

Taxing the Business of Sports

Robert Holo

Jonathan Talansky

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TAXING THE BUSINESS OF SPORTS

by

Robert Holo
Jonathan Talansky

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PART I - INTRODUCTION*

*“The rising value of American professional franchises, together with league expansions and more sale transactions, has caused the Internal Revenue Service to take interest.”*¹

Major professional sports in America, according to several estimates, is a \$225 billion industry. While fan interest may wax and wane as athletes and organizations are beset by scandal and, even worse, mediocrity, the enterprise of sports continues to thrive and to occupy a disproportionate share of the public consciousness. Sports leagues today are immensely profitable businesses – more interested, perhaps, in the bottom line than the box score. Yet, somewhat anomalously, the purveyors of sport claim to be providing a public service – to the fans and to the communities in which they play. Sports leagues and franchises routinely assert that they, more so than most private enterprise, are entitled to a sizable share of the public fisc to finance their expansion. State and local governments have responded in unprecedented ways; during the 1990s alone, taxpayers shelled out approximately \$11 billion to fund new sports facilities for the owners of major American sports franchises.²

As the sports industry has come to rely on public funding for its rapid growth, the Internal Revenue Service (“IRS,” or “Service”) has attempted to ensure that these increasingly complex and profitable businesses are timely and accurately paying their taxes.³ The tax law tirelessly attempts

* Rob Holo is a partner and Jonathan Talansky is an associate in the Tax Department of Simpson Thacher & Bartlett LLP in New York. This article was first prepared for a presentation at the Tax Forum on January 7, 2008. The authors would like to thank Steven Todrys, Dickson Brown, and Aaron Cohen for their invaluable assistance.

1. Paul L.B. McKenney & Eric M. Nemeth, *Tax Law: The Purchase and Sale of a Sports Team: Tax Issues and Rules*, 80 Mich. Bar J. 54, 54 (June 2001).

2. It is by no means clear that sports franchises generate net economic surplus to their home communities and economies. For an instructive discussion (well beyond the scope of this paper) regarding the extent to which sports owners should be entitled to costly public subsidies (primarily in the form of tax-exempt municipal bond financings), see Paul C. Weiler, *Leveling the Playing Field*, 263-77 (Harvard University Press 2000). See also John R. Dorocak, *Tax Advantages of Sports Franchises: The Stadium*, Tax Notes, Nov. 13, 2000, at nn. 3-4; Andrew Zimbalist, *Baseball and Billions*, 136-40 (BasicBooks 1992).

3. In fact, in 1999, the IRS established a sports franchise office and staffed it with specialists in the business and law of sports. See also “Market Segment Specialization Program, Sports Franchises,” (Aug. 1, 1999), available in LEXIS,

to keep pace with the sophisticated economic transactions that are now the hallmarks of the business of American sports. This paper will examine selected United States federal income tax issues that arise in sports, with a nearly exclusive emphasis on the franchise (as opposed to the athlete) as taxpayer.

While sports owners inevitably grapple with ordinary issues of business taxation, the peculiarities of sports involve a unique set of problems that may require particular scrutiny. Part II of this paper will address issues relating to prepaid income and the timing of income recognition associated with common sports transactions, as well as a 2004 Revenue Procedure that may offer greater flexibility and tax planning alternatives to sports franchises. Part III examines the singular role of certain intangible assets in the tax profile of sports teams and chronicles the evolving tax treatment of player contracts. In this area, recent legislative and regulatory action stands to affect significantly the valuation of sports franchises and the structuring of their acquisitions. Part IV takes a bit of a digression and briefly addresses the well publicized topic of the “record home-run ball.”

PART II - PREPAID INCOME

“Look, we play the ‘Star Spangled Banner’ before every game. You want us to pay income taxes too?”⁴

Sponsorship and broadcasting are two of the most important sources of revenue to sports leagues and their teams. (By way of background, the major sports ‘leagues’ are generally operated as tax exempt organizations under section 501(c)(6) of the Internal Revenue Code of 1986, as amended (the “Code”).⁵ For the most part, individual sports teams enter into advertising agreements with local businesses (or national companies seeking local exposure) for the right to be associated with the franchise and its trademarks.

1999 TNT 225-9 (“MSSP”). The MSSP is only an internal training manual for IRS examiners and has no precedential value, but it is useful in that it reveals the Service’s thinking on several key issues.

4. Zimbalist, *supra* note 2, at 35 (quoting Bill Veeck, the former Major League Baseball owner known for his innovative ideas (such as team revenue sharing) and equally imaginative quips).

5. Unless otherwise noted, all references to the “Code” and “Sections” are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder. Although § 501(c)(6) only refers to “professional football leagues,” the Service has interpreted it to apply to other sports leagues as well. See, e.g., PLR 8321094 (1983) (golf).

Television and radio broadcasting exist both on the national and local level, and involve the rights to air broadcasts of games to viewers and listeners.⁶

As described below, advertising and broadcast agreements often call for large, up-front payments, followed by periodic payments over the duration of the contract. Sports franchises regularly attempt to defer the recognition of much of the initial payments and report such income as deferred revenue. Because of the sheer magnitude of these items of revenue, even a single year of deferral can create large tax savings. This section will consider the taxation of prepayments in typical sports contracts. It will also briefly address the prepayment doctrine in the context of sports ticket transactions between franchises and individual fans. A summary of the evolution of the legal principles is a helpful starting point.

A. Taxation of Prepaid Income - Overview

At the heart of the U.S. federal income tax system is the annual accounting concept. The Supreme Court, in its landmark decision in *Burnet v. Sanford & Brooks*,⁷ established that the essence of any tax system is to produce revenue that is measurable and payable at regular intervals. These goals are not entirely consistent with the principles of financial accounting, which are preoccupied with accurate snapshots of economic wealth. Clearly, taxpayers are loath to pay taxes on income that has not been duly matched with related expenses. These “vastly different objectives” of financial and tax accounting have given rise to a great deal of tension in the administration of the federal income tax. As Justice Blackmun eloquently framed it, “[f]inancial accounting, in short, is hospitable to estimates, probabilities, and

6. Sports broadcasting revenue has exploded over the past 25 years. This explosion has been due primarily to the passage of the Sports Broadcasting Act of 1961, codified at 15 U.S.C. § 1291. The Act, a monumental result of intense lobbying efforts, grants antitrust immunity to sports leagues and enables them to sell packaged broadcasting rights to national television networks. See *United States v. NFL*, 116 F.Supp. 319 (E.D. Pa. 1953) (precursor to the Sports Broadcasting Act); Zimbalist, *supra* note 2, at ch.7; Paul C. Weiler & Gary R. Roberts, *Sports and the Law*, 684-738 (3rd ed. West 2004). The various sports leagues have benefited immeasurably from this cartel power. One sports economist estimated that within two years of the passage of the Act, National Football League (“NFL”) and Major League Baseball (“MLB”) revenues tripled, while the number of broadcast games was cut in half. See *infra* note 39.

7. 282 U.S. 359, 365-66 (1931). For a helpful discussion, see, e.g., Stephen F. Gertzman, *Federal Tax Accounting*, ¶ 12.02 (Warren, Gorham & Lamont 1988).

reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty.”⁸

Congress has enacted various Code provisions relating to tax accounting in an effort to strike a workable balance between these competing principles. Section 446(a) states that taxpayers should generally use their method of financial accounting when computing their taxes. However, the Commissioner, under section 446(b), may require that the taxpayer use a tax accounting method that “clearly reflects income.” Section 451(a) contains the general rule regarding advance receipts – specifically, “the amount of any item 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 of a different period.” Regulations section 1.451-1(a) interprets this standard and states that under the accrual method, income is includible “when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.”⁹

The well known ‘trilogy’ of Supreme Court cases during the 1950s and 1960s, decided under the statutory predecessor of section 446, established the general rule that advance payments for services may not be deferred by accrual method taxpayers.¹⁰ In *Automobile Club of Michigan v. Commissioner*,¹¹ the Court required an accrual method taxpayer to include in income advance payments for membership dues which entitled members to

8. *Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 543 (1979) (upholding the Commissioner and holding that under the relevant provisions, conformity with generally accepted accounting principles does not create a presumption of proper tax accounting). Accord *Frank Lyon Co. v. United States*, 435 U. S. 561, 577 (1978); *Comm’r v. Idaho Power Co.*, 418 U.S. 1 (1974); *Boise Cascade Corp. v. United States*, 530 F.2d 1367, 1373 (Ct. Cl. 1976) (“*Boise Cascade*”) (tax accounting “starts from the premise of a need for certainty... and focuses on the concept of ability to pay”).

9. The so-called “all events test” is satisfied when (1) the payment is earned through performance, (2) payment is due to the taxpayer, or (3) payment is received by the taxpayer, whichever happens earliest. See Rev. Rul. 84-31, 1984-1 C.B. 127; Rev. Rul. 80-308, 1980-2 C.B. 162. The origin of the all events test was the Supreme Court’s decision in *United States v. Anderson*, 269 U.S. 422 (1926).

10. The seminal prepaid income decision prior to the trilogy cases was *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955), which involved prepaid newspaper subscriptions. The Tenth Circuit noted that the Code permitted an accrual method of accounting, and held that requiring current inclusion of such prepayments “would in most cases result in a distortion of an accrual taxpayer’s true income.”

11. 353 U.S. 180 (1957).

receive certain services during the following year. Deferral of the prepaid dues did not clearly reflect income because pro-rating the recognition of the prepayment was “purely artificial and [bore] no relation to the services which [the taxpayer] may in fact be called to render for the member.”¹² Therefore, in rejecting the taxpayer’s method of tax accounting, the Commissioner was properly exercising his statutory discretion.

*American Automobile Association v. United States*¹³ involved facts similar to those in *Automobile Club of Michigan*. However, the taxpayer in AAA provided an expert witness who testified that the deferral of the prepaid dues was consistent with generally accepted accounting principles. The witness adduced statistical evidence showing that the cost of providing member services correlated with the period of time over which the dues were recognized. The court held that the prepaid dues did not sufficiently relate to the incurrence of ‘fixed’ expenses, and therefore that the taxpayer’s method of accounting did not clearly reflect income. The AAA court also pointed to the fact that section 452 (which sanctioned the deferral of prepaid income) was enacted in 1954 in order to provide consistency between financial and tax accounting, but was retroactively repealed in 1955 because of excessive revenue loss.¹⁴

In the last of the trilogy cases, *Schlude v. Commissioner*,¹⁵ the Supreme Court held that an accrual method dance studio could not defer prepaid dance lesson fees. The taxpayer sought to defer including the tuition until the lessons were actually taken. In ruling against the taxpayer, the court stressed the importance of deferring to the Commissioner in tax matters and section 446’s broad grant of discretion. Importantly, however, *Schlude* asserted that it was relying upon an “additional ground” deployed by AAA, one that was “also controlling here.”¹⁶ Specifically, the taxpayer’s method of tax accounting was artificial because the advance payments related to services to be performed only upon each customer’s demand without relation to fixed dates in the future. Arguably, the lack of certainty pertaining to the schedule of future services was what gave the Commissioner the discretion to reject the deferral method of tax accounting.

12. *Id.* at 189.

13. 367 U.S. 687 (1961) (“AAA”).

14. *Id.* at 695. Furthermore, in 1958, § 455 was enacted, allowing accrual method publishers of newspapers, magazines and other periodicals to defer prepaid subscription income until the periodicals are delivered. These Congressional enactments and repeals, reasoned the AAA court, suggested that Congress was well aware of the problems surrounding prepaid income and that any taxpayer relief would come via explicit statutory codification.

15. 372 U.S. 128 (1963).

16. *Id.* at 135-36.

Seizing primarily upon the “additional ground” in *Schlude*, several courts have interpreted the trilogy cases to have left a deferral “window” open in appropriate circumstances. In *Artnell Co. v. Commissioner*,¹⁷ for example, the Seventh Circuit reversed a decision of the Tax Court which had relied on AAA to uphold the Commissioner’s disallowance of the taxpayer’s method of deferral tax accounting. At issue in the case was a baseball owner’s practice of deferring the unearned receipts attributable to game tickets, parking and media rights. Instead, these items were reported only as the games to which they were allocated were played. The *Artnell* court stated that “there must be situations where the deferral technique will so clearly reflect income that the Court will find an abuse of discretion if the commissioner rejects it.”¹⁸

Several courts have relied on the trilogy cases to deny income deferral and to express their disapproval of the result in *Artnell*.¹⁹ As for the Service, its response to *Artnell* was clearly stated in its subsequent Action on Decision.²⁰ The IRS asserted that it would “not follow *Artnell* to the extent the rules for deferral could be deemed to be broader than those contained in Rev. Proc. 71-21.” As discussed below, Rev. Proc. 71-21²¹ was issued on the heels of *Artnell* in order to more firmly establish the principles embraced in the trilogy cases. Yet, the ruling offers taxpayers some degree of flexibility and has been viewed by some as a concession on the Service’s part given the weight of judicial authority supporting the general rule of non-deferral.²²

17. 400 F.2d 981 (7th Cir. 1968) (“*Artnell*”). See also *Morgan Guaranty Trading Co. of N.Y. v. United States*, 585 F.2d 988 (Ct. Cl. 1978).

18. *Id.* at 985.

19. See, e.g., *Hagen Adver. Displays, Inc. v. Comm’r*, 407 F.2d 1105, 1109 n.7 (6th Cir. 1969). See also Gertzman, *supra* note 7, ¶ 4.03 (pointing out the “sound tax policy” embraced by the trilogy cases and suggesting that “it was appropriate for concepts of ability to pay, certainty, and protection of the public treasury to require that the income be recognized on its receipt”).

20. AOD 1971 WL 29312 (July 27, 1971). The IRS issues Actions on Decision at its discretion and only with respect to unappealed issues decided adversely to the government in the Tax Court. Such documents do not affirmatively state official IRS positions that may be relied upon, but rather provide guidance to IRS personnel.

21. 1971-2 C.B. 549.

22. See, e.g., Jules Silk, *Advance Payments – Prepaid Income: Recent Developments; an Old Problem Put to Rest*, 30 N.Y.U. Inst. Fed. Tax. 1651, 1659, 1666 (1972) (noting that, by its issuance of Rev. Proc. 71-21, the Commissioner had “relented” and “decided to forego, in part, the favorable results which he has received in litigation”); Jonathan Sobeloff, *New Prepaid Income Rules: IRS Reversal of Position Will Aid Many Taxpayers*, 33 J. Tax’n. 194 (1970). A survey of post-

Rev. Proc. 71-21 was promulgated pursuant to the Commissioner's authority under section 446 and its stated purpose was to "reconcile the tax and financial accounting treatment" of advance payments for services "without permitting extended deferral."²³ Section 3.02 of the Revenue Procedure states the general principle that "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 payment in gross income as earned through the performance of services." However, if the taxpayer has not completed performance of all contemplated services by the end of that next succeeding taxable year, "the amount allocable to the services not so performed" must be included in income for that year regardless of when, if ever, such services are actually performed. If, under the agreement, any portion of the services is to be performed after the end of the following year, or, alternatively, if any portion of the services is to be performed at an unspecified future date, the entire amount of income must be reported in the year of receipt.²⁴ Thus, Rev. Proc. 71-21 mandates harsh results for taxpayers whose large service agreements call for payments allocable to services scheduled to be performed more than a year hence.

Eight years after *Artnell*, the Court of Claims in *Boise Cascade* focused on the "additional ground" relied upon in *Schlude* and rejected the government's argument that income received for the future performance of services may never be deferred absent an explicit statutory exception.²⁵ Although decided in 1976, *Boise Cascade* involved tax years 1955 through 1961.²⁶ The taxpayer in *Boise Cascade* called expert witnesses to support its

Schlude cases reveals that an overwhelming majority of taxpayers were unable to overcome the "purely artificial" designation.

23. The issuance of Rev. Proc. 71-21 was preceded by a report by a Presidential task force in September 1970 expressing concern regarding the many instances in which accrual method taxpayers were being required to include prepaid amounts in income.

24. Rev. Proc. 71-21, § 3.03. Section 3.11 adds that the amount of any advance payment included in income cannot be less than the amount that has been reported as income for financial accounting purposes.

25. *Boise Cascade*, supra note 8, at 1375. The government emphasized, as had the Court in *AAA*, the Congressional enactment in 1958 of § 455. The courts in *Artnell* and *Boise Cascade* were unwilling to permit unfettered Congressional discretion notwithstanding the proper "reflection of income" under § 446(b).

26. Although Rev. Proc. 71-21 was not applied in *Boise Cascade*, the taxpayer invoked it to counter the government's reliance on a strict nondeferral position based on the trilogy cases.

claim that the deferral of advance payments for engineering services clearly reflected income. Refusing to read the trilogy as “an unvarying rule of law,” the court underscored the relevance of a fixed and certain schedule of future services and permitted deferral of the advances until the related services were performed.

Not surprisingly, the Service did not take well to *Boise Cascade*. In its Action on Decision, the Service took the court to task for applying the ‘certainty of performance’ test and focusing on the *alternative* ground for decision in *Schlude*. Specifically, such analysis “overlooks the PRIMARY ground upon which the Supreme Court relied in refusing income deferral: the ‘long-standing’ principle that ‘accounting systems deferring prepaid income could be rejected by the Commissioner’ pursuant to the broad discretion given him by IRC section 446.”²⁷ In support of its position, the Service cited favorably to *RCA Corp. v. United States*,²⁸ which held that the Commissioner has a great deal of discretion pursuant to section 446 to reject accounting methods that rely upon “prognostications and assumptions about the future demand for services.”²⁹

Ostensibly to further reduce controversy in this “troublesome and confusing area of tax law,”³⁰ the IRS in 2004 issued a more comprehensive ruling that softened some of the standards of Rev. Proc. 71-21 and extended certain carefully circumscribed deferral rights to other situations. Indeed, the stated purpose of Rev. Proc. 2004-34³¹ (“2004-34”) was to reduce the “considerable controversy” that abounded regarding the scope of Rev. Proc.

27. AOD 1986-014 (Feb. 19, 1986) (emphasis in original).

28. 664 F.2d 881, 888 (2nd Cir. 1981).

29. AOD 1986-014 (Feb. 19, 1986). Significantly, a number of cases in the Tax Court decided subsequent to the issuance of Rev. Proc. 71-21 lend support to the continued vitality of an independent “certainty of performance” criterion. For example, in *T.F.H. Publications, Inc. v. Commissioner*, 72 T.C. 623, 644 (1979) (“*T.F.H.*”), the court stated that “it will not follow the rationale of [*Artnell*] unless the facts present a certainty, of performance or fixed dates, such as was presented in *Artnell*.” Similarly, in both *Standard Television Tube Corp. v. Commissioner*, 64 T.C. 238, 242 (1975) and *Allied Fidelity Corp. v. Commissioner*, 66 T.C. 1068, 1077-78 (1976), the Tax Court chose to distinguish the facts at bar from those in *Artnell*, as opposed to questioning *Artnell*’s applicability. The continued viability of *Artnell* and the “certainty of performance” doctrine is discussed more fully infra Part II.D.

30. *Boise Cascade*, supra note 8, at 1374.

31. 2004-22 I.R.B. 991 (“2004-34”), modifying and superseding Rev. Proc. 71-21. For a helpful general discussion, see Boris I. Bittker, Martin J. McMahon & Lawrence A. Zelenak, *Federal Income Taxation of Individuals*, ¶ 39.03 (Warren, Gorham & Lamont 1995 & Supp. 1 2008). Section 6.01 of 2004-34 provides that the ruling is effective for taxable years ending on or after May 6, 2004.

71-21. At its most basic level, 2004-34, which does not apply to cash method taxpayers, did away with the limitation in Rev. Proc. 71-21 which stated that deferral was only permitted if all the services contemplated by the arrangement were scheduled to be performed by the end of the succeeding taxable year. However, as under the prior ruling, 2004-34 only allows deferral, where permitted, to the next succeeding taxable year.³² Section 5.02 of 2004-34 is the operative provision permitting deferral tax accounting for certain advance payments. This method is identified as a proper method of accounting for the purposes of Regulations section 1.451-1. The application of the ruling, and its liberalization of the prior standards, will be explored more fully below in the context of sports sponsorship agreements, broadcast agreements, and ticket purchases.

B. Advance Payments: Sponsorship and Broadcast Agreements

1. Timing Considerations

In the MSSP,³³ the Service describes the typical structure of a sports sponsorship agreement and its appropriate tax treatment. Team X enters into a sponsorship agreement with local Bank Y, under which the bank will be the ‘official bank’ of Team X and will be entitled to a host of rights, including print and broadcast advertising, stadium signage, ATM placement and the right to publicize its affinity with the team.³⁴ The sponsorship

32. An illustration of this difference can be seen in the following example: an advance payment of \$100,000 is received in 2007 for services to be performed in 2008 and 2009. Under Rev. Proc. 71-21, the entire advance payment is required to be recognized when received in 2007. However, under 2004-34, assuming certain conditions are satisfied, the taxpayer may defer until 2008 the recognition of that portion of the payment allocable to services scheduled to be performed after 2007. The IRS did not provide an explanation under either ruling as to why the deferral privilege was limited to one year. It is likely that one year was a compromise between the competing tax policies of matching income and expenses, on the one hand, and taxing only those who are able to pay, on the other. See generally Susan Kalinka, Proposed Revenue Procedure May Offer More Opportunities for Deferral for Accrual Method Taxpayers, 81 *Taxes* 5 (2003); Bittker, McMahon & Zelenak, supra note 31, ¶ 39.03[4][b].

33. Supra note 3, at 3-4. Recall that this internal guidance was promulgated prior to Rev. Proc. 2004-34.

34. An example of a wide-ranging sports sponsorship agreement is that between the Jones Soda Co., Inc. and the Seattle Seahawks football team, publicly filed (in redacted form) pursuant to the Securities Exchange Act of 1934. Jones Soda Co., Current Report (Form 8-K) (May 23, 2007). Under the terms of the agreement, Jones is entitled to act as the exclusive beverage of Qwest Field, to use the team’s trademark in its promotional materials, to have unobstructed signage at the stadium,

agreement is a 5-year contract worth approximately \$6 million. For obvious reasons, the franchise would like to receive a large portion of the contract price up front, with periodic payments to be made over the course of the agreement.³⁵ Upon execution of the contract, Bank Y pays \$4.2 million to Team X, representing a \$3.75 million ‘exclusivity rights’ fee (\$750,000 per year, all paid up front) and a \$450,000 sponsorship fee for the first year. Each year thereafter, Bank Y pays Team X another \$450,000 fee.

On these facts, 80% of the \$3.75 million rights fee must be analyzed under the rules governing advance payments.³⁶ The Service states that under Rev. Proc. 71-21, it would reject the taxpayer’s attempt to defer any of the \$3.75 million payment. This is because the payment is made pursuant to an agreement for the performance of services where a portion of the services is to be performed after the end of the immediately succeeding taxable year. Pursuant to section 3.03(a) of Rev. Proc. 71-21, the entire advance payment must be included in income in the year of receipt. Indeed, since most sponsorship agreements have terms stretching over a number of years, the IRS position (prior to 2004-34) was that most advance sponsorship payments were ineligible for deferral.

Under the deferral method of 2004-34, however, the taxpayer on these facts may argue that exactly 20% of the rights fee is earned during each of the five years of the agreement.³⁷ Therefore, under section 5.02(3)(b) of that revenue procedure (which requires that advance payments be included in the year of receipt only to the extent earned in that year, with the remaining

and to occupy a luxury suite. In exchange, Jones is required to pay the Seahawks a sponsorship fee each year. This agreement will be referred to throughout this section.

35. Front-loaded sponsorship agreements are most common where a team is selling the naming rights to a new stadium and seeks extra capital to finance the project.

36. Whether such payment is properly characterized as an advance payment for “services” will be addressed more fully *infra* Part II.B.2. For purposes of this section, it will be noted that the Service has expressed its preference for first addressing timing questions (and thus the applicability of the relevant rulings) so as to avoid the more difficult determination of whether an item of income is for “services” or for some other right. Nonetheless, the MSSP makes it clear that the Service is willing to posit an alternative argument that the rights fee may be a payment in exchange for a property right and thus, under the general principal of § 451, includible in the year of receipt.

37. This would satisfy the requirement in § 5.02(1)(b) of 2004-34 that a taxpayer, in order to qualify for deferral of advance payments, “must be able to determine... the extent to which advance payments are earned... in the taxable year of receipt.” The example also assumes that the taxpayer franchise is not public and does not prepare a financial statement as defined in § 4.06 of 2004-34.

amount to be included in the following year), the taxpayer may defer the recognition of \$3 million of the rights fee until the year following the execution of the agreement. Similarly, in the Jones Soda/Seahawks agreement, the sponsorship fees are paid in two installments per year; if the payments are frontloaded, the Seahawks may be entitled to defer, until year two, a portion of the sponsorship fee paid in year one, since a portion of the first year fee may be allocable to subsequent years (i.e., they are not “earned” in year one) under the deferral method of 2004-34.

As described above, sports franchises benefit from both local and national broadcasting deals. These agreements generally involve sums that were unfathomable at the time the first televised baseball game (an Ivy League matchup between Columbia and Princeton) was aired on May 17, 1939.³⁸ The league-wide broadcasting contracts are shared equally by the teams in the four major American sports leagues, and payments are usually made on a per-season basis.³⁹ Franchises may therefore receive payments for broadcasting rights during the tax year preceding the year to which these payments relate. In such cases, the question that arises under the applicable rulings is whether the franchise may postpone inclusion of these (sizeable) amounts until the following year.

An example of a typical broadcast agreement is contained in the MSSP guide.⁴⁰ Team X is a member of a league that has entered into a national television broadcasting deal with a national sports network. The contract covers the 1994 through 1997 seasons (assuming, for the sake of simplicity, that the seasons do not straddle the calendar year). Payments under the contract are to be made quarterly by the network, beginning on October 1, 1993. The franchise, a calendar year taxpayer, receives its \$7.5 million share of the first quarterly payment on that date.

The Service concluded that Rev. Proc. 71-21 does not even apply to the broadcast revenue of a sports team, since such income is not for personal services but rather for the sale of a property right (for reasons that are explained more fully below). Today, this type of arrangement would be governed by 2004-34, which clearly covers more than just service income.

38. Zimbalist, *supra* note 2, at 149.

39. In 2005, MLB signed an 8-year extension with ESPN for an estimated \$2.368 billion for the right to nationally broadcast various games each week. The NFL’s current television contracts with CBS, FOX, ESPN and NBC generate revenue of approximately \$3.7 billion *annually*, which computes to approximately \$115 million per year for each of the 32 NFL franchises, which in most cases is a majority of the team’s revenue. See Roger Noll, *The Economics of Sports Leagues, Law of Professional and Amateur Sports*, at 17.8; Bill Griffith, *Baseball, ESPN Renew Contract*, *Boston Globe*, Sept. 15, 2005; *Late Season Games Can Be Moved to Monday Nights*, available at <http://www.espn.com/nfl/news/story?id=1918761>.

40. MSSP, *supra* note 3, at 4-3.

Under section 4.01 of 2004-34, the \$7.5 million payment is an advance payment, and the taxpayer may defer its inclusion until tax year 1994. Similarly, if the payments were to be made in full annual installments payable on October 1 of each year, the taxpayer would likely be entitled to defer the full amount of the October 1, 1993 payment until 1994, the year in which the games will be played and the broadcasting revenue will be ‘earned’ pursuant to section 5.02(3)(b) of 2004-34. Moreover, if the franchise prepared the financial statements described in section 4.06 of 2004-34, and recognized some fraction of the October 1, 1993 installment payment in revenue for that year, 2004-34 would mandate that the same percentage of such payment be included in taxable income for 1993.⁴¹

As far as the broadcast networks are concerned, the IRS Chief Counsel ruled, in CCA 200726023 (May 25, 2007), that broadcast companies may not deduct the entire amount of license fees called for under a sports contract in the year the contract is signed. Section 461 governs the timing of the networks’ deductions, and Regulations section 1.461-1(a)(2) states that under the accrual method, a deduction is permitted only if the liability is fixed or payment is due. Furthermore, under section 461(h), economic performance does not occur until the sports league provides the network with the “property” represented by the right to air the game broadcasts. Since these agreements usually cover multiple sports seasons, the entire fee liability is not incurred, for the purposes of the accrual method, in the year the contract is entered into. It is the party’s performance, and not the mere execution of the contract, that establishes the fact of the liability.

2. Property Rights or Services?

On its terms, Rev. Proc. 71-21 was limited to prepayments for “services.” Under that ruling, the IRS’s audit posture called for a threshold determination of whether the prepayment was in exchange for services or some other tangible or intangible property right. Specifically, “[s]ince 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.”⁴² As in the broadcasting example described above, if a payment was adjudged to be in exchange for a property right of some sort, the taxpayer was precluded from relying upon the special deferral privilege of Rev. Proc. 71-21 and instead was subjected to the section 451 baseline of current inclusion, where s/he faced a strong presumption of non-deferral.

41. 2004-34, § 5.03, ex. 15.

42. MSSP, *supra* note 3, at 3-6.

The IRS generally permitted taxpayer reliance on Rev. Proc. 71-21 with respect to the advance payment of sponsorship fees. In the MSSP, the Service cited *T.F.H.*,⁴³ a case holding that a taxpayer must include in income the value of property received (in this case, in the form of a reduction in purchase price) in exchange for advertising to be supplied in the future. *T.F.H.* assumed without much analysis that “advertising is considered a service.”

Notably, most sports sponsorship agreements provide for an elaborate hybrid of “services” and rights. For example, the Jones Soda/Seahawks agreement purports to grant to the sponsor certain “Beverage Availability Rights” at the stadium, including the right to be the exclusive beverage concession sold at specified sporting events. Jones is also entitled to merchandise its products at Seahawks football games, and to promote its strategic sponsorship relationship with the team. In addition, the Seahawks have granted Jones the right to use its team logo and other trademarks on beverage containers. As for billboards and signage, section 3.3 of the agreement provides that “Jones is entitled to have permanent signage in the [stadium] for Jones Beverages” and that “[a]ny changes or modifications to such signage will be paid by Jones. Jones will specify the advertising message and graphics for its signage. All other aspects of the design, construction, and general appearance of the signage must meet Jones’s reasonable specifications.”

With respect to the obligations of the team, section 3.5 (“Obligations to Maintain Signage”) states that the Seahawks “will install and maintain all materials and lighting used for the signage...and the structures supporting the signage” and “repair any malfunction, damage, or destruction to the signage or supporting structures within a commercially reasonable period. All installation, maintenance and repair will be at [the Seahawks’] expense, except that Jones will pay the cost of installing any replacement signage used to modify Jones’s initial advertising message or graphics.”

Despite the wide variety of rights granted to Jones under the above agreement, the sponsorship fees are not broken out or allocated to different components of the contract. Thus, it is not clear how much the sponsor is paying for advertising, merchandising rights, or the exclusivity privilege. The IRS does not appear to have sought an allocation of sponsorship fees in its audits of contracts of this type; therefore, to the extent the Service characterized prepaid sponsorship fees as advance payments for advertising (and thus, on the authority of *T.F.H.*, for “services”), it appears that

43. *Id.* at 3-3 (quoting *T.F.H.*, *supra* note 29, at 640).

taxpayers were able to benefit from the deferral rules of Rev. Proc. 71-21 even for prepayments on various non-service items.⁴⁴

It is somewhat surprising that the Service has not questioned whether advertising truly constitutes a “service” for tax purposes. As mentioned above, the Tax Court in *T.F.H.* did not provide an explanation for its conclusory determination that advertising revenues were entitled to treatment under the special rules for prepaid services income. Similarly, the Service in TAM 200147032 (November 26, 2001) cited *T.F.H.* for this proposition without any discussion. Clearly, as the Jones Soda/Seahawks agreement demonstrates, the typical sponsorship agreement entered into by sports teams and their sponsors grants various self-styled “rights” to the sponsor. Although these contracts are generally in the nature of advertising arrangements, since they also memorialize a sale of such rights, it would not have been unreasonable for the IRS to insist on current inclusion of any advance payments for such rights due to the inapplicability of Rev. Proc. 71-21.

To be sure, it is difficult to find a clear definition of “services” for purposes of the prepaid income rules. In *Barnett Banks of Florida, Inc. v. Commissioner*,⁴⁵ the Tax Court held that annual credit card membership fees constituted prepaid income for services under Rev. Proc. 71-21. Specifically, the credit card company provided its customers with data processing services, assisted them with lost or stolen cards, and authorized the issuance of credit. The court rejected the IRS’ argument that the annual fees were “for membership in the card plan” and thus analogous to additional interest or a commitment fee.⁴⁶ In *Signet Banking Corp. v. Commissioner*,⁴⁷ however, the Tax Court ruled that the annual credit card fees at issue were not received in exchange for services and that, accordingly, deferral under Rev. Proc. 71-21 was not available. Although the credit card issuer in *Signet Banking* did perform a host of card-related services, the court meticulously scrutinized the operative cardholder agreement and concluded that while many services were indeed contemplated by the agreement, the issuer fixed its right to earn the fee when it opened the account and established a credit limit for the holder. In the court’s words, the credit card provider “performed all of the acts that it was required to perform in order to be entitled to the annual membership fee when it issued a credit card to the customer.”⁴⁸ The Federal

44. A review of various agreements reveals that sponsorship and broadcasting rights are often subsumed under one “rights fee.”

45. 106 T.C. 103, 116 (1996).

46. *Id.* at 110.

47. 106 T.C. 117 (1996), *aff’d* 118 F.3d 239 (4th Cir. 1997).

48. *Id.* at 126.

Circuit took up the question of “services” under Rev. Proc. 71-21 in *American Express Co. v. United States*,⁴⁹ but concluded only that the term was ambiguous and therefore that the Service’s interpretation of its own Revenue Procedure should be granted deference.

Other Code and regulatory provisions that refer to personal services, such as sections 448(d)(2) (definition of “qualified personal service corporation”), 269A (definition of “personal service corporation”) and 469(j)(2) (same), section 954(a)(3) (foreign base company services income), sections 861(a)(3) and 862(a)(3) (income sourcing rules), Regulations section 1.512(b)-1(c)(5) (for UBTI purposes, amounts paid for occupancy do not constitute “rent from real property” where substantial services are rendered to the occupant), and sections 351 and 721 (nonrecognition upon incorporation or formation of a partnership) do not shed sufficient light on whether advertising (at least in the context of sports sponsorships) is properly classified as a “service” (as opposed to a license of a limited property right) for United States federal income tax purposes.

The distinction between services and property rights was at least partially eliminated when the Service issued 2004-34. In addition to liberalizing the rules regarding the timing of performance, 2004-34 expanded the scope of Rev. Proc. 71-21 by allowing income deferral for items other than services. Given the ambiguity of the term ‘services’ under prior law, this revenue procedure eliminated a prime basis for dispute. Section 2.04 of 2004-34 asserts that “taxpayers and the Internal Revenue Service frequently disagree about whether advance payments are, in fact, for ‘services.’” Section 4.01 provides that the deferral is available under 2004-34 for payments made in exchange for services as well as various other items of income, including “the use (including by license or lease) of intellectual property.” ‘Intellectual property’ is further defined in section 4.03 of 2004-34 as “copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights (such as franchise rights and arena naming rights).”

Extending the benefits of deferral to rights in intangible property may have a real effect on sports broadcasting agreements. Under such agreements, licensing fees are paid to sports franchises (or sports leagues) in exchange for the rights to broadcast the team’s games over the air. In PLR 8331053 (April 29, 1983), a taxpayer attempted to defer the first installment of a payment made pursuant to a television contract. The Service disallowed such deferral under Rev. Proc. 71-21 and stated that “the payments received under the contracts with the networks in the present case are made not in exchange for services but in exchange for the [t]axpayer’s property interest in the publicity of its enterprise.” The Service cited a number of cases in

49. 262 F.3d 1376, 1381 (Fed. Cir. 2001).

support of its conclusion, including *Board of Regents of the University of Oklahoma v. NCAA*,⁵⁰ which held that “[t]he 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.”

Usually, broadcast agreements do not contemplate the provision of services on the franchise’s part, but merely grant the network the right to broadcast the action. Thus, whereas under prior law any advance payments were treated as a current sale of property rights, subject to a presumption of current inclusion under section 451, under 2004-34 these intangible property rights likely constitute “intellectual property,” and sports leagues and franchises should be entitled to the deferral benefits so long as they meet the other requirements of the ruling.

Advance credit card fees similar to the ones addressed in the *Barnett* and *Signet* cases, however, are not eligible for deferral treatment under 2004-34. Credit card issuers have had difficulty convincing the IRS and the courts that annual fees were paid in exchange for services, as opposed to the mere availability of credit. In this regard, the Service has stated that the annual fee “is a fee charged for the acquisition of a property right, the right to the use of money, and not for the performance of services.”⁵¹ Although section 4.03 of 2004-34 extended deferral benefits to intellectual property and “similar intangible property rights,” section 4.02 of 2004-34 provides that an “advance payment does not include – payments with respect to...credit card agreements.” Since 2004-34 effectively broadened the standards set forth in Rev. Proc. 71-21,⁵² credit card issuers seeking income deferral can plausibly argue that, to the extent a prepaid credit card fee constitutes service income (contrary to the Service’s conclusion in PLR 8543004), it is entitled to the more limited deferral of Rev. Proc. 71-21 despite its being excluded from the scope of 2004-34.

50. 546 F. Supp. 1276, 1328 (W.D. Okl. 1982). See also *Uhlaender v. Hendrickson*, 316 F.Supp. 1277 (D. Minn. 1970); *Weiler & Roberts*, supra note 6, at 434 (noting that copyright law creates a property right in the public broadcasting of sporting events but not in the bare events of a game). See *MSSP*, supra note 3, at 4-2, 4-3 (disallowing deferral relating to broadcasting contracts on grounds that these payments are in exchange for property rights, not services).

51. PLR 8543004 (July 18, 1985). See also Rev. Rul. 81-160, 1981-1 C.B. 312.

52. Section 2.04 of 2004-34 asserts that “the Service has determined that it is appropriate to expand the scope of Rev. Proc. 71-21 to include advance payments for certain non-services.” In light of this statement, one can take the position that 2004-34 does not disallow the deferral of any service income that falls within Rev. Proc. 71-21.

C. Advance Payments: Ticket Sales & Seat Licensing

Sports franchises derive a significant amount of revenue from ticket sales. Tickets are often sold as part of single- or multi-season packages, with substantial sums paid up front as deposits or advances. Seat licensing involves advance sales of the right to purchase season tickets for a specified period of time. In the case of luxury suites or skyboxes, which are most commonly occupied by corporations and large sponsors, the advances can be quite sizable.⁵³

Of course, in the case of prepayments for tickets, as is the case with all prepayments, it must first be determined that the prepaid sum constitutes a taxable advance payment (as opposed to a nontaxable deposit) for the trilogy and related doctrines to apply. That question, which is beyond the scope of this paper, is governed by the “complete dominion” standard as expressed by the Supreme Court in *Commissioner v. Indianapolis Power & Light Co.*⁵⁴ In general, the distinction between a tax-free deposit and a (generally)taxable advance payment will depend on the precise contractual terms and the use to which the funds are put, since the difference is one of degree rather than kind. Payments for seat licenses and (although to a lesser degree) season tickets usually are refundable only if the games are not actually played, which militates against deposit treatment.

These types of sports ticket transactions have played a prominent role in the development of the prepaid income doctrine. *Artnell* involved the proceeds of advance ticket sales by the Chicago White Sox, and the 7th Circuit in that case easily distinguished the facts at bar from those in the trilogy cases. Specifically, the court pointed out that since baseball games are played on a fixed schedule, “the uncertainty stressed in those decisions is not present here.”⁵⁵ Unlike the dance lessons in *Schlude* or the member services in *AAA*, the scheduled playing of baseball games can be relied upon with

53. By selling seat licenses, a sports team “receives a substantial additional and accelerated source of income, with no obligation of repayment.” Schuyler Moore, *Taxation of the Entertainment Industry*, ¶ 1304 (CCH 2008).

54. 493 U.S. 203 (1990). See generally Burgess J.W. Raby & William L. Raby, *Taxable Advance Payments vs. Deposits and Deferrals*, 2001 TNT 164-88 (Aug. 23, 2001) (advising practitioners to carefully structure escrow arrangements and advances for their clients so as to maximize income deferral). To the extent an arrangement is silent as to refundability, IRS guidance suggests that the complete dominion test will be met. See TAM 200619023 (Feb. 1, 2006) (holding that a prepayment made pursuant to a service contract that did not contain any refund provision was a taxable advance payment since the payor surrendered control of the proceeds once they were paid).

55. *Artnell*, supra note 17, at 984.

near certainty (subject to occasional rain-outs or the like). Therefore, the court ruled, the deferral of income in such circumstances embodies a near-perfect reflection of income.⁵⁶

The Tax Court had an opportunity to apply the reasoning of *Artnell* in the 2002 case of *Tampa Bay Devil Rays, Ltd. v. Commissioner*.⁵⁷ In *Devil Rays*, the taxpayer partnership received payments in 1995 and 1996 for season tickets and luxury suites for games that were to be played in 1998, the inaugural year for the Devil Rays baseball franchise. For book and tax purposes, these amounts were not reported until the games were played in 1998. After reviewing the trilogy cases and subsequent developments, the court concluded that “the facts before [it] in the instant case fall within the narrow fact pattern of *Artnell*.”⁵⁸ Since all game-related expenses were to be predictably incurred beginning in 1998, deferral of income was proper under section 446. Additionally, the advances were refundable in the event the Devil Rays did not play the 1998 season.

In the case of seat licenses, the IRS has ruled that deferral is not permitted beyond the date of receipt of the license fee. In CCA 200247035 (August 16, 2002), a professional sports franchise sold personal seat licenses to help finance the construction of a new stadium. The licensing fee was paid in three installments to be paid over three years, and entitled the licensees to purchase tickets to all future games to be played at the new stadium. The license agreement provided that “the licensees had only a revocable right of personal privilege and that the licenses did not confer any real property or leasehold interest in any particular stadium seats.” The IRS chief counsel, relying on sections 446 and 451, ruled that the taxpayer was required to include in income each installment payment under the contract at the time it became due and payable or was paid, whichever occurred first. One commentator has observed that this ruling was decided correctly and that

56. In the various IRS rulings and reported cases, advance payments for sports tickets have been uniformly treated as prepayments for services. See *Artnell*, supra note 17 (assuming without analysis that advance ticket payments are for services to be performed when game is played); *Silk*, supra note 22, at 1662 (characterizing the rendered service as “the playing of the game”). Undoubtedly, franchises perform numerous services for ticket-holders, such as parking, concessions and promotions. However, most of a ticket’s value is attributable to the right it vests in the holder to gain admittance into the arena to view the sporting event. Since the game is played irrespective of fan attendance, query whether advance ticket payments are perhaps more properly viewed as prepayments for a limited property right, (a license to enter private property for a limited purpose).

57. T.C. Memo 2002-248 (“*Devil Rays*”).

58. *Id.* at 19. Notably, in *Devil Rays* the advance payments represented 25% of the total season ticket prices.

under the prevailing authorities on prepaid service income, deferral of seat license fees would be improper because of the uncertainty regarding if and when the seat license will actually be used.⁵⁹

The nature of seat licenses, however, raises the question of whether it would be more appropriate to treat such prepayments as option premiums (and therefore subject to the tax accounting applicable to options) instead of items of prepaid income subject to section 451 and the trilogy cases. Under section 1234(b), a grantor of an “option in property” does not incur taxable income until the option transaction is completed through lapse, exercise or other disposition.⁶⁰ This “open transaction” treatment is accorded because the prepayment is eventually applied (if and when the option is exercised) as a credit to the purchase price of the tickets.⁶¹ While section 1234(b) on its terms only applies to options in stock, securities, commodities and commodity futures, options on other types of property are probably still entitled to open transaction accounting under pre- section 1234 case law.⁶² If the seat license lapses, the team’s gain will generally be ordinary income under the extinguishment doctrine.⁶³ Therefore, to the extent a seat license is

59. Moore, *supra* note 53, ¶ 1304 (“If payments for a seat license were not taxable on receipt, it would be difficult to rationalize why any other advance payments would be taxable”). Moore points out that another typical seat license arrangement involves the licensee’s purchasing an interest-free bond from the franchise in exchange for which the franchise grants a seat license. These loan proceeds are obviously not taxable to the franchise. Yet, under the rules of § 7872, the purchaser is deemed each year to receive imputed interest income from the team and to make a non-deductible payment for the seat license.

60. See Rev. Rul. 78-182, 1978-1 C.B. 265.

61. See *Comm’r v. Dill Co.*, 294 F.2d 291 (3d Cir. 1961) (\$50,000 paid for five year extension on a license to use a trademark, which license included an option to purchase, was not currently includible to licensor because it was intended to be a downpayment on the purchase price in the event the licensee exercised the purchase option). A similar payment in a capital transaction was found not to be currently taxable in *Virginia Iron Coal & Coke Co. v. Commissioner*, 99 F.2d 919 (4th Cir. 1938), since at the time the payments were made, it was impossible to know whether the sum would ultimately represent a return of capital or premium on a lapsed option. See also Rev. Rul. 58-234, 1958-1 C.B. 279.

62. See, e.g., *Virginia Iron Coal & Coke Co.*, *supra* note 61. Where the call option is exercised, the premium constitutes part of the writer’s amount realized on the sale, and will take the character based on the nature and holding period of the underlying property being sold. Rev. Rul. 78-182, *supra* note 60.

63. *Leh v. Comm’r*, 260 F.2d 489 (9th Cir. 1958); Rev. Rul. 57-40, 1957-1 C.B. 266. Capital treatment would not be available under § 1234A, which grants sale/exchange treatment to the termination or lapse of certain contracts. The provision was expanded by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1003(a), to cover “right[s] or obligation[s]” with respect to all property which would

an ‘option’ for tax purposes, a prepayment could conceivably be subject to deferral, character notwithstanding.

Regrettably for sports franchises, a seat license is likely not an option for tax purposes. Firstly, the arrangement does not entitle the holder to purchase seats at a fixed price; instead, he typically must pay the going price at the time of purchase. This militates against option treatment since the presence of a ‘strike price’ is one of the hallmarks of a true option.⁶⁴ Second, since advance payments for tickets themselves have been treated as prepayments for services, payments for the *right* to purchase a ticket may not constitute an option to buy property, but rather a payment creating an executory obligation to purchase services. The language of section 1234(a) suggests that there must be underlying property in order for a statutory option to exist. Consequently, a seat license fee is probably not entitled to deferral, while a true prepayment for specific tickets (as described above) can be deferred under *Artnell* and *Devil Rays*. The next part of the paper discusses the broader importance of these cases in the area of income deferral.

D. Continuing Viability of the “Certainty of Performance” Standard

The court in *Devil Rays* relied on the theory of *Artnell* to permit deferral without even mentioning, much less applying, the strictures of Rev. Proc. 71-21. The advance payments in that case would have failed the

be a capital asset in the hands of the taxpayer. Thus, a seat license fee (assuming it were an “option”) could still be entitled to sale treatment (to the team) upon lapse if the license were “with respect to” property (i.e., the ticket), and such ticket would be a capital asset in the team’s hand. However, tickets are clearly not capital assets in the team’s hands under § 1221(a)(1), and thus § 1234A would not apply. Consequently, even if a seat license were an option, a lapse would result in ordinary income to the team.

64. The underpinnings of the Service’s approach to options taxation can be found in the seminal case of *Burnet v. Logan*, 283 U.S. 404 (1931). An option transaction has been described by the Service in Rev. Rul. 58-234, supra note 61: “just as the optionee thereby acquires a right to sell, or buy, certain property at a *fixed price* during a specified future period or on or before a specified future date, so does the optioner become obligated to accept, or deliver, such property at that price” (emphasis added). The fact that a seat licensee is not taking an economic “position” with respect to the seats makes a seat license unlike a traditional option. See generally Stanley I. Langbein, *Federal Income Taxation of Banks & Financial Institutions*, ¶ 4.06 n. 322 (Warren, Gorham & Lamont 2001). Admittedly, a seat license may still be similar enough to a “traditional” option to warrant open transaction treatment under general principles.

applicable requirements since the services to be performed by the team were to take place as many as three years after the payments were made. The Tax Court nevertheless found *Artnell* to be determinative of the deferral question.

Sports tickets are perhaps the quintessence of “fixed and definite” services, and these two “ticket cases” lend great support to the proposition that, as a general matter, and notwithstanding the trilogy, service agreements that are drafted with enough precision and specificity may enable taxpayers to defer income recognition over multiple taxable years. While the trilogy involved prepayments for services and appear to represent weighty authority against deferral, it is not unreasonable to read the cases as being limited to their facts. Indeed, the nature of the prepaid income rules require fact-specific inquiries into whether a particular taxpayer’s method of tax accounting represents a clear reflection of *his* economic income. The trilogy taxpayers employed methods that were artificial and indeterminate, and statistical showings could not persuade the courts that deferral resulted in a clear reflection of income. Arguably, income earned in advance of services that are as fixed and definite as the occurrence of baseball games should not be limited by Rev. Proc. 71-21 or 2004-34.

The above conclusion is borne out by a careful review of post-trilogy court decisions. Initially, many cases interpreted the non-deferral principle broadly and categorically.⁶⁵ However, courts eventually began to focus on the particular circumstances before them, and acknowledged that the Supreme Court had not established an inflexible rule of law.⁶⁶ Although most of these decisions have articulated a high threshold for *Artnell* treatment, they have consistently intimated that deferral is appropriate on the right set of facts.⁶⁷ Thus, even in light of the 1971 and 2004 IRS revenue procedures, taxpayers should still be able to find support in the case law. As one

65. See, e.g., *Gillis v. United States*, 402 F.2d 501, 506 (5th Cir. 1968) (“The theory behind the accrual system is not complicated. Income items are reported in the year in which the right to receive them becomes fixed even though such items are not immediately receivable. At no time, however, are such items reportable later than the year of actual receipt”).

66. In addition to *Artnell* and *Boise Cascade*, see generally *T.F.H.*, supra note 29 and *Chesapeake Financial Corp v. Commissioner.*, 78 T.C. 869 (1982) (disallowing deferral of mortgage banker’s commitment fees on the grounds that it “lack[ed] a precise breakdown as to... the time the service was provided”).

67. *Automated Mktg. Sys., Inc. v. United States*, 34 AFTR 2d 5427 (N.D. Ill. 1974) (allowing deferral of marketing service income for more than two years); *Handy Andy T.V. & Appliances, Inc. v. Comm’r*, T.C. Memo 1983-713 (stating that deferral may be permitted “based upon contract terms or historical data regarding services performed for the specific payee”); *Collegiate Cap & Gown Co. v. Comm’r*, T.C. Memo 1978-226 (applying *Artnell* because future performance was fixed). See also cases cited supra note 29.

commentator has noted, “depending on the particular facts, pre-trilogy cases may be just as applicable today as both the trilogy and post-trilogy cases.”⁶⁸

Indeed, the Service itself in a number of rulings has not given dispositive weight to the taxpayer’s failure to comply with the requirements of Rev. Proc. 71-21. In TAM 200001006 (January 7, 2000), the taxpayer provided various consulting services for its clients, including carrying out market research studies over a specified period of time to study retail consumer trends. Fees for these studies were generally received in advance of the performance of the services. With respect to specific types of market studies, the taxpayer argued that although he failed to come under the ambit of Rev. Proc. 71-21, the *Boise Cascade/Artnell* line of cases furnished a basis for deferral of income. The Service did not reject the argument in principle, but instead distinguished these cases and concluded that the taxpayer’s method of tax accounting did not clearly reflect income under the trilogy and its progeny.

In TAM 200619023,⁶⁹ the Service addressed a taxpayer’s deferral claim based on *Artnell* and its progeny despite the taxpayer’s clear failure to secure the Commissioner’s consent, as required by Rev. Proc. 71-21. Specifically, section 5.01 of Rev. Proc. 71-21 states that with respect to services performed by related parties, the adoption of the deferral method of accounting under the revenue procedure is to be treated as a change in method of accounting subject to the consent requirements of section 446(e).

The taxpayer in the TAM received advance payment from a related party (for whom it had contracted to perform services) and utilized the deferral method without procuring consent. Nevertheless, the taxpayer cited to *Artnell* and *Devil Rays* and argued that its deferral methodology clearly reflected income. The Service held that the services provided by the taxpayer were not performed on a fixed schedule. Rather, the trucking services at issue were carried out based upon reasonable request, albeit during pre-determined time intervals. The ruling is critical not so much for its result but for the fact that the Service proceeded to address the *Artnell* claim even after determining that the taxpayer clearly ran afoul of Rev. Proc. 71-21.

Sports franchises that enter into lucrative sponsorship agreements that feature sizeable front-loaded payments are well served to draft contracts that are excruciatingly specific about the “services” owed to the sponsor. Doing so can serve to support the (accrual method) taxpayer’s position that deferral of inclusion until the time that services are performed is a clear reflection of income. The credit card fee cases demonstrate the significance

68. Gertzman, *supra* note 7, ¶ 4.03[3]. See also Moore, *supra* note 53, at 61 (suggesting that *Artnell*, *Boise Cascade* and *Devil Rays* may still be good law).

69. See *supra* note 54.

of precise drafting in this fact-intensive area of tax law, as courts and the Service are likely to insist that the smallest amount of uncertainty or ambiguity precludes the deferral of prepaid income. Indeed, “a simple change in the language of the applicable agreement may provide the basis for a deferral.”⁷⁰

Exhibit C to the Jones/Seahawks agreement discussed above (“signage specifications”) deals with Jones’ advertising and signage rights at Qwest Field. The agreement provides,

Each Agreement Year, Jones is entitled to the following permanent signage:

- One (1) 42’ x 12’ tri-vision panel on the North tower scoreboard.
- One (1) in stadium LED rotation per Seahawks home game.
- One (1) 28’ x 4’ backlit interior Qwest Field Event Center panel.
- One (1) 2’ x 2’ Qwest Field Event Center exterior sign.

If a prepaid income question were to arise on audit, the Seahawks could point to the precise wording of the contract and the ‘fixed and definite’ nature of the advertising services they are called upon to perform under the contract, especially since such services are ultimately linked to the games scheduled to be played by the Seahawks. In this case, the deferral of advance payments is perfectly consistent with the “clear reflection of income” standard as developed by the courts.

While the prepaid income doctrine is relevant to the ongoing operations of sports teams, there are also numerous tax issues that arise in connection with the acquisition and sale of such franchises. The next part of this paper will address the colorful historical backdrop and legal developments pertaining to one such issue; the amortization of player contracts (and other intangibles).

70. Gertzman, *supra* note 7, ¶ 4.03[3][e]. See also C.L. Kelley & A.H. Lieberman, *How to Defer Revenue From Prepaid Service Income*, 75 *Taxes* 3, (1997). Kelley and Lieberman draw on the credit card cases discussed above and conclude that the Tax Court’s analyses in these cases “can be helpful to other taxpayers with service income such as health clubs, cellular phone companies, online service providers and law firms.”

PART III - SPORTS FRANCHISES AND PLAYER CONTRACTS

“You go through The Sporting News of the last 100 years, and you will find two things are always true. You never have enough pitchers, and nobody ever made money.”⁷¹

The acquisition and sale of sports franchises have always piqued the interest of the IRS. This fascination is due to the fact that the value of sports teams consists disproportionately of intangible assets, a characteristic that presents tremendous challenges in the areas of allocation and valuation. According to the IRS, nearly 90% of the value of a sports franchise is attributable to its intangible assets.⁷² Moreover, buyers are usually wealthy individuals with extensive business interests outside the franchise itself.⁷³ The tax treatment of these intangible assets, which include franchise value, player contracts, and media rights, has substantially affected the market's valuation of franchises. Part III of this paper will explore the current treatment of “sports intangibles” under the applicable tax laws and will describe the concerns that have fueled Congressional and judicial action in this area, one that is rich with tax policy considerations.

A. Taxation of Sports Intangibles – Pre-2004

Although sports teams usually own a small number of tangible assets such as uniforms and equipment,⁷⁴ their most valuable assets are generally

71. Donald Fehr, former director, MLB Players' Association, quoted in Zimbalist, *supra* note 2, at 47.

72. IRS Memorandum, Examination of Sports Franchise Acquisitions, 2003 TNT 221-37 (Oct. 24, 2003). This directive is discussed further *infra* note 137 and accompanying text.

73. See Robert F. Reilly, Sports Franchise Acquisitions: Purchase Price Allocation Procedures, *The CPA Journal* (Oct. 2003).

74. Even the most valuable sports franchises generally do not own their own stadiums, but instead rely on public financing for such costs. For example, the New York Yankees' new stadium, under construction in the Bronx at the time of this writing, is expected to cost \$930 million, and the team will receive \$866 million from tax-exempt bonds issued by New York City. In January 2009, the Yankees requested an additional \$370 million in tax-exempt bond financing. Richard Sandomir, Hearing on Bonds for new Yankees Stadium Gets Testy, *N.Y. Times*, Jan. 14, 2009. Bryan Virasami, Mets Detail Stadium Financing, *Newsday*, Apr. 11, 2006. By brandishing the threat of relocation, teams have been able to negotiate

the league franchise (and the concomitant right to geographical exclusivity), rights to league-wide revenue streams (especially media and licensing contracts), and player contracts.⁷⁵ Since these assets comprise such a substantial percentage of the sports franchise, the available methods of cost recovery stand to impact overall franchise value.

1. Early Cases and the Franchise Value Explosion

Until 1993, with the introduction of section 197 and its 15-year amortization of most intangibles, the amortization of intangible assets was governed exclusively by section 167 and its regulations. Regulations section 1.167(a)-3 provides that depreciation deductions are available with respect to intangible assets only if it can be demonstrated that such assets have limited useful lives and ascertainable values, and that no depreciation is allowable with respect to goodwill.⁷⁶ Therefore, taxpayers traditionally sought to allocate large amounts of purchase price to amortizable intangible assets such as player contracts, while the IRS would insist on allocating value to intangible assets with indeterminate useful lives such as the franchise itself, or goodwill. Under Regulations section 1.167(a)-1(b), the estimated useful life of an asset is “the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income.”⁷⁷

The tax benefit attributable to sports player contracts purchased as part of a franchise acquisition can be traced back to a number of cases from the 1920s and 30s. At the time, typical contracts used in professional baseball, football and basketball provided for one year of service and contained a “reserve” clause granting the team an option to renew the contract for another year. The athlete and the team would typically

favorable leases in stadiums built with taxpayer dollars. See *supra* note 2 and accompanying text.

75. See Stephen A. Zorn, ‘Couldna Done it Without the Players’: Depreciation of Professional Sports Player Contracts Under the Internal Revenue Code, 4 *Seton Hall J. Sport L.* 337 (1994).

76. See also *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. den.*, 414 U.S. 1129 (1974); Rev. Rul. 74-456, 1974-2 C.B. 65. The disallowance for amortizing goodwill was first introduced in T.D. 4055, VI-2 C.B. 63; Reg. 69, Art. 163 (Revenue Act of 1928, Reg. 69, Art. 163). Treas. Reg. § 1.167(a)-3 still contains the general rule for intangible assets, but now cross references § 197 for the treatment of goodwill and certain other intangibles acquired after Aug. 10, 1993.

77. Of course, costs are treated as capital expenditures in the first place only if they are attributable to the acquisition of an asset whose useful life extends substantially beyond the taxable year. Treas. Reg. § 1.263(a)-2(a).

renegotiate the salary prior to the option year; however, if no agreement was reached, the club had a limited right to fix the salary. If negotiations turned acrimonious, the team, of course, could not force the player to play, but could prevent the player from playing for another team in the league.⁷⁸

The first tax case to address the issue of player contracts in connection with the purchase of an entire team was the 1935 decision in *Chicago National League Ball Club*.⁷⁹ In that case, the taxpayer had

78. The reserve clause was a key feature in professional sports contracts from as far back as the late 1800s. The seminal Supreme Court decision in *Federal Baseball Club v. National League*, 259 U.S. 200 (1922), held that baseball was an “amusement,” and therefore not subject to the antitrust laws. This ruling ensured that the reserve clause, and the bargaining power it gave to baseball owners, would remain a fixture of the game for many years. However, in 1975, an arbitrator ruled that two pitchers playing under the reserve clause could bargain with other teams, since a sports league could not retain the services of a player indefinitely. The ruling was upheld by the Eighth Circuit and gave rise to the advent of free agency, changing the course of modern professional sports.

79. B.T.A. Memo. 1933-197 (1933), *aff’d per curiam*, 74 F.2d 1010 (7th Cir. 1935) (“*Chicago National League*”). To be sure, owners of sports franchises had litigated the issue of cost recovery on player contracts from as early as the 1920s. However, prior to *Chicago National League*, the question primarily arose with respect to the acquisition of *individual* player contracts (where it was clear that a specific sum was allocable to a particular contract), as opposed to purchases of franchises that included an aggregate of contracts. Indeed, *Chicago National League* also involved deductions with respect to individually acquired player contracts. The first case to address the sale of individual player contracts was *Dallas Athletic Ass’n. v. Commissioner*, 8 B.T.A. 1036 (1927), which held that amounts paid by one minor league baseball team to another for player contract rights were in the nature of capital expenditures and were not ordinary and necessary business expenses. In later cases, however, including *Chicago National League*, The Board of Tax Appeals (the “Board”) reversed course and permitted current expensing of the cost of acquiring player contracts. In these later cases, the courts’ holdings were based on highly questionable analyses of the reserve clause. For example, in *Pittsburgh Athletic Co. v. Commissioner*, 27 B.T.A. 1074, 1076 (1933), the Board permitted a current deduction even though the contracts were sure to benefit the club for more than a single year, as baseball’s version of the reserve clause gave the team the right to unilaterally set the salary for the renewal year. The Third Circuit affirmed the Board, 72 F.2d 883, 884 (3d Cir. 1934), pointing out that “if the player should cease to engage in professional baseball, the option for renewal of his contract would become valueless.” See also *Helvering v. Kansas City American Assoc. Baseball Co.*, 75 F.2d 600 (8th Cir. 1935). Notably, *Pittsburgh Athletic Co.*, *Chicago National League* and *Kansas City American Assoc. Baseball Co.* were accepted by the IRS in two administrative pronouncements, I.T. 2932, XIV-2 C.B. 61 (1935) and I.T. 4078, 1952-1 C.B. 39. The Service eventually realized that the reserve clause did in fact

purchased a baseball franchise and the thirty or so player contracts that were owned by it at the time. The Board clearly accepted in principle an allowance for the depreciation of these contracts; however, due to lack of proof and a failure by the taxpayer to allocate the purchase price between the contracts and the franchise, the Board effectively passed on the question of amortization.

In Rev. Rul. 54-441,⁸⁰ the IRS squarely addressed, for the first time, the proper tax treatment of player contracts acquired as part of a larger acquisition. The Service held that the cost of a roster of baseball player contracts must be capitalized and recovered over the useful life of such contracts. Since the contracts at issue were uniform one-year player contracts with then-standard reserve clauses, the Service stated that it would be reasonable to compute their useful lives based on the prior owner's pattern of exercising the options.⁸¹

With respect to the acquisition of individual player contracts, by contrast, Rev. Rul. 54-441 agreed to full deductibility in the year of purchase, thereby approving of the results in prior Board cases. However, the Service eventually rejected these cases (along with Rev. Rul. 54-441) in Rev. Rul. 67-379,⁸² where it held, quite sensibly, that all costs of acquiring player contracts must be capitalized and amortized over their useful lives. Capitalization was mandated even with respect to the 1-year contracts with reserve clauses, since the effect of the team's option "is the same as if the player were expressly to bind himself to play only for the club which owns his contract for the entire period of his useful life as a player in organized baseball, subject to annual salary adjustments." A similar conclusion was reached with respect to professional football contracts in Rev. Rul. 71-137,⁸³ which likened football's "option clause" to baseball's reserve clause and disallowed current deductibility of such costs. In these rulings and cases, the point of contention was current deductibility versus capitalization and amortization. At no point did the IRS argue that player contracts were not

give teams an upper hand on players and rejected current deductibility for all acquisitions of player contracts (requiring instead depreciation over the useful life of such contracts). See Rev. Rul. 67-379, *infra* note 82.

80. 1954-2 C.B. 101.

81. In baseball, unlike football and basketball, when the renewal option was exercised, the renewed contract would itself contain an option to extend. Although this feature could have furnished an independent basis for the Service to differentiate between the useful lives of baseball player contracts and those in other sports, it never attempted to do so. See Leslie S. Klinger, *Professional Sports Teams: Tax Factors in Buying, Owning and Selling Them*, 39 J. Tax'n. 276, 277 n.4 (1973).

82. 1967-2 C.B. 127.

83. 1971-1 C.B. 104.

depreciable property, which proved to be a boon to the sports franchises that claimed these deductions to the tune of millions in tax savings.

Because of the ability to amortize the costs of player contracts over a relatively short timeframe, taxpayers involved in the purchase of sports teams began to allocate a substantial portion of acquisition costs to the contracts.⁸⁴ This phenomenon proved to be a driving force behind the explosive growth of professional sports franchises throughout the 1950s and 1960s. The deduction attributable to purchased player contracts roughly doubled the value of major league sports franchises from 1959 to 1975.⁸⁵ The favorable tax rules also fueled expansion of the sports leagues themselves. Indeed, by 1974, the number of professional sports teams had increased to 114 from just 42 in 1959.⁸⁶ Notably, many franchises continued to report tax losses as cash income and enterprise values continued to rise. According to one commentator, “the purchasers were attracted by the tax shelter aspects of the business rather than by the prospect of operating profits.”⁸⁷

In the mid 1970s, the courts again began to look seriously at the amortization of player contracts in sports. In *Laird v. United States*,⁸⁸ the government argued that an allocation of over 90% of a sports franchise’s purchase price to the player contracts was improper. The taxpayer in *Laird* was a shareholder of the S corporation that had purchased the NFL’s Atlanta Falcons as an expansion franchise in 1966. Pursuant to the acquisition documents, the taxpayer paid total consideration of \$8.5 million for a “bundle of inextricably related assets” that included participation in the NFL’s lucrative television contract with CBS, a right to participate in an expansion draft and acquire 42 veteran player contracts, and the right to be the sole NFL team within a 75-mile radius.⁸⁹ On its tax return, the taxpayer reported the cost of the player contracts as \$7.7 million (91% of the purchase price), and claimed sizeable depreciation deductions accordingly.

The momentous nature of the *Laird* case is evidenced by the fact that the IRS held approximately 130 cases in abeyance pending the District

84. Zorn, *supra* note 75, at 345, 351.

85. *Id.* at 351 n. 49. See also Steven Braun & Michael Pusey, Taxation of Professional Sports Teams, 7 Tax Adviser 196 (1976) (pointing out that the ability to amortize player contracts (at least as of 1976) is the most significant tax aspect of sports franchise ownership).

86. Zorn, *supra* note 75, at 351 (citing Richard A. Koch, Note, The Professional Sports Team as a Tax Shelter – A Case Study: The Utah Stars, 1974 Utah L. Rev. 556 (1974)).

87. *Id.* The “tax shelter” nature of the player contract amortization allowance is discussed *infra* Part III.A.2.

88. 391 F. Supp. 656 (N.D. Ga. 1975), *aff’d* 556 F.2d 1224 (5th Cir. 1977).

89. *Id.* at 659.

Court's decision.⁹⁰ Clearly troubled by the zeal with which sports franchises were writing off their intangible assets, the government's stance was that it would "no longer accept the arbitrary valuations placed on player contracts for depreciation purposes."⁹¹ After hearing expert witnesses describe, in great detail, the proper method of valuating each of the player contracts, the court in *Laird* disallowed the taxpayer's allocation and concluded that a significant portion of the purchase price was allocable to the present value of the (nonamortizable) league-wide television rights. Specifically, in reducing the amortizable basis of the player contracts to \$3.03 million, the court ruled that "the allocation of the entire amount of the purchase price to player contracts and nothing to the extraordinarily valuable television rights which also were owned by and acquired from the member teams in the same transaction" did not comport with "the principles of economic reality."⁹²

The tax treatment of transferred franchises (as opposed to the expansion teams at issue in *Laird* and *First Northwest*) was addressed in *Selig v. United States*⁹³ a case dealing with the 1970 purchase of the Seattle Pilots, an American League baseball team that was ultimately moved to Milwaukee as the Brewers. The syndicate of purchasers, led by Allan 'Bud' Selig, allocated \$10.2 million of the \$10.8 million purchase price to the major league and minor league player contracts acquired along with the team.⁹⁴ The District Court heard the testimony of appraisers on both sides and concluded that Selig's appraisers had offered the more convincing valuations. Interestingly, the court suggested that the small size of the Milwaukee market supported the modest franchise allocation ("The right to play baseball in Milwaukee is not worth much; everyone agrees on that"⁹⁵). The Seventh Circuit affirmed the District Court in *Selig* in what reads more

90. S. Barksdale Penick, *The Selig Case and Amortization of Player Contracts: Baseball Continues its Winning Ways*, 6 *Comm. Ent. L. J.* 423, 430 (1984). The Commissioner testified that these cases involved "millions of dollars in additional taxes." *Inquiry into Professional Sports before the House Select Committee on Professional Sports*, 94th Cong., 270 (2d Sess. 1976).

91. Weill, *Depreciation of Player Contracts – The Government is Ahead at the Half*, 53 *Taxes* 581, 584 (1975).

92. *Laird*, *supra* note 88, at 659, 669. In a similar case, *First Northwest Industries of America, Inc. v. Commissioner*, 70 T.C. 817 (1978), *rev'd and remanded on other grounds*, 649 F.2d 707 (9th Cir. 1981) ("*First Northwest*"), the taxpayer was the purchaser of the Seattle Supersonics of the National Basketball Association ("NBA"). The Tax Court reduced a 91% player contract allocation to 28.6%.

93. 565 F. Supp. 524 (E.D. Wis. 1983).

94. *Id.* at 525. The purchasers allocated only \$500,000 to the franchise itself.

95. *Id.* at 535.

like a Ken Burns paean to baseball than a legal opinion.⁹⁶ (In a strange twist of irony, Selig, then (and still) the commissioner of baseball, appointed a panel in 1999 in response to owners' clamoring about the escalation of player salaries.)⁹⁷

The *Selig* case has been called the "high water mark of taxpayer success" in allocating purchase price to player contracts.⁹⁸ Indeed, the owners of the Pilots were able to write off nearly their entire investment over five years, the approximate "useful life" of a baseball player at the time. The government clearly found the allocation in *Selig* to be abusive and even went so far as to suggest that baseball clubs and their tax lawyers were colluding to establish artificially high contract valuations in a conspiracy to deprive the government of its taxes.⁹⁹

In response to cases such as *Selig*, Congress enacted section 1056 as part of the Tax Reform Act of 1976.¹⁰⁰ That provision established a rebuttable presumption that when a sports franchise "is sold or exchanged," not more than 50% of the purchase price is allocable to player contracts. It also provided that the purchaser's basis in a player contract cannot exceed the seller's adjusted basis plus the seller's recognized gain on the transfer. According to Senate testimony, the provision was expected to generate upwards of \$5 million per year in additional tax revenue.¹⁰¹ In TAM

96. *Selig v. United States*, 740 F.2d 572 (7th Cir. 1984). Judge Bauer opens the opinion with a detailed discussion of the history of baseball and a recounting of momentous events and legendary players. Sprinkled throughout are excerpts from "Casey at the Bat." The decision famously concludes, "[T]here should be joy somewhere in Milwaukee – the district court's judgment is affirmed." *Selig*, 740 F.2d at 580.

97. William H. Baker, Symposium: Sports Law in the 21st Century: Taxation and Professional Sports – A Look Inside the Huddle, 9 Marq. Sports L.J. 287, 287 n.2 (1999).

98. Zorn, *supra* note 75, at 389.

99. One of the appraisers used by the Pilots was a close friend and confidante of Selig's, a fact that the court noted but dismissed. It concluded that the appraisal was independent and fair, and supported by generally accepted accounting principles.

100. Tax Reform Act of 1976, Pub. L. No. 94-455, § 212(a)(1). Section 1056 was ultimately repealed as part of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (the "Jobs Act"), discussed *infra* Part III.B.

101. Ultimately, § 1056 failed to serve its intended purpose, as sports ownership structures proved too sophisticated given the limited scope of the rule. In the first case to interpret § 1056, the Tax Court exposed one such flaw. In *P.D.B. Sports, Ltd. v. Commissioner*, 109 T.C. 423 (1987), the taxpayer purchased a 61% interest in the partnership that owned the NFL's Denver Broncos, triggering a deemed termination of the partnership under § 708(b)(1)(B). Under the applicable

9617001 (April 26, 1996), the Service clarified that section 1056 applied to the creation of a new expansion franchise and not only the sale of an existing franchise.

The 1976 legislation also enacted section 1245(a)(4), which provided for the recapture of previously taken depreciation of player contracts upon the sale or exchange of a sports franchise.¹⁰² This rule essentially amalgamated all player contracts for depreciation recapture purposes. In Congress' view, this provision worked hand-in-hand with the basis rule of section 1056. According to the Senate Report, under section 1056, "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)."¹⁰³

Even with the limitation imposed by section 1056, however, the depreciability of player contracts proved to be a boon to some sports owners. The syndicate of investors who purchased the Boston Red Sox in 2002 for \$700 million allocated \$350 million to player salaries. Thus, the first \$70 million of Red Sox operating profits for each of the next five years¹⁰⁴ were

regulations, the transaction was treated as a deemed distribution of the partnership property to the new and continuing partners followed by a contribution of the property to the 'new' partnership, triggering a basis step-up under the partnership basis provisions of §§ 732 and 743. The Service contended that § 1056 still applied despite the fact that the contracts were acquired through the transfer of a partnership interest (as opposed to a transfer of the franchise itself). The Tax Court held that since there was no "sale or exchange" of a sports franchise, the § 1056 limitation did not apply. Consequently, the partnership was able to take a fair market value basis in the player contracts (approximately \$36 million) irrespective of the gain recognized by the selling partner with respect to the player contracts and despite the fact that the prior partnership had a basis in such contracts equal to \$6 million. In light of the fact that many sports teams are operated through partnerships, the failure of Congress and Treasury to explicitly address the interplay of § 1056 with the self contained basis provisions of Subchapter K left a large hole in the statute. See also Jasper L. Cummings, Jr. & Robert P. Hanson, *American Jobs Creation Act of 2004: A Selective Analysis*, ¶ 5.02 (Warren Gorham & Lamont 2005) (arguing that the result in *P.D.B. Sports* essentially made § 1056 elective).

102. Tax Reform Act of 1976, *supra* note 100, at § 212(b)(1) (effective for player contracts transferred as part of a sale occurring after Dec. 31, 1975). This provision was also eventually repealed by the Jobs Act.

103. S. Rep. No. 94-938, 94th Cong., 90 (2d Sess. 1976), 1976-3 Vol. 3 C.B. 128.

104. Under the § 1056 regime, the Service generally accepted useful lives of between three and six years for baseball contracts. This was based on the

essentially tax free. Similarly, of the \$130 million franchise fee paid by the partnership that acquired the expansion Tampa Bay Devil Rays, approximately \$75 million was allocated to the 35 players selected by the team in the expansion draft.¹⁰⁵ In these cases, even if initial team profits fell short, the excess deductions were able to be used by the owners to offset their other business income.¹⁰⁶

2. *Player Contract Amortization as Tax Shelter?*

Several commentators have suggested that the Service was not aggressive enough in its early rulings (and the early judicial decisions) regarding player contract amortization and the allocation of purchase price in franchise acquisitions.¹⁰⁷ Interestingly, the early IRS pronouncements, such as Rev. Ruls. 54-441 and 67-379, were hailed by some as government victories against aggressive sports owners seeking to gain current write-offs for longer term “capital” investments.¹⁰⁸ However, later cases demonstrated that these franchises, along with their crafty financial advisors, were able to parlay the new legal standards into tremendous after-tax results. Given the deductibility of player salaries and various player development expenses, there were certainly a number of theories on which the government could have argued that the cost of a player contract is recoverable only upon disposition.¹⁰⁹ It is possible that the government failed to anticipate the

historically accepted measure of the average player’s productive career. See MSSP, supra note 3, at 9-1.

105. See *Devil Rays*, supra note 57, at 1538.

106. See Nathan R. Scott, Take Us Back to the Ballgame: The Laws and Policy of Professional Sports Ticket Prices, 39 U. Mich. J.L. Reform 37, 58-59 (2005); Klinger, supra note 81, at 277 n.6.

107. See, e.g., Zorn, supra note 75 (characterizing the amortization of player contracts as a “tax shelter” and arguing that under pre-2004 law, no deduction should be allowed with respect to player contracts acquired in bulk). See also Gerald W. Scully, *The Business of Major League Baseball* 130 (1989); Klinger, supra note 81.

108. Zorn, supra note 75, at 379.

109. The costs of player development (including the operation of a farm system and the employment of talent scouts) is a deductible expense under § 162. The court in *Selig*, supra note 93, at 528, pointed out that the allowance for player contract amortization, combined with the current deductibility of these development costs “in effect enables the owners to double up on expenses (i.e., tax deductions) during the first five years of operation (i.e., the period of amortization).” See also Zorn, supra note 75, at 392-93.

growth in sports franchise value, and that it consequently abandoned any argument that player contracts should not be amortizable at all.

The amortization of player contracts consistently yielded significant benefits to sports owners at least through the 1980s. In fact, such a practice resulted in the “puzzling phenomenon” of skyrocketing franchise values’ coinciding with sustained tax losses.¹¹⁰ As an illustration, in 1974, only five of the 27 professional basketball teams reported a profit.¹¹¹ In baseball, the Pittsburgh Pirates experienced steady growth on the field and at the box office between 1986 and 1991. During that period, their payroll more than doubled from \$6 million in 1986 to \$15.5 million in 1990. Yet, large amortization deductions turned the Pirates’ operating profits into tax losses.¹¹²

Stephen Zorn argues that the Service was not aggressive enough in disputing the courts’ penchant for treating franchise value as a residual similar to goodwill. In too many cases, argues Zorn, the court would preoccupy itself with valuing the player contracts and would drastically underestimate the value of the franchise itself. In most cases, the league franchise and the right to operate a sports team in a geographical area are the most economically significant dimensions of sports ownership. In the era of free agency, players may come and go, but fans remain loyal to their home teams.¹¹³

Another possible shortcoming in the IRS’ early litigating position was its failure (at least after *Laird*) to assert the so-called “mass asset” rule to player contracts. The mass asset rule, a judicially created doctrine, denies

110. See Weiler & Roberts, *supra* note 6, at 632 (describing Victor Kiam’s purchase of the New England Patriots in 1988 for \$85 million. Within four years, the Patriots had suffered great financial losses both on and off the field. In 1992, however, Jim Orthwein purchased the team for an estimated \$105 million, and after three seasons of continued operating losses, sold the team in 1995 to its current owner, Robert Kraft, for \$160 million). This skepticism is not limited to the ranks of legal scholars such as Weiler and Zorn. Whitey Herzog, the former baseball player, coach and manager, referring to the claim by then Kansas City Royals owner Ewing Kauffman that his team lost \$1.8 million in a [very successful] 1985 season, asserted that “there’s no way – if you draw two million people – that you can lose money. Unless you’re trying.” Zimbalist, *supra* note 2 at 72. See also *supra* notes 86-87 and accompanying text.

111. U.S. News & World Report, Aug. 12, 1974, at 51.

112. Zimbalist, *supra* note 2, at 69-70.

113. Zorn, *supra* note 75, at 364-65. See also Zimbalist, *supra* note 2, at 35 (“it is obvious that the overwhelming share of the value of a franchise belongs to the monopoly rent that is generated by belonging to Major League Baseball and the exclusive territorial rights membership confers, not the player contracts”). Empirically, it is undeniable that many clubs have loyal fans who fill the seats even where the teams perform poorly.

depreciation where acquired intangible assets are an indivisible part of an aggregate intangible that does not deplete over time.¹¹⁴ Under the mass asset rule, if the intangibles with a definite life have no value separate and apart from the indefinite assets, amortization will be denied. In *Laird*, while the IRS put forth a mass asset argument, it appears to have undermined its own cause by conceding (in the alternative) that the contracts did have separate value.¹¹⁵ The court seized on this concession and rejected the government's mass asset position, asserting that "the concession of value reveals the flaw in the mass asset theory."¹¹⁶ From that point forward, the Service essentially abandoned the theory completely, choosing instead to engage in valuation disputes (often with little success, as in cases such as *Selig*) with taxpayers and their well prepared experts.¹¹⁷ Had the Service continued to insist that player contracts have *no* value at all apart from the franchise, it would have better served its argument that an allowance for depreciation is economically unsound.

Even in its focus on valuation of the player contracts, the Service appears to have lost sight of a fundamental principle of contract valuation. Namely, an intangible asset is only as valuable as the income it produces for its owner. When the asset is an executory contract for the performance of services, which includes bilateral obligations, a proper framework for valuation must compare the revenue generated by the player with the compensation called for under the contract. Indeed, it is the contract that must be amortized, not the player himself. If a player is "overpaid", his contract is technically of no value to the franchise (from a purely economic perspective), and any allocation thereto should be denied.

Based on an earlier mathematical model developed in the mid-1970s, Andrew Zimbalist estimated the "marginal revenue product" of various baseball players in 1989.¹¹⁸ The findings indicate that players with six or

114. *Boe v. Comm'r*, 35 T.C. 720 (1961), *aff'd* 307 F.2d 339 (9th Cir. 1962); *First Northwest*, *supra* note 92, at 845. Note that this rule is far less consequential with the advent of § 197, and various cases have cast great doubt on its continued viability. But the doctrine was very much in play in the early rulings regarding contract amortization.

115. *Laird*, *supra* note 88, at 1237.

116. *Id.* at 1233.

117. Zorn, *supra* note 75, at 383-38. Zorn also argues that the IRS did not adequately pursue the argument based on the disallowance of "hobby" losses under § 183.

118. Zimbalist, *supra* note 2, at 90-92. This method of deriving a player's effect on team revenue, developed by economist Gerald Scully, is based on rough approximation and assumptions (which are beyond the scope of this paper). For instance, it does not account for the "intangible" qualities that a ballplayer provides

more years of experience are generally overpaid, while players with fewer than three years of service are generally exploited (i.e., their contracts have positive value for the franchise). It does not appear that the IRS used these “net value” principles in the player contract cases.¹¹⁹ Doing so could have been effective in fighting the very large allocations that became a chronic IRS concern over the years.

3. Passage of Code Section 197 and the Sports Exception

Section 197 was enacted in 1993 as part of the Revenue Reconciliation Act¹²⁰ in order to provide more clarity to an area that was rife with litigation. It provides for straight-line amortization over a period of fifteen years of the basis of certain intangible assets used in a trade or business. Section 168, which sets out a comprehensive cost recovery system, applies only to tangible property; intangible assets were historically left to the murky standards of section 167 and its regulations. Consequently, prior to 1993, taxpayers and the IRS frequently disputed the valuation and useful lives of intangible assets acquired as part of a business. Additionally, there were disputes concerning whether an amortizable intangible asset existed in the first place. By enacting section 197, “Congress believed that much of the controversy that arises under present law with respect to acquired intangible assets could be eliminated by specifying a single method and period for recovering the cost of most acquired intangible assets and by treating acquired goodwill and going concern value as amortizable intangible assets.”¹²¹

Under section 197, the cost of an “amortizable section 197 intangible” is amortized on a straight line basis over 180 months, beginning with the month in which the intangible is acquired.¹²² The statutory recovery period represented a compromise, as the legislative history makes clear that

to his teammates and his club. However, Scully’s approach involves robust formulas, has been published in reputable peer-reviewed journals, and has been used in arbitration hearings.

119. The “net lease” concept is not unfamiliar to the tax law. For example, for purposes of FIRPTA, the fair market value of a lease is the present value of the difference between the rental payments and the current rental value of the real property. Treas. Reg. § 1.897-1(o)(3).

120. Pub. L. No. 103-66 (1993).

121. H.R. 111, 103rd Cong., 760 (1st Sess. 1993).

122. The Tax Reduction and Reform Act of 2007, H.R. 3970, § 3402 (2007), sponsored by Rep. Charles Rangel (D-NY), contained a proposal to change the amortization period from 15 to 20 years. In light of the value of intangible assets owned by sports teams, such an amendment could disproportionately affect their valuation. The provision has not been enacted into law.

the mandated 15-year amortization period would have favorable effects on the tax treatment of certain transferred intangibles but detrimental effects on others, depending on the useful lives of the intangible at issue.¹²³ Section 197 applies only to costs that are otherwise required to be capitalized and does not apply to either immediately deductible or permanently nondeductible expenses.¹²⁴ For example, if a cost is deductible under section 162 but is also incurred to improve goodwill, section 197 will not pre-empt the operation of section 162 by denying a current deduction.

At the time section 197 was enacted, taxpayers could amortize intangible assets only if they could establish that the intangible possessed two critical features: that it was distinct from goodwill (for which no depreciation deduction was allowed) and that it was of use in a trade or business for a limited period, the duration of which could be determined with “reasonable accuracy.”¹²⁵ This standard, specifically the former component, proved difficult for taxpayers to establish. For example, the IRS continually argued that most “customer-based” intangibles (such as a subscriber list or an advertiser account) were too bound up with goodwill in order to warrant separate cost recovery.

The Supreme Court, in its seminal decision in *Newark Morning Ledger Co. v. United States*,¹²⁶ allowed the buyer of a newspaper to depreciate the portion of the purchase price allocable to the intangible asset styled as “paid subscribers.” While acknowledging the great difficulties inherent in the treatment of intangible assets, the Court asserted that an asset’s relationship to general business goodwill (or “the expectancy of continued patronage”) is not the sole factor in determining whether depreciation is permitted; rather, the more important inquiry is whether the asset in question can be valued and whether it wastes over a limited useful life.¹²⁷ Although *Newark Morning Ledger* represented a significant taxpayer

123. See generally Ronald E. Creamer & Emily S. McMahon, Tax Planning for Transfers of Business Interests, ¶ 3.03 (Warren, Gorham & Lamont 2003).

124. Treas. Reg. § 1.197-2(a)(3). See Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, ¶ 23.4 (Warren, Gorham & Lamont 2003).

125. Treas. Reg. § 1.167(a)-3. See supra note 76 and accompanying text.

126. 507 U.S. 546 (1993).

127. *Id.* at 555-56 (“Because intangible assets do not exhaust or waste away in the same manner as tangible assets, taxpayers must establish that public taste or other socioeconomic forces will cause the intangible asset to be retired from service, and they must estimate a reasonable date by which this event will occur”) (citing Bittker & McMahon, Federal Income Taxation of Individuals, ¶ 12.4, 10-12 (1988)). The non-categorical approach taken by the Supreme Court in *Newark Morning Ledger* had been tentatively accepted in Rev. Rul. 74-456, 1974-2 C.B. 65, in which

victory, it did not establish a rule of thumb or an administrable standard. The strain on judicial resources was sure to remain significant, and this burden compelled Congress to enact section 197.

Congress deliberately excluded sports franchises from the scope of section 197. As originally enacted, section 197(e)(6)¹²⁸ had provided that any items acquired in connection with the acquisition of a sports franchise were not subject to section 197 amortization. This exclusion had been enacted so that the treatment of sports intangibles would continue as under then-current law.¹²⁹ Consequently, while section 197 effectively ended the protracted disputes regarding purchase price allocations in general, it did not settle the long-standing clashes between sports owners and the Service.

While it is true that certain sports owners received large tax benefits from player contract allocations, the IRS throughout the 1990s became more attuned to the issue and began to question purchase price allocations with greater frequency and fervor. The Commissioner's stated position under pre-2004 law was that since sports franchises do not have a determinable useful life, the sports franchise intangible asset is not eligible for amortization under section 167. Since player contracts were amortizable under section 167 over a short period, the Service was focused on ensuring that buyers and sellers were properly applying the residual allocation method of section 1060 and were complying with the player contract limitation in section 1056.¹³⁰ Where adversity of tax interests between the parties could not be relied upon (such as where the seller had unused net operating losses or capital losses), the IRS applied heightened scrutiny to the taxpayers' allocation. Additionally, the IRS clearly interpreted section 1056 as establishing only a "presumed upper

the IRS, contrary to its prior guidance, conceded that in "unusual cases," where a customer-based intangible such as a subscriber list was distinct from goodwill, depreciation would be permitted.

128. § 197(e)(6), before amendment by Jobs Act, *supra* note 100, § 886.

129. See H.R. 213, 103rd Cong., 682 (1st Sess. 1993) ("The term "section 197 intangible" does not include a franchise to engage in professional baseball, basketball, football, or other professional sport, and any item acquired in connection with such a franchise. Consequently, the cost of acquiring a professional sports franchise and related assets (including any goodwill, going concern value, or other § 197 intangibles) is to be allocated among the assets acquired as provided under present law (see, for example, § 1056 of the Code) and is to be taken into account under the provisions of present law").

130. MSSP, *supra* note 3 at 10-5 ("The Service has the authority to value the franchise rights to determine the reasonableness of the player contracts valuations"). The MSSP also clarifies that the IRS would resort to substance over form principles in altering the allocation contractually agreed upon by the parties.

limit” on the amount allocable to player contracts, with the precise amount to be allocated based on facts and circumstances of the particular transaction.¹³¹

Between 1993 and 2004, the Service challenged the depreciability of media and broadcasting rights acquired along with sports franchises. For example, in FSA 200142007 (July 3, 2001), the taxpayer was a limited partnership that acquired a professional sports team. In addition to the franchise itself, the taxpayer acquired local television and radio contracts as well as a right to share in the league’s national television broadcast revenues. The taxpayer engaged an accounting firm to value these media rights and to demonstrate that they were indeed distinct from goodwill. The IRS asserted that the ability to separately identify and value intangible rights was not sufficient to establish depreciability under section 167. The intangible asset must also have a limited useful life. In this case, although the television and radio contracts were not automatically renewable, past practice indicated that the contracts would be renewed, whether with the current network or a new one. Since these media rights were a component of the franchise, they did not have a limited useful life. The contractual term of the broadcast agreements was of no moment; since “the life of an asset cannot be limited by the remote, speculative possibility that renewal of a contract might not occur.”¹³²

FSA 200142007 was consistent with several cases that had addressed the amortization of rights to share in sports broadcast agreements. In *Laird*,¹³³ the court held that the acquired television rights were essentially coextensive with the franchise itself and would therefore continue indefinitely. *First Northwest* (basketball)¹³⁴ and *McCarthy v. United States* (baseball),¹³⁵ which characterized these acquired contracts as “links in a perpetual chain of broadcast revenues,” reached similar conclusions. Unlike the subscriber lists at issue in *Newark Morning Ledger*, which would diminish over a predictable period of time, the media rights attendant to a sports franchise are self-regenerating. The acquired asset is not the rights to a particular broadcast contract, but the enduring right to share in any such contracts. This ongoing entitlement ceases only upon the elimination of the franchise as a member of the league.¹³⁶

131. Id. at 10-6.

132. FSA 200142007 (July 3, 2001) (citing *Richmond Television Corp. v. United States*, 354 F.2d 410, 412 (4th Cir. 1965)).

133. See supra note 88 and accompanying text.

134. See supra note 92.

135. 807 F.2d 1306 (6th Cir. 1986).

136. See also TAM 200244019 (Nov. 1, 2002); Brian Cornell et. al., *Media Rights Coincident to Sports Franchise Acquisition Are Not Depreciable*, 96 J. Tax’n Vol. 2 (Feb. 2002).

This treatment of media rights demonstrates the breadth of the sports franchise exception as it existed under section 197(e)(6) as originally enacted. The language of prior section 197(e)(6) carved out from section 197 treatment a “franchise to engage in professional football, basketball, baseball or other professional sport, and any item acquired in connection with such a franchise.” The Service interpreted the “in connection with” language broadly, requiring only that there be a nexus between the acquired intangible and the franchise in order for section 197(e)(6) to apply. Taxpayers argued, to no avail, that the exception was only applicable to intangibles that were acquired concurrently with a sports franchise, and not to separate rights that existed between the seller and a third party (e.g., a broadcast network).¹³⁷

Because sports teams were exempted from section 197 treatment, the process of structuring franchise acquisitions continued to grow more complex and less certain throughout the 1990s and early 2000s. The strain on IRS and taxpayer resources reached something of a crescendo in 2003, when the IRS issued a directive to its examiners spelling out certain compliance tools to be deployed in evaluating sports franchise acquisitions. As the allocation between amortizable player contracts and non-amortizable league membership rights was highly disputed in nearly every IRS examination, the directive had a stated goal of enabling agents to “resolve acquisition issues...in a more focused and expedited manner.”¹³⁸

The published “compliance measure” instructed agents not to adjust claimed amortization deductions arising out of a sports franchise acquisition if the present value of such deductions (not including claimed media rights deductions, which are categorically disallowed) did not exceed 60% of the purchase price allocable to all acquired intangibles, using a 5.5% discount rate.¹³⁹ For example, a taxpayer acquires a sports franchise for \$200 million and allocates \$20 million to hard assets. Of the \$180 million allocated to

137. TAM 200244019, *supra* note 136.

138. 2003 TNT 221-37 (Oct. 24, 2003).

139. In a simultaneously issued field directive, the Service advised agents to expect taxpayers to claim useful lives of between four and five years on the player contracts and to allocate approximately 55% of the franchise purchase price to the contracts. It also described the way in which asset bases are adjusted in the event a taxpayer’s claimed amortization exceeds the 60% threshold. Essentially, when the present value of the scheduled amortization deductions exceeded 60% of the amount allocated to all acquired intangible assets, the basis of the amortizable intangibles is stepped down until 60% is reached, and the reduction in basis is re-allocated pro-rata to acquired nonamortizable intangibles such as franchise or media rights. The basis reallocation procedure contemplated by this field directive is emblematic of the time consuming nature of the disputes that arose prior to 2004 on audit of sports franchise acquisitions, and no doubt contributed to the changes wrought by the Jobs Act. See 2003 TNT 221-38 at ¶¶ 5, 6, 17 (Oct. 24, 2003).

intangibles, \$38 million is allocated to nonamortizable assets such as future media rights and the league franchise itself. Of the \$142 million remaining, the taxpayer allocates \$15 million to current media rights, \$115 million to player contracts and \$12 million to various other amortizable assets such as sponsorship agreements and luxury suite contracts. Under the compliance measure, the first action taken is to disallow (for purposes of the compliance measure) any amortization relating to the \$15 million allocation to media rights, since these rights were not amortizable under well established principles. Then, the present value of the future deductions on the \$127 million allocated to amortizable intangible assets is computed, based on the useful lives of the assets. The present value is \$112,558,000,¹⁴⁰ which is 62.31% of the \$180 million that was allocated initially to all acquired intangibles. Because this number exceeds the 60% threshold, the agent must impose a downward adjustment to the \$127 million of amortizable intangibles. Since the present value exceeded the threshold by 3.85% (i.e., 2.31 percentage points above 60%), the basis adjustment must be 3.85% of \$127 million, or \$4,708,233. This amount is subtracted from the amount initially allocated to amortizable intangibles and added as a basis step-up to the amount allocated to the nonamortizable intangibles (each on a pro rata basis).¹⁴¹

B. Sports Intangibles and the American Jobs Creation Act of 2004

Fortunately, the complex standard created by the compliance measure was short lived, as Congress determined in 2004 that section 197 treatment is appropriate for all types of businesses and repealed the section 197(e)(6) exception for property acquired after October 22, 2004.¹⁴² Thus, the 15-year recovery period applicable to section 197 intangibles now extends to professional sports franchises as well as any other intangible assets acquired in connection with the franchise. The House Committee Report to section 886 of the Jobs Act states that “the present-law rules for acquisitions of sports franchises do not eliminate the potential for disputes, because they address only player contracts, while a sports franchise acquisition can involve many intangibles other than player contracts . . . [t]he Committee further believes that the section 197 rules should apply to all

140. This present value is computed using a discount rate of 5.5% and the following useful lives: player contracts – 3.29 years; season ticket holder list – 21 years; concession agreement – 5.5 years; sponsorship agreements – 2.5 years; luxury suite contracts – 2 years. *Id.* at Example 1.

141. *Id.*

142. Jobs Act, *supra* note 100, § 886.

types of businesses regardless of the nature of their assets.”¹⁴³ This description was an accurate assessment of the uncertain state of the law, as the Service and taxpayers continued to expend considerable resources litigating purchase price allocations. Even the “present law rules” alluded to by the House Committee relating to player contracts were the subject of considerable uncertainty and ambiguity.¹⁴⁴

As a result of the 2004 legislation, disputes between the IRS and sports owners are sure to dwindle, at least with respect to the allocation of purchase price between the acquired assets. Currently, any tangible property acquired along with a sports franchise will be depreciated (as always) under section 168, while intangible assets are now amortizable under the existing standards of section 197. Player contracts, sponsorship agreements, luxury suite contracts and various other intangibles (including the franchise itself)¹⁴⁵ are now written off ratably over a 15-year period. To conform with the repeal of the section 197 exception, the Jobs Act also repealed section 1056, on the theory that special basis limitation rules were no longer needed in the absence of strong taxpayer incentive to allocate value away from the nondepreciable franchise to the player contracts.

The Jobs Act also repealed sections 1253(e) and 1245(a)(4) in order to conform with the new treatment of player contracts. Section 1253(a) states that where a seller of a franchise, trademark or trade name retains any “significant power, right, or continuing interest” in the franchise, the sale is not treated as the sale or exchange of a capital asset. This provision, enacted in 1969, reflects Congressional judgment that where a transferor retains supervisory authority over the transferee’s operation of a franchise, capital treatment is inappropriate.¹⁴⁶ Prior to its repeal, section 1253(e) stated that section 1253 “shall not apply to the transfer of a franchise to engage in professional football, basketball, baseball or other professional sport.”

The Jobs Act amendment to section 1253 brings sports franchises within the ambit of the rule; thus, where power over a sports franchise is retained in an acquisition, section 1253(a) will deny capital treatment (even assuming the transaction qualifies as a sale or exchange of a capital asset as defined in section 1221). This provision looms large in the area of expansion sports teams. Generally, incoming owners pay the existing owners for the

143. H.R. Rep. No. 108-548.

144. In its 2001 budget proposal, the Treasury noted that § 1056 had failed to serve its intended purpose and that sports franchises could no longer be excluded from § 197. See General Explanation of the Administration’s Fiscal 2001 Revenue Proposals, Pt. 2 (Feb. 2, 2000). See also *supra* note 101.

145. Section 197(d)(1)(F).

146. Section 1253 also denies capital treatment to a transferor of a franchise where the proceeds include amounts that are contingent upon the productivity or use of the franchise. Section 1253(c).

right to operate an expansion sports franchise. Historically, it was not uncommon for the franchise agreement to provide that the expansion team could not be transferred or assigned without the consent of a majority of the other league franchises. This veto right falls squarely within section 1253(b)(2)(A), which states that “[a] right to disapprove any assignment” of the franchise constitutes a “significant power or interest.” Consequently, after the Jobs Act, any gain realized by the current owners on the sale of the expansion franchise will be ordinary income where the owners retain veto rights.

As described above, before its repeal, section 1245(a)(4) contained a special depreciation recapture rule where player contracts were transferred in connection with the acquisition of a sports franchise. That provision required the seller of a team to calculate his “recomputed basis” in the transferred contracts (for the purpose of depreciation recapture) by adding to his adjusted basis in such contracts the greater of 1) the previously unrecaptured depreciation on contracts acquired by the seller at the time the franchise was acquired, and 2) the previously unrecaptured depreciation on contracts involved in the particular sale at hand. This provision had the effect of recapturing the depreciation taken on contracts of players who retired or died while playing for the team. Because these players’ contracts were never sold or exchanged, recapture was not otherwise triggered in the absence of a special rule.¹⁴⁷ The legislative history of section 1245(a)(4) makes it fairly clear that the special recapture rule does not apply to the transfer of individual player contracts, but only contracts transferred in connection with the sale of an entire franchise.¹⁴⁸ Even after the repeal of section 1245(a)(4), however, the “standard” recapture rules of section 1245 still apply to player contracts.¹⁴⁹

C. Measuring the Effect of the Jobs Act on Sports Franchise Values

The sports provisions of the Jobs Act have generated much discussion and debate, due in no small part to their potential impact on franchise values. As a technical matter, the key Jobs Act amendment is easy to summarize. While under prior law, sports franchises were able to write off

147. Baker, *supra* note 97, at 294.

148. See S. Rep. No. 94-938, 94th Cong., 90 (2d Sess. 1976).

149. Treas. Reg. § 1.197-2(g)(8) (“an amortizable § 197 intangibles constitute § 1245 property”). As discussed *infra* Part III.D.1, individually acquired player contracts are not § 197 intangibles. These contracts constitute § 1245 property since they are subject to the allowance for depreciation under § 167. See § 1245(a)(3).

the values of player contracts over three to five years, after the Jobs Act, teams could amortize their basis in *all* intangible assets (including player contracts acquired with the organization) over fifteen years. Yet, due to the numerous variables that go into the complex valuation of sports franchises, the legislation's overall effect was, and remains, unclear.

Both Congress and the sports industry have claimed political victory. The Clinton administration's fiscal 2001 budget proposal contained an extension of the section 197 rules to sports franchises, but the measure remained dormant until it appeared as part of the Senate Finance Committee's version of the Jobs and Growth Reconciliation Tax Act of 2003.¹⁵⁰ The Joint Committee on Taxation report accompanying the Jobs Act states that the measure will increase taxes for sports owners by \$382 million over ten years.¹⁵¹ A spokesman for the House Ways and Means Committee characterized the bill as a "revenue raiser,"¹⁵² and the spokeswoman for then-chairman Bill Thomas of the Senate Finance Committee posited that the section 197 sports amendment was included in the bill "to bring down the overall cost of the legislation."¹⁵³

Despite these pronouncements from lawmakers, the sports industry itself, somewhat anomalously, was the key lobbyist in support of the legislation. As far back as 1999, MLB had hired William Schweitzer, a Washington attorney, to lobby regarding "legislation affecting amortization, depreciation and allocations in regard to franchise purchase prices."¹⁵⁴ In a letter to then-Treasury Secretary Summers on behalf of MLB, Schweitzer stated that the league supported a general rule permitting amortization of all intangible assets over a fifteen year period. Schweitzer pointed out that although player contracts and various other intangible assets have useful lives significantly less than fifteen years, MLB nevertheless supported a rule that would "provide consistent treatment and minimize disputes regarding acquired intangibles."¹⁵⁵

Several commentators have asserted that the legislation will ultimately prove to be a boon to sports owners. Some have estimated that the

150. Pub. L. No. 108-27 (2003). See Martin A. Sullivan, Sports Franchises May Win Big in ETI Bill, Tax Notes, Jun. 21, 2004.

151. JCX-69-04, "Estimated Budget Effects of the Conference Agreement for H.R. 4520, the 'American Jobs Creation Act of 2004,' Fiscal Years 2005 – 2014" (Oct. 7, 2004).

152. Duff Wilson, Bill Would Raise Franchise Value of Sports Teams, N.Y. Times, Aug. 2, 2004.

153. Analysts: Profitable Franchises Likely to Benefit, Associated Press, Aug. 3, 2004, www.espn.com.

154. Political lobbyist summaries available at www.sopr.senate.gov.

155. Letter from William H. Schweitzer to Honorable Lawrence H. Summers, 2000 TNT 213-26 (Nov. 2, 2000).

change would add 5% to the values of sports teams, and noted commentator Robert Willens has suggested by way of example that the New York Jets, who were sold in 2000 for \$635 million, could be worth an additional \$55 million under the proposal.¹⁵⁶ Many other experts in the area of sports ownership agreed that the repeal of section 197(e)(6) would increase the sale value of franchises across the board, particularly NFL franchises, which have been estimated to receive upwards of \$77 million per year from national broadcast rights negotiated by their league.¹⁵⁷ Based on Forbes Magazine's 2002 estimates of franchise values, if the Jobs Act benefits sports teams by adding 5% to their value as a result of the tax savings, the industry as a whole effectively received a \$2 billion subsidy.

The empirical data regarding franchise values is difficult to interpret, largely because it is based on various assumptions and financial projections. There are also many confounding factors, such as baseball's revenue sharing and luxury tax systems¹⁵⁸ as well as the increased revenues attributable to a new stadium or ballpark. Moreover, any value increases attributable to the Jobs Act amendments would be manifest only in new acquisitions of sports teams, since the legislation was made effective only to property *acquired* after the date of enactment (October 22, 2004).¹⁵⁹ In other words, current owners cannot realize the benefits of the amendments through modified amortization, but only through the (potentially) enhanced purchase price their teams can fetch based on the market's valuation of the present value of *incremental* amortization deductions available in the future. Forbes' value

156. Duff Wilson, *supra* note 152. According to Wilson, Willens was "mystified" by the Congressional claims regarding the revenue raising nature of the proposal. Aaron Barman was also quoted as rather categorically stating that "at the end of the day, [there is no doubt the amendment adds to the current value of franchises]."

157. *Id.*

158. For example, the New York Yankees, who recently surpassed the \$1 billion value mark in the annual Forbes report, paid an estimated \$70 million in revenue sharing in 2006. Forbes Franchise Values: Yankees Franchise Hits Value of \$1.2 Billion, Associated Press, Apr. 20, 2007, http://findarticles.com/p/articles/mi_qn4188/is_20070420/ai_n19038349. A luxury tax is designed to penalize the teams that spend more than their counterparts. The National Football League uses a "hard" salary cap, which is based on a percentage of league revenues. The NBA also uses a salary cap that is based on a percentage of league revenues, though its cap is a "soft" cap. The nature of the NBA's "soft" cap is such that teams may exceed the cap in certain instances, such as when re-signing their own free agents. To encourage adherence to the cap, the NBA also imposes a luxury tax on teams that exceed the prescribed salary limits.

159. Jobs Act *supra* note 100, § 886(c)(1). The legislation also does not affect the treatment of individual player contracts, as discussed below.

estimates are based on multiples of revenue and are adjusted for new ballparks, but they probably do not capture the somewhat subtle effects of changes to tax write-offs going forward. Therefore, the effect of the Jobs Act on sports valuation will be seen in future sale transactions, as bankers, accountants and lawyers evaluate the actual tax savings (or cost) on a case-by-case basis.¹⁶⁰ Franchises with the most lucrative national and local broadcasting contracts stand to gain the most from the Jobs Act amendments, since the primary effect of the new law is to permit depreciation on these heretofore unamortizable intangibles.

There are a number of ways to account for the inconsistent pronouncements from the government and the sports industry regarding the repeal of section 197(e)(6). One possibility goes to the underlying difficulty inherent in valuing future cash flows. Recall that the IRS' 2003 directive regarding player contract amortization capped the present value of claimed amortization at 60% of the total acquired intangibles, using a 5.5% discount rate. Under the new law, all intangibles are amortized over fifteen years; yet, the present value of such write-offs depends in large part on the discount rate used.¹⁶¹ The appropriate rate may depend on the franchise's creditworthiness, its ownership of hard assets, or its future prospects. Since the chosen rate will affect (along with many other factors) current valuation, it is not surprising that different parties (with different perspectives of the market) will take divergent views on an economic proposal.

Furthermore, the discount rate problem is related to the relevant timeframes used in estimating the revenue impact of a proposal. The government's 10-year time horizon will obviously bias the short term gains and losses, while the financial models of the sports teams themselves may utilize a longer-term measurement window. Government budget windows are also subject to change and can be based on political gamesmanship, while private actors such as sports owners utilize their own financial modeling techniques to assess legislative reforms.¹⁶²

160 The Forbes franchise value estimates show an increase in overall team values in the four major sports between 2003-2007, with Major League Baseball experiencing a slight decline from 2003-2004. An economic interpretation of these results is well beyond the scope of this paper. A graphical representation is available at http://www.forbes.com/2005/09/28/forbes-sports-index-mlb-nfl-nhl-nba_cz_sportsindex.html.

161. See generally Sullivan, *supra* note 150 ("the higher the discount rate, the less attractive will be a change to 15-year amortization").

162. See e.g., *id.* In fact, the U.S. Office of Management and Budget has indicated that it will phase out ten-year budget projections since this relatively short horizon obscures the true economic effects of fiscal policies. See <http://www.whitehouse.gov/omb/budget/fy2003/bud08.html>. For an instructive

A second, and more concrete explanation is that the repeal of section 197(e)(6) will simplify the tax reporting positions of sports teams. Indeed, section 197 was enacted in order to reduce the level of costly disputes regarding the amortization of intangible assets under section 167.¹⁶³ As discussed above, the litigation between sports owners and the IRS continued well beyond 1993. After 2004, however, the buyer of a sports team need not hire appraisers and accountants to support a specific allocation, a change no doubt resulting in millions of dollars in cost savings throughout the industry. It is fair to assume that on an individual basis, taxpayers value a simpler, less litigious regime more so than the government, which is involved in audit activity regardless. Consequently, it is possible that the sports industry internalized these benefits of tax simplification to a greater degree than did the government, leading to disparate conclusions.

D. Individual Player Contracts – Collateral Tax Issues

Sports player contracts are constantly exchanged, acquired and re-negotiated even outside the context of franchise acquisitions. Since these contracts are highly valuable assets, such market transactions naturally implicate various tax rules aside from section 197. This section will briefly describe the relevant considerations involving individual player contract transactions.

I. Purchasers

Despite the repeal of the section 197(e)(6) exclusion, player contracts that are acquired separately remain exempt from the 15-year amortization period of section 197, as section 197(e)(4)(B) excludes from the definition of a “section 197 intangible” any right to receive tangible property or services under a contract where such right is not acquired as part of a larger acquisition of a trade or business.¹⁶⁴ Thus, the cost of separately acquired player contracts remains subject to pre-Jobs Act law and may be recovered over the useful life of the contract. In the case of an individual player contract, the amortizable basis will generally be the signing bonus paid to the player, which is a capitalized expense (and is not currently

discussion on budget “games,” see Elizabeth Garrett, Comment: Accounting for the Federal Budget and Its Reform, 41 Harv. J. on Legis. 187 (2004).

163. See supra notes 117 and 121 and accompanying text.

164. See also Treas. Reg. §1.197-2(c)(6), -2(c)(13). This exception applies even where the right would otherwise be amortizable under § 197.

deductible) under section 263 and the regulations thereunder.¹⁶⁵ In PLR 9303002 (Oct. 5, 1992), the Service ruled that a baseball team may begin amortizing a player's signing bonus as soon as the contract is signed. The theory of the ruling was that a signing bonus establishes a "service liability," whose economic performance occurs (under the principles of section 461 and Regulations section 1.446-1(c)(1)(ii)(A)) upon the player's signing of the contract.¹⁶⁶

Since the useful lives of player contracts are still relatively short (typically 3-6 years), the ability to amortize acquisition costs still provides a significant tax benefit to the sports team. In the era of free agency, the government no longer has in its arsenal an argument that contracts have no definite useful life, as players are clearly free to negotiate with other clubs when they attain free agency. Additionally, outside of team purchases, there is no issue of valuation or allocation, as acquisition costs for individual contracts will be delineated clearly.

2. Player Trades

Generally, player trades constitute like-kind exchanges under section 1031, and gain will be recognized in such transactions only to the extent of "boot."¹⁶⁷ Consequently, the team's basis in the acquired contract will be the carried over basis in the contract exchanged, decreased by the boot received and increased by any recognized gain.¹⁶⁸ Moreover, if the acquired contract has a shorter useful life than the contract traded away, amortization is taken over the shorter useful life.

Frequently, player trades involve future draft picks. It has been the IRS' position that a team does not have an ascertainable tax basis in future draft picks given up in a trade. Of course, the franchise that acquires a draft

165. Professional athletes may not terminate their contracts at will and do not have the right to go play for a competitor. Therefore, signing bonuses represent amounts paid by the teams to receive services and must be capitalized. See Treas. Reg. § 1.263(a)-4(d)(6)(i),(iv),(vii) ex. 8. Signing bonuses were first popularized in the 1960s and today they are a staple of sports contract negotiations. In 2004 Peyton Manning inked a deal with the Indianapolis Colts worth approximately \$100 million, including a record \$34.5 million signing bonus. Alex Rodriguez's \$275 million contract included a \$10 million signing bonus.

166. Signing bonuses were also the subject of a significant tax development in 2004. In Rev. Rul. 2004-109, 2004-50 I.R.B. 958, the Service held that signing bonuses constitute wages for federal employment (FICA and FUTA) and income tax withholding purposes. This ruling represented a significant reversal in IRS policy on an issue that was watched closely by sports teams.

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

168. Section 1031(d).

pick may obtain a basis therein under the principles of section 1031. If and when the draft pick is exercised and a player is drafted, the basis in the pick will be capitalized into the basis of that player's contract.¹⁶⁹ In the MSSP guide, the Service identifies as an "emerging issue" the question of whether future draft picks and existing player contracts constitute like kind property for the purposes of section 1031. Treas. Reg. section 1.1031(a)-2(c) states that while intangible personal property is categorically eligible for like-kind treatment, whether an exchange actually involves like-kind property will depend on the nature of the underlying rights and property. On the one hand, the rights underlying both future draft picks and actual contracts are the services of a professional athlete. However, a team has a separate basis in player contracts while the right to future draft picks is an inseparable component of the franchise intangible asset, a difference that tends towards non like-kind treatment.¹⁷⁰

3. Sellers

Where an individual contract is sold, the portion of the gain that exceeds recaptured depreciation can receive capital gains treatment under section 1231.¹⁷¹ Specifically, if the gains resulting from the sale of player contracts (which will generally constitute depreciable property used in a trade or business, as required by section 1231) exceed the losses from the sale of such property, both gains and losses are treated as long term capital gains and losses. In PLR 9617001 (Dec. 19, 1995), the Service ruled that where a sports franchise cuts a player, an ordinary loss is allowed under section 165 in an amount equal to the team's adjusted basis in the contract.

PART IV - THE HOME-RUN BALL

*"Sometimes pieces of the tax code can be as hard to understand as the infield fly rule. All I know is that the fan who gives back the home run ball deserves a round of applause, not a big tax bill."*¹⁷²

169. MSSP, supra note 3, at 12-2, 12-3.

170. Id. at 12-7.

171. Rev. Rul. 67-380, supra note 167. See also Rev. Rul. 71-123, 1971-1 C.B. 227 (applying the reasoning of Rev. Rul. 67-380 to the gain recognized by established football franchises upon their sale of individual player contracts to an expansion team. The ruling also held that the gain in excess of that which was allocable to the contracts constituted gain from the sale of the "franchise property right," and was a sale of a capital asset by the old teams to the new team).

172. Press Release, IRS Commissioner Charles Rossotti, Sept. 8, 1998.

It would appear that the intersection of tax and sports cannot be adequately addressed without at least a *brief* nod to the perplexing question of the record-breaking home run ball. This issue, however esoteric and theoretical, has captured the attention of the mainstream media and numerous commentators. In fact, in a 2005 speech to the Tax Section of the New York State Bar Association (delivered, appropriately, on the grounds of the national Baseball Hall of Fame in Cooperstown, N.Y.), IRS chief counsel Donald Korb characterized Mark McGwire's then-record 62nd home run ball as "the most significant tax event in the history of baseball."¹⁷³

Mark McGwire's home run ball, which was clubbed at Busch Stadium in St. Louis on September 8, 1998, was actually not caught by a fan. A Cardinals groundskeeper retrieved the ball and returned it to McGwire. However, an IRS representative had touched off a firestorm a few days earlier by stating on the record that a fan who caught such a ball, and subsequently returned it to McGwire, would be subject to a gift tax. As Korb described in his speech, the Service soon retracted its position, but not before Congressional lawmakers attempted "to make an income and transfer tax repeal issue out of baseball's home run race."

Matt Murphy became a household name when he emerged from a AT&T Park scrum with Barry Bonds' record-breaking 756th career home run on August 7, 2007. The next month, Murphy sold the ball at auction to New York fashion designer Marc Ecko for \$752,467.20,¹⁷⁴ giving new life to the tax debate.

To be clear, the fan who catches the ball and immediately returns it is not subject to federal income tax. This conclusion is based on Rev. Rul. 57-374,¹⁷⁵ which states, in its entirety, that "[w]here an individual refuses to accept an all-expense paid vacation trip he won as a prize in a contest, the fair market value of the trip is not includible in his gross income for federal income tax purposes." The bill that was impulsively introduced in the House the day after McGwire's home run came to the same conclusion.¹⁷⁶ The more

173. Lest this be taken as a negative reflection on the authors' choice of topic, Korb ranked the *Selig* case and the issue of player contract allocation as the third and fourth most significant events, respectively.

174. Press Release, SCP Auctions, Barry Bonds Record Breaking 756 Home Run Ball Sold for \$752,467.20 (Sept. 15, 2007), www.scpauctions.com/html/auctions/bonds/results/bondspostsale.html.

175. 1957-2 C.B. 69. At least two commentators have pointed out that this principle is not necessarily consistent with the doctrine of constructive receipt as embodied in Treas. Reg. § 1.451-2(a), which states that income is constructively received by a taxpayer at the time it is made available to him "although not actually reduced to a taxpayer's possession." Lawrence A. Zelenak & Martin McMahon, Jr., *Taxing Baseballs and Other Found Property*, Tax Notes, Aug. 30, 1999.

176. See H.R. 4522, 105th Cong. (2d Sess. 1998).

interesting tax question arises where the fan holds the ball as a keepsake or for ultimate sale.

Clearly, catching a record breaking artifact represents an accession to wealth under section 61. In *Commissioner v. Glenshaw Glass Company*,¹⁷⁷ the Supreme Court recognized that Congress, in defining gross income, intended to exert the full measure of its taxing power and to tax all gains without limitation as to their source.¹⁷⁸ The gross income regulations generally embody this principle. Treas. Reg. section 1.61-14(a) states that “treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.”

The treasure trove regulation has been applied on extremely rare occasions by the courts and the Service in the context of found property or windfalls. In one case, a taxpayer found cash in an old piano several years after purchasing it at an auction. The court held that the currency was taxable in the year of discovery rather than when the piano was purchased.¹⁷⁹ The Tax Court has stated in dictum that the treasure trove regulation is properly applied to a person who finds a sweepstakes ticket, even where the ticket turns out to be a loser later in the same day.¹⁸⁰ In PLR 6205104610A (May 10, 1962) the IRS suggested that the treasure trove rule is applicable to items found by individuals who are in the “business” of searching for valuables in sunken ships.

In the context of unsolicited merchandise, the Service has ruled that a reviewer of books was taxable on the value of unsolicited books sent to him by a publisher.¹⁸¹ The IRS retreated from this position in a subsequent ruling where it stated that the taxpayer would be taxed on the value of the books only where he donated them to charity and claimed a deduction for

177. 348 U.S. 426 (1955) (“*Glenshaw Glass*”).

178. Prior to *Glenshaw Glass*, the prevailing gross income standard was stated in the Supreme Court’s decision in *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) where the Court defined income as “the gain derived from capital, from labor, or from both combined.” Under that standard, an argument could be made that a “pure” windfall, resulting from neither a capital investment nor labor, was not income. *Zelenak & McMahon*, supra note 175, at n. 21. However, the Court in *Glenshaw Glass* clearly asserted that “Congress applied no limitations as to the source of taxable receipts,” thereby taking much of the appeal out of the foregoing arguments. *Id.* at 429.

179. *Cesarini v. United States*, 296 F. Supp. 3 (N.D. Ohio 1969), *aff’d per curiam*, 428 F.2d 812 (6th Cir. 1970).

180. *Collins v. Comm’r*, T.C. Memo. 1992-478.

181. Rev. Rul. 70-330, 1970-1 C.B. 14.

their value.¹⁸² Apparently, the theory of the ruling is that the recipient has not truly reduced the property to his possession until he has committed an act consistent with dominion and ownership. Although based on broad notions of gross income under section 61, the unsolicited merchandise rulings are probably not a helpful framework for analyzing the home-run ball, since dominion is clearly demonstrated by the mere act of retaining the ball.

A home run ball is also not perfectly analogous to a prize or award, which are generally taxable under section 74. Although the provision contains exceptions to the general rule,¹⁸³ the courts have refused to interpret these exceptions as applying to an award based on professional sports performance.¹⁸⁴ A home run ball caught by a spectator is probably not a prize or award in the first place, so section 74 and its exceptions are likely inapposite.

Two commentators, Lawrence Zelenak and Robert McMahon, Jr., have argued that the fan who catches the home run ball should not be taxed (until sale) since the treasure trove regulation is of questionable validity, primarily because the Service has adopted an unofficial practice of not taxing found property.¹⁸⁵ Specifically, in dealing with commercial fishermen and big game hunters, the IRS has not invoked the treasure trove rule to argue for immediate inclusion of fish or game, but has imposed a tax at the time of sale.¹⁸⁶ With respect to miners, Treas. Reg. section 1.61-3(a) states that gross income is generally defined as “total gross sales, less the cost of goods sold.” This provision appears to embody an assumption that miners are not taxable upon their extraction of the minerals from the ground, but only upon sale.

As a normative manner, Zelenak and McMahon posit that “found” property is analogous to self-created property such as a work of art, and should be treated as non-taxable imputed income.¹⁸⁷ Taxpayers who grow

182. Rev. Rul. 70-498, 1970-2 C.B. 6.

183. Section 74(b).

184. See, e.g., *Hornung v. Comm’r*, 47 T.C. 428 (1967). In that case, the most valuable player of a professional football game received a Corvette from a prominent sports magazine in recognition of the achievement. The court held that the award was not covered by the exceptions to the taxability of prizes under § 74(b), and that it was not a gift under § 102. See also *Wills v. Comm’r*, 411 F.2d 537 (9th Cir. 1969) (player taxed on receipt of a belt in recognition of baseball accomplishments since sports award is not in recognition of religious, charitable, scientific, educational, artistic, literary or civic achievement).

185. See Zelenak & McMahon, *supra* note 175.

186. *Id.*

187. H.R. Rep. No. 413, 91st Cong., at 149 (1st Sess. 1969) (discussing the exception of self created property from the definition of capital asset in section 1221(3) and stating that “it is appropriate to treat the income arising from the sale of such property as ordinary income.”) The implication is that the value of the property

crops for self-consumption or hunt game for food are not taxed unless and until such items are sold.¹⁸⁸ Similarly, services rendered for one's own family in the home do not give rise to taxable services income. Clearly, in all these cases the taxpayers have experienced an accession to wealth. However, the policy of the tax law is to forgo taxation.¹⁸⁹ These commentators argue that found property (other than cash) should be treated in the same way as self created property and thus excluded from gross income (like imputed income) until the time it is disposed of.

Clearly, Zelenak's and McMahon's argument is open to ample criticism. First and foremost, the treasure trove regulation has the force of law notwithstanding the Service's failure to assert it in various contexts. Furthermore, a windfall in the form of found property is arguably very different from self created property in that the latter entails an investment of capital and services, while the former rings of "something for nothing." Catching a \$1 million baseball is an unmistakable accession to wealth, and the notion of "imputed income" is not needed to reach that conclusion.¹⁹⁰

One may argue that catching a home run ball does not entail "finding" anything, and the legal definition of "treasure trove" is "valuables (usu. gold or silver) found hidden in the ground or other private place, the owner of which is unknown."¹⁹¹ In addition to resembling a mere sophism, this argument overlooks the fact that an in-kind windfall can still constitute residual gross income under section 61 even if it is not a "treasure trove." Specifically, Treas. Reg. section 1.61-1(a) states that "gross income includes income realized in any form." In this way, the treasure trove regulation can be understood as a limiting rule; namely, that with respect to a unique subset

upon creation is not taxable to the artist/creator. Zelenak & McMahon, *supra* note 174, at n.62.

188. See, e.g., *Morris v. Comm'r*, 9 B.T.A. 1273, 1277-78 (1928) (farmer not taxable on the value of crops produced and personally consumed).

189. For a general discussion of imputed income, see Haskell and Kauffman, *Taxation of Imputed Income*, 17 Nat'l. Tax. J. 232 (1964). Broadly stated, imputed income is economic gain that is hypothetical because it results from non-market behavior.

190. For a comprehensive criticism of the Zelenak & McMahon theory of imputed income, see Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the 'Claim of Right' Doctrine to Found Objects, Including Record-Setting Baseballs*, 4 Fla. Tax. Rev. 685 (2000) (arguing that the treasure trove regulation is a perfectly valid rule regarding the taxability of in-kind windfalls and that catching a record home run is a taxable event so long as the ball is not disclaimed by the taxpayer within a reasonably short period of time).

191. Black's Law Dictionary (8th ed. 2004).

of receipts (“treasure trove”), gross income includes only those items that are “reduced to undisputed possession.”¹⁹²

Although the home run ball may be difficult to value at the time it is caught, this should not affect whether a taxable event has occurred. Record-setting home runs are now preceded by frenzied anticipation and excessive media coverage. Experts customarily opine on the expected price tag and potential buyers sound off on how much they are willing to pay. In this way, to the extent there is a “valuation” issue at all, it is far less salient than in the case of one who truly “finds” a singular item with no established market. More fundamentally, difficulty of valuation is not generally treated as a prerequisite to income realization in the tax law, with a few possible exceptions.¹⁹³ Recall that an option premium is not taxable upon receipt,¹⁹⁴ but the rationale for such treatment is not difficulty of valuation, but the more central question of whether there is income at all with respect to the underlying property.

Perhaps catching the home run ball is tantamount to a “commercial bargain purchase,” that is, the acquisition of property at a cost (equal to the money spent on the ticket) that is less than the value. The property is therefore “purchased” with a considerable amount of built-in, unrealized appreciation, and in the absence of a separate ground for treating the bargain as income to the purchaser (for example, where the parties share an employer/employee or corporation/shareholder relationship), tax is deferred until sale or disposition.¹⁹⁵ Under this approach, catching the ball is the

192. See Dodge, *supra* note 190, at 689-90, where this argument is put forth in a more articulate and comprehensive manner.

193. Arguably, the treatment of compensatory stock option grants under § 83 runs counter to the argument that the tax law does not postpone income realization due to difficulties in valuation. Significantly, however, the issue of valuation in the compensatory option context is usually tied up with forfeiture risk, and contingencies that could completely negate the value of the options. Moreover, catching the home run ball is comparable to the *exercise* of the option (whereby the underlying property is obtained), as opposed to the granting of the option, and by all accounts the exercise of a compensatory option is taxable under sections 83(a) and (b) irrespective of difficulties in valuation. See Treas. Reg. § 1.83-7(a); section 83(e)(3). Finally, § 83 is a specific statutory exception to general rules of income recognition, and in the noncompensation setting, general gross income principles should apply. See Dodge, *supra* note 190, at 725.

194. See *supra* note 61. The same reasoning applies to financial instruments such as prepaid forward contracts, which are generally thought not to produce income tax consequences until they are settled, on the theory that the transaction relates to the underlying property and is “open” until the property is physically delivered (or the contract is cash settled).

195. See, e.g., *Pellar v. Comm’r*, 25 T.C. 299 (1955); *Palmer v. Comm’r*, 302 U.S. 63, 68 (1937).

consummation of a capital investment, analogous to exercising an option on property. The problem with this argument is that the nexus between the ball and the purchase of the ticket is attenuated. Stated otherwise, the cost is not “purposefully incurred in an activity or venture to obtain valuable property.”¹⁹⁶ Rather, the ticket’s cost is wholly attributable to the entertainment value of the game, with no accompanying “investment” in the chance to catch the ball (which is simply an in-kind windfall to the extent it occurs). While a fan’s motivation for purchasing a ticket may very well be for the chance to catch a record baseball, the likelihood of such an occurrence is sufficiently remote so as to preclude the characterization of the transaction as a “purchase.”

In sum, once one accepts that “income” is not synonymous with “cash,” and that our tax law recognizes in-kind wealth accretion, there is no principled reason to conclude that the home run ball produces only “hypothetical” economic gain or that it simply embodies some type of bargain capital investment. The better view is that under current law the catch is a taxable event, subject to the administrative grace (and the good sense) of the IRS.

PART V - CONCLUSION

In describing what he refers to as the “sports factor,” Schuyler Moore observes that “a recurrent theme throughout taxation of the sports industry is that Congress, the courts, and the Service are astounding in their favoritism of the industry, which may be attributable to the reverence and awe that team sports are accorded in American culture.”¹⁹⁷ Andrew Zimbalist describes Judge Bauer, who wrote the opinion for the Seventh Circuit in *Selig*, as “confused and addled by his love for baseball.”¹⁹⁸ To the extent the sports industry has been accorded special treatment over the years, the 2004 legislation appears to represent a shift in such a trend. While sports are still a diversion, at the professional level it is a business enterprise with its own

196. Dodge, *supra* note 190, at 695. By way of example, Dodge posits that a personal consumption cost, such as a vacation to Belize, should not be treated as an “investment” in valuable property (such as gold coins) that the traveler fortuitously finds in Belize. Of course, the purposive nature of the expenditure is a factual question, and theoretically a fan could have incurred the expense

197. Moore, *supra* note 53, ¶ 1301.

198. Andrew Zimbalist, *In the Best Interests of Baseball? The Revolutionary Reign of Bud Selig* (2006), at 131. In a similar vein, the District Court in *Selig* asserted that “baseball is good for Americans (who can argue with this).” *Selig*, *supra* note 96, at 528.

legislative agenda and special interests. The topics addressed above hopefully provide an insightful perspective on the way tax policy impacts the economics of sports in ways not always obvious to the everyday fan.