First Northwest Industries of America, Inc. v. Commissioner, 70 T. C. 817 (1978)

Costs of acquiring specific rights in an NBA expansion franchise can be amortized if they have a limited useful life and a determinable value separate from goodwill.

Summary

First Northwest Industries acquired an NBA expansion franchise for the Seattle SuperSonics for $1. 75 million, with the agreement allocating $1. 6 million to player draft rights and $150,000 to franchise rights. The Tax Court rejected the IRS's mass asset theory, which argued that the franchise's rights were indivisible and non-amortizable. Instead, the court found that certain rights, such as those related to veteran player drafts and future expansion proceeds, could be separately valued and amortized over a limited life, while others, like national TV contract rights, were non-amortizable due to their indefinite nature. The decision set a precedent for how the costs of acquiring sports franchises can be allocated and treated for tax purposes.

Facts

In January 1967, the NBA granted First Northwest Industries an expansion franchise for the Seattle SuperSonics for $1. 75 million. The agreement allocated $1. 6 million to the right to participate in veteran and college player drafts and $150,000 to franchise rights. The veteran draft allowed Seattle to select 15 players from a pool of 50, and the college draft gave them specific selections. The franchise also included rights to national TV revenues, local broadcasting, playoff and all-star game revenues, merchandising, and future expansion proceeds. The IRS challenged the allocation, asserting that the entire purchase was a lump sum for indivisible assets.

Procedural History

The IRS issued a notice of deficiency for the fiscal years ending May 31, 1969, and 1970, asserting that the amount allocable to draft rights did not exceed $450,000, with the remainder being for non-amortizable franchise rights. First Northwest contested this, leading to a Tax Court trial. The IRS amended its answer to argue the mass asset theory, claiming none of the $1. 75 million was allocable to amortizable assets. The Tax Court rejected the mass asset theory but partially upheld the IRS's allocation, finding $500,000 allocable to veteran player rights and $250,000 to future expansion proceeds.

Issue(s)

1. Whether the mass asset theory applies to the purchase of an NBA expansion franchise?
2. Whether the costs of acquiring specific rights in an NBA franchise can be

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amortized?
3. How should the $1. 75 million purchase price be allocated among the rights acquired?
4. How should the proceeds from subsequent NBA expansions be treated?

Holding

1. No, because the mass asset theory is inapplicable as certain rights, such as veteran player draft rights and future expansion proceeds, are separately identifiable in life and value.
2. Yes, because certain rights have a limited useful life and a determinable value separate from goodwill, making them amortizable.
3. The court allocated $500,000 to veteran player rights (amortizable over 5 years), $250,000 to future expansion proceeds (offset against received proceeds), and the remainder to non-amortizable franchise rights.
4. The court held that a portion of expansion proceeds should be allocated to players selected by new teams, with the rest treated as capital gain reduced by the franchise's adjusted basis.

Court's Reasoning

The court rejected the IRS's mass asset theory, reasoning that certain rights like veteran player drafts and future expansion proceeds could be separately valued and had a limited life. The court found the $1. 6 million allocation to player drafts in the agreement lacked economic substance and reallocated $500,000 to veteran players (amortizable over 5 years) and $250,000 to future expansion proceeds. National TV rights were deemed non-amortizable due to their indefinite nature. The court emphasized that the key rights purchased were the right to play other NBA teams and participate in drafts, which were essential to the franchise's value. The decision was based on the facts known or reasonably anticipated in January 1967, with valuation being an approximation.

Practical Implications

This decision established that certain costs associated with acquiring sports franchises can be amortized if they have a limited life and separate value from goodwill. It set a precedent for allocating franchise costs between amortizable and non-amortizable assets, impacting how similar transactions are analyzed for tax purposes. The ruling influenced subsequent cases involving sports franchise acquisitions, such as *Laird v. United States*, and led to the enactment of section 1056 of the Tax Reform Act of 1976, limiting allocations to player contracts. Practitioners must carefully allocate costs to maximize tax benefits while adhering to the court's principles.

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