Washington Law Review

Volume 54 | Issue 4

10-1-1979

Federal Income Tax—Amoritization and the Expansion Sports Franchise—First Northwest Industries of America, Inc. v. Commissioner, 70 T.C. 817 (1978)

Roberta Reiff Katz

Follow this and additional works at: https://digitalcommons.law.uw.edu/wlr

Part of the Taxation-Federal Commons

Recommended Citation

Roberta R. Katz, Recent Developments, *Federal Income Tax—Amoritization and the Expansion Sports Franchise—First Northwest Industries of America, Inc. v. Commissioner, 70 T.C. 817 (1978)*, 54 Wash. L. & Rev. 827 (1979).
Available at: https://digitalcommons.law.uw.edu/wlr/vol54/iss4/5

This Recent Developments is brought to you for free and open access by the Law Reviews and Journals at UW Law Digital Commons. It has been accepted for inclusion in Washington Law Review by an authorized editor of UW Law Digital Commons. For more information, please contact cnyberg@uw.edu.

FEDERAL INCOME TAX—AMORTIZATION AND THE EXPANSION SPORTS FRANCHISE—*First Northwest Industries of America, Inc. v. Commissioner*, 70 T.C. 817 (1978).

In January 1967, the Board of Governors of the National Basketball Association (NBA) granted First Northwest Industries, Inc. the right to establish a professional basketball team (the "Sonics") in Seattle. The purchase agreement obligated First Northwest to pay $150,000 for the rights, privileges, and benefits enjoyed by a franchise holder, and $1,-600,000 for the right to participate in an expansion draft and the 1967 college draft.[1] In its federal income tax returns, the Sonics corporation deducted as amortization[2] the $1,600,000 allocated to the right to obtain players in the 1967 drafts. In October 1973, however, the Commissioner of Internal Revenue issued a notice of deficiency for the 1968–69 and 1969–70 tax years.[3] The notice stated that only $450,000 of the purchase price could be allocated to the right to participate in the expansion and 1967 college drafts.[4] The remaining $1,300,000 represented the amount paid for the franchise and was not amortizable.

After the Sonics filed suit to protest the notice of deficiency, the Commissioner, in his answer, made a different claim based on the "mass asset theory."[5] The Commissioner said no portion of the $1,750,000 purchase price could be deducted as depreciation. He alleged that the allocation of the purchase price made by the parties in their agreement was "devoid of economic substance" and that the Sonics actually had bought "a [nonamortizable] mass of indivisible intangible assets for a lump sum price."[6]

In *First Northwest Industries of America, Inc. v. Commissioner*, 70 T.C. 817 (1978), the Tax Court held that the "mass asset theory" did not

1. The total purchase price of $1,750,000 was divided among the 10 existing teams in the NBA. Each team received $15,000 for the Sonics' franchise rights and $160,000 for the Sonics' right to obtain players in an expansion draft and the 1967 college draft. First Northwest Indus. of America, Inc. v. Commissioner, 70 T.C. 817, 823 (1978).

2. "Amortization" is the depreciation of intangible assets, such as contract rights, leases, or patents and copyrights. A depreciable or amortizable asset gives rise to a deduction from a taxpayer's gross income. *See* notes 31–32 and accompanying text *infra*.

3. Although the Commissioner determined that First Northwest understated its income for the 1967–68 tax year due to the amortization deduction, he did not claim a deficiency for that year because the increase merely resulted in a revised loss. 70 T.C. at 818 n.1.

4. The $450,000 was to be divided so that the team owners would have a separate amortizable basis in each of the 12 players on the 1967–68 team. That amortizable basis could then be deducted over a five-year useful life period. *Id.* at 841.

5. The "mass asset theory" is explained in Part II—*A infra*.

6. 70 T.C. at 842.

apply to the purchase of this expansion franchise.[7] It found that the Sonics obtained thirteen different categories of rights and privileges in exchange for the payment of $1,750,000.[8] Two of these—the right to share in 1968–69 expansion proceeds and the right to participate in an expansion draft—were distinguished by the court as having a determinable useful life and economic value. The separate value of the right to

---

7. *Id.* at 846–47. In addition to its decision on the applicability of the "mass asset theory," the Tax Court decided a second important issue which is not the primary focus of this note. This issue was whether a professional sports team could subtract any of its basis in the franchise from the money it received as a result of league expansion. In the 1973 notice of deficiency sent to the Sonics, the Commissioner stated that he would allow the team to subtract from expansion proceeds only its basis in the players lost in expansion drafts. In his answer to the Sonics' suit, however, the Commissioner stated that he would not permit the team to subtract even its basis in the players lost because he no longer viewed the expansion as a sale of players. This position was consistent with his revised claim that the expansion franchise involved the sale of an indivisible "mass asset" rather than the sale of the various elements which composed that asset.

The Tax Court held that income received from subsequent league expansion was due to the sale of both players and other franchise rights. The team could deduct from expansion money its basis in players lost through expansion drafts and a portion of its $1,000,000 basis in the franchise. *Id.* at 867–68. Six of the 16 Tax Court judges strongly dissented from this half of the decision. They concluded that none of the Sonics' basis in the franchise should be deducted from expansion proceeds because such proceeds were the result of "development efforts" rather than a sale. *Id.* at 869.

The majority's holding on this issue was based, in part, on the Commissioner's acknowledgment in his answer that the expansion proceeds should be treated as long-term capital gain. In light of this acknowledgment, the court said it would "take as a 'given' that a sale occurred . . . . [It would] not consider the possible question whether there was, in fact, a disposition of a portion of a capital asset by reason of the addition of an expansion team to the NBA." *Id.* at 863. The court also stated that it "[did] not see how respondent can concede the fact of a sale of an interest in property and, at the same time, deny a basis attributable to the cost of its acquisition." *Id.* at 867.

8. The court defined these rights as follows:

> (1) The right to select 15 of the then-available 50 veteran players in a special expansion draft . . . (2) the right to participate in the 1967 NBA college draft . . . (3) the right to participate in all post-1967 NBA college drafts . . . (4) the right and obligation to participate in the exhibition of NBA professional basketball by competing against other teams in the NBA; (5) the exclusive right to exhibit NBA basketball within a 75-mile radius of Seattle and a corresponding prohibition of exhibiting basketball or relocating within 75 air miles of another NBA city; (6) the right to share ratably in all revenues derived from national broadcasting of NBA games . . . (7) the exclusive broadcasting rights and the right to retain all revenues, if any, from the local broadcasting (television and radio) of the Sonics' games . . . (8) the right, subsequent to 1967, to share in revenues from NBA playoff games and NBA all-star games; (9) the right to share in revenue derived from NBA promotional and merchandising activities; (10) the opportunity to promote and develop a reputation and goodwill in a portion of the United States which previously did not have a major league professional sports franchise and the rights to enjoy the benefits of NBA reputation and goodwill; (11) the rights and obligations of participating in a system which . . . establishes, within the NBA, priority rights to basketball players and recognizes the exclusive NBA bargaining rights of each member franchise to its respective players; (12) the right to share, ratably, in any proceeds from NBA expansion in 1968 and later years; (13) all other rights, benefits, and obligations attendant to being a member of the NBA . . . .

Id. at 823–25 (footnotes omitted).

1968–69 expansion proceeds was set at $250,000.[9] The useful life of this asset could be determined from the payment schedule of the 1968 expansion agreements.[10] The right to participate in a special expansion draft was held to have a separate value of $500,000[11] and a useful life of five years.[12] The remaining $1,000,000 of the purchase price was allocated to all other franchise rights, which were not amortizable because they had an indeterminate useful life.

The significance of *First Northwest* derives from the current interest of Congress and the IRS in eliminating tax shelters. This interest is reflected in I.R.C. § 1056, which became effective in 1976. Section 1056 places a presumptive limit on the amount of the purchase price of a sports franchise that can be allocated to amortizable player contracts.[13] For franchise transfers that occurred before section 1056 became effective, however, the IRS has attempted to disallow amortization of sports-franchise assets through the use of the "mass asset theory." The use of this theory in the context of the sports franchise is the subject of this note.

First Northwest is noteworthy for two additional reasons. First, many cases are now pending with facts similar to those of *First Northwest,* and other courts will no doubt be influenced by its holding.[14] Second, if appealed, the case will go to the Court of Appeals for the Ninth Circuit. That court has frequently applied the "mass asset theory" in cases involving intangible assets.[15] If the Ninth Circuit were to apply this theory in

9. This amount represented the difference between a $1,500,000 preliminary purchase agreement that specifically excluded the right to participate in the 1968–69 expansion program and the $1,750,000 final purchase agreement which contained no such exclusion. *Id.* at 849.

10. *Id.* at 847.

11. In assigning a value to this right, the court agreed with the Commissioner that the allocation in the parties' written agreement of over 90% of the price to the right to select players and less than 10% to franchise rights was "devoid of economic substance." *Id.* at 848. *See* notes 86–89 and accompanying text *infra* (discussion of how the court determined the value to be $500,000).

12. The Sonics and the Commissioner agreed to the five-year period but only if the court found that the right to obtain veteran players in an expansion draft has a limited useful life. *Id.* The figure represents the time a professional basketball player is likely to remain with a team.

13. See text accompanying note 28 *infra* for further explanation of I.R.C. § 1056.

14. During the expansion of all professional sports leagues in the 1960's and early 1970's, franchise buyers routinely allocated a large part of the sales price to player contracts. The IRS later disagreed with these allocations and claimed tax deficiencies which were then challenged by the franchise owners. In September 1976, the Commissioner of Internal Revenue stated that there were over 130 of these sports franchise cases pending or docketed and that the cases involved millions of tax dollars. *Inquiry into Professional Sports: Hearings Before the House Select Comm. on Professional Sports,* 94th Cong., 2d Sess., pt. 2 at 270 (1976) [hereinafter cited as *Select Committee Hearings*].

15. *See* Ralph W. Fullerton Co. v. United States, 550 F.2d 548 (9th Cir. 1977) (purchased insurance accounts are part of "mass asset" because not shown to have a value separate from goodwill); Sunset Fuel Co. v. United States, 519 F.2d 781 (9th Cir. 1975) (customer list is a "mass asset"); Tomlinson v. Commissioner, 507 F.2d 723 (9th Cir. 1974) (insurance expirations are indivis-

First Northwest, however, it would directly conflict with the Court of Appeals for the Fifth Circuit, which held in *United States v. Laird*[16] that the theory did not apply to the purchase of a National Football League expansion franchise.[17]

This note will first discuss past taxation practices of professional sports franchises. It will explain the "mass asset theory" as it has been applied to intangible assets outside the sports context and then examine the conflicting positions of the IRS and the Sonics as to the theory's applicability to the expansion franchise. Next, it will discuss the Tax Court's reasons for deciding not to apply the theory in *First Northwest* and suggest that the Ninth Circuit should similarly conclude that the theory is inappropriate in the context of expansion franchises. Finally, the note will explain the primary problem that results from a refusal to apply the "mass asset theory"—how to assess the value of the right to obtain the contracts of veteran players.

I. BACKGROUND: TAXATION OF PROFESSIONAL SPORTS FRANCHISES

A professional sports team typically consists of three types of assets: office and athletic equipment, a franchise granting all the rights of membership in a particular league, and player contracts.[18] In baseball,

ible from partnership goodwill); Boe v. Commissioner, 307 F.2d 339 (9th Cir. 1962) (medical service contracts are part of indivisible asset that cannot be amortized). In Commissioner v. Seaboard Fin. Co., 367 F.2d 646 (9th Cir. 1966), the court held that the "mass asset theory" would not apply where the result would be to deny amortization of the amount allocated to insurance contracts in the purchase of a loan business. A footnote in a later case, however, indicates that the theory would have been applied in *Seaboard* had that case been argued differently. Sunset Fuel Co. v. United States, 519 F.2d 781, 784 n.5 (9th Cir. 1975).

16. 556 F.2d 1224 (5th Cir. 1977), *cert. denied,* 435 U.S. 923 (1978). In *Laird,* the owner of the Atlanta Falcons attempted to amortize over 90% of the puchase price of the expansion franchise. The Commissioner argued that the "mass asset theory" prevented any amortization. The court ultimately allowed the taxpayer to amortize 36% of the purchase price, which represented the value of the player contracts. *Id.* at 1242. To date, *Laird* and *First Northwest* are the only decided cases involving the allocation of purchase price to player contracts in an expansion franchise.

17. The *Laird* decision was consistent with the Fifth Circuit's previously expressed unwillingness to establish a "monolithic 'mass asset' theory." Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1253 (5th Cir. 1973), *cert. denied,* 414 U.S. 1129 (1974) (newspaper subscription lists held to be amortizable intangible assets). The court also stated in *Houston Chronicle* that "[m]ost of the cases purporting to apply the 'mass asset' rule involve evidentiary failures on the part of the taxpayer. . . . [W]e 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." *Id.* at 1249–50.

18. Staff of the Joint Comm. on Int. Rev. Taxation for the Comm. on Ways and Means, 94th Cong., 2d Sess., Tax Shelters: Professional Sports Franchises 1 (Comm. Print 1975); Klinger, *Professional Sports Teams: Tax Factors in Buying, Owning and Selling Them,* 39 J. Tax. 276 (1973); Strandell, *The Impact of the 1976 Tax Reform Act on the Owners of Professional Sports Teams,* 4 J. Contemp. L. 219 (1978).

hockey, football, and basketball, player contracts have traditionally been for one year with a "reserve" or "option" clause that allows the team owner to renew the contract at the end of the playing season.[19] Attempts by team owners to deduct the costs of player contracts have been the subject of IRS concern since the 1930's.[20]

Earlier Revenue Rulings allowed a baseball team owner to deduct in full the costs of individual player contracts in the year of purchase.[21] In 1954, however, the IRS ruled that the cost of an entire roster of baseball players, as opposed to a single player contract, would have to be capitalized and amortized.[22] In 1967, the same year the Sonics' expansion franchise was purchased, the IRS overruled its earlier position on individual player contracts and ruled that they too had to be amortized over several years rather than fully deducted in one year.[23]

In 1971, two economists testifying before a Senate subcommittee suggested that sports franchises had become tax shelters, in part due to the depreciability of player contracts.[24] If a high percentage of the purchase price of a franchise were allocated to player contracts and then amortized

---

19. The NBA player contract used when the Sonics franchise was formed had a standard clause which gave the team owner the option, at the end of the playing season, to tender the player a new contract for the following year. If the player refused to sign the new contract, the existing contract was automatically renewed for a second year of play at 75% of the salary of the prior year. Any team signing a player after he had played out his option year was required to compensate the team which had owned his former contract. First Northwest Indus. of America v. Commissioner, 70 T.C. at 825 n.13.

20. During the 1930's, the IRS challenged the practice of deducting the costs of one-year baseball player contracts in the year they were purchased. This practice was upheld by three federal courts of appeals. *See* Commissioner v. Chicago Nat'l League Ball Club, 74 F.2d 1010 (7th Cir. 1935); Helvering v. Kansas City Am. Ass'n Baseball Co., 75 F.2d 600 (8th Cir. 1935); Commissioner v. Pittsburgh Athletic Co., 72 F.2d 883 (3d Cir. 1934).

21. I.T. 2932, XIV–2 C.B. 61 (1935); I.T. 4078, 1952–1 C.B. 39. Although the IRS originally challenged this practice, it subsequently adopted a position consistent with the decisions of the Third, Seventh, and Eighth Circuit Courts of Appeals. *See* note 20 *supra*.

22. Rev. Rul. 54–441, 1954–2 C.B. 101.

23. Rev. Rul. 67–379, 1967–2 C.B. 127. This ruling applied to baseball contracts, and its requirements were attributed to the standard "reserve" clause:

> By virtue of the renewal or reserve clause, which confers the exclusive right to the player's services during his baseball career, the purchaser of a player contract obtains an asset which has a useful life extending substantially beyond the taxable year in which the contract is acquired. Accordingly, the cost of a uniform baseball player contract owned or controlled by a major league club must be capitalized and depreciated over its useful life pursuant to section 167 of the Internal Revenue Code of 1954.

Id. at 129. In 1971, the IRS used almost identical language in a ruling requiring the amortization of a standard football player's contract. Rev. Rul. 71–137, 1971–1 C.B. 104.

24. *Professional Basketball: Hearings on S. 2373 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 92nd Cong., 1st & 2nd Sess., pt. 1 at 339; pt. 2, at 992 (1971) (testimony of Roger G. Noll and Benjamin A. Okner) [hereinafter cited as *Professional Basketball Hearings*].

over a five-year period, the team might show a tax loss even when it had a positive cash flow. Because most sports franchises were organized as partnerships or Subchapter S corporations,[25] the team owners could use that loss to offset income in their individual tax returns.[26]

As a result of this testimony, both the Treasury Department and Congress acted to reduce the use of sports franchises as tax shelters. In January 1973, the IRS published guidelines for the auditing of sports franchises which stated that a high allocation of franchise purchase price to depreciable player contracts would be improper.[27] Shortly thereafter, Congress included in the 1976 Tax Reform Act two provisions intended to reduce the tax benefits of sports franchise ownership. The first, I.R.C. § 1056, lists several requirements for the transfer of player contracts and states that there is a rebuttable presumption that no more than fifty percent of the purchase price of a sports franchise is allocable to player contracts.[28] The second, I.R.C. § 1245(a)(4), provides that upon the sale or exchange of a sports franchise there will be recapture[29] of the deductions previously allowed the seller for the depreciation of the player contracts acquired with the franchise. This recapture will occur even if the particular player contracts transferred in the franchise sale are not those that were depreciated.[30] Both statutes became effective January 1, 1976.

---

25. I.R.C. §§ 1371–79 define and explain the operation of a Subchapter S corporation. The unique feature of a Subchapter S corporation is that, with the consent of its shareholders, it can elect not to pay federal tax on its income. Instead, the shareholders declare their respective shares of the corporate income on their individual returns. The shareholders, then, also individually deduct their shares of any net corporate loss.

26. *Professional Basketball Hearings, supra* note 24, pt. 1 at 411–12. Under I.R.C. § 701, members of a partnership declare individually their respective shares of the partnership's taxable income or loss. Similarly, I.R.C. §§ 1371–79 permit shareholders in a Subchapter S corporation to declare individually their respective shares of corporate profit or loss.

27. Internal Revenue Service, Audit Coordination Digest No. 65 (Jan. 2, 1973), *reprinted in Select Committee Hearings, supra* note 14, at 305. During the period 1967 to 1971, the professional basketball teams then in existence submitted a total of 97 tax returns, yet there was only one IRS audit of one of the teams. *Professional Basketball Hearings, supra* note 24, pt. 2 at 1000.

28. I.R.C. § 1056.

29. The IRS has ruled that player contracts are section 1231 assets. Rev. Rul. 67–380, 1967–2 C.B. 291; Rev. Rul. 71–123, 1971–1 C.B. 227. Section 1231 assets, which include property used in a trade or business, are often referred to as "quasi-capital assets" because gain on their sale or exchange may be treated like gain on the sale of capital assets. I.R.C. § 1231. Certain section 1231 assets, however, are subject to the recapture rules of I.R.C. § 1245. The recapture rules provide that upon the sale of a section 1245 asset, the amount by which the lower of (1) the recomputed basis of the property, or (2) the amount realized, exceeds the adjusted basis of the property, will be treated as *ordinary* rather than capital gain income. Treas. Reg. § 1.1245–1(a), T.D. 6832, 1965–2 C.B. 299–300.

30. I.R.C. § 1245(a)(4).

II. THE ARGUMENT: DOES THE "MASS ASSET THEORY" APPLY TO EXPANSION SPORTS FRANCHISES?

A. *An Explanation of Depreciation and the "Mass Asset Theory"*

I.R.C. § 167(a) states that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income."[31] Treasury Regulations explain that intangible assets can be subject to depreciation if they are "known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy . . . ."[32] For example, patents and copyrights are amortizable intangibles[33] because they are granted for a specific number of years,[34] while goodwill is not amortizable[35] because it is assumed to have an unlimited useful life.[36]

The "mass asset theory," which concerns the amortization of intangible assets, was first stated in *Danville Press, Inc. v. Commissioner*.[37] In that case, the petitioner purchased an ongoing newspaper business and attempted to depreciate the cost of the newspaper subscriptions that expired within the twelve months following the purchase. The court held that the cost of the expired subscriptions was not amortizable because the subscription list was an indivisible, permanent asset related to the goodwill of the business; it was part of a nondepreciable "mass asset."

Since *Danville Press*, the theory has been argued most frequently in cases involving newspaper subscription lists,[38] other customer lists,[39]

---

31. I.R.C. § 167(a).

32. Treas. Reg. § 1.167(a)-3, T.D. 6182, 1956-1 C.B. 101.

33. *Id.*

34. *See* Schenk, *Depreciation of Intangible Assets: The Uncertainty of Death and Taxes*, 13 WAYNE L. REV. 501, 501 (1967).

35. Treas. Reg. § 1.167(a)-3, T.D. 6182, 1956-1 C.B. 101.

36. It has been argued that this assumption is inaccurate and that goodwill should be amortizable. Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 HARV. L. REV. 859 (1968).

37. 1 B.T.A. 1171 (1925).

38. *See, e.g.*, Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) (subscription list held amortizable because taxpayer proved it was not part of goodwill and had a determinable useful life).

39. The issue in customer list cases is whether the subsequent loss of, or failure to contract with, customers on the list makes the list depreciable. These cases arise when a customer list alone is purchased and when a customer list is included in the purchase of an entire business. *See, e.g.*, Golden State Towel and Linen Serv., Ltd. v. United States, 373 F.2d 938 (Ct. Cl. 1967) (customer list purchased as part of business held not depreciable because it had an indefinite life indistinguishable

customer service contracts,[40] location contracts,[41] insurance expiration lists,[42] and various intangibles owned by radio and television stations.[43] In all these cases, the IRS argued that the particular intangible asset that the petitioner wanted to amortize was too closely related to other, nonamortizable assets to have a distinguishable value or useful life.[44] In general, courts have applied the "mass asset theory" when they have found the asset to be a facet of the goodwill of the business purchased,[45] or when they have concluded that the wasting of a particular asset was unclear or insignificant in light of the asset's close relationship to other, nonwasting business assets.[46]

B. *The "Mass Asset Theory" Argument in* First Northwest

In *First Northwest,* the Commissioner contended that the Sonics had paid $1,750,000 for a single, indivisible asset, which he defined as "the right to do business as a member of the NBA."[47] As proof that one "mass

from goodwill); Holden Fuel Oil Co. v. Commissioner, 479 F.2d 613 (6th Cir. 1973) (separately purchased customer list held 75% depreciable; the remaining 25% represented the nonwasting value of the list).

40. These cases arise when the taxpayer has purchased existing customer contracts and wants to depreciate their cost to reflect either a limited period of usefulness or likely future cancellations. *See, e.g.,* Klein v. Commissioner, 372 F.2d 261 (2d Cir. 1966) (customer contracts held not amortizable because they had an indeterminate useful life and included elements of goodwill).

41. *See, e.g.,* Scalish v. Commissioner, 21 Tax Ct. Mem. Dec. (CCH) 260 (1962) (location leases for vending machines comprised an indivisible asset with an indefinite useful life).

42. Insurance expiration lists contain information about the various policies held by an insured, including the dates on which those policies will expire. The lists are valuable because they facilitate policy renewals. Depreciation cases typically involve the purchase of an ongoing insurance business. *See, e.g.,* Marsh & McLennan, Inc. v. Commissioner, 420 F.2d 667 (3d Cir. 1969) (insurance expiration lists were not amortizable because they were linked with goodwill and no reasonably accurate useful life had been proved).

43. *See, e.g.,* KFOX, Inc. v. United States, 510 F.2d 1365 (Ct. Cl. 1975) (employment contracts of radio station manager and disc jockeys were amortizable because they were severable from nondepreciable assets purchased at the same time for a lump sum); Meredith Broadcasting Co. v. United States, 405 F.2d 1214 (Ct. Cl. 1969) (television advertising contracts were a nondepreciable mass asset).

44. If the asset is closely related to other amortizable assets, of course, the whole "mass asset" can be depreciated over its useful life. The "mass asset theory" precludes amortization only when an intangible asset of a depreciable nature is very closely linked with one or more nondepreciable assets.

45. As one court stated, "the precise issue is often whether or not the asset involved is either ordinary goodwill or so much like goodwill that the reasons for denying amortization deductions for goodwill are fully applicable." Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1247–48 (5th Cir. 1973), *cert. denied,* 414 U.S. 1129 (1974).

46. The Tax Court has expressed this view: "The theory is designed to prevent a taxpayer from allocating to relatively insignificant depreciable assets the price actually paid for nondepreciable intangibles." Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 234 (1975).

47. Brief for Respondent at 155, First Northwest Indus. of America v. Commissioner, 70 T.C. 817 (1978).

asset" had been purchased, the Commissioner noted that negotiations had been for a lump-sum price; that the allocation to player contracts in the purchase agreement had been arbitrary and strictly for tax purposes; that the transfer was of intangibles, including goodwill and the right to use "the benefits of ongoing operations built up" by the NBA;[48] and that the various intangibles comprising the mass could not be separately evaluated because they all derived their value from the existence of the franchise.[49]

After defining the "mass asset," the Commissioner gave four reasons for concluding that it was not depreciable. First, it included intangibles of an indefinite duration which provided the means to replace intangibles of limited usefulness.[50] Second, the value of the right to draft veteran players was insignificant in comparison with the aggregate value of the intangibles of indefinite life that also had been purchased.[51] Third, the right to draft veteran players had no value outside the franchises of the league.[52] Finally, the Commissioner noted that the value of the whole asset did not diminish with the termination of the contracts of the drafted veteran players but rather showed constant growth since 1967.[53]

The Commissioner's argument, therefore, was based on two important allegations. One of these was that the Sonics did not purchase individual player contracts but rather "a variety of rights designed to initially fill and continually replenish a roster of twelve players."[54] The other was that the various rights obtained by the Sonics "virtually assured [them] . . . the right to derive revenues from the operation of an NBA team through the goodwill and reputation of the NBA."[55]

The Sonics cited a number of reasons to support their view that the "mass asset theory" did not apply. First, they argued that this case was distinguishable from the customer list and customer contract cases in which the theory previously had been applied.[56] Although customer lists and customer contracts are often self-regenerating, individual basketball players are not.[57] The Sonics noted that the players originally acquired

48. *Id.* at 190.

49. *Id.* at 188–90.

50. More specifically, the Commissioner argued that the right to participate in an annual college draft would provide players to replace those obtained through the expansion draft. *Id.* at 194–95.

51. *Id.* at 194–98.

52. *Id.* at 199–203.

53. *Id.* at 204–14.

54. *Id.* at 131.

55. *Id.* at 136.

56. *See* notes 39 and 40 *supra*.

57. Opening Brief of Petitioner at 34–37, First Northwest Indus. of America v. Commissioner, 70 T.C. 817 (1978).

had an average playing life of five years. To continue in business at the end of those players' useful lives, the team "had to acquire replacements at considerable capital expense."[58] The existence of a league draft system could help the team secure replacement players but would not give the original players an indefinite useful life.[59] Furthermore, the Sonics argued, the players, unlike customer lists and customer contracts, were not part of the customer structure and goodwill of an ongoing business. The veteran players acquired by the Sonics came from teams in different cities. The Sonics had to develop a new business with its own customer structure in Seattle.[60]

The Sonics acknowledged that the player contracts were more valuable within the NBA but contended that they still had a "reasonably-definite" value[61] separate from the league franchise because they could be sold to the teams of the Eastern League or the Harlem Globetrotters.[62] Moreover, they asserted, the "uncontroverted fact" that the players had a determinable useful life was significant, for "[i]f the assets in question are sufficiently distinct to have an ascertainable useful life of their own, they clearly are not 'inseparable' or 'indivisible' in law or in fact."[63] Finally, the Sonics argued that case law and IRS rulings in other factual contexts required an allocation of price when various assets are purchased together for a lump sum, and therefore such an allocation should be made in the instant case.[64]

The arguments presented by the IRS and the Sonics illustrate that the applicability of the "mass asset theory" to the purchase of expansion franchises depends in large part on how the expansion transaction is characterized. Does an expansion team buy particular players for its initial roster, or does it buy the right and means to have a continuing roster of players? If the latter, the asset is a self-regenerating one that cannot be amortized. Similarly, is an expansion franchise a new business or an offshoot of an ongoing business? If the franchise is an offshoot, many of the intangibles purchased, including the player rights, will be part of the goodwill of the parent business and therefore nondepreciable.

---

58. *Id.* at 36.

59. Reply Brief of Petitioner at 75–76, First Northwest Indus. of America v. Commissioner, 70 T.C. 817 (1978).

60. *Id.* at 77–80.

61. Opening Brief of Petitioner at 38, First Northwest Indus. of America v. Commissioner, 70 T.C. 817 (1978).

62. *Id.* at 39–40.

63. *Id.* at 37.

64. *Id.* at 45–46.

III. THE RESULT: THE "MASS ASSET THEORY" DOES NOT APPLY

A. *The Reasoning of the* First Northwest *Court*

The Tax Court refused to apply the "mass asset theory" in *First Northwest* because it could separately identify and evaluate two wasting intangibles. The right to receive 1968–69 expansion proceeds could easily be identified because it had been separately negotiated.[65] The right to veteran players, though more problematic, could also be "separated out" from the other assets purchased.[66] The court thus adopted the argument that the Sonics had paid a separate amount for fifteen veteran players, not an indivisible amount for the right to maintain an ongoing roster of twelve players.[67] The court also adopted the Sonics' view that while the expansion franchise grant "contained a valuable element of goodwill,"[68] it was a new business that would have to be developed in the Seattle locale. The veteran player contracts therefore were not goodwill but a means to attract customers to the new business.[69] After distinguishing the player contracts from the other intangibles purchased, the court found in the contracts the two factors necessary for a depreciation deduction—a useful life[70] and a cost basis.[71]

65. *See* notes 9–10 and accompanying text *supra*.

66. 70 T.C. at 847 (1978). The Sonics had also claimed that the right to participate in the 1967 college draft was depreciable because it had been negotiated separately, but the court "[did] not see any rational basis for distinguishing that year's college draft from the college drafts of ensuing years. College drafts . . . emanate from the Sonics' nonamortizable franchise rights." *Id.* at 858.

67. The court observed that the veteran players made "a unique, identifiable contribution to the franchise." *Id.* at 848. As it explained:

> The expansion draft players were important to the initial financial success of the franchise. Obviously the Sonics could not reasonably expect to field a competitive team in the early years from the college draft alone. They needed a nucleus of proven professional players with some degree of name recognition. The amount of revenue from ticket sales and local TV and radio contracts could be anticipated to be directly related to the success of the team on the court.

Id. at 847–48 (footnote omitted). Similarly, the Fifth Circuit found the contracts of expansion players in a football franchise to be "independent and uniquely valuable assets to the taxpayer," separate from goodwill, and therefore amortizable. Laird v. United States, 556 F.2d at 1233 (quoting KFOX, Inc. v. United States, 510 F.2d 1365, (Ct. Cl. 1975)).

68. 70 T.C. at 857.

69. The court explained:

> Only through the efforts of petitioner's management was it able to build a financially successful enterprise in Seattle. Furthermore "The acquisition of an asset or service that will attract customers is not goodwill. . . . Nor does a contract to acquire such assets or services constitute goodwill." . . . Production assets such as player contract rights are a significant means to attract customers, now and in the future, and should not be considered goodwill.

Id. (citations omitted).

70. The useful life of the right to obtain veteran players was five years. *See* note 12 *supra*.

71. The court determined the cost basis to be $500,000. *See* text accompanying notes 84–89 *infra*.

B. The Ninth Circuit's Predicted Result

The Ninth Circuit has applied the "mass asset theory" with relative frequency,[72] but if it decides *First Northwest* on appeal, there are several reasons that court might not apply the theory in this case. First, the IRS's characterization of a sports franchise as a "mass asset" is inconsistent with the fact that in an expansion draft the existing teams in the league do lose players whose contracts have had a distinct value to them. The IRS's characterization is also inconsistent with the fact that an expansion franchise does not replace an existing business but, rather, is intended by a professional sports league to develop interest in the sport in a new location.[73] This latter consideration makes it difficult to argue that all the intangible assets of the franchise are related to league goodwill, especially in light of the Ninth Circuit's definition of goodwill as "the expectancy of *continued* patronage."[74]

Second, the Ninth Circuit might be influenced by the growing desire of some courts to limit the application of the "mass asset theory."[75] These courts have come to view the theory as involving factual determinations. Thus, if the taxpayer can prove with reasonable accuracy that a particular intangible has a distinct useful life and a value separate from goodwill, it will be amortizable even if it is the type of asset to which the "mass asset theory" has traditionally been applied.[76] This approach has been approved by both the IRS[77] and the Ninth Circuit.[78] Applying the

72. *See* note 15 and accompanying text *supra*.

73. The NBA Board of Governors was willing to sell an expansion franchise for the Seattle area because a market study had shown the city had the sports enthusiasm necessary to support a new team. Brief for Respondent at 9–10, First Northwest Indus. of America v. Commissioner, 70 T.C. 817 (1978).

74. Boe v. Commissioner, 307 F.2d 339, 343 (9th Cir. 1962) (emphasis added).

75. *See, e.g.*, Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1253–54 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974); Miller & Sons, Inc. v. United States, 537 F.2d 446, 452 (Ct. Cl. 1976); Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 232 (1975); Manhattan Co. of Virginia, Inc. v. Commissioner, 50 T.C. 78, 91 (1968). *See also* Jones, *Amortization and Nonamortization of Intangibles in the Sports World*, 53 TAXES 777, 780 (1975).

76. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1250 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

77. Revenue Ruling 74–456 states in part:

> Rev. Rul. 65–175 and Rev. Rul. 65–180 are modified to remove any implication that customer and subscription lists, location contracts, insurance expirations, etc., are, as a matter of law, indistinguishable from goodwill possessing no determinable useful life. The depreciability of assets of this nature is a factual question, the determination of which rests on whether the taxpayer establishes that the assets (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

Rev. Rul. 74–456, 1974–2 C.B. 65, 66.

78. Ralph W. Fullerton Co. v. United States, 550 F.2d 548, 550 (9th Cir. 1977). The Ninth Circuit cases applying the "mass asset theory" have all concerned intangibles in the nature of

approach in *First Northwest,* if the Sonics have proved that the right to player contracts had a value separate from goodwill, that right should be amortizable.[79]

Finally, although I.R.C.§ 1056 does not apply to this case,[80] its existence should not be overlooked by the Ninth Circuit if it is asked to decide whether to apply the "mass asset theory" in *First Northwest.* The statute indicates that player contracts are amortizable in a franchise transfer and that the separate value of such contracts could be as much as fifty percent of the purchase price of the franchise.[81] Because this statute applies to all franchise transfers made after 1975, the precedential value of a holding in *First Northwest* that the player contracts are not amortizable would likely be limited to pre-1976 transfers.

IV. VALUATION OF THE PLAYER CONTRACTS

If the "mass asset theory" is not applied in the context of the expansion franchise, the separate value of the veteran players' contracts must be assessed. This assessment presents a difficult factual problem because the IRS and team owners have used inconsistent methods of valuation. At least three methods have been employed. The "prudent investor approach" uses a formula to determine the amount an investor expecting a reasonable rate of return would spend for the player contracts.[82] Under the "subtraction approach," the value of all other assets is subtracted from the franchise price to obtain the value of the contracts.[83] The "ex-

customer lists, customer contracts, and insurance expirations. If the Ninth Circuit were to apply the theory in *First Northwest,* it would clearly be expanding it.

79. Useful life, the first part of the factual test, has not been an issue in *First Northwest. See* note 12 and accompanying text *supra.*

80. I.R.C. § 1056 does not apply because it was not effective until 1976. *See* text accompanying note 28 *supra.* The events of *First Northwest* occurred prior to 1976.

81. Although the statute does not state specifically that it pertains to expansion franchises, committee reports make it clear that Congress intended the statute to apply to newly created franchises. *See, e.g.,* S. REP. No. 94–938, 94th Cong., 2d Sess. 87–88 (1976), *reprinted in* 1976–3 (Vol. 3) C.B. 49, 125–26.

82. As noted earlier, the IRS published guidelines for the auditing of sports franchises in 1973. *See* note 27 and accompanying text *supra.* These guidelines advocated the use of the "prudent investor" method to evaluate player contracts. The formula used is $S = RP$, where S represents the initial net cost of investment, R represents the amount of net cash receipts, and P represents the present value of an annuity of one dollar. Internal Revenue Service, Audit Coordination Digest No. 65 (Jan. 2, 1973), *reprinted in Select Committee Hearings, supra* note 14, at 308–309. *See also* L. SOBEL, PROFESSIONAL SPORTS AND THE LAW 558–60 (1977); Blum, *Valuing Intangibles: What are the choices for valuing professional sports teams?,* 45 J. TAX. 286 (1976) (discussion of the "prudent investor" method of evaluation).

83. This method was one of several used by the trial court in *Laird* and has been subject to criticism. *See* Laird v. United States, 556 F.2d 1224, 1237 (5th Cir. 1977), *cert. denied,* 435 U.S. 923 (1978); Blum, *supra* note 82, *passim.*

pert" approach uses an economist or a person knowledgeable in the sport, such as a team manager or scout, to determine the value of the veteran players on the basis of their skill, previous playing time, experience, and salaries.

The "expert" method was used in the trials of both *Laird*[84] and *First Northwest*[85] and, predictably, the IRS's experts came up with very different figures from the teams' experts. In each case, the trial court ultimately used a "compromise approach,"[86] supplying a new figure that reflected its own evaluation of the asset based on the record in the case.[87] Despite the subjectivity of this approach, it was upheld by the Fifth Circuit in *Laird*. That court stated that the valuation of assets "is necessarily an approximation" and that the trial court's figure need be only "within the range of figures that may properly be deduced from the evidence."[88] The Tax Court used similar language to justify its determination in *First Northwest*.[89]

Sections 1056 and 1245(a)(4) of the Internal Revenue Code will help solve these valuation problems for post-1975 franchise transfers. Besides placing a presumptive limit of fifty percent of the purchase price on the value of player contracts, section 1056 requires the seller of a franchise to file with the IRS reports of the cost basis of player contracts transferred, and these reports are binding on both seller and buyer. In addition, section 1245(a)(4) will encourage more accurate price allocation, for its expanded recapture provisions work to the disadvantage of a franchise seller who allows the buyer to allocate an unrealistic amount to player contracts.[90]

---

84. 556 F.2d at 1237–38.

85. 70 T.C. at 850–54.

86. The Fifth Circuit applied this term to describe the method used by the court below. Laird v. United States, 556 F.2d at 1238.

87. Laird v. United States, 391 F. Supp. 656, 670–71 (N.D. Ga. 1975); First Northwest Indus. of America v. Commissioner, 700 T.C. at 856 (1978).

88. Laird v. United States, 556 F.2d at 1239 (quoting Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957), *cert. denied*, 356 U.S. 950 (1958)). The court continued:

> The fact that the valuation method adopted by the district court arrived at what was, in essence, a compromise figure—roughly midway between the positions of the parties—in no way diminishes the validity of that valuation. The district court was called upon to measure the worth of men, not machinery, a task of no small proportions. In a situation like the one at bar, arriving at a compromise figure was an acceptable valuation solution.

Id. at 1241 (citing Anderson v. Commissioner, 250 F.2d at 248–49).

89. 70 T.C. at 856.

90. *See* Zaritsky, *Amortization of Intangibles: How the 1976 TRA and* Laird *Affect Sports Franchises*, 48 J. Tax. 292, 294 (1978).

V. CONCLUSION

This note has suggested that the "mass asset theory" should not be extended to expansion sports franchises. The Fifth Circuit has taken this position,[91] and if the Ninth Circuit were to agree by affirming the Tax Court on the "mass asset theory" issue in *First Northwest*, the IRS might not press the theory in the many pending cases involving a high allocation of franchise price to player contracts. The effect of this change in strategy would be to focus the attention of the parties and the courts squarely on the difficult problem of how to value player contracts. This problem requires attention not only because of the pending cases, but because disputes over the value of player contracts may continue to arise under I.R.C. § 1056. The methods of valuation used in the past have been inconsistent and, in some cases, highly subjective, thus demonstrating the need for a more standardized approach.

Roberta Reiff Katz

91. Laird v. United States, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 435 U.S. 923 (1978).