Five key accounting and tax challenges testing the sports industry
The professional sports industry is often presented with unique challenges regarding the application of accounting principles and tax regulations. Issues for teams and leagues range from how to accurately apportion revenue, to optimizing franchise ownership structure, and consistently accounting for player contracts and signing bonuses, especially after an athlete is traded or released.

Accounting and tax decisions will become even more complicated over the next several years, as the Financial Accounting Standards Board (FASB) implements new guidance for revenue recognition and leases. These changes could have a significant impact on stadium and arena deals and existing contracts with sponsors, media rights holders, and licensees.

The sports industry is evolving and being tested with new accounting guidance. Deloitte’s sports practice has identified five challenges that chief financial officers, finance and tax executives, and controllership functions should plan around before moving forward.
New revenue recognition criteria

Companies should be prepared to implement the FASB’s new revenue recognition model, which goes into effect for annual reporting periods beginning after December 15, 2017, for public entities, and after December 15, 2018, for non-public entities. While the standard’s new criteria for recognizing revenue applies to all industries, there are several unique considerations for sports properties, given their array of revenue streams such as sponsorships, media rights, and burgeoning digital opportunities.

The new guidance will require companies to determine if variable consideration, such as discounts or performance bonuses, is included within contracts with vendors and customers. The concept of variable consideration may result in a change in timing of recognition based on the new criteria. For multi-year contracts such as media transactions and sponsorships, entities will have to determine whether a significant financing component exists. In such cases, rights holders may have to incorporate the time value of money in payments, including both up-front and deferred sums, to appropriately reflect the financing benefit received for the multi-year deal. For licensing, entities that hold intellectual property rights for leagues and teams will have to determine if the license provides a right to “use”—in which case revenue would be recognized at a specific point in time—or a right to “access”—in which case revenue would be recognized over a period of time.

Revenue recognition remains a key consideration for income tax purposes, given the number of potential revenue streams and the advance cash payments typically received. Deferred revenue balances in acquisitions and divestitures of sports franchises can be particularly challenging, as often the liability assumed is the cost to perform the obligation rather than the actual deferred revenue amount stated on the target company’s balance sheet before purchase accounting.

1 Early adoption is permitted for all entities for annual reporting periods beginning after December 15, 2016.
Accounting for athlete contracts

Sports teams commonly employ “capologists,” whose primary responsibility is to understand their league’s collective bargaining agreement and manufacture cap space to sign free agents. Naturally, there are accounting and financial reporting implications of signing players to long-term, multimillion-dollar contracts.

Like those of other employees, the salaries of athletes are expensed when incurred. Depending on the league in which they are a member, teams can offer additional consideration to players as part of their total compensation package. This consideration includes signing bonuses, guaranteed (or non-guaranteed) contracts, performance clauses, or long-term deferred compensation. Each of these methods of paying players require special treatment on the balance sheet and income statement. Properly accounting for player compensation helps teams determine the present value of long-term contracts, how to amortize up-front signing bonuses, and ensure financial statements appropriately reflect a team’s long-term liabilities.

Income tax implications exist as well. Even if a player contract includes a signing bonus, if the bonus payments are deferred throughout the life of the contract, capitalization and amortization does not occur until the payment is made. This tends to be more common in leagues where contract lengths are not limited, but is a concept all teams should be aware of. Additionally, player trades often result in an exchange being considered like-kind exchange for income tax purposes, which requires a rollover of the remaining basis in the contract and potential gain for cash boot received.
Apportioning revenue and expenses

One of the inherent benefits for stakeholders of sports enterprises is an avid national—if not international—fan base. Because of their loyalty, fans often do not hesitate to buy merchandise or tickets in support of their favorite team. In return, teams and leagues incur millions of dollars in operating expenses staging events and transporting players from city to city for games.

In the same way athletes are subject to “jock taxes” in the jurisdictions in which they play games, teams and leagues also are responsible for paying taxes in the municipalities where they generate income. This issue is not just limited to the US. Apportionment of revenue and expenses will present new challenges over the next several years as sports enterprises increasingly look to grow in international markets.

Over the last five years, regular season games for US-based sports leagues have been played in cities as diverse as London, Sydney, and Tokyo. As part of this growth strategy, leagues also are considering permanently placing a team overseas. The potential legal and tax structures of international operations are likely to play a role in limiting foreign income and non-income tax exposure. Effectively identifying where revenue is being generated and resources expended is critical in limiting income tax exposure and could play a key role in where and how sports stakeholders expand abroad.
Active versus passive team ownership

An attractive way for sports team owners to defray the large capital investment necessary to buy a franchise is by bringing on limited partners. For these investors, holding a small stake in a team has its perks. Limited partners frequently can travel on the team plane, meet with players in exclusive settings, or receive an option to buy the franchise outright at a later date. However, since 2013, these minority owners have faced a new challenge with the Net Investment Income (NII) Tax, which imposes a 3.8 percent tax on certain passive activities.

Teams often have managing partners responsible for setting a budget, hiring coaches, and representing the franchise on league boards. These individuals are typically active in running the business. But for the limited partners to avoid paying the NII tax, or to mitigate the risk that tax losses incurred by the franchise be suspended due to the passive activity loss rules, they must exhibit “material participation” in the franchise. Material participation of limited partners is generally determined by the amount of time and type of work contributed to the team.

Understanding the income tax complexities of active vs. passive participation is critical for both the managing and limited partners. By structuring partnership agreements to give investors certain responsibilities and opportunities and having the partners carefully manage and document time spent on franchise business affairs, managing partners and their limited partners may be able to meet the “material participation” requirements necessary to reduce exposure to the 3.8 percent NII tax assessed on passive income.
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Stadium and arena leases

Over the past two decades, the sports industry has experienced a stadium and arena boom, with teams and local governments spending billions of dollars on new and renovated facilities. Often times, the land or actual buildings are owned by a third party, public entity, or stadium authority, with teams signing long-term leases to cover the debt service period. As the FASB rolls out new guidance for lease accounting, teams should consider the impact the standard will have on their stadium rental agreements. The guidance for public entities is effective for fiscal years beginning after December 15, 2018. For non-public entities, the new guidance is for fiscal years beginning after December 15, 2019.

The new lease standard eliminates the requirements to perform bright-line tests for lease classification and introduces a lessee model that brings most leases onto the balance sheet. The impact will force teams and their lenders to reevaluate and more closely monitor league-level compliance requirements and third party debt covenants to ensure default has not occurred. Teams will also have to ensure that any resulting book and tax differences that arise through changes in lease treatment are accounted for.

Another key issue from an income tax perspective is that for stadiums financed with both public and private money, franchises may be permitted to “allocate” their contributions to the project to specific stadium assets. In this scenario, franchises typically want their contributions allocated to shorter-lived properties in order to take advantage of accelerated cost recovery. Therefore, it is important in planning and drafting the agreements to ensure that proper provisions are included to allow the franchise to utilize this allocation methodology.

While the requirement to perform bright-line quantitative tests was eliminated by the new standard, the criteria for classifying leases as finance versus operating under the new standard are substantially similar to the criteria for classifying leases as capital versus operating under the existing standard. Therefore, an entity may still find it useful to perform the bright-line quantitative tests contained in the existing standard when evaluating the classification criteria under the new standard.
These are just some of the accounting and tax challenges sports organizations encounter on a regular basis. To learn more about how Deloitte’s sports practice can help your enterprise, please contact the authors below.

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