



APPEALS COORDINATED ISSUE  
SETTLEMENT GUIDELINES  
SPORTS INDUSTRY

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**MEDIA RIGHTS ACQUIRED IN CONNECTION WITH A SPORTS FRANCHISE  
UIL 167.03-03**

**STATEMENT OF ISSUES<sup>1</sup>**

1. Whether media rights acquired in connection with the acquisition of a professional sports franchise prior to October 23, 2004 are an asset separate and distinct from goodwill?
2. For acquisitions prior to October 23, 2004, if the media rights are a separate asset, are they, or any part of them, subject to depreciation or amortization?

**COMPLIANCE'S POSITIONS**

1. If a sports franchise has utilized a valuation approach similar to the methodology allowed in Newark Morning Ledger v. U.S., 507 U.S. 546 (1993), 93-1 USTC ¶150,228, then the identified media rights will likely have an ascertainable value, separate and distinct from the goodwill of the acquired enterprise. See Field Service Advice 200142007 (July 3, 2001).
2. With the purchase of either an existing or an expansion sports franchise, a taxpayer acquires certain media rights, including the current broadcast contracts and the right to enter into future broadcast contracts. While the current broadcast contracts cover certain distinct and ascertainable periods, the Service contends that the asset represented by these contracts is the sports franchise's perpetual right to share in and to receive national and local broadcast revenue.

Accordingly, it is the Service's position that although the current broadcast contracts can be viewed as providing a measurement of the broadcast rights over a specific period of time, each sports franchise's right to broadcast its games and the right to receive such revenue will continue indefinitely. While the

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<sup>1</sup> Section 886 of the American Jobs Creation Act of 2004 (H.R. 4520/P.L. 108-357) enacted on October 22, 2004 extends the 15-year recovery period under IRC §197 to professional sports franchises and intangible assets acquired therewith, including player contracts. Accordingly, these guidelines apply to sports franchise acquisitions prior to October 23, 2004.

term of a particular contract will expire, the Service contends that the right to the broadcast revenues will continue indefinitely and the contract will either be renewed with the current broadcaster or replaced with a contract with a competing broadcaster. Thus, any changes in the contract or the parties to the contract will not affect either the continuous nature of the revenue stream generated by these media rights or the sports franchise's right to share in or receive such broadcast revenue.

Since a limited life cannot be ascertained, it is the Service's position that no portion of the media rights (i.e. the current broadcast contracts or the right to enter into future broadcast contracts) are amortizable under IRC §167 or IRC §197. See Technical Advice Memorandum 200244019 (June 19, 2002) and Field Service Advice 200142007 (July 3, 2001).

## **INDUSTRY/TAXPAYER POSITIONS**

In regards to Issue 1, both the Service and the Industry agree that the overall media rights can be valued using a discounted cash flow analysis or a comparable approach. Therefore, a sports franchise utilizing this type of valuation technique will probably be able to establish that the identified media rights have an ascertainable value that is separate and distinct from the goodwill of the acquired enterprise. However, as with any valuation issue, the specific amount to be allocated to the media rights is a factual determination.

With respect to Issue 2, three court cases decided prior to Newark Morning Ledger v. U.S., *supra*<sup>2</sup>, held that the acquired media rights, represented by the current broadcast contracts and the right to negotiate and enter into future broadcast contracts and to receive payments from such future contracts, could not be amortized under IRC §167 because these rights did not have a limited useful life.

The Industry agrees with the Service's position that a sports franchise's right to enter into future broadcast contracts after the expiration of the current contracts, the right to receive the broadcast revenue stream from such future contracts, and/or the franchise right are not amortizable under IRC §167. However, the Industry has advanced the following arguments in support of its position that the current broadcast contracts are amortizable under IRC §167:

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<sup>2</sup> Under Newark Morning Ledger, an intangible asset, such as the media rights at issue herein, which would otherwise fall within the concept of goodwill, is depreciable provided it has an ascertainable value and a limited useful life that can be determined with reasonable accuracy.

- ✍ The three cases that pre-date Newark Morning Ledger relied upon a “link in a perpetual chain” theory<sup>3</sup> which is outdated and no longer legally controlling. Essentially, the Industry asserts that the three pre-Newark decisions are both factually and legally flawed and are inconsistent with the Supreme Court’s holding in Newark Morning Ledger.
- ✍ As part of its asset purchase, the Industry claims that a sports franchise acquires two related but distinct intangible assets—the current broadcast contracts and the right to enter into future broadcast contracts. As a result, the Industry concludes that the current broadcast contracts are amortizable under IRC §167 as it meets the two-pronged factual test set forth in Newark Morning Ledger.
- ✍ Finally, the Industry maintains that the current broadcast contracts do not self-regenerate, are not automatically replaced and by its terms are not renewable. Each new broadcast contract is negotiated only through the substantial efforts of the league on behalf of its member clubs or by the individual sports franchise. In addition, these new contracts contain different substantive terms than the prior contracts and can be made with different networks.

Based on these arguments, the Industry concludes that the current broadcast contracts have a limited useful life, are not self-regenerating, and according to Newark Morning Ledger are amortizable under IRC §167.

## **DISCUSSION**

### **Background/Facts**

Professional sports franchises are generally operated as either partnerships or corporations. Each individual franchise is a member of their respective league association. The primary purpose of the league association is to promote the sport, maintain the integrity of the game, negotiate national television broadcast rights, negotiate national sponsorship agreements, enter into collective bargaining agreements with the players association, and protect the interests of the sports franchise owners and the sports league as a whole.

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<sup>3</sup> This concept, which the Industry contends is essentially a restatement of the mass-asset rule, provides that the current broadcasting contracts are merely links in a perpetual chain of broadcasting revenue that will continue for as long as the sports franchise and/or the respective league is in existence. Thus, these decisions are based on each court’s determination that the current broadcast contracts and the right to enter into future contracts are part of the same asset.

## Organizational Form of the Professional Sports Leagues<sup>4</sup>

The National Football League (“NFL”) is an unincorporated association, not organized or operated for profit.<sup>5</sup> However, the NFL carries out several business transactions through its independent NFL Properties, Inc., which is operated for profit. Membership and the rights thereof are limited and restricted. There are two sources of authority in the NFL: the Executive Committee and the Commissioner. The Executive Committee includes one representative from each member team, usually the team owner. Its powers are provided by the NFL Constitution and acts by affirmative vote of no less than three-fourths of its members. The Commissioner is also present at each meeting of the Executive Committee.

The National Basketball Association (“NBA”) and the National Hockey League (“NHL”) are, generally speaking, organized in the same manner as the NFL. They are unincorporated, non-profit associations with limited membership and a franchise system. The leagues have an elected Commissioner with similar powers and the owners are organized in a common council, called the “Board of Governors”.<sup>6</sup>

Baseball is structured somewhat differently. The two leagues, the American League of Professional Baseball Clubs and the National League of Professional Baseball Clubs, are unincorporated non-profit associations with limited membership and a franchise system.<sup>7</sup> Basically, these two leagues are independent from each other with their own executive power. The Major League Baseball Agreement contains the governing rules for the business of baseball. The agreement renders the power to the Commissioner and sets up an Executive Council consisting of the Commissioner and eight Club members, four from each league.

Essentially, the Commissioner can be described as the chief executive officer of the league. The Commissioner is elected by the owners and is an employee of the league. The league’s regulations vest the Commissioner’s office with the authority to arbitrate disputes between members of the associations and the Commissioner has full, complete, and final jurisdiction of any dispute (except those excluded by the collective bargaining agreements). The Commissioner, acting on behalf of the league collectively, may disapprove any contract entered into by a franchise with a player or with television

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<sup>4</sup> “The Legal Concept of Professional Sports Leagues: The Commissioner and an Alternative Approach from a Corporate Perspective”, by Gregor Lentze, Marquette Sports Law Journal, Fall, 1995 (6 Marq. Sports L.J. 65)

<sup>5</sup> National Football League Constitution and By-Laws

<sup>6</sup> National Basketball Association Constitution and By-Laws; National Hockey League Constitution and By-Laws

<sup>7</sup> Constitution and Rules of The National League of Professional Baseball Clubs; Constitution of The American League of Professional Baseball Clubs

networks, and no sale or trade by a sports franchise is binding without the Commissioner's approval.

### Acquisition of a Sports Franchise-Rights Obtained

With the acquisition of a professional sports franchise, the purchaser becomes a member of the league organization in which the team competes. Membership in the league carries with it substantial and valuable rights and benefits. Some of these rights include:

- a. The exclusive right to exhibit league games within a designated geographical area from the corporate limits of the home team. No other member of the league is permitted to play games (except games with the home club) in the home territory of a member and no franchise can be granted for operation within the home territory of a member without the prior written consent of that member.
- b. The right to participate in and obtain players through the college or amateur drafts, trades with other teams and by other methods determined by the respective leagues.
- c. The benefit of league administrative services including: preparation of game schedules, negotiation of television contracts, organization of the college draft, resolution of disputes among member clubs and others.
- d. The benefit of league rules and regulations.
- e. The right to share in league-wide revenue sources including national television contracts and licensing/merchandising/promotional activities as well as proceeds from league expansion.
- f. Exclusive local television and radio broadcast rights.
- g. A share of the league's goodwill.
- h. The right to participate in the exhibition of the league's professional sport by competing with other teams in the league as well as other rights and benefits of being a member of the league.

According to the Constitutions and By-Laws of the various leagues, each member Club owns the right to license the television, radio, video, audio, etc. broadcast rights for those games in which it participates in.<sup>8</sup> However, the Clubs have designated the League's Commissioner to act on their behalf with respect to certain contracts such as the national broadcast contracts.<sup>9</sup> As a result, the various league agreements grants the Commissioner the authority to pool each Club's right to broadcast its games nationally.

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<sup>8</sup> See NFL Constitution §10.2 (stating that, subject to certain limitations and exceptions, "member clubs participating in any games are authorized to telecast and broadcast such game anywhere...") Also see MLB Constitution §§10.3, 10.4.

<sup>9</sup> See NFL Constitution §8.10; See MLB Constitution §10.4

These so-called “pooled rights agreements” have been in existence for approximately 43 years. In 1961, the NFL teams at the time, agreed to sell their collective television rights as a single package and to share broadcast revenue equally among all franchises. This decision was in direct response to arguments made by then Commissioner Pete Rozelle that the league’s competitive balance on the field would eventually be destroyed if teams in major television markets continued to sell their broadcast rights individually. In the long run, Commissioner Rozelle believed great differentials in television revenues among teams would lead to a competitive imbalance that would diminish the overall attractiveness of the NFL’s product.<sup>10</sup>

As a result, by the end of 1961, Congress passed the Sports Broadcasting Act (Sept. 30, 1961, P.L. 87-331, §1, 75 Stat. 732, codified as amended at 15 USCS §1291). This act permitted professional sports leagues to negotiate the sale of national broadcast rights as a single economic unit. This provision applies to professional baseball, hockey and basketball, as well as football.

Accordingly, the League Commissioner negotiates and executes the national broadcast contracts on behalf of its member Clubs. The revenues attributable to the sale of these rights are payable to the League Commissioner as agent for the Clubs. These revenues are remitted to a centralized fund and are allocated to the Clubs, generally equally, although there is some variation for participation in post-season games.<sup>11</sup> It should be noted that although the Commissioner has the sole authority to arrange, negotiate, alter, amend, and enforce the national broadcast contracts, these agreements are not binding unless ratified by either a majority or three-fourths of the members of the League.<sup>12</sup>

Typically, the national media contracts have renewal provisions providing for exclusive negotiation rights with respect to any future contract. However, if no agreement can be reached with the particular major broadcast network and/or the cable television partner, the leagues have the ability to negotiate with other networks. Local media contracts also contain similar provisions.

Generally, the owner of a particular sports franchise has the ability to negotiate its own local television, cable, satellite and radio broadcast contracts. This local media revenue remains with the respective team and is not shared among the other league members.

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<sup>10</sup> See United States Football League v. National Football League, 842 F.2d 1335, 1346 (CA 2<sup>nd</sup> Cir. 1987).

<sup>11</sup> See Section 10.3 of the NFL Constitution which provides that if an NFL club, pursuant to the authority granted to it in Section 10.2, negotiates a broadcast contract with a network on its own, it must share the resulting revenues with the other clubs in the league. Also see the MLB Constitution.

<sup>12</sup> See NFL Constitution §8.10 and MLB Constitution §5.2.

## The Negotiation Process for National Broadcast Contracts

During the first stage, the Commissioner, with input from the league's committee members, discusses with the networks the terms that the Clubs and the terms that the networks want included in the contracts. This dialogue continues as the Commissioner and the networks bargain over what terms will be included in the final contracts.

During this process, both the leagues and the networks formulate detailed revenue/profitability models to ascertain the "maximum reasonable amount" the networks would be capable of paying.<sup>13</sup>

The first stage of the negotiations leads to the creation of several different contract packages, each of which grants the contracting network the right to broadcast a certain "inventory" of games. According to the Industry, the specific makeup of the inventory included in each package is the subject of significant discussion, negotiation, and bargaining between the Leagues and the networks. The inventory of a particular package contract often changes from one contract cycle to the next.

In addition to determining the inventory of games for each package, the Leagues and the networks will also negotiate the following items, which can change from contract to contract and from cycle to cycle:

- ✍ whether the contract package will include any pre-season games as well as regular season and post-season games;
- ✍ when games will be played and televised;
- ✍ how many commercials the network will be entitled to air during a game, and when these commercials may be inserted in the telecast;
- ✍ what types of commercials may or may not be aired;
- ✍ what rights the network will have to the subsequent use of the audio and video feeds for the game;
- ✍ the timing of the kickoff and the length of half-time;
- ✍ what announcements promoting its own programming the network will be entitled to make during the telecast; and

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<sup>13</sup> "The NFL-Network Television Contracts, 1998", authored by Professor Stephen A. Greyser, Harvard Business School, June 17, 1999 (9-599-039)



✍ the placement of commercial signage in the stadium.

At the second stage of the contract negotiations, each of the networks is invited to bid on the various contract packages offered by the Leagues. After the networks' bids are opened, the Commissioner and the Clubs decide which network will be awarded each contract package.

## **Issue 1-Law and Analysis**

Media rights can be valued using an income approach known as the discounted cash flow method.<sup>14</sup> This technique estimates the fair market value of an intangible asset by calculating the present value of annual net cash flows.

Annual cash flows are computed by determining the net receipts from the identified media source less allocated operating expenses and income taxes. Net receipts are determined by taking into consideration the media contracts in place at the time the sports franchise is acquired. Since the franchise will continue to generate cash flows related to these media rights beyond the expiration of the current contracts, it is necessary to determine the value of the cash flows for these subsequent periods.

Accordingly, the discounted cash flow analysis typically incorporates a "terminal" or a "remainder" value using a constant growth model. This estimate merely continues the projection of cash flow based on a percentage increase in revenues reflecting expected inflation rates. Operating expenses allocated to the projected media revenues can be based, for example, on a percentage of the relative amount of revenues from all applicable sources.

Thus, based on a discounted cash flow approach, the fair market value of the media rights can be bifurcated into two components. The first component represents the present value of the media rights for the existing contracts as of the acquisition date. The useful life of this component is based on the terms of the actual contracts, generally three to five years in duration. It is this component of the media rights that the Industry contends is amortizable.

The second component represents the right to enter into future broadcast contracts after the expiration of the current contracts and the anticipated revenue stream from these future contracts. This element is based on the assumption that a sports franchise has a perpetual right to enter into national and local broadcast contracts as long as it remains a member of the respective league and/or as long as the league is in existence. Accordingly, this component has an indefinite life and is not eligible for depreciation or

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<sup>14</sup> See Newark Morning Ledger vs. U.S., supra, (the discounted cash flow approach was an appropriate method to value the intangible asset under consideration).

amortization. The Industry agrees that a sports franchise's inherent right to enter into future broadcast contracts after the current contracts expire and to receive such revenues derived from these future contracts is not eligible for depreciation or amortization under IRC §167 or IRC §197.

Another way to value the media rights is by the use of a residual method.<sup>15</sup> It should be noted that in the past, various sports franchises have not separately valued the acquired media rights. As a result, the value of this intangible asset was included in either franchise value or goodwill.

## **Issue 2-Law and Analysis**

IRC §167 and IRC §197 provide the rules for depreciation and amortization of intangible assets. IRC §197 provides for a 15-year amortization period and generally applies to a broad range of purchased intangible assets. Section 197 is effective for intangibles acquired after August 10, 1993. Section 167 provides for the amortization of intangible assets not covered by, or specifically excluded from Section 197.

IRC §197(e)(6) provides that the term "section 197 intangible" shall not include a franchise to engage in professional sports, and any item acquired in connection with such a franchise. Also see Reg. §1.197-2(c)(10)<sup>16</sup>. Thus, the broadcast contracts and the other media rights acquired by a sports franchise are excluded from amortization under IRC §197.

Section 886 of The American Jobs Creation Act of 2004 (H.R. 4520/P.L. 108-357), enacted on October 22, 2004, extends the 15-year recovery period under IRC §197 to professional sports franchises and intangible assets acquired therewith, including player contracts.

Therefore, for sports franchises acquired after the October 22, 2004 enactment date of the American Jobs Creation Act of 2004, the following changes will apply:

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<sup>15</sup> IRC §1060 requires both the buyer and the seller of a trade or business to allocate the consideration paid or received among assets using the residual method prescribed by regulations issued under IRC §338. Under this method individual assets are assigned to an "asset class." The consideration attributable to the class is split proportionately among the assets in the class to determine the basis or gain or loss. For asset acquisitions after January 5, 2000, there are seven asset classes. For asset acquisitions after February 13, 1997, and before January 6, 2000, there were five asset classes. For asset acquisitions prior to February 14, 1997, there were four asset classes.

<sup>16</sup> Section 197 intangibles do not include any franchise to engage in professional baseball, basketball, football, or any other professional sport, and any item (even though otherwise qualifying as a section 197 intangible) acquired in connection with such a franchise.

- ✍ IRC §197(e), relating to exceptions to the definition of a section 197 intangible, is amended by striking paragraph 6 and by redesignating paragraphs 7 and 8 as paragraphs 6 and 7, respectively.
- ✍ IRC §1056, relating to basis limitation for player contracts transferred in connection with the sale of a franchise, is repealed.
- ✍ IRC §1245(a), relating to gain from the disposition of certain depreciable property (player contracts), is amended by striking paragraph 4.
- ✍ IRC §1253, relating to transfers of franchises, trademarks and trade names, is amended by striking subsection (e).

IRC §167(a) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in a trade or business. The property must be an intrinsically wasting asset, Griswold v. Commissioner, 400 F.2d 427, 433 (5<sup>th</sup> Cir. 1968), however, its useful life is not necessarily the useful life inherent in the asset but it is the period over which the asset may reasonably be expected to be useful in the taxpayer's trade or business. See Regs. §1.167(b)-1. The term "property" includes intangible assets, and Reg. §1.167(a)-3<sup>17</sup> provides that where an intangible asset is known from experience or other factors to be of use in the business for only a limited time, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation deduction. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life.

In order to qualify for the depreciation deduction under IRC §167(a), the taxpayer must establish that the intangible asset has an ascertainable value separate and distinct from goodwill, and has a limited useful life, the duration of which can be ascertained with reasonable accuracy. See Houston Chronicle Publishing Co. v. U.S., 481 F.2d 1240, 1250 (5<sup>th</sup> Cir. 1973), cert. denied, 414 U.S. 1129 (1974).

In Houston Chronicle, the taxpayer acquired a subscription list of a defunct newspaper. Because the newspaper would not continue to be published, there was no issue of whether the list was self-regenerating. The Service sought to impose the "mass-asset" rule to deny depreciation deductions. The Fifth Circuit, however, concluded that the

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<sup>17</sup> In conjunction with issuance of the final regulations on capitalizing amounts paid to acquire or create intangible assets (Reg. §1.263(a)-4 and Reg. §1.263(a)-5, effective as of December 31, 2003), Reg. §1.167(a)-3 was amended by adding paragraph (b)—Safe harbor amortization for certain intangible assets. This new section provides for a 15-year safe harbor amortization period applicable to certain created intangible assets that do not have readily ascertainable useful lives and for which an amortization period is not otherwise prescribed or prohibited by the Code, regulations, or other published guidance. It appears that sports franchises will be unable to rely on this safe harbor provision as the media rights/current broadcast contracts represent acquired intangible assets.

availability of a depreciation deduction was determined by analyzing the facts of each case, and that the mass-asset rule did not result in a per se prohibition merely because the asset was related to goodwill. The Court in Houston Chronicle embraced the two-part test described above as the appropriate standard for determining whether the subscription list could be depreciated. Specifically, the Court stated the following:

"Without compiling the myriad case that discuss the "mass asset rule", we are satisfied that the rule does not establish a per se rule of non-amortizability in every case involving both goodwill and other intangible assets. In light of §167(a) of the Code and Regulation §1.167(a)-3, we are convinced that the "mass asset" rule does not prevent taking an amortization deduction if the taxpayer properly carries his dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable certainty. " 481 F2d at 1249-50.

Thus, it was contended that Houston Chronicle represented a clear departure from the blanket application of the mass-asset rule. After Houston Chronicle, the mass rule tended to disappear from the case law, but it was somewhat revived by the Tax Court in Ithaca Industries, Inc. v. Commissioner, 94-1 USTC ¶50,100 (CA-4), affirming Tax Court, 97 TC 253 (1991).

Prior to the Supreme Court's decision in Newark Morning Ledger, the Tax Court issued its opinion in Citizens and Southern Corp. v. Commissioner, 91 T.C. 463 (1988), aff'g without op. 900 F.2d 266 (11<sup>th</sup> Cir. 1990) and Ithaca Industries, Inc. v. Commissioner, 97 T.C. 253, 262 (1991), aff'd, 94-1 USTC ¶50,100 (4<sup>th</sup> Cir.), cert. denied, 513 U.S. 831 (1994).

In Citizens and Southern Corp. v. Commissioner, supra, the taxpayer acquired nine banks and allocated a portion of the purchase price to an identified deposit base as a separate intangible asset subject to amortization. The "core deposit base" is defined as the present value of the future stream of income expected to be derived through the servicing, use and investment of the core deposits of a purchased bank. *Id.* at 465-55. Core deposits are liabilities represented by the deposits held in the bank and include regular savings, demand deposits (checking) and time deposit accounts. *Id.* at 465.

During the trial, after an exhaustive factual analysis, the taxpayer established that the deposit base had an ascertainable cost basis separate and distinct from the goodwill and going-concern value of the acquired banks and that it had a limited useful life.

In ruling that Citizens and Southern had proven that its core deposit base was separate and distinct from goodwill, the court applied the Houston Chronicle test, stressing the factual nature of the issue. Relevant to the Court's decision was the fact that Citizens

and Southern presented evidence from regulatory authorities and generally accepted accounting principles that recognized core deposits as a separate asset from goodwill. *Id.* at 496-98.

In Ithaca Industries, Inc. v. Commissioner, *supra*, the taxpayer purchased the stock of a corporation which it then liquidated. Ithaca, an apparel manufacturer, allocated the price of the stock among the assets it acquired, including two assets designated as the “assembled work force” asset and the “raw materials contracts” asset. Ithaca entered into contracts with hosiery and other retailers to supply them with a stated quantity of garments over a specific period of time. In anticipation of meeting these contract requirements, Ithaca entered into long-term contracts to purchase raw materials used in the manufacture of these garments. The Service argued that the taxpayer could not amortize either asset because both assets were part of goodwill and going-concern value, and that both assets would self-regenerate.

In regards to the assembled work force asset, the Tax Court concluded that this was not a wasting asset with an ascertainable life. The court noted that the taxpayer failed to establish that the value of the assembled work force diminished over time because when one employee left, another employee was hired to take such employee’s place. The Tax Court characterized the turnover of employees as merely representing the “ebb and flow of a continuing work force”. In reaching its decision, the Tax Court advised that the facts in Newark Morning Ledger’s District Court’s decision<sup>18</sup> and Citizens & Southern Corp. v. Commissioner, 91 T.C. 463 (1988), *aff’g* 900 F.2d 266 (11<sup>th</sup> Cir. 1990) were distinguishable from the facts in this particular case.

The Tax Court next considered whether the taxpayer could amortize the raw materials supply contracts. This asset can be described as a favorable supply contract for yarn. One of the arguments presented by the Government was that the contracts under consideration were indefinite in length because the existing contracts would be replaced with new contracts with the same suppliers and therefore, were regenerative.

The Tax Court disagreed with the Government’s argument and held that the raw materials supply contracts could be amortized because it was separate from goodwill and did not self-regenerate. In addressing this issue, the Court stated the following:

“While new contracts might or might not be negotiated by petitioner with the same supplier, neither the purchaser nor the supplier would be willing to enter into a contract that was automatically renewable or consider any contract as automatically renewable with prices as volatile as those of the yarn market.”

Thus, one factor that was relevant to the Court in reaching its determination was the volatility of the cotton and the polyester markets (i.e. market conditions). In addition, the

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<sup>18</sup> 734 F. Supp. 176, 90-1 USTC ¶50,193 (DC)

evidence submitted by Ithaca established that the raw material supply contracts were not automatically renewed and that all of the contracts were entered into only after negotiations. The Government did not appeal this issue.

In Newark Morning Ledger v. U.S., supra, as the result of a 1987 merger, Newark Morning Ledger Co., a newspaper publisher, was the successor to another newspaper publisher, The Herald Company, which itself had purchased substantially all the shares of a third publisher, Booth Newspapers, Inc. Herald allocated a portion of its purchase price for the Booth shares to an intangible asset denominated “paid subscribers”. This intangible consisted of a list of some 460,000 paid subscribers to the eight Booth newspapers. Herald amortized this “paid subscribers” intangible asset based upon the estimated length of time subscribers to each newspaper would continue their relationship with the paper. The government disallowed the deduction, asserting that the paid subscribers asset was indistinguishable from goodwill and was therefore unamortizable.

Consistent with Houston Chronicle, Newark Morning Ledger argued at trial that to amortize the acquired subscriptions list, it was only required to prove that (1) “paid subscribers” was a wasting intangible whose life could be estimated with reasonable accuracy, and (2) the intangible had an ascertainable value separate and distinct from goodwill. Newark Morning Ledger submitted, and the government stipulated to, statistical evidence showing that “paid subscribers” had a limited useful life and an ascertainable value determined by the use of a discounted cash flow approach.

The government, however, argued that Newark Morning Ledger had not overcome the essential hurdle to such amortization deductions—that in addition to establishing a useful life and a direct value, the taxpayer was required to prove that the intangible was not goodwill. The Government viewed the income expected to be generated from the at-will subscribers as value associated with the expectancy of continued patronage, and, accordingly, was not separate and apart from nondepreciable goodwill.

The District Court rejected the government’s argument and allowed Newark Morning Ledger’s amortization deductions, finding that it had satisfied the dual burden of proving that the “paid subscribers” asset was not self-regenerating, and that it had a limited useful life the duration of which could be calculated with reasonably accuracy. The Court also found that the value of the asset was properly calculated and that the asset was separate and distinct from goodwill.

On appeal, the government argued that the lower court improperly defined goodwill as a mere residual and that Newark’s Morning Ledger’s amortization deductions should have been denied because it had failed to establish that the “paid subscribers” had a value “separate and distinct from goodwill”.

The Third Circuit<sup>19</sup> agreed with the government and reversed the District Court. In its decision, the Court determined that even though the “paid subscribers” asset may have a limited useful life that can be ascertained with reasonable accuracy, its value is not separate and distinct from goodwill. The Third Circuit reasoned that goodwill has a substantive meaning, “the expectancy that old customers will resort to the old place of business”, and that “paid subscribers” is the essence of goodwill.

The law governing the amortization of acquired intangibles both before and after Newark’s Third Circuit’s decision was unclear and conflicting. Many cases considered the amortization of the same intangible asset and the majority of these cases utilized the Houston Chronicle analysis, but none of the outcomes could be predicted with any reasonable degree of certainty. In an effort to resolve this conflict and ambiguity, the Supreme Court granted Newark Morning Ledger’s petition for certiorari.

In a five to four decision, the Supreme Court reversed the Third Circuit and held that in order to amortize intangible property under Reg. §1.167(a)-3, a taxpayer must prove that the intangible property satisfies a two-pronged factual test: (1) the intangible property must have an ascertainable cost basis; and (2) the intangible property must have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

The majority concluded that the definition of goodwill as the expectancy of continued patronage “is of little assistance to a taxpayer trying to evaluate which of its intangible assets is subject to a depreciation allowance.” 507 U.S. at 556. The Court pointed out that all intangibles acquired as part of an operating business are in some way tied to the expectancy of continued patronage. Thus, the significant question for purposes of depreciation is not whether the asset falls “within the core of the concept of goodwill”, but whether the asset is capable of being valued and whether that value diminishes over time.

In determining whether an intangible asset has a limited useful life, the Supreme Court in Newark Morning Ledger also referred to the “mass asset” rule or the “indivisible asset” rule, which is described as follows:

“Certain kinds of intangible assets are properly grouped and considered as a single entity; even though the individual components of the asset may expire or terminate over time, they are replaced by new components, thereby causing only minimal fluctuations and no measurable loss in the value of the whole.... The mass-asset rule prohibits the depreciation of certain customer-based intangibles because they constitute self-

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<sup>19</sup> See 91-2 USTC ¶50,451 (CA-3), reversing and remanding District Court decision, 90-1 USTC ¶50,193, 734 F. Supp. 176

regenerating assets that may change but never waste.” 507 U.S. at 557-558.<sup>20</sup>

Although the end result of Newark’s Supreme Court decision was essentially a clarification of Houston Chronicle’s factual standard, the Court was careful not to imply that the taxpayer’s burden of proving the life and value of an intangible asset was insignificant.

It was contended by some legal experts that the precedential value of Newark Morning Ledger was rather limited. Not only was it a five to four decision, it was thought that the government erred by not contesting the taxpayer’s expert evidence and by stipulating to the useful life estimates of the “paid subscribers”. While Newark Morning Ledger clarified the legal issue—that certain intangibles such as customer lists may sometimes qualify for amortization despite their association with the expectancy of continued patronage—the factual hurdle still remained. The Supreme Court’s caveat on the taxpayer’s burden of proof indicated that continuing disputes and burdensome fact-intensive inquiries remained inevitable. Congress recognizing the concerns associated with this decision predicted that “these types of disputes can be expected to continue to arise, even after [Newark Morning Ledger].”<sup>21</sup>

Consequently, in 1993, IRC §197 was added to the Code in an effort to eliminate controversies concerning the determination of whether an intangible asset is amortizable and the proper method and period for recovering the cost of an acquired amortizable intangible.

Therefore, the purpose of IRC §197 was to allow for a single method and period for recovering the cost of most acquired intangible assets (ratably over 15 years) and treating acquired goodwill and going concern value as amortizable intangibles. As discussed earlier, sports franchises are excluded from the provisions of §197.

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<sup>20</sup> It should be noted that the mass or the indivisible asset rule survived in Newark Morning Ledger. See Footnote 8 of Ithaca Industries, Inc. v. Commissioner, 94-1 USTC ¶150,100 (CA-4<sup>th</sup>), affirming the Tax Court, 97 TC 253 (1991) (“The Court left intact the so-called mass-asset rule...” “Newark Morning Ledger subsumes the mass asset rule under a broader inquiry aimed at determining whether the asset can be valued and whether its useful life is limited”); also see Globe Life and Accident Insurance Co. v. U.S., 54 Fed. Cl. 132, 136 (Ct. Cl. 2002) (“In determining whether an intangible asset had a limited useful life, the Newark Morning Ledger Court also referred to the mass-asset rule...”).

<sup>21</sup> See S. Rep. No. 1134, 103d Cong., 1<sup>st</sup> Sess. 216 (1993) and H.R. Rep. No. 103-11, 103<sup>rd</sup> Cong., 1<sup>st</sup> Sess. 760(1993) (The Conference Managers commented that much of the controversy in this area would be eliminated by specifying a single amortization method and amortizable life for all amortizable intangible assets and by treating goodwill as such an asset. Moreover, the Managers expressed concern over the majority’s statement that the burden on the taxpayer to meet the test for depreciability would “often prove too difficult to bear”. Id. citing Newark Morning Ledger, 113 S. Ct. at 1681).



Subsequent to Newark's Supreme Court decision, the Fourth Circuit issued its decision in Ithaca Industries, Inc. v. Commissioner, 94-1 USTC ¶ 50,100 (CA 4<sup>th</sup> Cir.). In affirming the Tax Court, 97 TC 253, the Fourth Circuit held that a corporation's work force was not an amortizable asset, because its useful life could not be accurately estimated. However, the Fourth Circuit concluded that the "mass-asset" rule did not apply to this situation because the work force was not a self-regenerating asset as it was preserved only through the company's substantial training and recruiting efforts.<sup>22</sup>

Thus, in order to determine whether the media rights at issue satisfy the two-pronged factual test set forth in Newark Morning Ledger, it must be established that this intangible asset can be valued and has a limited useful life. As previously discussed in Issue 1, a sports franchise will be able to establish an ascertainable value for its media rights if it utilizes an appropriate valuation method. However, the question as to whether the current media contracts<sup>23</sup> have a limited useful life and represent a wasting asset is not as straightforward.

Prior to the 1993 Newark Morning Ledger decision, three court cases considered the issue of whether national media rights were amortizable under IRC §167. E. Cody Laird v. U.S., 556 F.2d 1224 (5th Cir. 1977), [77-2 USTC ¶9569], cert. denied, 434 U.S. 1014 (1978), involved the tax treatment of the purchase of the Atlanta Falcons professional football franchise. One of the issues presented in Laird was whether the purchaser of the Falcons was entitled to amortize its ratable share of the revenues produced by a four-year contract executed by the Commissioner of the NFL and CBS under which CBS received the right to televise the NFL's games. The NFL franchises had agreed to bargain collectively for the sale of their television rights and to share ratably in the income produced by such sale. *Id.* at 1229. Faced with these facts, the Fifth Circuit first observed that the franchise owner's television rights were, by agreement, to continue as long as the Falcons remained a member of the NFL; thus, the television rights were inherent in the franchise. The court then rejected the taxpayer's contention that the right to broadcast revenue under the four-year CBS contract constituted a separate and amortizable asset from the franchise's future, uncontracted television rights. The taxpayer argued that the CBS contract was a wasting asset, and therefore amortizable, because it had a proven value—the present value of the guaranteed future income under the contract—and a limited useful life—the four year contract term. The court, in adopting the government's "link in a perpetual chain" theory, stated the following:

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<sup>22</sup> As stated in footnote 10 of this opinion, "The important question is whether the asset's maintenance is accomplished by significant efforts not already expended in the initial formation or purchase of the asset."

<sup>23</sup> This can be described as the present value of the existing broadcast contracts as of the acquisition date. As stated earlier in this discussion, the Industry agrees that a sports franchise's inherent right to enter into future broadcast contracts after the expiration of the current contracts, the right to receive the broadcast revenue stream from such future contracts and/or the franchise rights are not amortizable under IRC §167 or IRC §197.

“As the Government correctly points out, the rights under the CBS contract were only a “four-year link” in a “perpetual chain” of television income. Though the existing contract provided a measure of the purchaser’s television rights over a particular four-year period, nevertheless the rights were to continue indefinitely...Because the rights pursuant to the CBS contract were only a link in a chain of revenue which would continue as long as the Atlanta Club holds an NFL franchise, they did not constitute a wasting asset...”

*Id.* at 1236-37. Based on this analysis, the Court concluded that it was “clear that the unlimited life of the television rights defeats any attempt to amortize the income received under the CBS contract.” *Id.* at 1237.

In First Northwest Industries v. Commissioner, 70 T.C. 817 (1978), rev’d and remanded on other grds., 649 F.2d 707 (9th Cir. 1981) [81-2 USTC ¶9529], the Court addressed a National Basketball Association team’s right to share in revenues from the national television broadcast of NBA games. The Court held there was a reasonable expectation that the NBA would continue to have a favorable national television contract and, since such rights could continue indefinitely, they were not amortizable. Citing Laird with approval, the Court found that the rights under the then current television contract were only a link in a continuing chain of national television income. These rights would last for as long as the team held an NBA franchise and the source of the rights was the NBA membership. Thus, the current contract only provided a measure of value for the acquired rights to the NBA television revenue. Such rights continued indefinitely, and therefore, could not be amortized.

The case of McCarthy v. U.S., 807 F.2d 1306 (6th Cir. 1986) [87-1 USTC ¶9101], aff’g in part and vacated in part, remanded, 622 F.Supp. 595 (N.D. Ohio, 1985) [86-2 USTC ¶9510], also dealt with the amortization of broadcast rights acquired in the purchase of a sports franchise, a professional baseball team. Both national and local broadcast contracts were acquired, and the taxpayer attempted to characterize the broadcast rights acquired (as is the situation herein) as being comprised of two components: the current broadcast contracts existing at the time of the purchase, and the future broadcast rights inherent in the franchise which had yet to be contracted for. The taxpayer argued that the current rights had both a limited useful life represented by the unexpired term of the existing contracts and an ascertainable value. Accordingly, the taxpayer contended that it met the test of Houston Chronicle, supra, and these rights were subject to amortization.

However, the Court reached the opposite conclusion. It found the rights did not have a limited useful life which could be ascertained with reasonable accuracy and, therefore, could not be amortized as wasting assets. The Court reasoned that both the national and the local broadcast contracts were links in a perpetual chain of broadcasting revenues. Accordingly, as long as the club remained a major league baseball franchise, the club would have the right to share in the revenues produced by the national

contract. Upon expiration of each contract, a new contract providing for further revenues would be executed. Although the then current broadcast contract covered a distinct ascertainable period, the asset represented by the contract did not have a limited useful life and, therefore, could not be considered a wasting asset. The same conclusion was reached in regards to the local broadcast contracts. The Court reasoned that each team's right to contract for the local broadcast of games was a right inherent in the franchise and this right had an indeterminate useful life coextensive with the life of the franchise. In reaching its decision, the Court stated that the right to broadcast games locally and nationally was still extremely valuable to the franchise at the expiration of the current contracts. The Court reasoned that while the franchise will certainly become a party to a new broadcast contract at the expiration of each preceding contract, it does not do so in order to reacquire an asset; rather it does so in order to obtain revenues from an existing asset.

In summary, this trilogy of cases holds that a broadcast contract, even if it can be identified, valued and given a life, is not a separate amortizable asset but is merely representative of the current value of a sports franchise's broadcast rights, which has no ascertainable useful life since this right exists for as long as the sports franchise is a member of its respective league.

Therefore, based on the three pre-Newark cases previously discussed, it is the Service's position that a sports franchise acquires only one media asset rather than two related but distinct assets as argued by the Industry. While the current broadcast contracts cover certain distinct and ascertainable periods, the intangible asset represented by these contracts, the sports franchise's perpetual right to receive both national and local broadcast revenue, does not have a limited useful life and, accordingly, cannot be considered a wasting asset. The Service maintains that both the national broadcast rights and the right to contract for the local broadcast of games are rights inherent in the acquired franchise. Therefore, these rights have an indeterminable useful life, coextensive with the life of the franchise itself. Although the term of a particular contract will expire, the Service contends that a new contract will be entered into with either the same broadcaster or a competitor. However, the revenues generated by the broadcast contracts continue indefinitely, as the asset, the overall media rights, never expires.

The Service also contends that due to distinguishable facts and circumstances, Newark Morning Ledger does not render the older case law obsolete. According to the Service, in contrast with other types of customer-based or supplier-based contracts, the media contracts and the underlying rights acquired by the owner of a sports franchise are dependent only upon the membership in the particular league in which the team plays. The only qualification of the franchise's right to share in the income from the national and local broadcast contracts is related exclusively to its continued membership in the league. This membership terminates only upon the elimination of the franchise as a member team, or alternatively, the demise of the league as an organization.

The Industry, in disagreeing with the Service's position, asserts that a sports franchise acquires two related but distinct assets as part of the asset purchase—the current broadcast contracts and the right to enter into future broadcast contracts and receive the income from such contracts. The Industry contends that under Newark Morning Ledger, the current broadcast contracts are amortizable while the latter rights are not. Since the current media rights can be measured by the existing media contracts that are of a limited duration, the Industry maintains that this component has an ascertainable useful life and therefore, is amortizable under IRC §167.

The Industry also argues that the legal analysis in Laird, McCarthy and First Northwest Industries is inconsistent with the Supreme Court's decision in Newark Morning Ledger. These cases all rely on the theory that the current broadcast contracts and the right to enter into future contracts are part of the same asset. According to the Industry, this “link in the chain” or “ebb and flow” analysis is essentially an application of the mass-asset rule which has been discarded by Newark in favor of that case's two-pronged test.

As argued by the Industry, cases such as Newark Morning Ledger, the Fourth Circuit's decision in Ithaca Industries, and the Tax Court decision in Citizens & Southern, however, all demonstrate that the current broadcast contracts and the right to enter into future contracts should not be grouped together but instead should be treated as separate and identifiable assets. Accordingly, the Industry concludes that as a legal matter, the three pre-Newark cases that addressed the broadcast contracts/media rights issue are no longer legally controlling and should be accorded no weight.

Furthermore, the Industry contends that the three prior cases contain fundamental flaws in their factual descriptions of the broadcast contracts and as a result, these decisions are based on incorrect facts<sup>24</sup>. Additionally, the Industry asserts that significant efforts are expended in negotiating new broadcast contracts. The new contracts contain substantive terms significantly different from the terms contained in the prior contracts. The new contract packages are often made with networks that were not parties to the old contracts. Therefore, the current broadcast contracts do not self-regenerate and have a limited useful life.

## **SETTLEMENT GUIDELINES**

### **Issue 1**

As discussed in an earlier section, the overall media rights can be valued using a discounted cash flow approach. This technique bifurcates the overall media rights into a

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<sup>24</sup> For example, the court in McCarthy assumes that future broadcast contracts will be “similar” to the current contract. 807 F.2d 1308 (“the franchises contemplated the execution of future network broadcasting contracts similar to the [existing] contract.”)

current component (i.e. the current broadcast contracts) and a future component (i.e. the right to enter into future broadcast contracts). Accordingly, if a sports franchise utilizes a valuation approach similar to the technique allowed in Newark Morning Ledger Co. vs. U.S., supra, there should be no dispute that the media rights have an ascertainable value, separate and distinct from the goodwill of the acquired enterprise. This conclusion is consistent with the Service's position set forth in Field Service Advice 200142007. However, as with any valuation matter, resolution of this issue will normally be on a factual basis.

Recently, the LMSB Industry Director for Communications, Technology, and Media issued two directives that provide examiners with a Compliance Measurement Tool to be used in the classification and the examination of taxpayers that acquire sports franchises. (Refer to 2003 TNT 221-37 and 2003 TNT 221-38, release date: October 24, 2003).

Based on these directives, Compliance will consider the sports franchise's allocation to, and amortization of, the acquired intangible assets to be acceptable if the sum of the present values of the amortization deductions for the acquired amortizable intangible assets does not exceed 60% of the purchase price allocable to all acquired intangible assets. The Compliance Measure Tool excludes consideration of the media rights issue. Therefore, the issue as to whether the media rights intangible asset, or any part thereof, can be amortized will be addressed at the Appeals level.

In addition, pursuant to the terms of the LMSB Industry Directives, participating sports franchises will be required to enter into closing agreements setting forth the values allocable to all of the acquired intangible assets, including the current broadcast contracts and the right to enter into such future contracts. Therefore, based on the terms of this initiative, it is anticipated that Appeals will not encounter asset valuation issues typically associated with the acquisition of a business enterprise.

In the event a sports franchise does not elect to participate in the Compliance Measurement Tool or is ineligible to do so, sufficient documentation (e.g. valuation appraisals) should be included with the administrative file in order to establish the specific fair market values to be allocated to the media rights and the other intangible assets. Undeveloped cases may have to be returned to Compliance for further analysis and consideration.

## **Issue 2**

The Appeals Settlement Guidelines take into consideration the following issues:

- ✍ What is the acquired asset or property right obtained by a sports franchise?
- ✍ Whether the pre-Newark cases are obsolete and no longer legally controlling.
- ✍ Whether the cases cited by the Industry are distinguishable.

✍ Whether the media rights asset self-regenerates.

✍ **What is the acquired asset or property right obtained by a sports franchise?**

As a preliminary matter, resolution of the media rights issue centers on one critical question, what is the identity of the asset acquired? As part of its asset purchase, a sports franchise either acquires one media asset (an indivisible asset referred to as the continuing or perpetual broadcast rights), or two related but distinct and separate media assets (the current broadcast contracts with stated lives and the continuing/perpetual broadcast rights). Therefore, in the event of litigation, a court would have to make a factual determination as to the exact nature of the asset(s) or the property right(s) acquired by the purchaser of a sports franchise. In addition, a court will have to determine whether the current contracts at issue are amortizable or whether the current contracts are merely representative of the value of the asset underlying or generating the broadcast contracts and thereby not subject to amortization.

In making its determination, it is anticipated that a court will focus on the respective franchise agreements, the constitutions and by-laws of the various leagues, the relationship between the parties, the terms of the national and local media broadcast contracts, etc. Based on a review of these documents, the following facts warrant mention:

1. According to the terms of the national broadcast contracts, the respective league grants to the network the “right to deliver in or into the broadcast area a single live broadcast of each game”. This is generally referred to as the “Television Rights Transferred”. Therefore, by its contract terms, the parties acknowledge that the respective league is selling and the television networks (for example) are purchasing a package of games and with it the property rights/license to these games for an extended period of time. A sports franchise receives its pro-rata share of the national television broadcast revenue notwithstanding the number of games that are broadcast. In fact, the games will be played by a particular team despite television coverage.
2. According to the franchise agreement and the league’s constitution and by-laws, membership in a particular league carries with it substantial rights and benefits. Relevant to this discussion, a sports franchise acquires the following: (a) the right to share in league-wide revenue sources, including national television contracts, (b) the right to license the television, radio, video, audio, etc. broadcast rights for those games in which it participates in; and (c) exclusive local television and radio broadcast rights. These rights continue for the duration of the team’s and/or the league’s existence.

3. The members have designated the league's Commissioner to act on their behalf with respect to certain contracts such as the national broadcast contracts. As a result, the league's agreement grants the Commissioner the authority to pool each member's right to broadcast its games nationally. These so-called "pooled rights" agreements came into existence in 1961 by virtue of the passage of the Sports Broadcasting Act (Sept. 1961, P.L. 87-331, §1, 75 Stat. 732, codified and amended at 15 USCS §1291).<sup>25</sup>

Accordingly, each of its member clubs authorizes the league to license to the networks its telecasting rights in games in which they play. Thus, the national broadcast contracts represent the networks' payments for the transfer of each member's property rights (i.e. license of its broadcast rights) for a certain "inventory" of games and for a specific length of time. As a result, a sports team acquires an interest or a right to share in the revenue stream derived from these national contracts.

In light of the Newark Supreme Court decision, the Industry's argument that the purchasing sports franchise acquires two broadcast related assets—the current contract and the right to enter into future broadcast contracts—cannot be ignored or dismissed based solely on the holdings in the three pre-Newark cases. However, in reviewing the facts and applicable law, Appeals also acknowledges that the Service's position—that the asset acquired is the perpetual right to receive broadcast revenues which is derived from league membership—has some merit.

Appeals views this matter as follows: In order to resolve this issue, a court must first make a factual determination as to what is the identity of the acquired asset or assets. Second, due to similar fact patterns,<sup>26</sup> the Service relies on the Laird, McCarthy and First Northwest Industries cases to support its' position. The Industry, however, maintains that these three cases are no longer legally controlling in light of the Newark decision. Thus, a question arises as to how much emphasis a court would place on these prior cases in making its determination. In reaching its decision, a court would also have to consider the following: (a) whether Newark does in fact render these three cases obsolete, and (b) whether the cases cited by the Industry in support of its position are distinguishable from the facts in the media rights issue.

Accordingly, due to the uniqueness of this media rights issue and these unresolved areas, it is difficult for Appeals to speculate as to how a court would rule on this particular matter with any degree of certainty.

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<sup>25</sup> Based on discussions with the Industry, the national network television contracts, negotiated and executed by the League Commissioner, are generally not made available to member clubs for their review or examination.

<sup>26</sup> The pooling arrangements in today's leagues appear to be similar to that described in the McCarthy and Laird cases. Also, see the McCarthy case for a description of the process by which the Commissioner of Major League Baseball entered into television contracts on behalf of its member clubs.

## Whether the pre-Newark cases are obsolete and no longer legally controlling

While three separate court cases have upheld the Service's position that the asset in question is the non-amortizable perpetual media rights, these decisions were rendered prior to the Supreme Court decision of Newark Morning Ledger. As previously discussed, these cases held that the current broadcast contract did not constitute a separate asset, but instead, simply provided a means for measuring the value of a sports franchise's perpetual right to enter into broadcast contracts.

In light of the Newark decision, the Industry maintains that the Service faces substantial litigating hazards in regards to the media rights issue. Obviously, the Service does not agree with this position.

According to the Industry, the "link-in-a chain" theory was adopted by the dissent in Newark Morning Ledger. The dissent in that case contended that the "paid subscribers" asset was not a separate amortizable asset, but instead was "unmistakably a direct measurement of goodwill". See Newark Morning Ledger Co. v. U.S., supra, (Souter, J. dissenting). Thus, the Industry maintains that the theory of the Newark dissent and of Laird, McCarthy and First Northwest Industries is also the same theory that the Service advanced in Federal Home Loan Mortgage Corp. v. Commissioner, 121 T.C. No. 13 (Sept. 29, 2003). In this recent case, the Service contended that the taxpayer's right to use borrowed money at below-market rates had "measurable economic value," but that the right did not constitute an amortizable asset.

As stated by the Industry, in all of these cases (Laird, McCarthy, First Northwest Industries, Newark, and Federal Home Loan Mortgage), the Service argued that the current asset was no more than a measuring stick for the value of a portion of the non-amortizable goodwill. However, according to the Industry, the Supreme Court in Newark held that this "stick" could be amortized because the right acquired was a separate asset. Thus, the Industry insists that Newark discarded the "link-in-a-chain" theory. In Newark, the Supreme Court held that the current subscription contracts did not simply provide a measurement of goodwill, but instead constituted an amortizable asset separate and distinct from the right to enter into future subscription revenue. See 507 U.S. at 569 ("The cost of generating a list of new subscribers is irrelevant, for it represents the value of an entirely different asset"). Applying this rationale to the current broadcast contracts, it is the Industry's position that these contracts do not simply provide a measurement of a portion of a sports franchise's goodwill or franchise value. Instead, the current contracts constitute a distinct, amortizable asset "susceptible of measurement" even though both they and the right to enter into future contracts generally relate to the production of broadcast revenue.



As discussed in an earlier section, the Supreme Court in Newark Morning Ledger essentially de-emphasized the definition of goodwill, and instead adopted a two-pronged test for the amortization of intangible assets. Thus, Newark, in rejecting the Service's definitional goodwill theory, established that in order to amortize an intangible asset under pre-§197 law, a taxpayer must satisfy two requirements: (1) that the intangible asset has an ascertainable value; and (2) that the asset has a limited useful life (i.e. is not self-regenerating). If an asset meets this two-pronged test, then by definition the intangible is not goodwill regardless of whether the asset is related to an expectancy of continued patronage.<sup>27</sup>

The Supreme Court's analysis in Newark closely followed the decision in Houston Chronicle, supra, and basically adopted the test advocated by the Fifth Circuit, in which the Court expressly held that a subscription list, regardless of its connection to future patronage, was not per se part of residual goodwill value. Newark, however, effectively eliminated the third prong of the Houston Chronicle test, which required the taxpayer to additionally prove that the asset was "separate and distinct" from goodwill.

Therefore, after Newark, it is no longer appropriate to classify an intangible asset based on its resemblance to the classic concept of goodwill or going-concern. In essence, the Newark decision precludes the Service from arguing that goodwill-related assets may not be amortized as a matter of law. Instead, it is forced to concentrate on factual inquiries regarding the method of valuing the asset, the asset's claimed life, and the period over which the asset should be amortized. Despite the clarification of the law as it applied to intangible assets, the Newark decision left many unanswered questions and disputes between the Service and taxpayers were expected to continue. As a result, IRC §197 was enacted to resolve these controversies. However, sports franchises are excluded from the provisions of section 197.

It should be noted that in reaching its decisions in the three pre-Newark cases, each of the respective courts considered either the mass-asset theory and/or some of the same cases also considered by the Supreme Court in Newark Morning Ledger (i.e. Houston Chronicle, Boe v. Commissioner, 62-2 USTC ¶9699, Richard S. Miller & Sons, Inc. v. U.S., 76-2 USTC ¶9481). Also see the Laird case, in which the court concluded that if the taxpayers were able to prove that the television rights had a limited life, the mass-asset rule would not bar a depreciation deduction for those rights. Accordingly, it has been suggested by the Service that this supports its argument that Newark does not render these earlier cases obsolete. Obviously, there is a possibility that a court may find some validity in this position.

As previously discussed, in addition to the Newark decision, the Industry relies on other cases in support of its position. Based on a review of these cases, it should be pointed out that these cases all have one central premise, that a factual determination was

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<sup>27</sup> As stated by the Fourth Circuit in Ithaca Industries, Inc. v. Commissioner, supra, "although Newark addressed only goodwill specifically, it's teaching is equally applicable to going concern value".

made by the court as to whether the intangible asset at issue was amortizable and had a limited useful life.<sup>28</sup> For example, in addressing the assembled work force asset, the Tax Court in Ithaca Industries stated the following:

“The facts in this case are distinguishable from Citizens & Southern Corp. v. Commissioner, supra. In Citizens & Southern, this court made a factual determination that the core deposits at issue did not possess any characteristics of goodwill. On the facts in this case, we conclude that the assembled work force is not an asset that is separate and distinct from going-concern value since it is not a wasting asset.”

Newark Morning Ledger made a similar factual determination in characterizing the asset at issue. Also see Global Life and Accident Insurance Company v. U.S., supra, (“the determination of whether the taxpayer has proven that an intangible asset may be amortized is a question of fact”). The conclusion reached by the Tax Court in Federal Home Loan Mortgage Corp. v. Commissioner, supra, can be summarized as follows:

“Favorable financing involves the right to use borrowed money at below-market interest rates. The right to use the proceeds of financing arrangements with below-market interest rates constitutes an economic benefit. The benefit of petitioner’s below-market financing, can, as a matter of law, constitute an intangible asset which *could be amortized if petitioner establishes a fair market value and a limited useful life as of January 1, 1985*”. (emphasis added).

In FMR Corp. & Subs. v. Commissioner, 102 T.C. 402(1998), in disallowing amortization deductions relating to expenditures incurred in launching a number of regulated investment companies, the Court explained that the availability of an amortization deduction relating to an intangible asset is “primarily a question of fact” with the taxpayer bearing the burden of proof. Id. at 430 (citing Newark Morning Ledger Co. v. U.S., 507 U.S. at 560, 566).

In Meredith Corp. & Subs. v. Commissioner, 102 T.C. 406 (1994), in disallowing claimed amortization deductions related to an employment contract, the court explained that the taxpayer’s burden of proof was “not insignificant and that burden often will prove too great to bear.” Id. at 436 (quoting Newark Morning Ledger Co. v. U.S., supra at 566).

Also refer to Houston Chronicle. In this particular case, the Court considered the Fifth’s Circuit’s decision in Blaine v. U.S., 71-1 USTC ¶9373, 441 F.2d 91, which addressed the issue of whether subscription lists are non-amortizable as a matter of law. Although the Fifth Circuit reversed the case, the Houston Chronicle court stated the following:

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<sup>28</sup> The Industry recognizes this concern but insists that it can meet the substantial evidentiary burden imposed by Newark Morning Ledger.

“In other words, we refused to find that the lists there involved were non-amortizable as a matter of law; to the contrary, we treated the issue as a factual question, i.e. whether the limited and ascertainable lives of the intangibles had been proven by sufficient competent evidence”.

Based on the above, Appeals contends that an argument can be made that Newark Morning Ledger does not resolve the following factual questions: (1) what media assets are acquired by the purchaser of a sports franchise (i.e. one indivisible asset or two separate but related assets), and (2) whether the media asset under consideration is a wasting asset with a limited useful life.<sup>29</sup>

The decision rendered in Moore v. Commissioner, T.C. Memo 1995-52, warrants some discussion. The issue addressed by the Tax Court was whether the taxpayers were able to separately depreciate or amortize a premium paid to acquire real property (an office building) with an above-market lease in place. In Moore, on September 1, 1986, the taxpayers entered into a contract to purchase an office building. As of this date, the building was subject to a lease which obligated the lessee to pay rent which exceeded market rent until April 30, 1989. The purchase price for the property was \$2,210,644. The various documents memorializing the sale did not purport to allocate the purchase price among the building, land, personal property or the lease.

The taxpayers allocated \$932,715 of the total purchase price to the building and reported depreciation deductions computed under the straight line method over 19 years. At the same time, the taxpayers allocated \$1 million of the purchase price to the premium value of the lease as a separate, depreciable asset, and began amortizing this item over the 32-month remaining rental period. On the basis of Newark Morning Ledger, the taxpayers contended that they “need only show that the premium value of the lease has an ascertainable value and a limited useful life”. The Service disallowed the amortization deductions for the taxable years 1986 through 1989.

The Tax Court rejected the taxpayers’ argument. The Court noted that the issue raised in this case is in no sense a novel one.<sup>30</sup> Specifically, the Court stated that “there is no basis in law or fact for treating the premium value of the lease in question as an asset separate and distinct from the fee interest in the property that the taxpayer acquired. In simple terms, the value of the lease (whether favorable or otherwise) is reflected in the value of the property that encumbers it”. In reaching this conclusion, the Tax Court rejected the argument that Newark Morning Ledger was applicable.

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<sup>29</sup> It can be reasoned that the two-pronged test set forth in Newark Morning Ledger is a test to determine whether an asset is amortizable rather than a test for identifying the particular asset for purposes of amortization. Again, the identification of the asset(s) is a factual determination to be made by the court.

<sup>30</sup> Effective for property placed into service after August 10, 1993, I.R.C. §167(c) (2) and I.R.C. §197(e) (5) statutorily resolves this issue.

Although the nature of the media rights asset is distinguishable from the asset considered by the Tax Court in Moores, it is possible that a court could view the Moores case as somewhat analogous to the three pre-Newark cases, as in all of these cases, each of the taxpayers attempted to segregate and amortize a portion of a larger asset. For example, in Moores, the taxpayers attempted to segregate the premium value of the lease from the fee interest in the property that the taxpayers acquired. In regards to the media rights issue, the Industry is attempting to segregate the current broadcast contracts from the acquired perpetual media rights.

In Capital Blue Cross, et. al. v. Commissioner, 122 T.C. No. 11 (3/12/2004), the Tax Court held that a medical insurer was not entitled to loss deductions under IRC §165(a) for terminated group health insurance contracts. Agreeing with the Service, the Court concluded that the taxpayer's valuation of the group contracts was deficient since these contracts were valued as part of a block rather than as separate assets. The Tax Court, in reaching its decision, considered Newark Morning Ledger and cases both preceding and subsequent to Newark Morning Ledger. Specifically, the Court considered and discussed some of the following cases: Newark Morning Ledger, Houston Chronicle, Richard S. Miller & Sons, Inc. v. U.S., Citizens and Southern Corp., Ithaca Industries, Global Life & Accident Insurance Co., etc.

Prior to considering the evidence before the Tax Court relating to the valuation of the taxpayer's health insurance contracts, the Court discussed the legal precedent relevant to the valuation and the amortization of customer-based intangible assets. According to the Court,

"The court opinions typically frame the issue as whether a taxpayer's evidence, valuation and (where relevant) useful life determination relating to intangible assets are adequate to support the separate and discrete tax treatment claimed. Where the taxpayer's evidence is found to be lacking, the intangible assets may be referred to as "mass assets".

The purpose for mentioning the Capital Blue Cross case in this discussion relates to the Tax Court's analysis and consideration of several cases that were decided prior to the Supreme Court's opinion in Newark Morning Ledger. The cases cited by the Tax Court involved loss deductions claimed under section 165 and attempted valuations of customer-based intangible assets. As stated by the Court,

"A number of court opinions decided prior to the Supreme Court's opinion in Newark Morning Ledger Co. v. United States, supra, involved loss deductions claimed under section 165 and attempted valuations of customer-based intangible assets, and we believe them still to have relevance in the context of the instant case".

Accordingly, the above statement that was made in a recent Tax Court decision indicates that there is a chance that a court could reach a similar conclusion with

respect to the media rights issue (e.g. that the pre-Newark cases still have some relevancy even after the Newark decision).

In another recent case, the issue of whether discount brokerage customer accounts are amortizable was addressed by the Tax Court in The Charles Schwab Corp., et. al. v. Commissioner, 122 T.C. No. 10 (3/9/2004). In this case, the taxpayer acquired all of the outstanding shares of another discount stock brokerage company, Rose & Co. Investment Brokers, Inc. The taxpayer wanted to acquire Rose's customer base in order to expand its presence in the Chicago and New York markets. Because the taxpayer was unable to acquire Rose's customer base separate from Rose's other assets, the taxpayer purchased Rose's stock and discarded the Rose name and infrastructure to gain access to Rose's customer base. Based on an appraisal, approximately \$13 million was allocated to the Rose customer accounts acquired by the taxpayer.

Although the Service admitted that customer accounts are one type of intangible asset for which amortization is available under IRC §167, the Service focusing on the "seminal" holding in Newark, argued that customer accounts of brokers differ from newspaper subscriptions in ways which would make the Newark holding inapplicable to the facts of this case. In the event the court determined that the acquired customer accounts were amortizable, the Service raised an alternative argument that the taxpayer had not established the values or the useful lives of this acquired intangible asset.

Basically, the Service's argument was that brokerage accounts differed to such an extent that they did not fall within the factual content of the Supreme Court's holding in Newark. In deciding that the Rose customer accounts are amortizable under §167, the Court agreed with the taxpayer that "brokerage customers are not, per se, distinguishable from newspaper subscribers in any way that would make the circumstances we considered here distinguishable from those in Newark". In regards to the Service's alternative arguments, the Court accepted the values and the useful lives advocated by the taxpayer's expert as his methodology was determined to be more appropriate and reliable as compared to that of the government's expert.

Although on hindsight, it appears that the Service's primary argument was relatively weak, the Court, again, made a factual determination as to whether the asset at issue was amortizable and had a limited useful life. Appeals also recognizes that a court, in deciding the media rights issue, could reach a similar conclusion as that reached by the Tax Court in The Charles Schwab Corp. case—that the media rights asset is not "per se distinguishable" from the intangible asset considered by Newark. If this were to occur, it appears the Industry would likely prevail in its argument.

✍ **Are media contracts/rights distinguishable from the intangible assets in the cases cited by the Industry?**

The Industry relies upon the holdings in cases such as Newark Morning Ledger, Citizens and Southern, and Ithaca Industries as authority that the purchaser of a sports

franchise acquires two separate but related assets, one of which has a limited useful life.

As discussed in an earlier section, Houston Chronicle and Newark dealt with acquired subscription lists while Citizens and Southern, Ithaca Industries and Federal Home Loan Mortgage Corp. addressed core deposits, raw material supply contracts /assembled work force and favorable financing, respectively.

The Industry contends that the Ithaca Industries Tax Court decision supports its position that the media contracts at issue have a limited useful life and thus, are amortizable. During the Tax Court proceedings, one of the arguments advanced by the Government was that the raw material supply contracts have an indefinite life because the existing contracts would be replaced with new contracts with the same supplier and therefore, were regenerative. The Tax Court did not agree with the Government's argument and held that the raw material supply contracts are assets separate and distinct from goodwill or going-concern value with an ascertainable value and a limited useful life. In reaching this conclusion, the Court determined that due to the volatility of the cotton and the polyester markets, the contracts "were not renewable as a matter of course".

Although this case poses a hazard for the Service, it can be argued that the Ithaca contracts are clearly distinguishable from the media rights/contracts acquired by a sports franchise. In addition, the customer structural relationships for each situation are completely different. In Ithaca, the raw material contracts represented the company's right to purchase a certain commodity at a fixed price. Due to the volatility of the cotton and the polyester markets, the raw material supply contracts had the ability to become very valuable in the event of favorable price fluctuations. This volatility made the issue of renewability questionable. It does not appear that a sports league's national broadcast contracts exhibit the same level of volatility as that of the yarn markets. Also, the raw materials (i.e. cotton and polyester) were available from different sources/suppliers and Ithaca's suppliers had the ability to sell its products to other enterprises.

In regards to the media contracts, the situation is the exact opposite as that presented by Ithaca. Rather than purchasing raw materials, the leagues, as agents for its member clubs, are selling to the various networks a package of games and with it the property rights to these games for an extended period of time. For example, each club in either the NFL or MLB authorizes its respective league, acting as agent for all of its teams, to license to the networks its telecasting rights in games in which they play. According to the national contracts, the league grants to the network the right to deliver, in or into the broadcast area, a single live broadcast of each game (e.g. the television rights transferred). Thus, all of the contracts expressly provide for the sale of the rights to broadcast games. If the network cannot telecast a particular game being played, the contracts generally provide that there will be no reduction in the rights to fees if any other game telecast is available to be substituted for the scheduled telecast. In this way, all teams will be ensured their pro-rata portion of the broadcasting income regardless of the overall performance or attendance of any particular game.

In regards to a supply contract such as the one addressed in Ithaca, the favorable terms made available by the supply seller can be described as the right or privilege set forth in the contract that is of value or benefit to the supply purchaser and it is that element that wastes (depreciates) over the term of the contract. With respect to the media rights, it is the sale of the broadcast rights that produces the income rather than the use or consumption by the sports franchise of a wasting asset. Thus, the question to be addressed by a court is whether the value of the media rights diminishes as the result of the passage of time or through its use.

In light of the Capital Blue Cross decision, there is the prospect that a court will find the McCarthy Sixth Circuit's distinction between player contracts and national broadcasting contracts to be instructive even after the Newark decision. In addressing the issue of the amortization of player contracts, the Sixth Circuit noted that both the taxpayer and the Commissioner contended that player contracts were analogous to the broadcasting contracts because when they lapsed after a definite term, new player contracts were always executed. In response to this argument, the Court stated the following:

“The appellants [taxpayers] and the Commissioner ignore a very significant distinction between the two types of contracts. When a player contract expires, the franchise, which was a party to the contract, no longer has an asset with any value. The asset represented by the contract, the player's agreement to play for the franchise, no longer exists. Accordingly, the asset “wasted” over the period of the contract. The only way the franchise can reacquire the asset is to re-contract with the player, committing itself to pay additional amounts to the player in return for the player's services. In short, the franchise must reinvest additional capital to retain the asset.

Broadcasting contracts are very different. At the expiration of those contracts, the franchise still retains the very valuable asset of the right to broadcast its games. It need not *reinvest in order to retain the asset*. (emphasis added). Thus, the asset does not “waste away” during the term of any specific broadcasting contract. While a franchise will certainly become a party to a new broadcasting contract at the expiration of each preceding contract, it does not do so in order to reacquire an asset, rather, it does so in order to obtain revenues for an existing asset.” 807 F.2d 1312-1313.

The fundamental premise behind depreciation or amortization is “to reflect the loss in value of an asset used to produce income and to make a meaningful allocation of the cost to the tax period benefited by the use of the asset”. (See the Ithaca Industries Tax Court decision, citing Massey Motors, Inc. v. U.S., 60-2 USTC ¶9554, 364 U.S. 92 (1960)).

In the case of a player's contract, it is the right to the player's services that is of value to the sports franchise and it is this use of the player's services that both generates revenue and wastes over the term of the contract. What is pointed out by the McCarthy decision is that the value of a broadcast contract is not dependent on the identity of the particular broadcaster. Its value does not originate from the acquisition of a right from the broadcaster that wastes over the term of the contract. Instead, it is the sale of its broadcast rights that generates revenue rather than the sports franchise's use or consumption of a wasting asset. To a sports franchise, the value of a broadcast contract originates from its inherent broadcast rights that are sold or can be sold in the future. In measuring this value, it would appear that the identification of the particular buyer-broadcaster may not be very pertinent.

On a different thought, some law journal articles have raised the argument that the collective sale of television rights by sports leagues may have an anti-competitive effect in the marketplace by forcing the buyers of those rights (e.g. the networks) to deal with and acquire the rights from only one source. "If pooling creates a collective or joint product that only may be obtained from a single seller and if that single seller enjoys "market power" over buyers or consumers of that product, then the single seller will have and invariably will exercise the power to restrict sales and drive up prices above competitive pricing levels."<sup>31</sup>

Although it is not the intention of Appeals to express an opinion on this particular argument, the relevancy of the above paragraph to this discussion is merely to establish that the relationship between the leagues and its member clubs along with the various broadcast networks represents a very unique situation in the market place.<sup>32</sup>

Essentially, there is only one source of the broadcast rights (i.e. each respective league) and there is only one product (i.e. the member clubs' collective rights to broadcast

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<sup>31</sup> See The Legality of the Exclusive Collective Sale of Intellectual Property Rights by Sports Leagues, Author Gary R. Roberts, Virginia Journal of Sports and the Law, Spring 2001, 3 Va. J. Sports & L. 52

<sup>32</sup> This unusual arrangement was addressed in the Laird decision. As stated in this decision, "The member clubs of the NFL were in a unique relationship with each other. While the precise nature of the association is impossible to describe in purely legal terms, it might be characterized as a joint venture, or trade association organized for the purpose of promoting and fostering the primary business purpose of its member. While the member teams were competitors on the playing field, they were seldom competitors in the business sense. The nature of the League was such that the members were bound by rules and regulations designed to promote competitive balance among them." Recognizing that while television rights were owned by the member teams individually rather than by the League, the court commented that Congress had passed legislation in the early 1960's exempting the NFL and other professional sports leagues from the anti-trust laws in order to allow them to bargain collectively for the sale of television rights. This pooling of television rights was of great benefit to league members and was considered a major factor in the growth of the NFL.



games). So, the league, as agent for its member clubs, is the exclusive seller and the controller of the media rights asset. In addition, the bidding and the negotiation process appears to be different for sports related media contracts as compared to other customer-related and/or supplier-related intangibles.

Based on the above, Appeals believes that the unique nature of the media rights asset in conjunction with the distinguishing characteristics of this asset as compared to the intangible assets considered by Newark Morning Ledger and the other cases relied upon by the Industry, poses a litigating hazard for the Industry.

### **✍ Whether the broadcast contracts/rights self-regenerate?**

It is the position of the Industry that the national broadcast contracts do not self-regenerate. According to the Industry, there is “no automatic replacement” of the broadcast contracts, nor are they renewable. The leagues negotiate entirely new contracts for each contract cycle. These new contracts contain different substantive terms than the prior contracts and can be made with different networks. For example, for each contract cycle, the parties re-negotiate the game “inventory” for each package, the number of advertising units available to the network, the networks’ right to the audio and video feed, the fee that the networks will pay to the league/member clubs for the right to broadcast games. As a further example of the negotiation of each new contract, it is anticipated that Internet rights will be an issue during the negotiations for the next contract package. Thus, each new broadcast contract is negotiated only through the substantial efforts of the league on behalf of its member clubs. Relying on the Ithaca Industries Tax Court decision, the Industry argues that simply because one contract may be replaced with a similar contract does not prevent a taxpayer from amortizing the value of the first contract.

In the alternative, the Service contends that although a new broadcast contract would replace the current contract, it is for the same media right (either the national or the local broadcast right) but for a subsequent period. While the individual contract might end, the right to broadcast and its related revenue, inherent in the ownership of the sports franchise, would continue to exist and remains a valuable asset. In addition, the user of this media right (the broadcaster), is not the source of the asset being valued. The source is the franchise’s right to receive the broadcast revenue, from whatever broadcaster, and this right is solely attributable to the team’s membership in its respective league. Thus, the Service concludes that the media rights are self-regenerative as the asset is singular in nature, and a contract to use the asset (i.e. the perpetual media rights) is replaced (or expected to be replaced) one for one as it expires.

As discussed in an earlier section, the mass or indivisible asset rule survived after the Supreme Court decision of Newark Morning Ledger. Under the mass asset rule,

certain types of intangible assets are grouped together and treated as a single asset even though the individual components of the asset may expire or terminate over time; they are continuously replaced by new components resulting in no measurable loss in the value of the entire asset. Thus, a mass asset is considered a wasting asset if it does not self-regenerate. A mass asset does not self-regenerate if the mass/indivisible asset is maintained only through the substantial efforts of the owner of this asset. Thus, the question as to whether an asset self-regenerates is a factual one.

Again, resolution of this question focuses on the definitional question—What is the acquired asset? As previously stated, the Service identifies the acquired asset as the right to receive broadcast revenues derived from league membership, which does not have an ascertainable life, while the Industry characterizes the acquired asset of consisting of two separate and distinct components, one being the current contracts which have an ascertainable life.

The Service contends that although the terms of the contracts may vary each cycle period, the renewal of the national broadcast contracts is almost certain.<sup>33</sup> Therefore, the Service maintains that existing case law provides that the life of an asset cannot be limited by the remote, speculative possibility that renewal of a contract might not occur. See Richmond Television Corp. vs. U.S., 354 F.2d 410, 412 (4<sup>th</sup> Cir. 1965)<sup>34</sup>. Also see Nachman v. Commissioner, (5<sup>th</sup> Cir. 1951), 191 F.2d 934, in which the Fifth Circuit held that a taxpayer who purchased a liquor license which possessed, by custom, a valuable renewal privilege of undefined duration, could not amortize the cost of the license.

Although Appeals agrees that the media contracts are not automatically renewable and the terms of the contracts vary each contract cycle, historical data and past practice within the Industry evidences that the national media contracts have been renewed either with the current contracting network or with a competitor. See generally, United States Football League v. National Football League, 842 F.2d 1335 (2<sup>nd</sup> Cir. 1988).<sup>35</sup>

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<sup>33</sup> See McCarthy v. Commissioner (upon expiration of each broadcasting contract, a new contract would be executed); Also see Laird and First Northwest Industries. In the alternative, the Industry argues that these decisions are factually flawed.

<sup>34</sup> This case considered the issue of whether the taxpayer's radio and television broadcasting licenses had a limited useful life. In determining that these licenses had an indefinite useful life, the court concluded that there was very little chance that the FCC would refuse to renew the taxpayer's license at the end of the first three-year period. However, Appeals cannot ignore the Ithaca Industries Tax Court decision, which poses a litigating hazard for the Service.

<sup>35</sup> The Industry also points out that for the 1962-63 and 1963-64 basketball seasons, the NBA did not have a national television contract with the national broadcasting companies (i.e. NBC, ABC, CBS). However, this matter was addressed in First Northwest Industries as follows: "Although there was no certainty the NBA would continue, after 1967, to have a favorable national television contract, the record indicates that there was a reasonable expectation of such a contract after 1967 and in future years.... Although the picture was bleak from 1962 through 1964, by 1967, it was much brighter. The overall popularity of the NBA was steadily growing.

For example, based on historical data generated by the NFL Broadcasting Department, for each regular and post-season between 1970 and 1997, the league entered into national broadcast contracts with the major networks (i.e. ABC, CBS, NBC, FOX, ESPN, and TNT). And other than the 1982 and the 1987 seasons, which were impacted by strikes, revenues generated from these national television rights have increased dramatically.<sup>36</sup>

Appeals is of the opinion that the concept of self-regeneration focuses on the nature of the asset under consideration. As stated in footnote 10 of the Fourth Circuit's decision in Ithaca Industries, "The important question is whether the asset's maintenance is accomplished by significant efforts not already expended in the initial formation or purchase of the asset". Also see McCarthy, which determined that a sports franchise did not have to reinvest in order to retain the asset, defined as the continuing media rights.

### **Alternative Positions**

Alternative positions have also been raised with respect to the media rights issue. For example, it has been contended that when the market value of the income stream generated by a particular media contract exceeds the league average, that excess can be identified as a separate asset amortizable over the remaining years of the media contract.

As another variation, it has been asserted that the negotiated purchase price for the sports franchise reflects a premium paid for a "superior" share of television revenues. This "premium or incremental television revenue" argument is based on the theory that this revenue represents an independent, unique and valuable asset that can be identified, valued and which declines over the terms of the existing contracts.

In regards to this position, the mere fact that the purchaser of a sports franchise increased its initial offering price and/or allegedly paid a "premium" for the franchise, does not establish that a separate amortizable asset has been created. It appears that an argument can be made that this alleged "premium" is the result of marketplace

Gate receipts increased...the NBA embarked on a 4 year, 8-team expansion program and hoped within 10 years to grow from 9 to 24 teams. The addition of more franchises throughout the country would strengthen the NBA's position for a more substantial monetary national television contract, and in turn national television would develop ready-made audiences for new expansion teams. In short, a sport cannot be "major league" without national television and in 1967 continued national television exposure was reasonably certain. Moreover, the taxpayer's own financial projections reflected national television revenue further illustrates the petitioner's reasonable expectation of a continuing national television contract".

<sup>36</sup> "The NFL-Network Television Contracts, 1998", authored by Professor Stephen A. Greyser, Harvard Business School, June 17, 1999 (9-599-039)

considerations and/or negotiations--essentially, what a willing buyer and seller would agree to, assuming arms length transactions. Thus, the relevant inquiry requires an examination of: (a) the specific share of revenue acquired in the transaction, (b) whether the incremental income stream generates a separate and identifiable asset, and (c) whether the right to receive these revenues under the existing media contracts is divisible and has a finite life. This issue is both factual and legal in nature and any resolution of this issue should be discussed with the ACI coordinator.

## SUMMARY

### Sports Franchise Acquisitions Prior to October 23, 2004

Based on the above discussion, it is the opinion of Appeals that both the Service and the Industry face hazards in litigating this issue. In the event of litigation, a court will have to make a factual determination as to the exact nature of the asset(s) or property right(s) acquired by the purchaser of a sports franchise and whether any portion of this intangible asset has an ascertainable useful life. Intertwined in this determination, a court will also have to resolve the following matters: (a) Whether the three pre-Newark cases are still valid authority; and (b) Whether the cases relied upon by the Industry are distinguishable from the media rights issue. Appeals believes that the self-regeneration issue will be settled once the court defines and identifies the asset(s) acquired.

In the event a court accepts the Industry's argument that a sports franchise acquires two related but distinct assets as part of the asset purchase—the current broadcast contract(s) and the right to enter into future broadcast contracts, then a sports franchise would be able to establish an ascertainable value and a useful life determinable with reasonable accuracy for these current/existing contracts. If on the other hand, the court agrees with the Service's position and determines that the actual asset acquired by a sports franchise is the perpetual media rights (i.e. the right to broadcast revenues, the right to contract for the broadcast of its games, etc. that is linked to the ownership of the franchise), then the Service would likely prevail on this issue.

Although both the Industry and the Service have advanced some valid arguments in support of their positions, Appeals believes there is no clear indication in the authorities as to how a court would decide this issue. To date, no court has addressed the Industry's argument that the three pre-Newark decisions are factually and legally flawed and are inconsistent with the Newark Supreme Court decision.

As previously discussed, the Newark Supreme Court decision left many unanswered questions and, as anticipated, disputes between the Service and taxpayers continue.

This is evidenced by several recent court decisions which addressed the issue of whether certain intangible assets are subject to amortization.

Further, as discussed in an earlier section, there is no dispute that the Ithaca Tax Court decision and The Charles Schwab case presents hazards to the Service. However, it is the opinion of Appeals that the unique nature and the specific characteristics of the media rights asset as compared to the other intangible assets discussed in the cases relied upon by the Industry poses a litigating hazard to the Industry as well.

While there is no doubt that the Newark Supreme Court decision creates a litigating hazard to the Service, Appeals does not perceive this hazard to be significant enough that would warrant a full or a substantial concession of the issue by the Service (e.g. 75 or greater as suggested by the Industry). Although the Industry also faces litigating hazards, Appeals also contends that these hazards do not justify either a full or a substantial concession of this issue by the Industry.



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#### Sports Franchise Acquisitions After October 22, 2004

The American Jobs Creation Act of 2004 (H.R. 4520/P.L. 108-357) resolves this issue for sports franchises acquired after October 22, 2004. As a result, sports franchises will be entitled to amortize its media rights over a 15-year recovery period under IRC §197.