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Taxation and Professional Sports - A Look Inside the Huddle

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TAXATION AND PROFESSIONAL SPORTS—A LOOK INSIDE THE HUDDLE

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I. INTRODUCTION

People have been saying for years that sports has become a big business. As we move toward the end of the century, that seems to be a gross understatement. Every aspect of sports involves sums of money that were unthinkable just a few years ago. Michael Jordan reportedly received $30 million for playing for the Chicago Bulls in the 1997-1998 season.[1] Salaries in baseball also have escalated.[2] The cost of acquiring a franchise has continued to move upward to the point where the Washington Redskins are expected to sell for over $700 million.[3] Ticket prices paid by spectators have gone so high that only the affluent can now attend the events in person. Some have speculated that the way things are going, in the not-too-distant future, games may be played in the stark silence of a studio environment while millions of fans watch on television screens. The cost of new stadiums has also kept pace with the upward trend of the other aspects of sports.

Despite all of the big dollar figures that apply to sports, the Government has contended in litigation that professional sports franchises were, in part, hobbies or toys in the hands of rich owners who were enjoying

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1. *See* Frederick C. Klein, *On Sports: Basket Case*, WALL ST. J., Oct. 30, 1998, at W6.

2. *See id.* at W6. According to the press, the New York Mets signed Mike Piazza to a $91 million, seven year contract, at the end of 1998. *See id.* Albert Belle left the Chicago White Sox to join the Baltimore Orioles for a reported $65 million over 5 years. *See* Ronald Blum, *Johnson Picks D-Bucks; Baltimore Signs Belle*, TULSA WORLD, Dec. 1, 1998, at 4. Baseball owners have been complaining about escalating salaries, and Commissioner Selig appointed a panel of three people to investigate the sport's economic system. *See Selig to Appoint Panel on Economic Situation*, SAN FRANCISCO EXAMINER, Jan. 14, 1999, at D3. On the subject of escalating salaries, the Los Angeles Dodgers gave pitcher Kevin Brown a contract providing for $105 million over seven years. *See id.* The baseball collective bargaining agreement runs through the year 2000, but the players' association has the option to extend it for one more year to 2001. *See id.*

3. Rupert Murdock paid over $300 million for the Los Angeles Dodgers and is reported to be offering $1 billion for the Manchester United soccer team. *See* Andrew Serwer, *The Redskins are Worth How Much?*, FORTUNE, Feb. 1, 1999, at 161. The Cleveland Browns were sold to Baltimore interests for about $530 million. *See id.*

the fun of being franchise owners.[4] The Government lost that argument in the *Selig* case, but if it had won, there could have been an allocation between the joy value and the business value for tax purposes. The Government would have allocated the joy value to the franchise as a nondepreciable asset. The "joy argument" was a very difficult one to make because the enormous sums involved, the scope of activities engaged in by professional franchises, and the way the activities are managed, indicate that these activities clearly are businesses. In addition, even if the activity were one partly engaged in for pleasure, the amount allocated to the pleasure portion would apply to a portion of all of the activities engaged in and not just the franchise itself. Once that allocation was made, depreciation could be determined properly on player contracts.

The Court in *Selig* ruled against the Government on that point and held that owning a professional sports franchise does constitute a business.[5]

As the dollar amounts have gone up in professional sports, the tax issues relating to the key aspects of sports have become more significant. The primary purpose of this article is to focus on the three aspects of professional sports with respect to which tax considerations play a very important part—franchises, stadiums, and players' income.

II. Franchises

When a sports franchise is bought, the purchaser receives a number of different items of property. A small amount of tangible personal property (equipment and supplies) is received. The significant part of the acquisition is the intangible assets—player contracts, the right to share in league television and licensing income, and the franchise itself (the right to be a team in the league, to play the schedule with the other teams and participate in the player draft). In some instances, although it is unusual, a stadium comes along with the deal also.

The question of allocation becomes important because, with respect to the various items acquired, depreciation deductions would be permitted only as to the player contracts (and the small items of tangible personal property that are acquired). Of course, if a stadium is acquired in the acquisition, depreciation also would be allowed for various items of property associated with the stadium.[6]

4. *See* Selig v. U.S., 565 F. Supp. 524 (E.D. Wis. 1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984).
5. *See id.* at 526.
6. *See* discussion *infra.*

A. *Player Contracts*

If the acquisition of a sports franchise does not include a stadium, the only items which would be subject to the allowance for depreciation are the player contracts and the relatively small amount of equipment and supplies.[7] In Revenue Ruling 67-379,[8] the Internal Revenue Service took the position that the cost of a player contract could not be deducted but had to be depreciated, where the contract was a one-year baseball contract with a standard renewal option (known as the reserve clause). According to the Revenue Ruling, the effect of the reserve clause operating with league rules was to bind the player to the particular club for his entire useful life as a player because the club had the right to the player's services for as long as he was capable of playing baseball.[9] The club could not force the player to play for it, but it could deny him the right to play for any other team.[10] In light of this position, the Ruling concluded that the player contract had a useful life extending beyond one year, and it, therefore, had to be depreciated over its useful life.[11]

Although the reserve clause no longer binds baseball players to their clubs, the Revenue Ruling is the basis for the position that player contracts have to be depreciated over their useful lives. Under present league rules, where individual players are bought, the depreciation would take place over the years the services are contracted for in the contract.

It should be noted, however, that in baseball, for example, a player does not become a free agent until he has played in major league baseball for six years.[12] Accordingly, if a team acquires a player who has not yet played in the majors for six years, and signs him to a contract which will expire before the six year period ends, it would appear that depreci-

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7. It is noted that I.R.C. § 197, which permits amortization of goodwill and various other intangible assets, referred to as an "amortizable section 197 intangible," over a 15-year period, specifically excludes from a "section 197 intangible" any benefits for sports franchises and any item acquired in connection with a sports franchise. I.R.C. § 197(e)(6). Without regard to § 197, an intangible can be amortized only if the intangible has an ascertainable value and an ascertainable and defined useful life. *See* McCarthy v. U.S., 807 F.2d 1306 (6th Cir. 1986).

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

9. *See id.*

10. *See id.*

11. *See id.*

12. *See* BASIC AGREEMENT BETWEEN THE AMERICAN LEAGUE OF PROFESSIONAL BASEBALL CLUBS AND THE NATIONAL LEAGUE OF PROFESSIONAL BASEBALL CLUBS AND MAJOR LEAGUE BASEBALL PLAYERS ASSOCIATION, 1997-2000 (2001), Article XX, B. Free Agency, at 54.

ation on the amount paid for the contract should be taken over the time remaining in the six year period.

Because of the depreciation deductions available with respect to players' contracts, in the past, the purchasers of sports franchises have tried to allocate most of the purchase price to player contracts and very little to the other assets acquired. Because the player contracts were the only significant item of depreciable property, it is easy to understand why they followed that procedure.

Three early cases dealt with the question of allocation when a sports franchise is purchased.[13] In the *Laird* and *First Northwest Industries* cases, both of which involved expansion franchises, the Government argued its mass asset theory and took the position that depreciation could not be allowed on player contracts because they were so intertwined with the other assets which were acquired that no amount logically could be allocated to the contracts.[14] Both courts ruled against the Government on that argument, and the Government did not make the mass asset argument in the later *Selig* case.[15] The Government conceded in that case that it is possible to make an allocation of cost among the assets acquired.[16] The contest then centered on the proper way to make such an allocation.[17] Before an allocation can be made, the question of valuation of the player contracts arises.[18]

In the *Selig* case, the court pointed out that there are three principal markets where player contracts are traded.[19] First, the player market, which is the most common, is where teams buy and sell contracts involving individual players and small groups of players. These transactions usually involve individual players who are traded either for cash or for another player or players. These transactions indicate the value of players between two existing teams negotiating with each other. The court found that the data produced by this market is not reliable in determining value of player contracts when an existing franchise is purchased (which includes players contracts) because, at the time of the *Selig* case,

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13. *See* Laird v. U.S., 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978); First Northwest Indus. of America, v. Commissioner, 70 T.C. 817 (1978), *rev'd on other grounds*, 649 F.2d 707 (9th Cir. 1981); *see* Selig v. U.S., 740 F. 2d 572 (7th Cir. 1984).

14. *See Laird*, 556 F.2d at 1224; *First Northwest Indus. of America*, 649 F.2d at 707.

15. *See id.*; *see also* Selig, 740 F.2d at 572.

16. *See Selig*, 740 F.2d at 579.

17. *See id* at 580.

18. For a discussion of the valuation of baseball players' contracts, *see* Steven J. Harwood, *Valuation of Player Contracts When Acquiring a Professional Baseball Team - An Analysis of Selig v. United States*, TAXES, Oct., 1983, at 670.

19. *See Selig*, 740 F.2d 572.

the waiver and reserve rules which were in effect in baseball, restricted the supply and the prices of players. The player market, therefore, was not a "free market."

The second type of market discussed in *Selig* was the free agent market. That market involves players who are first entering either the major or minor leagues and negotiating their contracts. An experienced player who is no longer under contract and who is a free agent would also fall into this category, but such free agency did not exist until subsequent to the time period involved in *Selig*. This market produces data which is useful in placing a value on players in the free market, but it is not particularly useful in trying to compare values in this market with values in the player market.

The third type of market discussed in *Selig* is the club market where entire teams are bought and sold at a particular time. That was the type of transaction involved in *Selig* because the Seattle Pilots were purchased, and the transaction included the franchise itself, the player contracts and a small amount of tangible assets. The Court found that this market was the closest to a free market because the purchase price is established through arm's length negotiations of the parties. This market was held to be the relevant market for purposes of valuing the player contracts.

The District Court relied on two of the four appraisals submitted by the plaintiff. In addition, the plaintiff offered other evidence to support its valuation of the player contracts—the cost of player development, the amount of insurance covering the players and the high prices being paid in the free agent market. There also was testimony to indicate that the actual value of the franchise itself was small because Milwaukee was a relatively small city where there was competition between several professional sports franchises for the support of the public. Accordingly, the value of the franchise was very small, and most ($10.2 million) of the consideration paid for the Pilots ($10.8 million) was held to have been paid for the player contracts. The District Court rejected the testimony of the Government's expert economist as well as the two appraisals submitted by the Government. The net result was that about 94% of the total consideration paid for the Pilots was allocated to the player contracts.[20] The player contracts were given a five year useful life by the Milwaukee Brewers, and that useful life was not contested by the Government.[21]

20. *See Selig*, 740 F.2d at 575.
21. *See id.*

The *Laird* case, which involved the acquisition of an expansion franchise, the Atlanta Falcons,[22] and *First Northwest Industries* which involved the acquisition of an expansion franchise, the Seattle Supersonics, demonstrate how the amount of the purchase price available for application to player contracts is affected by the acquisition of other intangible rights acquired in the purchase.[23] In both of those cases, a portion of the purchase price was allocated to national television rights which meant that a smaller amount of the purchase price was available to allocate to player contracts.[24] National television rights constitute a large part of the income of professional football and basketball teams. That is not one of the major income sources, however, for professional baseball teams.[25]

B. *Section 1056*

On the question of allocation of the purchase price of a sports franchise to player contracts, Congress got into the act in 1976 and enacted Section 1056 of the Internal Revenue Code.[26] That section attempts to place a lid on the amount that can be allocated to player contracts acquired in connection with the franchise of a sports enterprise.[27] It provides a presumption that not more than 50% of the consideration is allocable to player contracts, unless it is established to the satisfaction of the Government that an amount in excess of 50% is properly allocable to such contracts.[28] In addition, the section provides that the basis of a contract acquired by the transferee will be whatever the basis of the transferor was, increased by any gain recognized by the transferor on the transfer of the contract.[29] The provision relating to basis does not apply to exchanges that fall under section 1031 and to property acquired from a decedent where basis is determined under section 1014(a) of the Code.[30]

Section 1056 refers to an allocation to player contracts where a franchise is acquired in a sale or exchange, and in connection with that sale or exchange, there is the transfer of a contract relating to the serv-

22. *See Laird*, 556 F.2d at 1224.
23. *See First Northwest Indus. of America*, 649 F.2d at 707.
24. *See Laird*, 556 F.2d at 1224; *see also First Northwest Indus. of America*, 649 F.2d at 707.
25. *See* Remarks of Bug Selig, Commissioner of Baseball, THE SPORTING NEWS, Aug. 24, 1998.
26. *See* I.R.C. § 1056(d).
27. *See id.*
28. *See* I.R.C. § 1056(d).
29. *See* I.R.C. § 1056(a).
30. *See* I.R.C. § 1056(b).

ices of an athlete. Although a reading of section 1056 may make one wonder if it only applies to a sale of an existing franchise and its players, in a private letter ruling, the Service has expressed the view that the section also applies in the case of expansion franchises.[31] Although private letter rulings may not be used or cited as precedents,[32] they, nevertheless, provide some insight into the thinking of the Internal Revenue Service on a particular issue.

With respect to "any applicable asset acquisition,"[33] with respect to an acquisition of assets occurring after May 5, 1986,[34] Section 1060 requires that the transferee's basis in the assets, and the gain or loss of the transferor, should be determined by allocating the consideration paid for the assets among the assets in accord with section 338(b)(5). Section 1060 defines the term "any applicable asset acquisition" to mean any transfer of assets which constitutes a trade or business and with respect to which the transferee's basis is determined wholly by reference to the consideration paid for the assets.[35]

The purchase of an existing sports franchise comes within the provisions of Section 1060. The Regulations under section 1060 make it clear, however, that the amount of consideration allocable to an asset under that section

> is subject to any applicable limitations under the Code or general principles of tax law. For example, if the applicable asset acquisition is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of consideration the purchaser may allocate to a contract for the services of an athlete shall not exceed the limitation imposed by that section.[36]

Accordingly, the presumption that no more than 50% of the purchase price is allocable to player contracts should be determined first, and once that is done, the allocation would be made in accordance with the provisions of section 1060.[37]

In a recent case, the first litigated case to involve section 1056, the Tax Court held that section 1056 did not apply to the purchase of a more

31. *See* Priv. Ltr. Rul. 96-17-001 (April 26, 1996).
32. *See* I.R.C. § 6110(j)(3).
33. *See* I.R.C. § 1060(a), (c).
34. *See* Treas. Reg. § 1.1060-1T(a)(2).
35. *See* I.R.C. § 1060(c).
36. Treas. Reg. § 1.1060-1T(e)(2).
37. *See* I.R.C. § 1060. Section 1060 provides for allocation under the so-called residual allocation method. The allocation is made in a sequential manner among five classes of assets and is based on fair market value. *See id.*

than 50% interest in a partnership which owned a sports franchise.[38] That case is particularly interesting because it points out how different amortization rules relating to player contracts can apply depending upon whether the contracts themselves have been transferred directly to a purchaser, along with the other assets of a sports franchise, or an interest in the entity holding the player contracts and other assets have been transferred.

C. *Recapture of Depreciation—Section 1245*

When personal property is sold on which depreciation has been taken, the Internal Revenue Code requires that the depreciation be recaptured and treated as ordinary income.[39] A special provision, however, is provided for player contracts.[40] This provision is to the effect that where player contracts are transferred in connection with the sale or exchange of a sports franchise, the recomputed basis of the player contracts in the hands of the transferor is their adjusted basis, increased by the greater of unrecaptured depreciation with respect to player contracts acquired by the transferor when the franchise was acquired, or unrecaptured depreciation of the player contracts being transferred.[41]

The effect of this special rule is to include in the amount recaptured and treated as ordinary income, depreciation taken on player contracts where the player retired or died. Because the contracts of those individuals ordinarily would not be subject to recapture because no sale or exchange occurred, this special provision serves to make these amounts of depreciation subject to recapture anyway.[42]

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38. *See* P.D.B. Sports, Ltd. v. Commissioner, 109 T.C. 423 (1997). In that case, the taxpayer was successful in arguing that under the facts, the fair market value of the player contracts which were acquired when the partnership interest was acquired, could be amortized by using their fair market value in accordance with partnership basis provisions of the Code. On the other hand, the Government argued that Section 1056 applied to limit basis in the player contracts to their basis in the hands of the seller, plus any gain recognized by the seller on the sale. *See id.*

39. *See* I.R.C. § 1245(a)(1). Under this section, the amount recaptured and treated as ordinary income is the amount by which the lower of the recomputed basis or the sale price (or fair market value in the case of dispositions other than sales, exchanges or involuntary conversions), exceeds the adjusted basis of the property. The term "recomputed basis" refers to the adjusted basis of the property recomputed by adding to it, the adjustments for depreciation or amortization which have been allowed or were allowable. *See* § 1245(a)(2)(A).

40. *See* I.R.C. § 1245(a)(4).

41. *See* I.R.C. § 1245(a)(4)(A).

42. *See id.*

D. *Determining Basis of Player Contracts*

In the case of the purchase of a player contract, the cost of the contract which may be depreciated is the purchase price.[43] In addition, any signing bonus provided to a player also may be depreciated.[44] Assets are depreciable from the date on which they are placed in service, and in the case of signing bonuses, the placed in service date is the date on which all parties have signed the contract.[45]

The MACRS and ACRS methods of determining depreciation are not applicable to player contracts because they are intangible assets.[46] The proper method for depreciating player contracts is the straight line method, if the taxpayer is unable to justify the use of some other method.[47] The Service has referred to football players' contracts as being intangible property under section 167(a) of the Code, for depreciation purposes.[48]

The Regulations provide that in the case of intangibles, depreciation may be taken only on assets "to be of use in the business or in the production of income for only a limited period."[49] At one time, when the reserve clause was in effect in baseball, for example, a logical argument could have been made that a player's contract had no definite life because the team could retain the player under the reserve clause when his contract ended. In the present era of free agency, however, it seems less likely that such an argument would be successful. It is still possible for the Government to argue that a team's history and experience shows that players' contracts are almost always renegotiated when the contract expires, and, therefore, in reality, they have no fixed and determinable life. But when a player is a free agent, he is free to seek employment with another team when his contract ends, and it would seem to be difficult to contend that such a contract was renewable. One could make that argument about any contract. In any event, it is a good idea to have in the contract a very clear provision indicating that when the contract terminates, the player is free to leave, as he pleases, and the team has absolutely no power to retain him.

With respect to the possibility of depreciating non-monetary bonuses such as performance and attendance bonuses, etc., it has been suggested

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43. *See* I.R.C. § 1012.
44. *See* Rev. Rul. 67-379, 1967-2 C.B. 727.
45. *See* Tech. Adv. Mem. 93-0-002, 1992 WL 408935 (I.R.S.), Jan. 5, 1993.
46. *See* I.R.C. § 168(a).
47. *See* Treas. Reg. § 1.167(b)-1(a).
48. *See* Rev. Rul. 71-137, 1971-1 C.B. 104.
49. Treas. Reg. § 1.167(a)-3.

that these bonuses might possibly be the source of additional depreciation deductions.[50] It also might be noted that if player contracts should be acquired in a non-taxable exchange, basis of the contracts received would be the same as the basis of the contracts transferred.[51]

E. Sales of Player Contracts

Where player contracts are sold, the part of the gain over and above the recaptured depreciation, can receive capital gains treatment.[52] Under Section 1231 of the Code, if the gains resulting from the sale or exchange of depreciable property used in a trade or business exceed the losses from the sale of such property, both gains and losses are treated as long-term capital gains and losses.[53]

F. Other Dispositions of Player Contracts

It is possible to exchange a player contract for another player contract and come within the non-taxable provisions of section 1031 of the Code. As indicated previously, under section 1031, the basis of the contract acquired would be the same as the basis of the contract transferred in exchange for it.[54] If the player contract that is acquired has a shorter remaining life than the contract for which it is exchanged, the team acquiring the contract with the shorter life will be able to depreciate its basis over a shorter time period than would have been possible before the exchange, which, in effect, would provide a form of accelerated depreciation.[55] There may be some question, however, of qualifying contracts of different remaining terms, as like-kind property.[56]

III. Stadiums

In recent years, there has been considerable movement of professional teams—particularly in football—from one place to another.[57] Local governments are willing to offer such outstanding financial packages

50. *See* Philip J. Harmelink & David W. Vignes, *Tax Aspects of Baseball Player Contracts and Planning Opportunities*, Taxes, Aug. 1981, at 535.

51. *See* I.R.C. § 1031(d).

52. *See* I.R.C. § 1231.

53. *See* I.R.C. § 1231(a)(1).

54. *See* I.R.C. § 1031(d).

55. *See* Harmelink & Vignes, *supra* note 50, at 538.

56. It also has been suggested that the involuntary conversion provisions of section 1033 might be applicable where a player dies and insurance proceeds are paid pursuant to his death. *See* Harmelink & Vignes, *supra* note 50, at 543.

57. In 1996, the Cleveland Browns moved to Baltimore and became known as the Ravens. The old Baltimore Colts departed Baltimore in 1984 to become known as the Indianapolis

to sports teams that the teams are interested in greatly increasing their profits as well as the value of their franchises.[58] It seems that cities and states are willing to go to almost any length to attract these professional sports teams because having such a team has become a matter of great local pride. Although some have contended that having a professional team in their location serves to enhance their economies, there is no evidence to substantiate that claim.[59]

The primary attraction to a new locaation for a sports team owner is the deal surrounding the new stadium. The stadium is the key because it is the source of very large revenues that do not have to be shared with other teams in the league. In the NFL, teams do share gate receipts on a 60-40 basis with the home team getting the larger share. In the NBA, the home team gets 100% of the gate receipts, and in MLB, National League home teams get 90% of the gate receipts and in the American League, home teams receive 80%.

But in the NFL, the revenue that is generated by the most expensive seats is not shared. It is the skyboxes, the club seats and the personal seat licenses which can provide very significant income for team owners. Some companies are willing to pay $350,000.00 a year for a skybox at a stadium.[60] The income from these fancy seats can amount to half of the profits that a team makes.[61] The 208 "executive suites" available to the Washington Redskins were expected to produce $15 million in 1998 which would be about one-third of the team's estimated profits for the year.[62] Even the Baltimore Ravens, a relatively new team, has suites which produce about $12 million per year.[63] Some of these suites are rented for a ten year time period.[64] It is expected that the total annual income form all luxury boxes soon will surpass $200 million. The teams which occupy older stadiums which have none of the fancy new seating arrangements often find themselves looking toward other cities which

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Colts. In 1995, the Los Angeles Rams moved to St. Louis. In 1987, the St. Louis Cardinals' franchise was transferred to Phoenix.

58. *Antitrust Implications of Sports Franchise Relocation: Hearings on Professional Sports Franchise Relocation - Antitrust Implications Before the House Comm. on the Judiciary*, 104th Cong. 149-154, 1996 WL 48006, Feb. 6, 1996 (testimony of Professor Andrew Zimbalist, Smith College).

59. *See* Adam Safir, Note, *If You Build It, They Will Come: The Politics of Financing Sports Stadium Construction*, 13 J.L. & POL. 937, 952 (1997).

60. *See* Sam Walker, *The Best and Worst Stadium Boxes*, WALL ST. J., Oct. 30, 1998, at W1.

61. *See Suite Dreams: Rating the Boxes*, WALL ST. J., Oct. 30, 1998, at W6.

62. *See id.*

63. *See id.*

64. *See id.*

would be agreeable to building a new stadium with all of the lucrative seating configurations. Some look for a new stadium in their present area. The Chicago Bears have been complaining about their stadium for years and threatening to move either to the suburbs or out of the state. The Detroit Lions do not earn any income from suite sales, and the suites in the Silverdome are unattractive and almost twenty go unrented each game.[65] But the Lions believe that things will greatly improve when they move into a new downtown stadium.

The owners contend that they need more income in order to cover the increasing sums expended on player contracts. In recent years, particularly in football, we have seen teams move from city to city with part of the deal involving a new stadium with plenty of skyboxes and luxury seats.

In 1996, the Committee on The Judiciary of the United States Senate held hearings on "Challenges Facing the Future of the [Professional Sports] Industry."[66] Interesting views were expressed by congressmen and others concerning the way to slow down the movement of teams from one city to another. Senator Strom Thurmond of North Carolina expressed the view that a requirement to share stadium revenue would result in less incentive for owners to move.[67] The answer which Senator Diane Feinstein of California suggested was that an antitrust exemption should be granted to professional football similar to the exemption of professional baseball.[68] Paul Tagliabue, Commissioner of the NFL also took the position that an antitrust exemption with regard to franchise relocation would help to solve the problem. One of the witnesses before the committee, Andrew Zimbalist, a professor of economics at Smith College, testified that the enormous sums of money generated by all of the new stadiums ends up being divided between the players in the form of higher salaries and profits of the owners.[69] He did not believe that the suggested antitrust exemption for football would solve the problem of relocation and might even make it worse.[70] In his view, the heart of the problem is the NFL's monopoly position, and the only way of dealing

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65. *See id.*

66. *See Senate Judiciary Committee Hearing on Professional Sports: The Challenges Facing the Future of the Industry*, S. Hrg. 104-59 (1996), 1996 WL 26248 (hereinafter Industry Hearing).

67. *See id.* *3.

68. *See id.* *9. Senator Feinstein referred to significant moves of the decade-and-a-half prior to 1996. *See id.*

69. *See id.* *53.

70. *See id.* *54.

with it is either to create more competition or regulate the problem.[71] One possibility would be to break up the leagues into two or more entities. Competition for the leading cities would tend to equalize supply and demand. He also suggested that Congress could enact legislation that would give cities a right of first refusal, so that before a team could leave a city, the city would be given the right to buy the team within a certain time period.[72] The city could buy the team either publicly or by naming private investors.[73]

Since those hearings took place, the movement of franchises and the building of stadiums has continued. The prices keep going up. The Washington Redskins were reported to have sold for $800 million, which includes the stadium. The Cleveland Browns recently acquired a new franchise for $530 million. Rupert Murdoch is reported to have paid $350 million for the Los Angeles Dodgers, a deal which included the stadium as well as other facilities in other places.

The new stadium of the Baltimore Ravens cost $200 million and was built with public funds.[74] The deal secured by the Ravens provides that the team gets to play in the stadium without paying any rent, and the team is not required to pay any of the debt service. The agreement provides that the team must pay for the operating and maintenance costs of the stadium, about $3-4 million, and is responsible for a 10% city and state admissions tax. The Ravens' share of the sale proceeds of Personal Seat Licenses is $68.4 million, and the team gets to keep the revenue produced by luxury suites, premium seats, concessions and advertising within the stadium.[75] The arrangement also provides that the Ravens will receive 50% of all revenue produced at the stadium from events other than football games taking place there.[76]

Almost half of the cost of building the $223 million stadium, or $91 million, came from tax-free bonds. These bonds will be serviced over a period of thirty years with lottery funds.[77]

The reason why local governments are successful in getting people to buy their bonds is because these bonds produce tax free interest by virtue of section 103 of the Internal Revenue Code. That section provides

71. *See Industry Hearing, supra* note 66, *54.
72. *See id.*
73. *See id.* *55.
74. *See* Jonathan R. Laing, *Foul Play?*, BARRON'S, Aug. 19, 1996, at 23 & 25.
75. *See id.*
76. *See id.*
77. *See* Erik Brady, *Some Legislators Say Baltimore Money Misspent,* USA TODAY, Sep. 6, 1996, at C19.

that "[e]xcept as provided in subsection (b), gross income does not include interest on any State or local bond."[78] A very significant exception contained in subsection (b) provides that any private activity bond which is not a qualified bond under section 141 of the Code, will not qualify for the tax free interest benefit. The policy reason behind section 103 is to provide a tax benefit for members of the public who lend funds to a state or local government which funds are to be used for public as opposed to private activities. Tax-exempt bonds permit the states and local governments to pay out less in the form of interest because the lower interest rate they pay is not subject to tax in the hands of the recipients.

On the other hand, if the proceeds of bond issues are to be used for private activities, no tax benefit is to be available. When section 103 of the Code is applicable and the interest paid on a bond is excludable from income, although there is a benefit to the bondholders, in effect, the rest of the taxpayers in the country bear the burden of paying the tax liability that is not paid by the bondholders.

Ordinarily, private activity bonds do not fall under the category of tax-exempt bonds, unless they are "qualified" private activity bonds.[79] Qualified bonds[80] are private activity bonds of various types, none of which includes stadiums or other athletic facilities.[81] A volume cap applies to such bonds so that there is a limit on how much can be obtained with such bonds after which the interest on them would be subject to income tax.

A bond will be classified as a private activity bond and, therefore, not be tax-exempt, if, in general, the proceeds are used for private rather than public purposes. In defining which bonds constitute private activity bonds, the Internal Revenue Code indicates that bonds will be classified as private activity bonds if any bond issued as part of an issue meets the "private business use test" and the "private security or payment test," or meets the private loan financing test.[82]

A stadium which is used more than 10% of the time for athletic purposes by a professional football team will satisfy the first plank of the test. The second plank of the test is known as the "private security or payment test." That test will be satisfied if payment of the principal or

78. *See* I.R.C. § 103.
79. *See* I.R.C. § 103(b)(1).
80. *See* I.R.C. § 141(e).
81. *See* I.R.C. § 147(e). A private activity bond cannot be a "qualified bond" if it is issued as part of an issue and any part of the proceeds of the issue are to be used for a skybox or other private luxury box (and for other purposes as well). *See id.*
82. *See* I.R.C. § 141(a).

the interest on more than 10% of the proceeds of such issue is directly or indirectly secured by any interest used or to be used for a private business use, or the payments are secured by the payments in respect of such property.[83] The private security test also will be met if the payment on the principal or interest on more than 10% of the bonds is to be derived from payments in respect of property, or borrowed money, to be used for a private business use.[84]

Both the private use test and either the private security or payment test must be met if the bonds are to be private activity bonds. It would be very difficult to avoid the private business use test in the case of a stadium because, ordinarily, more than 10% of the use of the stadium will be for private purposes. The states and local governments sidestep the private activity bond rule by making certain that not more than 10% of the payments of principal and interest on the securities are paid with funds produced by activities related to the stadium. For example, when the Cleveland Browns became the Baltimore Ravens, and the new arrangement included a new stadium for use by the Ravens, the arrangement was structured so that the payments of principal and interest would be made out of a sports lottery fund.[85]

Senator Daniel Patrick Moynihan of New York introduced a bill, S434 which, as a practical matter, would have done away with the financing of stadiums with tax-exempt bonds. The bill did permit the lesser of 5% of the proceeds of a bond issue or $5 million to avoid being treated as private activity bonds. That bill was introduced to the Senate Finance Committee on March 12, 1997, but never came out of the Committee. One can only speculate as to whether it will be reintroduced, and if it is, what its fate will be.

On the subject of stadiums and particularly skyboxes and other luxury seats, it already has been noted that owners of teams are keenly interested in the funds produced from these sources. It is interesting to note that although these skyboxes are often leased to corporations which use them for entertainment customers and business associates, the Internal Revenue Code limits the deductions available for lease payments made on these accommodations. If a skybox or private luxury box is

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83. *See* I.R.C. § 141(b).

84. *See* I.R.C. § 141(b)(2)(B).

85. *See* Dennis Zimmerman, *CRS Report For Congress: Tax-Exempt Bonds and the Economics of Professional Sports Stadiums*, May 29, 1996, *reprinted in CRS Reports on Tax-Exempt Bonds Used to Finance Sports Stadiums*, TAX NOTES TODAY (May 30, 1996); *see also* Andrew Gasper, *Senator Moynihan's Field of Dreams: If You Build It, They Will Come... But Not At The Federal Taxpayers' Expense*, 17 VA. L. REV. 341 (1997).

leased for more than one event, the deduction may not exceed "the sum of the face value of non-luxury box seat tickets for the seats in such box covered by the lease."[86] The fact that the tax deduction available to the companies leasing these skyboxes is severely limited, does not seem to deter them from leasing them. Companies often pay well over $100,000.00 per year to rent skyboxes. The fact that they are willing to pay such sums without getting a tax deduction for most of the amount paid underlines the fact that major sporting events have achieved such a degree of significance and importance that companies believe that the goodwill achieved by letting customers use these seating arrangements far exceeds the lack of tax benefit available.

It might also be noted that the tax deduction available for any ticket to a sports event cannot exceed the face value of such ticket.[87]

IV. THE PLAYERS

Looking toward the 21st century, the players will have the same tax concerns they have always had. They will continue to feel that they pay too much in taxes, and if salaries continue to escalate, they may become even more tax conscious than they have been in the past.

The primary means by which players have sought to ease their tax burden is through deferment. Those athletes who play for teams in one of the major leagues are able to participate in the qualified pension plan offered by their team. That is an excellent arrangement which permits them to delay the receipt of taxable income. The qualified plan also permits the income that is placed in trust for the athletes to earn income on a tax free basis until such time as it is distributed.[88]

Individual athletes, who are not members of a team, are also able to have qualified plans, which are usually referred to as either Keogh plans or HR-10 plans. At one time, the benefits available to corporate employ-

86. *See* I.R.C. § 274(l)(2).

87. *See* I.R.C. § 274(l)(1)(B). An exception is made for tickets to a sports event organized primarily to benefit a charitable organization. *See id.*

88. Qualified plans can be defined benefit plans, which are based on how much a participant in the plan will receive on retirement and require the employer to make contributions on a regular basis to provide for the amounts which will be paid when the employee retires. The annual benefit available to a participant on retirement, beginning in 1998, may not exceed the lesser of $130,000.00 or 100% of the participant's average compensation for his high 3 years. *See* I.R.C. § 415(b)(1); (Notice 97-58). Qualified plans can also be defined contribution plans. This type of plan focuses on the amount that the employer can contribute to the plan. The annual addition to such plans cannot exceed the lesser of $30,000.00 or 25% of the participant's compensation. *See* I.R.C. § 415(c). Cost of living adjustments can adjust upward the figures shown for each of the above types of plans. *See* I.R.C. § 415(d).

ees under their plans were superior to those available to individuals, but beginning with years after 1983, the benefits available to individuals were made to be substantially the same as those of corporate employees. Accordingly, individual athletes can set up their own retirement plan which will be similar to the plans of team players.

A team player covered by a qualified plan, may not set up his own qualified retirement plan. If an athlete would prefer to have his own plan rather than be part of the team's plan, he might think in terms of creating his own corporation and being an employee of that corporation. His corporation might then "loan-out" the athlete's services to the professional team for which he will perform.[89] The NBA collective bargaining agreement does not permit teams to contract with corporations which loan out an athlete's services to them.[90] Apparently, only some baseball teams will contract with these corporations, and such contracts have seldom been entered into in the NFL.[91] The NHL does permit this arrangement.[92]

It does not appear that these loan-out corporations are widely used by athletes, and there have been only three decided cases involving them.[93] It would seem that only in the NHL should players give any serious thought to this arrangement. Even there, the cost of incorporating and the annual expenses which operating such a corporation will require for attorneys and accountants, make these arrangements troublesome to arrange as a practical matter. In addition, as indicated by the Government's position in the three litigated cases referred to, the Service does not look with favor on these corporations.

It should be noted, however, that they do have certain other advantages, unrelated to qualified pension plans, for individual athletes. For example, medical expenses paid by the corporation for its athlete-employee, would be fully deductible by the corporation and not subject to the rule applicable to individuals which allows deductions for medical expenses only if they exceed 7.5% of adjusted gross income.[94] Group

89. Although most of the professional teams have excellent qualified retirement plans, the plans of the National Hockey League are not as beneficial as those of the other leagues, and for that reason, a player might think about creating his own corporation and establishing a qualified plan for that corporation.

90. *See* Martin J. Greenberg, Sports Law Practice § 9.26(b) (1993).

91. *See id.*

92. *See id.*

93. *See* Johnson v. Commissioner, 78 T.C. 882, *aff'd without opinion*, 734 F.2d 20 (9th Cir. 1984), *cert. denied* 469 U.S. 857 (1984); Sargent v. Commissioner, 93 T.C. 572 (1989), *rev'd* 929 F.2d 1252 (8th Cir. 1991); Leavell v. Commissioner, 104 T.C. 140 (1995).

94. *See* I.R.C. § 213(a).

term life insurance premiums, health and disability insurance premiums and accident insurance premiums also would be deductible by the corporation. Certain expenses for meals and lodging incurred by the corporation would be deductible by the corporation and excludable from income by the employee-athlete, if they qualify as meals and lodging furnished on the business premises of the employer for the convenience of the employer.[95] An individual could not benefit from those expenditures if he were not incorporated.

Loan-out corporations, which, in reality, are personal service corporations, also provide the possibility of having the corporation be on a fiscal year (with its year ending on January 31, for example) basis, while the employee-athlete is on a calendar year basis. That can permit a delay in reporting the income by the individual. Ordinarily, personal service corporations must use the calendar method for computing taxable income,[96] but a taxpayer will not be deemed to be a personal service corporation if his principal activity is the performance of services as an athlete.[97] Only the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting will be treated as the performance of personal services for purposes of determining a taxpayers's principal activity.[98]

A tax advantage could result in some situations where, for example, the loan-out corporation uses a fiscal year ending on January 31 of the year and the individual employee-athlete uses the calendar year basis of reporting. The salary, and perhaps other income, received by the corporation during year one from the loan-out of the employee-athlete's services, could all be paid at the very end of the corporation's year, in January of year two. That would mean that the individual employee-athlete would not have income until year two instead of year one. If the employee happened to be in a lower tax bracket in year two, which probably would be unusual, that would be of benefit to him.

Another tax benefit that can result from a loan-out corporation relates to the time value of money. If the athlete were to receive a salary as a direct employee of a team, it would be subject to withholding tax as it is paid. But if the athlete is employed by a loan-out corporation which loans his services to the team and the team pays the loan-out corporation under the loan-out contract, no withholding tax would be withheld until

95. *See* I.R.C. § 119.
96. *See* I.R.C. § 441(i).
97. *See* Treas. Reg. 1.441-4T(d), (e)(1), (2).
98. *See id.*

the loan-out corporation pays the athlete, and that could be at the end of the loan-out's year. All of the tax would be withheld at the end of the loan-out's year rather than during the entire year. Accordingly, more money would be available to invest during the year, and a time value of money benefit would result to the athlete.[99]

Aside from qualified plans, there are non-qualified arrangements that are available to athletes that can be beneficial. One of the major problems in this area is the financial security of the team that contracts to make payments in the future to the athlete. The case of the U.S. Football League demonstrates that teams may not be around to honor their long-term commitments.

One of the favorite non-qualified plans that athletes have used is the so-called Rabbi Trust.[100] That is an irrevocable grantor trust under which income will not be taxed to the athlete until it is actually paid. The assets in these trusts remain subject to the claims of creditors, and the employer is taxed on the income produced by them under the grantor trust rules.[101]

Looking into the 21st century, we might expect to see some new tax provisions designed to alleviate the burden on athletes who receive such large incomes over a relatively small number of years and who pay taxes at the highest rate for those years. We might see proposals that would permit taxpayers who have contracted to earn extremely large amounts over a relatively few years to be taxed as if they earned these large amounts over perhaps 30 years, which would put them on a par with corporate executives whose earning careers span a much longer period of time. A new provision might provide for an athlete, at his option, to either pay tax on the income when he earns it, or pay the income into a trust fund, get a deduction for the payment and be taxable only when the funds are withdrawn after a particular age.

The other area where activity probably will occur in the 21st century is in the state and local taxation field. In recent years, when athletes and their teams have traveled to away games, the states where the games are

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99. *See* Mary LaFrance, *The Separate Tax Status of Loan-out Corporations*, 48 VAND. L. REV. 879 (1995); Bret M. Kanis, *The Utility of Personal Service Corporations for Athletes*, 22 PEPP. L. REV. 629 (1995); Bruce M. Stiglitz & Thomas N. Lawson, *Tax Planning for Entertainers, Artists, and Athletes*, C515 ALI-ABA 247 (1990).

100. Rabbi trusts are discussed in Bruce M. Bird & Mark A. Segal, *Nonqualified (Rabbi) Trusts Remain A Sound Choice To Defer Compensation*, 16 TAX'N FOR LAW. 354 (1988).

101. For a discussion of other non-qualified plans, *see* Richard D. Landsberg, *Entertainment Retirement: A Primer On Nonqualified Deferred Compensation*, 14 WTR ENT. & SPORTS LAW. 7 (1997).

played have taxed the athletes on income earned as a result of playing in a game there. In recent years, cities, looking for new sources of revenue, also have begun to tax visiting athletes participating in events in their cities.[102] The taxation by cities and states of visiting athletes has placed a tremendous burden on the athletes in connection with filing returns and keeping records. Although ordinarily, they, personally, do not prepare all of these returns, they must pay an accountant or lawyer to handle these matters. There is enormous complexity associated with these requirements. It may be that federal legislation could be enacted to simplify this problem. A federal statute might provide that states cannot tax a nonresident on income earned in that state from personal services unless the individual is present there with some degree of permanence or continuity. Playing in one or two games a year in a particular city and state would not seem to meet that test.

V. Conclusion

As we enter the 21st Century, the key areas where taxation will be most important will be in connection with franchise movement, stadium building and players' income. There probably will be legislation affecting the relocation of franchises which will affect the tax advantages available to owners. It is likely that legislation will be enacted in the area of tax-free bonds, which could affect the rush to build new stadiums with lucrative skyboxes and other luxury seating arrangements. Players will seek relief from the burden of having all of their large sums of income bunched into a few taxable years, and a simpler system probably will be sought with respect to the nonresident taxation of athletes by states and cities.

102. For a discussion of the taxation of nonresident athletes, *see* William H. Baker, *The Tax Significance of Place of Residence For Professional Athletes*, 1 Marq. Sports L. J. 1 (1990); Jeffrey L. Krasney, *State Income Taxation of Nonresident Professional Athletes*, 2 Sports Law. J. 127 (1995); Richard E. Green, *The Taxing Profession of Major League Baseball: A Comparative Analysis of Nonresident Taxation*, 5 Sports Law. J. 273 (1998).