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The Tax Implications of Owning a Professional Sports Franchise

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Contents

I. Introduction

The sports franchise industry as a whole is in a great state of prosperity, evident by recent activity such as American billionaire businessman and television personality Tilman Fertitta's purchase of the National Basketball Association's (NBA) Houston Rockets for $2.2 billion.[1] The job of owner does not come without its own set of challenges as there are still daily responsibilities and, depending on the market, the pressure is immense to put out a desirable product for the fans. After all, a strong team performance leads to more ticket sales and merchandising deals among other benefits like increased franchise value to the owners of the franchise.

According to Forbes's annual NBA team valuations, the league average for operating income is equal to $52 million.[2] Thus, the annual franchise income is unlikely to cover the initial purchase price for decades. Based on Tilman Fertitta's multi-billion-dollar purchase, if we assume that the Houston Rockets brings in around $95 million in operating income before interest, taxes, depreciation and amortization[3] it would take Fertitta about 24 years to recover the purchase price. There are other factors that affect the valuation, such as merchandising and endorsement deals, and Fertitta has other ventures in addition to his NBA team ownership. The decision to acquire a sports franchise in spite of the massive initial barrier to entry and marginal returns may be a personal ambition, but this paper explores the possible tax savings aspect of the transaction. These tax savings come about through a variety of factors, including ownership structure and the related tax treatment of professional sports franchises.

II. Ownership Structure

To begin to consider the tax implications involved with sports ownership, the first major factor to consider is the ownership structure. There are four different types of ownership structures found throughout professional sports leagues each with their own sets of advantages and disadvantages. These options include private ownership, public ownership through stock, public ownership through the community, and single entity ownership. This paper explores the different types of

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[1] https://www.bloomberg.com/view/articles/2017-09-08/buy-a-sports-team-get-a-tax-break
[2] https://www.forbes.com/sites/forbespr/2018/02/07/forbes-releases-20th-annual-nba-team-valuations/#53487b4034e6
[3] https://www.forbes.com/teams/houston-rockets/

issues associated with ownership structure as well as the reasoning behind one particular choice of ownership structure over another relating to potential tax treatment.

A. Private Ownership

The first type of sports team ownership is private ownership. This method of ownership, whether it be by individual investors or privately-held corporations, is by far the most popular method of ownership across all of the major professional sports leagues. Among this list of ownership structures also includes unincorporated partnerships made up by a handful of investors who act as the shareholders.[4]

1. Advantages of Private Ownership

There are multiple advantages and benefits to this particular form of sports franchise ownership. One of the main advantages is that private investors are often more suited for the task of sports team ownership, whether that be due to their sources of capital, time available, managerial talent available or past business experience. Along with this, the private investor group has a vested interest in the financial success of the franchise because it is purely the main focus of their business efforts. Because the ownership group is likely to be much smaller than the large number of stakeholders that would be involved in a public ownership situation, private owners have greater freedom to make decisions regarding the team's operations. One of the biggest advantages to private ownership, however, is having the ability to keep the company's financial statements private. This highly valued factor of private ownership means the owners can avoid potential scrutiny from the public. They also do not have to worry as much about maintaining investor confidence, as the financial statements are often important pieces of information that investors use to make decisions. Private owners also do not have to worry about other investor purchasing shares of their ownership stake because that is not an option under the private ownership rules. Finally, some sports leagues, such as the MLB and NFL, favor private ownership over public for reasons discussed in the public ownership section of this paper. In this case the league rules either outright prohibit or otherwise strictly limit public ownership options.[5]

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[4] Smith, Brad (2003) "How Different Types of Ownership Structures Could Save Major League Baseball Teams from Contraction," *Journal of International Business and Law*; Vol. 2: Iss. 1, Article 6
[5] *Ibid.*

2. Disadvantages of Private Ownership

The main disadvantage that exists in private ownership structures can often depend on the quality of the ownership group. If the ownership group is profit-driven, they might only be interested in actions that lower costs or raise revenue, such as raising ticket prices or cutting costs by paying their players the least amount of compensation possible. This type of management behavior could also lead to the owners being against other franchises entering into their immediate area as they are afraid of losing fans to competing franchises. Overall, the community takes notice of these actions and correctly realizes that such an extreme focus on the bottom line of a sports franchises' operations is certainly not healthy for the league.

Another disadvantage that exists under the private ownership structure is the difficulty of raising funds for the team's operations. A publicly owned franchise has many more options than a privately-owned franchise when it comes to funding capital. For example, if the franchise wanted to fund a new project such as a new stadium for the team, the publicly owned franchise can just issue shares of stock to the public. Private owners do not have this option and often have to use private funds for these ventures.

Finally, private owners do not have as easy of an "exit option" as public owners do. Because the ownership is not in the form of publicly traded stock, the only option for private owners to liquidate their investment is to make a direct sale with another investor. Liquidation can be a difficult and time-consuming task, especially considering the rising prices of ownership stakes in sports franchises. Also, all private owners and those who are in a partnership are individually liable for the sports franchises' debts depending on the type of partnership structure, which can be a very large cost to have to pay for the investors.[6]

B. Public Ownership

Another type of ownership structure is public ownership. One of the most prominent examples of this type of ownership structure is the Madison Square Garden Company. The company owns sports franchises MSG Sports, which includes teams such as the New York Knicks of the NBA, and the New York Rangers of the National Hockey League (NHL).[7] The primary sources of the revenue through their operations include ticket sales, distributions from television contracts,

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[6] *Ibid.*

[7] http://investsnips.com/list-of-publicly-traded-sports-franchises/

event-related revenue, local media rights, advertising and rental of suites.[8] Direct operating expenses include compensation expenses for players and team personnel, NBA luxury tax payments, revenue sharing, event costs, venue leases and maintenance. This type of ownership began in the 1990s when public companies mostly found in media, entertainment and communications participated in sports team ownership through this method. It was mostly the case when a media company owned multiple teams from different leagues in the same area. In the case of the Madison Square Garden Company, the company also owns Madison Square Garden, the arena where their sports franchises play their games.[9] However, this is a trend that has reversed over time since the companies involved in ownership have decided to divest of their non-core assets, such as the sports franchises they owned, and questioned their ability to maintain their role in team ownership.

1. *Advantages of Public Ownership*

One of the advantages of public ownership is easier fundraising through the issuance of stock. Companies first go public to raise funds for their ongoing developments that they would finance with equity rather than issuing debt. These funds could then be used for important purposes such as paying players their signing bonuses and annual salaries, as well as providing a means to fund construction of new stadiums.

Another desirable reason for public ownership is that it provides an "exit option" for team owners. Because of the appreciating values of sports franchises, actual sales and purchases of sports franchises are relatively rare, and investors could be forced to maintain their investment for a longer time than they would wish. Giving owners the means to divest some of their investment by selling their shares of stock in the franchise is an easy method of getting cash value for their investments and adds flexibility with its liquidity.

Another reason that public owned franchises might be beneficial is that public companies often have the resources, personnel, and funds required to enter into team ownership. A reason that a public company might undergo this process is because it provides synergies with their ongoing business model (e.g. Madison Square Broadcasting Company purchasing the rights to the New York Knicks instead of buying the rising costs of broadcasting rights). Public ownership

[8] Madison Square Garden Company. *2017* Form 10-K. Web. 18 April 2018.
[9] *Ibid.*

in general is good for sports leagues because teams owned by public corporations often have the resources needed to be successful, which in turn makes the rest of the league more profitable due to a sudden increase in franchise value and rules like revenue-sharing.[10]

2. Disadvantages of Public Ownership

There are also disadvantages to public team ownership. The sports leagues themselves often implement policies that severely limit this type of ownership structure. For example, the MLB has a rule that only allows 49% of a team to be distributed through stock in an IPO, and the voting rights for publicly held shares are strictly limited. The National Football League (NFL) is even stricter when it comes to public ownership, prohibiting corporate ownership entirely and requiring league ownership approval of at least 75% in order for a transfer of ownership assets to occur. Public offerings of shares are also prohibited in the NFL. The NFL contends that this would provide an unfair competitive advantage for nonpublic company held teams due to a lack of funds, as well as create a shift in focus from football to a rise in commercialization.[11]

Secondly, public companies are subject to new public disclosure requirements. Like all publicly traded companies, a franchise which is publicly traded is subject to the rules and regulations of government agencies such as the Securities and Exchange Commission; thus, they would have to declare previously privately held information, such as sales, profits, executive compensation, and certain key shareholder activities. In fact, most of the policies put in place by the leagues that limit public ownership were established to prevent this kind of information from being subject to public scrutiny by the media, government officials, or even players seeking a contract with a team.[12]

Another potential issue with public ownership is the cost. In terms of time and finances, issuing an IPO requires consulting with lawyers, accountants, and investment bankers. For example, a $500,000 IPO could cost the owners upwards of $700,000 to fully implement, and will appear as an ongoing expense on the disclosures given to the public.[13] Another thing that is important to consider when issuing an IPO is inspiring and maintaining investor confidence. An IPO can only be considered successful if it is issued at a price that potential investors and

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[10] *Ibid.*
[11] *Ibid.*
[12] *Ibid.*
[13] https://www.pwc.com/us/en/services/deals/library/cost-of-an-ipo.html

shareholders will be willing to purchase them, which is a tough challenge for many publicly traded companies. An IPO might fail because investors are more aware of business practices used by these public companies, as well as the actual values of the teams that are owned by these public companies. The publicly held companies have a hard time getting their shareholders a reasonable return on their investment due to the appreciating value of franchises over time rather than continual improvement demonstrated in quarterly and annual reports.

Finally, when a sports franchise goes public, the owners often lose some amount of flexibility and control over the business due to the issuance of shares and the voting rights, which adds to the risk of a hostile takeover.

C. Public Community Ownership

A unique type of ownership structure is public community ownership. The main factor that separates this type of ownership from the standard public ownership is that the public owns the majority of the stock, which in these instances is a majority interest of 70-75%. The remaining 25-30% is sold to a private management group or investor who actually operates the team and is responsible for the team's profits, expenses, and losses. Once this process is complete, the team's laws are modified to require a supermajority (¾) to approve of team relocation, effectively keeping the team attached to its original city and fans. The actual process is done through a market test, so if the public does not show any interest the team gets put back on the market and is sold to a public or private investor instead.[14]

The most notable example of a sports franchise that utilizes this type of ownership structure are the Green Bay Packers of the NFL. This unique situation exists because the Packers ownership structure was grandfathered into the NFL around the same time that the NFL banned community ownership from the league when they implemented their new revenue-sharing plan in 1961.[15]

An interesting facet of this type of ownership is that there have been legal attempts to promote its expansion and growth into professional sports leagues. These efforts include state laws such as the *New York Sports Fan Protection Act*,[16] which would create a State Sports Authority that could condemn a franchise through eminent domain and sell shares of the team to

[14] *Ibid.*
[15] http://www.leagueoffans.org/2012/04/06/green-bay-packers-ownership-structure-remains-the-ideal/
[16] https://ilsr.org/rule/2787-2/

the public if either the cost of its stadium exceeded the value of the franchise or if the owners tried to relocate elsewhere. There have been multiple efforts on the federal level, including the *Give Fans a Chance Act of 2011*[17] and the *Fairness in Antitrust in National Sports (FANS) Act of 2001*.[18] The effective purpose of these acts was to prevent the league from outlawing community ownership and help fans regarding possible elimination or relocation of local sports franchises.

D. Single Entity Ownership

The final type of ownership structure is single-entity. This option means that all of the teams in the league are owned by a single entity, in most cases the league themselves. However, this doesn't really exist as a viable option in most scenarios because it would require the governing body of the league, such as the MLB or NFL, purchasing all of the teams in a league from their private owners. As such, this type of ownership structure would be best suited for a professional sports league that is not as established as some of the major sports leagues, such as Major League Soccer (MLS). Under this situation, the MLS is the sole employer of all of its players as opposed to the individual private owners that we see in other professional sports leagues.

E. Summary

Most sports team owners only have one real option when it comes to ownership structure, which is private ownership. Because the professional sports leagues generally have rules that prohibit and/or strictly limit the ability of teams to undergo a public ownership structure, it is clear that the leagues have a preference in regards to this matter. One of the main favorable factors to the private ownership structure was that the owners have no legal obligation to disclose their financial information to the public. This means that the owners do not have to disclose their earnings and profits and do not have to worry as much about maintaining investor confidence, which is an issue that other publicly owned companies deal with on a daily basis. Because the owners do not have this issue, they can report losses to their investors at a greatly reduced risk, which they can then use for their own tax benefit. The next section discusses why and how owners may want to generate losses.

[17] https://www.congress.gov/bill/112th-congress/house-bill/3344
[18] https://www.congress.gov/bill/107th-congress/senate-bill/1704

III. Downward Earnings Management

A. Why downward

Owners may want to manage earnings downward earnings for two reasons: 1. Minimize income tax expense and 2. Increase negotiating power with unions. Because the majority of team ownership groups are not publicly owned, the owners do not need to disclose their financial information, making it difficult to detect earnings management.[19]

Professional sports owners have an incentive to use claims of financial distress to justify their negotiating position in collective bargaining with the players. Financial experts and the players' associations counter, saying that the owners are able to shelter their revenue streams by using questionable methods.

As the two main parties involved in a professional sports league, the players and the owners both engage in negotiations to reach more agreeable solutions to the league's problems for both sides.[20] The focus of these debates is mainly centered around how the league revenue is split between the owners and the players. The main focus of the players union during this process is to get the most benefits for the players, including better pay and benefits. To counter this, the owners will make their own arguments pointing to financial and economic distress which leads to dropping profits and increased spending expenses, meaning they cannot bear the burden that would come with giving the players more of their revenue.

Of course, for the owners to actually make this argument they must support it with evidence, including financial information. Owners want to put themselves in the best position possible and do so through these techniques. The public perception of the financial situation of the teams is also important to manage. Portraying the team as being susceptible to financial distress could help create at least some form of tolerance when it comes to tough financial decisions such as raising ticket prices or concessions. This strategy could also help in other areas as well, such as providing justification for a conservative strategy when it comes to using the team's resources to upgrade the team through free agency, lobbying for government subsidies when petitioning to build a new stadium, or even as leverage when threatening to relocate.

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[19] Estes, Brent C. "Manipulating the Numbers: Earnings Management Techniques in Professional Sports," *Business Studies Journal*; Volume 4, Special Issue, Number 1, 2012

[20] http://www.jwj.org/collective-bargaining-101

B. Managing GAAP and Tax Income Downward

Managing earnings downward occurs whether the team uses generally accepted accounting principles (GAAP) or tax rules. Paul Beeston, former Vice President of the Toronto Blue Jays, was once quoted saying, "Anyone who quotes baseball profits is missing the point. Under generally accepted accounting principles, I can turn a $4 million profit into a $2 million loss and I could get every national accounting firm to agree with me."[21] It is impossible to know whether or not the different sports franchises follow GAAP rules due to the nature of private ownership, but the quote by Beeston still demonstrates how the RDA works for tax purposes as well.

A common technique for both is to "pay yourself first." Simply put, the owners will pay themselves a salary or get paid in fees by the team itself, which is an expense on the team's financials, thus reducing net income. This idea could also apply by using the team's money to purchase services from another company that is owned by the same ownership group.

Another type of earning management technique is to reallocate the revenues generated by the team among other different entities also owned by the same ownership group. For example, the ownership group not only owns the team, but also the stadium where the team plays. In this case, they can allocate certain portions of the revenue to one group or the other, resulting in a general decrease of overall earnings between the two entities.[22]

Finally, the tax on earnings can be manipulated by the choice of ownership structure of the franchise. In the case of professional sports franchises, many owners have structured their ownership in the form of a subchapter S corporation or partnership. Not only does this provide certain tax advantages, but it also allows the income earned by the entity flows through directly to the owners, avoiding entity taxation. For example, if a corporation reported a loss of $30 million and the shareholder had a 10% stake in ownership, the shareholder would be able to claim a $3 million loss onto a personal tax return and offset other forms of income.[23] If there was any loss remaining after offsetting current year income it could be carried forward to the following year as well, making this a very beneficial tax planning strategy.[24]

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[21] Keeney, Stephen R. The Roster Depreciation Allowance: How Major League Baseball Teams Turn Profits into Losses. *The Baseball Research Journal* Volume 45, Number 1 Spring 2016
[22] *Ibid.*
[23] https://www.thebalancesmb.com/business-losses-to-offset-income-397687
[24] *Ibid.*

IV. Income for Tax Purposes: The Roster Depreciation Allowance

Sports franchise owners are able to shelter taxable income through the Roster Depreciation Allowance (RDA). The RDA has existed since 1946, when Bill Veeck convinced the IRS that the roster of players on his newly acquired Cleveland Indians was a depreciable asset.[25] When a purchase of a sports franchise is made, the purchase price is allocated to the different assets that were received in the transaction. Thus, if the purchase price allocation was mainly allocated to player contracts, the owners could effectively amortize the actual purchase price of the sports franchise, creating a large deduction that creates tax savings.

Throughout its existence, the RDA has been a controversial provision, and it has gone through many different iterations during its existence. The amount that could be amortized as well as the period over which the amortization could occur has changed, but the basic principles behind the law have remained the same: the cost allocated to player contracts is amortizable.

The reason that the amortization is large enough to create significant tax savings is mostly due to the nature of the initial purchase of a sports franchise. Sports franchises are made up of assets and liabilities like any other business, but the majority of the value of the franchise results from franchise rights. Essentially any right that comes with the unique position of owning and operating a franchise in a professional sports league is included in this definition. These franchise rights include rights to revenue-sharing as well as intellectual properties like trademarks, trade names, and licenses. This asset also includes local broadcast rights, stadium contracts, concession income, drafting players, and the services of players under contract.

Of course, different rights have different values, but the key is that they are intangible in nature. Unlike other intangible assets which are traded on a marketplace such as stock or physical tangible assets that have a fair market value such as equipment or machinery, the value of these franchise rights is much more difficult to determine. Because of this, the allocation of the purchase price is mostly up to the owners, and owners have an incentive to allocate as much as possible to assets with a shorter useful life.

[25] Veeck, B. and E. Linn. 1962. *The Hustler's Handbook*. New York, NY: G.P. Putnam's Sons.

A. Early Developments in the Pre-RDA Era

There are two court cases from the 1920s relating to baseball teams and their treatment of player contracts that predate the RDA. These cases are *Chicago Nat'l League Ball Club v. Commissioner*[26] and *Commissioner v. Pittsburgh Athletic Co.*[27] The Pittsburgh Pirates and Chicago Cubs of the MLB were using the difference between their player contracts that they bought and sold during any given year as a deduction. However, both the Chicago Cubs and Pittsburgh Pirates changed their practices in the late 1920s so that instead of deducting the difference between the player contracts bought and sold, they took the entire amount spent on player contracts during a given year and deducted the full amount. The teams argued that the contracts effectively had a useful life of only one year and as such should be expensed in the year that the expense is incurred instead of being amortized over time.

The IRS argued that under the reserve clause, a rule in baseball that gave all player contracts a perpetual team options, a team could effectively retain their players for their entire careers as long as they exercised the options each year.[28] Therefore, the IRS argued that player contracts amount should be deducted over a period of at least three years, the average length of a player's career during that time period. In both cases, the courts ruled in favor of the teams because while the options did exist for their players, they did not account for the fact that a player could choose to retire at any point in time during their contract. Also, the fact that the option exists does not change the fact that the contracts really did have a one-year period of enforcement. Because of this, player contracts did not really have an indefinite life as the IRS argued.

B. The Beginnings of the RDA

In 1946, entrepreneur Bill Veeck bought the Cleveland Indians.[29] Veeck, a businessman who owned multiple baseball franchises over his lifetime, was the first individual to argue that player contracts were depreciable assets. At the time, intangible assets were not subject to amortization because they did not decline in value over a determinable amount, and even if they did it was

[26] Chicago Nat'l League Ball Club v. Commissioner, 1933 WL 4911 (B.T.A.) (1933), affirmed sub nom Commissioner of Internal Revenue v. Chicago Nat'l League Ball Club, 74 F.2d 1010 (1935)
[27] Commissioner of Internal Revenue v. Pittsburgh Athletic Co., 72 F.2d 883 (1934)
[28] *Ibid.*
[29] http://heathoops.com/2014/11/a-history-of-tax-sheltering-for-sports-team-ownership/

even harder to determine the time period over which the value declined with reasonable accuracy. Because the majority of the assets that were purchased with a sports franchise were intangible, no amortization was claimed. However, there was one asset that was subject to amortization - player contracts.

When a sports franchise is purchased it is necessary to allocate the purchase price among all of the various assets and liabilities acquired in proportion to their fair market values. With no rule in the tax law preventing the owners from assigning the majority of the purchase price of the sports franchise to player contracts, Veeck argued that the amount of the purchase price allocated to the player contracts should be treated as an amortizable asset.

C. Issues with the RDA

Buyers pursued a high allocation of initial purchase price for player contracts despite the fact that the franchise rights were by far the more valuable of the two assets because they wanted as much of their purchase to be depreciable as possible. The first major case demonstrating this issue was seen in 1965 when the NFL expanded and welcomed the Atlanta Falcons as a new team.[30] As a part of this process the NFL held an expansion draft where the new owners chose from the existing NFL team rosters and ended up with 42 players and contracts for their new franchise. Then, when the new owners tried to depreciate both the cost of acquiring the players and the cost of the franchise right of being an NFL franchise the IRS argued that the new owners were allocating too much to the players and not enough to the franchise rights. There was also an argument that the "mass asset rule" applied to the owners' allocation.[31] The mass asset rule prevents the amortization of intangible assets of an indeterminate life if they can be tied together with other intangibles of determinate life. In this case the franchise rights were the former and the player contracts were the latter. The IRS felt this rule applied because they believed that it was unreasonable to separate the costs of becoming an NFL franchise and the costs of acquiring the players. The rule would also prevent the owners from dividing up the allocation between the player contracts and the franchise rights and limit the amortization deduction. However, the court disagreed with the IRS, ruling that the mass asset rule did not apply for two reasons: the player contracts had a distinct value that was separate from the franchise rights and they also had a

[30] "Atlanta Falcons Team Page," NFL.com, http://www.nfl.comk/teams/atlantafalcons/profile?team=ATL
[31] Laird v. U.S., 556 F. 2d. 1224, 1226-1230 (5th Cir. 1977)

limited life that could be determined with an accurate value.[32] This decision resulted in the continued practice of separating and amortizing player contracts and franchise rights.

As another part of the ruling, it was also determined that franchise rights such as television revenue rights were not depreciable due to the nature of their indeterminate life, which lasted as long as the franchise is a part of the NFL. Therefore, owners got the most benefit from allocating as much of their purchase price to player contracts as possible, which they would continue to do going forward.

D. The Importance of Player Contracts

A player's contract outlines the amount of compensation that will be paid to the player as well as the necessary things that need to be done to earn that compensation. The contracts also state over how many years it applies and includes other things like signing bonuses and other options. The rights to a player's contract, on the other hand, relate to the ability to enforce the contract and making sure that the player it applies to will abide by its ruling.

A practice that existed early on in the history of American sports but has since been phased out is the buying and selling of the rights to a player's contract. The value of these rights was determined by looking at the amount of potential revenue that a player would bring in to the franchise and comparing it to the average salary of the player. For example, if a player had a $5 million annual salary and was expected to bring in revenue of $7 million, an opposing franchise might be willing to pay $1 million for the rights to that player's contract. In this way, the $7 million in revenue minus the $5 million in salary and the $1 million purchase price of the player's contract would leave a net total of $1 million in revenue to be gained by the franchise.[33] If another player had the same amount of salary but was projected to bring in much more revenue, another franchise would be willing to pay much more for the rights to that player's contract. These rights to player contracts were represented by the player contracts asset when purchasing a sports franchise.

Thus, it was important to determine how valuable the player contracts are to the franchise. The greater the portion of the overall purchase price is determined to be allocated to player contracts and rights, the greater amount that needs to be amortized, and the larger tax

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[32] *Ibid.*

[33] https://sportslaw.uslegal.com/sports-agents-and-contracts/sports-contracts-basic-principles/

deduction that results. For example, in 1970, Bud Selig, who would go on to become the commissioner of the MLB, purchased the Seattle Pilots for $10.8 million. Of that $10.8 million, $10.2 million (or about 94%) was allocated to the purchase of player contracts.[34] This amount was allocated this way despite the fact that the contracts themselves were only worth about $607,400.[35] The proposed allocation was upheld in court. Congress acted to prevent these types of allocations in the future,[36] but it still serves to help understand how important player contracts are and how they work within the scope of the RDA.

E. Tax Law Changes in the 1970s

The constant battle of proper allocation between franchise rights and player contracts came to a head in 1970 when Bud Selig purchased the Seattle Pilots. The announcement of Selig's proposed allocation is what caused Congress to take action on this issue and take the first steps necessary to prevent these kinds of allocations in the future.

Congress enacted Section 1056 as part of the Tax Reform Act of 1976, which helped to regulate the tax treatment of player contracts.[37] Subsections (a)-(c) dealt with basis, but the main focus for the purposes of allocation was in subsection (d).[38] This subsection created a presumption that the purchase price of a sports franchise could not be allocated to player contracts in an amount greater than 50% of the total purchase price. It could exceed 50%, however, if the owners could establish that the proposed allocation was reasonable in nature. The amount related to player contracts could then be amortized over a five-year span rather than over the life of each individual contract. After the five years were up the player contracts asset would be fully used up and the depreciation deduction would no longer exist. The law was known as the 50/5 rule, which streamlined the process of the allocation and created one depreciable asset on the sports franchises' books for all of the franchises' contracts. However, it did not entirely act as a general rule for purchase price allocation as it was only written into law as a presumption. As a result, many franchise owners continued to go to the IRS seeking to allocate as much purchase price as possible into player contracts. Because the IRS believed that franchise rights were not

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[34] Selig v. U.S., 740 F. 2d. 572, 574 (7th Cir. 1984)
[35] "1969 Seattle Pilots Roster," Baseball-Almanac.com, http://www.baseball-almanac.com/teamstats/roster.php?y=1969&t=SE1.
[36] *Ibid.*
[37] 26 U.S.C. § 1056
[38] https://www.govtrack.us/congress/bills/94/hr10612/text

amortizable because they did not have a determinable life and that player contracts were amortizable due to their easy to determine useful life (only being valuable for however many years the contract applied to the player), buyers decided to allocate as much of the purchase price of the franchise to player contracts as they could.[39]

V. The RDA Post-1976

The rules that were created as a result of the Tax Reform Act of 1976 persisted until Congress made some changes related to the RDA, as well as the general tax treatment of professional sports franchises, in 2004. During this time frame there were also major changes made which further changed how the RDA would behave going forward.

A. The Omnibus Budget Reconciliation Act of 1993

Leading up to the 2004 change, there was a law passed by Congress in 1993 under Section 197 as part of the Omnibus Budget Reconciliation Act of 1993.[40] Section 197 changed the tax treatment of intangible assets, making it so that all intangible assets that were purchased in an acquisition could be amortized, and would be done so over a 15-year period. This was known as the 100/15 rule.

There was one industry which was excluded from this new treatment, which was the sports franchise industry. As a result, the RDA continued to exist and the 50/5 rule would continue to apply as a result of the exclusion of the sports franchise industry from Section 197.

B. The Tax Reform Act of 2004

Section 1056 persisted until 2004 when the Tax Reform Act of 2004[41] was passed. The ruling would repeal Section 1056, which is what originally defined and established the proper tax treatment of player contracts in the 1970s and created the 50/5 rule. As a result of the repeal, Congress allowed sports franchises to receive the same treatment that all other industries were subject to related to the amortization of intangible assets under Section 197. Congress allowed this because under Section 197 the amortizable deduction for intangible assets was allowed for “workforce in place” (equivalent to the player contracts asset) and “any franchise, trademark, or

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[39] *Ibid.*
[40] https://www.congress.gov/bill/103rd-congress/house-bill/2264
[41] https://www.congress.gov/108/plaws/publ357/PLAW-108publ357.pdf

trade name".[42] Other reasons for allowing sports franchises to be applied under this ruling include making the law more uniform across all industries and cutting the costs of administration and enforcement to the IRS when it came to allocation disputes. There was also an argument that the overall tax revenue would actually increase as a result of the ruling. Although the actual amount of the deduction increased from 50% to 100%, the amortization period tripled from five years to fifteen years. This means that although more of the intangible assets were depreciated, they were also being depreciated over a significantly longer period of time. As a result, owners would be depreciating a much smaller amount each year and be taking a smaller deduction when it came to filing their income taxes, leading to more of the tax revenue being collected in the short term than under the previous ruling.[43]

C. Impact of the Tax Reform Act of 2004

Once the specific exclusion of sports franchises was repealed, owners were now subject to the 100/15 rule, meaning that nearly all of the purchase price of these franchises was fully amortizable over a fifteen-year period. This was only the case when the allocation of the purchase price was significantly in favor of intangible assets since tangible assets did not fall under the same rulings allowed under Section 197. During the allocation of the purchase price, an amortizable deduction was created that flowed through to the partners/shareholders and their income tax returns. One thing that had not changed throughout the history of tax rulings related to professional sports was that the vast majority of what is purchased when acquiring a professional sports franchise is intangible. The kind of assets that are tangible, including equipment and facilities, are often so minor when compared to the overall purchase price of the entire sports franchise that it makes sense to allocate most of the purchase price to the intangible assets anyway. With the end result of the ruling being more tax revenue could be recognized in the short term, the new changes had their desired effect and finally helped to limit the tax deductions that were taken by professional sports franchise owners.[44]

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[42] 26 U.S.C. § 197(d)(1)(C)(i)
[43] *Ibid.*
[44] *Ibid.*

D. Other Aspects of the RDA

There are some other factors that need to be considered when looking at the overall effects of the RDA. One of these factors is that the actual tax deduction that is taken each year is only temporary. The amount that is taken as a deduction in each tax year will eventually be paid to the IRS when the franchise is sold and the owners likely report a gain on the sale due to the depreciation of the franchise and its assets. In this way, while the RDA does not affect the total amount of tax dollars that are paid by a sports franchise to the IRS, it does have its uses when it comes to other tax planning strategies. One of these uses is that it allows for more revenue to go by untaxed due to the increase from 50% to 100% of intangible assets being depreciated.

Another is that it allows the owners to have lower revenue numbers on their income statement. While this revenue will eventually be paid back, the tax breaks created by the RDA help to create what is essentially a deferred tax liability because the tactics allow the owners to defer paying their taxes until a later date in the future. In this way the RDA almost acts like an interest-free loan from the government, but with the owners are also generating income from the operations of the sports franchise they are still realizing a net benefit overall.

Finally, it is interesting to consider that while the ruling is known as the Roster Depreciation Allowance, the main focus is with intangible assets, which are subject to amortization rather than depreciation. Amortization and depreciation are effectively the same, but the naming convention is a result of Section 197, which governs the treatment of intangibles, not being enacted until 1993 under the Omnibus Budget Reconciliation Act. Therefore, during the time that the RDA was enacted into law, amortization was a less common principle and depreciation was used to define the tax treatment of player contracts.

VII. Future Developments for Tax and the RDA

Since the passage of the Tax Reform Act of 2004 there has not been much change regarding the tax treatment of professional sports franchises. But with the passage of the new Tax Cuts and Jobs Act (TCJA) in late 2017, it is possible that change is on the horizon for the sports franchise industry.[45] While the current law does not change the status quo for sports franchises, the fact that major tax changes are underway means that it is always a possibility for

[45] https://www.lbmc.com/blog/us-tax-reform-summary-of-the-tax-cuts-and-jobs-act

some changes to occur in the future. The current effects of the TCJA are yet to be seen, but there are some major takeaways from the new law. The focus of the new ruling is mainly seen in the operations of corporations and individual tax treatment. There has been an overall cut of income tax rates for both parties, including a drop from a 35% rate to a flat 21% rate for corporations. On the other hand, the top individual rate has dropped from 39.5% to 37%. Other changes include the doubling of the standard deduction and the elimination of personal exemptions. Lastly, the changes being made for corporations are permanent while the individual changes will eventually phase out at the end of 2025.[46] In terms of the main rule that impacts sports franchise owners, Section 197, the TCJA doesn't add anything new or change any existing terms. The law remains unchanged and owners can continue to use creative accounting techniques to use the RDA to their tax advantage.

VIII. Conclusion

The RDA is a unique aspect of professional sports franchise ownership which allows for deductions and tax savings that are very beneficial to sports franchise owners. It cannot be denied that as long as the RDA remains a commonplace practice in professional sports accounting it will be a prevalent aspect of the industry. This could remain a vital area of the industry for many years to come, especially considering the lack of action related to Section 197 in the recent Tax Cuts and Jobs Act. On the other hand, as long as creative accounting techniques remain a hot buzz issue in the accounting profession, the RDA is likely to be scrutinized and analyzed for its validity and legitimacy for many years to come. Whether or not the analysis results in any significant changes to the RDA will remain to be seen.

Ever since its inception back in the 1940s the RDA has caused problems for Congress and it has gone through a significant amount of changes, so change in the future is a definite possibility. While the average sports fan probably is not interested in how their teams' owners file their income tax returns, they are definitely invested in seeing their team perform well. Having the ability to spend money and invest capital into the franchise is key, so avoiding paying taxes now to reinvest into the franchise could very well pay dividends in the future when the

[46] *Ibid.*

team is successful and bringing in more revenue. As long as something like the RDA helps the team to remain competitive in a cutthroat industry, expect it to remain for the foreseeable future.