

## SPORTS FRANCHISE VALUATION: DEFENDING AGAINST AN INTERNAL REVENUE SERVICE CHALLENGE

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### INTRODUCTION

Much has been written about the dramatic increases in the values of professional sports franchises. What has not received much attention is the increased challenges that team owners face in supporting the valuation of their franchise (or franchise assets) during an Internal Revenue Service audit.

In the past several years, the Service has started to more aggressively audit the tax positions taken by franchise owner taxpayers with regard to professional sports franchises.

In the spring of 1997, due to the explosive increase in the prices paid for sports franchises, the Internal Revenue Service formed an industry specialist program related to professional sports franchises. The purpose of the industry specialist program is to educate and coordinate the Service engineers, agents, and attorneys on the tax and valuation issues related to professional sports franchises.

The Service industry specialists have no jurisdiction over the disposition of any audit case. They do, however, act as technical advisors and can have a good deal of influence on the local engineers in matters of strategy, valuation methodology and even negotiations with taxpayers. The franchise owner taxpayer, however, should be aware of the culture of the Service local audit team. This is because their willingness to work with the industry specialists can be impacted by local Service office politics and personalities.

### TECHNICAL ADVISORS GROUP

Since 1997, the industry specialist program (now called technical advisors—professional sports franchise) has held two national conferences for Service engineers, agents, and attorneys. The purpose of the conference was to educate them on the changing environment of sports franchises and the

Service's positions regarding tax and valuation issues related to professional sports franchises.

This technical advisors group, currently headquartered in South Florida, reviews all valuation reports that the Service receives regarding sports franchises. Part of their job is to create a network among the Service engineers to share ideas and resources related to the audits of sports franchises.

While the technical advisors group has a long way to go in educating and coordinating engineers' efforts nationally, the group has made significant progress over the last several years.

Sports franchise taxpayers will no longer be able to rely on the Service's industry inexperience. That inexperience historically caused many audit cases to be disposed of with relatively minor adjustments to the tax-

payer's original position, regardless of whether that position was credible or not.

While the Service and the taxpayer will always disagree to some extent in tax-related matters, it is beneficial to both parties to be on the "same page" when it comes to the core concepts of valuing a professional sports franchise.

The continued progress of the Service technical advisors group has made it critical for the sports franchise owner taxpayer to have a credible, defensible valuation report.

### SPORTS FRANCHISE VALUATION APPROACHES

Professional sports is a unique industry, and the valuation of a professional sports franchise offers special challenges. Understanding the industry and the underlying economics of the individual franchise is a crucial step before beginning the appraisal process. The economics of each of the four major professional sports—National Football League, Major League Baseball, National Basketball Association, and National Hockey League—are unique and constantly changing.

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Accordingly, the valuation analyst should have a thorough understanding of (1) the industry, (2) the franchise ownership interest or franchise asset subject to appraisal, (3) the specialized valuation issues involved, and (4) the tax laws and their impact on franchise value.

Any credible valuation of a sports franchise, or the assets of a sports franchise, begins with the consideration/selection of generally accepted valuation approaches. Numerous methods, techniques, and analyses may be appropriate as part of the appraisal of the assets or ownership interest of a sports franchise. Each of the methods, however, has the same objective: to arrive at a reasonable indication of value for the subject ownership interest or asset.

Accordingly, methods that are based upon the same fundamental economic principles are grouped into valuation approaches. The three fundamental approaches used in valuing assets or business interests are: the cost approach, the market approach, and the income approach.

#### COST APPROACH

Within the cost approach, there are several different methods, each of which uses a definition of cost that is relevant to the analysis. All cost approach methods typically include a comprehensive and all-inclusive definition of cost. That is, the cost measurement typically includes the cost of all: (1) materials, (2) labor, (3) overhead, (4) developer's profit, and (5) entrepreneurial incentive (for example, return on capital during the development period).

Basic economic theory indicates that, regardless of the type of cost quantified, cost alone does not typically provide a reasonable indication of value. This is because various forms of obsolescence have to be identified, quantified, and subtracted from the cost of the subject asset or business interest in order to estimate its value.

The most common forms of obsolescence include physical depreciation, functional obsolescence, technological obsolescence, and economic obsolescence. Each form of obsolescence indicates a decrease in the value of the subject asset due to a very specific reason.

Clearly, not every asset will suffer from all forms of obsolescence. However, the consideration, identification, and quantification of the various forms of obsolescence is an important step in every application of the cost approach.

The cost approach is generally not applicable in valuing the sports franchise business enterprise. However, it is often appropriate in valuing individual tangible and intangible assets owned by the sports franchise.

#### MARKET APPROACH

One market approach method, the guideline transaction method, derives an indication of value based on a comparison of the subject sports franchise (or its assets) to actual market-determined prices for similar franchises (or assets). In selecting, analyzing, and adjusting transactional data, the key elements of comparison include: (1) geographic location, (2) time of sale, (3) stadium lease terms, and (4) the independence/relationships of the parties to a transaction.

These elements of comparison are considered in the analyst's selection of the market-derived pricing multiples. And, the selected market-derived pricing multiples are applied to the subject sports franchise financial fundamentals in order to conclude a value indication.

There have been many acquisitions of sports franchises in recent years in all of the four major sports. Identifying and analyzing the appropriate franchise sale transactions requires a rigorous analytical process. Nonetheless, the available transactional information generally results in a credible indication of the value of a sports franchise.

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#### INCOME APPROACH

An investor "anticipates" that economic income will be earned or "expected" from an investment. This expectation of prospective economic income is converted to a present worth—that is, the indicated value of the subject asset or business interest. There are numerous definitions of economic income that can provide a reasonable indication of value for a sports franchise asset or ownership interest.

The income approach requires the analyst to estimate the investor's required rate of return on the prospective economic income generated by the investment. This required rate of return will depend on many economic variables, including the risk—or the uncertainty—of the expected economic income.

Numerous measures of economic income may be relevant to the various income approach methods. These measures include gross or net revenues, gross income, net operating

income, net income before tax, net income after tax, operating cash flow, net cash flow, and several others.

In the discounted cash flow method, the analyst projects the appropriate measure of economic income for several discrete periods into the future. Then, the analyst converts this projection of prospective economic income into a present value by using a present value discount rate. The present value discount rate is the investor's required rate of return, or yield rate, during the expected term of the economic income projection.

It is noteworthy that (1) the duration of the discrete income projection period and (2) the selection of the residual (or terminal) value at the conclusion of the discrete projection period depends—in large measure—on the analyst's professional judgement.

The discounted cash flow method is often used in the valuation of sports franchise intangible assets. However, it may be difficult to use this method in the valuation of the sports franchise business enterprise. This is because many sports franchises either earn negative income or do not generate sufficient positive economic income to support the prices paid in actual team sales. Thus, the appropriate use of this method requires (1) the experienced judgment of the valuation analyst and (2) the consideration of the individual facts and circumstances of the specific valuation assignment.

The starting point of a credible sports franchise valuation analysis is the selection of generally accepted valuation approaches. However, it is vital to understand that the traditional application of these valuation approaches is not always appropriate to sports franchise assets or ownership interests. Accordingly, the analyst should have (1) a thorough understanding of the economics of the industry and the operation of the franchise as well as (2) the relevant experience and knowledge to consider and apply all appropriate valuation methodologies.

## VALUATION REPORT

The final step in performing a defensible valuation analysis is the written report. Many experienced analysts believe that report writing is the most important part of the valuation process. If the report is confusing, vague, misleading or incomplete, the analysis has failed. This is true regardless of the rigor, sophistication, or accuracy of the analytical models used in the analysis.

If the report audience (e.g., a Service agent or engineer) is confused, cannot follow the logic of the presentation, or does

not believe the presented results, the analysis has failed. The results of the analysis may be reasonable, but that will not matter if the report fails to communicate the results of the analysis effectively to the intended audience.

The general guideline for report writing is that the report should state exactly (1) what was valued and (2) how it was valued. All valuation methods and variables used in those methods should be described and supported thoroughly. The same is true with the use of publicly available data relied upon in the analysis.

The source of all data used in the analysis should be clearly referenced, so that the reader can verify the subject data. It is confusing to the report audience when analytical procedures are not explained. If the report reader has to ask, "How did the analyst get from here to there?" then the credibility of the report suffers.

The valuation report should be clear, concise, convincing, and cogent. The use of vague or ambiguous statements and superfluous narrative should be avoided. The key to a credible analysis and report is

to "do what you say" and "say what you did."

Finally, the defensible report (1) should present the valuation conclusion through logical analysis and (2) provide mathematical calculations that are easy to replicate and verify. The report should leave the reader to believe that a credible analysis has been performed.

The use of generally accepted valuation approaches and reporting of the analysis in a clear and cogent manner do not guarantee a sports franchise taxpayer an unchallenged tax return. However, they do provide the sports franchise taxpayer with a position of strength from which to defend the tax return.

## CONCLUSION

The valuation of a professional sports franchise is challenging and unique in many respects. A credible, quality appraisal is essential for a successful defense against a sports audit. The quality of any appraisal is determined (1) by the rigor and comprehensiveness of the analysis and (2) by the effective communication of that analysis in the written report.

In the current era of close scrutiny of professional sports franchise valuations, a credible and defensible valuation report is necessary in order to withstand an aggressive challenge.

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