

[85] Because the sponsorship issue involves the timing of income, it constitutes a change in the sports franchise's method of accounting for sponsorship revenue. Accordingly, examiners need to follow the change in method of accounting issue procedures in raising sponsorship issues.

[86] The IRC section 481(a) adjustment amount is the deferred income balance at the beginning of the first tax year examined. The current year IRC section 446 adjustments are the yearly changes to the deferred income balances for each tax year beginning with the first year examined. This is illustrated in the issue example given earlier in this chapter.

## CHAPTER 4

### BROADCAST REVENUE

#### INDUSTRY PRACTICE

[87] Broadcast revenue is one of the single largest revenue generators for a sports franchise. Generally, national broadcasting contracts are consummated at the league level, with each sports franchise receiving a pro rata share. Additionally, sports franchises usually negotiate and enter into local broadcasting agreements on an individual basis. The income generated by local broadcasting agreements is usually not shared with the other sports franchises in the league.

#### National Broadcasting Contracts

[88] The leagues normally enter into multiple year contracts with various television networks for the sale of broadcasting rights to the games played among its sports franchises. The money received under these contracts is normally divided equally among each sports franchise in the league.

[89] Payments under the league contracts are generally made on a per-season basis; that is, the networks pay a fixed amount for the broadcasting rights for each season covered under the contract. The payments for each season may be made in installments, often quarterly. Depending on the sports franchise's tax year period, one or more of the installments may be received in a tax year immediately preceding the year in which the season takes place.

#### Local Broadcasting Contracts

[90] Individual sports teams usually enter into broadcasting agreements with both local television and radio stations for the sale of broadcasting rights to the games played at the home stadium. Similar to the national contracts, the local agreements are usually for multiple years. Additionally, the agreements may include other special programs; for example, a coach's show, pre-game show, post-game show, etc.

[91] The local agreements may also include team sponsorship; for example, an official team station. Generally, these contracts require a substantial payment upon contract execution, as well as periodic payments (normally annual) through the contract term. Again, depending on the tax year period, a sports franchise may receive a periodic payment in a tax year preceding the year to which the payment relates.

#### AUDIT ISSUE

[92] It is important to determine whether the sports franchise has improperly deferred the reporting of broadcast revenue. More specifically, whether the sports franchise is unable to rely on the income deferral provisions of Rev. Proc. 71-21 because the advance payment is for property rights, rather than for services provided by the sports franchise.

#### TAX LAW

[93] Whether broadcast revenue is received for services or property rights is addressed in this chapter. The general prepaid income tax law and Rev. Proc. 71-21, 1971-2 C.B. 549, are addressed in Chapter 3. The case law on the taxation of fixed and definite prepaid services is addressed in Chapter 5.

#### Services or Property Right?

[94] In *Pittsburgh Athletic Co. v. KQV Broadcasting Co.*, 24 F.Supp. 490 (W.D. Pa. 1938), the court addressed the issue of a baseball team's interest in the broadcasting rights to its games. Employees of a radio station were standing on a hill overlooking the stadium and broadcasting a play-by-play description of the games. In granting an injunction against the broadcast of the games, the court held:

It is perfectly clear that the exclusive right to broadcast play-by-play descriptions of the home games played by the 'Pirates' at their home field rests in the plaintiffs. \* \* \* That is a property right of the plaintiffs with which defendant is interfering when it broadcasts the play-by-play description of the ball games. \* \* \* The Pittsburgh Athletic Company by reason of its creation of the game, its control of the park, and its restriction of the dissemination of news therefrom, has a property right in such news.

In *Uhlaender v. Henrickson*, 316 F.Supp. 1277 (D. Minn. 1970), the defendants marketed a baseball table game. The game employed the names, numbers, and

statistics of the players in major league baseball. The players sued to enjoin the use of their names and statistics for profit. The court held:

It is this court's view that a celebrity has a legitimate interest in his public personality. A celebrity must be considered to have invested his years of practice and compensation in a public personality which eventually may reach marketable status. That identity, embodied in his name, likeness, statistics and other personal characteristics, is the fruit of his labors and is a type of property.

[95] In *Zacchini v. Scripps-Howard Broadcasting Co.*, 433 U.S. 562 (1977), the Supreme Court considered the interrelationship between a performer's right to publicity of his performance and the First Amendment. A television station had aired as a news clip the entire performance of a "human cannonball." The performer sued for compensation for the use of his professional property. The Court agreed that the First Amendment did not prohibit such a suit and described the plaintiff's interest as follows:

\* \* \* the State's interest in permitting a 'right of publicity' is in protecting the proprietary interest of the individual in his act in part to encourage such entertainment. As we later note, the State's interest is closely analogous to the goals of patent and copyright law.

[96] In *Board of Regent of the University of Oklahoma v. National Collegiate Athletic Association*, Civil No. 81-1209 (W.D. Okl. 1982), the court considered television contracts entered into by the NCAA for the broadcast of its member schools' football games. The plaintiffs, the Board of Regents of the University of Oklahoma and the University of Georgia Athletic Association, claimed that the contracts violated the Sherman Act, 15 U.S.C. sections 1 and 2. In holding the contracts violated antitrust laws, the court held:

The right to telecast college football games is the PROPERTY of the institutions participating in the games, and that RIGHT may be sold or assigned by those institutions to any entity at their discretion.

#### TAX LAW APPLICATION

[97] Regardless of whether the payments received by a sports franchise are from a national broadcasting contract or from a local broadcasting contract, the tax treatment is the same. In the case of a sports franchise, the right to receive the advance broadcast income is fixed for the tax year in which the amounts are received.

[98] Based on the court cases cited above, the payments received under television and radio broadcasting contracts are made not in exchange for services but in exchange for property rights (the sports franchise's proprietary rights in the publicity of its enterprise). The networks, local television stations, and local radio stations are not paying for services but rather for the right to exploit the sports franchise's property right. Accordingly, the Rev. Proc. 71-21 provisions that allow the deferral of income from services do not apply to the broadcast revenue of a sports franchise.

#### EXAMPLE

Sports franchise ABC receives a pro rata share of the league's national television broadcasting revenue. The contract entered into by the sports league and the national television



broadcaster for the 1994 through 1997 seasons was entered into on April 15, 1993. The national broadcasting contract provides for quarterly payments of the annual amount, payable the first day of each quarter. The first payment was to be paid October 1, 1993, with the last payment due July 1, 1997.

The sports franchise received \$ 7.5 million on October 1, 1993 applicable to the 1994 season. The sports franchise did not include the \$ 7.5 million in gross income on its 1993 tax return. Instead, the \$ 7.5 million was reflected in the balance sheet as a current liability. A supporting statement characterized it as deferred revenue.

The sports franchise received \$ 7.5 million on January 1, 1994, April 1, 1994, and July 1, 1994, applicable to the 1994 season. Additionally, ABC received \$ 10 million on October 1, 1994, applicable to the 1995 season. On its 1994 tax return, ABC reported \$ 30 million of broadcast revenue (the four \$ 7.5 million payments received on October 1, 1993, January 1, 1994, April 1, 1994, and July 1, 1994). The \$ 10 million received on October 1, 1994 was treated as deferred revenue.

The sports franchise received \$ 10 million on January 1, 1995, April 1, 1995, and July 1, 1995, applicable to the 1995 season. Additionally, ABC received \$ 12 million on October 1, 1995, applicable to the 1996 season. On its 1995 tax return, ABC reported \$ 40 million of broadcast revenue (the four \$ 10 million payments received on October 1, 1994, January 1, 1995, April 1, 1995, and July 1, 1995). The \$ 12 million received on October 1, 1995, was treated as deferred revenue.

In summary, the sports franchise's tax return deferred broadcast revenue balances attributable to the league's national television broadcast contract as follows:

December 31, 1993	\$ 7.5 million
December 31, 1994	\$ 10 million
December 31,	\$ 12 million

During an examination of the sports franchise's 1994 calendar year tax return, the examiner determined sports franchise ABC was not entitled to defer the reporting of its broadcast revenue under Rev. Proc. 71-21. The examiner's report adjustments are as follows:

	1994	1995
	_____	_____
IRC section 481(a) Adjustment	\$ 7,500,000	--
IRC section 446 Adjustment	\$ 2,500,000	\$ 2,000,000
Total Adjustment	\$ 10,000,000	\$ 2,000,000

The IRC section 481(a) adjustment is the deferred revenue balance at the beginning of the year of change (1994) of \$ 7.5 million. The 1994 IRC section 446 adjustment is the \$ 2.5 million increase in the deferred liability account balance from \$ 7.5 million at the beginning of 1994 to \$ 10 million at the end of 1994. The 1995 IRC section 446 adjustment is the \$ 2 million increase in the deferred liability balance from \$ 10 million at the beginning of 1995 to \$ 12 million at the end of 1995.

Because the broadcast revenue issue is a change in method of accounting, the examiner also picked up the sports franchise's 1996 tax return to make the IRC section 446 adjustment. Since the examiner's case was closed unagreed, the examiner prepared a Form 5346, Examination Information Report, for the sports franchise's subsequent tax years which were not yet filed or due to be filed when the examiner closed the case.

#### EXAMINATION TECHNIQUES

[99] Documents and information that should be obtained in determining whether you have one or more deferred broadcast revenue issues include:

1. All agreements, contracts, and other documents with national and local television and radio broadcasting regarding rights to broadcast the sports franchise's games (including special programming) that remain in effect for the tax year under examination.
2. Workpapers and schedules reflecting the amount of revenue recognized and the amount of deferred revenue at year end for each separate broadcast contract in which advance payments were received.

[100] The precise nature of the broadcast payments can be determined by analyzing the contracts. Usually, the contracts do not provide for the performance of any particular service. Instead, the contracts expressly provide for the sale of the rights to broadcast games. Generally, under the broadcasting contract terms and conditions, the broadcasting contracts are not service contracts within the meaning of Rev. Proc. 71-21.

[101] The primary argument is that Rev. Proc. 71-21 does not apply, because the advance payments are for property rights, not services. Then, if applicable, an alternative argument that if it is in fact an advance payment for services, then Rev. Proc. 71-21 does not apply because the services are not provided by the end of the subsequent tax year.

[102] Because the broadcast revenue issue involves the timing of the sports franchise's reporting of broadcast income, it constitutes a change in the sports franchise's method of accounting for sponsorship revenue. Accordingly, examiners need to follow the change in method of accounting issue procedures in raising this issue.

[103] The IRC section 481(a) adjustment amount is the deferred income balance at the beginning of the first tax year examined. The current year IRC section 446 adjustments are the yearly changes to the deferred income balances for each tax year beginning with the first year examined. This is illustrated in the example given in this chapter.

#### CHAPTER 5

#### SEASON TICKET REVENUE

#### INDUSTRY PRACTICE

#### Categories of Seating

[104] A major revenue source for a sports franchise is its ticket receipts. There are normally three categories of seats: regular or general admission seats, club seats, and luxury or skybox suites.

[105] A regular seat ticket entitles a sports fan admittance to the stadium for a specific game or a specific season of games. Generally, this category of seat contains no added benefits and the cost of the ticket is normally determined by seat location.

[106] Regular seat tickets can be sold on a game-by-game basis, although the majority are sold on a season ticket basis. Regular season seat tickets can be sold for a single season or for multiple seasons. For the sports franchise, the sale of season tickets ensures a stream of income for a specified time frame, as well as fan turn-out which can impact ancillary income; for example, parking revenue, concession revenue, etc.

[107] Normally, club seat tickets cost more than regular seat tickets, and in some cases as much as double. This additional cost is primarily due to the club seat location in the stadium, offering patrons a better view of the action; however, the increased cost is also due to the added benefits usually afforded these patrons.

[108] Club seat tickets entitle the ticket holders to admittance to the game, usually through a separate entrance from the general public; moreover, usually these sports fans also have access to a club facility at which they may purchase concessions in climate controlled surroundings before, during, or after the game. Additionally, the club area may include a lounge area in which the sports fans may socialize before, during, or after the game. Closed circuit television coverage allowing the patrons continued coverage of the field action while away from their seats is not uncommon in these facilities. Club seat ticket holders are often offered the right to acquire parking privileges close to the stadium.

[109] In the skybox category, the patron, normally a corporation, purchases a box of seats rather than a single seat. The number of seats in each box can vary within a particular stadium, depending on the stadium design and configuration. Similarly, the number of skyboxes varies from stadium to stadium.

[110] Skyboxes are the most expensive category of seats. This is not only due to the number of seats acquired, but also due to the facility and benefits provided as part of the skybox package.

[111] Usually, skyboxes are elaborate facilities, containing climate control, comfort seating, closed circuit television equipment, as well as kitchen and bar facilities. It is not uncommon for skybox patrons to also receive a preferred parking location either adjacent to the stadium or in close proximity.

[112] Club seat tickets and skyboxes are normally sold on a multiple season basis. This ensures the sports franchise a steady income stream for a specific number of years.

#### Accounting for Season Tickets

[113] Accounting for revenue from the sale of regular SINGLE SEASON ticket sales is straight forward. For both generally accepted accounting principles (GAAP) purposes and for tax purposes, the revenue is recorded as the games are played. This is true even if the playing season begins in one tax year and ends in the next tax year.

[114] Usually, the sale of MULTIPLE YEAR season tickets requires a commitment from the sports fan to purchase season tickets for a specified number of years.

Regardless of the seat category, the sports franchise normally issues terms and conditions, outlining the rights and obligations of both the ticket holder and the sports franchise. The terms and conditions usually specify the number of years for which the sports fan is obligated to purchase tickets, the cost of tickets per season (including any potential price increases), consequences to the ticket holder in the event of default, and other miscellaneous provisions.

[115] Multiple year season ticket sales, regardless of seat category, often require a security deposit. The terms and conditions usually contain provisions regarding the security deposit, including cancellation, application, and refund provisions.

#### AUDIT ISSUES

1. Whether the reporting of advance payments on multiple season ticket sales can be deferred, or instead can be included in gross income in the tax year received; and
2. Whether amounts treated by the sports franchise as non-taxable security deposits are, instead, taxable advance payments.

#### TAX LAW

##### Fixed & Definite Services

[116] Generally, payments received in advance are income to both accrual and cash basis taxpayers in the year of receipt, provided there is no restriction on the use of such payments. This income recognition rule holds true even though the advance payments are returnable upon the happening of some specified event. For accrual basis taxpayers, deferral of prepayments for future services is permitted, provided the services do not extend after the tax year following the year of receipt. Chapter 3 addresses the general year of income inclusion rules and Rev. Proc. 71-21, 1971-2 C.B. 549.

[117] While the general rule for tax purposes is that payments received for services to be performed in the future must be included in gross income in the taxable year of receipt, several courts have allowed deferral of prepaid income when the contract obligations to perform the services are fixed and determinable. *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968), *Boise Cascade Corp. v. United States*, 530 F.2d 1367 (Ct. Cl. 1976), cert. denied, 429 U.S. 867 (1976).

[118] In *Artnell* the court allowed the deferral of prepaid SINGLE SEASON baseball tickets because unlike *American Automobile Association v. United States*, 367 U.S. 687 (1961), and *Schlude v. Commissioner*, 572 U.S. 128 (1963), the time and extent of future services was certain (except for rained out games, the baseball games were played on a fixed schedule). The court in *Boise Cascade Corp.* also allowed the deferral of prepaid engineering services until the year the services were performed because performance was required on fixed dates or as expeditiously as possible. These courts reasoned "there were situations when deferral so clearly reflected income that it must be permitted."

[119] In the action on decision on *Boise Cascade Corp.*, dated February 19, 1986, the Service stated:

We believe that the reasoning of the Court of Claims is incorrect. The so-called 'fixed and definite' or 'certainty of performance' test, which suggests that income deferral might be possible if certain standards are met for the matching of deferred income with future services and expenses, (see *Artnell v. Commissioner*, 400 F.2d 981 (7th Cir. 1968)) is premised on a

misinterpretation of the Supreme Court's holdings in Schlude and A.A.A. In those cases, the Supreme Court cited as an 'additional ground' (Schlude, at 135) for disallowing income deferral the fact that the advance payments related to services which were to be performed without relation to fixed dates in the future. From this holding, it is argued that the Supreme Court 'left an opening' (Artnell at 984) allowing for deferral if the extent and time of future performance are 'certain'. However, there is no implication that the Supreme Court, in disallowing deferral of income in Schlude, A.A.A. and Michigan, intended expressly or impliedly to state a positive rule allowing for income deferral. To the contrary, advance payments for services to be rendered in future years and received without restriction as to use, are income in the year received by an accrual basis taxpayer. *RCA Corp. v. United States*, 664 F.2d 881 (2d Cir. 1981); *Simplified Tax Records, Inc. v. Commissioner*, 41 T.C. 75 (1963); *Popular Library, Inc. v. Commissioner*, 39 T.C. 1092 (1963).

Moreover, the fixed-and-definite theory, which argues by implication from the 'additional ground' in Schlude and A.A.A., overlooks the primary ground upon which the Supreme Court relied in refusing income deferral: the 'long-standing' (Schlude at 134) principle that 'accounting systems deferring prepaid income could be rejected by the Commissioner' (Id.) pursuant to the broad discretion given him by I.R.C. section 446. With certain limited exceptions, Service position is that all the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. See: Rev. Rul. 80-308, 1980-2 C.B. 162; Rev. Rul. 79-292, 1979-2 C.B. 287; Rev. Rul. 79-195, 1979-1 C.B. 177.

[120] The Service disagreed with both the Artnell and Boise Cascade decisions, and in response to the Artnell decision published Rev. Proc. 71-21. In the Action on Decision on Artnell, dated July 27, 1971, Chief Counsel stated "the Service will not follow Artnell to the extent the rules for deferral could be deemed to be broader than those contained in Rev. Proc. 71-21."

#### Advance Payment Versus Deposit

[121] A distinction between a deposit in the nature of a loan and an advance payment turns on the nature of the rights and obligations that are assumed when the deposit is made. The leading case addressing the taxability of customer deposits is the Supreme Court's opinion in *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990). In this case, the Supreme Court applied what has become known as the "complete dominion test" to determine whether customer deposits should be included in taxable income when received.

[122] In *Indianapolis Power & Light*, customers with poor credit (about 5 percent of all customers) had to make deposits to a utility to ensure prompt payment of future electric bills. The deposits were collected pursuant to terms established by a public utilities regulatory authority. The deposits would accrue interest if held for more than 12 months. The utility would refund the deposits upon termination of service or earlier if the customer demonstrated acceptable credit (by making timely payments for a certain period). The customer could receive a cash refund or could elect to apply the deposit as payment of his electric bill. The utility did not segregate the deposits, and the deposits were subject to its use and control.

[123] One of the major factors considered by the Supreme Court was the fact that the customers in this case could cancel at any time. The Court stated:

Here in contrast, a customer submitting a deposit made no commitment to purchase a specified quantity of electricity, or indeed to purchase any electricity at all. [Footnote 6] IPL's right to keep the money depends upon the customer's purchase of electricity, and upon his later decision to have the deposit applied to future bills, not merely upon the utility's adherence to its contractual duties.

The Supreme Court stated in Footnote 6:

A customer, for example, might terminate service the day after making the deposit. Also, IPL's dominion over a deposit remains incomplete even after the customer begins buying electricity. As has been noted, the deposit typically is set at twice the customer's estimated monthly bill. So long as the customer pays his bills in a timely fashion, the money he owes the utility (for electricity used but not yet paid for) almost always will be less than the amount of the deposit. If this were not the case, the deposit would provide inadequate protection. Thus, through the period the deposit is held, at least a portion is likely to be money that IPL has no real assurance of ever retaining.

[124] The Supreme Court held that control over the deposits, unrestricted use of the funds, and nonpayment of interest were not controlling factors in determining whether a taxpayer exercised complete dominion over deposits received or is obligated to repay the deposits. THE CONTROLLING FACTOR WAS THAT, AT THE TIME DEPOSITS WERE MADE, THE UTILITY HAD NO GUARANTEE THAT IT WOULD BE ALLOWED TO RETAIN THEM. The utility acquired the deposits subject to an express obligation to repay at some future date (at the time of termination of service or earlier, if the customer established good credit).

The Supreme Court noted:

The individual who makes an advance payment retains no right to insist upon the return of the funds. On the other hand, a customer submitting a deposit retains the right to insist upon repayment in cash, even though he may choose to apply the deposit to purchase goods. \* \* \*

An advance payment, like the deposits at issue here, concededly protects the seller against the risk that it would be able to collect money owed it after it has furnished goods or services. But an advance payment does much more; it protects against the risk that the purchaser will back out of the deal before the seller performs. \*\*\* Here, in contrast, a customer submitting a deposit made no commitment.

In section 3.03 of Rev. Proc. 91-31, 1991-1 C.B. 566, the Service stated:

Change in treatment of deposits. If a utility company consistently includes customer deposits in gross income in the year of receipt and those deposits are not taxed upon receipt under the decision in Indianapolis Power, a change in the treatment of those deposits is a change in method of accounting.

## TAX LAW APPLICATION

[125] Except perhaps for multiple season ticket contracts covering just two regular seasons, most multiple season contracts will not meet the requirement under Rev. Proc. 71-21 that the services be provided by the end of the tax year following the year of receipt. This Rev. Proc. 71-21 requirement is addressed in Chapter 3.

[126] There are significant differences between Indianapolis Power & Light and a professional sports franchise. First, the deposits in Indianapolis Power & Light were typically set at twice the estimated monthly bill. Advance payments/deposits required by sports franchises normally are exactly equal to the cost of one year's season ticket.

[127] Second, the customers in Indianapolis Power & Light were not obligated to purchase any electricity and could terminate the service at any time, requiring an immediate refund (either in cash or in credit). Multiple year season ticket holders, on the other hand, are usually obligated to purchase tickets for a specified number of years, which may range from 3 to 10 years, depending on the sports franchise and the seat category.

[128] The customers in Indianapolis Power & Light were assured of a complete refund upon termination. Thus, the customers controlled both the timing and the method of their refunds. In contrast, multiple year season ticket contracts often do not contain a cancellation provision whereby the ticket holder will receive an UNCONDITIONAL refund. Sports franchise multiple year season ticket contracts that do provide for "early" refunds often contain restrictions on the timing of the refund or the amount of the refund. For example, the contract may specify a refund will only be made if the ticket is resold and that the refund will be reduced by a reselling charge or cancellation charge.

[129] As a regulated utility, the taxpayer in Indianapolis Power & Light was required by the State to treat the amounts in question as deposits. Additionally, unclaimed deposits were required to be transferred to the State. While sports franchises are members of their respective leagues, they are not regulated entities. Thus, there are no industry regulations governing the accounting of a sports franchise's season ticket advance payments/deposits. Moreover, any unclaimed advance payments/deposits remain with the sports franchise.

[130] Another factor is the rights the sports franchise possesses with respect to the advance payments/deposits and the season ticket contracts. In a number of sports franchise cases, the sports franchise pledged the advance payments/deposits and season ticket contracts as security for third party financing. As stated earlier, control over the deposits and unrestricted use of funds are not the controlling factors in determining whether a taxpayer has complete dominion over the deposits and is obligated to repay deposits.

[131] Substance versus form is controlling for tax purposes. The Supreme Court noted in Indianapolis Power & Light:

When the Commissioner examines privately structured transactions, the true understanding of the parties, of course, may not be apparent. It may be that a transfer of funds, though nominally a loan, may conceal an unstated agreement that the money is to be applied to the purchase of goods or services.

[132] Generally, a sports franchise advance payment/deposit issue is not going to be a black and white issue. Each sports franchise's potential advance payment/deposit issue must be evaluated based on the sports franchise's unique facts and circumstances.

## EXAMINATION TECHNIQUES

[133] Documents and information that should be obtained in developing a sports franchise advance payment/deposit issue include:

1. The season ticket application packages. This may consist of the actual application submitted by a prospective season ticket holder, along with any attachments such as seating selections, payment options, etc. If different applications are used for different categories of seats, each type should be secured. The applications should provide basic information such as application fee required, cost of ticket (per season), location of seating, etc.
2. Sample copy of season ticket agreements (original, as well as any later amendments, or terms in any form) for each category of seat, including club seats. In some cases, the terms and conditions are significantly different for regular season tickets, club seats, and skyboxes.
3. A breakdown of the total number of seats in each seat category. A listing of season ticket holders, including name, purchase date of ticket, total purchase price, date and amount of the advance payment/deposit, subsequent payments (if any), and remaining amount due.
4. The payment plan agreement for each category of seat, which outlines the various payment options available to the season ticket holders. Sometimes sports franchises will offer the ticket holder the option to pay annually or pay monthly. The various payment plan agreements will specify the amount of each periodic payment, how many payments are due, when the payments are due, etc.
5. Sample cover letter to ticket holders transmitting coupon books for those who opted to pay by monthly check, and if available, a sample coupon book. Similarly, a sample confirmation letter or signature authorization, if any, sent to those who opted for an automatic monthly withdrawal to pay for their tickets.
6. A copy of the sports franchise's policy regarding liquidating damages, cancellation fees, resale fees, etc., when the multiple year season ticket agreements were entered into. If the sports franchise has a written policy, retain a copy for the case file workpapers. If the agreements or policies have changed over time, secure a copy of all agreement and policy changes through the date the examination is closed. Some policy changes may apply retroactively.
7. Listing of ticket holders who requested refunds of their deposits. The list should reflect the date the refund was requested, the date the refund was made, as well as the amount of the refund.
8. Sample packages of cancellation requests for each seat category. This would include the request from the ticket holder, the response from the team, any default letters sent, etc.
9. Sample renewal letters sent to ticket holders whose contracts were due to expire. Examiners need to analyze these letters to



determine the disposition of any advance payment/deposit which may have been paid up front by the ticket holder.

10. Media packages for the marketing of skyboxes. These often have separate marketing campaigns which are targeted to the larger local businesses.

[134] The contracts utilized for multiple season tickets, regardless of seat category, should be carefully analyzed. Additionally, it may be helpful to use a look-back approach. Securing refund packages may give some insight as to any unstated agreements. These packages may consist of refund requests from the ticket holder and response letters from the sports franchise, as well as the final letter transmitting or denying the refund.

[135] Depending on the length of time the sports franchise has been in existence, it may be helpful to trace the disposition of advance payments/deposits for those ticket holders who do not renew their seats. The invoice and correspondence sent for the final season should be inspected to ascertain if the sports franchise automatically applies the advance payment/deposit against the final season's ticket price.

[136] In developing a potential advance payment versus deposit issue, the examiner needs to look beyond the form of the sports franchise's privately structured contracts and agreements, and to focus on the substance of the rights and obligations of parties under the season ticket agreements. This includes consideration of unstated agreements and understandings among the parties. Substance versus form is controlling for tax purposes.

[137] Because the multiple year season ticket revenue issues addressed in this chapter involve the timing of the sports franchise's reporting of season ticket revenue, they constitute a change in the sports franchise's method of accounting for multiple year season contract revenue. Accordingly, examiners need to follow the change in method of accounting issue procedures in raising season ticket revenue issues.

#### POTENTIAL EMERGING ISSUE

[138] Some districts have raised the question of whether advance payments on season contracts are advance payments for property rights versus advance payments for services. Rev. Proc. 71-21 only applies to advance payments for services. Chapter 4 addresses the case law in this area and a similar issue for broadcasting rights. Chapter 3 addresses a similar issue for sponsorship agreements that convey exclusivity rights to the sponsor. This issue is currently under review by the Sports Franchise ISP Team and should be discussed with the ISP before proposing an adjustment to the taxpayer.

#### CHAPTER 6

##### RELOCATION INCENTIVES

##### INDUSTRY PRACTICE

[139] The number of major league sports franchises has increased over the last several years. For example, in 1991 there were 102 professional teams in the National Football League (NFL), National Basketball Association (NBA), National Hockey League (NHL), and Major League Baseball (MLB). In 1995 there were a total of 111 teams in these four major sports leagues. In addition, there has been a significant number of sports franchise teams relocating from one city to another.

[140] Cities and states may offer significant incentives to lure a sports franchise's team to a certain area, whether through expansion or through relocation. One incentive offered may be in the form of lease inducements for the use of a municipal stadium or arena. As with other commercial real estate leases, inducements to sports franchises may be in the form of cash advances, loans, and free or substantially reduced rental rates. City and state relocation incentives structured in the form of a cash advance or loan transaction may be income to the sports franchise.

#### AUDIT ISSUE

[141] It is necessary to determine whether sports franchise relocation incentives structured in the form of a cash advance or a loan are income to the sports franchise in the tax year received.

#### TAX LAW

[142] Under IRC section 61, gross income includes all income from whatever source derived. Gross income includes "accessions to wealth, clearly realized and over which the taxpayer has complete dominion." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[143] Generally, loan proceeds do not constitute income to the borrower because the benefit is offset by the obligation to repay. *United States v. Rochelle*, 384 F.2d 748 (5th Cir. 1967); *Arlen v. Commissioner*, 48 T.C. 640 (1967); *Vaughan v. Commissioner*, 67 CCH Tax Ct. Mem. 1936 (1994). Whether a specific transaction actually constitutes a loan, however, must be determined based on all the facts and circumstances. *Fisher v. Commissioner*, 54 T.C. 905 (1970).

[144] In *Milenbach v. Commissioner*, 106 T.C. 184 (1996), the Tax Court held that municipal funds received by a football sports franchise, repayable only from specific sources of revenue, were not loans and had to be included in gross income, because the obligation to repay the funds was not unconditional.

[145] The Tax Court in *Milenbach* found that the Raiders sports franchise announced in 1980 that it was moving from Oakland to Los Angeles. Under the terms of the agreement with the Los Angeles Memorial Coliseum Commission (LAMCC), the LAMCC loaned the sports franchise \$ 6.7 million under a promissory note to be repaid with 12 percent of the net receipts from operations of suites, or skyboxes, to be constructed by the sports franchise at the Los Angeles Coliseum. The agreement further provided that construction of the suites would begin as soon as practical as determined by the sports franchise.

[146] The sports franchise was to begin repayment of the loan 3 years after the completion of construction of the suites. The loan was non-recourse against the sports franchise, secured solely by the improvements to be made. The \$ 6.7 million loan was funded with a \$ 4 million advance in 1984, and by credits against rent due from the sports franchise during the years 1982 through 1986 in the total amount of \$ 2.7 million.

[147] The construction of the suites began in early 1987, but was halted shortly thereafter. Construction was stopped due to a dispute between the sports franchise and the LAMCC to perform certain improvements to the Los Angeles Coliseum. The sports franchise made no payments on the LAMCC loan and did not complete construction of the suites.

[148] The sports franchise relied on *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), to support its argument that the \$ 6.7 million represented a valid debt not includible in its taxable income.

[149] The Tax Court in Milenbach determined "The Supreme Court's reasoning does not support petitioner's position. \* \* \* The Raiders, unlike the power company, were not subject to an express obligation to repay within the lender's control." The Tax Court concluded:

The Raiders had the discretion to determine if and when the suites would be constructed, \* \* \* Although both documents limited the Raiders discretion by a standard of reasonableness, the agreements gave the Raiders great latitude in the timing of construction. \* \* \*

Repayment of the \$ 6.7 million was to commence 3 years after the construction of the suites, and repayment was to be solely from the net revenues from suite operations. If the Raiders did not construct the suites, which was the case, there would be no suite revenues to use for repayment. No default or alternative payment provision was included in the 1982 MOA [memorandum of understanding], the 1984 lease, or the promissory note. The nonrecourse promissory note was secured only by the improvements, i.e., the suites. When the Raiders did not construct the suites, the LAMCC was without a source for repayment.

[150] The Tax Court determined an unconditional, enforceable debt did not exist for tax purposes due to the contingent nature of the sports franchise's obligation. The court sustained the government's determination that the sports franchise had income in the years 1982 through 1986 equal to the amount of rental credits, and in 1984 the sports franchise had income from the additional \$ 4 million cash advance.

#### TAX LAW APPLICATION

[151] Relocation incentives which appear to be structured in the form of a cash advance or loan transaction may be income to the sports franchise. In the case of a cash advance or loan, the tax treatment will depend largely upon the terms under which the money is advanced. If the terms of the cash advance or loan do not establish an unconditional obligation to repay, the cash advance or loan may constitute taxable income to the sports franchise in the tax year received.

#### EXAMINATION TECHNIQUES

[152] Examiners should consider the transactions that the sports franchise may have with state or local government. Contracts, agreements, and related documents should be carefully inspected for relocation incentives that constitute income to the sports franchise. The substance of relocation provisions should be considered to determine if they conform with the form of amounts characterized as cash advances or loans.

#### CHAPTER 7

#### STRIKE FUND PAYMENTS

#### INDUSTRY PRACTICE

[153] A sports league owners' association may maintain a strike fund to loan funds to the league's sports franchises, as needed, during player strikes. At least one major sports league (National Football League) is known to have a strike fund. This chapter addresses the taxation of strike fund payments made by a sports franchise to the sports league owners' association.

[154] A sports league owners' association may establish a strike fund to provide a source of funds during player strikes. Typically, the strike fund is funded by pro rata assessments to the sports franchises in the league. The league's rules and the strike fund provisions usually determine the circumstances and categories of expenditures for which disbursements may be made from the strike fund. These provisions, however, are likely to be subject to suspension or modification by a vote of a specified number of league owners.

#### AUDIT ISSUE

[155] The issue to be determined is whether strike fund payments made by a sports franchise to the league association are deductible in the tax year in which they are paid or incurred, or whether they are instead nondeductible capital expenditures.

#### TAX LAW

[156] Under IRC section 162, ordinary and necessary expenses incurred in carrying on a trade or business are deductible in the tax year paid or incurred. IRC section 263(a) provides for the capitalization of capital expenditures. Treas. Reg. section 1.263(a)-2(a) requires the capitalization of costs having a useful life, extending beyond the close of the tax year in which the expenditure is paid or incurred. An expenditure that is otherwise an ordinary and necessary expense under IRC section 162 must be capitalized if it constitutes a capital expenditure under IRC section 263.

[157] The determination must be made of whether an expenditure is currently deductible or a capital expenditure is fact specific, and no one factor can control this determination. *National Starch & Chemical Corp. v. Commissioner*, 918 F.2d 426 (3d Cir. 1990). There is no readily available formula for determining in every context whether a particular expenditure is currently deductible or a capital expenditure. In *Welch v. Helvering*, 290 U.S. 111 (1933), the Supreme Court observed, "the decisive distinctions are those of degree and not of kind." Courts, however, have employed a variety of standards in making this determination.

[158] Capital expenditures are expenditures that result in a benefit to the taxpayer which could be expected to produce returns for many years in the future. *E.I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052 (3d Cir. 1970). Capital expenditures are expenditures with the purpose of betterment for the indefinite future or, for a time, somewhat longer than the current taxable year, in contrast to being devoted to the income production or other needs of the more immediate present. *General Bancshares Corp. v. Commissioner*, 326 F.2d 712 (8th Cir. 1964), cert. denied, 379 U.S. 832 (1964). See also, *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), *Indopco Inc. v. Commissioner*, 503 U.S. 79 (1992), and *National Starch & Chemical*.

[159] Notwithstanding the fact that there is no bright line test for determining, in all cases, whether an expenditure is currently deductible or a capital expenditure, the expenditures that create or enhance a capital asset are generally required to be capitalized. See *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), and the cases cited therein.

[160] In *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971), the savings and loan association was required to pay premiums to a secondary reserve maintained by the Federal Savings and Loan Insurance Corporation (FSLIC). Each insured association had a pro rata shared interest in the secondary reserve. Each association received an annual credit from the FSLIC for the earnings on its share of the secondary reserve. An association's share in the reserve was transferable for FSLIC approved situations of merger, consolidation, transfer of bulk assets,

and similar transactions. An insured association could obtain a cash refund of its pro rata share if its status as an insured was terminated.

[161] Based on these factors, the Supreme Court found that each insured association had a distinct and separate property interest in the secondary reserve, even though there was a possibility that the secondary reserve might be consumed by FSLIC's losses and never refunded to the association. The Supreme Court concluded the association's premium payments to the secondary reserve constituted capital expenditures.

[162] In contrast, in Rev. Rul. 82-15, 1982-1 C.B. 29, the taxpayer was required to pay its trade association increased dues earmarked for a loan fund to be used by any member of the association which was experiencing a strike and needed a loan to continue in business, and to continue to participate in collective bargaining with the labor union. There was no relationship between eligibility for, or the size of the loans and the dues payment uniformly required of members. The loans would be made only to the trade association's members during strikes, and then only under circumstances establishing that a member would not be able to continue in business and to bargain in good faith without a loan. Loan applications would be evaluated by using criteria similar to those used by lending institutions. Default on repayment would result in the initiation of collection procedures and suspension of the borrower's membership in the association. If the fund was terminated, any remaining amounts would be used to further the trade association's exempt purposes.

[163] The ruling held the increased dues did not result in the acquisition by the taxpayer of a permanent interest in property. The taxpayer's additional payments entitled the taxpayer only to the benefits of continued membership in the association, which included the use of the loan fund. Accordingly, the Service concluded the increased dues were current period expenses, not capital expenditures.

#### TAX LAW APPLICATION

[164] If a sports franchise is determined to have a separate and distinct property interest in a sports league's strike fund, then the strike fund payments may constitute a capital expenditure in the tax year paid or incurred; however, as addressed above, consideration of whether strike fund payments are currently deductible or capital expenditures is not limited to whether the sports franchise may have some continuing property interest in the strike fund. All relevant facts and circumstances need to be developed and considered. In addition, whether a sports franchise has separate and distinct property interest in the strike fund is a factual and legal question requiring detailed analysis.

[165] Relevant facts and circumstances in determining whether a sports franchise has a separate and distinct property interest in a league's strike fund include, but are not limited, to the following questions:

1. Are strike fund payments required payments of each sports franchise in the league or optional?
2. If strike fund payments are required, how is each franchise's required payment determined (pro rata, team player salaries, team revenue, etc.)?
3. If strike fund payments are required, what are the provisions for delinquent payments?
4. Does the league keep track of each individual sports franchise's accumulated payments to the strike fund?

5. For recordkeeping purposes, are earnings on strike funds allocated to the individual sports franchises based on their respective accumulated payments to the strike fund?
6. Does the league periodically provide an accounting to the league members of each member's accumulated strike fund payments and earnings?
7. Does the sports franchise reflect its share of the strike fund as an asset in its financial statements or tax returns?
8. Is the use of strike funds restricted to certain types of expenditures under specified circumstances?
9. Do strike funds specifically benefit a specific sports franchise to the extent of its accumulated strike fund payments and earnings?
10. Is there any relationship between a sports franchise's accumulated strike fund payments and its eligibility for strike fund loans or payments?
11. Are loans from the strike fund to be repaid and, if so, under what terms and conditions?
12. If a sports franchise is sold, how are prior strike fund payments accounted for by the sports league, the seller, and the buyer?
13. What are the provisions if the strike fund is terminated or a decision is made to reduce the amount of the strike fund?
14. What are the procedures for modifying the operating or distribution provisions of the strike fund (majority vote of owners, etc.)?
15. Does the sports franchise have a continuing economic or property interest in the strike fund?
16. Does the form of the strike fund provisions reflect the substance of the strike fund?

[166] To the extent that the sports franchise and sports league do not furnish documents and information to address the above and other relevant questions, it may be appropriate to take the position that the sports franchise has not established that strike fund payments are currently deductible.

#### EXAMINATION TECHNIQUES

[167] Initial documents and information that should be obtained in developing a sports franchise strike fund issue include:

1. The strike fund agreement,
2. The resolutions and minutes of league meetings in which the strike fund agreement and funding were discussed,
3. Financial statements or supplementary financial information of the sports league association which address the league

strike fund, and

4. Workpapers and schedules reconciling the amount deducted in the sports franchise's tax return to the amount in its books and financial statements. This includes reconciliation of accruals at the beginning and end of each year under examination.

[168] The above documents and information should be requested early in the examination. IT IS RECOMMENDED THAT ALL EXAMINER REQUESTS FOR RECORDS AND INFORMATION FROM A SPORTS LEAGUE BE COORDINATED WITH THE NATIONAL ISP SPORTS FRANCHISE TEAM. Because the sports league owners association may closely guard the details of its strike fund, consideration may need to be given to the issuance of a summons. ISSUANCE OF A SUMMONS TO A SPORTS LEAGUE SHOULD BE COORDINATED WITH THE NATIONAL SPORTS FRANCHISE ISP TEAM.

## CHAPTER 8

### STADIUM ISSUES

#### INDUSTRY PRACTICE

[169] The nineties have been a time of sports stadium construction and sports stadium expansion. The increasing significance of revenue generated by club seats and luxury suites, which offer an advantage to new and renovated stadiums, is a major impetus for stadium expansion.

[170] Expansion sports franchises and relocated sports franchises generally have new or renovated stadiums. In addition, established sports franchises are commonly pursuing stadium expansion or, in some instances, new stadiums.

[171] A major factor in a sports franchise's financial success includes having a favorable stadium deal. Numerous cities have proven their willingness to mortgage their futures through taxes and the sale of bonds to attract or keep a sports franchise.

[172] As a result of new stadium construction and city concessions, sports franchises in larger markets, once thought to have an insurmountable economic advantage over franchises in smaller markets, have, in many instances, been surpassed in profits and value by their smaller market counterparts. The willingness of cities to build stadiums and the large increases in revenues related to the new stadiums creates an environment where it appears that in many leagues a sports franchise will need new stadiums and favorable concessions packages to remain competitive in their league.

[173] The sports franchise will either own its stadium or lease it from another party. The stadium owner may be an entity related to the sports franchise, a public entity, or an unrelated third party. The sports franchise's stadium interests, leased or owned, are a strong component of the sports franchise's overall value; accordingly, the agreements between the sports franchise and the local sports authority tend to be heavily negotiated, lengthy, and complex.

[174] It is not uncommon for the owner of a sports franchise to also own other entities related to the sports franchise. For instance, one entity may own the actual sports franchise, while another separate entity may own the sport facility or hold the long-term lease to the facility. Additionally, another related entity could hold the concession contract, while yet another can provide the parking. The ways in which ancillary services can be segregated into separate entities is almost limitless. Moreover, most sports franchise owners also own other businesses

which, while unrelated to sports franchise operations (such as a television or radio station), may be enhanced by the ownership of a professional sports team.

[175] Examiners should consider whether the agreements among an owner's businesses are entered into on an arms-length basis. Since these related party transactions will, in all likelihood, be unique, a thorough analysis is required to determine the true nature of the transactions. When related party transactions are determined to be at less than arms length, IRC section 482 may be used to reallocate income and expenses in order to reflect the proper taxable income. The applicability of IRC section 267 should also be considered for transactions among related parties.

[176] Because there are different audit issues and audit risk for a sports franchise which owns its stadium and a sports franchise which leases its stadium, the ownership and lease of a sports stadium are addressed separately in this chapter.

## STADIUM OWNERSHIP

### Overview

[177] As with all real estate owned, there are burdens and benefits that go with a sports franchise's ownership of its stadium. The sports franchise that owns its stadium will have a large capital asset on its balance sheet, and significant depreciation will be claimed. Rental expense will be drastically reduced in comparison to a sport franchise that leases its stadium. Unless the city has made concessions (which is not unlikely), the sports franchise will probably have significant property taxes. A sports franchise that owns its stadium is also likely to have a higher payroll than a sports franchise that leases its stadium.

[178] Stadium ownership by a sports franchise or an entity related to the sports franchise is generally achieved through construction or acquisition. In both instances, the basis of the asset will be the costs directly and indirectly chargeable to the stadium and related facility assets.

[179] In computing depreciation, the value of the land is excluded from the depreciable assets. With new construction, the determination of land value is generally provided in a separate acquisition closing statement; however, when an existing stadium is acquired, the determination of land value is more problematic.

[180] The contract on the acquisition of an existing stadium should allocate the acquisition price as negotiated by buyers and sellers among the various assets acquired. Even though the buyer and seller have agreed on the purchase/sale price allocations, the examiner is not prevented from challenging allocations to reflect their actual fair market values.

## [181] AUDIT ISSUES

1. This issue relates to whether the allocation to land versus buildings and other depreciable assets is proper. As with any other purchase of real estate, the value allocated to land should be reviewed to determine its reasonableness.
2. Whether the depreciable assets have been assigned proper recovery periods is a further issue. There are various structural components which are considered to be part of the stadium structure. Some components, such as stadium seats, the score board and message board have a considerably shorter life than the stadium structure. Therefore, it is important to determine that assets have been appropriately classified and the correct recovery



period is applied in calculating depreciation.

3. For stadiums constructed using tax exempt bonds, another issue is whether the sports franchise properly used the alternative depreciation system versus the regular depreciation system.

#### Recovery Periods

[182] A sports stadium is a single purpose structure in that it provides spectator space for the viewing of sports and other events. It is limited to this functional use and is not readily adaptable to other more general business use or activities. A sports stadium is nonresidential real property. Accordingly, the stadium structure and its structural components normally have a recovery period of 39 years.

[183] The term "structural components" includes parts of the building such as: walls; partitions; floors; ceilings; permanent coverings such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; escalators and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.

[184] There are certain stadium-related assets which are considered personal property in nature and are, therefore, entitled to a shorter recovery period than the stadium structure and its structural components. Rev. Rul. 69-170, 1969-1 C.B. 28, addresses whether stadium seats and other miscellaneous items associated with a sports stadium qualify as IRC section 38 property for purposes of investment credit. This ruling indirectly provides guidance on what assets, associated with a sports stadium, qualify for recovery periods separate from (and thereby qualifying for shorter recovery periods) the stadium building and its structural components.

[185] The taxpayer in Rev. Rul. 69-170 operated a concrete and steel baseball stadium. The items of property in question were the stadium seats, score boards and message board (including equipment and circuitry), field lights, backstop, batter's eye screen, foul and flag poles, and signs.

[186] The stadium seats were wooden with metal frames and were attached to the stadium with bolts that were embedded in the concrete floor.

[187] The backstop was located behind home plate and was made of wire mesh attached by cables to the stadium structure. The batter's eye screen was located in center field and consisted of a metallic screen across steel poles that were attached to concrete foundations with steel bolts. The foul and flag poles were four steel poles embedded in concrete and were separate from the stadium structure.

[188] The score boards and message board were in the nature of electrical signs. Both were mounted on large steel poles, attached to concrete foundations with steel bolts. These boards were separate and apart from the stadium structure.

[189] The field lights consisted of eight clusters of lights, each cluster having approximately 200 bulbs. Each cluster of lights was supported by steel poles that were attached to concrete foundations with steel bolts. Six of these steel poles were attached to foundations that were part of the stadium structure while the other two had foundations set apart from the structure.

[190] The signs consisted of numerous directional and traffic signs located in the parking lots and traffic lanes adjacent to the stadium.

[191] The Service ruled the stadium seats, the backstop, the flagpoles mounted on the stadium, and the equipment and circuitry contained in or attached to the score boards, and the message board were tangible personal property. In contrast, the Service ruled the score boards and message board (excluding equipment and circuitry), field lights (including those mounted on the stadium), batter's eye screen, foul line poles, flagpoles (excluding those mounted on the stadium), and sign structures (including the basic signs) were other tangible property.

[192] A change in the useful life of property under IRC section 167 is not a change in method of accounting. Treas. Reg. section 1.446-1(e)(2)(ii)(b). The allowed or allowable depreciation provisions apply to IRC section 167, useful life changes.

[193] A change in the recovery period of a class of assets under IRC section 168 is a change in method of accounting. Accordingly, the allowed or allowable depreciation provisions do not apply to recovery period changes under IRC section 168. Instead, the IRC section 481(a) and IRC section 446 change in accounting method provisions apply.

Tax Exempt Bond Financing

[194] IRC section 168(g) requires the use of the alternative depreciation system for tax exempt bond-financed property. Under the alternative depreciation method, the straight line method is used and the applicable recovery periods are:

	Recovery Period	
	-----	
1. Property not described in 2 or 3 property with no class life	the class life	2. Personal
residential rental property	12 years	3. Nonresidential real and
40 years		

EXAMINATION TECHNIQUES

[195] Documents and information that should be obtained for sports franchises that own their sports stadium include:

1. stadium agreement(s),
2. purchase/sale contract(s),
3. appraisals,
4. real property tax assessments,
5. tangible tax returns, and
6. depreciation schedules and workpapers.

[196] Inspection of real property tax assessments and tangible tax returns filed is often a quick and easy way to determine the examination potential of allocation issues. Chapter 10 addresses purchase/sale price allocations in more detail.

[197] Consider whether the sports franchise is improperly treating categories of assets as being separate from the stadium building and its structural components. The sports franchise's recovery period characterizations of tangible personal property should be reviewed.

[198] Apply the allowed or allowable depreciation provisions to IRC section 167 useful life changes. Apply the IRC section 481(a) and IRC section 446 change in

accounting method adjustment computation provisions and change in accounting method examination procedures for a change in the recovery period of a class of assets under IRC section 168.

## STADIUM LEASES

### Overview

[199] If the stadium is being leased by the sports franchise, then leasehold improvements are a potential issue area. The general rule is that depreciation of improvements to real property, subject to a lease, is calculated in the same manner as the depreciation deduction for the underlying property would have been calculated had the property been placed in service at the same time as the addition or improvement, without regard to the lease term.

[200] The IRC section 467 rental agreement provisions may apply to a sports franchise's lease arrangements.

### [201] AUDIT ISSUES

1. Whether amounts claimed as repair and maintenance expenses are lease improvements that should be capitalized under IRC section 263.
2. Whether depreciation is being properly computed on leasehold improvements.
3. Whether IRC section 267 or IRC section 482 apply to lease payments to related parties.
4. Whether IRC section 467 is properly applied to rental arrangements.

### Leasehold Improvements

[202] Since a stadium lease is generally long term in nature, the examiner should consider whether amounts classified by the sports franchise as repair and maintenance expenditures are instead leasehold improvements that should be capitalized.

[203] The right to claim depreciation is not predicated on ownership of property, but on an investment in the property. The cost of improvements made by a lessee are generally depreciable. IRC section 168(i)(8)(A).

[204] Under IRC section 168, the depreciation of a capital asset is computed without regard to the lease term; thus, the cost of the improvement is recovered over the applicable recovery period. If, upon termination of the lease, the lessee does not retain the improvements, gain or loss is computed by reference to the adjusted basis in the improvements. IRC section 168(i)(8)(B).

[205] If the leasehold improvements are financed with tax exempt proceeds, under IRC section 168(g)(3)(A) the recovery period used for purposes of the alternative depreciation system is not less than 125 percent of the lease term.

### IRC Section 467 Rental Agreements

[206] IRC section 467 rental agreements include leases in which the sum of the lease payments are in excess of \$ 250,000, and either (1) at least one amount, allocable to the use of the property in one calendar year, is payable after the

close of the subsequent calendar year, or (2) there are periodic increases in the rent.

[207] IRC section 467 requires both the lessor and lessee to report rental income and expense (and interest on rent) using an accrual method of accounting. Under IRC section 467, one of three different accrual methods may apply depending on the circumstances:

1. constant rental accrual;
2. accrual in accordance with the allocation of rents provided in the rental agreement, or
3. accrual in accordance with the allocation of rents provided in the rental agreement, adjusted to take into account present value concepts.

[208] The proper IRC section 467 accrual method must be determined on a lease-by-lease basis.

[209] The constant rental method of IRC section 467(b)(2) applies when:  
(1)

the rental agreement contains no allocation of rents, or (2) the rental agreement contains an allocation with stepped rents, a principal purpose for providing the stepped rents is avoidance of tax, and the agreement is either a leaseback or long-term agreement. If a rental agreement does not specify how much rent is allocable to the periods under the lease, the rent payment schedule should be treated as the rent allocation schedule. Because almost all rental agreements contain rent payment schedules, rarely will a rental agreement be subject to the constant rental accrual method because of a failure to allocate rent.

[210] If the constant rental method applies, the agreement of the parties concerning the allocation of rent will be totally disregarded, and the rent leveling provisions of IRC section 467(b)(2) will determine the income and expenses for each taxable year during the rental period. The constant rental amount is defined in IRC section 467(e)(1) as the amount which, if paid as of the close of each lease period under the agreement, would result in an aggregate present value equal to the present value of the aggregate payments required under the agreement. Section 1.467-3 of the proposed IRC section 467 regulations provides a formula for determining the constant rental method.

[211] For an IRC section 467 rental agreement for which the constant rental method does not apply, rents are generally recognized as specified in the rental agreement. The parties will be required to report the rent allocable to the period on the accrual basis regardless of their method of accounting; thus, there will be "matching" on an accrual basis by both lessors and lessees.

[212] If the payment of rent is deferred and adequate interest is not charged on the deferred rent, the amount of rent allocated to a period must be discounted to its present value, and interest on the unpaid rent must be taken into account as it accrues. One reasonable method for discounting rent to present value is contained in section 1.467-2 of the proposed regulations.

[213] The section 467 regulations also apply IRC section 467 rules to rental agreements providing for prepaid rent and/or decreasing rents. In some cases a sports franchise may lease a stadium from a tax-exempt entity. In such cases, if the rental agreement has decreasing rents, and if it is subject to the final section 467 regulations, application of the constant rental method should be considered.

[214] The above constitutes just an overview of the detailed IRC section 467 provisions. More detailed guidance on IRC section 467 can be found in the Construction ISP team's coordinated issue papers entitled:

- Section 467 Rental Agreements -- The Constant Rate Method, and
- Section 467 Rental Agreements -- The Economic Accrual Method.

#### EXAMINATION TECHNIQUES

[215] Documents and information that should be obtained in developing the sports franchise stadium lease include:

1. lease agreements,
2. concession agreements,
3. audited financial statements (the terms of the lease agreements and related party transactions should be disclosed in the footnotes),
4. workpapers and schedules on the application of IRC section 467,
5. copies of the returns of any related entity returns involved, and
6. workpapers and schedules reconciling the amount deducted on the return with the amounts per the books (Schedule M-1). This should include year end accruals.

[216] Large repair and maintenance costs should be reviewed to determine if they are in the nature of a capital improvement.

[217] If the lease payments are to a related party, then IRC section 267 or IRC section 482 may apply. Generally, under IRC section 267, related entities are required to use the same method of accounting so that there is no mismatching of income and expense between the two parties. To clearly reflect income and prevent the evasion of taxes, IRC section 482 enables examiners to re-allocate income and expense among entities when the transactions are not at arms length.

[218] With respect to IRC section 467, the first step is to determine if you have an IRC section 467 rental agreement. The second step is to determine whether the constant rental method or the economic accrual method applies. The third step is to determine whether the constant rental method or the economic accrual method provisions were properly applied by the sports franchise.

[219] Because the application of IRC section 467 involves the timing of the sports franchise's lease expenses, IRC section 467 issues constitute a change in the sports franchise's method of accounting for leases. Accordingly, examiners need to follow the change in method of accounting issue procedures in raising an IRC section 467 issue.

## CHAPTER 9

### AMORTIZATION

#### OVERVIEW

[220] Amortization issues are likely to have more examination potential for sports franchises than for most other categories of taxpayers. There are two reasons for this.

[221] The first is the significance of player contracts to a sports franchise. Player contracts are likely to represent the most significant asset category of a sports franchise. Because player contracts are amortized over the useful lives of the individual player contracts, which typically range from 3 to 6 years, this is likely to represent the greatest expense category of the sports franchise.

[222] With respect to player contracts not acquired in connection with the acquisition of the sports franchise, issues arise on the tax treatment of player signing bonuses, performance bonuses, and other contract contingencies. In addition to determining the amount subject to amortization, issues arise in the determination of the useful lives of the individual player contracts and the dates the contracts are placed in service.

[223] The second reason amortization has greater audit potential for most sports franchises than taxpayers in other market segments is the fact that IRC section 197(e)(6) provides that if a franchise is engaged in professional sports, any item acquired in connection with such a franchise is excluded from IRC section 197 amortization. Because a sports franchise does not have a determinable useful life, the franchise intangible asset is not eligible for amortization under IRC section 197. Issues exist on whether items treated as separate intangible assets are, instead, part of the franchise intangible asset. For items determined to be separate from the franchise intangible asset, the question then becomes whether the intangible asset has an ascertainable value and a determinable useful life.

[224] Although the government has not always been successful in arguing that an intangible asset does not have an ascertainable value separate from goodwill, going concern value, and the franchise intangible asset, the government has been successful in arguing most separate intangible assets do not have determinable useful lives. For example, as addressed in this chapter, the government has successfully established in court that broadcasting rights are not subject to amortization because they do not have determinable useful lives.

[225] The following summarizes the likely intangible asset categories of a sports franchise and their general amortization periods:

Intangible Asset Category	General Amortization Period
Organizational expenses	Amortized over 60 months if an IRC section 248 or 709 election is made
Player contracts	Amortized over the useful lives of the specific player contracts (which average between 3 to 6 years)
The franchise	No amortization, not an IRC section 197 intangible, has an indefinite useful life
Other intangible assets in connection with the acquisition of the sports franchise it has: (1) an ascertainable value separate from goodwill, going	Not an IRC section 197 intangible, acquired in connection with the acquisition of the sports franchise; this usually results in not being amortizable concern value, and the franchise intangible asset, and (2) has a determinable useful life; this usually results in not being amortizable

Start-up expenses	Amortized over 60 months if IRC section 195 is elected
Lease and loan costs	Amortized over the life of the lease or loan

#### PLAYER CONTRACTS

#### AUDIT ISSUES

1. Whether the cost basis of player contracts not acquired in the acquisition of the sports franchise have been properly computed.
2. Whether the useful lives used for the individual player contracts are proper.

#### Tax Law Application

[226] A player contract is an intangible asset to the sports franchise. Player contracts are likely to represent the most significant costs incurred in the operation of a sports franchise.

[227] A player contract is a contract for the services of an athlete employed by the sports franchise. A player contract is likely to obligate the player to:

(1) play the sport solely for the sports franchise, (2) not participate in certain other sports, (3) attend team practices, meetings, and perhaps promotional events, and (4) keep himself in top physical condition.

[228] Player signing bonuses have become common. Some player contracts may contain performance bonuses. More than the specified period of the player contract, most player contracts contain renewal and team option provisions which extend the useful life of the contract.

[229] The provisions of IRC section 461 are applied in determining a sports franchise's cost basis for player contract amortization. Under Treas. Reg. section 1.446-1(c)(1)(ii)(A), a liability is incurred, and generally is taken into account for federal income tax purposes in the taxable year in which all events have occurred that establish the fact of the liability, and the amount of the liability can be determined with reasonable accuracy. Under IRC section 461(h)(2)(A), economic performance for services provided to a taxpayer occurs as the services are provided.

[230] The cost of a player contract to a sports franchise is the total amount incurred by the sports franchise on the player contract under IRC section 461. Signing bonuses are included in the cost of the player contract. Performance bonuses and other contingent payments are not taken into account until the sports franchise's obligation to pay becomes certain.

[231] While the contractual terms of player contracts vary with the type of sport involved, the typical contract will provide employment for more than one year. Even when the player contract is just for one year, the employer usually has a unilateral option to renew the contract an additional year or more at a specified percentage of the player's previous salary.

[232] Generally, an accrual basis taxpayer is entitled to deduct unpaid expenses for the taxable year in which all the events have occurred which determine the fact of liability and in which the amount can be determined with

reasonable accuracy. Under this general rule, accrued salaries would ordinarily be deductible expenses for the taxable year in which the salaries are earned by the employees, even if paid in the following taxable year. Any expenditure, however, that results in the acquisition of an asset having a useful life which extends beyond the close of the taxable year may not be deductible for the taxable year in which the liability for the expenditure was incurred. Treas. Reg. section 1.263(a)-2.

[233] The cost of a player contract having a useful life of more than a year must be capitalized and amortized over the useful life of the contract. The sports franchise's player contracts are amortized under IRC section 167. Amortization is computed on each individual player contract based on the useful life of the individual player contract. Treas. Reg. section 1.167(a)-1(b) provides the estimated useful life of an asset is the period over which it may reasonably be expected to be useful to the taxpayer.

[234] In general, the period over which the cost of a player contract is amortizable includes periods in which the club controls the player through options to renew the contract or restrictions on the ability of the player to contract with other clubs. In Rev. Rul. 67-379, 1967-2 C.B. 127, the Service ruled that due to reserve clauses, a player contract often has a useful life extending beyond the taxable year in which the contract was acquired. The Service ruled the same for option clauses or any other clause which gives the sport franchise the opportunity to unilaterally extend the existing contract. Although the useful life varies from sport to sport and player to player, the sports franchise's player contracts typically have useful lives averaging from 3 to 6 years.

[235] The placed-in-service date of the player's signing bonus is the date all required signatures are affixed to the contract. Accordingly, a sports franchise begins claiming amortization on the player contract, including the signing bonus, when the necessary signatures are affixed to the player contract.

[236] General guidance on the amortization of the sports franchise's player contracts can be found in:

1. Rev. Rul. 67-379, 1967-2 C.B. 127,
2. Rev. Rul. 70-318, 1970-1 C.B. 113, and
3. Rul. Rul. 71-137, 1971-1 C.B. 104.

[237] In amortizing player contracts, care must be taken to distinguish payments made to third parties to acquire a player contract, as opposed to payments made to a player pursuant to the underlying contract. Payments made to acquire a player contract are to be amortized over the life of the contract. Payments made to a player pursuant to the contract may constitute straight salary which is deducted as economic performance occurs. On the other hand, such payments may constitute disguised payments for other contract rights (for example, options to extend the contract, exclusivity agreements extending beyond the "salary" payment period, etc.). In such cases, the ostensible salary payments should be divided into two portions; amounts allocable to services and amounts allocable to other contract rights. Amounts allocated to payments for services should be deducted as economic performance occurs. Amounts allocated to other contract rights should be amortized over the life of the contract.

[238] EXAMPLE -- PLAYER CONTRACT AMORTIZATION

BCD sports franchise, a calendar year taxpayer, and STAR athlete agree to a player contract for STAR. The player contract is signed by all parties on July 1, 1994. The player contract is



for 3 years from the signing date and includes 2 renewal periods. BCD sports franchise has the option to extend STAR's contract to a fourth and fifth year. Under the contract, STAR can request salary renegotiation at the end of the third year. If STAR chooses salary renegotiation, and STAR and the BCD sports franchise do not agree on the renegotiated contract terms, then BCD sports franchise has the right to sell or trade STAR's player contract to another sports franchise in the league.

Under the player contract, STAR receives a \$ 200,000 signing bonus. STAR's base salary (payable monthly) is \$ 150,000 the first year, \$ 120,000 the second year, and \$ 150,000 for the third year, and each season runs from July 1 to June 30. The base salary for the fourth and fifth years (renewal option years) is \$ 150,000 each year. The examiner makes a factual determination that \$ 50,000 of the first year's "salary" is actually a disguised payment for the option to extend the contract for the fourth and fifth years.

The contract also provides for both team and player performance bonuses. In any season in which the sports franchise's team meets a specified team goal, STAR is paid a team performance bonus. In any season in which the team plays in the league conference championship game, STAR receives a \$ 30,000 team performance bonus. In any season in which the team wins the league's championship game, STAR is paid an additional team bonus of \$ 50,000.

In any season in which STAR is named to the league's all star team, STAR receives a \$ 20,000 performance bonus. In any season in which STAR is voted the league's most valuable player, STAR is to receive an additional \$ 50,000 player performance bonus.

In year two, STAR made the league's all star team (\$ 20,000 player performance bonus). In year three, the sports franchise made it to the league's championship game (\$ 30,000 team performance bonus).

The useful life of the player contract is 5 years (the 3 year contract period plus the two 1-year renewal option years). Amortization begins on July 1, 1994, the date all parties signed the player contract. The amortized player contract tax basis does not include performance bonuses since these are contingencies. Accordingly, the amortized tax basis in the player contract consists of the \$ 200,000 player signing bonus and the \$ 50,000 disguised first year payment for options. BCD's amortized tax basis in the STAR player contract is computed as follows:

\$ 200,000	Player Signing Bonus
\$ 50,000	Disguised First Year Payment for Options
<hr/>	
\$ 250,000	Amount to be Amortized

BCD's yearly amortization on its STAR player contract is:

First Tax Year	\$ 50,000
Second Tax Year	\$ 50,000

Third Tax Year	\$ 50,000
Fourth Tax Year	\$ 50,000
Fifth Tax Year	\$ 50,000
Total Amortization	<u>\$ 250,000</u>

Additionally, salary amounts are to be deducted as economic performance occurs.

Because ratable amortization is allowed as STAR furnishes the services to the BCD sports franchise, economic performance occurs under the provisions of IRC section 461(h) as the ratable amortization is allowed.

BCD is also entitled to additional deductions for the second year player performance bonus (\$ 20,000) and the third year team performance player bonus (\$ 30,000). The tax year in which BCD deducts these bonuses is the year in which these are allowed under BCD's overall method of accounting (which is usually the cash method or the accrual method of accounting).

#### EXAMINATION TECHNIQUES

[239] Documents and information that should be obtained in developing sports franchise player contract amortization issues include:

1. For the prior, current, and subsequent tax years:
  - a. the sports franchise's schedules and workpapers reflecting:
    - 1) the player contracts owned by the sports franchise,
    - 2) the sports franchise's tax basis in each player contract, and
    - 3) the useful life used by the sports franchise for each player contract.
  - b. to the extent not included in "a," copies of the schedules and workpapers used to compute player contract amortization. This should include any schedules and workpapers necessary to reconcile this with the total player contract amortization amount reflected on return Form 4562.
2. Depending on the number of player contracts owned by the sports franchise, copies of all or a sampling of the player contracts.

[240] To reduce taxpayer burden and sharpen your examination focus, you may want to address the sports franchise's player contract business practices before deciding which player contract to request. For sports franchises with a large number of player contracts, you should consider conducting a skewed sampling of player contracts based on their likely issue potential. For example, consider first focusing on:

1. the sports franchise's marquee player contracts (likely to be higher dollar contract amounts and more likely to have

bonuses, options, and contingencies),

2. player contracts that have certain characteristics (such as bonus provisions, options, or contingencies), and
3. player contracts with short useful lives.

[241] A common examination technique many examiners use for taxpayers claiming significant amounts of depreciation or amortization is to analyze the taxpayer's prior and subsequent years' depreciation and amortization schedules. Due to the significance of player contract amortization, this is likely to be a good examination technique for most sport franchise examinations. Check to ensure the cost basis and useful lives used are consistent from year to year. Player contracts on the prior or current year's schedule that are omitted from the current or subsequent year's schedule should be reconciled to the sports franchise's player contract gain and loss return schedules.

[242] The following player contract issues constitute a change in the sports franchise's method of accounting for player contracts:

1. a change from expensing to capitalizing all player contracts or categories of player contracts, and
2. a change in the sports franchise's method or policies in determining its tax basis in player contracts under IRC section 461.

[243] The IRC section 481(a) and IRC section 446 change in accounting method adjustment computation procedures (versus the allowed or allowable depreciation rule) apply to player contract change in method of accounting issues.

[244] Because the change is a change in the useful life under IRC section 167 versus a change in recovery period under IRC section 168, a change in the useful lives of individual player contracts is not a change in the method of accounting. Accordingly, the allowed or allowable depreciation rule applies to player contract useful life changes.

#### INTANGIBLE ASSETS ACQUIRED IN THE ACQUISITION OF A SPORTS FRANCHISE

##### Audit Issues

1. Whether in the acquisition of a sports franchise, the allocation of the purchase price among player contracts, the franchise, other intangible assets, and other assets is proper. This is addressed in Chapter 10.
2. Whether intangible assets other than player contracts acquired in connection with the acquisition of a sports franchise have an ascertainable value and determinable useful life: A major issue area is broadcasting rights, which the government has successfully argued do not have a determinable useful life.

##### Tax Law Application

[245] The franchise intangible assets and other intangible assets acquired in the acquisition of a sports franchise are specifically excluded from the definition of an IRC section 197 intangible. Accordingly, unlike most other taxpayers, a sports franchise is not entitled to 15 year amortization on the intangible assets acquired with the acquisition of the sports franchise. This

includes goodwill, going concern value, the franchise intangible asset, and other intangible assets such as broadcasting rights.

[246] This means that pre-IRC section 197 law applies in determining whether the intangible assets acquired in the acquisition of sports franchises are eligible for amortization. To be subject to amortization, the sports franchise's intangible asset must have: (1) an ascertainable value separate and apart from goodwill, going concern value, and the franchise intangible asset, and (2) a determinable useful life.

[247] IRC section 197(f)(4)(A) uses the definition in IRC section 1253(b)(1)

for the definition of a franchise under IRC section 197. IRC section 1253(b)(1)

states "the term 'franchise' includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area."

[248] IRC section 197(e)(6) excludes from the definition of an IRC section 197 intangible, "A franchise to engage in professional football, basketball, baseball, or other professional sport, and any item acquired in connection with such a franchise." After stating the above IRC section 197(e)(6) statement, H.R. Rep. No. 103-213, 103rd Cong., 1st Sess. (1993), 1993-3 C.B. 560, states:

"Consequently, the cost of acquiring a professional sports franchise and related assets (including any goodwill, going concern value, or other section 197 intangibles) is to be allocated among the assets acquired as provided under present law (see, for example, section 1056 of the Code) and is to be taken into account under the provisions of present law."

[249] To be subject to amortization, the intangible asset must have: (1) an ascertainable value separate and apart from goodwill and going concern value, and (2) a determinable useful life. Because the franchise intangible asset acquired with the acquisition of a sports franchise has an indefinite useful life, it is not subject to amortization. Player contracts acquired in the acquisition of a sports franchise do have an ascertainable value separate and apart from goodwill, going concern value, and the franchise intangible asset. Player contracts also have determinable useful lives.

[250] Therefore, the non-IRC section 197 intangible issue centers on whether intangible assets other than the franchise intangible asset and player contracts acquired in connection with the acquisition of a sports franchise have: (1) an ascertainable value separate and apart from goodwill, going concern value, and the franchise intangible asset, and (2) have a determinable useful life. This is addressed further by covering the tax treatment given to broadcasting rights.

#### Broadcasting Rights

[251] One of the intangible assets acquired in the acquisition of a sports franchise is the right to share in the income from national broadcasting rights along with the other sports franchises in the league.

[252] The national broadcasting contracts are between the commissioner of the respective league, on behalf of the league's sports franchises, and the networks. A sports franchise in a particular league confers a right to receive a pro rata share of this revenue as long as the sports franchise is a member of the league.

[253] National broadcasting rights acquired with the acquisition of a sports franchise are not subject to amortization under IRC section 197. Thus, to be depreciable or amortizable as a "wasting asset," intangible property must have (1) an ascertainable value separate from goodwill, and (2) a limited useful life ascertainable with reasonable accuracy. See Newark Morning Ledger Co. v. United States, 507 U.S. 546, 113 S. Ct. 1670 (1993). The burden of proving that an intangible asset has these characteristics is on the taxpayer.

[254] In *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), cert. denied, 434 U.S. 1014 (1978), one of the issues addressed by the Fifth Circuit was whether amortization was allowable on the national broadcast intangible asset acquired on the taxpayer's acquisition of a National Football League (NFL) sports franchise. The Commissioner of the NFL had executed a 4-year contract on behalf of the league's sports franchises with the CBS Television Network under which CBS received the right to televise the NFL's games. The NFL sports franchises ratably shared the revenue generated under the national broadcasting contract.

[255] The taxpayer argued the broadcast intangible asset was a wasting asset, and therefore amortizable, because it had a proven value (present value of the guaranteed future income under the contract) and a limited useful life (the 4-year term of the contract).

[256] Although the Court rejected the government's argument that the broadcasting rights did not have an ascertainable value separate from goodwill, going concern value, and the sports franchise intangible asset, it noted the television rights were to continue as long as the sports franchise remained a member of the NFL. The court adopted the government's "link in a perpetual chain" analogy and stated:

"As the government correctly points out, the rights under the CBS contract were only a 'four year link' in a 'perpetual chain' of television income. Though the existing contract provided a measure of [the purchaser's] television rights over a particular four year period, nevertheless the rights were to continue indefinitely. \* \* \* Because the rights pursuant to the CBS contract were only a link in a chain of revenue which would continue as long as the Atlanta Club chain holds an NFL franchise, they did not constitute a wasting asset."

[257] The tax court reached the same conclusion, in *First Northwest Industries v. Commissioner*, 70 T.C. 817 (1978), rev'd on other grounds, 649 F.2d 707 (9th Cir. 1981). This case involved the purchase of a National Basketball Association (NBA) sports franchise. Included among the rights acquired in the purchase was the right to an equal share of all revenues from national broadcasting of NBA games. In response to the claim that the current broadcasting contract was a wasting asset, the Tax Court held the contract was not amortizable because it merely represented a "link in a continuing chain of national television income" which would continue as long as the sports franchise remained a member of the NBA.

[258] The Sixth Circuit also reached this conclusion in *McCarthy v. United States*, 807 F.2d 1306 (6th Cir. 1986). This case involved the purchase of a Major League Baseball (MLB) sports franchise. Included among the inherent rights acquired in the purchase of the sports franchise was the right to broadcast the sports franchise's games. The three broadcasting contracts at the time of purchase were: (1) a network contract among the National Broadcasting Company (NBC) and the Commissioner of MLB, (2) a local television broadcasting contract with the sports franchise, and (3) a local radio broadcasting contract with the sports franchise. In deciding the broadcast intangible assets were not amortizable because they did not have limited useful lives, the Sixth Circuit stated "the current broadcasting contracts likewise are merely links in a perpetual chain of

broadcasting revenues" which the sports franchise will have the rights to as long as it remains in the MLB.

[259] Although the government has not yet been successful in arguing that a broadcasting right intangible asset is not separable from goodwill, going concern value, and the franchise intangible asset, the government has been successful in arguing the broadcasting rights acquired on the acquisition of a sports franchise do not have a determinable useful life. Accordingly, like the franchise intangible asset, broadcasting rights are not subject to amortization.

#### ORGANIZATIONAL EXPENDITURES AND START-UP EXPENSES

##### Audit Issues

1. Whether expenses treated as organizational expenses and start-up expenses are qualifying expenditures under IRC sections 248, 709, and 195. More specifically, whether expenses directly connected with the acquisition of a sports franchise are improperly amortized under these IRC sections.
2. Whether organizational expenses and start-up costs are improperly characterized by the sports franchise as current period deductions.

##### Tax Law Application

[260] IRC section 248 for corporations and IRC section 709 for partnerships prescribe that organizational expenditures be treated as deferred expenses amortizable over a period of not less than 60 months. Both sections define "organizational expenditures" as any expenditure which:

1. is incident to the creation of the corporation or partnership,
2. is chargeable to a capital account, and
3. is of a character which, if expended incident to the creation of a corporation or partnership having a limited life, would be amortizable over such life.

[261] Costs of issuing stock in a corporation, syndication fees in the case of a partnership, and expenditures connected with the transfer of assets are examples of costs that are not organizational expenditures.

[262] Under IRC section 195, start up costs are defined as any amount paid or incurred in connection with investigating the creation or acquisition of an active trade or business, creating an active trade or business, or any activity engaged in for profit or production of income before the day on which the activity begins, and which, if paid or incurred in connection with the operation of an existing active trade or business, would be allowable as a deduction for the tax year in which it was paid or incurred. Start up costs are amortizable over a period of not less than 60 months.

##### Potential Emerging Issue For Start-up Expenses

[263] For a league expansion sports franchise there may be a potential emerging issue of whether amortization of qualifying IRC section 195 start-up expenses begins when:

1. the sports franchise first solicits ticket subscriptions,

2. the league awards the sports franchise, or
3. the sports franchise plays its first league game.

## CHAPTER 10

### PURCHASE AND SALE OF A SPORTS FRANCHISE

#### OVERVIEW

[264] This chapter furnishes general guidance on the tax issues associated with the purchase and sale of a sports franchise. Because the tax issues (including numerous asset acquisition elections) are often quite complex, the guidance given is not a substitute for examiner tax law research and analysis based on the specifics of the particular sports franchise acquired or sold.

[265] This chapter addresses the purchase and sale of an existing sports franchise. The acquisition of a league expansion franchise and league expansion revenue are addressed in Chapter 11. The sales and exchanges of player contracts not associated with the purchase, and sale of an entire sports franchise are addressed in Chapter 12.

[266] There are two unique aspects to the purchase/sale of a sports franchise from the purchase/sale of other types of businesses. The most significant distinction is the allocation and tax treatment with respect to player contracts. Special rules apply to the purchase/sale price allocations to a sports franchise's total amount of player contracts along with rules on the allocations among individual player contracts because: (1) this is likely to be the most significant asset category of the sports franchise, (2) the buyer and seller are required to make consistent allocations, and (3) the buyer and seller often have competing tax consequences on player contract allocations. This is an area warranting significant consideration during the examination of the purchaser or seller of a sports franchise.

[267] Another unique aspect on the purchase and sale of a sports franchise is that, unlike most all other categories of taxpayers, there are no IRC section 197 intangibles. As addressed in Chapter 9, to claim amortization, the buyer has to apply pre-IRC section 197 law to establish: (1) the intangible has an ascertainable value separate from goodwill, going concern value, and the franchise intangible asset, and (2) a determinable useful life.

[268] The inapplicability of IRC section 197 to the intangibles acquired on the purchase of a sports franchise, is likely to result in valuation and life studies on intangibles that are no longer relevant for most other categories of taxpayers. In addition, the inapplicability of IRC section 197 may impact the buyer's negotiating posture with the seller on the amounts allocated to intangible assets other than player contracts.

[269] The purchaser and seller of a sports franchise are required to use the same allocation of the purchase/sale price to the assets acquired/sold. This chapter addresses both the purchase and sale of a sports franchise. Whether you are initially assigned the purchaser's or the seller's return for examination, adequate issue consideration requires full consideration of the other party's allocations and tax treatment. In addition, if a purchase/sale price allocation issue is raised during the examination of either the buyer or seller, then the issue is almost always a "whipsaw" issue requiring a related case pick-up or collateral examination request of the other party to the transaction.

#### AUDIT ISSUES

1. Whether the buy/sell agreement allocations among the sport franchise's assets properly reflect the relative fair market values of the asset categories. Specific consideration of the IRC section 1056 player contract allocation provisions are warranted.
2. Whether the residual allocation method of IRC section 1060 is properly applied in the buy/sell agreement allocations.
3. Whether both the buyer and the seller used the buy/sell agreement allocations in their respective tax returns.
4. Whether the buyer under examination properly computed its basis in the franchise assets acquired. Specific consideration of IRC section 1056 is warranted.
5. Whether the seller under examination properly computed its gain on the sale of its sports franchise.

#### VALUATION OF THE SPORTS FRANCHISE

[270] As with other businesses, the valuation of a sports franchise generally involves professional studies of the sports franchise and the arms-length negotiations among the parties. Generally, the resulting purchase/sale price reflected in the executed buy/sell agreement constitutes the total fair market value of the sport franchise's assets for tax purposes.

[271] In arriving at the total fair market value of the sports franchise, the fair market values of individual asset categories are often addressed. The fair market values given in the studies to specific asset categories are relevant because they are likely to be the basis for, or at least influence, the buy/sell agreement allocations among asset categories.

[272] Like most business valuations, the valuation of a sports franchise is generally determined utilizing a combination of:

1. a valuation of the entire sports franchise,
2. a valuation of the specific assets acquired,
3. an analysis of historical and future income streams.

[273] The market method of valuing the entire sports franchise is based on the premise that the value of an asset can be estimated by analyzing the publicly known and verifiable prices paid for similar assets or property. For many sports leagues, the market values of the sports franchises in the league have skyrocketed over the last decade. The potential resale value may have a greater impact on the resulting purchase/sale price than the valuation of specific assets or the estimated future revenue/costs of operating the sports franchise.

[274] A sports franchise includes the assets common to most other businesses, plus player contracts, exclusive territorial rights, sponsorship rights, and participation in shared league revenue such as national broadcasting revenue. The asset categories involved in the purchase/sale of a sports franchise are likely to include:

1. cash equivalents
2. season ticket advance payments/deposits



3. various receivables
4. long-term ticket subscriptions
5. player contracts
6. lease agreements
7. fixed assets (perhaps including a stadium or sports arena)
8. goodwill, going concern value, and the franchise intangible asset, and
9. other non-IRC section 197 intangible assets.

[275] In valuing individual asset categories and individual assets, the appraiser may rely on a combination of replacement value, market value, and the income method. Fair market value is generally used for valuing player contracts. The amounts allocated to player contracts are addressed later in this chapter.

[276] Allocations to intangible assets that the buyer asserts have an ascertainable value separate from goodwill, going concern value, and the franchise intangible asset may be a significant issue area. Amortization of a sports franchise's intangible assets is addressed in Chapter 9.

[277] In some cases, determination of the actual purchase/sale price in the buy/sell agreement may be complicated by contingencies. Contingent payments may be provided for contingencies involving future league expansion, stadium agreements, food and beverage concessions, and relocation of the sports franchise contingency provisions. These are just some of the contingencies that may be included in a sports franchise buy/sell agreement. The cutoff date used in determining the valuation of the sports franchise can have relevant

[278] The cutoff date used in determining the valuation of the sports franchise can have relevant consequences for accrued and deferred items of revenue and expense. The cutoff date used can also significantly impact the valuation of benefits the sports franchise is entitled to such as season ticket revenues, sponsorship revenues, broadcasting rights, and expansion revenue. Accordingly, consideration should be given to time span accounting and valuation differences from the cutoff date used in valuation studies and the actual purchase/sale date in the buy/sell agreement.

[279] As with other businesses, the valuation of a sports franchise and its component assets often involves complex methodologies, approaches, and computations. A complete valuation of the entire sports franchise may be necessary for the best approach. Obtaining the formal assistance of an IRS engineer or economist may be necessary or advisable.

#### THE RESIDUAL ALLOCATION METHOD

[280] As provided in IRC section 1060 and the regulations, both the buyer and seller in asset acquisitions are required to allocate the purchase/sale price in the buy/sell agreement among the component asset categories using the residual method.

[281] The residual method is set forth in Temp. Tres. Reg. section 1.1060-1T, 1997-12 I.R.B. 35 (March 24, 1997), which generally applies to asset acquisitions after February 14, 1997. Under Treas. Reg. section 1.1060-1T, assets are divided into five categories or "classes." They are: Class II assets (consisting of cash

and cash equivalents, like bank accounts), Class II assets (liquid assets, like certificates of deposit, government securities, and readily marketable stock or securities), Class III assets (all assets other than Class I, II, IV, and V assets), Class IV assets (all IRC section 197 intangibles except intangibles in the nature of goodwill and going concern value), and Class V assets (intangibles in the nature of goodwill and going concern value). The purchase price is allocated first to the Class I assets (on a dollar for dollar basis), then to Class II assets to the extent of their fair market value, to the Class III assets to the extent of their fair market value, to the Class IV assets to the extent of their fair market value, and finally, any residual is allocated to the Class V assets. The differing tax treatment of the assets in each class, for example, the extent to which depreciation or amortization is available, provides an incentive to manipulate the valuation or character of the assets in order to affect the purchase price allocation.

[282] With regard to asset acquisitions made prior to February 14, 1997, Treas. Reg. 1.1060-1T provides that the previous regulations apply. The previous regulations provide that the assets are divided into four, rather than five, categories or "classes." Under this provision, Class III assets are all assets other than Class I, II, and IV assets. Class IV assets are intangible assets in the nature of goodwill and going concern value. There is no Class V asset category.

[283] These allocations are subject to other applicable limitations under the Code. For example, in the context of a sports franchise, the allocation provisions of IRC section 1056(a) for player contracts have to be taken into account in applying the residual allocation method rules.

[284] Often high values are placed on player contracts, so that under the residual method as little as 10 percent is allocated to franchise rights. The Service has the authority to value the franchise rights to determine the reasonableness of the player contracts valuations.

[285] The mandatory use of the residual method does not restrict the Service's ability to challenge the taxpayer's determination of ANY asset's fair market value. Treas. Reg. section 1.1060-1T(e)(4) specifically provides:

"In connection with the examination of a return, the Internal Revenue Service may challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties. For example, in certain cases the Internal Revenue Service may make an independent showing of the value of goodwill and going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets."

#### PLAYER CONTRACTS

[286] IRC section 1056, Basic limitation for player contracts transferred in connection with the sale of a franchise, reads as follows:

##### (a) GENERAL RULE

If a franchise conducting 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
- (2) the gain (if any) recognized by the transferor on the transfer of such contract.

\* \* \* \* \*

[287] Accordingly, under IRC section 1056 the purchaser's basis in a player contract is the seller's adjusted basis in the player contract plus the seller's recognized gain on the player contract. This provision is explained in S. Rep. No. 94-938, 94th Cong., 2d Sess. 90 (1976), 1976-3 Vol. 3 C.B. 128, which reflects:

"The committee amendment provides that in the case of the sale or exchange of a sports franchise (or the creation of a new franchise) the amount of consideration allocated to a player contract by the transferee shall not exceed the sum of the adjusted basis of the contract in the hands of the transferor immediately before the transfer and gain (if any) recognized by the transferor on the transfer of the player contract. In this way, the committee believes that a more appropriate allocation will be achieved since, to a substantial extent the buyer and seller will be adverse parties with respect to the allocation (i.e., to the extent that the amount of gain attributable to player contracts will be fully recaptured as ordinary income, the buyer and seller will be operating at arms-length with respect to the allocation)."

[288] IRC section 1056(d), Presumption as to amount allowable to player contracts 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."

[289] The legislative history to IRC section 1056(d) indicates that Congress intended only to provide a rebuttal upper limit to the amount allocable to player contracts. H. R. Rep. No. 94-658, 94th Cong. 1st Sess. 117-118, 1976-3 Vol. 2 C.B. 809 - 810, reflects:

"The bill also provides that in the case of the sale or exchange of a sports franchise, it is presumed that not more than 50 percent of the consideration is allocable to player contracts unless the taxpayer can satisfy the Secretary of the Treasury that under the facts and circumstances of the particular case, it is proper to allocate an amount in excess of 50 percent. However, your committee's bill makes it clear that the presumption does not mean that an allocation of less than 50 percent of the consideration to player contracts is proper. The proper allocation is to depend upon the facts and circumstances of each particular case. Factors to be taken into account by the Secretary are to include the amount of gate receipts received by the past owner of the franchise (as well as the amount to be

received in the future), the amount of radio and television receipts that were received by the past owner of the franchise (as well as the amount to be received in the future), etc. Your committee recognizes that there are differences among the various sports which are relevant to the proper allocation and, therefore intends that factors peculiar to each sport (and to each team) be taken into account."

[290] Thus, the legislative history indicates that IRC section 1056(d) does not provide a presumption that 50 percent of the purchase price of a sports franchise should be allocated to player contracts. IRC section 1056(d) merely provides a presumed upper limit on the amount allocable to player contracts. The exact amount to be allocated depends on the particular facts and circumstances of each case. See *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), cert. denied, 434 U.S. 1014 (1978).

[291] In *First Northwest Industries v. Commissioner*, 70 T.C. 817 (1978), rev'd on other grounds, 649 F.2d 707 (9th Cir. 1981), an opinion issued after the enactment of IRC section 1056 but dealing with taxable years before its effective date, the Tax Court rejected the Service's assertion that player contracts should be treated as a mass asset. In reaching this conclusion the Tax Court noted that IRC section 1056 also envisions an allocation among player contracts.

[292] IRC section 1056 provides a basis limitation as to the percent of the total purchase price that can be allocated to player contracts. The portion of the purchase price allocated to player contracts, on the other hand, is further allocated to the individual players' contracts and amortized over the period that the club is expected to have control over each respective player.

[293] With respect to the seller of a sports franchise, the player contract amalgamation rule of IRC section 1245(a)(4) applies. Under the player contract amalgamation rule, player contracts are treated as a consolidated asset (or mass or pooled asset) to the seller on the sale of a sports franchise. IRC section 1245(a)(4)(D) defines a player contract as "any contract for the services of an athlete which, in the hands of the taxpayer, is of a character subject to the allowance for depreciation provided in section 167."

[294] Under the player contract amalgamation rule, the seller's IRC section 1245 recapture is based on the IRC section 167 amortization claimed on all player contracts. If the total amount allocated to player contracts in the buy/sell agreement exceeds the seller's adjusted basis in all of its player contracts and also exceeds the total amortization previously claimed by the seller on its player contracts, then, to the extent gain is recognized, the seller has IRC section 1245 ordinary income equal to the amortization previously claimed. If, however, the amount allocated to player contracts in the buy/sell agreement is less than the seller's original cost basis in all its player contracts then the seller's IRC section 1245 recapture is limited to the gain recognized.

[295] As addressed earlier, the buyer's basis in the player contracts under IRC section 1056 is the seller's adjusted basis in the player contracts plus the gain reported by the seller on the player contracts. Whether the seller's gain on the player contract is an IRC section 1231 gain or IRC section 1245 ordinary gain has no impact on the buyer's basis. Both an IRC section 1231 gain and an IRC section 1245 ordinary gain increase the buyer's basis by an equal amount.

Extract

IRC section 1056(c)

(c) Transferor required to furnish certain information.

Under regulations prescribed by the Secretary, the transfer[or] shall, at the time and in the manner provided in such regulations, furnish to the Secretary and 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 the transferee.

[296] The Treasury has not promulgated regulations under IRC section 1056.

#### TAX PLANNING CONSIDERATIONS

[297] In addition to the usual tax planning considerations given to buy/sell agreements on the purchase/sale of the assets of a trade or business, in the context of sports franchises, additional tax planning considerations involve the amounts allocated to player contracts and other intangible assets.

[298] Generally relevant to both the buyer and the seller is the amount allocated in the buy/sell agreement to player contracts. The amount allocated in the buy/sell agreement to player contracts determines the seller's gain on the player contracts and the buyer's basis in the player contracts.

[299] Due to IRC section 1245 recapture, the amounts allocated to player contracts is likely to increase the amount of the seller's ordinary gain versus IRC section 1231 gain on the sale. Accordingly, the seller may have a tax incentive to minimize the purchase/sale price allocation to player contracts. Because player contracts lead to amortization (with useful lives of player contracts averaging 3 to 6 years), buyers have a tax incentive to maximize the amount allocated to player contracts.

[300] Unlike most other categories of taxpayers, the intangible assets acquired in connection with the acquisition of a sports franchise are not IRC section 197 intangibles, the amounts the buyer wants allocated to intangible assets may be subjected to tax planning. Because they are not amortizable, the buyer has a tax incentive to minimize the amounts allocated to goodwill, going concern value, and the franchise intangible asset.

[301] Buyers taking aggressive tax positions, may negotiate for buy/sell agreement allocations to what they believe are intangible assets with short useful lives (such as 3 to 4 years). An example of this is broadcasting rights which are addressed in Chapter 9. Clearly, a 3 to 4 year amortization period beats the 15 year amortization period under IRC section 197 that is mandated for buyers of most other categories of businesses. This creates tax planning opportunities on the acquisition of a sports franchise.

#### ECONOMIC REALITY, STRONG PROOF DOCTRINE, AND THE DANIELSON RULE

[302] As with the purchase/sale of other types of businesses, the Service is not bound by the buy/sell agreement allocations of the purchase/sale amount to the component assets in the purchase/sale of a sport franchise. Upon examination, the

Service can re-allocate the purchase/sale amount to reflect the economic reality of the transaction and the relative fair market value of asset components. In this regard, substance versus form is controlling for tax purposes.

[303] In *First Northwest Industries v. Commissioner*, 70 T.C. 817, 843 (1978), rev'd on other grounds, 649 F.2d 707 (9th Cir. 1981) the Tax Court found the IRS was not bound by the allocation of costs by the NBA and the expansion team.

[304] Although there is no bar on the Service to challenge the buy/sell agreement allocations, taxpayers (either the buyer, the seller, or both) have significant hurdles to overcome if they attempt to disregard the buy/sell agreement allocations for tax purposes.

[305] As noted earlier, IRC section 1060(a) provides that the allocation of the purchase/sale amount among component assets in the buy/sell agreement "shall be binding on both the transferor and the transferee unless the Secretary determines that such allocation (or fair market value) is not appropriate." In addition, IRC section 1056(a) provides that the adjusted basis and gain amounts on player contracts the seller furnishes to the buyer, as required by IRC section 1056(c) "shall be binding on the transferor and on the transferee."

[306] Under general case law, allocations in a written buy/sell agreement are usually binding upon the parties to the agreement. Where the parties clearly and unequivocally allocated amounts to asset components, the courts have refused to allow one of the parties subsequently to alter the tax consequences of the expressed amount unless he/she can overcome the contract terms by strong proof that the agreement does not reflect the parties' true intentions. This is known as the strong proof doctrine. *Major v. Commissioner*, 76 T.C. 239 (1981); *Sonnleitner v. Commissioner*, 598 F.2d 464 (5th Cir. 1979).

[307] The Service and some appellate courts, relying on *Commissioner v. Danielson*, 389 U.S. 858 (1967), require an even stronger degree of proof before one party will be permitted to alter the allocation for tax purposes. Under the Danielson rule, a party may contradict an unambiguous contractual term, for tax purposes, only by offering proof which would be admissible in an action between the parties to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, or duress.

[308] Although the Tax Court has rejected the Danielson rule, preferring the less stringent strong proof rule, under the rule given in *Golsen v. Commissioner*, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971), the Tax Court will follow a United States Court of Appeals opinion which is squarely on point where appeal of the Tax Court decision would lie in that circuit. The Danielson rule has been adopted by the Third, Fifth, Sixth, and Eleventh Circuits. See *Danielson*; *Spector v. Commissioner*, 641 F.2d 376 (5th Cir. 1981), cert. denied, 454 U.S. 868 (1981); *Schatten v. United States*, 746 F.2d 319 (6th Cir. 1984); and *Bradley v. United States*, 730 F.2d 718 (11th Cir. 1984), cert. denied, 469 U.S. 882 (1984).

[309] In addition, H.R. Rep. No. 101-964, 101st Cong., 2nd Sess. (1990), reflects that taxpayers are bound by their IRC 1060 asset acquisition allocations unless they are able to refute the allocation or valuation under the standard set forth in Danielson.

#### EXAMINATION TECHNIQUES

[310] The examiner should determine in the early stage of the examination whether valuation assistance from an IRS engineer or economist is warranted. If so, submit Form 5202 to request the assistance of an IRS engineer or follow local procedures to request the assistance of an IRS economist. The national sports

franchise ISP team, which is working with the engineering group in South Florida on sports franchise valuation issues, is another sports franchise valuation guidance resource.

[311] Documents and information that should be obtained in developing sports franchise purchase/sale issues include:

1. the buy/sell agreement,
2. all buyer and seller correspondence on the buy/sell negotiations, understandings, etc.,
3. all valuation studies conducted by or for either the buyer or seller,
4. the sports franchise agreement,
5. the required information previously furnished by the seller to the buyer and the Service in accordance with IRC section 1060(b), and IRC section 1056(c), and the regulations, and
6. your taxpayer's tax return schedules and workpapers on the purchase/sale.

[312] Whether you are initially assigned the purchaser's or the seller's return for examination, adequate issue consideration requires full consideration of the other party's allocations and tax treatment. If the other party did not follow the buy/sell agreement component asset allocations, this may indicate the allocations have no economic substance or are not at fair market value. In addition, if a purchase/sale price allocation issue is in fact raised during the examination of either the buyer or seller, then the issue is almost always a "whipsaw" issue requiring a related case pick-up or collateral examination request of the other party to the transaction.

[313] If you are assigned the buyer's return, obtain a copy of the seller's return, and if you are assigned the seller's return, obtain a copy of the buyer's return. First, check AIMS to see if the other party is under examination and verify the service center and district with which the other party files. If the other party is an out of district taxpayer, consider pursuing collateral examination procedures in the early stages of your examination.

[314] The IRC section 1056 player contract provisions and IRC section 1060 are based on an assumed adversity of tax interests among the buyer and the seller. To the extent this is not the case, the buy/sell agreement allocations may warrant additional consideration.

[315] Consider determining to what extent the buyer and seller have adverse tax interests in the various asset component allocations. Because the assumed tax adversity may not exist for the seller, this is especially the case if you are assigned the buyer's tax return. Factors impacting the seller's tax posture include the tax differential between the ordinary income tax rate and the capital gains tax rate and whether the seller has unused net operating losses or capital losses. Since a C-Corporation's capital gains are taxed at the regular corporate tax rate, whether the seller is a C-Corporation, S-Corporation, or a partnership can be relevant.

[316] Determine if the total amount allocated to player contracts in the buy/sell agreement reflects the fair market value of the sports franchise's player contracts. Consider whether the player contract terms, contract periods, and the

athletes' fair market trade values on the buy/sell agreement date are in line with the amount allocated to player contracts.

[317] The buyer has a tax incentive to allocate more to player contracts with shorter useful lives than player contracts with longer useful lives. If you are assigned the buyer's tax return, consider the buyer's allocation of the total amount allocated to player contracts in the buy/sell agreement to the individual player contracts. Compare the seller's adjusted basis in the individual player contracts and the gains reported with the buyer's individual player contract purchase/sale price allocations.

[318] If you are assigned the seller's tax return and there is a tax consequence in whether gains are ordinary versus capital, verify the seller's IRC section 1245 recapture amount on the player contracts.

## CHAPTER 11

### LEAGUE EXPANSION

#### OVERVIEW

[319] Over the last decade, many sports leagues have added new sports franchises to their leagues through league expansion. League expansion results in a significant payment by the expansion sports franchise ownership group to the league, which is then usually divided among the established sports franchises in the league.

[320] The expansion sports franchise grants the new franchisee the exclusive right to hold league games in a specified geographical area. Ancillary assets and rights are also transferred to the expansion sports franchise. As part of its sports franchise, the expansion sports franchise generally has an equal right to share in future league revenue. A major source of league revenue is revenue from national broadcasting rights and league sponsorship rights.

[321] In most instances, the expansion sports franchise obtains the same rights and obligations as the already established sports franchises in the league. This includes participation in league voting.

[322] An expansion draft is often included, in which the expansion sports franchise is able to obtain the rights to player contracts held by the established sports franchises in the league. In addition, league expansion often grants the new sports franchise additional draft picks in future player drafts.

[323] The two major asset categories transferred for tax purposes to the expansion sports franchise are: (1) the sports franchise intangible asset, and (2) the right to acquire player contracts from the established sports franchises in the sports league. Potential issues exist concerning whether additional intangible assets that are separable from the franchise intangible asset are also transferred from the league and the established sports franchises to the expansion sports franchise.

[324] There will typically be an expansion agreement between the league and the expansion sports franchise. As a general rule, both the expansion sports franchise and the established sports franchises are bound by the allocation of the expansion price among the asset components reflected in the expansion agreement. However, the Service is not bound by the expansion price allocation among the asset components reflected in the expansion agreement. In *First Northwest Industries v. Commissioner*, 70 T.C. 817, 843 (1978), rev'd on other grounds, 649 F.2d 707 (9th Cir. 1981) the Tax Court held the Service was not bound by the allocation of costs by the sports league and the expansion sports franchise.



[325] Generally, what is addressed in Chapter 10 on the purchase and sale of a sports franchise also applies to new sports franchises created in a sports league expansion. Instead of reiterating what is addressed in Chapter 10, this chapter focuses on aspects unique to league expansion.

#### AUDIT ISSUES

1. Whether the expansion agreement allocations among the assets transferred properly reflect the relative fair market values of the asset categories. Specific consideration of the IRC section 1056 player contract allocation provisions are warranted.
2. Whether the residual allocation method of IRC section 1060 is properly applied in the expansion agreement allocations.
3. Whether the existing sports franchises in the league and the expansion sports franchise used the expansion agreement purchase/sale price allocations in their respective tax returns.
4. Whether the expansion sports franchise properly computed its basis in the assets acquired. Specific consideration of IRC section 1056 is warranted.
5. Whether the established sports franchises properly computed their gains on the league expansion.

#### TAX LAW APPLICATION

##### Established Sports Franchises

[326] Rev. Rul. 71-123, 1971-1 C.B. 227, addresses a professional football league expansion. The expansion agreement granting the new sports franchise provided that the expansion sports franchise was to pay a stated amount to the sports league. A portion of the payment was to be retained by the league, with the balance distributed among the league's established sports franchises. Under the expansion agreement, the new sports franchise made the payments in question as consideration for the assignment of three player contracts by each of the established sports franchises to the expansion sports franchise. The amount distributed to each of the established sports franchises exceeded the value of the three player contracts transferred.

[327] The Service concluded that the amount received by the established sports franchises for their three player contracts transferred to the expansion sports franchise were taxed based on the guidance given in Rev. Rul. 67-380, 1967-2 C.B. 291. This resulted in IRC section 1231 gains and IRC section 1245 ordinary income recapture to the established sports franchises on the sale of their player contracts.

[328] The player contract amalgamation rule of IRC section 1245(a)(4), which is addressed in Chapter 10, does not apply in computing an existing sports franchise's IRC section 1245 gains on player contracts transferred to the expansion sports franchise. This is based on the legislative history behind IRC section 1245(a)(4), which indicates the player amalgamation rule only applies if a sports franchise, together with substantially all of its player contracts, is sold.

[329] S. Rep. No. 94-938, 94th Cong., 2d Sess. 90 (1976), 1976-3 Vol. 3 C.B. 128, reflects "The special recapture rules [IRC section 1245(a)(4)] would only apply in the case of the sale or exchange of the entire sports franchise and not

in the case of the sale or exchange of individual player contracts.'" Footnote 2 reflects "The sale of an individual player contract will continue to be governed by the general recapture rule of sec. 1245." Refer to Chapter 12 for additional guidance on the sale of individual player contracts.

[330] In Rev. Rul, 71-123, the Service also concluded that the amounts received by the existing sports franchises in excess of the amounts allocable to player contracts was received by them for their franchise property right. The Service held "the new franchise is a valuable property right that was created by the old teams \* \* \* the grant of the franchise was the sale of a capital asset by the old teams to the new team." Therefore, the gain attributable to the franchise property rights was held to be capital gain under IRC section 1222.

[331] In Rev. Rul. 71-583, 1971-2 C.B. 312, the Service addressed a similar situation. In conjunction with the league's expansion, an expansion team was established in the same geographical area as an existing league franchise. Because of this, the existing franchise was awarded a greater share of the expansion payment from the new sports franchise. This was due to the existing franchise's relinquishment of part of its exclusive right to host games within its geographical area.

[332] The Service concluded that even though the existing sports franchise received more than the league's other franchises (due to its greater relinquishment of property rights), the Service's ruling in Rev. Rul. 71-123 applies. The Service held that "the amount received by the instant taxpayer for the relinquishment of its exclusive territorial rights is an amount received for the sale of a capital asset and resulted in a capital gain TO THE EXTENT OF THE AMOUNT RECEIVED."

[333] "To the extent of the amount received" is significant in that it reflects the established sports franchise has no tax basis in the relinquishment of part of its exclusive territorial rights which is part of the franchise intangible asset. This reflects the Service's position that the established sports franchises do not have a determinable tax basis in the portion of their franchise property rights transferred in a league expansion. Since they do not have a determinable tax basis in the portion of their franchise property rights transferred to the new sports franchise, the full amount allocated to their franchise property rights constitutes capital gains to the established sports franchises.

[334] However, in *First Northwest Industries v. Commissioner*, 649 F.2d 707 (9th Cir. 1981), remanding 70 T.C. 817, 843 (1978), the Tax Court rejected the government's argument that the taxpayer did not have a tax basis in the franchise property rights transferred to an expansion sports franchise. In its April 26, 1979 Action on Decision, the Service stated "The court [Tax Court] erred in holding that an existing team may offset expansion proceeds by a ratable portion of its franchise acquisition costs."

[335] Whether the taxpayer was entitled to claim a tax basis in the franchise property rights was appealed to the Ninth Circuit. The Ninth Circuit concluded:

"A portion of the remaining 'basic nonterminable rights' was transferred. /9/ The Tax Court made no attempt, however, to determine the cost of these rights. Only if their cost can be satisfactorily ascertained may taxpayer subtract its basis in the portion transferred. /10/ See *United States v. Laird*, 556 F.2d 1224 (5th Cir. 1977), cert. denied, 434 U.S. 1014, 98 S.Ct. 729, 54 L. Ed. 2d 758 (1978) (permitting amortization of player contracts because they had ascertainable value and limited useful life); *Ralph W. Fullerton Co. v. United States*, 550 F.2d

548 (9th Cir. 1977) (refusing to permit loss deduction for lost accounts where cost of individual accounts could not be satisfactorily ascertained).

All of the 'basic nonterminable rights' acquired by taxpayer derive value from the league's goodwill, and sale of new teams is a 'portioning out' of NBA goodwill. See Rev. Rul. 71-583. The critical question on remand will be whether there is sufficient evidence to allocate the \$ 1,000,000 cost between those rights which were and those which were not transferred. Recognizing that they all are related to goodwill does not resolve the question.

On remand, the Tax Court will determine whether there is sufficient evidence to ascertain the cost of the rights which were transferred. If there is, taxpayer may subtract its basis."

[336] Footnote number 9 reflects the rights in question, to "include the right to share in national broadcasting revenues, all- star and playoff game proceeds, expansion proceeds, and proceeds of NBA promotional and advertising activities."

[337] As addressed above in Rev. Rul. 71-123 and Rev. Rul. 71- 583, the Service's position remains that the franchise property rights transferred in a league expansion (1) do not have an ascertainable value separate from the retained franchise property rights, and (2) do not have a determinable useful life.

#### Expansion Sports Franchises

[338] The same general tax provisions that apply to the purchase of an existing sports franchise also apply to the purchase of an expansion sports franchise. Refer to Chapter 10 for additional guidance on the tax treatment given to the acquisition of a sports franchise through league expansion.

[339] It has been asserted that IRC section 1056 does not apply to the creation of a new sports franchise via league expansion, because it does not constitute the sale or exchange of an existing sports franchise. The government's position is that IRC section 1056 applies to the creation of a new sports franchise as part of a league expansion.

[340] The above coverage of Rev. Rul. 71-123 and 71-583 reflects how the Service treats the creation of a new sports franchise in a league expansion as the sale or exchange of player contracts and relinquishment of part of each of the established teams' franchise property rights. In addition, S. Rep. No. 94-938, 94th Cong., 2d Sess. 90 (1976), 1976-3 C.B. 128, in addressing IRC section 1056 specifically states:

"The committee amendment provides that in the case of the sale or exchange of a sports franchise (OR THE CREATION OF A NEW FRANCHISE) the amount of consideration allocated to a player contract by the transferee shall not exceed the sum of the adjusted basis of the contract in the hands of the transferor immediately before the transfer and gain (if any recognized by the transferor on the transfer of the player contract."  
[underlining added]"

Accordingly, just as the provisions of IRC section 1056 apply to the purchase/sale of an existing sports franchise, the provisions of IRC section 1056 also apply to the creation of a new sports franchise via league expansion. The IRC section 1056 provisions are addressed in detail in Chapter 10.

EXAMPLE -- LEAGUE EXPANSION

The successful sports league decides to expand by one sports franchise. The expansion sports franchise purchase/sale price is established to be \$ 100 million. In addition to the numerous sports franchise property rights transferred on the awarding of the expansion franchise, the expansion franchise is entitled to acquire 3 player contracts from each of the 10 established sports franchises in the Successful sports league. A Successful sports league committee is to negotiate with the expansion sports franchise's representatives on the fair market value of each of 30 player contracts to be transferred to the expansion sports franchise.

Each of the 10 established sports franchises is to receive an amount equal to the agreed on fair market value of its 3 player contracts transferred to the expansion franchise. Since the total fair market value of all 30 player contracts is anticipated to be substantially less than \$ 100 million, the expansion agreement provides that the balance of the \$ 100 million (\$ 100 million less the agreed on fair market value of the 30 player contracts transferred) is to be distributed equally among the ten established sports franchises.

The expansion agreement provides that \$ 10 million of the balance of the \$ 100 million not allocated to player contracts is allocated to XYZ intangible asset. The remaining balance of the \$ 100 million is to then be allocated to the sports franchise property right.

The sports league committee and expansion sports franchise subsequently agree that the fair market value of the 30 player contracts transferred to the expansion sports franchise is \$ 50 million. Accordingly, under the expansion agreement:

- \$ 50 million is allocated to player contracts,
- \$ 10 million is allocated to the XYZ intangible, and
- \$ 40 million is allocated to the sports franchise property rights.

ABC, one of the 10 established Successful sports league franchises, had its 3 player contracts transferred to the expansion sports franchise valued under the agreement at \$ 6 million (\$ 6 million of the total \$ 50 million fair market value of the 30 player contracts is attributable to ABC's 3 player contracts). Accordingly, under the expansion agreement, ABC received \$ 6 million for its player contracts, \$ 1 million (1/10 of \$ 10 million) for its share of the XYZ intangible, and \$ 4 million (1/10 of \$ 40 million) for its sports franchise property rights.

ABC's tax consequences include a likely \$ 1 million capital gain on the XYZ intangible and a \$ 4 million capital gain on the franchise property rights. If ABC claimed a tax basis in either the XYZ intangible or its franchise property rights, then this would appear to be an examination issue.

Because the player amalgamation rule of IRC section 1245(a)(4)

does not apply, the computation of ABC's IRC section 1245 recapture gains on the 3 player contracts is computed individually for each player contract. The following summarizes for each of ABC's 3 player contracts (1) the sales price (fair market value) under the expansion agreement, (2) ABC's adjusted basis, (3) ABC's total gain, and (4) ABC's prior player contract amortization.

	Fair Market Value	ABC's Adjusted Basis	ABC's Gain	ABC's Prior Year Amortization	
Strong Player Contract	\$ 3 M	\$ 1 M	\$ 2 M	\$ 1 M	
Fast Player Contract	\$ 2 M	\$ 1 M	\$ 1 M	\$ 2 M	
Big Player Contract	\$ 1 M	\$ 1 M	0	\$ 1 M	
	\$ 6 M	\$ 3 M	\$ 3 M	\$ 4 M	Totals

\$ 1 million of ABC's Strong Player Contract gain of \$ 2 million is IRC section 1245 recapture income, and the \$ 1 million balance is an IRC section 1231 gain. ABC's Fast Player Contract gain of \$ 1 million is all IRC section 1245 recapture income. ABC has no gain on its Big player contract. Accordingly, ABC's player contract gains are summarized as follows:

	IRC Sec. 1245 Recapture	IRC Sec. 1231 Gain	ABC's Total Gain	
Strong Player Contract	\$ 1 M	\$ 1 M	\$ 2 M	Fast Player Contract
\$ 1 M	0	\$ 1 M	0	0
0				
Totals	\$ 2 M	\$ 1 M	\$ 3 M	

If the player contract amalgamation rule was improperly used, the entire \$ 3 million gain on player contracts would all be IRC section 1245 recapture income since the prior year amortization on all 3 player contracts exceeded the \$ 3 million total gain.

Under IRC section 1056, the new sports franchise's tax basis in the 3 player contracts acquired from ABC is \$ 6 million. This consists of ABC's adjusted basis in the 3 contracts of \$ 3 million plus ABC's gain on the 3 player contracts of \$ 3 million.

Based on the expansion agreement and the application of IRC section 1056, the expansion sports franchise's tax basis is:

Player Contracts	\$ XX million (see comment below)	The XYZ	
intangible asset	\$ 10 million	The franchise intangible asset	\$ 40
million			
Total Basis	\$ 50 million plus \$ XX million		

The expansion sports franchise's tax basis includes its player contract basis amount of \$ 6 million from ABC's 3 player contracts plus its player contract basis amounts (under IRC

section 1056) from each of the 9 other established sports franchises in the Successful sports league.

The IRC section 1056 basis amount in the 3 contracts transferred from ABC equal the fair market value assigned to ABC's player contracts because ABC reported (recognized) the realized gain on each of its 3 player contracts. This is not necessarily the case for the player contracts received from the 9 other established sports franchises. This will not be the case to the extent that the other established sports franchises have a tax loss, or realized but unrecognized gains on any of their player contracts transferred to the expansion sports franchise.

If the expansion sports franchise claims amortization on the XYZ intangible, this would appear to be an examination issue.

#### EXAMINATION TECHNIQUES

[341] Documents and information that should be obtained in developing sports league expansion purchase/sale issues include:

1. the expansion agreement,
2. all league and expansion sports franchise correspondence on the expansion agreement negotiations, understandings, etc.,
3. all valuation studies conducted,
4. the expansion sports franchise agreement,
5. the required information previously furnished by the established league sports franchises to the expansion sports franchise and the Service in accordance with IRC section 1060(b), and IRC section 1056(c) and the regulations, and
6. your taxpayer's tax return schedules and workpapers on the league expansion purchase/sale.

[342] Refer to Chapter 10 for coverage of examination techniques common to both a purchase/sale of an existing sports franchise and the purchase/sale of an expansion sports franchise.

[343] As noted in Chapter 10, examination changes to the purchase/sale agreement are usually "whipsaw" adjustments that have tax consequences to both parties in the purchase/sale of an established sports franchise. The "whipsaw" issue tax consequences of a reallocation in a sports league expansion agreement can be significant.

[344] For example, consider the NFL which had 28 sports franchises prior to its expansion in 1993. An examination issue on one of the NFL's 31 sports franchises, in which the expansion agreement allocation is changed, has "whipsaw" issue potential for the other 30 teams in the sports league. Accordingly, the national ISP sports team is considering a requirement that before a sports franchise league expansion agreement allocation is challenged during an examination, the examiner must first coordinate the potential reallocation issue with the ISP sports team.

## CHAPTER 12

### SALES AND EXCHANGES OF INDIVIDUAL PLAYER CONTRACTS

## INDUSTRY PRACTICE

[345] Occasionally, a sports franchise will sell a player contract. However, more frequently, a sports franchise will trade one or more player contracts for player contracts owned by another sports franchise in the league. Future draft picks are often included in these trades.

[346] The special provisions under IRC section 1245(a)(4) and IRC section 1056 for the transfer of player contracts on the purchase/sale of a sports franchise are addressed in Chapter 10. Transfers of player contracts in a sports league expansion are addressed in Chapter 11.

[347] This chapter addresses the tax treatment of player contract trades among established sports franchises in a sports league not associated with the purchase/sale of an established or expansion sports franchise.

## AUDIT ISSUES

[348] Potential audit issues for purchases, sales, or trades of player contracts not connected with the purchase/sale of an established or expansion sports franchise include:

1. Whether the seller or transferor (player trades) properly reported the amount of IRC section 1245 and IRC section 1231 gains.
2. Whether the purchaser or transferee (player trades) properly computed its tax basis under IRC section 1012 and IRC section 1031 in the player contracts acquired.

## TAX LAW APPLICATION

### Gains and Losses on Player Contracts Given Up

[349] Player contracts constitute intangible personal property. As addressed in Chapter 9, if the player contract has a useful life of more than a year, it must be capitalized and amortized over the life of the player contract under IRC section 167.

[350] Gains and losses on the sale or exchange of player contracts held by the sports franchise for more than a year constitute IRC section 1231 gains and losses. However, to the extent of amortization claimed under IRC section 167, player contract gains are subject to IRC section 1245 ordinary income recapture.

[351] In general, player contract trades qualify for IRC section 1031 nonrecognition treatment for like kind exchanges. Gains recognized on player contract trades are limited to the amount of boot and, if applicable, non-qualifying property received by the transferor.

[352] Rev. Rul. 67-380, 1967-2 C.B. 291 and Rev. Rul. 71-137, 1971-1 C.B. 104, specifically address these general provisions for sports franchise player contracts.

[353] IRC section 1031(a) provides that no gain or loss is recognized if property used in a trade or business is exchanged solely for like kind property. Under IRC section 1031(b), any realized gain is recognized to the extent money or property that is not like kind is received in the exchange. Treas. Reg. section 1.1031(b)-1(c) provides:

Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be

treated as "other property or money" for the purposes of section 1031(b). Where on an exchange described in section 1031(b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability; then, in determining the amount of "other property or money" for purposes of section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). See section 1.1031(d)-2, examples (1) and (2).

[354] To the extent of IRC section 1245 recapture, gains recognized on player trades are ordinary gains. The IRC section 1245(a)(4) amalgamation rule for player contracts (addressed in chapter 10) only applies to player contracts transferred in connection with the purchase/sale of an entire sports franchise. Accordingly, the IRC section 1245(a)(4) amalgamation rule does not apply to the sale or trade of two or more player contracts by a sports franchise to another sports franchise. This means the IRC section 1245 recapture provisions are applied on an individual player contract basis versus an aggregate player contract basis.

[355] Accordingly, the tax treatment to the transferor on the sale or exchange of a player contract is the same as the tax treatment given the sale or exchange of tangible personal property, such as machinery, used in any trade or business.

[356] In the sports franchise's tax year in which a player is cut, the sports franchise is entitled to an ordinary deduction under IRC section 165 for its adjusted basis in the player contract.

[357] Generally, a sports franchise does not have an ascertainable tax basis in future draft picks GIVEN UP in a player trade (treated as an inseparable part of the franchise intangible asset). Accordingly, in determining the sports franchise's basis in player contracts acquired in trades, a zero adjusted basis should be used for future draft picks given up in the trade. To the extent a gain on a future draft pick given up in a trade is recognized under IRC section 1031, the gain is an IRC section 1231 gain.

[358] A potential emerging issue, that future draft picks and existing player contracts do not constitute like kind property for purposes of IRC section 1031, is addressed at the end of this chapter.

#### Tax Basis in Acquired Player Contracts

[359] If a sports franchise purchases a player contract, the cost basis provisions of IRC Section 1012 apply. If a sports franchise acquires a player contract in a player trade, the basis provisions of IRC section 1031 apply. In a player trade the sports franchise's basis in the player contract(s) acquired is:

1. its adjusted basis in the player contracts given up in the trade,
2. less the player contract liabilities transferred,
3. plus player contract liabilities assumed in the exchange,
4. plus any gain recognized due to the receipt of boot.

[360] IRC section 1056, which is addressed in Chapter 10, only applies to player contracts transferred in connection with the purchase/sale of an entire sports franchise. Accordingly, the IRC section 1056 sports franchise buyer basis rules do not apply to the sale or trade of two or more player contracts among sports franchises.



[361] A sports franchise ACQUIRING future draft picks in a player trade will have a tax basis in the draft picks acquired based on the application of IRC section 1031. The sports franchise's tax basis in the future draft pick becomes part of the sports franchise's capitalized cost basis in the player contract signed as a result of the draft pick.

[362] Accordingly, except for the future draft pick basis "wrinkle" addressed above, the tax basis rules on the acquisition of player contracts is the same as the tax basis rules on the purchase or exchange of tangible personal property, such as machinery, used in any trade or business.

[363] EXAMPLE -- PLAYER CONTRACT TRADE

Sports franchise A and sports franchise B are unrelated calendar year TEFRA partnerships. Sports franchise A trades the player contract of athlete Strong (Strong player contract) for sports franchise's B player contract of athlete Fast (Fast player contract) on January 1, 1996.

Sport franchise A's Strong player contract was entered into on January 1, 1994. On January 1, 1996, there are 2 years remaining on the original 4 year contract. A's original amortizable basis in the Strong player contract was \$ 800,000, and A claimed \$ 200,000 of amortization for the year 1994 and \$ 200,000 for the year 1995. Accordingly, A's adjusted basis in the Strong player contract on January 1, 1996, is \$ 400,000. The payments remaining on the Strong Player contract on January 1, 1996, are \$ 300,000.

Sports franchise B's Fast player contract was entered into on January 1, 1995. On January 1, 1996, there are 3 years remaining on the original 4-year contract. B's original amortizable basis in the Fast player contract was \$ 600,000, and B claimed \$ 150,000 of amortization for the year 1995. Accordingly, B's adjusted basis in the Fast player contract is \$ 450,000 on January 1, 1996. The payments remaining on the Fast Player contract on January 1, 1996, are \$ 400,000.

Due to the team needs of both sports franchises, and taking into account the relative fair market values of the two player contracts (based on Strong's and Fast's prior season performance) on January 1, 1996, sports franchise A agrees to an even trade (no cash or other property consideration by either A or B) of its Strong player for sports franchises B's Fast player.

Sports franchise A and sports franchise B agree that on January 1, 1996, the fair market value of the Strong player contract is \$ 500,000, and the fair market value of the Fast player contract is \$ 600,000.

The gain computed by sports franchise A and sports franchise B is determined as follows:

	Sports Franchise A	Sports Franchise B	Consideration
Received:	_____	_____	

FMV of Fast Player Contract	\$ 600,000	
Strong Contract Liability Transferred	\$ 300,000	
FMV of Strong Player Contract		\$ 500,000
Liability Transferred	\$ 400,000	Total Consideration Received
\$ 900,000	\$ 900,000	
Less Adjusted Basis In Contract Transferred	\$ 400,000	\$ 450,000
Gain Realized	\$ 500,000	\$ 450,000
Gain Recognized	\$ 0	\$ 100,000

Sports franchise A does not have a gain recognized because it received no boot. It received no boot because the player contract liability assumed of \$ 400,000 exceeded its player contract liability transferred of \$ 300,000.

Sports franchise B has a recognized gain of \$ 100,000 since this is the amount of boot received. Sports franchise B received \$ 100,000 of boot in the exchange because the player contract liability it transferred of \$ 400,000 exceeded the player contract liability it assumed of \$ 300,000. Due to the \$ 150,000 amortization claimed in 1995, all of B's recognized gain of \$ 100,000 is IRC section 1245 recapture ordinary income.

Sport franchise A's and sports franchise B's tax basis in the player contracts acquired in the trade are computed as follows:

	Sports Franchise A	Sports Franchise B	
Adjusted Basis In Contract Given Up	\$ 400,000	\$ 450,000	Less liability
Transferred	(300,000)	(400,000)	Plus Liability Assumed
400,000	300,000	Plus Gain Recognized	0
100,000			
Tax Basis in Contract Acquired	\$ 500,000	\$ 450,000	

Sport franchise A's tax basis in its newly acquired Fast player contract is \$ 500,000 as computed above. This is comprised of its \$ 400,000 adjusted basis in the Strong player contract it traded to B plus the additional \$ 100,000 player contract liability A assumed in the trade. A amortizes its \$ 500,000 adjusted basis in its newly acquired Fast player contract over the three years remaining on the Fast player contract.

Sport franchise B's tax basis in its newly acquired Strong Player contract is \$ 450,000 as computed above. This is comprised of its \$ 450,000 adjusted basis in the Fast player contract it traded to sports franchise A less the net \$ 100,000 contract liability relieved of on the trade plus the \$ 100,000 gain it recognized on the trade. Sports franchise B amortizes its \$ 450,000 adjusted basis in its newly acquired Strong player contract over the two years remaining on the Strong player contract.

## EXAMINATION TECHNIQUES

[364] Documents and information that should be obtained include:

1. A copy of all player contract sale or trade agreements for the tax year under examination.
2. The sports franchise's workpapers and schedules on the computations of gains and losses for the tax year under examination. This includes workpapers and schedules which reconcile with the return Form 4797 amounts.
3. For the prior, current, and subsequent tax years:
  - a. the sports franchise's schedules and workpapers reflecting:
    - 1) the player contracts owned by the sports franchise,
    - 2) the sports franchise's tax basis in each player contract, and
    - 3) the useful life used by the sports franchise for each player contract,
  - b. to the extent not included in (a), copies of the schedules and workpapers used to compute player contract amortization. This should include any schedules and workpapers necessary to reconcile this with the total player contract amortization amount reflected on return Form 4562.

### Gains and Losses on Player Contracts Given Up

[365] For player trades, focus on the player trades in which your sports franchise received cash or other taxable boot (such as player contract liabilities given up in excess of player contract liabilities assumed) in the IRC section 1031 exchange.

[366] Detailed guidance on the computation of the IRC section 1231 and 1245 gains on player contracts is not addressed in this guide because it is the same as for sales and exchanges of tangible personal property by any business taxpayer. For general guidance, refer to the coverage given earlier in this chapter under tax law application.

[367] IRC section 165 abandonment losses on players cut shortly after the player's contract was acquired may warrant consideration. If the player contract was acquired in connection with the acquisition of the sports franchise (either the purchase of an existing sports franchise or an expansion sports franchise), consider the basis allocated to player contract in the acquisition. To obtain IRC section 165 loss deductions, a new sports franchise may allocate more of the purchase price than warranted to players contracts of players it plans on cutting.

[368] A common examination technique is to analyze the taxpayer's prior and subsequent year's player contract listings, depreciation, and amortization schedules. Player contracts on the prior or current year's schedule that are omitted from the current or subsequent year's schedule should be reconciled to the sports franchise's player contract gain and loss return schedules.

### Tax Basis in Acquired Player Contracts

[369] Detailed guidance on the computation of the tax basis under IRC section 1012 and 1031 on player contracts is the same as for tangible personal property of other business taxpayers. For general guidance, refer to the coverage given earlier in this chapter under tax law application.

[370] In player contracts acquired in a multiple player contract trade, you may want to ascertain that more basis than warranted is not allocated to the player contracts acquired with the shortest useful lives.

#### POTENTIAL EMERGING ISSUE ON FUTURE DRAFT PICKS

[371] The coverage given above on IRC section 1031 exchanges assumes that a player contract and a future draft pick are like kind property. There may be a potential emerging issue on whether this is, in fact, the case.

[372] This potential emerging issue impacts whether the trade of a single future draft pick for a single existing player contract can qualify for IRC section 1031 nonrecognition. For multiple future draft and player contract trades, it impacts whether other property (nonlike kind) is received in the exchange.

[373] Treas. Reg. section 1.1031(a)-2(c)(1) provides the general rule that exchanges of intangible personal property qualify under IRC section 103

\* \* \* only if the exchanges of properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates.

[374] Treas. Reg. section 1.1031(a)-2(c)(2) provides "The goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business."

[375] The underlying property for both a future draft pick and a current player contract is the future or current contractual services of a professional athlete. However, while a sports franchise has a separable ascertainable value and basis in player contracts (separable from goodwill, going concern value, and the franchise intangible asset), this does not appear to be the case for future draft picks. It appears that future draft picks of a sports franchise are inseparable from its franchise intangible asset.

[376] Accordingly, it appears that future draft picks and existing player contracts do not constitute like kind property for purposes of IRC section 1031.

#### EXHIBIT A

##### SPORTS FRANCHISE CITATIONS

##### CODE, REGULATIONS, AND COMMITTEE REPORTS

IRC section 197(e)(6)	Intangibles acquired in connection with the acquisition of a sports franchise are not IRC section 197 intangibles
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H.R. Rep. No. 103-213, 103rd Cong., On enactment of IRC section 1st Sess. (1993), 1993-3 C.B. 197(e)(6) 555-560,

IRC section 1056

Player Contracts

S. Rep. No. 94-938, 94th Cong.,  
1976-3 Vol. 3 C.B. 124-129,

Addresses IRC section 1056 2d Sess. 90 (1976),

H. R. Rep. No. 94-658, 94th Cong.,  
1976-3 Vol. 2 C.B. 770-777 & 807-810,

Addresses IRC section 1056 1st Sess. 117-118,

IRC section 1245(a)(4)

Player contract amalgamation rule

#### SERVICE GUIDANCE

#### REVENUE RULINGS

Rev. Rul. 67-379, 1967-2 C.B. 127

Cost of baseball player contracts

Rev. Rul. 67-380, 1967-2 C.B. 291

Trade of player contract  
considered like-kind exchanges

Rev. Rul. 69-170, 1969-1 C.B. 28

Stadium structures (seats,  
lights, scoreboard, etc.)

Rev. Rul. 70-318, 1970-1 C.B. 113

Accounting method change on  
player contract acquisition costs

Rev. Rul. 71-123, 1971-1 C.B. 227

Amounts received for player  
contracts transferred to  
expansion team

Rev. Rul. 71-137, 1971-1 C.B. 104

Football player contracts, costs  
included

Rev. Rul. 71-583, 1971-2 C.B. 312

Payments for relinquishment of  
exclusive territorial rights are  
considered as payments for  
capital asset, capital gain  
treatment allowed

#### COURT CASES

Artnell Co. v. Commissioner.  
(7th Cir. 1968), acq., 1968-2 C.B. 1  
Action On Decision dated July 27, 1971

Deferral of season ticket revenue 400 F.2d 981  
Action On Decision dated September 17, 1970

Baltimore Baseball Club, Inc. v.  
States, 481 F.2d 1283

Installment method of accounting United  
for sale of players not permitted (Ct.Cl. 1973)

Board of Regent of the University  
National Collegiate football games is a property  
right of the athletic institution 81-1209 (W.D. Okl. 1982)

The right to televise college of Oklahoma v.  
Athletic Association, Civil No.

Buffalo Bills, Inc. v. United  
Cl. 1994), 74 AFTR.2d deferred compensation and 6006,  
severance payments 56 F.3d 84 (Fed. Cir. 1995)

Taxability of FICA and FUTA for States, (Ct.  
dismissed without op.,

Chicago Stadium Corp. v. United  
50,352 (N.D. Ill. 1991)

Unreasonable compensation. States, 91-2 USTC

First Northwest Industries v.  
Commissioner, 70 T.C. 817 (1978),

Allocation and deduction of sports  
franchise costs on the acquisition rev'd on

other grounds 649 F.2d of an expansion sports franchise 707 (9th Cir. 198 1)  
Action on and also subsequent league Decision dated April 26, 1979  
expansion revenue

Hollywood Baseball Association v. Commissioner, 423  
F.2d 494 contracts held ordinary income (9th Cir. 1970), cert. denied,  
400 U.S. 848 (1970)

Kauffman v. United States, Allocation of franchise cost (Ct. Cl. 1977),  
77-2 USTC 9664

Laird v. United States, Allocation and amortization of 556 F.2d 1224  
(5th Cir. 1977), player contracts and TV rights aff'g, 391 F. Supp. 656 (N.D.  
Ga. 1975), cert. denied, 434 U.S. 1014 (1978), Action on Decision dated August  
4, 1977

Leavell v. Commissioner, Player who contracted through PSC 104 T.C. 140  
(1995) was employee of sports team not  
PSC

McCarthy v. United States, Amortization of TV and radio 807 F.2d 1306  
(6th Cir. 1986) contracts, partnership  
organizational fees considered  
franchise acquisition costs.

Milenbach v. Commissioner, Loans versus taxable income, 106 T.C. 184  
(1996) damage settlement versus taxable  
income, discharge from  
indebtedness

New Orleans Louisiana Saints Ltd. v. Commissioner, T.C. Memo 1997- Allocation of the purchase price of an existing sports franchise 246

PDB Sports Ltd. v. Commissioner, Held the IRC section 1056 basis 109 T.C. 423  
(1997) limits apply to sale of team  
franchise, not to sale of  
partnership that owns the  
franchise

Pittsburgh Athletic Co. v. Broadcast rights of a baseball KQV  
Broadcasting Co., 24 F.Supp. sports franchise are property 490 (W.D. Pa. 1938)  
rights

Selig v. United States Allocation of sports franchise 740 F.2d 572  
(7th Cir. 1984) cost to player contracts

Uhlaender v. Henrickson, Basketball players have a 316 F.Supp. 1277 (D.  
Minn. 1970) property right in their status

Examiners are encouraged to contact the Sports Franchise ISP for information  
on informal Service guidance, such as general counsel memorandums, private letter  
rulings, and new citations.

#### EXHIBIT B

#### INTERNET RESOURCES

[377] There are numerous web sites on the Internet devoted to sports. The major  
web sites are:

## Website Sponsor

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[www.nfl.com](http://www.nfl.com) Official NFL site  
[www.majorleaguebaseball.com](http://www.majorleaguebaseball.com) Official MLB Site [www.nba.com](http://www.nba.com)  
Official NBA Site [www.nhl.com](http://www.nhl.com) Official  
NHL Site [www.nhlpa.com](http://www.nhlpa.com) NHL Players Association  
espnetsportszone.com ESPN [www.usatoday.com](http://www.usatoday.com)  
USA Today [www.foxsports.com](http://www.foxsports.com) FOX Sports  
[www.pathfinder.com/si](http://www.pathfinder.com/si) Sports Illustrated onlinesports.com  
Online Sports [www.sport-hq.com](http://www.sport-hq.com) Am. Sports  
Headquarters, Inc. [www.allsports.com](http://www.allsports.com) Allsports, Inc.  
[www.sportsline.com](http://www.sportsline.com) Sportsline USA, Inc [www.sportsnetwork.com](http://www.sportsnetwork.com)  
The Sports Network, Inc. [www.wgcd.com/stadiums.html](http://www.wgcd.com/stadiums.html)  
Wide World Collectors Digest  
(Stadiums)

## GLOSSARY

**Box Seats** Box seats are generally regarded as the best seats in the stadium; that is, closest to the field with the best view of the action. In baseball, the box seats are behind home plate, whereas in football, the box seats are around the 50 yard line.

**College Draft** Draft system for sports franchises to bid on college players. In general, the teams with the worst records select earlier than teams with better records. The rules for drafting players among the leagues vary, in some leagues the number of players drafted are limited, whereas in the baseball there is no limitation.

**Expansion Draft** Draft system whereby expansion sports franchises obtain players from the existing sports franchises in their league.

**Expansion Sports Franchise** The addition of a new sports franchise to the league through league expansion (increase in the number of sports franchises in the league).

**Farm Team** A farm team is where the big league clubs "grow" players. Skills are refined and worked on, and then as a player develops, he moves up through the system until he reaches the major league level. Most big league teams have at least 4 minor league farm teams: AAA being the highest, followed by AA, then at least one, and sometimes two A clubs. If there are two A clubs, one is usually high and one is low. There are also various short season, winter leagues, etc., where players can go to retain their skill level year round.

**Free Agency** Free agency in its purest form, is a status in which the rights to a player's athletic services are not owned by a sports franchise and may be shopped around by the player in a quest for the

most attractive bid. Before 1970, many player contracts contained a reserve clause which bound a player to a team for life unless a team chose to sell the contract.

Salary Cap System	A salary cap system establishes an overall wage framework that provides both a maximum amount of payroll allowed for each sports franchise and a minimum payroll floor that each sports franchise must pay. Salary caps are generally expressed as a percentage of gross average sports franchise revenues for the league.
Sports Franchise	<p>A sports franchise in a professional sports league generally includes the right to:</p> <ol style="list-style-type: none"><li>1. be the sports league's sole provider of the professional sport within a given geographical area,</li><li>2. be protected by league rules and regulations from intra-league business competition,</li><li>3. share in the proceeds of future league expansion,</li><li>4. share equally with other sports franchises in the league in the revenue from all single network television contracts negotiated on a league-wide basis,</li><li>5. sell local broadcast rights for preseason television and for both pre-season and regular season radio,</li><li>6. share with other sports franchises in the league in revenue from national merchandising,</li><li>7. sell programs and advertising space therein at home games,</li><li>8. participate in the college draft and the expansion draft (for expansion sports franchises), and</li><li>9. share in the league's goodwill.</li></ol>
Right of First Refusal	A right of first refusal permits a sports franchise to match any offer made to one of its current players by another sports franchise and thus retain the player's services. The right of first refusal generally applies only to restricted free agents, that is; for example players having a specified amount of limited experience.
Uniform Player Contract	The major sports leagues require that all players sign a uniform player contract that



contains provisions prescribed by the league.

\*\*\*\*\* End of Document \*\*\*\*\*