# "COULDNA DONE IT WITHOUT THE PLAYERS:"* DEPRECIATION OF PROFESSIONAL SPORTS PLAYER CONTRACTS UNDER THE INTERNAL REVENUE CODE

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* IRA BERKOW & JIM KAPLAN, THE GOSPEL ACCORDING TO CASEY 120 (1992).

** Associate Professor of Law, Pace University School of Law. Thanks to Jean Zorn of City University of New York Law School and Jim Fishman of the Pace faculty for first suggesting that this topic be taken seriously, to Ron Jensen of Pace for clarifying comments, and to the New York Mets, whose performance every day on the field brings into question the legitimacy of the depreciation deduction for player contracts. *See* BOB KLAPISCH & JOHN HARPER, THE WORST TEAM MONEY COULD BUY (1993) (describing "the collapse of the New York Mets").

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> *Look, we play the "Star Spangled Banner" before every game. You want us to pay income taxes, too?*
>
> —Bill Veeck[1]

## I. INTRODUCTION

Major League Baseball's (MLB) newest expansion teams, the Colorado Rockies and the Florida Marlins, lost nearly 200 games in

1. BILL VEECK & ED LINN, THE HUSTLER'S HANDBOOK 328 (1965). Veeck, who at various times owned the Cleveland Indians and Chicago White Sox, and who was involved in management of several other teams, is well known for his imaginative ideas, including an early, and unpopular, advocacy of increased revenue sharing among teams. ANDREW ZIMBALIST, BASEBALL AND BILLIONS 57 (1992). Veeck has also been called "the only owner who ever gave a damn about his players." HANK GREENBERG: THE STORY OF MY LIFE 223 (Ira Berkow ed., 1989) [hereinafter HANK GREENBERG].

their initial season, 1993, each finishing near the bottom of its respective National League division.[2] Nonetheless, the presumably tax-aware owners of the two new franchises, who paid $95 million each for the right to finish next to last in their respective divisions, will probably, on their 1993 tax returns, claim approximately $9.5 million each in depreciation deductions attributable to the value of the player contracts for the performers who created these records. The new owners of the Baltimore Orioles, who agreed to pay $173 million for that franchise, could benefit from more than $17 million in annual depreciation deductions for their player contracts.[3] These deductions will be in addition to the deductions that the owners of the clubs will take on the same tax returns for paying about $30 million plus in current salaries to the same players, as well as for the $4.5 to $8.5 million that teams spend on player development (minor league salaries and team expenses and scouting) to replace

2. Colorado had a record of 67 wins and 95 losses (.414 winning percentage) and finished in sixth place in the Western Division of the National League, six games ahead of the San Diego Padres, while Florida had a record of 64 wins and 98 losses (.395 winning percentage) and finished in sixth place in the Eastern Division, five games ahead of the hapless New York Mets. N.Y. TIMES, Oct. 4, 1993, at C4. Since baseball's expansion era began, the records of the expansion teams in their first year have been as follows:

| YEAR | TEAM | WON | LOST | PCT. | PLACE |
|---|---|---|---|---|---|
| 1961 | Los Angeles Angels (AL) | 70 | 91 | .435 | 8* |
| 1961 | Washington Senators (AL) | 61 | 100 | .379 | 10 |
| 1962 | Houston Colt 45s (NL) | 64 | 96 | .400 | 8* |
| 1962 | N.Y. Mets (NL) | 40 | 120 | .250 | 10 |
| 1969 | Montreal Expos (NL) | 52 | 110 | .321 | 6 |
| 1969 | San Diego Padres (NL) | 52 | 110 | .321 | 6 |
| 1969 | Seattle Pilots (AL) | 64 | 98 | .395 | 6 |
| 1969 | Kansas City Royals (AL) | 69 | 93 | .426 | 4* |
| 1977 | Toronto Blue Jays (AL) | 54 | 107 | .335 | 7 |
| 1977 | Seattle Mariners (AL) | 64 | 98 | .395 | 6* |
| 1993 | Florida Marlins (NL) | 64 | 98 | .395 | 6* |
| 1993 | Colorado Rockies (NL) | 67 | 95 | .414 | 6* |

* indicates other than last-place finish.

TOTAL BASEBALL 446-533 (John Thorn & Pete Palmer eds., 2d ed. 1991); N.Y. TIMES, Oct. 4, 1993, at C4.

3. I.R.C. § 167 and the regulations thereunder provide for straight-line depreciation of intangible assets over their estimated useful life. Treas. Reg. § 1.167(a)-3 (as amended 1960). I.R.C. § 1056 establishes a presumption that not more than 50% of the purchase price of a sports franchise should be allocated to player contracts, and the player life used in the decided cases has been on the order of five years. *See* Selig v. United States, 565 F. Supp. 524 (E.D. Wis. 1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984) (upholding five-year useful life for purposes of depreciating baseball player contracts).

the very players whose contracts they will currently be depreciating.[4] When two new teams join the National Football League (NFL) for the 1995 season, at a cost of $140 million each,[5] the depreciation deductions attributable to players drafted by the new teams will, if the current practices of the team owners and the Internal Revenue Service (IRS) continue to apply, be of similar magnitude.[6]

These depreciation deductions are but one example of some 175 types of intangible "assets" for which taxpayers have recently claimed depreciation deductions under I.R.C. § 167.[7] In a five to four decision, the United States Supreme Court has recently held that certain "customer-based" intangibles (for example, newspaper subscriber lists, or banks' "core deposit" bases) may, given sufficient

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4. *See* ZIMBALIST, *supra* note 1, at 59 (discussing player development costs). Three teams, the New York Mets, the Los Angeles Dodgers, and the Boston Red Sox, had team salaries exceeding forty-two million dollars in 1992. Ken Gurnick, *Big Spenders Must Pick up the Pieces*, BASEBALL AMERICA, Nov. 10, 1992, at 11. The average player salary on Opening Day, 1993, was $1.16 million per player, suggesting an average team payroll of $29 million. Tracy Ringolsby, *Owners Should Take a Long Look in the Mirror*, BASEBALL AMERICA, June 14-27, 1993, at 7.

5. Thomas George, *N.F.L. Entry Fee Is Set at $140 Million*, N.Y. TIMES, May 26, 1993, at B13.

6. Assuming that the new NFL franchise owners allocate 50% of the $140 million cost to player contracts, consistent with the presumption established by I.R.C. § 1056, and that they depreciate the contracts on a straight-line basis over an estimated useful life of 5.25 years, as was done in Laird v. United States, 391 F. Supp. 656, 658-59 (N.D. Ga. 1975), *aff'd*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978), the allowable depreciation deduction would be $13.33 million per year. Assuming a marginal federal income tax rate of 39.6%, the tax benefit to the owners would be $5.28 million. In *Laird*, the court upheld the taxpayer's proposed useful life of 5.25 years, although it reduced the taxpayer's proposed allocation of $7,722,914, or 90.9% of the total $8,500,000 cost of the franchise, to player contracts, reducing the allowable player contract amount to $3,035,000, or 35.7% of the total. *Id.* at 671.

7. I.R.C. § 167(a) (1988 & Supp. II 1990). Section 167(a) of the Code provides that:

> GENERAL RULE. - There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) -
> (1) of property used in the trade or business, or
> (2) of property held for the production of income.

*Id.*

The treasury regulations pursuant to I.R.C. § 167 make it clear that depreciation deductions may be taken with respect to certain intangible assets. Treas. Reg. § 1.167(a)-3 (as amended in 1960).

A listing of approximately 175 types of intangible assets for which taxpayers have claimed depreciation deductions under this regulation is provided in GENERAL ACCOUNTING OFFICE, TAX POLICY: ISSUES AND POLICY PROPOSALS REGARDING TAX TREATMENT OF INTANGIBLE ASSETS 40 app. (1991).

factual showings by the taxpayer, be depreciated under I.R.C. § 167.[8] Even more recently, Congress has taken steps to eliminate most of the increasing volume of litigation over depreciation of intangibles when it enacted new I.R.C. § 197,[9] which provides 15-

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8. Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670 (1993). In this case, the taxpayer allocated $67.8 million, or roughly 20% of the purchase price of a group of newspapers, to an intangible asset defined as "paid subscribers." *Id.* at 1672. It then sought depreciation deductions for these subscribers, based on expert testimony that the subscriptions had an ascertainable useful life that could be estimated with reasonable certainty. The specific subscription lives claimed varied between newspapers, from 14.7 years to 23.4 years. *Id.* at 1673. The government argued that the subscriptions, representing ongoing business customers, were indistinguishable from nondepreciable goodwill. *Id.* The Supreme Court upheld the taxpayer's position, holding that a taxpayer may depreciate an intangible asset if the taxpayer can show that the asset can be valued and that it has a limited useful life. *Id.* at 1681. Justice Souter dissented, arguing that "paid subscribers" are indistinguishable from nondepreciable goodwill. *Id.* at 1684. For a discussion of the case, see Reuven S. Avi-Yonah, Newark Morning Ledger*: A Post-Litem and Some Implications*, 59 TAX NOTES 813 (1993); George L. Middleton, Jr. & Christian M. McBurney, *The Morning After* Newark Morning Ledger: *What Should Taxpayers Do Now?*, 59 TAX NOTES 817 (1993).

9. The Revenue Reconciliation Act of 1993, Title XIII of the Omnibus Budget Reconciliation Act of 1993, added I.R.C. § 197, generally effective with respect to property acquired after the date of enactment, which provides, in pertinent part:

> (a) GENERAL RULE. — A taxpayer shall be entitled to an amortization deduction with respect to any section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.
>
> (b) NO OTHER DEPRECIATION OR AMORTIZATION DEDUCTION ALLOWABLE. — Except as provided in subsection (a), no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 intangible.
>
> ....
>
> (d) SECTION 197 INTANGIBLE. — For purposes of this section —
>
> (1) IN GENERAL. — Except as otherwise provided in this section, the term "section 197 intangible" means —
>
> (A) goodwill,
>
> (B) going concern value,
>
> (C) any of the following intangible items:
>
> (i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,
>
> (ii) business books and records, operating systems or any other information base (including lists or other information with respect to current or prospective customers),
>
> (iii) any patent, copyright, formula, process, design, pattern, knowhow, format or similar item,
>
> (iv) any customer-based intangible,
>
> (v) any supplier-based intangible, and
>
> (vi) any similar item,
>
> (D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,
>
> (E) any covenant not to compete (or other arrangement to the extent such

year straight-line amortization[10] for most, but not all, types of intangible assets. I.R.C. § 197 will apply not only to customer-based intangibles but also goodwill, going concern value, and even the value of an "assembled workforce."[11]

Neither the result in *Newark Morning Ledger Co. v. United States*[12] nor the new I.R.C. § 197, however, will resolve the question of whether and to what extent the player contracts acquired when a new owner buys a professional sports franchise -- either from a previous owner or through expansion -- should be depreciable. As discussed below, *Newark Morning Ledger* does not address the issue of intangible assets other than "customer-based" intangibles,[13] and sports player contracts do not fall into the customer-

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> arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and
>
> (F) any franchise, trademark or trade name.
>
> (2) CUSTOMER-BASED INTANGIBLE. —
>
> (A) IN GENERAL. — The term "customer-based intangible" means —
>
> (i) composition of market,
>
> (ii) market share, and
>
> (iii) any other value resulting from future provision of goods and services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.
>
> ....
>
> (e) EXCEPTIONS. — For purposes of this section, the term "section 197 intangible" shall not include any of the following:
>
> ....
>
> (6) TREATMENT OF SPORTS FRANCHISES. — A franchise to engage in professional football, basketball, baseball, or other professional sport, and any item acquired in connection with such a franchise.

Act of Aug. 10, 1993, Pub. L. No. 103-66, § 13261, 1993 U.S.C.C.A.N. (107 Stat.) 532 (to be codified at 26 U.S.C. § 197).

10. Prior to the enactment of Pub. L. No. 103-66, § 13261, deductions with respect to intangibles were allowable, if at all, under I.R.C. § 167, which refers only to "depreciation" and not to amortization. The two terms are used interchangeably in this article.

11. The Tax Court denied a taxpayer's claim to depreciate the value of the assembled workforce acquired in a purchase of an ongoing business in Ithaca Industries, Inc. v. Commissioner, 97 T.C. 253 (1991), *aff'd*, No. 92-1045, 1994 WL 51924 (4th Cir. Feb. 23, 1994).

12. 113 S. Ct. 1670 (1993).

13. Customer-based intangibles include those attributes of a business that derive from the existence of a customer base, circulation base, undeveloped market or market growth, insurance in force, or other relationships with customers involving the future provision to them of goods and services. The most common examples of such assets are newspaper circulation lists, insurance contracts in force, and banks' "core deposit bases." *See* Citizens & S. Corp. v. Commissioner, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1991) (discussing bank deposits).

based category. Moreover, the 1993 legislation specifically exempts sports franchise transactions from its provisions,[14] and the legislative history makes it clear that current (i.e., pre-1993) law is intended to continue to apply to purchasers of existing and expansion franchises.[15] Thus, while developments in 1993 may have rendered moot much of the voluminous literature generated by the tax treatment of intangibles in recent years,[16] the sports franchise player contract question remains one of the last arenas for dispute in this contentious field.

When a purchaser acquires a major league baseball team, the acquisition typically involves a small amount of tangible assets (equipment, uniforms, etc.) and three major categories of intangibles: (1) the league franchise itself, which gives the team exclusive territorial rights and the right to compete against other teams in

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14. I.R.C. § 197(e)(6) excludes from the general (15-year amortization) rule of § 197 "a franchise to engage in professional football, basketball, baseball or other professional sport, and any items acquired in connection with such a franchise." Act of Aug. 10, 1993, Pub. L. No. 103-66, § 13261, 1993 U.S.C.C.A.N. (107 Stat.) 532.

15. H.R. REP. NO. 213, 103d Cong., 1st Sess. 682 (1993), states:

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

*Id.*

16. *See, e.g.*, Reuven S. Avi-Yonah, Newark Morning Ledger: *A Threat to the Amortizability of Acquired Intangibles*, 55 TAX NOTES 981 (1992); Renato Beghe, *Income Tax Treatment of Covenants Not to Compete, Consulting Agreements and Transfers of Goodwill*, 30 TAX LAW. 587 (1977); John A. Bogdanski, *Contractual Allocations of Price in Sales of Businesses*, 15 J. CORP. TAX'N 99 (1988); Lawrence M. Dubin, *Allocation of Costs to, and Amortization of, Intangibles in Business Acquisitions*, 57 TAXES 930 (1979); Charles Edward Falk, *Amortizing Insurance Expirations: the Meaning of* Decker, 67 TAXES 391 (1989); William C. Fowler, *Intangible Assets — Planning for Purchase Price Allocation and Amortization Deductions*, *in* 1 N.Y.U. 44TH ANNUAL INSTITUTE ON FEDERAL TAXATION 28-1 (1986); Calvin H. Johnson, *The Mass Asset Rule Reflects Income and Amortization Does Not*, 56 TAX NOTES 629 (1992); George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179 (1987); Lee A. Sheppard, *Bank Deposits and the Mass Asset Rule*, 41 TAX NOTES 99 (1988) [hereinafter Sheppard, *Bank Deposits*]; Lee A. Sheppard, *News Analysis: Amortization of Intangibles: Something Out of Nothing*, 52 TAX NOTES 984 (1991) [hereinafter Sheppard, *News Analysis*]; J. Tyler Haahr, Note, *Core Deposit Base: A Depreciable Intangible or Goodwill*, 41 TAX LAW. 867 (1988); Timothy E. Johns, Note, *Tax Treatment of the Costs of Internally Developed Intangible Assets*, 57 S. CAL. L. REV. 767 (1984); Daniel Patrick Meehan, Note, *Core Deposit Intangibles and Amortization:* Citizens & Southern Corp. & Subsidiaries v. Commissioner, 44 TAX LAW. 577 (1991); Linda J. Pissott, Note, *The Amortization of Customer-Based Intangibles: The "Separate & Distinct from Goodwill" Requirement and H.R. 3035's Proposal for Change*, 45 TAX LAW. 1031 (1992); Catherine A. Tanck, Comment, *Depreciation of the Core Deposit Intangible: A Tax Incentive to Acquire a Failed Bank*, 32 S.D. L. REV. 80 (1987).

the league; (2) the right to share in league-wide revenue, notably national television contracts and income from licensing; and (3) a group of player contracts, entitling the team to the services of established players.

Owners of sports franchises have claimed depreciation with respect to individual player contracts that they purchased since at least as early as the 1920s.[17] A recent study of baseball economics, however, dates the emergence of wholesale, full-team depreciation to a 1959 discovery by baseball and horse-racing entrepreneur Bill Veeck. Veeck felt that players were no different from the machinery used in an industrial plant and that, therefore, they should be similarly depreciated.[18] Veeck's innovation allowed purchasers of sports teams to take what amounts to a double deduction.[19] First, the team owner takes a depreciation deduction with respect to the player contracts acquired when the team was purchased. Second, the owner, at the same time, takes a current deduction under I.R.C. § 162[20] for the salaries paid to the same players whose contracts are being depreciated and for the costs of developing replacements for those players.[21]

The issue became more significant in the 1960s and 1970s with the expansion of professional sports teams and the increasing rapidity of franchise sales, spurred in part by the perception that sports franchises were effective tax shelters.[22] Some commenta-

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17. *See* Dallas Athletic Ass'n v. Commissioner, 8 B.T.A. 1036 (1927) (determining whether amounts paid for individual player contracts are current expenses or capital expenditures, depreciable over a period of years).

18. ZIMBALIST, *supra* note 1, at 34; GERALD W. SCULLY, THE BUSINESS OF MAJOR LEAGUE BASEBALL 130 (1989). It appears, however, that the IRS was at least aware of the issue earlier. Rev. Rul. 54-441, in an attempt to defer deductions when an entire team was purchased, required amortization of player contracts over their useful life when the contracts were purchased in connection with an existing franchise. Rev. Rul. 54-441, 1954-2 C.B. 101.

19. Bill Veeck's other contributions to the game include bat day promotions, exploding scoreboards, and using a midget as a pinch hitter.

20. Section 162(a) provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." I.R.C. § 162(a) (1988 & Supp. IV 1992).

21. The costs associated with developing replacements for major league players include minor league player salaries and expenses as well as scouting costs.

22. For examples of the tax shelter possibilities inherent in sports franchise ownership, see Leslie S. Klinger, *Tax Aspects of Buying, Selling and Owning Professional Sports Teams*, 48 LOS ANGELES BAR BULL. 162 (1973); Leslie S. Klinger, *Professional Sports Teams: Tax Factors in Buying, Owning and Selling Them*, 39 J. TAX'N 276 (1973); Richard A. Koch, Note, *The Professional Sports Team As a Tax Shelter — A Case Study: The Utah Stars*, 1974 UTAH L. REV. 556 (1974).

tors[23] have assumed that the issue was largely resolved by the Tax Reform Act of 1976, which introduced I.R.C. § 1056, establishing a presumption that player contracts would not account for more than 50% of the value of a sports franchise,[24] and by three significant

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23. *See, e.g.*, Howard Zaritsky, *Amortization of Intangibles: How the 1976 TRA and Laird Affect Sports Franchises*, 48 J. TAX'N 292 (1978) [hereinafter Zaritsky, *Amortization*]; Howard Zaritsky, *Taxation of Professional Sports Teams After 1976: A Whole New Ballgame*, 18 WILLIAM & MARY L. REV. 679 (1977) [hereinafter Zaritsky, *Taxation*]; Charles Dickenson & Zook Sutton, Note, *The Effect of the 1976 Tax Reform Act on the Ownership of Professional Sports Franchises*, 1 COMM/ENT L.J. 227 (1977); Valerie Nelson Strandell, Note, *The Impact of the 1976 Tax Reform Act on the Owners of Professional Sports Teams*, 4 J. CONTEMP. L. 219 (1978).

24. Tax Reform Act of 1976, Pub. L. No. 94-455, § 212(a)(1), 1976 U.S.C.C.A.N. (90 Stat.) 1545. Section 1056 provides as follows:

> (a) GENERAL RULE. — If a franchise to conduct any sports enterprise is sold or exchanged, and if, in connection with such sale or exchange, there is a transfer of a contract for the services of an athlete, the basis of such contract in the hands of the transferee shall not exceed the sum of —
>
> (1) the adjusted basis of such contract in the hands of the transferor immediately before the transfer, plus
>
> (2) the gain (if any) recognized by the transferor on the transfer of such contract.
>
> (b) EXCEPTIONS. — Subsection (a) shall not apply —
>
> (1) to an exchange described in section 1031 (relating to an exchange of property held for productive use or investment) and
>
> (2) to property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent (within the meaning of section 1041(a)).
>
> (c) TRANSFEROR REQUIRED TO FURNISH CERTAIN INFORMATION. — Under regulations prescribed by the Secretary, the transferor shall, at the times and in the manner provided in such regulations, furnish to the Secretary and the transferee the following information:
>
> (1) the amount which the transferor believes to be the adjusted basis referred to in paragraph (1) of subsection (a),
>
> (2) the amount which the transferor believes to be the gain referred to in paragraph (2) of subsection (a), and
>
> (3) any subsequent modification of either such amount.
>
> (d) PRESUMPTION AS TO AMOUNT ALLOCABLE TO PLAYER CONTRACTS. — In the case of any sale or exchange described in subsection (a), it shall be presumed that not more than 50 percent of the consideration is allocable to contracts for the services of athletes unless it is established to the satisfaction of the Secretary that a specified amount in excess of 50 percent is properly allocable to such contracts. Nothing in the preceding sentence shall give rise to a presumption that an allocation of less than 50 percent of the consideration to contracts for the services of athletes is a proper allocation.

I.R.C. § 1056 (1988).

At the time Congress enacted the provision in 1976, it was estimated that limiting player contract allocations to 50% of the franchise cost would generate approximately five million dollars per year in increased tax revenue. 122 Cong. Rec. S19568 (daily ed. June 22, 1976) (statement of Sen. Bentsen). *See Tax Reform Act of 1975: Hearings on H.R. 10612 Be-*

cases decided in the 1970s and early 1980s, involving the Atlanta Falcons (NFL),[25] the Seattle Supersonics (National Basketball Association (NBA))[26] and the Milwaukee Brewers (MLB).[27] However, the increasing value of sports franchises in the 1990s,[28] together with a return to higher marginal tax rates,[29] which increase the value of tax shelters,[30] gives the issue more relevance today.

Admittedly, the tax strategies of a few well-off team owners may not be the single most pressing tax issue facing the United States, but the $10 to $20 million in annual tax revenues foregone because of player contract depreciation is not an insignificant amount. In particular, by applying (1) the long-established case law rule against depreciating that portion of the purchase price of a business that is attributable to goodwill or going concern value, (2)

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*fore the Senate Finance Committee*, 94th Cong., 2d Sess., pt. 2, at 609-61 (1976) (statement of Bowie Kuhn, Commissioner of Baseball, et al.). The 1976 legislation is discussed in James F. Ambrose, *Recent Tax Developments Regarding Purchases of Sports Franchises — The Game Isn't Over Yet*, 59 TAXES 739, 743 (1981).

25. Laird v. United States, 391 F. Supp. 656 (N.D. Ga. 1975), *aff'd*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978). For a discussion of *Laird*, see Ambrose, *supra* note 24, at 743-45; Steven Braun & Michael Pusey, *Taxation of Professional Sports Teams*, 7 TAX ADVISER 196 (1976); John B. Jones, Jr., *Amortization and Nonamortization of Intangibles in the Sports World*, 53 TAXES 777, 784-86 (1975); Jay R. Weill, *Depreciation of Player Contracts — The Government Is Ahead at the Half*, 53 TAXES 581 (1975); Zaritsky, *Amortization*, *supra* note 23; Michael L. Lewis, Note, *Professional Sports Franchising and the IRS*, 14 WASHBURN L.J. 321, 326-27 (1975).

26. First Northwest Indus. of Am., Inc. v. Commissioner, 70 T.C. 817 (1978), *rev'd and remanded on other grounds*, 649 F.2d 707 (9th Cir. 1981). For a discussion of the *First Northwest* case, see Howard M. Zaritsky, *Amortizing a Sports Team's Player Contract: An Analysis of* First Northwest Industries, 52 J. TAX'N 88 (1980); Roberta Reiff Katz, Note, *Federal Income Tax - Amortization and the Expansion Sports Franchise* - First Northwest Industries of America, Inc. v. Commissioner, 70 T.C. 817 (1978), 54 WASH. L. REV. 827 (1979).

27. Selig v. United States, 565 F. Supp. 524 (E.D. Wis. 1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984). For a discussion of the *Selig* case, see Steven J. Harwood, *Valuation of Player Contracts When Acquiring a Professional Baseball Team — An Analysis of* Selig v. United States, 61 TAXES 670 (1983); S. Barksdale Penick, *The* Selig *Case and Amortization of Player Contracts: Baseball Continues Its Winning Ways*, 6 COMM/ENT L.J. 423 (1984).

28. The new National League baseball franchises in Denver and Miami cost their owners $95 million each. George, *supra* note 5, at B13. Compare to a franchise cost of $10.8 million for the Milwaukee Brewers in 1968. *Selig*, 565 F. Supp. at 525. And the latest sale of a baseball franchise, the Baltimore Orioles in 1993, was for $173 million. *See infra* note 59.

29. The Revenue Reconciliation Act of 1993, Title XIII of the Omnibus Budget Reconciliation Act of 1993, § 13202, increased the maximum marginal personal income tax rate from 31% to 39.6%.

30. Because of the recapture provisions of I.R.C. § 1245(a)(4), discussed below, *see infra* part VI.E., the depreciation deduction for player contracts acts as a deferral, rather than a complete elimination, of tax liability. Nonetheless, this deferral is an important advantage. I.R.C. § 1245 (1988 & Supp. II 1990).

the "mass asset" theory,[31] and (3) the "hobby loss" provisions of I.R.C. § 183,[32] the IRS and the courts could generate appreciable revenue for public purposes without doing violence to the true economic nature of sports franchise ownership.

Part II of this Article discusses the tax shelter nature of sports franchises, with particular attention to the role of player contracts in generating depreciation deductions. Part III reviews the general case law and statutory rules that deny deductions with respect to assets that are part of goodwill or going concern value, and that continue to apply to professional sports player contracts, notwithstanding the Supreme Court's decision in *Newark Morning Ledger* and the enactment of the new I.R.C. § 197, affecting other categories of intangibles. Part IV considers the mass asset rule, which has been used by the IRS to deny depreciation deductions in the case of certain intangibles, and the rule's somewhat unhappy history at the hands of the courts. Part V analyzes the possible limitation on player contract depreciation that might be imposed by the use of the hobby loss provisions of I.R.C. § 183. Part VI analyzes the IRS

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31. *See infra* part IV.

32. I.R.C. § 183 provides, in part, as follows:

(a) GENERAL RULE. — In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) DEDUCTIONS ALLOWABLE. — In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed —

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) ACTIVITY NOT ENGAGED IN FOR PROFIT DEFINED. — For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) PRESUMPTION. — If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit....

I.R.C. § 183 (1988).

revenue rulings and the cases dealing with the player contract issue that have raised questions regarding each of the three theories for denying or limiting player contract depreciation. Part VII critically assesses the current state of the law and attempts to harmonize the decisions with relevant economic theory that might be used to assign a value to the player contracts. The article concludes that, where an entire franchise, as contrasted with a single player contract, is purchased, no deduction should be allowed with respect to the player contracts acquired as part of the transaction.

## II. Economic Changes in the Sports Business and the Growth of Sports Tax Shelters

Twenty years ago, tax shelters were generally defined as investments made with the principal aim of generating current deductions giving rise to ordinary losses, and which might, if the investment were ultimately sold at a profit, also convert the earlier ordinary loss deduction to capital gain.[33] Since then, Congress has substantially tightened the rules, eliminating the most egregious forms of shelters. The "at-risk" rules of I.R.C. § 465 limit the deductions that can be attributed to a taxpayer's investment financed with non-recourse debt,[34] while the passive-activity-loss rules of I.R.C. § 469[35] further limit the deductions that can be taken by a nonparticipating limited partner in an investment venture. Finally, the conversion of prior losses into capital gain has been substantially eliminated by the recapture rules of I.R.C. § 1245.[36] Nonetheless, if the possibility exists that an investment may generate tax losses that do not clearly reflect the investor's actual income

33. One definition of a tax shelter is "an investment primarily intended to produce deductions and losses which may be set-off against other income of the taxpayer, thereby giving that taxpayer a 'tax profit,' while not necessarily producing genuine profits." James C. Corman, *The Use and Misuse of Tax Shelters: The Congress and Tax Reforms*, 49 NOTRE DAME L. REV. 509, 510-11 (1974).

34. I.R.C. § 465 (1988 & Supp. II 1990).

35. I.R.C. § 469 (1988 & Supp. II 1993).

36. I.R.C. § 1245 generally requires that, when a depreciable asset is sold, that part of the gain realized on sale, if any, that represents depreciation deductions previously allowed or allowable with respect to that property be "recaptured" as ordinary income, rather than treated as capital gain. In the specific case of sports franchises, I.R.C. § 1245(a)(4) requires recapture of the greater of (1) actual depreciation allowed or allowable with respect to the specific player contracts transferred to the new purchaser or (2) previously unrecaptured depreciation with respect to the player contracts originally acquired by the seller when the seller, in turn, had purchased the team. I.R.C. § 1245 (1988 & Supp. II 1990).

from the investment, it still seems fair to speak of such investments as tax shelters. By this measure, professional sports franchises continue to offer shelter opportunities.

What do the rules governing depreciation of intangible assets mean for sports franchises? To understand what is at stake, one needs to appreciate both the specific nature of the allowable deductions that contribute to the tax shelter aspect of such franchise purchases and the increasing value of transactions in sports teams. This section of the article addresses these primarily economic concerns.

### A. *The Growth of Sports Franchise Tax Shelters*

The growth of sports franchises as tax shelters began, ironically, with an IRS action designed to *increase* tax collections, not decrease them. In Revenue Ruling 54-441,[37] the IRS required that the cost of player contracts acquired as part of the purchase of an entire franchise be depreciated over the estimated useful life of the contracts, rather than being expensed in the year of purchase, as had been permissible with respect to amounts paid for player contracts acquired in single-player transactions.[38] The IRS's attempt to delay deductions with respect to player acquisition costs became the occasion for a massive tax shelter when sports franchises became more moveable, and more valuable, in the 1950s[39] and when all of the major professional sports, baseball, football, basketball and hockey, expanded in the 1960s. By allocating a substantial portion of the multi-million dollar purchase price of a team to player contracts, a purchasing group, often organized in the form of a partnership or an S corporation,[40] could generate deductions usable

37. Rev. Rul. 54-441, 1954-2 C.B. 101.

38. For the history of the decisions establishing the current deductibility of costs incurred in single-player transactions, see *infra* part VI.A.

39. For 50 years, beginning in 1903, not a single MLB franchise moved. Then, in 1953, the Boston Braves moved to Milwaukee, in 1954 the St. Louis Browns moved to Baltimore, and in 1955 the Philadelphia Athletics moved to Kansas City. All of these transfers involved teams with losing records and poor attendance, but, following the 1957 season, two successful franchises, the Brooklyn Dodgers and the New York Giants, moved to Los Angeles and San Francisco, respectively, signalling the supremacy of the owners' pure business considerations over traditional loyalty between local fans and their baseball teams. Steve Mann & David Pietrusza, *The Business of Baseball*, *in* TOTAL BASEBALL, *supra* note 2, at 621, 626. Altogether, between 1953 and 1972, 10 major league baseball teams changed their home city, but there has been no further movement since 1972. ZIMBALIST, *supra* note 1, at 125.

40. If a corporation meets the requirements of I.R.C. § 1361, it may elect to have its

against the partners' or shareholders' other income. Recent studies of baseball economics suggest that the effect of the player depreciation deduction may be to turn a break-even business into one that produces a substantial tax loss or to turn a profitable business into one that merely breaks even for tax purposes.[41]

Sports entrepreneurs eagerly used these shelter opportunities. For example, Bill Veeck reports that the group that purchased the

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shareholders treated for tax purposes essentially as if they were partners in a partnership, thus avoiding taxation at the corporate level before distributions are made to the shareholders. *See* I.R.C. §§ 1361-1379 (1988 & Supps.). The principal requirements for S corporation status are that the corporation have no more than 35 shareholders, all of whom must be individuals (except for certain estates and trusts) who are United States citizens or residents and that the corporation have only a single class of stock.

41. The following table, loosely based on published figures for the economics of an expansion baseball franchise in 1993, illustrates the tax shelter potential of depreciating player contracts.

TABLE - HYPOTHETICAL BASEBALL TEAM ECONOMICS
(in millions of dollars)

| REVENUE | | EXPENSES | |
|---|---|---|---|
| Gate Receipts | $21.0 | Player Salaries | $40.0 |
| Spring Training | 2.0 | Stadium Operations | 3.5 |
| National TV | 13.0 | Admin. Salaries | 4.0 |
| National Radio | 0.4 | Player Development[b] | 7.5 |
| Local Radio/TV | 13.1 | Misc. Admin. | 3.0 |
| Concessions | 6.0 | Publicity | 2.0 |
| MLB Properties | 4.5 | | |
| TOTAL REVENUE | 60.0 | TOTAL EXPENSES | 60.0 |
| Profit from operations before depreciation | 0.0 | | |
| Depreciation of player contracts[a] | (10.0) | | |
| Other depreciation | (0.5) | | |
| NET INCOME (LOSS) | (10.5) | | |

a Assuming team purchased within past five years for $100 million, 50% of purchase price allocated to contracts, 5-year estimated life.
b Minor league salaries, team expenses and scouting.

*Source:* ZIMBALIST, *supra* note 1, at 48-73; SCULLY, *supra* note 18, at 135-43.

Thus, the effect of player contract depreciation is to turn a hypothetical break-even operation into a substantial loss. In the case of teams owned by individuals, partnerships, or S corporations, where the net results are reported on the owners' individual tax returns, the ten million dollar depreciation deduction for player contracts would produce, at the 1993 maximum marginal rate of 39.6%, a tax saving to the owners of nearly four million dollars.

Milwaukee Braves after the 1965 season and moved the team to Atlanta paid a total of $6.218 million, of which they allocated $50,000 to the value of the franchise and the balance, $6.168 million (over 99% of the total purchase price) to player contracts.[42] By one estimate, the existence of a deduction attributable to purchased player contracts roughly doubled major league sports franchise values from 1959 to 1975.[43] Certainly, the tax shelter potential of sports team ownership was a factor in the expansion of professional sports from 42 teams in 1959 to 114 in 1974.[44] In professional basketball, in particular, the tax shelter aspect of ownership seemed paramount, as only five of twenty-seven professional teams reportedly operated at a profit in 1974, without regard to player contract depreciation.[45] Plainly, the purchasers were attracted by the tax shelter aspects of the business rather than by the prospect of operating profits.

All professional sports leagues in the Unites States expanded significantly in the 1960s and 1970s, and buyers of expansion franchises, as well as purchasers of existing teams, routinely allocated a major portion of the purchase price to amortizable player contracts. As early as 1971, testimony before Congress had identified the tax shelter potential of professional sports franchises.[46] As commentators have noted, the ability to amortize player contracts is the most significant tax aspect of owning professional sports teams.[47] Even for a well-off owner, the difference between a break-even operation and a significant annual tax benefit is important.

Congressional attention focused on the tax aspects of sports franchises when the Washington Senators (itself an expansion team that had replaced the original Washington Senators, who became the Minnesota Twins) moved to Arlington, Texas in 1971 where they became the Texas Rangers.[48] The reported tax shelter aspects of the Washington-Texas transaction[49] apparently were the source

42. VEECK & LINN, *supra* note 1, at 330. The 99% allocation was subsequently reduced on audit to a mere 90%. Benjamin Okner, *Taxation and Sports Enterprises, in* GOVERNMENT AND THE SPORTS BUSINESS 159, 166 (Roger Noll ed., 1974).

43. ZIMBALIST, *supra* note 1, at 209 n.25.

44. Koch, *supra* note 22, at 557 n.9.

45. U.S. NEWS & WORLD REPORT, Aug. 12, 1974, at 51.

46. *Professional Basketball: Hearings on S. 2373 Before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary*, 92d Cong., 1st Sess., pt. 1, at 339-419 (1971) (testimony of Roger G. Noll and Benjamin A. Okner).

47. Braun & Pusey, *supra* note 25.

48. *See* Ambrose, *supra* note 24, at 739-40.

49. The Senators' owner, Bob Short, was reported to have made a $6 million profit on an

of the Congressional hearings that resulted in the passage of I.R.C. § 1056, limiting depreciation deductions with respect to player contracts.[50]

As in the case of most tax shelters, the advantage of depreciating player contracts is a deferral of tax liability, rather than a complete elimination of the liability. I.R.C. § 1245 provides that any depreciation claimed, e.g., with respect to player contracts, is subject to recapture as ordinary income on the sale or other disposition of the team.[51] In the specific case of player contracts sold in connection with the transfer of a sports franchise, I.R.C. § 1245(a)(4) provides that the amount subject to recapture is the greater of (1) any previously unrecaptured depreciation of player contracts ac-

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equity investment of one thousand dollars, using various forms of debt instruments to pay the balance of the purchase price and writing off the losses generated by player contract depreciation against income from other sources. *Id.* An analysis of the Washington Senators transaction by the Library of Congress, however, discounts the tax shelter aspects of the Senators' sale because the Senators were organized as a C corporation, not an S corporation, and thus were subject to taxation at the corporate level. In addition, Short apparently did invest at least $5.6 million of his own capital in the team. Howard M. Zaritsky, *Federal Income Taxation of Professional Sports, reprinted in* REPRESENTING PROFESSIONAL AND COLLEGE SPORTS TEAMS AND LEAGUES 517, 528 (Philip R. Hochberg ed., 1977).

50. Tax Reform Act of 1976, Pub. L. No. 94-455, § 212(a)(1), 1976 U.S.C.C.A.N. (90 Stat.) 1545. For text of § 1056, see *supra* note 24.

51. I.R.C. § 1245 provides, in pertinent part:

(a) GENERAL RULE. —

(1) ORDINARY INCOME. — Except as otherwise provided in this section, if Section 1245 property is disposed of the amount by which the lower of —

(A) the recomputed basis of the property, or

(B) (i) in the case of a sale, exchange or involuntary conversion, the amount realized, or

(ii) in the case of any other disposition of the property, the fair market value of such property, exceeds the adjusted basis of such property shall be treated as ordinary income . . . .

. . . .

(4) SPECIAL RULE FOR PLAYER CONTRACTS. —

(A) IN GENERAL. — For purposes of this section, if a franchise to conduct any sports enterprise is sold or exchanged, and if, in connection with such sale or exchange, there is a transfer of any player contracts, the recomputed basis of such player contracts in the hands of the transferor shall be the adjusted basis of such contracts increased by the greater of —

(i) the previously unrecaptured depreciation with respect to player contracts acquired by the transferor at the time of acquisition of such franchise, or

(ii) the previously unrecaptured depreciation with respect to the player contracts involved in such transfer.

I.R.C. § 1245 (1988 & Supp. II 1990).

quired by the seller in the original acquisition of the franchise or (2) any previously unrecaptured depreciation on the specific player contracts transferred along with the franchise,[52] subject in either case to a limitation that all recapture under I.R.C. § 1245 not exceed the seller's gain. This provision, in effect, recaptures depreciation taken on an asset (a particular player contract) that no longer exists (because the player has retired or otherwise left the team). The more general rules of I.R.C. § 1245, which recapture depreciation that has been taken with respect to the disposal of a specific asset, are intended to apply in the case of transfers of individual player contracts.[53]

In 1976, Congress amended the Internal Revenue Code, establishing a presumption that not more than 50% of the price paid for a sports franchise was allocable to player contracts,[54] and providing for recapture of the original player contract depreciation.[55] These changes were apparently intended to limit the excesses of the sports tax shelters. The subsequent increase in franchise prices, however, suggests that substantial tax shelter potential still exists. In fact, as franchise value increases, the effect of the 50% presumption embodied in I.R.C. § 1056, if it is applied uncritically, is to proportionately increase the tax loss to the United States Treasury as the prices that would-be sports impresarios are willing to pay increase.

### *B. The Value of Sports Franchises*

Depreciation deductions attributable to player contracts have had a measurable impact in inflating the value of sports franchises. The government's expert witness in *Laird v. United States*,[56] for example, calculated that treating 50% of the cost of a franchise as depreciable player contracts would increase the value of the team

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52. I.R.C. § 1245(a)(4).

53. S. REPT. NO. 938, 94th Cong., 2d Sess., pt. 1, at 90 n.2 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3439, 3526.

54. I.R.C. § 1056 (1988).

55. I.R.C. § 1245(a)(4).

56. Laird v. United States, 391 F. Supp. 656 (N.D. Ga. 1975), *aff'd*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978). In this case, the taxpayer attempted to allocate more than 90% of the cost of an expansion team to player contracts; the allocation was reduced by the court to less than 40%, largely because the taxpayer had made no allocation at all to the lucrative NFL national television contract in which the new team was to share. *Id.* at 668-69.

by 36%. Allowing 100% of the purchase price to be allocated to the player contracts would increase the franchise value by 113% over the base level.[57]

Whereas most sports franchise transfers in the 1960s and 1970s were for $10 million or less, prices rose rapidly thereafter. By the 1990s, prices set by the leagues for expansion franchises were $32.5 million for basketball, $50 million for hockey, $95 million for baseball, and $140 million for football.[58] In contrast, as recently as 1959, the fee for a franchise in the fledgling American Football League (AFL) was $25,000, and the fee for the last NFL expansion franchise before 1993, in 1974, was $16 million.[59]

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57. Weill, *supra* note 25, at 589.

58. George, *supra* note 5, at B13. The existing teams at the time of an expansion may treat proceeds received from the new team as capital gain. Rev. Rul. 71-583, 1971-2 C.B. 312.

59. George, *supra* note 5, at B13. The NFL teams added in 1974 were the Seattle Seahawks and the Tampa Bay Buccaneers.

The following table lists some franchise transfers and expansion franchise purchases whose prices have been publicly reported:

TABLE - SPORTS FRANCHISE PURCHASES

| Sport & Team | Year | Purchase Price |
|---|---|---|
| Baseball | | |
| Baltimore Orioles | 1993 | $173,000,000 |
| Colorado Rockies (Exp.) | 1993 | $95,000,000 |
| Florida Marlins (Exp.) | 1992 | $95,000,000 |
| San Francisco Giants | 1992 | $100,000,000 |
| Seattle Mariners | 1992 | $125,000,000 |
| Baltimore Orioles | 1988 | $77,000,000 |
| Seattle Mariners | 1987 | $77,000,000 |
| New York Mets | 1986 | $100,000,000 |
| Seattle Mariners | 1981 | $13,100,000 |
| New York Mets | 1980 | $26,000,000 |
| Oakland Athletics | 1980 | $12,700,000 |
| Baltimore Orioles | 1979 | $12,000,000 |
| Boston Red Sox | 1978 | $18,500,000 |
| Toronto Blue Jays (Exp.) | 1977 | $7,000,000 |
| Chicago White Sox | 1975 | $9,000,000 |
| Texas Rangers | 1974 | $9,000,000 |
| New York Yankees | 1973 | $10,000,000 |
| Cleveland Indians | 1972 | $9,000,000 |
| Milwaukee Brewers | 1970 | $10,800,000 |
| Montreal & San Diego (Exp.) | 1969 | $10,000,000 |
| Seattle & Kansas City (Exp.) | 1969 | $6,000,000 |
| Washington Senators | 1969 | $9,000,000 |
| Milwaukee/Atlanta Braves | 1965 | $6,168,000 |
| New York Yankees | 1964 | $15,000,000 |
| New York Mets (Exp.) | 1962 | $3,750,000 |

The growth in franchise values since the mid-1970s far outpaces inflation,[60] and is probably not entirely attributable to the tax shelter aspects of sports investment. Hugely lucrative national television contracts may have more than a little to do with the high prices being paid. If, however, prospective purchasers are willing to pay these astonishing prices, do they need the further incentive of what amounts to a double deduction, both amortizing the assumed cost of their player contracts and deducting the huge player salaries under I.R.C. § 162? Because neither *Newark Morning Ledger* nor the new I.R.C. § 197 addresses the specific issue of sports franchise player contracts, these questions must be answered within the framework of existing law, beginning with the general rules that have evolved in case law over the past several decades regarding the treatment of intangible assets.

## III. DEPRECIATION OF INTANGIBLES

Prior to the enactment of the new I.R.C. § 197, to depreciate an intangible asset, the taxpayer bore the burden of proving (1) that the asset had an ascertainable value separate and distinct from

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| | | |
|---|---|---|
| St. Louis Cardinals | 1953 | $3,750,000 |
| Baltimore Orioles | 1953 | $2,400,000 |
| St. Louis Browns | 1936 | $150,000 |
| Chicago Cubs | 1916 | $642,000 |
| Original National League Teams | 1876 | $100 |
| Football | | |
| 1994 Expansion Franchises | 1994 | $140,000,000 |
| 1975 Expansion Franchises | 1977 | $16,000,000 |
| Philadelphia Eagles | 1969 | $16,100,000 |
| Atlanta Falcons | 1966 | $8,500,000 |
| Philadelphia Eagles | 1963 | $5,500,000 |
| Cleveland Browns | 1961 | $4,000,000 |
| Cleveland Browns | 1953 | $600,000 |

*Sources*: Selig v. United States, 565 F. Supp. 524, 545 (E.D. Wis. 1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984); ZIMBALIST, *supra* note 1, at 3, 32, 208; George, *supra* note 5, at B13; JAMES EDWARD MILLER, THE BASEBALL BUSINESS: PURSUING PENNANTS AND PROFITS IN BALTIMORE 23-35 (1990); Mann & Pietrusza, *supra* note 39, at 634-35; HENRY G. DEMMERT, THE ECONOMICS OF PROFESSIONAL TEAM SPORTS 9 (1973); Okner, *supra* note 42, at 176; Bill Surface, *In Pro Sports the Dollar Is King*, READERS DIGEST, Mar. 1972, at 146-49; *Pro Football's Boom: From Sport to Glamour Industry*, U.S. NEWS & WORLD REPORT, Sept. 22, 1969, at 82-84.

60. The rate of inflation from 1980-91 for consumer goods in the United States, for example, was a mere 36%. UNITED NATIONS, STATISTICAL YEARBOOK 344 (38th ed. 1993).

goodwill and (2) that the asset had a limited useful life that could be estimated with reasonable certainty.[61] In recent years, especially in connection with the mergers and acquisitions activity of the 1980s, taxpayers eagerly took up this challenge.[62] Historically, the IRS has attempted to carve out two related exceptions to the possibility of depreciating intangible assets: (1) the disallowance of a deduction with respect to goodwill or going concern value and (2) the "mass asset" rule, which disallows deductions with respect to any particular intangible asset that is inextricably linked to other, nondepreciable assets.[63]

### *A. Goodwill*

Goodwill may be defined either negatively, as the excess of the purchase price of the business over the fair market value of identifiable assets,[64] or positively, as "the probability that old customers will resort to the old place"[65] or "the expectation of continued patronage for whatever reason."[66] While the IRS has generally argued that the residual method for valuing goodwill should rarely be used,[67] the courts have been more pragmatic, at least where the

61. Rev. Rul. 74-456, 1974-2 C.B. 65. Treasury Regulation § 1.167(a)-3 provides:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

Treas. Reg. § 1.167(a)-3 (as amended in 1960).

62. One commentator states, "Are there no assets of a purchased business that are not depreciated by ambitious taxpayers? Taxpayers are depreciating everything they can think of, acting on the premise that anything that can be described can be depreciated, and the IRS seemingly is fighting a losing battle." Sheppard, *Bank Deposits*, *supra* note 16, at 99.

63. *See infra* part IV.

64. I.R.C. § 1060(a) and Treas. Reg. § 1.338(b)-2T (as amended in 1986), effective for sales of going concerns purchased after May 6, 1986, require allocation of goodwill by the residual method. I.R.C. § 1060 (1988 & Supp. II 1990). For court decisions adopting the negative definition, see Jack Daniel Distillery v. United States, 379 F.2d 569, 579 (Cl. Ct. 1967). *See also* Solitron Devices, Inc. v. Commissioner, 80 T.C. 1, 21-22 (1983), *aff'd without pub. opinion*, 744 F.2d 95 (11th Cir. 1984); R. M. Smith, Inc. v. Commissioner, 69 T.C. 317, *aff'd*, 591 F.2d 248 (3d Cir. 1977), *cert. denied*, 444 U.S. 828 (1979).

65. Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 232 (1975).

66. Winn-Dixie Montgomery, Inc. v. United States, 444 F.2d 677, 681 (5th Cir. 1971) (citing Boe v. Commissioner, 307 F.2d 339, 343 (9th Cir. 1962)).

67. Rev. Rul. 65-193, 1965-2 C.B. 370.

residual allocation to goodwill results from an arms-length bargain between unrelated parties.[68] In contrast, attempting to calculate the value of goodwill, presumably by determining the present value of the profits that will be produced by existing customers resorting to the "old place," is at best, a highly speculative enterprise.

For accounting purposes, unlike for tax purposes, goodwill is generally required to be depreciated over a period of not less than forty years.[69] No necessary reason exists, however, for the tax law to imitate financial accounting depreciation provisions. The purpose of financial accounting is basically conservative. It gives current and potential investors a picture of the company's income that may, in the future, be available for distribution to them.[70] In this context, decreasing income by an amount that reflects the gradual attenuation of goodwill may be reasonable, but for tax accounting purposes, such a deduction understates current income. This is so because the enterprise's current expenditures (e.g., for advertising) to maintain the level of customer activity are also currently deductible under I.R.C. § 162. Allowing depreciation of goodwill that is being replenished by currently deductible expenditures, therefore amounts to double-counting of deductions.[71]

A substantial amount of recent litigation has concerned a particular class of intangible assets that the IRS has frequently argued to be inseparable from goodwill, namely, "customer-based intangibles." Until 1974, the IRS consistently held that assets such as customer lists, bank depositor bases, subscriber lists, and the like, when acquired as part of an ongoing business, were not separate from goodwill.[72] After several losses in court,[73] however, the IRS conceded

68. *Jack Daniel Distillery*, 379 F.2d at 579. *See also* Philadelphia Steel and Iron Corp. v. Commissioner, 23 T.C.M. (CCH) 558 (1964), *aff'd per curiam*, 344 F.2d 964 (3d Cir. 1965); Copperhead Coal Co. v. Commissioner, 272 F.2d 45, 48 (6th Cir. 1959); H & R Distrib. Co. v. Commissioner, T.C.M. (P-H) ¶ 72-203 (1972).

69. FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOUNTING STANDARDS 26638 (1983) (Standard No. I60.110).

70. Sheppard, *Bank Deposits, supra* note 16, at 102-03. *See also* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979).

71. Section 162 allows a deduction for "all the ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business . . . ." I.R.C. § 162(a) (1988 & Supp. IV 1992). Advertising and selling expenses are specifically made deductible under Treas. Reg. § 1.162-1(a) (as amended in 1988).

72. Sheppard, *Bank Deposits, supra* note 16, at 100. *See* Manhattan Co. of Va. v. Commissioner, 50 T.C. 78 (1968) (allowing depreciation deduction for customer list purchased separately, not as part of ongoing business).

73. *See, e.g.*, Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir.

the theoretical high ground in Revenue Ruling 74-456.[74] The IRS conceded that, in an "unusual case" a depreciation deduction might be allowable for an intangible, customer-based asset. In the twenty years following the issuance of Revenue Ruling 74-456, however, the "unusual case" posited by the IRS has become distressingly usual. In 1993, the United States Supreme Court held that at least one category of customer-based intangibles, newspaper subscription lists, could be separated from nondepreciable goodwill upon a sufficient factual showing of the subscriber lists' value.[75] The *Newark Morning Ledger* decision, however, does not address the treatment of intangibles that are not customer-based, like player contracts.

If goodwill, however measured, is basically the expectation of continued patronage, it would appear obvious that an established sports franchise has considerable goodwill. In the short term, sports fans are not easily dissuaded from attending their favorites' games, no matter how inept the exhibition.[76] Thus, where an existing sports franchise is sold, and the new owner does not move it to another city, it would seem logical that some appreciable part of the purchase price should represent goodwill. The contrast with a manufacturing enterprise is clear: if the manufacturer does not continue to produce tangible products, using depreciable machinery and equipment in the process, the best goodwill in the world will not produce revenue for the manufacturer because there will simply be no products to sell. If, however, the sports team can, by virtue of currently deductible expenditures (salaries for players, minor league development costs, etc.), continue to put on some sort of athletic exhibition, then goodwill will indeed produce revenue in the

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1973), *cert. denied*, 414 U.S. 1129 (1974) (allowing depreciation deduction for subscription list of a purchased, but subsequently discontinued newspaper); Seaboard Fin. Co. v. Commissioner, 367 F.2d 646 (9th Cir. 1966) (allowing depreciation deduction for the cost of acquiring customer loan accounts).

74. Rev. Rul. 74-456, 1974-2 C.B. 65.

75. Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670 (1993).

76. For anecdotal evidence of this claim, consider that the author of this article has continued to purchase a share in season tickets to New York Yankee games for the past 17 years, notwithstanding that for the past 12 of those 17 years, the Yankees have failed to qualify for post-season playoffs. Such is the vestigial loyalty engendered by having had Mickey, Yogi, and Phil as one's childhood idols. The scientific evidence is somewhat more ambiguous; a 1974 study concluded that there was a correlation between winning performance and higher attendance, and between the presence of star players and higher attendance, but that there is a tendency for a team with any record, whether winning or losing, to have higher attendance if it is located in a larger metropolitan area. Roger G. Noll, *Attendance and Price Setting*, *in* GOVERNMENT AND THE SPORTS BUSINESS 115, 154-56 (Roger G. Noll ed., 1974).

form of continuing ticket sales. The singular ineptness of the New York Mets in 1993 did not result in no revenue at all. In fact, well over 1.5 million fans still attended the team's home games.[77]

*B. Going Concern Value*

Even where a taxpayer can demonstrate that not all the purchase price of the intangible assets of a business is attributable to goodwill, part of that purchase price may still be allocable to the nondepreciable intangible asset that is labeled going concern value,[78] which is theoretically distinguishable from goodwill. The former is the ability of the business to generate income without interruption, even though a change in ownership has occurred.[79] The latter is a pre-existing business relationship, based on a continuous course of dealing, which may be expected to continue indefinitely.[80]

Going concern value is nondepreciable.[81] Recently, the United States Tax Court (Tax Court) has elaborated on the United States Supreme Court's definition of going concern value, attempting to distinguish it from goodwill. Going concern value has been defined as "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern"[82] and

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77. *See* Murray Chass, *Patience Is More Than a Virtue for McIlvaine; It's a Strategy*, N.Y. TIMES, Dec. 26, 1993, § 8, at 10 (discussing Mets' falling attendance).

78. Fowler, *supra* note 16, at 28-33. *See also* Richard L. Doernberg & Thomas D. Hall, *The Tax Treatment of Going Concern Value*, 52 GEO. WASH. L. REV. 353 (1984).

79. Winn-Dixie Montgomery, Inc. v. United States, 444 F.2d 677, 685 n.12 (5th Cir. 1971) (citing United States Indus. Alcohol Co. v. Helvering, 137 F.2d 511, 513 (2d Cir. 1943)).

80. Ithaca Indus., Inc. v. Commissioner, 97 T.C. 253, 264 (1991) (citing Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 232 (1975)), *aff'd*, No. 92-1045, 1994 WL 51924 (4th Cir. Feb. 23, 1994).

The Supreme Court, some 60 years ago, established the basic parameters of the definition of going concern value:

> This Court has declared it to be self-evident "that there is an element of value in an assembled and established plant, doing business and earning money, over one not thus advanced," and that this element of value is a "property right" which should be considered "in determining the value of the property upon which the owner has the right to make a fair return" .... [T]he going value thus recognized is not to be confused with good will [sic], in the sense of that "element of value, which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business."

Los Angeles Gas & Elec. Corp. v. Railroad Comm'r, 289 U.S. 287, 313 (1933) (citations omitted).

81. Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 232 n.7 (1975).

82. VGS Corp. v. Commissioner, 68 T.C. 563, 591 (1977); Conestoga Transp. Co. v. Commissioner, 17 T.C. 506, 514 (1951).

has been said to be shown by the business's ability to resume business activity without interruption and to continue generating sales after an acquisition.[83]

The Tax Court has on several occasions upheld an allocation of purchase price to nondepreciable going concern value even where it held that no goodwill was involved in the transaction.[84] Such an allocation is appropriate, in the Tax Court's view, where there is "an ongoing business that was earning money, had a trained staff of employees, had a product presently ready for sale, and equipment ready for immediate use."[85] The most recent statement of this view is in *Ithaca Industries, Inc. v. Commissioner*,[86] where the taxpayer acquired the stock of a corporation that it subsequently liquidated, allocating the purchase price among the target corporation's assets including its "assembled work force" and "raw materials contracts."[87] The taxpayer argued that the work force was depreciable because it had a limited useful life (employees would terminate their jobs, at the latest, when they died or retired) and an ascertainable value (the value of the work force was what it would cost in recruitment and training to replace the existing workers).[88] The Tax Court, in a common-sense approach, recognized that the work force would continue to exist so long as the company remained in business and its existence was independent of the departure of any particular employee.[89] Actual replacement costs would be currently deductible when incurred. In contrast, capital costs that might be incurred, for example, in purchasing a new machine, would be depreciable overtime.[90] While critics have found logical flaws in the Tax Court's distinction between the assembled work force on the one hand and customer-based intangibles on the other,[91] the basic reasoning appears sensible; assets that are replaceable with currently deductible expenses do not need the addi-

83. *Computing & Software, Inc.*, 64 T.C. at 235 n.10.

84. Concord Control, Inc., v. Commissioner, 35 T.C.M. (CCH) 1345 (1976), *aff'd*, 615 F.2d 1153 (6th Cir. 1980); UFE, Inc. v. Commissioner, 92 T.C. 1314 (1989); *VGS Corp.*, 68 T.C. at 563.

85. *Concord Control, Inc.*, 35 T.C.M. (CCH) at 1357.

86. Ithaca Indus., Inc. v. Commissioner, 97 T.C. 253 (1991), *aff'd*, No. 92-1045, 1994 WL 51924 (4th Cir. Feb. 23, 1994).

87. *Id.* at 261-62.

88. *Id.* at 263.

89. *Id.* at 267.

90. *Id.* at 271.

91. *See, e.g.*, Avi-Yonah, *supra* note 8.

tional tax benefit of a depreciation deduction.

While the new I.R.C. § 197 would make the value of an assembled work force depreciable, like other intangible assets, over fifteen years, the reasoning of *Ithaca Industries* is still relevant to professional sports which are excluded from the coverage of the new legislation. In *Ithaca Industries*, as in the case of sports franchises, ownership of the business carried with it the means of replacing the work force. In *Ithaca Industries*, the recruitment and training costs of hiring new workers were currently deductible as I.R.C. § 162 ordinary and necessary business expenses.[92] In the sports franchise cases, the cost of scouting prospective players and, where applicable, the costs of operating minor leagues are currently deductible operating costs.[93] Any bonuses paid to induce players to sign new contracts, however, are amortizable over the term of those contracts.[94]

In contrast to *Ithaca Industries*, which involved employment at will, the cost of acquiring certain personal service contract rights has been held to be depreciable. In the latter situation, the employment contract was for a limited duration, with no assurance of renewal, and had been purchased as part of a purchase of a radio station.[95] This situation may be distinguished, however, from most of the sports franchise cases because the value of a particular disk jockey in a particular local radio market may indeed be a very large proportion of the value of the station as a whole, while the value of a particular player — as contrasted to the rights to continue assembling, on an ongoing basis, a group of players to compete in the league — is significantly more difficult to quantify and may be a much smaller proportion of the total purchase price.[96] While cer-

92. *Ithaca Indus., Inc.*, 97 T.C. at 271.

93. Rev. Rul. 67-379, 1967-2 C.B. 127 (baseball); Rev. Rul. 71-137, 1971-1 C.B. 104 (football).

94. Rev. Rul. 67-379, 1967-2 C.B. 127 (baseball); Rev. Rul. 71-137, 1971-1 C.B. 104 (football).

95. KFOX, Inc. v. United States, 510 F.2d 1365, 1378 (Cl. Ct. 1975).

96. Several economists have attempted to develop formulas to predict player salaries, based on quantifiable aspects of the players' performance. *See, e.g.*, ZIMBALIST, *supra* note 1, at 90-94, 187-95; SCULLY, *supra* note 18, at 151-70; Gerald W. Scully, *Pay and Performance in Major League Baseball*, 64 AM. ECON. REV. 915 (1974) [hereinafter Scully, *Pay and Performance*]. As Zimbalist noted, however, "the model does not provide either a precise or a nuanced measure of a player's value. It does not include, for instance, the charisma contributions of certain star players . . . ; nor does it include the negative effects of poor fielding, bad baserunning, contentious or self-absorbed personalities, and so on." ZIMBALIST, *supra* note 1, at 187.

tain star players may have an appreciable effect on team revenue, such stars are rarely found on the rosters of the expansion teams that are the most conspicuous beneficiaries of the depreciation of player contracts.

In the sport franchise cases, the going concern approach applies most obviously to the situation where a new purchaser acquires an existing franchise and continues to operate it in the same city in which it previously operated. In this situation a strong argument also exists for a significant allocation of purchase price to goodwill, as sports fans are notorious for their long-term loyalties.[97] The more interesting cases involve expansion franchises and purchases where the buyer moves the franchise to a new city.[98]

In both expansion and franchise-transfer situations, the concept of goodwill is inapplicable. There is no "old place" to which the customers can return. In both situations, however, there is a business in existence as a result of the purchase. The expansion draft has stocked the new expansion team with a core of veteran players or the purchase of an existing franchise has brought to the new city an entity ready to play ball. Thus, the reasoning of the going concern cases like *Concord Control, Inc. v. Commissioner*[99] and *VGS Corp. v. Commissioner*,[100] which find going concern value even in

97. Several studies have identified a variety of factors affecting attendance at major league baseball games, including winning performance on the field, low ticket prices, size of the market, number of star players on the team, stadium age, etc. *See, e.g., Antitrust Policy and Professional Sports: Hearings on H.R. 823, H.R. 3287, & H.R. 6467 Before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary*, 97th Cong., 1st & 2d Sess. 445-57 (1982) (testimony of Jesse W. Markham); SCULLY, *supra* note 18, at 111-16. One of these studies concluded that each additional win by a team accounted for an additional 21,511 fans over the season, or 261 fans per game for the 81 home games. *Id.* at 113. Obviously, for most teams there is some minimum base attendance that is unaffected by team performance.

98. *See generally* Selig v. United States, 565 F. Supp. 524 (E.D. Wis. 1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984). For further discussion of *Selig*, see *infra* part VI.D.3.

99. Concord Control, Inc. v. Commissioner, 615 F.2d 1153 (6th Cir. 1980), *on remand*, 78 T.C. 742 (1982). In *Concord*, the parties to an acquisition allocated one dollar of the purchase price to goodwill and going concern value combined (as well as all other intangibles). The Tax Court, upheld by the United States Court of Appeals for the Sixth Circuit, found that there was no goodwill, but that there was a substantial element of going concern value because the purchaser acquired "an ongoing business that was earning money, had a trained staff of employees, had a product line presently ready for sale and equipment ready for immediate use." *Id.* at 1155.

100. VGS Corp. v. Commissioner, 68 T.C. 563 (1977). In this case, the Tax Court found that the small refinery business acquired by the purchaser "was more than a mere collection of assets. It was rather a viable, functioning and going concern capable of generating a profit, and [the purchaser] acquired a valuable property right as a result." *Id.* at 592.

situations where there is no goodwill, suggests that some substantial portion of the purchase price of even an expansion or geographically transferred sports franchise should be allocable to nondepreciable going concern value.

Calculating an appropriate number for going concern value is not easy. In *VGS Corp.*, the Tax Court allocated going concern values to each separate asset at levels ranging from 5% to 10% of the specific asset value in question.[101] When, in *Concord Control*, the United States Court of Appeals for the Sixth Circuit insisted that the Tax Court explain its rationale,[102] the Tax Court responded by setting forth a three-pronged approach to valuation: (1) if the parties were bargaining at arms length, and their tax interests in the allocation were truly adverse, then an allocation to going concern value agreed to by the parties may be respected; (2) if the value of the tangible assets can be ascertained with reasonable certainty, then the value of the intangibles (goodwill and going concern value) can be determined as a residual by subtraction; and (3) if neither of the first two methods is available (because the parties' tax interests were not adverse or because the value of the tangible assets could not be accurately determined), then a capitalization method will be employed.[103] Under this method the expected earnings of the particular company in question are projected forward. Those earnings are then compared to the industry-wide average return on assets and any excess is attributable to intangibles.[104] Obviously, any of these methods leaves some scope for argument.

### *C. Franchise Costs*

If a taxpayer purchases a perpetual or indefinitely renewable franchise, for example, a radio or television franchise, no depreciation deduction is allowed with respect to the cost of the franchise.[105] In the case of expansion sports franchises, purchasers

101. *Id.* at 594.
102. *Concord Control, Inc.*, 615 F.2d at 1156.
103. Concord Control, Inc. v. Commissioner, 78 T.C. 742, 744-47 (1982), *on remand from* 615 F.2d 1153 (6th Cir. 1980).
104. *Id.* at 747.
105. Commissioner v. Indiana Broadcasting Corp., 350 F.2d 580 (7th Cir. 1965), *rev'g* 41 T.C. 793 (1964), *cert. denied,* 382 U.S. 1027 (1966); Westinghouse Broadcasting Co., Inc. v. Commissioner, 309 F.2d 279 (3d Cir. 1962), *cert. denied,* 372 U.S. 935 (1963) (both dealing with renewable network television affiliation contracts); Coca-Cola Bottling Co., 6 B.T.A. 1333 (1927) (discussing the issue of perpetual licenses).

have typically sought to allocate to franchise cost only the relatively small amount actually paid to the league, and not any part of the much larger amount paid to existing league members.[106] In fact, the franchise has a substantial value apart from the players acquired by the new team or the television contract that comes with the purchase of the franchise. It is the franchise itself that permits the team to play ball against other league members, and it is these games that the fans and the television networks pay for. The courts that have considered the player-contract depreciation issue have made little effort to determine a realistic value for the league franchise itself.[107] Courts have focused their efforts on valuing the player contracts or other attributes of ownership such as the league's national television contract, thus leaving the franchise value as a sort of residual similar to goodwill. Unlike goodwill, however, franchise value is not merely a residual; the franchise has a positive value that could, presumably, be determined in the marketplace. Case law to date does not appear to fully take this value into account, relying instead on a process of subtraction to value the franchise.[108] One could reasonably suppose that, in a sports labor market that permits at least limited freedom of movement by athletes,[109] a prospective team owner would be willing to pay something for the league franchise and associated television revenue even without receiving any players in an expansion draft.

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106. Selig v. United States, 565 F. Supp. 524 (E.D. Wis. 1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984) (considering taxpayer's allocation of over 90% of purchase price to player contracts and $500,000, or 4.6% to the American League franchise); Laird v. United States, 391 F. Supp. 656 (N.D. Ga. 1975), *aff'd*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978) (considering taxpayer's claim to allocate 85% of the $8.5 million purchase price of the NFL Atlanta Falcons to player contracts and $50,000, or 0.6% to the franchise); First Northwest Indus. of Am., Inc. v. Commissioner, 70 T.C. 817 (1978), *rev'd and remanded on other grounds*, 649 F.2d 707 (9th Cir. 1981) (considering taxpayer's allocation of 91% of purchase price to player contracts and 9% to franchise rights). *See also* Louis H. Diamond, *Problems of the Teams: Recent Developments in Tax Law*, *in* REPRESENTING PROFESSIONAL AND COLLEGE SPORTS TEAMS AND LEAGUES 503, 506-07 (Philip R. Hochberg ed., 1977) (listing cases that were in litigation on the allocation issue); STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, TAX SHELTERS: PROFESSIONAL SPORTS FRANCHISES (Comm. Print 1975), *reprinted in* REPRESENTING PROFESSIONAL AND COLLEGE SPORTS TEAMS AND LEAGUES 535, 542 (Philip R. Hochberg ed., 1977) (showing contract allocation percentages for 28 basketball franchise sales).

107. *See infra* part VI.D.

108. In *Laird*, the court used a process of subtraction to arrive at a value for the NFL franchise, after determining values for the league television contract and the player contracts acquired by the expansion team. *Laird*, 391 F. Supp. at 671.

109. For a discussion of free agency, see *infra* notes 265-66 and accompanying text.

## IV. THE MASS ASSET RULE

The mass asset rule, as developed in *Boe v. Commissioner*,[110] denies a deduction for depreciation where the taxpayer has purchased an aggregate of intangible assets which are in reality part of a single collective asset that is not exhausted by the passage of time alone.[111] If a single mass asset is purchased, amortization of its component parts will not be permitted.[112] The following factors indicate that the intangible asset in question is part of a non-wasting mass:

> (1) the mass of assets purchased includes intangibles of indefinite duration which provide the means to replace those individual intangibles that are likely to expire, thus regenerating the value of the mass as an entity, (2) the intangibles of indefinite duration are relatively more significant in value than parts of the mass which may expire, and (3) the intangibles that do expire derive their value from, and have no value separate and apart from, the assets of indefinite duration.[113]

The mass asset rule was developed in the context of customer-based intangibles[114] such as names on a subscription list or insurance expirations.[115]

Even in the customer-based intangibles cases, the mass asset theory has not been uniformly successful. In *Seaboard Finance Co.*

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110. Boe v. Commissioner, 35 T.C. 720 (1961), *aff'd*, 307 F.2d 339 (9th Cir. 1962).

111. *Id.* at 726.

112. Darwin Broenen & Charles H. Reed, *Amortizing Intangible Assets: Setting & a Cost Basis and Determinable Life*, 44 J. TAX'N 130 (1976).

113. First Northwest Indus. of Am., Inc. v. Commissioner, 70 T.C. 817, 845 (1978), *rev'd and remanded on other grounds*, 649 F.2d 707 (9th Cir. 1981).

114. *Boe*, 35 T.C. at 720; Thrifticheck Serv. Corp. v. Commissioner, 33 T.C. 1038 (1960), *aff'd*, 287 F.2d 1 (2d Cir. 1961).

115. *See, e.g.*, Tomlinson v. Commissioner, 58 T.C. 570, 579 (1972), *aff'd*, 507 F.2d 723 (9th Cir. 1974) (insurance policy expirations); Thoms v. Commissioner, 50 T.C. 247 (1968) (insurance policy expirations); Danville Press, Inc. v. Commissioner, 1 B.T.A. 1171, 1172 (1925) (newspaper subscriptions).

Generally, the courts seem to have relied on a theory that equated the mass asset with goodwill:

> Any definition of goodwill includes the concept of the advantage that the proprietor of an existing business enjoys resulting from the probabilities that old customers will continue their patronage. Surely goodwill in the insurance agency business encompasses the advantage that the agency has, that its policyholders will renew their existing policies.

*Thoms*, 50 T.C. at 256, (citing V. L. Phillips & Co. v. Pennsylvania Threshermen, 199 F.2d 244, 246 (4th Cir. 1952)). *See also* Commissioner v. Killian, 314 F.2d 852 (5th Cir. 1963); Kenney v. Commissioner, 37 T.C. 1161 (1962); Aitken v. Commissioner, 35 T.C. 227 (1960).

*v. Commissioner*,[116] for example, the Tax Court permitted amortization of consumer loan contracts after the taxpayer had introduced evidence as to the valuation of such contracts. Further, in *Manhattan Co. of Virginia, Inc. v. Commissioner*,[117] the Tax Court permitted amortization of the cost of acquiring laundry and dry cleaning customer lists as each customer ceased to do business with the purchaser. In each of these cases, however, the taxpayer had purchased less than the entire business.[118]

Although the mass asset rule has, in the context of customer-based intangibles, been overruled or at least severely limited by the recent United States Supreme Court ruling in the *Newark Morning Ledger* case,[119] it still appears to be a plausible interpretation of the sports franchise situation.[120] A collection of player contracts would be wholly worthless without the nondepreciable rights, both of which are granted by the league franchise, to engage in games with other teams, and to participate in national television revenues. Both these latter rights, like the franchise itself, are of indefinite duration.

Under the first prong of the three-part mass asset test with respect to a sports franchise, the intangibles of indefinite duration consist principally of the franchise itself. The franchise carries with it the right to participate in drafts of players and to engage in player transactions with other league members. Thus a franchise holder possesses the means to replace the individual intangibles that are likely to expire.

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116. Seaboard Fin. Co. v. Commissioner, 23 T.C.M. (CCH) 1512 (1964), *aff'd*, 367 F.2d 646 (9th Cir. 1966).

117. Manhattan Co. of Va. v. Commissioner, 50 T.C. 78 (1968).

118. In *Manhattan Co.*, the purchaser acquired the names and addresses of the seller's laundry and dry-cleaning customers in a particular area, together with a noncompetition agreement by the seller not to solicit customers in that area in the future. *Id.* at 79. In *Seaboard Finance*, the purchaser had little interest in acquiring the sellers as ongoing concerns, but desired the sellers' loan accounts. *Seaboard Fin.*, 23 T.C.M. (CCH) at 1518.

119. Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670, 1678 (1993) (asserting that the mass asset rule does not prevent a depreciation deduction where the [insurance] expirations as a single asset can be valued separately and the requisite showing is made that the useful life of the information contained in the intangible asset as a whole is of limited duration).

120. *Id.* The Supreme Court in *Newark Morning Ledger* recognized that the mass asset rule may retain validity in situations not involving customer-based intangibles. *Id.* at 1677 (citing Ithaca Indus., Inc. v. Commissioner, 97 T.C. 253 (1991)). Commentators have argued that *Newark Morning Ledger* effectively spells the death of the mass asset rule in all contexts. *See, e.g.*, Avi-Yonah, *supra* note 8; Bernard J. Long, *Some Thoughts on* Newark Morning Ledger, 59 TAX NOTES 1555 (1993) (letter to the editor).

Second, the indefinite-duration intangibles are clearly more valuable than the intangibles of limited duration, especially in view of I.R.C. § 1056's presumption that player contract values do not constitute more than 50% of the total franchise acquisition cost.[121] Perhaps most important, ownership of a league franchise typically gives the franchise holder territorial exclusivity. Some measure of the value of this territorial right, which is of indefinite duration, may be gleaned from the payments made by the AFL when it agreed to merge with the NFL in 1966. Of the total $22.5 million payment, the New York Giants received $10 million and the San Francisco 49ers received $8 million to compensate those teams for an invasion of their exclusive franchise territory.[122]

Finally, the intangibles that do expire, the player contracts, have no value whatsoever apart from the franchise.[123] Several economists have attempted to quantify the value of individual players, relating player performance on the field to their team's gross revenue.[124] At best, these attempts have been inconclusive. None of them shows that player contracts are worth anything like half of the large amounts now being paid for professional sports contracts franchises. As attendance during the Colorado Rockies' opening season in 1993 showed, the performance of the team on the field may often bear not the slightest relation to attendance.[125] In Colorado, at least, it was the opportunity to see Major League Baseball being played — an attribute of the franchise, not of the player contracts — that accounted for most of the locally generated revenue of the team.

Thus, whatever its continuing validity with respect to customer-based intangibles, the mass asset rule still seems to be a good description of the realities of sports franchise purchases, and it should be applied to deny depreciation deductions with respect to player

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121. I.R.C. § 1056 (1988).

122. Weill, *supra* note 25, at 584.

123. The New York Mets would be hard-pressed to recoup the value of Bobby Bonilla's $6 million per year contract unless they could play against other major league rivals and share in the television revenue that the league as a whole generates.

124. *See, e.g.*, ZIMBALIST, *supra* note 1, at 90-94, 187-95; SCULLY, *supra* note 18, at 151-70; Scully, *Pay and Performance*, *supra* note 96.

125. The Rockies finished the 1993 season with a record of 67 wins and 95 losses (.414 winning percentage), in sixth place in the National League West. N.Y. TIMES, Oct. 4, 1993, at C4. Their attendance, the highest in MLB history, was nearly 4.5 million. Jerome Holtzman, *Colorado's Girardi Certain to Catch on as Big-League Manager*, CHI. TRIB., Jan. 30, 1994, sports §, at 8.

contracts acquired in such purchases. This conclusion is reinforced by the significant double-deduction issue with respect to sports player contracts. The entire cost of reproducing a team's active player roster in perpetuity is currently deductible, while, in the case of a tangible asset such as a machine, only a small part of the cost of keeping that machine running (i.e., repair costs) are currently deductible. The bulk of replacement costs in the latter situation will be capital in nature.

## V. HOBBY LOSS LIMITATIONS

In *Selig v. United States*,[126] a case involving the Milwaukee Brewers, the government abandoned its prior reliance on the mass asset theory[127] and argued that ownership of a sports franchise was, at least in part, a rich man's toy on the order of owning a yacht or a vacation home.[128] The trial court in *Selig* summarily rejected this argument, concluding with little analysis that baseball is a business and that even if teams typically lost money on operations, owners had a reasonable expectation of making a profit if and when they sold the franchise.[129] Nonetheless, there is substantial reason to argue that the hobby loss rules of I.R.C. § 183 are, at least in part, applicable to sports franchise ownership.

I.R.C. § 183 creates a dichotomy between activities engaged in

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126. Selig v. United States, 565 F. Supp. 524 (E.D. Wis. 1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984).

127. *Selig*, 565 F. Supp. at 527. Some commentators have seen the abandonment of the mass asset theory as inevitable in the light of *Laird, First Northwest Industries*, and the IRS's own rulings that the cost of individually acquired player contracts is amortizable over the life of the contract. *See, e.g.*, Rev. Rul. 67-379, 1967-2 C.B. 127 (baseball); Rev. Rul. 71-137, 1971-1 C.B. 104 (football); Harwood, *supra* note 27, at 671 n.4. For the reasons set out in the text, *see supra* part IV, the mass asset theory still has life in the context of entire franchise acquisitions, and the IRS may have prematurely abandoned this approach to the litigation.

128. *Selig*, 565 F. Supp. at 526.

129. *Id.* The literature of the sports business is replete, however, with statements of prospective owners that they were in the "business" at least partly for the fun of it. *See, e.g.*, Bart Barnes, *The Franchises: Putting a Price on Glamor*, WASH. POST, Nov. 19, 1983, at D1 (quoting Jack Kent Cooke, owner of the Washington Redskins of the National Football League as saying, "I know of no business, and I've been involved in many, which can match the ownership of a professional sports franchise for sheer fun."). Professional sports enterprises are not exempt from the hobby loss rules. Howard M. Zaritsky, *The Hobby Loss Rules of Section 183, Internal Revenue Code of 1954 — Application to Professional Sports Enterprises, reprinted in* REPRESENTING PROFESSIONAL SPORTS TEAMS AND LEAGUES 529, 531 (Philip R. Hochberg ed., 1977).

for profit on the one hand and all other activities on the other hand. If, in this Manichean view of the economic universe, an activity is not engaged in for profit, then the only deductions allowable with respect to that activity are (1) deductions that would be allowable without regard to whether the activity was engaged in for profit (e.g., certain state and local taxes deductible under I.R.C. § 164, or interest deductible under I.R.C. § 163) and (2) business-related deductions, but only to the extent of any taxable income that remains after subtracting the generally allowable deductions.[130] The section also establishes a presumption that an activity is engaged in for profit if gross income from the activity exceeds the deductions attributable to it (without regard to the for-profit limitation) in at least three of the most recent five taxable years.[131]

The regulations under I.R.C. § 183 recognize that the determination of whether an activity is engaged in for profit is a complex question which is dependent on the particular facts and circumstances of the case and involves a large number of factors.[132] Four of the factors cited in the treasury regulations, however, raise questions as to the proper classification of at least some sports franchises.

First, the regulations highlight the issue of whether ownership and operation of the activity contain elements of personal pleasure or recreation.[133] There is ample evidence that at least a portion of the motivation for owning sports franchises is personal pleasure, or

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130. I.R.C. § 183(b) (1988).

131. I.R.C. § 183(d). The presumptive standard was increased from two of five years to three of five years by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 143(a)(1)-(2), 100 Stat. 2120 (1986), effective for tax years beginning after December 31, 1986. It remains at two out of seven years for raising, breeding, training, racing, or showing horses but for no other activities. I.R.C. § 183(d).

132. *See* Treas. Reg. § 1.183-2(b) (1972). Among the factors listed are (1) the manner in which the taxpayer carries on the activity, (2) the expertise of the taxpayer or the taxpayer's advisers, (3) the time and effort expended by the taxpayer in carrying on the activity, (4) the expectation that the assets used in the activity may appreciate in value, (5) the success of the taxpayer in carrying on other activities, (6) the taxpayer's history of income or loss with respect to the activity, (7) the amount of occasional profits, if any, that are earned, (8) the financial status of the taxpayer (i.e., a lack of income from other activities may tend to support a view that the activity under scrutiny is engaged in for profit, and (9) elements of personal pleasure or recreation. *Id.*

133. Treas. Reg. § 1.183-2(b)(9) (1972). The regulations permit, however, the taxpayer to derive some incidental personal pleasure or recreation from the activity if the activity is, in fact, carried on for profit, as evidenced by the other factors cited in the regulation. *Id.*

at least personal aggrandizement.[134] In fact many owners portray themselves as "sportsmen" who are content to suffer huge financial losses "for the good of the game."[135] Even in the Congressional debates in 1976, on the adoption of I.R.C. § 1056 and the special recapture rules of I.R.C. § 1245 applicable to franchise sales, there was acknowledgement that not all professional sports are necessarily profitable.[136] Whether such assertions are true is another matter, but they are certainly made when it has been convenient for the owners to do so.

Second, the regulations direct attention to the financial status of the taxpayer.[137] In professional sports, many owners have substantial outside, unrelated incomes; a fact that tends to indicate that they could be operating the franchise as a hobby and not for profit.[138]

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134. Whitey Herzog, General Manager of the California Angels and formerly Manager of the Texas Rangers, Kansas City Royals, and St. Louis Cardinals, has commented that "[i]t's hard to imagine any group of people less sensible and less practical than the people who run baseball." ZIMBALIST, *supra* note 1, at 29. Often, ownership of a team has been an adjunct to the owner's principal business, providing both advertising and celebrity that the owner could not get out of his beer (Gussie Busch), chewing gum (Philip Wrigley), or shipbuilding (George Steinbrenner) business:

> Gussie [Busch], almost overnight, was transformed from a brewer of modest reputation into a celebrity .... He became one of baseball's most colorful curmudgeons, rolling into spring training in his private railroad car, kicking holes in the walls when his team performed poorly .... Gone were the days when his public relations flacks practically had to beg for publicity. Reporters now scampered after him by the dozens.

PETER HERNON & TERRY GANEY, UNDER THE INFLUENCE: THE UNAUTHORIZED STORY OF THE ANHEUSER-BUSCH DYNASTY 211 (1991). For a discussion regarding George Steinbrenner, see BILL MADDEN & MOSS KLEIN, DAMNED YANKEES (1990).

Knowledge about baseball appears not be a requirement for ownership. Marge Schott, owner of the Cincinnati Reds, seemed unaware, in a reported interview, of which teams were in the Reds' division, or even in the same league. KENNETH M. JENNINGS, BALLS AND STRIKES: THE MONEY GAME IN PROFESSIONAL BASEBALL 77 (1990). One of baseball executive Buzzie Bavasi's milder criticisms of former San Diego Padres' owner C. Arnholt Smith was that the latter was "ignorant about baseball matters." BUZZIE BAVASI & JOHN STREGE, OFF THE RECORD 147 (1987).

135. Koch, *supra* note 22, at 556.

136. *Inquiry Into Professional Sports: Hearings Before The House Select Committee on Professional Sports*, 94th Cong., 2d Sess., pt. 1, at 26 (1976) (statement of Bowie K. Kuhn, Commissioner of Baseball).

137. Treas. Reg. § 1.183-2(b)(8) (1972).

138. Zaritsky, *supra* note 129, at 531-34. Recent examples include Wayne Huizenga, the chairman of Blockbuster Video and principal owner of the expansion Florida Marlins; Robert Haas, a major shareholder and chief executive of Levi Strauss & Co., and head of the group that purchased the San Francisco Giants before the 1993 season; and Hiroshi Yamauchi, chief executive of Nintendo USA, and the largest investor in the group that purchased the

Third, the regulations direct attention to the proportion of the taxpayer's time and effort that is expended on the activity.[139] Many principal owners or managing partners of professional sports teams have other, perhaps more compelling business interests. While the time-and-effort factor might not tend to classify someone like George Steinbrenner, the perhaps overly involved principal owner of the New York Yankees, as a hobbyist, and would not, in any event, apply to teams owned by C corporations,[140] it does appear relevant to a substantial number of professional franchise owners.

Fourth, the regulations look to the presence of a pattern of continuing losses in the early years, unless attributable to unforeseen or fortuitous circumstances beyond the taxpayer's control, as evidence of a lack of profit motive.[141] If a team compiles a record of five or more years of continuous losses, caused at least in part by deductions for depreciation of player contracts, the IRS might well view such a record as evidence of lack of profit motive. This assumes that the losses could not be traced to such unforeseen events such as the early retirement or injury of a key player.

The regulations provide that operating losses may be disregarded, or at least balanced, by an expectation that assets used in the activity will appreciate in value, raising the possibility of a future gain on the sale of those assets.[142] In the context of a sports franchise, it is generally true that the only asset that may appreciate in value is the franchise itself. The player contracts, as the owners themselves assert, decline in value over relatively short periods.[143]

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Seattle Mariners, also before the 1993 season. *See* Kathleen Madigan, *Foul Ball: Major League Baseball's Monopoly*, BUS. WEEK, Nov. 30, 1992, at 42.

The days of the owner who depended on the team for his livelihood, like Clark Griffith of the Washington Senators and Minnesota Twins or Connie Mack of the Philadelphia and Kansas City Athletics, seem to be past.

139. Treas. Reg. § 1.183-2(b)(4) (1972). Treasury Regulation § 1.183-2(b)(4) makes it clear that lack of a substantial investment of time and effort, by itself, is not conclusive; a taxpayer may carry on multiple activities, each in a businesslike, profit-oriented way, without devoting a majority of time and effort to any one of them. *Id.*

140. I.R.C. § 183 applies only to individuals and S corporations. I.R.C. § 183(a) (1988).

141. Treas. Reg. § 1.183-2(b)(6) (1972).

142. Treas. Reg. § 1.183-2(b)(4) (1972).

143. *See, e.g.*, Laird v. United States, 391 F. Supp. 656, 658-59 (N.D. Ga. 1975), *aff'd*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978) (depreciating football player contracts over 5.25 years). In a few cases, there may be an expectation that the value of the contracts may appreciate, as, for example, in the case of young Cleveland Indian players like Carlos Baerga and Sandy Alomar, who both signed multi-year contracts early in their ca-

Thus, to the extent that a greater share of the cost of purchasing a franchise is allocated to the depreciable player contracts, the purchaser weakens the argument that there is an ultimate expectation of profit.

There are no reported cases dealing with the application of I.R.C. § 183 to professional sports franchises. The 1939 version of the hobby loss rule, codified at the time as I.R.C. § 130, provided that an individual having deductions (other than for interest and taxes) attributable to a trade or business that exceeded the gross income from the trade or business by more than $50,000 in each of five consecutive years would be allowed deductions only to the extent of $50,000 in each such year.[144] The only reported decision under that provision involving sports teams merely dealt with whether three separate NFL franchises owned by a single individual should be considered as a single trade or business for purposes of the $50,000 limitation.[145]

On balance, then, at least some sports franchises would appear to fit the definition of hobby encompassed by I.R.C. § 183, especially those owned by persons otherwise wealthy from, and engaged in, other business enterprises, and those whose owners use the sports team as their entrée to power or celebrity that they would otherwise not have. It is surprising that, after the brief appearance of the argument in the *Selig* case, the IRS has not more aggressively pursued this line of attack.

Because of the either-or nature of I.R.C. § 183, for tax purposes it is not possible to disallow some but not all of a class of deductions attributable to an activity on the basis of hobby characterization. Once the taxpayer has met the threshold burden of showing a profit motivation, then the personal pleasure motivation essentially becomes irrelevant. Given the widespread evidence that the ownership of sports franchises is partly a form of conspicuous consumption by rich egotists, a more accurate tax result would seem to be a

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reers.

144. Collins v. Commissioner, 34 T.C. 592, 595 (1960).

145. *Id.* at 596. The court concluded that the franchises were separate businesses. *Id.* at 597. It might be worth noting that the franchise cost in this case was $50,000 when the taxpayer purchased the Boston Yanks franchise in 1943, and no cost at all when he acquired the New York Bulldogs franchise in 1949, although he was required to pay the New York Giants $25,000 per year compensation for impinging on their exclusive territorial rights. *Id.* at 592-93. NFL expansion franchises for the 1994 season were to be sold for $140 million. George, *supra* note 5, at B13.

pro rata disallowance of loss-creating expenses (i.e., expenses that would be disallowed in full by current I.R.C. § 183). In such a scheme, for example, Congress might arbitrarily determine that 50% of the motivation for ownership of a sports franchise is personal rather than profit-oriented. The I.R.C. § 183 disallowance would then apply to 50% of the expenses that exceed the excess of sports franchise gross income over the deductions allowable without regard to the for-profit nature of the activity.[146]

## VI. THE SPORTS FRANCHISE TAX CASES

### A. *The Early Baseball Cases*

The early cases involving the tax treatment of player contracts involve the common practice of one team's simply purchasing contract rights to a player from that player's current team. The first judicial treatment touching on the player contract issue was in *Dallas Athletic Association v. Commissioner*,[147] in which the Board of Tax Appeals (the Board) held that amounts paid by one minor league baseball team to another team to acquire contract rights to players were in the nature of capital expenditures.[148] The taxpayer had argued that because the contracts were for periods of only one year, though subject to renewal at the club's option (the "reserve clause"),[149] the premiums paid to acquire the contracts

146. Of course, other activities, such as owning newspapers, might also be subject to attack on similar grounds, and the subjective judgment as to whether a particular activity is 10%, or 50%, or 75% entered into for personal, as opposed to profit motives, is exactly the kind of judgment that courts are likely to feel most uncomfortable making. That the issue is complex does not, however, mean that it should simply be ignored.

147. Dallas Athletic Ass'n v. Commissioner, 8 B.T.A. 1036 (1927).

148. *Id.* at 1040.

149. The "reserve clause" was a feature of all professional baseball contracts until the advent of free agency in the 1970s. The Uniform Player's Contract approved by the National Association of Professional Base Ball Leagues contained the following language:

> *Renewal*
>
> 7.(a) Any time prior to March 1st . . . by written notice to the Player, the Club or any assignee thereof may renew this contract for the term of that year except that the salary rate shall be such as the parties may then agree upon, or, in default of agreement, such as the club may fix.
>
> (b) In default of agreement, the Player will accept the salary rate thus fixed or else will not play during said year otherwise than for the Club or for an assignee hereof. . . .
>
> (c) The reservation to the Club of the valuable right thus to fix the salary rate for the succeeding year and the promise of the Player not to play during said year otherwise than with the Club or an assignee hereof, have been taken into consid-

should be currently deductible as ordinary and necessary business expenses.[150] The Commissioner countered and the Board agreed that the economic reality was that the team was purchasing not merely the rights to a player's services for the balance of the season in question,[151] but the perhaps more valuable right to renew the contracts on terms set by the team for subsequent seasons.[152] Because no evidence had been presented on the issue of the average useful life of the players acquired by the purchasing team, the Board further denied any amortization deduction with respect to the payments that the team had made to acquire the contracts.[153] In contrast to later decisions, however, *Dallas Athletic Association* dealt only with amounts actually paid by a team and not with a valuation of contract rights in the absence of a specific payment for those rights (as would be the case, for example, where there has been a lump-sum payment for the entire franchise including player contracts).

The missing evidence in *Dallas Athletic Association* as to the useful lives of baseball players was supplied by stipulation in *Houston Baseball Association v. Commissioner.*[154] In *Houston Baseball Association,* the parties stipulated to an average useful life for a professional baseball player of ten years, resulting in allowable deductions of 10% per year of the cost to the team of purchasing the contracts.[155] The double-deduction aspect of the player-contract problem was clearly evident in *Houston Baseball Association;* the Houston team had previously deducted the cost of purchasing the contracts as ordinary and necessary business expenses without audit challenge. The IRS presumably viewed the shift from current expensing of the cost to ten-year depreciation as á victory for gov-

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> eration in determining the salary specified herein and the undertaking by the Club to pay said salary is consideration for both the reservation and the promise.

*Id.* at 1038. For a brief history of the undoing of the reserve clause in baseball, see Mann & Pietrusza, *supra* note 39, at 623-24.

150. *Dallas Athletic Ass'n,* 8 B.T.A. at 1039.

151. The contracts of several of the players in question were purchased in September, with less than a month remaining in the current season. *Id.* at 1040.

152. *Id.* at 1041.

153. *Id.*

154. Houston Baseball Ass'n v. Commissioner, 24 B.T.A. 69 (1931).

155. The opinion in *Houston Baseball Association* does not deal with the issue of whether the players in question had already been playing for some years, and thus might have used up some of the stipulated career time before Houston bought their contracts. Apparently, from the face of the decision, a 10 year future career was assumed for an 18 year-old rookie and for a 35 year-old veteran. *Id.*

ernment revenue without much regard to the longer-term consequences of the approach.[156]

The current deduction approach surfaced again, at the major league level this time, in *Pittsburgh Athletic Co. v. Commissioner*,[157] a case in which the IRS challenged the Pittsburgh Pirates' practice of taking a deduction each year for the cost of player contracts acquired and including in gross income any amounts the Pirates received for the sale of their contract players.[158] Having apparently paid some attention to the realities of professional athlete careers, the Commissioner now argued for a three-year amortization period instead of the ten years stipulated in *Houston Baseball Association*.[159]

The Board, however, reversed its earlier position in *Houston Baseball Association*, instead relying on *Bonwit Teller & Co. v. Commissioner*.[160] In *Bonwit Teller*, the United States Court of Appeals for the Second Circuit had held that a taxpayer could amortize the cost of obtaining a leasehold over the original lease term, disregarding an option to renew, because it was only the original lease that was property then being used in the taxpayer's business.[161] In *Pittsburgh Athletic*, the Board reinstated the practice of permitting current deductions for the cost of acquiring player contracts even though, in a statistical, aggregate sense, it was clear that the contracts would be of benefit to the acquiring team for more than a single year. Following *Bonwit Teller*, the Board in *Pittsburgh Athletic* ignored the difference in renewal options between the two cases. In *Bonwit Teller*, the rental for the renewal period was to be determined by an appraisal if the parties could not agree,[162] whereas in *Pittsburgh Athletic*, as in all the baseball cases, the reserve clause gave the club the sole right to set the salary for the renewal term.[163] One might think that the club's unilateral right to determine future salaries would make the exercise of the

156. *Id.* at 73.
157. Pittsburgh Athletic Co. v. Commissioner, 27 B.T.A. 1074 (1933), *aff'd*, 72 F.2d 883 (3d Cir. 1934).
158. *Id.* at 1075.
159. *Id.* at 1076-77.
160. 53 F.2d 381 (2d Cir. 1931), *cert. denied*, 284 U.S. 690 (1932).
161. *Id.* at 383.
162. *Id.* at 382.
163. Pittsburgh Athletic Co. v. Commissioner, 27 B.T.A. 1074, 1076 (1933), *aff'd*, 72 F.2d 883 (3d Cir. 1934).

renewal option somewhat more certain and less speculative than in the case of a fair-market-value option as in *Bonwit Teller*. Addressing this distinction, however, the United States Court of Appeals for the Third Circuit affirmed the Board's decision and held that the player's right to escape from the contract (by not playing) rendered the renewal option sufficiently uncertain so that it need not be taken into account in determining the life of the property — the contract right — for amortization purposes.[164]

The Board of Tax Appeals followed the *Pittsburgh Athletic* holding in the first case involving the purchase of an entire professional sports franchise, rather than individual player contracts. In *Chicago National League Ball Club*,[165] the Board, relying on *Bonwit Teller*, allowed current deductions for the cost to the Chicago Cubs of acquiring player contracts from year to year, again denying the Commissioner's attempt to require three-year amortization of such costs.[166] The *Chicago National League* case also involved an attempt by the club, foreshadowing future efforts, to obtain amortization deductions with respect to the $642,151 that the owners had paid in 1916 to acquire the contracts of approximately thirty players then on the Cubs' roster.[167] The club also sought deductions with respect to a lease for a baseball field that the team, as it turned out, never used.[168] The Board did not rule out amortization of a mass purchase of player contracts, but held that there was insufficient evidence in this case on which to allocate the total purchase price between the player contracts and the franchise.[169] Thus, these relatively unsophisticated taxpayers (at least by the standards of the litigious 1990s) failed to meet the basic requirements of demonstrating that an asset proposed to be depreciated had an ascertainable value.

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164. Commissioner v. Pittsburgh Athletic Co., 72 F.2d 883, 884 (3d Cir. 1934). *Accord*, Helvering v. Kansas City Am. Ass'n Baseball Co., 75 F.2d 600, 604 (8th Cir. 1935).

165. Chicago Nat'l League Ball Club, B.T.A.M. (P-H) ¶ 33,197 (1933), *aff'd*, 74 F.2d 1010 (7th Cir. 1935).

166. *Id.*

167. The opinion in *Chicago* comments that "[a]mong the players whose contracts were acquired by petitioner [in 1916] were some well-known and valuable baseball players and many more who were mediocre." *Id.* The Cubs had finished fourth in the eight-team National League in 1915. *Id.*

168. *Id.*

169. *Id.*

*B. IRS Reaction to the Baseball Cases*

Faced with three different Courts of Appeal having reached the same conclusion, the IRS conceded in 1935 that the cost of acquiring player contracts could be deducted as an ordinary and necessary business expense in the year of acquisition, without regard to renewal options.[170] Only in the case of a contract whose current term, not including possible renewals, extended for more than the current year would amortization over that term be required.[171] Had the IRS maintained this position, at least with respect to individual player contracts, it might have been in a stronger position to argue against depreciation of the collection of player contracts acquired in the subsequent expansion and franchise-transfer cases, where the IRS could have relied on going concern or mass asset

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170. I.T. 2932, 14-2 C.B. 61 (1935).

171. *Id.* at 62. In I.T. 2993, 15-2 C.B. 146 (1936), the IRS extended these rules to the case of a contract purchased from one club by another in the off-season, when the purchase was, in effect, of only the renewal option. In that case, the ruling held, the amount paid would be regarded as part of the cost of whatever contract was subsequently entered into by the purchasing team's exercise of its renewal rights, and the purchase cost was amortized over the length of that subsequent contract. I.T. 2993, 15-2 C.B. 146, 148 (1936). After some 16 years of (perhaps fitful) contemplation, the Service revoked I.T. 2993 in 1952, holding that the cost of acquiring a player contract in the off-season (i.e., acquiring the renewal option under the reserve clause) was fully deductible in the year paid or incurred, depending on the purchaser's accounting method. I.T. 4078, 1952-1 C.B. 39, 40.

In a somewhat anomalous case, Hollywood Baseball Ass'n v. Commissioner, 423 F.2d 494 (9th Cir. 1970), *cert. denied*, 400 U.S. 848 (1970), the United States Court of Appeals for the Ninth Circuit held that, in the case of a minor league baseball team that was obligated by the terms of its working agreement with the major leagues to sell player contracts to the major league teams on demand, the player contracts were not held primarily for sale to customers in the ordinary course of business, but that capital gain treatment should not apply to the sale of those contracts in liquidation because of the *Corn Products* doctrine. *See* Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955) (holding that capital gain or loss treatment does not apply to property that is an integral part of the taxpayer's business operations). The validity of the *Hollywood* decision is brought into question, however, by the singular nature of the case. *Hollywood* involved a minor league franchise that, prior to the arrival of the major league Los Angeles Dodgers from Brooklyn for the 1958 season, had its own major league aspirations and, therefore, an incentive to retain, rather than sell, its player contracts. Harry B. Meran, Comment, *The Sale of Minor League Baseball Players During Liquidation — The Application of* Corn Products *to Depreciable Property*, 45 TEMP. L.Q. 291, 295-96 (1972). The *Hollywood* decision may also be rendered obsolete by the United States Supreme Court's holding in Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988), effectively limiting the *Corn Products* doctrine to cases involving inventory or close substitutes therefor. *Id.* at 222. In *Hollywood*, the Tax Court had held that the player contracts were property held primarily for sale to customers, and thus in the nature of inventory, but this holding was reversed by the United States Court of Appeals for the Ninth Circuit, which found that the team's principal source of profit was from ticket sales for its games, and not the sale of player contracts. *Hollywood Baseball Ass'n*, 423 F.2d at 494.

theories to deny such depreciation.

The issue of the tax treatment of player contracts purchased in bulk rather than one at a time, which had been left undecided for lack of factual proof in the *Chicago National League* case,[172] surfaced again in 1954 when the IRS prescribed different treatment for bulk purchases. Revenue Ruling 54-441[173] required team purchasers to capitalize that portion of the purchase price allocable to player contracts and to amortize that amount over a period of time reflecting the useful life of the assets (i.e., the contracts).[174] The revenue ruling held that determination of the actual useful life of a group of player contracts was a matter for factual determination, although the prior owner's experience could be relevant.[175] The ruling, however, continued the expensing treatment previously allowed in the case of the purchase of individual player contracts after the new owner had acquired the franchise.[176] With Revenue Ruling 54-441 the IRS managed to adopt the least defensible position with respect to both types of purchases, allowing a current deduction where a specific asset with an ascertainable life of more than a year (an individual player contract) was acquired and permitting depreciation of an asset (the mass of player contracts comprising a team) that was self-renewing and inseparable from the franchise itself.

### *C. IRS Reaction to Changes in the Sports Business*

Depreciation of sports franchise player contracts was of relatively little concern when franchises were sold for hundreds of thousands rather than hundreds of millions of dollars. By the 1960s, however, Bill Veeck's idea that players were little different from production machinery and should similarly be depreciated[177] had

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172. Chicago Nat'l League Ball Club, B.T.A.M. (P-H) ¶ 33,197 (1933), *aff'd*, 74 F.2d 1010 (7th Cir. 1935).

173. Rev. Rul. 54-441, 1954-2 C.B. 101.

174. *Id.* at 102.

175. *Id.* The revenue ruling further provided that, if any of the contracts originally acquired were subsequently sold, amounts received were to be subtracted from the remaining unamortized basis with the net adjusted basis to be amortized over the remaining term of the previously determined useful life. If any player contracts were disposed of after the original purchase price allocated to the contracts had been fully amortized, amounts received were to be treated as ordinary income. *Id.*

176. *Id.*

177. *See supra* text accompanying note 18.

borne fruit. The expansion of professional basketball in the 1960s was primarily fueled by the tax shelter aspects of the sport.[178] Similar considerations may have underlaid, at least in part, the expansion and franchise turnover in the other major professional sports in the same period.

The IRS's first attempt to adjust the tax rules to the new economics of sports came in 1967. In Revenue Ruling 67-379,[179] the IRS rejected the *Pittsburgh Athletic*, *Helvering v. Kansas City American Association Baseball Co.*,[180] and *Chicago National League* cases, holding that all player contract acquisition costs, including both amounts paid to other teams for the contract and signing bonuses paid directly to players,[181] were to be capitalized and amortized over the useful life of the contract, including an estimate of the period for which the contract would be renewed under the reserve clause.[182] The ruling recognized the economic reality of the time, namely that the reserve clause effectively converted one-year player contracts into contracts that were enforceable over the entire length of a player's career. While the IRS may have viewed Revenue Ruling 67-379 as a revenue-enhancing measure, because it eliminated current deductions for contract acquisition costs, the ruling further entrenched the concept that such costs were deductible over time, a concept that became increasingly important as franchise acquisition prices increased.

The IRS extended the reasoning behind Revenue Ruling 67-379 to professional football in Revenue Ruling 71-137,[183] which held that football's "option clause," which permitted a team to renew a player contract for 75% of the prior year's salary, was sufficiently like the reserve clause in baseball to require similar tax treatment. In related rulings the IRS held that, on the sale of an expansion

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178. *See supra* part II.A.

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

180. 72 F.2d 600 (8th Cir. 1935).

181. The practice of paying amateur players sizeable bonuses to sign contracts with major league organizations became prevalent after World War II, once the major league teams had established extensive farm systems. By 1964, the highest bonus paid was $205,000 (to Rick Reichardt by the California Angels). In 1965, the major leagues instituted a draft of amateur players, restricting the freedom of the latter to negotiate with more than one team. As a result, bonuses fell substantially, and the $205,000 figure was not exceeded, in real terms, adjusting for inflation, until 1991 (by Brien Taylor, who signed with the New York Yankees for $1,550,000). ZIMBALIST, *supra* note 1, at 109-11.

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

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

franchise, payments received by the established teams allocated to franchise cost were to be treated as capital gain income, while proceeds allocated to the value of the player contracts lost by the established teams in the expansion draft were subject to I.R.C. § 1245 recapture and constituted capital gain to the extent that any amounts realized exceeded the adjusted basis plus the recapture amount.[184] Another ruling granted capital gain treatment to payments received by an existing franchise for relinquishing its existing exclusive territorial rights.[185] Yet another held that large amounts of television income received by a sports franchise did not constitute passive investment income under I.R.C. § 1372(e)(5)(C) and hence would not adversely affect a Subchapter S election.[186] These rulings set the stage for three significant cases in the 1970s and 1980s which confirmed the tax shelter function of player contracts in sports franchise acquisitions.

### *D. The Expansion and Transferred Franchise Cases*

By 1976, the Commissioner of the IRS reported that more than 130 sports franchise cases were pending in audit or had been docketed in the Tax Court.[187] Only three of the cases, however, actually resulted in court decisions: those involving the Atlanta Falcons (NFL), the Seattle Supersonics (NBA), and the Milwaukee Brewers (MLB). Though the first two decisions resulted in limiting the amount of the player contract deductions claimed by the franchise owners, none of the cases upheld the IRS's argument that the contracts were inextricably linked to other, nonamortizable assets and, therefore, that the mass asset theory should apply to bar depreciation of any amount at all. Similarly, none of the cases adopted a goodwill or going concern approach to deny depreciation deductions, nor used the hobby loss provisions of I.R.C. § 183 to bar deductions with respect to player contracts.

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184. Rev. Rul. 71-123, 1971-1 C.B. 227.
185. Rev. Rul. 71-583, 1971-2 C.B. 312.
186. Rev. Rul. 71-407, 1971-2 C.B. 318.
187. *Inquiry Into Professional Sports: Hearings Before the House Select Committee on Professional Sports*, 94th Cong., 2d Sess., pt. 2, at 270 (1976) (statement of Donald C. Alexander, Commissioner, Internal Revenue Service).

1. *Laird v. United States*

*Laird v. United States*[188] involved the purchase of the Atlanta Falcons, an expansion franchise in the NFL, which began play in 1966.[189] Of the $8.5 million purchase price that the new owners paid the NFL, they allocated $7,722,914, or nearly 91% of the total, to the contracts of forty-two veteran players acquired in the expansion draft and took depreciation deductions for this cost based on an estimated useful player life of 5.25 years.[190] The NFL itself admitted that the allocation of a large proportion of the purchase price to the depreciable player contracts was motivated entirely by tax considerations and did not reflect economic reality.[191]

The IRS initially took the position that only $1,050,000 should be allocated to player contracts, the difference being reallocated to nondepreciable franchise costs.[192] At trial in the United States District Court for the Northern District of Georgia, however, the government advanced a mass asset position: "that the Falcons' owners had acquired a bundle of inextricably linked assets including membership in the NFL, the player contracts, a pro rata share of television revenue, territorial exclusivity, the right to participate

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188. Laird v. United States, 391 F. Supp. 656 (N.D. Ga. 1975), *aff'd*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978). E. Cody Laird, Jr. was one of the partners in the Atlanta Falcons' ownership group. *Id.* at 658. At the time *Laird* was decided, there were similar cases pending involving the Kansas City Royals (MLB), the Miami Dolphins (NFL), the Seattle Supersonics (NBA), the Philadelphia Flyers (National Hockey League) and the Kansas City Athletics (MLB). *Laird*, 556 F.2d at 1226 n.1. Of these pending cases, only the Seattle case resulted in a published decision. *See* First Northwest Indus. of Am., Inc. v. Commissioner, 70 T.C. 817 (1978), *rev'd and remanded on other grounds*, 649 F.2d 707 (9th Cir. 1981).

189. *Laird*, 391 F. Supp. at 661.

190. *Id.* at 658-59. Fifty thousand dollars were allocated to the (nondepreciable) cost of the NFL franchise, and the balance of $727,086 was treated as deferred interest. *Id.* Alternatively, the Falcons' owners argued that approximately $4.3 million of the acquisition cost should be allocated to the NFL television contract, which had, at the time, four years to run, and which provided that television revenues were to be shared among the member teams. *Id.* at 659.

191. The NFL has stated:

> The irrelevance of the expansion club tax information is also demonstrated when it is realized that there are a number of factors which determine the price of an expansion franchise. These include, among others, the intensity of the desire of the purchaser to become a part of professional football; the fact that he is acquiring the exclusive rights to play professional football in the NFL within a specified territory; the fact that he is acquiring valuable television and radio rights; the size and nature of the city in which the franchise is to be located . . . .

Weill, *supra* note 25, at 590..

192. *Laird*, 391 F. Supp. at 659.

in future player drafts and waiver and trade transactions, and other related assets."[193]

The litigation strategy in *Laird* set a pattern for the three test cases. The Falcons relied on the testimony of insiders Norb Hecker, the first coach of the team; Jim Finks, the General Manager of the Minnesota Vikings, Chicago Bears, and New Orleans Saints at various times; and Tex Schramm, the General Manager of the Dallas Cowboys.[194] The IRS, evidently unable to counter this insider expert witness approach on its own terms, relied instead on economists who attempted to prove that the substantial portion of the overall purchase price could be attributed to the NFL television contract.[195] In the end, the trial court more or less split the difference, accepting a valuation of $3,035,000, or 35.7% of the total purchase price as attributable to the player contracts.[196] The *Laird* court held that the balance of the amount allocated by the owners to the player contracts should instead be allocated to the NFL television contract.[197] The *Laird* court also held that the television contract, because of its renewable nature, did not have a limited useful life and was therefore nondepreciable.[198] Thus, while limiting the amount of the player contract deduction, the court rejected the IRS's mass asset argument.[199]

The United States Court of Appeals for the Fifth Circuit affirmed, also rejecting the IRS's mass asset argument on the authority of *Houston Chronicle Publishing Co. v. United States*,[200] a case that dealt with newspaper subscription lists, and *KFOX, Inc. v. United States*,[201] which involved the purchase of a radio station and the contracts of several disk jockeys and the station manager. Under the reasoning of these cases, the mass asset rule would not

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193. *Id. See* Weill, *supra* note 25, at 582.

194. *Laird*, 556 F.2d. at 1237-38.

195. *Laird*, 391 F. Supp. at 666-67.

196. *Id.* at 667.

197. *Id.* at 669.

198. *Id.*

199. The trial court in *Laird* stated:

> The government has conceded that the veteran player contracts were valuable assets. While it is true that in this case the task of proving the fair market value of the contracts was fraught with difficulties, the court cannot hold that it was impossible, either as a legal or factual matter . . . .

*Id.* at 670.

200. Houston Chronicle Pub. Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

201. KFOX, Inc. v. United States, 510 F.2d 1365 (Cl. Ct. 1975).

apply to any asset, including personal service contracts, if the taxpayer could show that the assets "represent independent and uniquely valuable assets to the taxpayer."[202] Once the government had conceded, as it did,[203] that the player contracts in *Laird* had "considerable value," then the mass asset theory, in the court's view, simply ceased to apply.[204] However, as discussed above, the mass asset rule does not require that a particular intangible asset have *no* value to be nondepreciable, but merely (1) that the clearly nondepreciable assets (e.g., the franchise) be of greater value and (2) that the putatively depreciable assets be inextricably linked with the nondepreciable assets.[205] Such appears to be the case in sports franchise purchases.

Although *Laird* was not governed by the 1975 amendment that added I.R.C. § 1056,[206] the United States Court of Appeals for the Fifth Circuit nonetheless relied on what it took to be the Congressional intent that "as a general proposition, half the total consideration for a sports franchise properly may be allocated to the players' contracts."[207] Because the apportionment ordered by the trial court, 35.7% of the total franchise purchase price, was well within the 50% limitation, the Court of Appeals had no trouble in accepting the trial court's figure as "within the range of figures that may properly be deduced from the evidence"[208] and hence not to be overturned on appeal.[209] A plausible case can be made that the implied Congressional intent in enacting I.R.C. § 1056 was to approve at least some depreciation deduction with respect to player contracts. Read literally, however, the statute does not say that; it establishes no presumption at all with respect to allocations of purchase price to player contracts that are less than 50% of the total. If a court were to conclude that the mass asset or going concern theories barred any depreciation deduction at all for player

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202. *Id.* at 1378.

203. In *Laird*, the IRS apparently took an initial position that the player contracts were worth one million dollars. *Laird*, 556 F.2d at 1237. This appears to have been an alternative to the mass asset argument that would have denied a depreciation deduction altogether.

204. *Id.* at 1233.

205. *See supra* part IV.

206. For the text of I.R.C. § 1056(d), see *supra* note 24. I.R.C. § 1056 generally applies to sales or exchanges of sports franchises occurring after December 31, 1975.

207. *Laird*, 556 F.2d at 1241.

208. Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957), *cert. denied*, 356 U.S. 950 (1958), *cited in Laird*, 556 F.2d at 1239.

209. *Laird*, 556 F.2d at 1242.

contracts, or that the hobby loss provisions of I.R.C. § 183 barred such deductions, that holding would not literally conflict with the words of I.R.C. § 1056.

### 2. *First Northwest Industries of America, Inc. v. Commissioner*

*First Northwest Industries of America, Inc. v. Commissioner*[210] involved the 1967 purchase of the Seattle Supersonics expansion franchise in the NBA.[211] The buyers received, among other things, an NBA franchise with territorial exclusivity; a share in the NBA's television, licensing, and future expansion revenue; rights to participate in the NBA's draft of college players; and rights to acquire fifteen veteran player contracts through an expansion draft.[212] Of the total purchase price, the franchise owners allocated $150,000 to the value of the nondepreciable franchise and $1,600,000, or 91.4%, to the value of player contracts obtained through both the expansion draft and the college draft.[213] This allocation was consistent with the approach taken both by owners of new expansion franchises and by buyers of existing NBA teams in the 1960s and 1970s. Of eighteen franchise transactions reported by the court in the *First Northwest* case, the percentage of the purchase price allocated to player contracts ranged from a low of 75% in the 1974 sale of the Detroit Pistons to a high of 96% for the 1966 Chicago expansion franchise.[214] In one baseball case, the transfer of the Milwaukee Braves to Atlanta in 1966, the new owners apparently allocated 99% of the $5.5 million purchase price to player contracts, an amount reduced to a mere 90% on audit.[215]

As in *Laird*, the IRS's litigation strategy in *First Northwest* was compromised at the beginning by its willingness to permit some deduction with respect to the player contracts. The IRS argued that the contracts should account for only $450,000 of the purchase price, rather than the $1,600,000 proposed by the owners.[216] Only in its amended answer, filed nearly three years after the initial

210. First Northwest Indus. of Am., Inc. v. Commissioner, 70 T.C. 817 (1978), *rev'd and remanded on other grounds*, 649 F.2d 707 (9th Cir. 1981). *See also* Katz, *supra* note 26.

211. *First Northwest Indus.*, 70 T.C. at 822. The total purchase price of the Seattle expansion franchise was $1,750,000. *Id.*

212. *Id.* at 823-25.

213. *Id.* at 832.

214. *Id.* at 832-35.

215. Okner, *supra* note 42, at 166.

216. *First Northwest Indus.*, 70 T.C. at 841-42.

notice of deficiency, did the IRS adopt the mass asset theory and argue that none of the purchase price should be depreciable.[217] In any event, the Tax Court in *First Northwest* held that the mass asset rule should be limited in application to cases involving customer-based intangibles.[218]

Also, as in *Laird*, the taxpayer's strategy involved using the testimony of sports insiders to establish a valuation of the player contracts.[219] These insiders presented detailed estimates of the value of each of the players acquired by the expansion franchise in the expansion draft.[220] Again, the IRS relied on an economist who "made no pretense at being an expert in evaluating the playing ability of the draftees," but rather "relied on an esoteric combination of variables" to arrive at his valuation.[221] The IRS's expert's valuation of the veteran player contracts was $60,000, a figure the Tax Court dismissed as "ridiculous."[222]

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217. *Id.* The IRS did not dispute the five-year useful life for player contracts proposed by the taxpayer. *Id.* The bundle of rights acquired by the Seattle Supersonics' owners from the NBA included:

> (1) the right to participate in a special expansion draft of veteran basketball players, (2) the right to participate in the 1967 and post-1967 NBA college drafts, (3) the right to share in all revenues derived from national television broadcasting of NBA games, (4) the right to share in revenues from the NBA all-star and playoff games, (5) the right to share in revenue from NBA promotional and merchandising activities, (6) the right to all revenues from local broadcasting of the SuperSonics' [sic] games, (7) the right to share in the NBA's goodwill . . . , (8) the right to share in the proceeds of the NBA expansion planned for 1968, (9) the right to share in the proceeds of any future expansion, (10) protection from intra-league competition for a team's rights to its players and draft choices, (11) the right to participate in exhibition of NBA professional basketball by competing with other teams in the league, [and] (12) the exclusive territorial rights for NBA basketball within a 75-mile radius of Seattle . . . .

Zaritsky, *supra* note 26, at 88.

218. *First Northwest Indus.*, 70 T.C. at 846.

219. In the Seattle case, the experts were Joseph Axelson, General Manager of the Kansas City (now Sacramento) Kings, Marty Blake, General Manager of the St. Louis (now Atlanta) Hawks, and Don Richman, the first general manager of the Seattle Supersonics. *Id.* at 850-51.

220. *Id.* at 852-53.

221. *Id.* at 853.

222. *Id.* at 854. Estimating the "value" of individual players is, at best, a somewhat subjective task. One recent attempt to determine the "marginal revenue product" of players and relate it to salaries reaches the unsurprising conclusion that players who qualify for free agency do much better than those with limited big league experience who are bound to their teams without competitive alternatives (assuming that, in each case, actual player performance is the same). ZIMBALIST, *supra* note 1, at 90-94. In *First Northwest*, the government's expert witness apparently used a similar formula, combining such statistics as playing time, rebounds, points scored, all-star game participation, age, and college draft round to arrive at

To bolster their argument, the owners also said that they would have suffered severe revenue loss, even with an NBA franchise, if they had not had rights to veteran players through the expansion draft.[223] The owners argued that a team composed of free agents[224] would "have been a competitive disaster" with adverse results on franchise revenues.[225] In view of the expansion team's 29-53 record in their first year of operation with the veteran players, one might wonder exactly what a competitive disaster would have looked like. The taxpayers further argued that the player contract rights were separable from the franchise value because the contracts were not inherently linked solely to the NBA but could, for example, be sold to the Harlem Globetrotters or to the (minor) Eastern League.[226] One might wonder, however, how much a minor league team without significant television revenue or major-city gate receipts would pay for the right to pay NBA salaries. Presumably, the taxpayers' attorneys told their clients that this argument could be made without laughing.

In the end, the Tax Court held that the value of the veteran player contracts was $500,000, or 28.6% of the total acquisition price.[227] The *First Northwest* court left to the parties, under a Rule 155 calculation,[228] the task of allocating the $500,000 among the fifteen players acquired in the expansion draft, only nine of whom actually signed with the expansion team.[229] The balance of the $1,750,000 cost of the franchise was allocated between the right to share in any 1968 expansion revenue received by the NBA

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an expected salary for each of the players drafted by the Sonics. *First Northwest Indus.*, 70 T.C. at 853.

223. *Id.* at 847 n.37.

224. Free agents are players not bound to a team by a contract.

225. *First Northwest Indus.*, 70 T.C. at 847 n.37.

226. Opening Brief for Petitioner at 39-40, First Northwest Indus. of Am., Inc. v. Commissioner, 70 T.C. 817 (1978), *cited in* Katz, *supra* note 26, at 836 n.62.

227. *First Northwest Indus.*, 70 T.C. at 856.

228. Under Tax Court Rule 155; the court decides all the outstanding factual and legal controversies, and the parties then stipulate to the amount of tax owed, based on those decisions. 26 U.S.C.A. § 7453, rule 155 (West 1989).

229. Five of the 15 simply retired before the start of the Sonics' first season, while one was waived by Seattle and acquired by another NBA team. *First Northwest Indus.*, 70 T.C. at 837. Among those who did play for the Sonics in 1967-68 were Walt Hazzard, who ranked seventh in scoring and fifth in assists in the league that year, and Tom Meschery, who led the team in minutes played and rebounds. Among the six players who did not play for the Sonics was Richie Guerin, former New York Knickerbocker star who became coach of the (then) St. Louis Hawks. *Id.* at 852-53.

($250,000) and the nondepreciable value of the league franchise itself, together with its continuing rights to share in television revenue and to participate in the college player draft ($1 million).[230]

On appeal, the allocation of $500,000 to the player contracts was not challenged, although the United States Court of Appeals for the Ninth Circuit reversed that portion of the Tax Court's decision dealing with the capital-gain treatment of expansion proceeds received by the Seattle Supersonics from the 1970 NBA expansion into Portland, Buffalo, and Cleveland.[231] As in *Laird*, the going concern and mass asset arguments against depreciating player contracts at all were largely ignored by the courts, and the hobby loss issue was apparently not raised.

3. Purchasing an Existing Franchise - *Selig v. United States*

*Selig v. United States*,[232] the third case fixing the parameters for depreciation of player contracts, involved the 1970 purchase by a Milwaukee investor group of the Seattle Pilots, an American League baseball expansion team, and their reincarnation as the Milwaukee Brewers following the departure of the National League Milwaukee (née Boston) Braves for Atlanta.[233] The new owners paid a total of $10.8 million for the Seattle Pilots franchise of which they allocated $100,000 to tangible assets, $500,000 to the nondepreciable franchise, and $10.2 million, or 94.4% of the total, to the 149 major and minor league contracts acquired from the previous owners.[234]

*Selig* differed from the prior cases both in that it involved the purchase of an existing, if financially troubled, franchise, rather than an expansion team, and in that it dealt with baseball. Such a

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230. *Id.* at 866-67.

231. *First Northwest Indus.*, 649 F.2d at 709.

232. 565 F. Supp. 524 (E.D. Wis. 1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984).

233. *Id.* An earlier case involving the same purchase resulted in a dismissal on the taxpayer's motion for summary judgment, apparently prompting the Brewers' ownership to pay the taxes sought and then sue for a refund in district court. Evinrude v. Commissioner, T.C.M. (P-H) ¶ 80,454 (1980).

234. *Selig*, 565 F. Supp. at 525. When the Pilots initially entered the league, before the 1969 season, their owners paid an initial fee of $5,350,000, of which all but $100,000, or 98.1%, was allocated to the 30 player contracts acquired in the expansion draft. *Id.* at 531. In addition, the Pilots agreed to pay their pro rata share of league operating expenses, to forego their share of any national television revenue for three years, and to pay the existing teams two percent of their gate receipts for three years. *Id.*

situation arguably differs from other professional sports because (1) the principal revenues derived from a baseball franchise are local, rather than national (as in the case of the NBA and NFL revenue-sharing arrangements) and (2) the Major League Baseball teams support an elaborate infrastructure of minor league players, designed to maintain a regular supply of players. In contrast, basketball and football do not have to pay comparable player development costs, relying instead on colleges and universities to develop their future players.[235]

At trial the Brewers' owners relied on sports insiders as expert appraisers to support their valuation of the player contracts.[236] In contrast, the government again relied on an economist who had testified for the government in the previous cases and who this time proposed a valuation of one million dollars for the player contracts.[237] As in *First Northwest*, the multiple-regression-analysis and income-sensitivity models developed by the government's economist appeared to carry far less weight with the court than the plain-talking and name-dropping presentations of the baseball insiders.[238] Perhaps aware of the unpersuasive nature of its economic arguments, the government also called in two supposed baseball insiders: (1) Dewey Soriano, the President of the Seattle Pilots before they were sold to Allan Selig's Milwaukee group and (2) Richard Walsh, General Manager of the California Angels.[239] For a variety of reasons, including the fact that their appraisals were made more than a dozen years after the fact, the court gave them little weight.[240] In the end the court approved the Brewer's proposed allocation of $10.2 million, or 94% of the total purchase price to the player contracts.[241] The United States Court of Appeals for

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235. Harwood, *supra* note 27, at 670-71.

236. *Selig*, 565 F. Supp. at 533. The appraisers used by the Brewers were Frank "Trader" Lane, former General Manager of the Chicago White Sox and subsequently General Manager of the Brewers; Cedric Tallis, General Manager of the Kansas City Royals; Marvin Milkes, first General Manager of the Seattle Pilots; and Bobby Mattick, a scout with both the Pilots and the Brewers. The trial court relied principally on the appraisals made by Lane and Tallis, who were, at the time, unconnected with the Brewers franchise, although Lane had been a longtime friend and adviser to Selig, the Brewers' principal owner. *Id.*

237. *Id.* at 539.

238. *Id.* at 537. ("[H]is [Noll's] analyses were fundamentally flawed .... Numerous practical difficulties in applying his theoretical model ... made his analyses even less reliable.").

239. *Id.* at 541.

240. Soriano appraised the player contracts at $3.2 million, while Walsh valued them in the range of $3.25 - $5.1 million. *Id.* at 541-42.

241. *Id.* at 543.

the Seventh Circuit, in an opinion notable more for its use of baseball poetry than its reasoning, affirmed, finding the allocation made by the lower court not to be clearly erroneous.[242]

The *Selig* case marked the first time that the hobby loss issue had been raised in player-contract litigation. The IRS argued that, at least in part, operating a baseball team was like owning a luxury yacht — a rich man's toy.[243] With no analysis whatsoever, the trial court concluded otherwise.[244] So much for I.R.C. § 262.[245]

Similarly, the lower court opinion in *Selig* summarily dismissed the mass asset argument against depreciation of player contracts, apparently because the IRS abandoned that approach after its de-

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242. Selig v. United States, 740 F.2d 572 (7th Cir. 1984). Each division of the opinion by Judge Bauer begins with a pithy comment from baseball literature, perhaps the most notable of which is Leo Durocher's "Show me a good loser and I'll show you an idiot." *Id.* at 577. The opinion contains, albeit mostly in footnotes, such gems as Ogden Nash's:

> *Y is for Young*
> *The Magnificent Cy;*
> *People batted against him,*
> *But I never knew why.*

*Id.* at 573. Section V of the opinion reads, in its entirety, as follows:

> *Oh! Somewhere in this favored land*
> *the sun is shining bright;*
> *The band is playing somewhere, and*
> *somewhere hearts are light.*
> *And somewhere men are laughing, and*
> *somewhere children shout;*
> *But there is no joy in Mudville —*
> *mighty Casey has Struck Out.*
>
> There should be joy somewhere in Milwaukee — the district court's judgment is affirmed.

*Id.* at 580.

243. *Selig*, 565 F.Supp. at 526.

244. *Id.* The trial court in *Selig* stated:

> Professional baseball is a business for tax purposes . . . .
>
> The government has argued that this is not so and that to an undetermined extent the operation of a professional baseball team is not for "business purposes" but is to give joy to the owners. It is further argued that this "joy" has a value and that this joy value should be attributed to the value of the franchise. Owners of baseball clubs, as well as owners of other enterprises, do receive a joy out of ownership. Allocation between the joy value and the business value is required for vacation homes and yachts . . . but this is not applicable here because professional baseball is a business, the allocation would be too speculative, and the tax laws do not recognize or tax the nonmonetary motivations of human beings . . . .

*Id.*

245. Section 262 provides, in pertinent part: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living or family expenses.
I.R.C. § 262(a) (1988).

feat in *Laird*.[246] While recognizing the economic unreality of any separate allocation of purchase price to the player contracts, the court apparently felt bound by prior decisions and by the IRS's litigating strategy to focus only on the question of how much to allocate to the contracts, rather than whether to allocate at all.[247] Although *Selig* was not decided until 1983, the lower court made no mention of the 1976 enactment of I.R.C. § 1056, which established a presumption that an allocation of more than 50% of the purchase price to player contracts was unreasonable.[248]

*Selig*, then, marks the high water mark of taxpayer success — allocating more than 90% of a team's purchase price to player contracts depreciable over only five years. In the decade since *Selig* was decided, no other cases have addressed the player contract issue.[249] Presumably, the IRS and the Justice Department have decided that this issue no longer merits serious litigation investment. In the government's view, perhaps, the enactment of I.R.C. §§ 1056 and 1245(a)(4) have established a sort of safe haven in which the right to depreciate up to 50% of the purchase price of a sports franchise by allocations to player contracts is considered to be balanced by I.R.C. § 1245(a)(4)'s recapture provisions. The latter does, at least address the short-term tax shelter issue that was so important during the Congressional hearings in the early 1970s.

### *E. Congressional Action and Current IRS Audit Guidelines*

The 1976 Tax Reform Act included two provisions apparently intended to reduce the tax shelter potential of professional sports franchises. The first, I.R.C. § 1056, establishes a rebuttable presumption that not more than 50% of the purchase price of a sports franchise is attributable to player contracts.[250] The second, I.R.C. § 1245(a)(4), provides for recapture of previously allowed depreci-

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246. *Selig*, 565 F. Supp. at 526.

247. *See id.* at 542-43.

248. Because the purchase of the Brewers occurred in 1970, I.R.C. § 1056 did not apply, but, as in *First Northwest*, its enactment could have been used by the court as a point of reference.

249. The 1973 purchase of the New York Yankees by a partnership headed by George Steinbrenner also resulted in litigation, but those cases dealt only with amortization of certain legal and accounting fees, McCarthy v. United States, 613 F. Supp. 67 (N.D. Ohio 1985), and with the tax treatment of broadcasting rights, McCarthy v. United States, 622 F. Supp. 595 (N.D. Ohio 1985), *aff'd in part and rev'd in part*, 807 F.2d 1306 (6th Cir. 1986).

250. For the text of I.R.C. § 1056(d), see *supra* note 24.

ation deductions for player contracts in the event of a sale or exchange of a sports franchise.[251] The effect of I.R.C. § 1245(a)(4) is to convert what would have been capital gain in the amount of the previously allowed depreciation into ordinary income for the seller in the year of the transfer.[252]

I.R.C. § 1056 appears to be a Congressional reaction to the extreme tax shelter aggressiveness described during the Congressional hearings. The statute does not purport to establish a reasoned position, but rather says, in effect, don't be greedy; 50% is enough. To date, there have been no applicable court cases, published rulings, or applicable regulations under I.R.C. § 1056.

In addition, in the wake of *Laird* and *First Northwest*, the IRS issued audit guidelines for allocation of sports franchise purchase prices.[253] The guidelines explicitly abandon the mass asset approach originally argued in *Laird*[254] and set out three alternative valuation methods: (1) the "prudent investor" approach based on the expected rate of return from the purchased assets;[255] (2) the "TV revenue" approach which assumes that the value of a sports franchise is based primarily on television revenues;[256] and (3) the "salary-allocation-gap" approach which attempts to measure the difference between the value of players to the team and the salary to be paid to those players.[257] In practical terms, unless

251. Pub. L. No. 94-455, § 212(b)(1) added I.R.C. § 1245(a)(4), effective in the case of transfers of player contracts in connection with the sale or exchange of a sports franchise occurring after December 31, 1975. I.R.C. § 1245 (1988 & Supp. II 1990).

252. On the sale of a § 1245 asset, the amount by which the lower of (1) the recomputed basis of the property, or (2) the amount realized, exceeds the adjusted basis of the property is treated as ordinary, rather than capital gain income. Treas. Reg. § 1.1245-1(a) (as amended in 1971).

253. INTERNAL REVENUE MANUAL- AUDIT, pt. 4, ch. 5, § (11)(34). The IRS had proposed to issue an earlier version of the guidelines as a published revenue ruling, but did not do so, apparently because of the adverse District Court decision in the Atlanta Falcons case. Gen. Couns. Mem. 35,680 (Feb. 19, 1974).

254. INTERNAL REVENUE MANUAL- AUDIT, pt. 4, ch. 5, § (11)(34).31(2). The IRS continued, however, to use the mass asset method, at least until the decision in *Newark Morning Ledger*, in some non-sports cases. *See, e.g.*, Decker v. Commissioner, 864 F.2d 51 (7th Cir. 1988) (insurance expirations).

255. INTERNAL REVENUE MANUAL- AUDIT, pt. 4, ch. 5, § (11)(34).32. The IRS itself admits, however, that many owners of sports franchises are not "prudent investors," but rather "wealthy individuals whose primary motive was to achieve personal satisfaction derived from owning something unique, prestigious, and at the same time, enjoyable." *Id.* § (11)(34).32(5).

256. *Id.* § (11)(34).33. The IRS distinguishes between sports with substantial network television contracts in which all teams share equally, like the NFL, and sports with no comparable television structure, like the National Hockey League. *Id.*

257. *Id.* § (11)(34).34. This approach relies on economists' attempts, using regression

television revenue can be shown to account for more than 50% of the value of the franchise, it does not appear that any of these methods would typically mandate an allocation to player contracts of much less than 50% of the purchase price.

## VII. The State of the Law and Economic Theory

### A. *The Current State of the Law*

The law relating to depreciation of player contracts, as it has emerged from the cases described above and Congressional and IRS response to those cases, essentially reflects the situation of professional sports in the early 1970s. In the 1970s franchises changed hands for six to ten million dollars apiece, and thus the potential tax benefits to purchasers and tax costs to the nation were much lower than today. Currently the stakes are higher because baseball and football franchises change hands for more than $100 million. The three decided cases all relate to team purchases made between 1966 and 1970, and the last word from Congress was in 1976. Emerging from this environment are the following rules:

(1) Player contracts are viewed as separately identifiable intangible assets, which, with sufficient expert testimony, can be shown to have determinable value and reasonably ascertainable lives;
(2) In general, not more than 50% of the purchase price of a franchise can be allocated to player contracts;
(3) The useful life of player contracts is typically fairly short, on the order of five years; and
(4) The courts have not applied mass asset theories, the prohibitions against depreciation of goodwill or going concern value, or the hobby loss rules of I.R.C. § 183 to bar depreciation of player contracts.

### B. *Double Deductions*

In both the purchase of an existing team and in an expansion situation, the new owner gains the unquestioned right to take depreciation deductions with respect to the player contracts acquired,

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analysis, to derive values for player contracts by predicting the salary that a player of certain abilities would earn, and then valuing that player's contract by subtracting the player's actual salary from that hypothetical salary. *Id.*

even though many of the players so acquired will never play for the new owner's franchise.[258] Moreover, the new owner also acquires the right, as a result of membership in the league, to maintain a set number of players on an active-duty roster.[259] Players on the roster can be replaced continuously by: "(1) participation in college drafts; (2) trades with other teams for players or future draft choices; (3) obtaining players through [the] waiver system . . . ;[260] and (4) free agents."[261] The costs of such replenishment are generally currently deductible under I.R.C. § 162.

As the trial court in *Selig* pointed out, the effect of allowing a large depreciation deduction with respect to acquired player contracts is that club owners effectively get a doubling of deductions in the first years after they acquire the team.[262] They are taking depreciation deductions with respect to their acquired player contracts, typically over a period of about five years. At the same time they are also deducting, as a current business expense under I.R.C. § 162,[263] the cost of developing new players to replace those originally acquired, including the cost of maintaining a scouting system and, in baseball at least, of paying minor league players and coaches. Evidence that the cost to develop a major league player through the minor league farm system was approximately $350,000, or $8.7 million for the twenty-five-player major league roster supported the high valuation for player contracts in *Selig*.[264] All of that cost is currently deductible, so that allowing the depreciation deduction is a clear case of double-deduction of the same cost.

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258. Of the 42 players drafted by the NFL Atlanta Falcons after the 1965 season, only 25 were on the team's roster at the beginning of the 1966 season, only 17 were still on the roster at the end of the 1967 season, and only eight by the end of the 1968 season, three years after the team started competing. Weill, *supra* note 25, at 587.

259. *Id.*

260. In 1969, Jim Bouton, a proven, if erratic, major-league pitcher on the Seattle Pilots' roster was waived out of the American League, because no team would pay the $25,000 waiver price to acquire his contract (which required that he be paid only $22,000 per year). JIM BOUTON, BALL FOUR 10, 326 (1970).

261. Weill, *supra* note 25, at 587 (making this point with respect to the trial court decision in the Atlanta Falcons case).

262. Selig v. United States, 565 F. Supp. 524, 528 (E.D. Wis. 1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984).

263. Section 162 permits a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." I.R.C. § 162(a) (1988 & Supp. IV 1992). Player development expenses, including the costs of maintaining a minor league system and a network of scouts, have been recognized as § 162 expenses. *See* Rev. Rul. 67-379, 1967-2 C.B. 127.

264. *Selig*, 565 F. Supp. at 534.

*C. The Impact of Free Agency*

All of the decided cases permitting sports franchise owners to depreciate player contracts acquired as part of a franchise relate to a period when the sports business was much different from what it is today. The principal difference is free agency, under which players in all the major professional sports are no longer bound to a single team for the length of their careers but instead are permitted to negotiate new contracts after a period of time in the league.[265] With free agency and enough money, the owner of a brand new franchise could presumably acquire players to stock the franchise and have an acceptable level of performance. Such an owner would still be able to deduct the salaries actually paid to the players under contract and, presumably, would amortize any bonuses over the length of the contract.

In an age of free agency, the development cost involved in restocking a franchise with new players as the existing players retire or diminish in skill is less relevant than before because the owner of a new team can recruit already-developed players. If the Colorado Rockies and the Florida Marlins had not been able to draft a single player from the other MLB teams before starting play in 1993, they would still have been able to bid for the services of 181 free agents with prior major league experience and more than 200 minor league free agents.[266]

The free agency argument was raised at least once before by the government in *Laird*. The taxpayer first argued that a negligible value should be assigned to the nonamortizable right to participate in the college draft because the bidding war between the NFL and the new AFL had made the college draft rights problematic.[267]

265. Free agency in baseball derives from an arbitrator's ruling in 1975 that the one-year reserve clause does not include an ongoing year-to-year renewal right. Professional Baseball Clubs, 66 Lab. Arb. (BNA) 101 (1975), *aff'd sub nom.*, Kansas City Royals Baseball Corp. v. Major League Baseball Players' Ass'n, 409 F. Supp. 233 (W.D. Mo.), *aff'd*, 532 F.2d 615 (8th Cir. 1976). The current collective bargaining agreement between the players' union and the owners provides for free agency after six years of major league service and for arbitration of salaries for players with two-plus to five years' major league service. ZIMBALIST, *supra* note 1, at 81-82. In addition, players who have spent six and a half years in the minor leagues and are not listed on their parent major-league team's 40-player roster are also eligible for free agency. Jim Callis, *Expansion Teams Eye Six-Year Free Agents*, BASEBALL AMERICA, Nov. 10, 1992, at 13.

266. Callis, *supra* note 265; *Major League Free Agents*, BASEBALL AMERICA, Nov. 10, 1992, at 13.

267. Weill, *supra* note 25, at 587.

The IRS countered by arguing that the inter-league competition for players must also make the rights to established veteran players less valuable because those players could jump to the new league.[268] The court, however, did not explicitly address this argument.

## VIII. CONCLUSION

The rules governing this somewhat arcane corner of tax law have been fixed for nearly two decades, despite two enormous changes in the economic reality of professional sports: (1) the huge increase in franchise values and (2) the emergence of free agency for players. If the rules ever reflected a reasonable solution, limiting tax shelter potential while preserving the IRS's litigation resources for more important issues, they no longer do so. The stakes are much higher today; a depreciation deduction that perhaps represented a tax benefit of perhaps three hundred thousand dollars per team in 1970 may be worth four million dollars per team per year today. The increasing stakes and the changed environment make it easier to argue that it is the franchise and the television contract, and not the players, that create the value of a sports franchise. Perhaps it is time for the IRS and the courts to take another look at the issue of player contract depreciation, and to invoke some or all of the goodwill/going concern, mass asset, and hobby loss arguments in support of denying entirely these unnecessary and unmerited deductions.

If the IRS and the courts do not act, and more than a decade of IRS inaction suggests that this is likely, Congress, which on occasion has been known to exercise its fascination with professional sports, might revisit the issue, last dealt with when Congress enacted I.R.C. § 1056 in 1976. The nearly two decades since then have wrought great changes in sports economics. Perhaps it's time for the relevant laws to catch up.

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268. *Id.*