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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, LMSB, AREA 1
CC:LM:FSH:BOS

FROM: Kathleen Reed
Senior Technician Reviewer CC:PSI:BR6

SUBJECT: Depreciation of Media Rights

This Chief Counsel Advice responds to your memorandum dated April 4, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:

Party A:

Franchise B:

League C:

Year 1:

M dollars:

N dollars:

ISSUES

1. Whether media rights acquired in connection with the acquisition of Taxpayer, a professional sports franchise, in Year 1 are an asset separate and distinct from goodwill?

2. If the media rights are a separate asset, are they, or any part of them, subject to depreciation or amortization?

CONCLUSIONS

1. As the taxpayer has utilized a valuation approach similar to the methodology allowed in Newark Morning Ledger v. U.S., 507 U.S. 546 (1993) the identified media rights likely have an ascertainable value, separate and distinct from goodwill of the acquired enterprise. We make no conclusion as to the specific values (a factual question) determined by Taxpayer.

2. With the purchase of Franchise B, Taxpayer acquired certain media rights, as evidenced by various broadcast contracts. While the individual contracts at issue cover certain distinct, ascertainable periods as well as later renewal periods, the assets represented by these contracts are the franchise's right to national and local broadcast revenue. These rights to broadcast revenues, or media rights, do not have a limited useful life and are not wasting assets. The contracts themselves are merely links in a continuous, indefinite chain of media-related income. While the term of a particular contract will expire, it will be either renewed with the current broadcaster or replaced with a contract with a competing broadcaster. The revenue flow will continue and Taxpayer's right to share in or receive that revenue will continue, unaffected by changes in the contract or parties to the contract. The asset, the right to broadcast revenue are inherent in the franchise acquired and have no determinable expiration. Therefore, these rights are not depreciable under § 167 of the Internal Revenue Code. Further, the intangible media rights were acquired with the acquisition of a professional sports franchise and are specifically excluded from amortization under § 197.

FACTS

Taxpayer (a limited partnership) acquired a professional sports franchise of the League C in Year 1 from a third party. Specifically, the current partners of Taxpayer acquired the entire partnership interest of the prior partners of Party A, which held Franchise B. The change in ownership of over 50% of the partnership interests resulted in an § 708 termination of Party A. Following the termination, Party A contributed all of its assets and liabilities to the new partnership, Taxpayer, and the terminated partnership distributed interests in the new partnership to the purchasing partners. Since a § 754 election was in place, the basis of partnership assets was adjusted pursuant to §§ 743 and 755. Taxpayer allocated the purchase price to the individual assets using the provisions of § 1060, pursuant to § 755.

Based on the consideration paid by Taxpayer for the 100% of the partnership interests of Party A and the liabilities assumed from the prior partners, the adjusted basis of the partnership assets was M dollars. An accounting firm was retained by Taxpayer to value the acquired assets. The fair market value of the assets was estimated to be N dollars. Among the assets identified, valued, and determined to have a useful life are both the national television rights and local media (television and radio) rights.

The acquisition of a League C sports franchise admits the purchaser into membership of the League C in which the sports team competes. Membership in the League C carries with it substantial and valuable rights. One of the rights of a franchisee is to share in League C-wide revenue sources, including national television contracts. This sharing is a perpetual right that exists for as long as the franchise exists. Individual franchises do not have the right to separately negotiate a national broadcast contract. The League C shares the national broadcast revenues among its franchise members. The home team retains local broadcast rights and the away team retains the right to broadcast the game back to its home territory except during playoff or championship matches. The national media contracts have renewal provisions providing for exclusive negotiation rights with respect to any further contract and if no agreement can be reached, League C may negotiate with others.

The franchisee has the right to negotiate local television and radio broadcast contracts. The current contracts have one year remaining, and have renewal language similar to the national television broadcast contracts.

These media rights were valued using a discounted cash flow analysis, i.e., the present value of annual net cash flows. These annual net cash flows were computed by determining the net receipts from the identified media source less the allocated operating expenses. Net receipts were determined by taking into consideration the media contracts in place at the time of the acquisition. Net receipts for all years beyond the current media contracts (without a determinable end) were based on a percentage increase in revenues reflecting inflationary rates. The operating expenses allocated to the media sources were based on a percentage of the relative amount of revenues from all applicable sources. The fair market values of the media rights so determined were divided between: the initial, contractually determinable periods (4 years and 1 year for the national and local contracts, respectively), the first renewal of the contract period (4 additional years for both national and local rights), and the remainder or all future time periods. The useful lives of the first two categories were based on the time frame of the contractually determined periods and the expected contractual time frame of the first renewals; the latter was determined to have an indefinite life. The tax basis of the first two categories of media rights were amortized over the same contractually determined periods. The remainder media rights were not amortized.

LAW AND ANALYSIS

Sections 167 and 197 provide the rules for depreciation or amortization of intangible assets. Section 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 depreciation of intangible assets not covered by, or specifically excluded from, § 197.

Section 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. Thus, the broadcast contracts and other media rights acquired in Taxpayer’s acquisition of Franchise B in Year 1 are excluded from amortization under § 197.

Section 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 (5th 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 § 1.167(b)-1 of the Income Tax Regulations. The term “property” includes intangible assets, and § 1.167(a)-3 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 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. Houston Chronicle Publishing Co. v. U.S., 481 F.2d 1240, 1250 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974). In Newark Morning Ledger Co. v. U.S., 507 U.S. 546 (1993), the Court held an intangible asset that 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. In order to determine whether the intangible assets at issue herein satisfy this test, one must determine whether these properly identified intangibles have an ascertainable value and a limited useful life.

In contrast with other types of customer-based or supplier-based contracts, the contracts and underlying rights given to Taxpayer, as the owner of the Franchise B, are dependent only upon membership in the League C. The only qualification of Taxpayer's right to share in the income from the national broadcast contracts was its continued membership in League C. This membership could cease only upon the elimination of Franchise B as a member club, or, alternatively, the demise of League C as an organization.

Under the terms of the television broadcast contracts at issue, the contracts are not automatically renewable. However, past practice within the industry shows these media contracts are always renewed, whether with the then current contracting network or with a competitor. See generally, United States Football League v. National Football League, 842 F.2d 1335 (2nd Cir. 1988). The life of an asset can not be limited by the remote, speculative possibility that renewal of a contract might not occur. Richmond Television Corp. v. U.S., 354 F.2d 410, 412 (4th Cir. 1965).

Rather than merely acquiring existing contracts, Taxpayer acquired certain media rights, as evidenced by the various television broadcast contracts. While the contracts at issue cover certain distinct, ascertainable periods, and later renewal periods, the asset represented by these contracts, the Franchise B's right to national and local broadcast revenue, does not have a limited useful life and can not be considered a wasting asset. Both the national broadcast rights and the right to contract for the local broadcast of games is a right inherent in the franchise acquired. Therefore, these rights have an indeterminate useful life, coextensive with the life of the franchise itself.

National media rights valuation and amortization were addressed in E. Cody Laird v. U.S., 556 F.2d 1224 (5th Cir. 1977), cert. denied, 434 U.S. 1014 (1978). The Court found that the taxpayer's television rights were to last as long as the Atlanta Falcons remained a member of the NFL. While the existing contract provided a measure of the taxpayer's television rights over a specific period of time, those rights were to continue indefinitely. Accordingly, the television rights were found to have an indeterminate useful life and could not be amortized. 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), the Court addressed a National Basketball Association team's right to share in revenues from national television broadcast of NBA games. The Court held there was 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. 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 as long as the team held an NBA franchise and the source of the rights was the NBA membership. The 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), aff'g in part and vacated in part, remanded, 622 F.Supp. 595 (N.D. Ohio, 1985), 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 case herein) as being comprised of two components: the current broadcasting contracts existing at the time of the purchase, and the future broadcasting rights inherent in the franchise which had yet to be contracted for. The taxpayer argued that the current rights had a limited useful life represented by the unexpired term of the existing contracts, and had ascertainable values, and thus met the test of Houston Chronicle, supra, and was subject to amortization. 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. Both national and local broadcast contracts were found to be links in a perpetual chain of broadcasting revenues. As long as the team remained a major league baseball franchise, the club would have the rights 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 contract broadcast contract covered a distinct ascertainable period, the asset represented by the contract, each franchise's national broadcasting rights, did not have a limited useful life and, therefore, could not be considered a wasting asset. The same was found to hold true for local broadcast contracts. The team's right to contract for local broadcast of games was a right inherent in the franchise and had a indeterminate useful life coextensive with the life of the franchise. The right to broadcast games locally and nationally was still extremely valuable to the franchise at the expiration of the current contracts. While the 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 from an existing asset.

Applying the McCarthy Court's analysis to the facts of this case, the outcome is the same. The current national and local broadcast contracts (as well as their first renewals) are links in a continuing chain of broadcast revenues of indeterminate duration that Taxpayer is entitled to share in revenues as long as they are a member of League C. The term of a particular contract will expire and a new contract entered into with either the same broadcaster or a competitor. The revenues flowing from the contracts would continue; the asset, the media rights, never expires.

In Newark Morning Ledger Co., supra, the Supreme Court dealt with the identification, valuation, and depreciability of intangible assets. The Court held that an intangible asset that would otherwise fall within the concept of goodwill is still depreciable, provided it has an ascertainable value and a limited useful life that can be determined with reasonable accuracy. However, this holding does not alter our determination that the assets acquired by Taxpayer are not individual contracts, but are the media rights which do not have a limited useful life, and therefore are not depreciable. In Newark, the taxpayer acquired groupings of paid subscribers to its various newspapers, valuing the subscribers based on the estimate of future profit to be derived from the continuation of subscriptions into the future, and depreciating this value over the expected remaining life of current subscriptions. The government argued that the valuation of the subscriptions represented the continuation of customer patronage, a core definition of non-depreciable goodwill. The Court held that an allowance for depreciation is permissible where the intangible has an ascertainable value separate and distinct from goodwill and has a measurable, limited useful life. "The significant question for the purposes of depreciation is not whether the asset falls 'within the core of the concept of goodwill' but whether it is capable of being valued and whether that value diminishes over time." 507 U.S. at 566.

Here a clear distinction can be drawn between the customer-based intangibles in Newark Morning Ledger, the subscriptions, and the intangible here, the media rights. The at-will subscribers in Newark were of a finite number that would waste, and not self-regenerate. One customer might be replaced with another, but the replacement would not self-regenerate, and would be a different customer, unrelated to the subscriber list. In the situation at issue here, a new contract would replace the current contract, for the same media right, but for a subsequent time period. And the user of this media right (the broadcaster) is not the source of the asset being valued. The source is the right to share in or receive the broadcast revenue, from whatever broadcaster, and this right is based upon membership in League C. The individual contract might end, but the right to broadcast and its derivative revenue, inherent in the franchise, would continue to exist and would still be valuable. The assets are singular in nature, and the contracts are replaced one for one as they expire. The media rights are thus self-regenerative. Therefore, the media rights are intangible assets with indefinite lives, and not subject to depreciation under § 167.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The case requires a complete review of all underlying franchise documents, agreements, and contracts to confirm they are consistent with such material addressed in the court cases that underpin the analysis herein.

If the court accepts Taxpayer's expected position that their defined intangible assets "Current Broadcast Contracts" are the intangible assets at issue and not the greater media rights, then Taxpayer would be able to show an ascertainable value and a useful life determinable with reasonable accuracy for such contracts. This position is stronger for the local broadcast contracts where Taxpayer is one of the parties to such contracts. However, since League C is the party to the national television broadcast contract and not Taxpayer, Taxpayer does not have the contract but rather the right to share in media revenues from the contract held by League C. This national contract is the bulk of the valuation at issue.

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Please call if you have any further questions.

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