The Effect of the 1976 Tax Reform Act on the Ownership of Professional Sports Franchises

Charles Dickenson

Zook Sutton

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The Effect of the 1976 Tax Reform Act on the Ownership of Professional Sports Franchises

By Charles Dickenson and Zook Sutton

Members, third year class.

Introduction

During the past few years, professional sports franchise owners have been dealt serious blows in the judicial arena. Baseball’s ninety-two year old reserve clause, football’s “Rozelle Rule” and the college draft have been either swept aside or significantly altered in well-publicized decisions. More recently, a less publicized, but no less effective attack has been mounted against sports franchise owners on another front. The Internal Revenue Service has become increasingly intolerant of the tax savings devices that once made team ownership so attractive. With the Congressional enactment of the Tax Reform Act of 1976, it has become apparent that the federal government wants to change the rules of the game.

This note will examine, from a historical perspective, the tax treatment of professional sports franchises with special focus on the impact of the recently-enacted Tax Reform Act of 1976. To introduce the concepts with which this note will deal, Part I will describe the “tax sheltering” aspects of team ownership as they existed in the recent past. Part II will trace the pre-TRA ‘76 development of depreciation.

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1. “Franchise” is defined as: “A special privilege conferred by government on individual or corporation, and which does not belong to citizens of countries generally of common right,” Black’s Law Dictionary 786 (4th ed. 1951). With regard to professional sports, the government granting the privilege will be the governing league body composed of representatives of each member franchise.

2. In re Arbitration of Messersmith, Grievance No. 75-27, Decision No. 29 (1975). A companion grievance heard and decided at the same time was that of David McNally (Grievance No. 75-25). See also Sobel, The Emancipation of Professional Athletes, 3 W. St. U.L. Rev. 9 (1976).


benefits available to franchise purchasers, and the correlative recapture of depreciation imposed upon franchise sellers. Inextricably related to these depreciation benefits and recapture burdens are the different tax strategies of the buyer and seller with regard to the allocation of purchase price to franchise assets. The application of these strategies and attempts by the IRS to limit the buyer's allocation practices will be discussed.

The note will proceed (in Part II) to an examination of section 1056 and subsection 1245(a)(4) under the Tax Reform Act. The addition of section 1056 curtails the use of a tax savings device previously available to the franchise purchaser by restricting the depreciation of player contracts. The amendment of section 1245 to add subsection 1245(a)(4) to the Internal Revenue Code is an attempt to limit the conversion of ordinary income into capital gain by redefining the recomputed basis element involved in the recapture of ordinary income.

I. THE PROFESSIONAL SPORTS FRANCHISE AS A TAX SHELTERING DEVICE

Prior to the TRA '76, investment in sports franchises offered the purchaser two significant tax sheltering advantages: 1) the deferral of taxable income, and 2) the conversion of ordinary income to capital gain. This section will introduce the theory and relationship of these two concepts as they existed before the Tax Reform Act of 1976.

Tax deferral was accomplished by deducting the cost of the depreciable assets acquired with the franchise from ordinary income pursuant to section 167 of the Internal Revenue Code. As will be fully discussed, player contracts and sports and office equipment are depreciable property. Typically the greatest part of the total purchase price of a franchise was allocated to these contracts. The resulting depreciation deductions taken on these player contracts were considerable. These deductions, when set-off against ordinary income, often resulted in a profitable franchise incurring paper losses for taxation purposes.

6. I.R.C. § 167(a) provides:
   (a) 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.

7. See text accompanying notes 17 and 20 infra.


By organizing as a Subchapter S corporation, or as a partnership, the owners are able to use these franchise losses to offset their individual income to the extent of their adjusted basis in the franchise. An example will help illustrate the tax advantages of depreciation to franchise owners.

Assume that in 1970 Mr. Bucks and four partners purchased an established professional sports franchise for $10 million. Of this amount, $1 million was in cash and $9 million was in the form of long term notes. For this purchase price the partners were entitled to the franchise rights, sports and office equipment, and player contracts. Assume further that for depreciation purposes the partnership allocated 90% of the purchase price to the depreciable player contracts, 2% to the equipment, and 8% to the franchise rights. A useful life of five years was adopted for the purpose of depreciating the player contracts and equipment. The partnership's income and expenses for the 1970 taxable year appear below.

<table>
<thead>
<tr>
<th>Income:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gate receipts</td>
<td>$3,055,000</td>
</tr>
<tr>
<td>Television and radio income</td>
<td>1,135,000</td>
</tr>
<tr>
<td>Parking and concessions</td>
<td>250,000</td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td><strong>4,440,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Player salaries</td>
<td>1,900,000</td>
</tr>
<tr>
<td>Coaches and staff</td>
<td>150,000</td>
</tr>
<tr>
<td>Interest</td>
<td>900,000</td>
</tr>
<tr>
<td>Lease rental</td>
<td>150,000</td>
</tr>
<tr>
<td>Training</td>
<td>125,000</td>
</tr>
<tr>
<td>Administration and overhead</td>
<td>875,000</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>4,100,000</strong></td>
</tr>
</tbody>
</table>

| Net income before depreciation              | 340,000  |

<table>
<thead>
<tr>
<th>Depreciation:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Player contracts</td>
<td>1,800,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total depreciation</strong></td>
<td><strong>1,840,000</strong></td>
</tr>
</tbody>
</table>

| Net loss for year                           | **1,500,000** |

10. See I.R.C. § 1374 (subchapter S corporations) and § 702 (partnerships).
As a result of $9 million having been allocated to the player contracts and depreciated over a five-year useful life, the franchise was entitled to a first-year player contract deduction of $1.8 million. Prior to the depreciation expenses, the franchise had a net income of $340,000. Due to the substantial depreciation deductions, the franchise shows a $1.5 million net loss for the year. However, each of the four partners received $68,000 from the franchise’s cash flow and was entitled to a $300,000 ordinary income loss based on the franchise’s net loss. Each partner was entitled to use this loss to offset other ordinary income.

However, the $300,000 in ordinary income sheltered in 1970 might not be avoided indefinitely, but might simply be deferred to a later date should the player contracts be sold or transferred in a gain transaction. This is because player contracts are subject to section 1245 recapture of depreciation. Section 1245 provides that, upon disposition of certain property, any gain to the extent of past depreciation deductions will be treated as ordinary income.11 When one player contract or the entire franchise is sold, gain attributable to the depreciable assets will be taxed at ordinary income rates. Therefore, the ordinary income tax liability deferred in 1970 would eventually be paid as the contracts depreciated are sold individually or in toto with the franchise.

The conversion of this deferred ordinary income into capital gain was the second tax benefit of sports franchise investment. Basically, this tax sheltering method was achieved by replacing all of the originally purchased player contracts, which were subject to large amounts of recapture liability, with new player contracts that were either non-depreciable or subject to very little recapture. This conversion was achieved in three steps. The first step involved fully depreciating and then disposing of contracts originally acquired. In our example, after five years, the $9 million allocated to the purchase of player contracts was fully depreciated. These contracts would be subject to section 1245 recapture of depreciation when sold. However, if the franchise had retired, abandoned, or sold any of the original players at a loss, it could avoid recapture.12 This is because section 1245 recaptures past depreciation deductions only to the extent of gain.13 Since the gain recognized in the retirement, abandonment or sale-at-a-loss of a player contract would be zero, the franchise would not be subject to recapture upon these dispositions.

11. See I.R.C. § 1245(a)(1), as amended by 1976 TRA.
12. See text accompanying notes 134-35 infra.
13. See I.R.C. § 1245(a)(1), as amended by 1976 TRA.
The second step was to purchase new player contracts. With the attrition of the players originally purchased with the franchise, the franchise would be restocked with players whose contracts were either non-depreciable or had a very low depreciable cost basis. For the purposes of this discussion assume that the new contracts resulted in $100,000 in depreciation deductions being taken against ordinary income.

Because the contracts which were subject to a large amount of recapture were previously disposed of, the franchise upon resale had the $9 million original deduction effectively insulated from recapture. Instead, section 1245 recaptured ordinary income on the depreciation taken on contracts currently involved in the transfer, which was a mere $100,000.

The final step in the conversion of ordinary income to capital gain was accomplished through the use of section 1231. As we have seen, only $100,000 in ordinary income deductions was subject to recapture. The remainder of the sale price would then have been taxed at capital gains rates according to section 1231. Section 1231 provides that, if in the year of sale, recognized gains from the sale of certain property used intrade or business, exceed such losses, the gain will be considered capital gain." The Commissioner has determined that player contracts are section 1231 assets.

Therefore, by depreciating a large percentage of the franchise acquisition cost in the form of player contracts over a short period, disposing of the contracts, and replacing them with non-depreciable contracts the seller avoided ordinary income tax liability. Through the operation of section 1231, the seller received capital gains treatment on the amount received from the sale of player contracts. Thus, the conversion of ordinary income to capital gain was achieved.

II. HISTORICAL DEVELOPMENT OF DEPRECIATION ADVANTAGES AVAILABLE TO SPORTS FRANCHISE PURCHASERS

A. Depreciability of Player Contracts

The primary tax incentive in recent years for investment in a sports franchise has been the benefit of player contracts depreciation. Player

14. See I.R.C. § 1231(a)(1)-(2), as amended by 1976 TRA (amendments not relevant to this discussion).

contracts represent only a portion of the purchase price of a given sports franchise. Upon acquisition, the new owner also receives team assets which fall into the following categories: (1) a league franchise and the rights attendant thereto, (2) operating assets (office and sports equipment), and (3) good-will.\textsuperscript{16}

The operating assets, as tangible business property with a determinable useful life, qualify for a depreciation deduction under section 167.\textsuperscript{17} The franchise itself and the player contracts and good-will acquired therewith, however, are intangibles. In order for an intangible to qualify for depreciation, it must be of use “for only a limited period, the length of which can be estimated with reasonable accuracy.”\textsuperscript{18} Because a league franchise is not granted for a limited period, and its useful life cannot be ascertained with reasonable accuracy, it is non-depreciable.\textsuperscript{19} This is also true of good-will, which is specifically disallowed as a depreciation deduction.\textsuperscript{20} Contracts, like the franchise and good-will, are intangibles. However, unlike these two, player contracts are considered depreciable assets.\textsuperscript{21}

Player contracts have not always been treated by the Internal Revenue Service as within section 167. In 1954 the Commissioner ruled that the “bulk” purchase of contracts (that is, a purchase involving the acquisition of an entire team) was to be treated as the purchase of one indivisible asset.\textsuperscript{22} The ruling required that the entire group of contracts be depreciated over the average useful life of the players.\textsuperscript{23} This

\begin{itemize}
  \item \textsuperscript{16}Goodwill and operating assets would represent a portion of the purchase price only upon the acquisition of an established franchise, as opposed to a league grant of an expansion franchise.
  \item \textsuperscript{17}See I.R.C. § 167(a). Since the purchase of an ongoing franchise will almost invariably entail the acquisition of used sports and office equipment, only the straight line method of depreciation is allowed. One prerequisite to the use of the accelerated methods of I.R.C. § 167(b)(2)-(4) is that property be new. See I.R.C. § 167(c)(2).
  \item \textsuperscript{18}Treas. Reg. § 1.167(a)-3, T.D. 6452, 26 C.F.R. § 1.167(a)-3; See Houston Chronicle Publ. Co. v. United States, 481 F.2d 1240, 1245 (5th Cir. 1973); Polhen v. Commissioner, 165 F.2d 258 (5th Cir. 1948).
  \item \textsuperscript{19}See Laird v. United States, 391 F. Supp. 656, 669 (D.C. Ga. 1975), appealed docketed, Civil No. 75-2113 (5th Cir. Dec. 9, 1975).
  \item \textsuperscript{20}Treas. Reg. § 1.167(a)-3, T.D. 6452, 26 C.F.R. § 1.167(a)-3.
  \item \textsuperscript{22}See Rev. Rul. 54-441, 1954-2 C.B. 101, 101-02.
  \item \textsuperscript{23}Id. It should be noted here that the estimated useful life “is not necessarily the useful life inherent in the asset, but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business.” Treas. Reg. § 1.167 (a)-1(b), T.D. 6452, 26 C.F.R. 1.167(a)-1(b). The useful life assigned varies from sport to sport. It is reported that basketball player contracts are typically treated as
ruling did not, however, apply to the acquisition of an individual player contract. Prior to 1967 the cost of such a contract was deductible as an "ordinary and necessary" business expense for the taxable year in which paid or accrued according to section 162.24 This "expensing" of contracts, rather than capitalizing and depreciating, was based on the theory that the contracts had a useful life of one year or less. The courts upheld this practice in litigation involving baseball franchises and found that baseball's reserve clause did not add to the useful life of the contracts.25

In 1967, the Commissioner ruled that such treatment would no longer be accorded baseball contracts and that the cost of a uniform player contract was to be capitalized and depreciated over its useful life pursuant to section 167.26 The Commissioner reasoned that the reserve clause, which in effect conferred upon the team exclusive rights to a player's services for his entire career, resulted in the purchaser of the contract obtaining an asset with a useful life substantially beyond the taxable year.27 In 1971 a Revenue Ruling was issued which ac-


24. I.R.C. § 162(a) provides: "There 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 . . . ."

25. See Commissioner v. Pittsburgh Athletic Club, 72 F.2d 883 (3d Cir. 1934); Helvering v. Kansas City Am. Ass'n Baseball Co., 75 F.2d 600 (8th Cir. 1935).


27. Id. This ruling also determined that the depreciable cost basis included amounts incurred upon the purchase of the contract and bonuses paid for signing; that contracts, as intangibles, would be precluded from the accelerated depreciation methods of § 167(b)(2)-(4); and that no § 38 investment credit would be allowed upon the purchase of a player contract. This ruling was inevitable in light of the operation of the reserve clause. As noted in Flood v. Kuhn, 316 F. Supp. 271 (S.D.N.Y. 1970), aff'd, 443 F.2d 264 (2d Cir. 1971), aff'd, 407 U.S. 258 (1972): "[The player] must sign a Uniform Player's Contract, the only form of contract permitted between player and club, which empowers the signing club unilaterally to renew his contract from year to year should he and the club fail to come to terms on a new agreement. Once signed he is thereafter forbidden to negotiate toward prospective baseball employment with any club other than the one to whom he is under contract. Thus, the club has a right to his services for as long as it wishes to renew his contract, subject only to his right to retire from baseball." Id. at 273-74.

In 1975 it was held that baseball's reserve clause was not perpetual, and that players could become free agents by playing out their options. In re Arbitration of Messersmith, Grievance No. 75-27, Decision No. 29 (1975). However, in light of baseball's new Uniform Player's Contract, the Messersmith decision should not affect the operation of Rev. Rul. 67-379, supra note 21. The contract, as agreed upon by the National League, the American League, and the Major League Baseball Players' Association, provides in part that a player may not become a free agent until he has completed at least six years of major league service. Rider to the Uniform Player's Contract of the National League of
corded similar treatment to football player contracts. The present policy of the IRS is to treat the contracts of all professional athletes as depreciable property.

B. Past Practice: Tax Strategy of Buyer and Seller on Team Transfer

As noted above, the purchase of a sports franchise involves the acquisition of both depreciable and non-depreciable assets. It is to the buyer’s benefit if the greatest portion of the aggregate purchase price be attributed to the depreciable player contracts so that he may immediately assign a useful life to them and begin taking depreciation deductions. Conversely, from the seller’s tax perspective, it is most beneficial that the non-depreciable franchise asset represent the greatest portion of the acquisition price because any gain realized from the sale of the non-depreciable franchise is taxed at favorable capital gains rates. Moreover, the seller’s gain from the transfer of the depreciable player contracts, to the extent of the depreciation taken, is subject to the recapture provisions of section 1245 and taxable at ordinary income rates. (However, as will be discussed infra, there are certain situations wherein recapture can be avoided.)

Due to these conflicting interests and the differential tax treatment accorded gain from the sale of various assets, the tax strategies of the buyer and seller on the transfer of a franchise will be polar opposites. The buyer, in order to maximize his depreciation deductions, will seek to allocate the greatest portion of the aggregate purchase price to the depreciable player contracts. On the other hand, the seller will seek to allocate as much as possible to the non-depreciable franchise and good-will in order to maximize capital gains treatment for any gain

Professional Baseball Clubs and the American League of Professional Baseball Clubs Agreed to by Clubs and Major League Baseball Players’ Association (approved Aug. 6, 1976).

30. The acquired operating assets are also depreciable (see text accompanying note 17 supra), but since their value is generally de minimis in relation to the value of the contracts and the franchise itself, this note will deal primarily with the depreciation of player contracts.
32. Id. Prior to 1967, the seller was not subject to recapture on the sale of player contracts. Because the contracts were “expensed” according to § 162, rather than depreciated under § 167, no recapture tax liability was incurred.
33. See text accompanying notes 134-35 infra, and discussion in section 2(a)(i) infra.
realized, and to minimize the amount subject to section 1245 ordinary income taxation.34

The actual practice of buyers of sports franchises in recent years clearly reflects this tax strategy, and typically, the largest portion of the purchase price is assigned by them to player contracts.35 In basketball franchise transfers, allocations to player contracts of over eighty percent are not uncommon, and some owners have allocated as much as 98.4%.36 Detailed figures from other sports are not as readily avail-

**TABLE I**

**ALLOCATION OF INITIAL TEAM ACQUISITION COST BETWEEN FRANCHISE AND PLAYER CONTRACTS**

**BY PROFESSIONAL BASKETBALL TEAMS**

(In thousands of dollars)

<table>
<thead>
<tr>
<th>CLUB</th>
<th>Total Cost</th>
<th>Franchise</th>
<th>Player Contracts</th>
<th>Players as percent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1</td>
<td>250</td>
<td>250</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>A2</td>
<td>985</td>
<td>100</td>
<td>885</td>
<td>89.8</td>
</tr>
<tr>
<td>A3</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>A4</td>
<td>295</td>
<td>15</td>
<td>289</td>
<td>94.9</td>
</tr>
<tr>
<td>A5</td>
<td>1,550</td>
<td>200</td>
<td>1,350</td>
<td>87.1</td>
</tr>
<tr>
<td>A6</td>
<td>452</td>
<td>172</td>
<td>280</td>
<td>61.9</td>
</tr>
<tr>
<td>A7</td>
<td>20</td>
<td>20</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>A8</td>
<td>606</td>
<td>*</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>A9</td>
<td>800</td>
<td>425</td>
<td>373</td>
<td>46.9</td>
</tr>
<tr>
<td>A10</td>
<td>255</td>
<td>255</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>A11</td>
<td>106</td>
<td>6</td>
<td>100</td>
<td>94.3</td>
</tr>
</tbody>
</table>

ABA TOTAL 4,713 1,443 3,270 69.4

* Not Available.

34. The non-depreciable assets include the franchise and good-will. However, as will be fully discussed in section 2(a)(1) infra, seller can also minimize his recapture liability by allocating part of the sales price to certain player contracts which have not been the subject of depreciation deductions.

35. See 1976 REPORT, supra note 8, at 88.

36. See Table 1.
<table>
<thead>
<tr>
<th>CLUB</th>
<th>Total Cost</th>
<th>Franchise</th>
<th>Player Contracts</th>
<th>Players as percent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>N1</td>
<td>500</td>
<td>250</td>
<td>250</td>
<td>50.0</td>
</tr>
<tr>
<td>N2</td>
<td>5,600</td>
<td>1,100</td>
<td>4,500</td>
<td>80.4</td>
</tr>
<tr>
<td>N3</td>
<td>5,175</td>
<td>1,035</td>
<td>4,140</td>
<td>80.0</td>
</tr>
<tr>
<td>N4</td>
<td>3,600</td>
<td>400</td>
<td>3,200</td>
<td>88.9</td>
</tr>
<tr>
<td>N5</td>
<td>3,437</td>
<td>400</td>
<td>3,037</td>
<td>88.4</td>
</tr>
<tr>
<td>N6</td>
<td>1,250</td>
<td>50</td>
<td>1,200</td>
<td>96.0</td>
</tr>
<tr>
<td>N7</td>
<td>1,016</td>
<td>416</td>
<td>600</td>
<td>59.1</td>
</tr>
<tr>
<td>N8</td>
<td>678</td>
<td>200</td>
<td>478</td>
<td>70.5</td>
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<tr>
<td>N9</td>
<td>3,635</td>
<td>465</td>
<td>3,170</td>
<td>87.2</td>
</tr>
<tr>
<td>N10</td>
<td>1,157</td>
<td>101</td>
<td>1,056</td>
<td>91.3</td>
</tr>
<tr>
<td>N11</td>
<td>100</td>
<td>100</td>
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<tr>
<td>N12</td>
<td>1,907</td>
<td>180</td>
<td>1,727</td>
<td>90.6</td>
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<tr>
<td>N13</td>
<td>3,496</td>
<td>331</td>
<td>3,166</td>
<td>90.5</td>
</tr>
<tr>
<td>N14</td>
<td>25</td>
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</tr>
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<td>N15</td>
<td>3,040</td>
<td>50</td>
<td>2,990</td>
<td>98.4</td>
</tr>
<tr>
<td>N16</td>
<td>23</td>
<td>0</td>
<td>23</td>
<td>100.0</td>
</tr>
<tr>
<td>N17</td>
<td>1,434</td>
<td>150</td>
<td>1,284</td>
<td>89.5</td>
</tr>
</tbody>
</table>

NBA TOTAL ..........36,073 5,253 30,821 85.4


It has been reported that baseball contract allocations have exceeded ninety-eight percent. In one case, the purchasing entity of a professional football expansion franchise allocated ninety percent of its purchase price to player contracts.

Prior to the enactment of the Tax Reform Act of 1976, there was no statutory rule regarding the manner of allocation of asset value on the transfer of a sports franchise. The Treasury Regulations provided only that upon the acquisition of depreciable and non-depreciable business property in a lump sum “the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time.” There is case law to the same effect.

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37. See 1976 Hearings, supra note 29, at 637 n.22.
38. This allocation reported on the tax returns of the purchasers of the Atlanta Falcons for the taxable years of 1967 and 1968, became the subject of the litigation in Laird v. United States, 391 F. Supp. 656. See text accompanying notes 46-63 infra.
Due to the lack of clearcut restrictions, franchise buyers and sellers in the past have successfully managed to implement their tax strategies in accordance with their own depreciation or recapture considerations. There was little or no bargaining in the allocation process. Instead, the buyer and seller independently determined the amount paid or received for the different assets, made different allocation in their books of account, and hoped that both would not be audited by the IRS.41

While the IRS did nothing to discourage these divergent allocations between buyer and seller, it did attempt to limit the buyer's practice of excessive allocation to the player contracts asset. Until recently, however, it appeared that the probability of IRS adjustment was low.42 It is reported that between the years 1967 and 1971 the IRS audited only one professional basketball franchise.43 In that case the IRS reduced the buyer's allocation to the player contracts asset from ninety percent to fifty percent.44 The Service's past treatment of baseball transfers is indicative of its once-lenient attitude toward allocation. In two separate transactions wherein contract allocations of 98.5% and 98.4% were reported, the IRS settled with the taxpayers for adjustments to 91.4% and 79.4%, respectively.45 In none of these cases did the Service challenge the basic concept of allocating a certain portion of the purchase price to player contracts for depreciation purposes. The only matter for owner concern was the extent to which the IRS would adjust the reported allocation figures.

The IRS has of late demonstrated a reversal of its past policy46 with regard to the depreciation of player contracts acquired in bulk. In Laird v. United States47 and First Northwest Industries of America v. Commissioner48 the IRS took the position that no part of the franchise purchase price is allocable to player contracts. Laird represents the first major IRS/franchise owner conflict over player contract valua-

43. Id.
44. Id.
45. See 1976 Hearings, supra note 29, at 637.
46. See text accompanying notes 22-23 supra.
47. 391 F. Supp. 456. As previously noted, Laird is presently on appeal to the Fifth Circuit Court of Appeals, supra note 19.
48. First Northwest Industries, No. 8899-73 (U.S. Tax Ct., Wash., D.C., Dec. 12, 1973), is currently under consideration in the U.S. Tax Court in Seattle, Washington. This case involves the purchase of a National Basketball Association expansion team, the Seattle Supersonics.
tion and depreciation, and merits discussion before we examine the impact of the Tax Reform Act of 1976.

C. *Laird v. United States: The Government Clamps Down on Buyer’s Allocation Practices*

Plaintiff was a stockholder of a Subchapter S corporation, the Five Smiths, Inc., which purchased from the National Football League an expansion franchise located in Atlanta, Georgia, in 1966. Of the total cash consideration of $8.5 million paid for the acquired assets, the corporate owner allocated $50,000 to the cost of the franchise asset, $727,086 to deferred interest and $7,722,914 to the cost of the forty-two player contracts and options acquired. The shareholders then took a first year depreciation deduction on the contracts computed on a cost basis of $7,722,914. Pursuant to audit, the IRS determined that only $1,050,000 should be allocated to the contracts and that the remainder of the purchase price, less interest, should be allocated to the non-depreciable franchise. Disallowance of the depreciation deductions ultimately led to this litigation. At issue was whether this $7,722,914 cost basis reflected the true acquisition cost of the contracts, or whether the sum was assigned arbitrarily and erroneously for the purpose of achieving favorable tax consequences.

Plaintiff taxpayer contended at trial that the contracts allocation figure was reasonable, as attested to by the fact that the sum was arrived at through arms-length negotiations between buyer and seller. The IRS countered that implicit in the taxpayer’s allocation was the conclusion that the television rights acquired with the franchise from the league had a market value of zero which in the Service’s view was clearly erroneous. It argued that the valuation of the contracts was unreasonably high and for the purpose of achieving favorable tax consequences.

Notwithstanding its past treatment of bulk contract pur-

49. 391 F. Supp. at 658.
50. Id. at 659. Plaintiff’s argument here is without merit. Arms-length negotiations here would not necessarily generate a reasonable sum reflecting economic reality, because at the time of the negotiations (1965) the sellers of the player contracts were not subject to § 1245 recapture. See Rev. Rul. 67-380, 1967-2 C.B. 291. Thus, they had no interest in negotiating a reduced allocation.
51. 391 F. Supp. at 660. The taxpayer’s right to receive television revenues arose pursuant to the sale agreement with the NFL, whereby the Atlanta club was to share equally with the other 14 member clubs in any single network television contract commencing in 1966. Pursuant to an agreement between the NFL and the CBS television network, CBS was granted the right to televise NFL games for the four-year term of 1966 through 1969, for a total cash consideration of $79,200,000. Five Smith’s pro rata share of this four-year contract amounted to $4,737,375. Id. at 664.
52. Id. at 660.
chases, and its determinations made in the original audit involved in the present case, the IRS took the position that no part of the purchase price was depreciable. It reasoned that the contracts were part of a bundle of inextricably related assets acquired with the expansion franchise, none of which were capable of independent valuation for depreciation purposes. In effect, the purchaser acquired one inseparable asset, the non-depreciable franchise. The Service also argued that the television rights acquired with the franchise were non-depreciable because they had an indeterminable useful life.

The court disagreed with the IRS in its contention that an expansion franchise is a single, non-depreciable asset and held that the player contracts could be independently valued with reasonable accuracy and depreciated. The court, however, agreed that the allocation had been misguided. It held that the television rights were non-depreciable, reasoning that the “Five Smith’s right to participate equally with the other member clubs in television contracts during the time Five Smith’s maintained its membership in the NFL had no definite limited useful life the duration of which could be ascertained with reasonable accuracy . . .”

The court found that of the total cost of $8.5 million the television rights alone had a market value of $4,277,043 on the date of the sale. The court also found that the allocation of $50,000 to the franchise asset was unreasonably low in that NFL membership included the following valuable rights and benefits: (1) the exclusive right to exhibit NFL football within a seventy-five mile radius, (2) the right to participate in the college player draft, trading with other teams and the waiver system, (3) the benefit of the league administrative services, and (4) the benefit of league rules and regulations restricting business competition among NFL franchises. The court finally deter-

53. See text accompanying notes 22-23 supra.
54. See text accompanying note 49 supra.
55. Because no operating assets are involved in the purchase of an expansion team, the parties did not contemplate this additional factor in their arguments. See 391 F. Supp. at 670.
56. 391 F. Supp. at 660.
57. Id. at 671 (the government has appealed this holding, see supra note 19).
58. Id. at 669 (plaintiff taxpayers have appealed this holding, see supra note 19).
59. Id. at 664. The district court discounted Five Smith’s pro rata share of the television contract at the prime interest rate of five percent in order to determine the market value.
60. These services included the preparation of game schedules, the negotiation of television contracts, the organization of the college draft, and the resolution of disputes among member clubs.
mined that $3,035,000 represented a reasonable allocation to player contracts, and that the remaining $410,871 would be allocated to the franchise. The net effect of the court’s valuation of the acquired assets was to reduce the purchaser’s allocation of ninety percent to player contracts to a figure representing merely thirty-six percent of the total consideration.

III. THE TAX REFORM ACT OF 1976

Barely had owners time to absorb the impact of Laird when another bombshell hit the pro sports franchise arena. This one was of Congressional origin, in the form of the Tax Reform Act of 1976. Sections 1056 and 1245(a)(4) deal with the tax sheltering aspects of team ownership. Section 1056 focuses on limiting the depreciation of player contracts available to franchise buyers. Section 1245(a)(4) deals with the seller’s end of the transaction by extending the scope of section 1245 recapture. This note will first examine the basis limitation provision of section 1056.

62. Plaintiff taxpayer offered expert testimony that the player contracts were worth between $7.3 and $6.8 million. The court rejected this assessment, and finally accepted the valuation made in a post-trial brief submitted by plaintiff which was based on the testimony of the Falcon’s first coach. The court held that this testimony, which analyzed veteran players and compared them among themselves and to various college rookies, proved with reasonable certainty that the fair market value of the player contracts was $3,035,000. Id. at 666-67.

63. Id. at 671. The following chart, appearing at page 671 of the opinion, sets forth the court’s allocation procedure.

TOTAL CONSIDERATION PAID BY FIVE SMITHS 8,500,000.02

MINUS: Items not in dispute
   (a) Membership fee 50,000.00
   (b) Interest +727,086.00

EQUALS: Total Amount in Dispute 7,722,914.02

MINUS: Minimum Present Value of Television Rights 4,277,043.00

EQUALS: Remainder of Purchase Price Available for Allocation to Remaining Assets Acquired 3,445,871.02

MINUS: Amount allocated to Player Contracts 3,035,000.00

EQUALS: Remainder to Be Allocated to the Franchise 410,871.02
A. Basis Limitation and Allocation Restriction
Provisions: Section 1056

Section 1056 establishes definitive rules for the treatment of player contracts upon the acquisition of a sports franchise. Basically, this section provides for (1) a player contract cost basis limitation, (2) a binding contract allocation scheme, and (3) a rebuttable presumption that not more than fifty percent of the purchase price is allocable to player contracts.\textsuperscript{64}

64. Section 1056 states:

(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.

For purposes of this section, gain realized by the transferor on the transfer of such contract, but not recognized by reason of section 337(a), shall be treated as recognized to the extent recognized by the transferor's shareholders.

(b) Exceptions. — Subsection (a) shall not apply—

(1) to an exchange described in section 1031 (relating to 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 1014(a)).

(c) Transfer 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 to the transferee the following information:

(1) the amount which the transferor believes to be the adjusted basis referred to in paragraph (1) of subsection (a),

(2) the amount which the transferor believes to be the gain referred to in paragraph (2) of subsection (a), and

(3) any subsequent modification of either such amount.

To the extent provided in such regulations, the amounts furnished pursuant to the preceding sentence shall be binding on the transferor and on the transferee.

(d) Presumption as the 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.

Note that this section applies to "any sports enterprise." I.R.C. § 1056(a). Thus,
Subsection (a) provides that, pursuant to the sale or exchange of a sports franchise, the cost basis of the transferee's contracts acquired therein shall not exceed the adjusted basis of the contract in the hands of the transferor immediately before the sale, plus any gain recognized by the transferor on the exchange.\textsuperscript{65} Subsection (b) carves out two exceptions to this cost basis limitation provision. It provides that subsection (a) shall not apply to like kind exchanges under section 1031, nor to property passing from a decedent within section 1014(a).\textsuperscript{66} The most common like kind exchanges in the sports industry involve trades of individual player contracts made between two different teams. However, the exception for like kind exchanges does not contemplate this type of exchange. Section 1056 deals only with situations wherein the franchise itself ("any sports enterprise")\textsuperscript{67} is exchanged. The wholesale exchange of franchises between owners is a rare occurrence.\textsuperscript{68}

As to the mechanics of the player contract valuation, subsection (c) provides a means of regulating both buyer's and seller's allocation practices. The transferor is required to submit to the Secretary of the Treasury and to the transferee the following information: (1) the
amount which the transferor believes to be the adjusted basis of the contracts immediately before the franchise transfer, and (2) the amount which the transferor believes to be the gain recognized by reason of the transfer.\textsuperscript{69} By providing that these figures be binding on both the buyer and the seller, the new code section effectively eliminates the possibility of independent allocation by the buyer and seller. That the buyer and seller should be bound by the same allocation figures seems only reasonable, and section 1056 (c) merely requires that the parties conform to sound tax accounting practices.

In allowing the transferor to make the contract valuation, without specifically providing for input by the transferee, this subsection may at first blush seem to make possible a unilateral allocation in a manner favoring the transferor’s tax strategy. The seller, for example, could value the contracts at an unreasonably low figure,\textsuperscript{70} thereby minimizing his recapture tax liability, while at the same time unfairly depriving the buyer a realistic cost basis for depreciation. However, this provision contemplates that the parties will jointly determine the basis allocable to the contracts during their arms-length negotiations. The reasoning seems to be that, given the adverse interests of the parties, their determinations should reflect the economic realities of the acquisition.

The Tax Reform Act provides another limitation on the buyer’s allocation practice. Subsection 1056 (d) establishes a presumption that not more than fifty percent of the consideration is allocable to the player contracts asset. The presumption is rebuttable upon a satisfactory showing to the Secretary of the Treasury that a specified amount over fifty percent is properly allocable to the contracts.

As a whole, the provisions of section 1056 will work to substantially reduce the tax sheltering effect of team ownership. This will be accomplished through the cost basis limitation provision of subsection (a), the subsection (c) requirement that basis determinations be binding on both parties to the exchange, and the fifty percent allocation presumption of subsection (d).

1. SUBSECTION 1056 (c): THE DISINTERESTED SELLER PROBLEM

The desired goal of this legislation is that buyers and sellers conform to sound and economically realistic tax accounting principles with regard to their asset allocation procedures. As demonstrated, the

\textsuperscript{69} See I.R.C. § 1056(c)(1)-(2), as amended by 1976 TRA.

\textsuperscript{70} The buyer is, of course, limited by the 50% presumption of I.R.C. § 1056(d), discussed infra.
buyer's primary tax consideration upon acquisition is to establish a substantial player contract cost basis for depreciation purposes. Conversely, it is in the seller's interest to realize a low book gain on the non-depreciable assets in order to minimize recapture tax liability. In the past, problems arose when the parties allocated independently according to these divergent interests. The problem was not so much that one party over- or under-valued a given asset but that neither was held accountable for the difference. As a result, the government was in many instances, deprived of tax revenue.

By precluding independent allocation by the buyer and seller, subsection (c) will in many cases prove to be efficacious in minimizing the sheltering effect of sports franchise ownership. This is because the adverse tax interests of the parties should result in an honest and realistic appraisal of the different asset values, rather than one which favors one party to the exclusion of the other. However, as will be discussed fully infra, in certain situations the seller will be subject to little if any recapture liability on the sale of the player contracts, and will therefore be disinterested in the allocation. Such a situation would occur if the players involved in the transfer had been selected through the player draft (without having been paid bonuses for signing) rather than having been acquired by the purchase of their respective contracts. Under these circumstances, the interests of the seller would not be adverse to those of the buyer because the seller would not be harmed by a high allocation to player contracts. To the contrary, the seller might benefit from such an allocation. If the seller agrees to the allocation, the buyer will be granted a larger depreciable cost basis, and may thus be willing to pay more for the franchise.

Thus, to the extent that the seller is disinterested in the allocation, subsection 1056(c) does not effectively deal with the allocation manipulation problem. Further regulation of the buyers and sellers in this regard was therefore necessary. The solution of the reformers was apparently the limitations outlined in subsection 1056(d).

2. THE FIFTY PERCENT PRESUMPTION: A REASONABLE LIMITATION?

The most unpleasant provision of the new law to franchise owners and prospective buyers is the rebuttable presumption under subsection 1056(d) that not more than fifty percent of the team acquisition cost is allocable to player contracts. This provision marks a substantial

71. The team owners, team attorneys and league officials of the various sports do not object to the provisions of subsections (a) or (c). See 1976 Hearings, supra note 29, at 616, 618, 630, 646, 653. They do, however, adamantly oppose the subsection (d)
change from past allocation practices, and will sharply reduce the depreciation deductions available to franchise purchasers.

In light of the Laird decision, wherein it was determined that only thirty-six percent of the acquisition cost of a football expansion franchise was allocable to player contracts, a fifty percent presumption might not seem unrealistically low. But the Laird determination was made in 1975 in the context of a unique factual situation, a National Football League expansion team purchased in 1966. Subsection 1056(d), however, applies without limitation to the sale of a franchise for “any sports enterprise” (thus including such enterprises as World Team Tennis and the North American Soccer League) whether or not that enterprise is an expansion franchise or an established franchise. When one considers the dissimilarities among different teams in a given sports league, and the much greater differences among sports (for example, as between professional baseball and professional volleyball), the validity of any presumption is questionable.

Laird is the only case in which the question of allocation of the acquisition cost of a sports franchise had been litigated. Assuming that the result was a proper one given the facts and circumstances of that case, it would seem reasonable to use Laird as an analytical model by which to examine the asset values of other sports franchises. Using the district court’s rationale, one can compare the relative asset values of different sports enterprises in an effort to assess the reasonableness of an across-the-board fifty percent presumption for player contracts. The allocation determination of Laird and the subsection 1056(d) presumption will first be viewed in the context of other professional football transfers.

Upon close examination, the purchase of the Atlanta Falcons, which was the focus in Laird, involved materially different factors than those
which exist in the present day purchase of either an expansion franchise or an established franchise. It can be demonstrated that these differences will affect the relative allocation of acquisition cost to the various team assets, and cast doubt on the reasonableness of the now codified allocation presumption.

Initially, a difference between an established team and an expansion team must be observed in that the purchase of an expansion team involves the acquisition of players of lesser quality than would be acquired in the transfer of an established team. The Atlanta Falcons received their forty-two players through an “expansion draft” whereby three players were chosen from each of the fourteen NFL member clubs. However, each team was allowed to protect, or “freeze”, twenty-nine of their forty players, leaving open for selection their least valuable eleven players. It seems clear that the portion of the total consideration reasonably allocable to these player contracts should be substantially less than that allocable to contracts acquired in the purchase of a championship team having more valuable players.

In Laird, only thirty-six percent or $3,035,000, was allocated to player contracts. However, of the total consideration of $8.5 million, $5,054,129 was allocated to what in effect were fixed costs, i.e., an undisputed $777,086 to the NFL membership fee and deferred interest, and $4,277,043 to the capitalized value of the four-year CBS television contract. The remaining $3,445,871 represented the amount available for allocation to both the player contracts asset and the franchise asset.

Herein lies the importance of the expansion team/established team distinction. Had the Laird situation involved the purchase of a successful established team, the acquisition cost would have been substantially greater than the $8.5 million paid for the Atlanta Falcons. The difference in cost would have been, for the most part, due to the fact

75. 391 F. Supp. at 663.
76. To evidence the fact that the player roster of an expansion team has a larger number of sub-standard players (whose contracts are, therefore, less valuable), consider the 1976 NFL expansion teams, the Tampa Bay Buccaneers and the Seattle Seahawks, whose players were selected through expansion drafts, and whose records were 0 wins – 14 losses, and 2 wins – 12 losses, respectively.
77. The $4,277,043 figure was by no means arbitrary, or even difficult to determine. It was arrived at by determining the team’s pro rata share of the amount to be paid the NFL by CBS over the 4-year contract period, and by discounting that figure by the prime interest rate of 5%. Id. at 664.
78. The San Francisco 49ers changed hands in February of 1977 for an estimated $17 million, with indemnities and other obligations increasing the total cost to approximately $22 million. S.F. Chronicle, Feb. 25, 1977, at 55, col. 1.
that the established team consisted of higher quality players of proven ability. Given the allocation rationale of *Laird*, and an identical television contract, but assuming that the established team had cost a mere $4 million dollars more than did the Falcons, the reasonable allocation to player contracts would have been well above the fifty percent presumption. Seen in this light, the subsection 1056(d) fifty percent presumption seems arbitrarily low.

Additionally, certain developments since *Laird* and the drafting of the Tax Reform Act of 1976 have tended to diminish the value of all NFL franchises. The first of these was the recent district court decision in *Smith v. Pro Football* ruling the NFL player draft illegal as a violation of federal antitrust laws. The court in *Smith* suggested, however, that the NFL could devise alternatives that would meet legal standards. As a result of this decision, the NFL owners and the NFL Players Association have agreed upon a modified version of the draft to be conducted for the first time in April of 1977. Whether this revised scheme is legally sufficient is a question which must await future litigation. The fact that this modified draft is generally less beneficial to the franchise owners, together with the current uncertainty regarding its legality should have some impact on the relative valuation of team assets. As the court found in *Laird*, the right to participate in and obtain players through the college draft was one of the “substantial and valuable rights” attendant to owning an NFL franchise. To the extent that this valuable right to select players without competitive bidding and at little or no acquisition cost has been impaired, the value of the franchise asset is diminished and, therefore, the proportionate value of the player contracts asset is increased.

Another recent court decision, *Mackey v. National Football*
League. The rule had provided that when a player had played out the standard option year and signed as a free agent with another club, the signing team was required to compensate the athlete's former club. If compensation conflicts occurred, the NFL Commissioner (Pete Rozelle) was empowered to determine a fair compensation either in the form of draft choices or other players. The court in Mackey found that the rule unfairly restricted the player's rights to negotiate with other teams after having completed their contracts, and restricted their ability to move from one team to another. As a result of the decision owners now have less control over their players, and the once-valuable rights of the franchise to be compensated for their loss is diminished. This decrease in the value of the rights attendant to the franchise asset means that the relative value of the player contracts asset is increased.

There are also major differences among sports which effect asset values, and which tend to make a blanket fifty percent presumption questionable. One such difference which sets baseball and hockey apart from other sports is their characteristic two-tier league systems. These sports are structured such that each consists of a "major" and a "minor" league. The minor leagues are a training and development ground for younger players. Most hockey and baseball players, after signing, are sent to the minor leagues for a certain number of years in preparation for major league participation. The player development costs incurred in this system are substantial. Bowie Kuhn, the Commissioner of Baseball, has testified that, between the years 1969 and 1973, baseball team owners spent over $160 million to train players in their minor league system. The cost to develop each baseball player graduated to the major league level is estimated to be $500,000. Professional hockey teams incur similar development costs, often in the form of subsidies to the minor league and amateur teams.

85. 407 F. Supp. 1000
87. 407 F. Supp. at 1006.
88. 1976 Hearings, supra note 29, at 618.
89. Id. at 631.
90. Id.
91. Id.
92. Id. at 618. Robert O. Swados, special tax counsel to the NHL, testified before the Senate Finance Committee that between 1971 and 1976 the NHL paid $5 million in subsidies to amateur hockey. In addition, each NHL club paid an average subsidy of $300,000 to professional minor league clubs.
This two-tier league system does not exist in other sports. Rookie players in football and basketball are placed directly on the active team roster after college though the player draft. Colleges, rather than the professional teams, provide the training ground and incur the "development costs" for potential professional players. Thus, a baseball or hockey player under a major league contract represents a much greater proportional investment than does a football, basketball or tennis player. To this extent, the player contracts in the former two sports should, if realistically valued, represent a relatively greater proportion of a franchise acquisition cost than in other sports.

Another consideration which makes questionable a blanket allocation presumption is the variable factor of television contract revenue in the professional sports arena. As we have seen from Laird, which involved 1966 dollar figures, this revenue is tremendous in professional football. The value of television rights alone in Laird was in excess of fifty percent of the purchase price, leaving little to allocate to player contracts. In this context, the subsection 1056(d) presumption does not seem unduly harsh on franchise owners. Consider, however, the dramatic results had there been no league television contract involved in the purchase. The total purchase price (absent the value of the television rights) would have been approximately $4,220,000 with the player contracts asset representing over seventy percent of the total consideration. Thus, television rights acquired with a franchise, the value of which is fixed by an independent contract, determine the upper dollar limit that can be allocated to player contracts. The implications of inter-sport and intra-sport broadcast revenue disparities thus bear heavily on an assessment of this indiscriminate fifty percent presumption.

With regard to inter-sport television revenue disparities, it is well known that certain sports have much more lucrative television contracts than other less popular sports. The figures for the total revenue from local and national broadcast rights from 1967 through 1969 for hockey, baseball and football are illustrative. While each football franchise received some $4,034,000 during this period and each baseball franchise $3,628,000, each National Hockey League franchise received only $350,000. At present, most sports leagues, including the NHL and World Team Tennis, have no national television contract. Thus,

93. However, some players can enter the professional leagues prior to college graduation if they can qualify as an economic "hardship" case.

broadcast revenue for these franchises is derived from local or syndication broadcasting agreements.

Also, the value of broadcast contracts can vary among different teams in a given sport. Football generally exhibits less interclub disparity than other sports. For example, in 1970, all of the twenty-six professional football teams received between $1.7 and $1.9 million in broadcast revenue.\textsuperscript{95} Baseball evidences a greater disparity. For instance, in 1977, the local television and radio revenue rights ranged from $2 million (Boston Red Sox) to $350,000 (Kansas City Royals).\textsuperscript{96} The extremes in hockey in 1967 ranged from $500,000 in Los Angeles to $190,000 in Pittsburgh.\textsuperscript{97} The disparity also exists in basketball. For the 1971-2 season, each NBA franchise received $325,000 from a national broadcast contract, plus additional revenue from local contracts.\textsuperscript{98} At the same time, the ABA teams had no national contract, and some received no local broadcast revenue.\textsuperscript{99} It is apparent from these figures that the allocable portion of team purchase price to television rights can vary significantly among different teams in a given sport. A franchise purchase involving little or no television revenue will realistically require a much greater proportionate allocation to player contracts than would a purchase involving a multi-million dollar television contract. To the extent that subsection 1056(d) does not distinguish among sports, and applies with equal force and effect to different teams in a given sport, it is arguable that this section is arbitrary and unduly harsh on purchasers of franchises with broadcast rights of minimal value.

The preceding observations compel the conclusion that this fifty percent presumption is unreasonably low when taken at face value. There is, however, room for flexibility and an element of discretionary judgment by the IRS in its application in that the presumption is rebuttable. The reasonableness and viability of section 1056 in effecting tax reform in this area would thus seem to depend upon how difficult the IRS makes it for a buyer to establish “to the satisfaction of the Secretary” that an allocation to player contracts in excess of fifty percent of the purchase price is proper. If the Service is adamant in adhering to a fifty percent allocation for every franchise purchase, without regard to the realistic determinations of the parties, the new

\textsuperscript{95} Id. at 291.
\textsuperscript{96} The Sporting News, April 9, 1977 at 38, col. 4.
\textsuperscript{97} Horowitz \textit{supra} note 94, at 291.
\textsuperscript{98} Id.
\textsuperscript{99} Id. The NBA and the ABA have since merged.
section will constitute an arbitrary and unduly harsh attack on professional sports franchise ownership, with the effect of curtailing future investment.100

B. Recapture of Depreciation: Section 1245

The second provision of the Tax Reform Act of 1976 to affect sports franchises deals with recapture of depreciation taken with respect to player contracts. In general, depreciable property, when sold, is subject to recapture under section 1245, and any gain realized that is attributable to previous depreciation deductions will be treated as ordinary income. The gain to be taxed at ordinary income rates is determined by subtracting the undepreciated adjusted basis in the property from the lesser of recomputed basis or amount realized. The recomputed basis is the first figure to check. Recomputed basis can be computed by adding the adjusted basis of the property and the depreciation deductions taken with respect to the property.101 If the amount realized from the transaction is less than the recomputed basis, it will be utilized. In short, by determining the recomputed basis and the amount realized and subtracting the adjusted basis from the lesser of the two figures, one can determine the amount of depreciation deductions that is to be recaptured at ordinary income tax rates.

As previously noted, the amounts paid or incurred upon the pur-

100. During the 1976 Hearings before the Senate Committee on Finance on H.R. 10612 Bowie Kuhn, the Commissioner of Baseball, and others voiced their strong objections to the 50% presumption. At the conclusion of the hearings, this interesting dialogue between the Committee Chairman and Mr. Kuhn took place:

The Chairman: Mr. Kuhn, my Uncle Earl used to like to refer to the bug under the chip; what the thing was really about. I want to see what your reaction is to this: I have heard a rumor that the whole purpose of all this, some of which for a ridiculous tax law, is to cause you people to put a baseball team back here in Washington, D.C. Have you heard that? Has that thought ever occurred to you?

Mr. Kuhn: I have heard the rumor, and the thought has occurred to me.

The Chairman: All I can say is, it is one hell of a way to write a tax law.

101. The regulations define recomputed basis in Section 1.1245-2:

(a) General rule—

(1) Recomputed basis defined. The term "recomputed basis" means, with respect to any property, an amount equal to the sum of—

(i) The adjusted basis of the property, as defined in section 1011, plus
(ii) The amount of the adjustments reflected in the adjusted basis.

(2) Definition of adjustments reflected in adjusted basis. The term "adjustments reflected in the adjusted basis" means—

(i) With respect to any property other than property described in subdivision (ii), (iii), or (iv) of this subparagraph, the amount of the adjustments attributable to periods after Dec. 31, 1961, . . . which are reflected in the adjusted basis of such property on account of deductions allowed or allowable for depreciation or amortization . . .
chase of player contracts and bonuses paid to players for signing player contracts are depreciable.\(^\text{102}\) The addition of subsection 1245(a)(4) to the Internal Revenue Code by the Tax Reform Act of 1976 modifies the general recapture provision with regard to player contracts involved in the sale of a franchise by instituting a new procedure for determining recomputed basis.\(^\text{103}\) Basically, the recomputed basis for recapture purposes will be the greater of previously unrecovered depreciation on player contracts either involved in the transfer of the franchise or acquired by the seller upon acquisition of the franchise.


103. The special rule for the computation of recapture on player contracts is found in subsection 1245(a)(4).

(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 unrecovered depreciation with respect to player contracts acquired by the transferor at the time of acquisition of such franchise, or

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

(B) Previously Unrecaptured Depreciation With Respect To Initial Contracts. — For purposes of subparagraph (A)(i), the term 'previously unrecovered depreciation' means the excess (if any) of—

(i) the sum of the deduction allowed or allowable to the taxpayer transferor for the depreciation of any player contracts acquired by him at the time of acquisition of such franchise, plus the deduction allowed or allowable for losses with respect to such player contracts acquired at the time of such acquisition, over

(ii) the aggregate of the amounts treated as ordinary income by reason of this section with respect to prior dispositions of such player contracts acquired upon acquisition of the franchise.

(C) Previously Unrecaptured Depreciation With Respect To Contracts Transferred. — For purposes of subparagraph (A)(ii), the term 'previously unrecovered depreciation' means—

(i) the amount of any deduction allowed or allowable to the taxpayer transferor for the depreciation of any contracts involved in such transfer, over

(ii) the aggregate of the amounts treated as ordinary income by reason of this section with respect to prior dispositions of such player contracts acquired upon acquisition of the franchise.

(D) Player Contract — For purposes of this paragraph, the term 'player contract' means any contracts for the services of an athlete which, in the hands of the taxpayer, is of a character subject to the allowance for depreciation provided in section 167.

(2) Effective Date — The amendment made by this subsection applies to transfers of player contracts in connection with any sale or exchange of a franchise after December 31, 1975.
This amendment does not affect the recapture treatment in individual player contract transactions which are handled under the general provisions of section 1245.104 These transactions include negotiations with new players, purchasing player contracts from other teams, acquiring player contracts through trades, trading a draft choice for a player contract, and abandoning player contracts. This portion of the note will first examine the treatment of individual player transactions under the general provisions of section 1245. Secondly, the treatment of the recapture of ordinary income on player contracts transferred in bulk upon the sale of a franchise under the new subsection 1245(a)(4) will be discussed.

1. INDIVIDUAL PLAYER CONTRACT TRANSACTIONS

a. Negotiations With New Players

Many player contracts are obtained through negotiations between the individual athlete and the franchise. Although such negotiations may result in a wide spectrum of compensation schemes, the basic distinction that must be made for accounting and taxation purposes is whether the stipend is a salary for services performed or a bonus for signing the contract.105 If characterized as a salary, the team may deduct as an ordinary and necessary business expense the total amount in the year paid.106 This is possible because a salary is considered to be payment for services rendered solely within the taxable year. On the other hand, a bonus to sign a contract having a length of greater than one year is considered an inducement to enter into a multi-year agreement.107 As such, a bonus for signing the contract results in the acquisition of an asset which, having a useful life beyond the end of the

104. See 1976 Hearings, supra note 29, at 637.
105. This distinction can be determined by the terms of the player's contract. For example, the Uniform Player's Contract for Professional Baseball's National League states in Clause 2 that:

"For performance of the player's services and promises hereunder the Club will pay the Player the sum of $_________ in semi-monthly installments after the commencement of the player season covered by this contract, except as the schedule of payments may be modified by a special covenant." "Uniform Player's Contract," The National League of Professional Baseball Clubs.

Clause 2 addresses payment for services in salary terms. A bonus for signing the contract agreement would be provided for under the special covenant section of the contract, which follows Clause 12. A challenge by the IRS that the owner was treating bonus payments as salary expenses would be met by producing the player contracts in question.

106. I.R.C. § 162.
107. However, a bonus to sign a one-year contract would not result in the acquisition of an asset having a useful life of greater than one year.
taxable year, must be "capitalized" and depreciated. The payment of a bonus will also affect the taxation of the athlete.

Depreciation of a bonus over the useful life of the player contract will be recaptured if the player contract is sold. Franchise owners would rather avoid depreciation and recapture in favor of expensing all payments made under the contract under section 162. Treating the player contract as an expense in the year paid theoretically means that the payment of a bonus resulted in the acquisition of an asset with a useful life of less than one year. Therefore, by expensing the cost of the player contract the franchise can deduct the entire amount of the bonus in the year paid and treat the contract as having a zero cost basis. Because the contract's usefulness is considered to be fully utilized after one year there will be no depreciation deductions in later years. Consequently, there will be no recapture of ordinary income when the contract is sold. The entire amount received for the contract may be taxed at the lower capital gains rates under the provisions of section 1231.

There are several ways a franchise owner may avoid the capitalization of bonuses for signing player contracts. One technique is to treat the bonus as a current expense. In 1970, Baltimore Baseball Club, Inc., owners of the Baltimore Orioles, took a $1.3 million deduction for team replacement expenses. The financial statement included the following explanation:

The Internal Revenue Service requires the cost of purchased player contracts together with payments of certain types of bonuses to be capitalized and amortized over the estimated number of years that the individual player can reasonably be expected to play. The company, however, has always charged these type expenditures to operations as they were incurred and is continuing to do so.

It is difficult to ascertain whether other franchises employ the same tax accounting strategy because, unlike the Orioles, most franchises


109. A maximum marginal tax rate of 50% on an individual's earned income is imposed by \$ 1348. Earned income defined under the proposed regulations is "compensation . . . for personal services actually rendered." (Treas. Regs. \$ 1.1348-3(a)(1)(i), T.D. 7446, 41 Fed. Reg. 55, 339 (1976) (to be codified in 26 C.F.R. \$ 1.1348-3(a)(1)(i)). Therefore, it would appear that a bonus paid to an athlete on signing a contract, if not predicated on the performance of any services, would not constitute earned income. Rev. Rul. 58-145, 1951-1 C.B. 360, on the other hand, stated that a bonus paid to an athlete conditions upon the player making the team constituted wages subject to withholding.


111. Okner, supra note 42, at 171.

112. Id. (footnote omitted).
do not release financial information. A franchise accountant interviewed by the authors indicated that the procedure his team employs is to treat every bonus under $5,000 as an expense. Any bonus for signing above that figure is capitalized and amortized. It has been reported that one other club uses the same procedure, but draws the line at $20,000.

A second method for avoiding depreciation and recapture on bonuses is to not offer bonus payments to players. By phrasing the entire multi-year contract package in terms of "salary", the franchise can deduct each year's salary outlay as an expense and achieve the desired goal of maintaining the player's contract at a cost basis of zero. For example, suppose that during negotiations the player asks for a four-year no-cut contract calling for a salary of $100,000 per year and a $100,000 bonus to sign. If the team feels that $500,000 over four years is fair, they may agree to the money and contract length demanded provided that the player accepts payment in the form of a salary of $125,000 per year. Thus, instead of a bonus with a $100,000 book value subject to recapture, the franchise will, by paying the player the same amount in the form of a salary, have a zero cost basis in the contract.

b. PURCHASING INDIVIDUAL PLAYER CONTRACTS FROM OTHER FRANCHISES

Owners must also be concerned with the tax consequences of purchasing individual player contracts from other franchises. The cost basis of a player contract purchased from another franchise is the amount paid for the contract. As we have seen, this amount is then depreciated over the useful life of the contract.

A hypothetical will help to illustrate this discussion. Suppose Player A, a top draft choice, has a three-year no-cut contract with the Giants. Player A's salary is $100,000 per year. After one season the Giants become disenchanted with Player A. The club wants to be relieved of the burden of having to pay another $200,000 to a hapless

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113. In 1973, only 14 of our 96 American sports franchises were publicly held corporations. The other franchises were privately held and do not have to prepare certified financial statements. Id. at 161.

114. This information was obtained in a personal interview with a franchise accountant who requested anonymity.


116. The franchise may instead offer the player a $100,000 interest free loan to be paid back in four years. By giving the player a $125,000 salary and deducting the $25,000 loan repayment in each of the contract's four years, the same tax result is achieved.


118. Id.
player they feel should not be riding the bench, much less the team bus. The Bears, another team in the league, feel that Player A has not been allowed to reach his athletic potential. They are willing to take a chance on Player A and to pay the $100,000 per year salary for two more seasons. The two franchises enter into a transaction whereby A’s contract is purchased by the Bears for $5,000.

The Bears must assign a depreciable cost basis to Player A’s contract.\textsuperscript{119} This basis will not be a function of the player’s salary. Instead the IRS requires only that the amounts paid or incurred upon the purchase of a player contract be depreciated.\textsuperscript{120} Therefore, the $5,000 paid for Player A’s contract will be the assigned basis depreciated over the contract’s useful life. On the other hand, the Bears will be able to deduct the entire $100,000 per year salary in the year it is paid as a business expense under section 162.\textsuperscript{121} Finally, the amount depreciated against Player A’s $5,000 cost basis will, to the extent of gain, be re-captured should Player A ever be resold by the Bears.\textsuperscript{122}

c. ACQUIRING INDIVIDUAL PLAYER CONTRACTS THROUGH TRADING

A player-for-player transaction between franchises, where no additional consideration is involved, is not a taxable event.\textsuperscript{123} Such a trade is considered a “like kind” exchange under section 1031,\textsuperscript{124} whereby the cost basis and useful life of a player contract traded remains with the original franchise and is imputed to the player contract received with no gain or loss recognized by either franchise. Where either franchise receives other property or money — commonly known as “boot” — in addition to the player contract, the gain is taxable to the extent of the fair market value of the additional “boot”.\textsuperscript{125}

Three examples will help to illustrate the effect of section 1031 on player contract trades.

Example 1:

Assume that two franchises, the Bears and the Giants, have engaged in player-for-player trades. In the first transaction the Giants trade Player A, whose contract has a $10,000 adjusted basis, to the Bears for Player B, whose contract has a $5,000 adjusted basis. In a straight

\textsuperscript{119} See I.R.C. § 162. This section specifically provides for the deduction of salaries for personal services rendered in carrying on a trade or business.

\textsuperscript{120} See I.R.C. § 1245, as amended by 1976 TRA.


\textsuperscript{122} See I.R.C. § 1031(a).

\textsuperscript{123} See I.R.C. § 1031(b).
player-for-player trade such as this, each franchise retains the adjusted basis and useful life of the contract traded. Therefore, the Giants have Player B subject to a $10,000 cost basis and the Bears own Player A’s contract subject to Player B’s former contract basis of $5,000.

Example 2:

Next, assume the Giants are willing to exchange Player A and $60,000 in cash for Player B. The new cost basis of Player B’s contract to the Giants will be the previous $10,000 basis in Player A’s contract plus the $60,000 paid to acquire Player B.\textsuperscript{126} Gain is recognized by the Bears to the extent of money, or “boot”, received. Thus the Bears will have Player A with a $5,000 cost basis. They will also receive a $60,000 section 1231 gain diminished by the ordinary income recapture of depreciation written off against Player B’s contract.\textsuperscript{127}

Example 3:

Finally assume that Player A of the Giants has a $50,000 adjusted basis and Player B of the Bears has a $2,000 adjusted basis.\textsuperscript{128} If the teams trade contracts with no additional consideration involved, another section 1031 tax-free exchange will transpire.\textsuperscript{129} This example highlights the fact that although actual gains and losses may be realized in like kind transactions, section 1031 does not allow them to be recognized under that tax law.\textsuperscript{130}

While recapture of depreciation is excluded from section 1031 transactions, section 1245 is not barred from recapturing ordinary income in future transactions involving contracts obtained through player trades. Should an athlete involved in a straight player-for-player trade ever be sold at a gain, depreciation taken against the cost basis of his contract will be recaptured.

d. Trading A Draft Choice for A Player Contract

The trade of a draft choice for a player contract will probably be considered a like kind transaction under section 1031.\textsuperscript{131} A future draft

\textsuperscript{126} See I.R.C. § 1031(d).
\textsuperscript{127} See 1976 TRA § 1245(b)(4) (amending I.R.C. § 1245).
\textsuperscript{128} Note that adjusted basis merely reflects the amount left to be depreciated on a player contract. Adjusted basis is not an indicator of the player’s athletic ability. A five-year veteran may be an outstanding performer and also have a fully depreciated contract with an adjusted basis of zero.
\textsuperscript{129} I.R.C. § 1031(b).
\textsuperscript{130} Although it may be unrealistic for the team’s general manager to consult their accountant before making trades, from a tax standpoint it would be more prudent for the Giants, in this situation, to sell Player A’s contract to the Bears for $2,000 and obtain a deductible $48,000 contract sale loss under I.R.C. § 165.
\textsuperscript{131} A similar transaction, the exchange of an option to purchase realty for realty, is not considered a like kind exchange. This is because the courts have held that there
choice, however, has no cost basis. Therefore, a franchise trading a draft choice receives a player contract subject to a cost basis of zero. The franchise receiving the draft choice has an asset with a basis the same as the adjusted basis of the player contract traded. If the player whom it later drafts is signed and given a non-deductible bonus, the basis of this new contract will be adjusted upward to include the value of the bonus in addition to the basis of the player contract traded. If the player contract is ever sold, section 1245 will recapture depreciation taken against the cost basis of the bonus and of the player contract traded.

e. ABANDONMENT OF INDIVIDUAL PLAYER CONTRACTS

A franchise is entitled to claim an abandonment loss under section 165132 in the year a player is cut or retires. The amount of ordinary loss that can be deducted is the adjusted basis of the player’s contract. Depreciation deductions written off against ordinary income in prior years cannot be recaptured when the contract is abandoned.133

2. RECAPTURE OF DEPRECIATION UPON SALE OF THE FRANCHISE

Prior to the passage of the Tax Reform Act of 1976, recapture of depreciation taken on player contracts transferred in bulk upon the sale of a franchise could be ascertained simply by applying the section 1245 formula. Under that formula, the seller of a franchise was subject to ordinary income taxation on the lower of recomputed basis or amount realized that exceeded adjusted basis on each individual contract. This recapture method will be referred as the contract-by-contract method. The Tax Reform Act of 1976 institutes a new pro-

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132. I.R.C. § 165, as amended by 1976 TRA.
133. This is because the fair market value of the abandoned contract is zero. Therefore, the amount realized from the transaction does not exceed the adjusted basis of the contract. In such a situation ordinary income is not recaptured by I.R.C. § 1245.
procedure for determining sports franchise sale recapture by the addition of subsection 1245(a)(4). This new subsection does not alter any of the aforementioned recapture procedures involving individual player contract transactions.134

The new rule for player contracts dictates that when a franchise is sold the amount to be recaptured is determined by computing the recomputed basis for each of two classifications of player contracts, and then subtracting the greater recomputed basis figure from the adjusted basis. Section 1245(a)(4) defines recomputed basis as the greater of the previously unrecaptured depreciation on player contracts the buyer is now purchasing with the franchise or the player contracts the seller originally purchased with the franchise, increased by the adjusted basis of such contracts. Once the greater recomputed basis figure is determined, it is compared with the amount realized from the sale of player contracts. The lesser amount is then used to compute recapture according to general section 1245 procedures.

a. **Computation of Recomputed Basis on Contracts Involved in the Transfer**

i) Explanation of subsection 1245(a)(4)(C)

The discussion will focus first on how to calculate the recomputed basis on those contracts held by the taxpayer which are purchased by the franchise buyer. As prescribed by subsection 1245(a)(4)(C), one first computes the amount of unrecaptured depreciation on the player contracts involved in the current transfer. This figure is reduced by the amount of depreciation previously recaptured on contracts disposed of by the present owner which he obtained upon acquisition of the franchise. Assuming that there has been no recapture on contracts the present owner acquired when he originally purchased the franchise, the recomputed basis will equal the adjusted basis and the aggregate depreciation taken on all contracts held at the time of sale. This method of computation may result in a greater recomputed basis than under the contract-by-contract method used under prior law.

An example will help to illustrate the application of subsection 1245(a)(4)(c). Suppose the Bears franchise is being sold for $2 million. The seller purchased the Bears five years ago for $1.2 million. Of that amount, $650,000 was allocated by the current seller for the purchase of five player contracts. The seller now is allocating $1 million, fifty percent of the Bears' sale price, to the sale of seven player contracts. Only three of the contracts, those of Players A, B and C, held

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134. See 1976 Report, supra note 8, at 90.
at the time of sale are subject to recapture.\textsuperscript{135} Further assume that both Players A and B were sold to the seller when he purchased the franchise five years ago. At that time, seller allocated $200,000 to Player A and $100,000 to Player B. Having used a five-year useful life,\textsuperscript{136} the seller has fully depreciated both Players A and B's contracts. According to section 1056(c) of the Tax Reform Act of 1976, when the franchise is sold the transferor must furnish the Secretary and the transferee with the amount which he believes to be the adjusted basis of the contract and the gain recognized on the transfer of the contracts. Since both contracts have been fully depreciated, the adjusted basis will be zero. Assume that Players A and B are old and used sparingly, and that the owner wants to avoid recapture. The owner allocates $10,000 to each of their contracts. This figure represents the amount of gain recognized by the owner on the transfer of the contracts.

Assume Player C was acquired three years after the seller's original purchase of the franchise. Player C received a $100,000 bonus to sign his contract. He has played for two seasons, and after $40,000 of depreciation deductions has a $60,000 adjusted basis. In his first year, Player C was voted rookie of the year and led the league in scoring in his sophomore season. On the basis of his past performance and future potential, the seller realistically assigns a $500,000 sale price to his contract. This figure represents the $60,000 adjusted basis in the contract and a $440,000 gain recognized on the transfer of the contract required to be disclosed by section 1056(c).

Before the Tax Reform Act of 1976, recapture would have been determined on a contract-by-contract basis. The seller would first determine the recomputed basis and the amount realized on each individual contract. Then by subtracting the contract's adjusted basis from the lesser of these two amounts, the ordinary income to be recaptured was computed. The amount realized would be utilized in our example above for the contracts of Players A and B, because that amount is less than each of their recomputed bases. The $10,000 gain recognized on each contract would then be subtracted from the adjusted basis of each contract, which in this case is zero. Therefore, $10,000 would be recaptured on each of Players A and B's contracts. On the other hand, the $100,000 recomputed basis is lower than the $500,000 realized on Player C's contract and would thus be reduced by the $60,000 adjusted basis in the contract.

\textsuperscript{135} In this example, the franchise has consciously sought to avoid the possibility of recapture by signing most players to contracts that do not include bonuses for signing.

\textsuperscript{136} The useful life of a player contract obviously depends upon the player's athletic potential. For the purposes of discussion, a five-year useful life will be utilized unless specifically noted.
basis. The recapture of ordinary income on Player C's contract would amount to $40,000. Thus, for Players A, B and C, a total of $60,000 would be recaptured using the former procedure.

The section 1245(a)(4)(C) method of determining recomputed basis avoids looking at each contract in favor of including all depreciation deductions taken on all contracts in one recomputed basis figure. This figure, if lower than the amount realized, is reduced by the total adjusted basis of the contracts involved. The new provision results in $340,000 ordinary income recapture in this example.

Compare:

<table>
<thead>
<tr>
<th></th>
<th>Contract-by-Contract Method</th>
<th>Subsection 1245(a)(4)(C) All three Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract Cost</strong></td>
<td>A $200,000</td>
<td>B $100,000</td>
</tr>
<tr>
<td><strong>Depreciation</strong></td>
<td>$200,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Adjusted Basis</strong></td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Depreciation</strong></td>
<td>200,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Recomputed Basis</strong></td>
<td>200,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Amount Realized</strong></td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Lesser of Recomputed Basis and Amount Realized</strong></td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Less Adjusted Basis</strong></td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Recapture on each contract</strong></td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total Recapture</strong></td>
<td>60,000</td>
<td></td>
</tr>
</tbody>
</table>

By aggregating the recomputed basis of all the contracts together the seller will have $340,000 of ordinary income recaptured compared with only $60,000 under the previous contract-by-contract method.

Subsection 1245(a)(4)(C) will not recapture greater amounts of depreciation than was possible under prior law. The contract-by-contract method recaptures the same amount as subsection 1245(a)(4)(C).
whenever the recomputed basis of each contract is utilized to determine ordinary income tax liability. In our example, if the seller allocated $200,000 or more to Player A's contract and $100,000 or more to each of the contracts of Players B and C, he would be subject to recapture on the entire $340,000 depreciation deduction regardless of which method was applied. The subsection 1245(a)(4)(C) method of recapture is no more burdensome upon the franchise owner than the previous contract-by-contract method.

ii) Avoidance of Recapture Through Allocation To Non-Depreciable Contracts

Like the contract-by-contract method, the franchise owner may avoid the heavy recapture burden imposed by section 1245(a)(4)(C) by taking advantage of the avoidance possibilities that arise under section 1056. Complying with section 1056 can be viewed as a two-step process. First the player contracts asset allocation, subject to the subsection 1056(d) presumption, is determined. Secondly, the seller must break down this evaluation into specific allocations for each player contract. Subsection 1056(c) requires that the buyer abide by the seller's individual player contract allocations.

The determination of the first figure will greatly affect each party's future tax liability. As discussed previously, the seller and buyer engaged in a franchise transfer are both interested in the value allocated to the player contracts asset. It is in the seller's interest to allocate as little as possible to player contracts if some contracts are subject to recapture. On the other hand, the buyer wishes to allocate a high percentage to player contracts so that he may depreciate a large portion of the franchise acquisition cost.

The amount the seller allocates to player contracts will be an important financial consideration in any franchise transfer. If the seller has expensed, rather than capitalized and depreciated, those contracts involved in the transfer, he will not be subject to subsection 1245(a)(4)(C) recapture. As discussed supra, a seller in this situation is therefore not adversely affected by a large allocation to the player contract asset. By agreeing to a high allocation the seller may be able to command a greater franchise sale price. This is because a franchise which has a large percentage allocated to player contracts is worth more to a buyer due to depreciation benefits than is a franchise with a low allocation.

A seller that has depreciated player contracts involved in the transfer is in a more difficult position. If the seller allocates a small portion of the sale price to player contracts he avoids recapture, but makes the
franchise less attractive to the buyer. By allocating a large percentage to the player contracts asset the franchise is worth more to the buyer, yet the seller is subject to greater recapture liability. However, under the new law this dilemma may be avoided. The seller who is subject to recapture on contracts involved in the transfer may both allocate a large percent to player contracts and reduce recapture liability. This can be accomplished through the knowledgeable allocation of values to specific player contracts.

It will be noted that the second step allocation of the aggregate player contracts asset into individual player contract allocations is of greater importance to the franchise seller than to the franchise buyer. Once the parties have agreed upon the player contracts asset allocation, the buyer knows the total amount of player acquisition costs he may depreciate. The components of that aggregate depreciable figure are not crucial. For example, suppose $600,000 in player contracts are purchased in a franchise sale and are to be depreciated over a five year useful life. The depreciation deduction on one $500,000 contract and one $100,000 contract or on two $300,000 player contracts will both equal $120,000. The buyer's primary concern is securing the highest aggregate player contracts asset allocation possible so that he can depreciate a large percentage of the franchise acquisition cost in the future.

On the other hand, the seller is greatly interested in the amount allocated to each contract because, through adroit allocation, recapture can be avoided. This is accomplished by allocating more of the aggregate player contract purchase price to those contracts which had a zero cost basis and thus were non-depreciable. Therefore, the amount realized on the remaining depreciable contracts will be reduced. If the reduction causes the total amount on depreciable contracts to fall below the combined recomputed basis of such contracts, the seller will be able to avoid a certain amount of ordinary income recapture.

The seller, according to subsection 1056(c), is in a position to allocate amongst depreciable and non-depreciable contracts. As previously indicated, subsection 1056(c) requires that the seller furnish information to the IRS concerning the adjusted basis and the gain on each player contract in the sale of a franchise. If the IRS does not challenge these statements, the seller will be able to escape or diminish recapture while allocating a large portion of the purchase price to the sale of player contracts for the buyer's benefit.

The example of the Bear franchise sale serves to illustrate this point. As previously stated, the seller is allocating $1 million, or fifty percent
of the Bears' sale price, to the sale of seven player contracts. The contracts of Players A, B and C are depreciable and thus subject to recapture. Players W, X, Y and Z were neither purchased or offered bonuses to sign. Their contracts call for yearly salaries and are thus not depreciable. Again, the seller allocates $10,000 to each of Players A and B's contracts. However, he only places a $60,000 sale price on star Player C's contract instead of the $500,000 value in the previous example. The remaining $920,000 of the $1 million player contract sale price is allocated among the four non-depreciable contracts. Because Players W, X, Y and Z's contracts are non-depreciable, they have no adjusted basis and are treated as a gain recognized on the transfer.

By allocating the major portion of the contract sale price to non-depreciable contracts, the amount realized on depreciable contracts is reduced. In this example, a reduction from $520,000 to $80,000 brings the amount realized figure to a total well below the stationary recomputed basis amount. Therefore, according to subsection 1245(a)(1), recapture will be determined by subtracting the adjusted basis from the amount realized.

<table>
<thead>
<tr>
<th>Subsection 1245(a)(4)(C)</th>
<th>Allocation to Non-Depreciable Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Allocation</td>
<td>ABC WXYZ</td>
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<tr>
<td>Contract Cost</td>
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<tr>
<td>Depreciation</td>
<td>340,000 0</td>
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<tr>
<td>Adjusted Basis</td>
<td>60,000 0</td>
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<tr>
<td>Depreciation</td>
<td>340,000 0</td>
</tr>
<tr>
<td>Recomputed Basis</td>
<td>400,000 0</td>
</tr>
<tr>
<td>Amount Realized</td>
<td>520,000 480,000</td>
</tr>
<tr>
<td>Lesser of Recomputed</td>
<td>400,000 -</td>
</tr>
<tr>
<td>Basis and Amount realized</td>
<td>80,000 -</td>
</tr>
<tr>
<td>Less Adjusted Basis</td>
<td>60,000 -</td>
</tr>
<tr>
<td>Recapture</td>
<td>340,000 -</td>
</tr>
</tbody>
</table>
As the example indicates, the seller will be able to significantly reduce recapture of ordinary income tax liability by allocating gain to non-depreciable player contracts, subject to section 1231 treatment.

The Tax Reform Act of 1976 attempts to deal with the conversion of ordinary income into capital gain. The subsection 1056(c) provision requiring buyer and seller to abide by the seller's player contract valuations will, in an arms length transaction, force the seller to attribute a greater share of the sale price to player contracts. Consequently, the seller will be limited in both the amount of the sale price he can allocate to non-depreciable franchise rights and the amount of recapture he can avoid. However, by 1) allowing the seller to allocate gain to the sale price of individual player contracts under subsection 1056(c) and 2) redefining only "recomputed basis" and not "amount realized" under subsection 1245(a)(4), the Tax Reform Act of 1976 does not effectively provide for recapture of depreciation on contracts involved in the transfer of a franchise. The aforementioned provisions, combined with the fact that some contracts involved in a franchise transfer will be non-depreciable, allow the seller the same benefit he had before the Tax Reform Act of 1976 was enacted. Where previously, he could allocate between depreciable contracts and non-depreciable franchise rights to avoid recapture, the seller can now allocate, subject to IRS scrutiny, between depreciable and non-depreciable contracts to accomplish the same objective.

iii) The Allocation to Non-Depreciable Contracts
Loophole: Possible Solutions

To discourage the seller's allocation to non-depreciable contracts the government may seek to redefine the term "amount realized" as it is used in the computation of recapture of depreciation deductions taken on player contracts transferred as part of a franchise sale. The government can deal with this potential subsection 1245(a)(4)(C) loophole by enacting an appropriate amendment to the Internal Revenue Code or by the promulgation of strict regulations.

A possible amendment alternative would be to specifically define the "amount realized" for subsection 1245(a)(4) purposes as the amount of the franchise sale price allocated to the aggregate player contracts asset. With such a mass asset redefinition of the subsection 1245(a) "amount realized" formula, a seller would no longer be able

137. See 1976 Report, supra note 8, at 89.
to arbitrarily allocate gain to the non-depreciable contracts. Instead, the amount realized would be the total amount which seller receives from the buyer for the player contracts asset. Such legislation would not work unfairly against the seller. As has been noted, the seller is taxed on the lower of recomputed basis or amount realized less adjusted basis under section 1245. If the portion of the purchase price allocated to the player contracts asset were greater than the total depreciation, the seller would be subject to recapture on the amount of the recomputed basis less the adjusted basis. If the allocation to player contracts is less than the depreciation deductions taken by the seller, the amount realized from the contracts, less the adjusted basis, would be subject to recapture. Therefore, the seller can never have ordinary income recaptured in excess of his aggregate depreciation deductions. Since the intent of Congress in refashioning section 1245 was to prevent the conversion of ordinary income into capital gain, a special definition of amount realized for subsection 1245(a) (4) would be consistent with that intent.

The IRS may also act to discourage a seller's arbitrary allocation to non-depreciable contracts by issuing a regulation concerning the determination of gain on individual player contracts. Subsection 1056(c) (2) requires the seller of a franchise to furnish the IRS with the amount of gain realized on each contract in the sale of a franchise. By requiring the seller to employ an independent appraiser for this evaluation and through careful IRS scrutiny of all franchise sales reports, the seller's avoidance of recapture may be precluded.

b. Computation of Recomputed Basis on Contracts Originally Purchased With The Franchise

i) Explanation of subsection 1245(a) (4)(B)

Under the new provision, section 1245(a) (4)(A) dictates that the recomputed basis figure used by the seller is the largest of two alternative computations under subsection 1245(a) (4)(B) and (C). The determination of the recomputed basis on contracts involved in a current transfer according to subsection 1245(a) (4)(C) has been discussed. The mechanics of how the recomputed basis on contracts acquired by the seller in the original purchase of the franchise is computed under subsection 1245(a) (4)(B) remain to be explored. Basically, one must first aggregate all depreciation and loss deductions taken

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138. Id.
on contracts initially acquired. That figure is then diminished by the total ordinary income recaptured on previous sales of such contracts. The remainder is then added to the currently held contracts' adjusted basis. The resulting figure is the recomputed basis.

Before fully discussing this provision it should be noted that the potential problem of a seller allocating gain to non-depreciable contracts arising under subsection 1245(a)(4)(C) will not affect the computation of recomputed basis under subsection 1245(a)(4)(B). Subsection 1245(a)(4)(A) calls for the greater of two recomputed bases to be applied. Only when the greater of the two computations is chosen is the amount realized on the transaction a factor in final recapture determination. Therefore, the allocation of gain to non-depreciable contracts, which affects the amount realized on depreciable contracts, will not interfere with the correct determination of subsection 1245 (a)(4)(B) recomputed basis. Furthermore, if subsection 1245(a)(4)(B) recomputed basis is greater than subsection 1245(a)(4)(C) recomputed basis, the allocation of gain to non-depreciable contracts loophole will not be available to the seller. This is because subsection 1245(a)(4)(B) recaptures depreciation on contracts initially acquired with the franchise. Since the seller purchased these contracts with the franchise they are all depreciable. Thus, the seller will not be able to allocate gain to non-depreciable contracts, since none were held at the time of purchase.

A return to the example of the Bears franchise sale will help illustrate how recapture under subsection 1245(a)(4)(B) applies. When the Bears franchise was purchased by the seller, $650,000 of the total franchise price was allocated to the purchase of the contracts of Players A, B, D, E and F. Of the five players originally purchased, Players A and B remained with the Bears the full five years the seller owned the team. Since the owner depreciated the player contracts over a five-year useful life, the contracts on Players A and B are fully depreciated. Assume that dollar figure under subsection 1245(a)(4)(B) is greater than that under 1245(a)(4)(C) and the amount realized on the sale is greater than the recomputed basis. The subsection 1245(a)(4)(B) recomputed basis figure is, therefore, appropriate for this franchise sale. The seller's previously unrecovered depreciation according to subsection 1245(a)(4)(B)(i) includes "the sum of the deduction al-

allowed or allowable to the taxpayer transferor for the depreciation of any player contracts acquired by him at the time of acquisition of such franchise." 140 Thus, the total amount depreciated on the contracts of Players A and B—$300,000 will be included in the sellers’ unrecaptured deductions.

Player D remained with the Bears for one season. The management depreciated one-fifth of his $100,000 contract leaving an $80,000 adjusted basis. At the end of the taxable year, but before the second season resumed, the Bears sold player D for $10,000 realizing a contract sale loss of $70,000. 141 A contract sale loss, which is subject to section 1231 treatment, is included in the seller’s recomputed basis according to subsection 1245(a)(4)(B)(i) upon the sale of the franchise. Furthermore, the $20,000 depreciation deduction taken in the first year is subject to recapture.

Player E’s contract was purchased from the original franchise for $100,000. Having been a Bear for two years, Player E had an adjusted basis of $60,000. At the end of her second year she retired for religious reasons. When a player retires or is cut, the franchise may take an abandonment loss for that year. 142 Hence, the Bears deducted $60,000 in their second year. However, when the franchise is sold not only the depreciation taken but also an abandonment loss deduction on an originally acquired contract will be subject to recapture under subsection 1245(a)(4)(B). The seller of the Bears will, therefore, be subject to recapture on the entire $100,000 cost basis of Player E’s contract.

The entire amount depreciated will not always be included in the subsection 1245(a)(4)(B) recomputed basis. Section 1245(a)(4)(B)(ii) reduces the recomputed basis by the previously recaptured depreciation on contracts acquired with the franchise. Assume Player F’s contract cost basis is $150,000 and was sold for $200,000 after one year. The new provision first included the $30,000 first year depreciation deduction in the aggregate recomputed basis and then subtracts the same $30,000 under subsection 1245(a)(4)(B)(ii) as having been previously recaptured at the end of year one.

141. See I.R.C. § 165 as amended by 1976 TRA.
142. Id.
Subsection 1245(a)(4)(B) Method

<table>
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<th></th>
<th>A</th>
<th>B</th>
<th>D</th>
<th>E</th>
<th>F</th>
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<td>100k</td>
<td>100k</td>
<td>150k</td>
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<td>490k</td>
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ii) Choice of Adjusted Basis

The chart above indicates that the sum of deductions arrived at under subsection 1245(a)(4)(B) is $490,000. By adding this figure to the adjusted basis the recomputed basis can be obtained. According to subsection 1245(a)(4)(A) the figure to be used is the adjusted basis of the player contracts involved in the transfer. The utilization of the currently held contracts’ adjusted basis instead of the adjusted basis of the contracts initially purchased may work to the seller’s advantage. Whenever recomputed basis is less than amount realized and the same adjusted basis figure is used to compute the recomputed basis and the recapture the employment of either adjusted basis figure will not affect the recapture liability.\textsuperscript{143}

A return to the example of the Bears franchise sale will help to illustrate this point. The total subsection 1245(a)(4)(B) deductions in the Bears sale equalled $490,000. The adjusted basis of contracts involved in the transfer is $60,000, whereas the adjusted basis of those fully depreciated contracts acquired upon acquisition of the franchise is zero. By adding an adjusted basis to the $490,000 in deductions, recomputed basis is derived. By subtracting this adjusted basis from recomputed basis the correct recapture amount will be ascertained.

\textsuperscript{143}. I.R.C. § 1245.
### Adjusted Basis of Contracts Involved in the Transfer  

<table>
<thead>
<tr>
<th>Total Subsection</th>
<th>Adjusted Basis of Contracts Involved in the Transfer</th>
<th>Adjusted Basis of Contracts Acquired with the Franchise</th>
</tr>
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<tr>
<td>1245(a)(4)(B) Deductions</td>
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<td>$490,000</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>60,000</td>
<td>0</td>
</tr>
<tr>
<td>Recomputed Basis</td>
<td>550,000</td>
<td>490,000</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>60,000</td>
<td>0</td>
</tr>
<tr>
<td>Recapture</td>
<td>490,000</td>
<td>490,000</td>
</tr>
</tbody>
</table>

However, when the amount realized is less than recomputed basis, recapture is affected by the Section 1245(a)(4)(A) choice of adjusted basis figures for currently held contracts. Using the same facts as above, suppose the amount realized is $480,000. The seller, by using the $60,000 adjusted basis of contracts involved in the transfer, is able to avoid some recapture liability.

### Adjusted Basis of Contracts Originally Acquired with the Franchise  

<table>
<thead>
<tr>
<th>Total Subsection</th>
<th>Adjusted Basis of Contracts Involved in the Transfer</th>
<th>Adjusted Basis of Contracts Originally Acquired with the Franchise</th>
</tr>
</thead>
<tbody>
<tr>
<td>1245(a)(4)(B) Deductions</td>
<td>$490,000</td>
<td>$490,000</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>60,000</td>
<td>0</td>
</tr>
<tr>
<td>Recomputed Basis</td>
<td>550,000</td>
<td>490,000</td>
</tr>
<tr>
<td>Amount Realized</td>
<td>480,000</td>
<td>480,000</td>
</tr>
<tr>
<td>Lesser of Amount Realized and Recomputed Basis</td>
<td>480,000</td>
<td>480,000</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>60,000</td>
<td>0</td>
</tr>
<tr>
<td>Recapture</td>
<td>420,000</td>
<td>480,000</td>
</tr>
</tbody>
</table>
The seller is also benefitted from the statute's choice of adjusted basis figures in that the burden of recordkeeping and documentation is eased. By not having to ascertain the adjusted bases of the contracts of players long since retired, the franchise will be able to avoid time-consuming, and possibly fruitless, record searches. The adjusted basis of contracts currently held, on the other hand, is information which a franchise will have close at hand.

iii) Extent of Recapture Liability Under Subsection 1245(a)(4)(B)

Returning to the discussion of the Bears franchise sale, the recomputed basis calculated under the subsection 1245(a)(4)(B) method is $490,000. The recomputed basis arrived at under the subsection 1245(a)(4)(C) method is $400,000. Subsection 1245(a)(4)(A) directs the seller to use the larger recomputed basis of the contracts involved in the transfer or of the contracts originally acquired. Therefore, in our example the subsection 1245(a)(4)(B) recomputed basis for originally purchased contracts will be utilized. It should be noted that the actual recapture figure is not determined by the subsection 1245(a)(4) method used. The new provision merely redefines recomputed basis. Thus, once the appropriate recomputed basis figure has been selected, the general section 1245 recapture rules involving the comparing of recomputed basis and amount realized and subtracting adjusted basis from the lower of those two figures become operative.

In the Bears franchise sale example, of the $650,000 allocated to the purchase of player contracts when seller acquired the franchise, $490,000 will be recaptured in the franchise transfer. Another $30,000, representing Player F's recaptured contract, has previously been treated as ordinary income. This leaves $130,000 not recaptured — the $10,000 received from Player D's contract sale and the $120,000 not depreciated on Player F's contract. As has been demonstrated, the extent of subsection 1245(a)(4)(B) recapture liability is very broad. Generally, when the player contracts asset sale price exceeds the subsection 1245(a)(4)(B) recomputed basis, every depreciation or loss deduction taken on originally purchased contracts will be recaptured.

The consequences of the Bears franchise sale example are as follows. The entire franchise was sold for $2 million, of which $1 million was allocated to the purchase of player contracts. The recomputed basis of the player contracts was less than amount realized from their sale, therefore subsection 1245(a)(4) recaptured the greater of the two
amounts. Under subsection 1245(a)(4)(B) $490,000 would be re-
captured on player contracts acquired upon seller’s acquisition of the
franchise. Subsection 1245(a)(4)(C) would recapture $340,000 on
player contracts involved in the transfer. Therefore, the seller in our
example will realize gain of $2 million of which $490,000 will be taxed
at ordinary income rates and the balance as capital gain.

C. Effect of Subsection 1245(a)(4)

i) Effect upon a Less Than 100% transfer of the Franchise

A franchise owner will not fall within the less burdensome general
recapture rules when a large percentage, but not the entire franchise,
is sold. The Senate Finance Committee foresaw the possibility of an
owner retaining a minority interest in the team in order to escape the
new franchise sale provision. Its report attempts to eliminate this
method of subsection 1245(a)(4) avoidance by stating that “it is in-
tended that the sale of a substantial portion of the assets will be treated
as the sale of the entire sports franchise.”144

ii) Effect upon Franchise Transfers

Subsection 1245(a)(4) was enacted in part because the concern
was with the conversion of ordinary income into capital gain.145 Owners
were able to convert ordinary income into capital gains by fully de-
preciating the player contracts. Then when the franchise was sold,
many, if not all, contracts were subject to capital gains taxation.

In the example above, the seller of the club allocated $650,000 to
the purchase of player contracts upon purchasing the Bears. The sel-
lver, in a five-year period, was able to either depreciate or claim losses
on these contracts totaling $490,000. Upon sale of the franchise, the
pre-1976 contract-by-contract method recaptured ordinary income only
on those contracts held at the time of sale. The previous depreciation
deductions on retired contracts were ignored. As a result, $60,000 was
recaptured out of the $1 million allocated to the sale of player contracts.
The remaining $940,000 would be taxed at capital gain rates. There-
fore, while $490,000 in depreciation and losses were deducted from
ordinary income in the first five years of ownership, only $60,000 was
subject to ordinary income recapture when the team was sold. The
$430,000 difference between the two figures is the amount which was
deducted against ordinary income in the last five years and was then

144. See 1976 Report, supra note 8, at 90.
145. Id. at 89.
taxed at capital gains rates. Such a conversion from ordinary income to capital gains offered a considerable tax benefit.\textsuperscript{146}

The other major tax benefit associated with sports franchise investments, the sheltering of taxable ordinary income, also occurred in the first few years of team ownership. Purchasers of sports franchises made it their practice to allocate a high percentage of the acquisition cost to player contracts. When this large amount was depreciated over a short useful life, the deductions in the early years of ownership in most cases were greater than the yearly franchise profit. Thus, the owner had a tax loss. As discussed previously, a loss incurred in the operation of a sports franchise will shelter other taxable income the owner may have.

In sum, the main tax benefits of sports franchise ownership were to be found in the first few years of ownership. These benefits, the conversion of ordinary income to capital gain and the sheltering of income, were made possible by the depreciation of player contracts. As previously illustrated, if the recomputed basis of contracts involved in the transfer is greater than the recomputed basis of contracts originally acquired, and if this figure is less than the amount realized, the conversion of ordinary income to capital gain may still be accomplished by allocating gain to non-depreciable contracts. However, assuming that the seller cannot or does not allocate in such a manner or, as discussed above, the government prohibits such allocations, section 1245 (a)(4) will limit the tax advantages of team ownership. The new provision frustrates the short-term purchaser who had planned to shelter other ordinary income by fully depreciating a large share of the purchase price allocable to player contracts over a short useful life and then selling the franchise subject to capital gain taxation.

Subsection 1245(a)(4) will also affect the long-term owner attempting to sell the club.\textsuperscript{147} Although the deferral of income through depreciation is still possible, the lack of conversion benefit reduces the value of the franchise. Furthermore, the franchise owner may now be subject to recapture on the contracts originally acquired. As mentioned, up to ninety percent of the purchase prices of some franchises

\textsuperscript{146} In our example, $430,000 taxed at the maximum ordinary income tax rate of 70\% yields $301,000 in ordinary income tax liability, whereas the same amount taxed at the maximum capital gains rate of 35\% yields only $150,500 in capital gains tax.

\textsuperscript{147} I.R.C. § 1245(a)(4) upset sports franchise owners. "An effort was made by lobbying groups to get a time limit put on it — to say they wouldn't go back more than 5 or 10 years. Another idea was to provide for a future grandfather clause, to say that if you held a time 10 years there would be no recapture." Maher, \textit{New Law Cuts Owners' Tax Benefits}, L.A. Times, Nov. 30, 1976, sec. 3, at 9, col. 1.
have been allocated to player contracts. Assume the amount allocated to the purchase of the player contracts in a proposed sale is high as well. The owner may be subject to a large amount of ordinary income tax due to either the amount realized in the transfer or to the recomputed basis of contracts initially acquired.

The effect, then, of subsection 1245(a)(4) is to discourage the sale of sports franchises. The potential short-term owner will not be as willing to invest in a franchise because the conversion of ordinary income to capital gain through player contract depreciation is now subject to recapture. The long-term owner will be less likely to sell or will be forced to attempt to sell at a higher price in order to realize a desired post-tax amount, because the amount depreciated from the high percentage allocated to player contracts initially acquired is now taxed at ordinary income rates.

Conclusion

Thus, the enactment of the Tax Reform Act of 1976 has worked substantial changes on the rules regulating the taxation of professional sport franchises. These changes follow the general spirit of the Tax Reform Act of 1976 which was largely devoted to the curtailment of tax shelters. Subsection 1056(c) to a great extent limits the allocation manipulations by the franchise buyer and seller, and thus limits buyer's depreciable cost basis and increases seller's recapture liability. It has been shown, however, that this limitation is viable only when the circumstances are such that the seller is interested in the outcome of the allocation. It has been argued that the fifty percent presumption of subsection 1056(d) is unreasonably and unrealistically low when taken at face value. Furthermore, the viability of this subsection in effecting tax reform will depend upon the burden of proof required of buyer by the IRS to rebut this presumption. With regard to this presumption, the IRS thus has the opportunity to either effect good tax law from an overly-broad and inclusive legislative enactment, or to make the worst of a bad situation by stringently holding franchise buyers to a fifty percent allocation.

The effectiveness of subsection 1245(a)(4) will depend upon how closely the IRS scrutinizes franchise transfers. If the IRS does not challenge individual player contract allocations, the seller may avoid recapture under subsection 1245(a)(4)(C) by allocating gain to non-depreciable contracts. However, that method of recapture avoidance is not possible under subsection 1245(a)(4)(B). As discussed, subsec-
tion 1245(a)(4)(B) will effectively recapture depreciation taken on contracts initially acquired with the franchise.

Close and consistent IRS scrutiny of franchise transfers will limit the conversion of ordinary income into capital gain benefit previously associated with sports franchises. The lack of the conversion benefit may discourage the sale by potential sellers and reduce the attractiveness to potential buyers of sports franchises. Yet unlike many investments, ownership of a sports franchise is not dictated entirely by profits and taxes. There are other considerations for the potential investor, such as the thrill and public notoriety of being involved in professional sports,\(^\text{148}\) which may transcend the restrictive effect of sections 1056 and 1245(a)(4).

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