Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:[redacted]:1:POSTF-147525-01
[redacted]

date: NOV 16 2001

to: [redacted]
Attn: [redacted]

from: [redacted]

subject: [redacted]
Amortization of Paragraph 5 Payments

Issues and Conclusion

You recently requested our advice concerning the taxpayer's method of amortizing Paragraph 5 payments (Signing Bonuses). For the reasons described below, we have concluded that the taxpayer's method of amortization does not accurately reflect income and should be disallowed. The Paragraph 5 Payments should be amortized over the life of the contract using the straight-line method. We have also concluded that the prior cycle IRS Appeals settlement of the same issue with this same taxpayer does not preclude you from challenging the taxpayer's accounting method in this cycle. That Appeals settlement resolved the controversy for those years only.

Background

The [redacted] are a professional football team and a member of the National Football League (NFL). Like other NFL teams, the [redacted] have a roster of players for each season. Each player signs a contract with the team which provides that he will play football exclusively for that team during the season(s), and the team will compensate the player. The [redacted] sign some players to contracts that last for only one season and sign other players to multi-year deals.

Many football players receive a substantial monetary bonus when they sign their football contract. The bonus is usually paid in a single lump sum when the contract is signed even if the contract term is for many years. The cash bonus in addition to the salary. For example, a player's salary for a four-year contract might be $[redacted] for each year plus a $[redacted] signing bonus.

Both the [redacted] and the IRS agree that if the term of the contract is one year, i.e., the current football season, then the salary and bonus may be deducted in the year paid. For contracts lasting more than one year, both the [redacted] and the IRS agree that the salary may be deducted when paid and the bonus must be capitalized and amortized. For the standard NFL Signing Bonus, the parties generally agree on the accounting. The Signing Bonus is a capital expenditure which has a life equal to the life of the contract. The Signing Bonus is amortized over the life of the contract using the straight-line method.

The [redacted] distinguish Signing Bonuses from something called "Paragraph 5 payments" and have created special accounting rules for the Paragraph 5 payments. We contend that a Paragraph 5 payment is the same thing as a signing bonus, only it has a different name. The [redacted] disagree. Both Signing Bonuses and Paragraph 5 payments provide additional compensation to the player. Both are paid when the contract is signed. Both are designed to make the player adhere to all the terms of the contract for the life of the contract. Both provide the player with additional compensation during the first year of the contract so that the [redacted] can secure the player's "loyalty" for the entire length of the contract. We note that none of the contracts which contained Signing Bonuses also contained Paragraph 5 payments; none of the contracts which contained Paragraph 5 payments also contained Signing Bonuses. You contend that the accounting rules for Paragraph 5 payments should be the same as for the signing bonuses.

For Paragraph 5 payments, the [redacted] contend that if the contract term is three years or more, the bonus has a three-year amortization period and the amortization rate is [redacted]% for year 1 and [redacted]% for years 2 and 3. You contend the asset has a life equal to the life of the contract, and the amortization method is the straight-line method.

<u>Standard NFL Contract with a Signing Bonus</u>

Paragraph 5 of the standard NFL contract states:

> 5. COMPENSATION. For performance of Player's services and all other promises of Player, Club will pay Player a yearly salary as follows: $_____ for the 19__ season;
> $_____ for the 19__ season;
> $_____ for the 19__ season.
>
> In addition, Club will pay Player such earned performance bonuses as may be called for in this contract ...

When the player received a Signing Bonus, the standard NFL contract included an addendum which states:

SIGNING BONUS

As additional consideration for the execution of NFL Player Contract(s) for the year(s) _____ and for Player's adherence to all provisions of said contract(s), Club agrees to pay Player the sum of $____. This signing bonus, subject to the terms below, shall be paid $____ on execution of this rider and $_____ due by _____.

In the event Player fails or refuses to report to Club, or leaves Club without its consent, ("Voluntary Breach or Failure to perform"), upon demand by Club, Player shall forfeit and shall immediately return to the club that amount of the bonus provided as follows:

(A) Voluntary Breach or Failure to Perform before January 31, ____: _____%
(B) Voluntary Breach or Failure to Perform before January 31, ____: _____%

Paragraph 5 Payments

When the [redacted] signed a player to a contract which contained a Paragraph 5 Payment, Paragraph 5 of the contract remained the same. However, the addendum stated:

[redacted]

[redacted]

[redacted]

You have observed that Paragraph 5 payments are the equivalent of signing bonuses. The differences in language between the two, including the additional "strings" attached to Paragraph 5 payments, do not change the function or character of the two payments. In fact, the "fill in the blank" provisions of the standard signing bonus could be completed in a way that would eliminate the differences between the two. All the player contracts are individually negotiated and the provisions, even in a standard contract, are flexible enough that the negotiator can arrive at the exact same agreement regardless what the [redacted] choose to call the signing bonus. We agree that Paragraph 5 payments are the equivalent of Signing Bonuses.

Historically, there may have been differences between the two. For years prior to [redacted], the Paragraph 5 payments could be forfeited by the player if the player failed to perform for all years of the contract. Beginning with the [redacted] season, the [redacted] imposed only a 1 year rule before the lapse of the forfeiture provision of the Paragraph 5 payment.

We do not know the extent to which the [redacted] signed players to contracts which contained Paragraph 5 payments during the years [redacted] through [redacted]. We do know that after the Appeals office settled the [redacted] and [redacted] years in [redacted], the [redacted] filed amended tax returns for [redacted] and [redacted] adopting a three-year accelerated amortization of the Paragraph 5 payments. The IRS did not challenge the [redacted] [redacted] and [redacted] amended tax returns apparently because of the Appeals settlement of the [redacted] and [redacted] years. We also know that the [redacted] had no contracts which had Paragraph 5 payments expiring in or continuing through [redacted].

Beginning with [redacted], the [redacted] seem to be using the Paragraph 5 payments once again. During the year which ended [redacted], the [redacted] signed [redacted] players to contracts. Each of the [redacted] contracts contained an addendum for a signing bonus or a Paragraph 5 payment. These bonuses and payments totaled $[redacted]. Of the [redacted] contracts, [redacted] players were no longer on the team's roster at the end of the season. Consequently, all the payments for those contracts were currently deductible.

Of the remaining [redacted] contracts, [redacted] had a term of only 1 year. Of the remaining [redacted] contracts, [redacted] contained addendums for signing bonuses totaling $[redacted] and [redacted] contained addendums for Paragraph 5 payments totaling $[redacted]. The [redacted] amortized these payments over three years -- [redacted]% in year 1 and [redacted]% in years [redacted] and [redacted]. Even if the player contract had a greater than three-year term, the [redacted] still amortized the bonus portion of the player's compensation over three years.

The following year, the [redacted] signed [redacted] players to contracts. Each of the [redacted] contracts contained an addendum for a signing bonus or a Paragraph 5 payment. These bonuses and payments totaled $[redacted]. Of the [redacted] contracts, [redacted] players were no longer on the team's roster at the end of the season. Consequently, all the payments for those contracts were currently deductible. Of the remaining [redacted] contracts, [redacted] contained addendums for signing bonuses totaling $[redacted] and [redacted] contained addendums for Paragraph 5 payments totaling $[redacted].

Analysis

The [redacted] are using an asset life and an amortization method for Paragraph 5 payments which does not clearly reflect income. An accounting method which clearly reflected income would life the asset for a term equal to the life of the contract and would amortize the asset using the straight-line method. The [redacted] demand an accelerated amortization for the Paragraph 5 payments in the current cycle because that is the deal they got from the IRS Appeals office [redacted] years ago for a prior cycle. In our opinion, that was a bad resolution of the issue. For these reasons, we recommend you set up the issue, again.

The prior cycle was resolved by the Appeals office. Appeals had jurisdiction over the [redacted] and [redacted] years, and the settlement resolved all the issues for both years. The agreement was contained on a Form 870-S(AD) signed by a corporate shareholder authorized to sign it. The Form 870-S(AD) contained a schedule of the proposed adjustments and the agreed upon numbers. The first adjustment was for "Wages" in the amount of $[redacted] for year 1 which ended [redacted], and $[redacted] for year 2 which ended [redacted]. The Appeals settlement reduced these two amounts to $[redacted] for the year ended [redacted] and $[redacted] for year ended [redacted].

Exam proposed a large adjustment because on their originally filed [redacted] and [redacted] tax returns, the [redacted] immediately deducted the entire Paragraph 5 payment as a wage expense. The [redacted] distinguished the language contained in Paragraph 5 payments from the Signing Bonus language and argued that because the player was no longer obligated to repay any of the funds after completion of the first year of the contract, the Paragraph 5 payment was deductible in the year paid. The Exam adjustment had 3 components: 1) a disallowance of the wage deduction for the full amount of the Paragraph 5 payment; 2) an allowance of previously unclaimed amortization for the amount of the Paragraph 5 payment the [redacted] would have been entitled to if the Paragraph 5 payment were amortized over the life of the contract using the straight-line method; and 3) an adjustment for a change in accounting method.

The IRS Appeals officer relied upon Revenue Ruling 71-137 which requires capitalization of signing bonuses and amortization over the contract's useful life. The Appeals officer then obtained a concession from the [redacted] for the first issue -- the capitalization issue. The [redacted] also conceded the second issue, but the amount of the concession (allowance of amortization) was different from the exam amount. The third issue was "agreed" to be moot so long as the [redacted] did not deduct the same Paragraph 5 payment twice.

Although not mentioned in the signed agreement, the Appeals settlement memorandum reflects an allowance of [redacted]% of the Paragraph 5 payments for year 1 and [redacted]% for each of the years 2 and presumably year 3, even though year 3 was not part of the case under Appeals jurisdiction. The Appeals Supporting Statement provides little insight into the now retired Appeals Officer's reason for resolving the case in this way. In [redacted] and [redacted], all the contracts with Paragraph 5 payments were either 3 or 4 years long. Because of some perceived but unstated "litigation hazards", the IRS Appeals officer allowed a three-year amortization of the Paragraph 5 payments. He claimed that it represented a "small concession" by the government. Additionally, de minimis signing bonuses of $[redacted] or less were not subject to capitalization and amortization even if the contract exceeded one year.

The Appeals' officer's settlement of the [redacted] and [redacted] years on the stated terms is difficult to justify,

and we will not attempt to do so. Nor will we follow it 10 years later when the [redacted] seek to apply the terms of this bad agreement to years outside the years of that Appeals officer's jurisdiction.

The underlying legal issue is the same in this cycle as it was in the cycle settled by Appeals. The Paragraph 5 payments are still the equivalent of signing bonuses. The accounting treatment for the two items should also be the same. Pursuant to Section 167 as interpreted by Revenue Ruling 71-137, the purchase price or acquisition cost of an NFL Player contract which has a useful life that lasts beyond the acquisition year must be capitalized and amortized over the life of the contract. The payment creates a separate and distinct asset. Lincoln Savings and Loan v. United States, 403 U.S. 345 (1971). When a newly created asset has a life exceeding one year, it must be capitalized. I.R.C. § 263.

The Paragraph 5 payment creates a separate and distinct asset. The asset has a life greater than one year, usually 3 or 4 years, which is the life of the contract. The Paragraph 5 payment must be capitalized and amortized over the life of the contract, using the straight-line method. That law has not changed. After all, if NFL teams could avoid amortization of signing bonuses simply by calling them something else and adding a few blanks which must be filled in, none of the NFL teams would sign a player to a contract with a signing bonus. They would all use "Paragraph 5 payments" instead.

Effect of Appeals Settlement

The Appeals settlement does not bind the government or the taxpayer for years other than [redacted] or [redacted]. In general, the IRS Appeals office is empowered to resolve specific tax controversies between taxpayers and the IRS. The Appeals office has the power to determine a tax liability for a specific taxpayer for specific years. The Appeals settlement was reflected on a Form 870-S(AD) (the S form was used because the [redacted] are an S Corporation). A Form 870-S(AD) includes the statement that if the offer is accepted, the matter will not be reopened absent fraud, malfeasance or misrepresentation, and the taxpayer may not file a claim for refund based on the treatment of the S items. The Form 870-S(AD) is not a closing agreement.

A closing agreement is identified in Section 7121 and is one of the two statutory methods for resolving tax

issues. A closing agreement resolves a tax controversy finally and completely for all years prior to the agreement and prospectively as well. Had the [redacted] and the IRS executed a Closing Agreement which allowed a three-year accelerated amortization for the Paragraph 5 payments, that agreement would have been binding on the current controversy. The more informal settlement agreements, Forms 870, do not have the same permanence as does a closing agreement. Alternatively, the [redacted] could have requested a ruling from our National Office for its treatment of the Paragraph 5 payments.

The Form 870-S(AD) signed by the [redacted] contains no additional provisions or reservations of issues. The back side of the copy of the Form 870-S(AD) contained in our file is blank. No statement on page 2 of the Form 870-S(AD), Schedule of Adjustments page, directs the reader to look for additional provisions included in the settlement. There were some remarks at the bottom of the Schedule of Adjustments page however these explain the agreement:

Remarks

*[redacted]

Those remarks indicate that no change in accounting method was needed or made. The [redacted] have exhausted their basis in all player contracts entered into prior to [redacted], because the [redacted] immediately deducted the payment. Apparently, future contracts were unaffected because the [redacted] must have convinced the Appeals Officer that Paragraph 5 Payments were a device to be used for a few years but not on an ongoing basis.

This was the only agreement, other than the stated amount of the adjustment to income, which Appeals made with the [redacted].

Accounting Method Change

Numerous Code sections and administrative pronouncements define and guide changes in accounting methods. The [redacted] immediate deduction of the Paragraph 5 payments is a method of accounting. Although not defined by the Code, Treasury Regulation 1.446-1 states that the term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting. See, Rev. Proc. 91-31, 1991-1 C.B. 566. The immediate deduction of a Paragraph 5 payment, as opposed to a multi-year amortization, falls within the category of a method of accounting.

Section 446(a) requires that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. The accrual method is among the permissible methods of accounting for keeping a taxpayer's books. I.R.C. § 446(c). The [redacted] use the accrual method of accounting for book and tax purposes. An immediate deduction of the Paragraph 5 payment would be a cash basis method of accounting.

A method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446-1(e)(2)(ii)(a). If a taxpayer has adopted a method of accounting under these rules, the taxpayer may not change the method by amending its prior income tax returns(s). See, Rev. Rul. 90-38, 1990-1 C.B. 57 and Rev. Proc. 97-27, 1997-1 C.B. 680 (the Rev. Proc. contains an expansive discussion of accounting methods).

The law requires the taxpayer to request permission from the Commissioner for any change of accounting method. I.R.C. § 446(e). A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a). When the [redacted] immediately deducted the Paragraph 5 payments, they had made an impermissible accounting change. The [redacted] filed no Form 3115 for this change. The [redacted] failed to obtain the Commissioner's permission for any such change.

The [redacted] cannot credibly claim that they were adopting an appropriate method of accounting for Paragraph 5 payments with the filing of the [redacted] and [redacted] tax returns. Paragraph 5 payments are the same as Signing Bonuses. They must be capitalized and amortized over the life of the asset. The government challenged the taxpayer's method of accounting for the first year the [redacted] used it.

The [redacted] contend that their settlement with the Appeals office of the [redacted] and [redacted] tax years represents a change in accounting method from an impermissible method to a permissible method. We disagree. We believe that the settlement with the Appeals office of the [redacted] and [redacted] tax years represents a change in accounting method from an impermissible method *to a less offensive but still impermissible method*.

An Appeals Officer, to reflect the hazards of litigation, may resolve a timing issue by changing the taxpayer's method of accounting using compromise terms and conditions. However, the Appeals officer in this case, failed to identify the method of accounting in the agreement itself. The agreement makes clear that the Paragraph 5 payments are to be capitalized and amortized. It does not indicate that the Paragraph 5 payments have a three-year life and 49% of the cost may be recovered in the first year.

For a method of accounting change, the Appeals officer is required to notify the [redacted] of the change. The notice must be in writing and frequently is included in a closing agreement finalizing the change. The notice would include a statement that the timing issue is being

treated as an accounting method change or a clearly labeled @ 481(a) adjustment, and would provide a description of the new method of accounting. The only mention of an accounting method change is to make the Paragraph 5 payments a capital expenditure. Ultimately, the Appeals resolution of the Paragraph 5 payment issue did not establish a new, permissible, method of accounting for the taxpayer.

Should the taxpayer establish that the actions of the Appeals office did, in fact, establish a new method of accounting, then we would argue that we are not precluded from changing the method of accounting again because the new method does not clearly reflect the taxpayer's income. Caldwell v. Commissioner, 202 F.2d 112 (2nd Cir. 1953); Ralston Development Corp. v. Commissioner, 937 F.2d 510 (10th Cir. 1991). This argument will be developed further should it become necessary to do so.

Alternative position

We suggest that you establish an alternative position which would accept the premise that the [redacted] are correct in interpreting their [redacted] and [redacted] settlement with Appeals as binding on the current cycle controversy. However, we should include all the Paragraph 5 payments and Signing Bonuses, including those which were related to contracts which had only a 1 year life. All of these contracts would have an amortization schedule of [redacted]% for year 1 and [redacted]% for years 2 and 3. Our alternative position should make them adhere to the three year amortization they so desperately demand.

Although we support the proposed adjustment, we want to consult with you on this matter before you issue any 30 day letter or otherwise execute any agreements with the taxpayer. This issue has a long history and has been mishandled by so many people in the past that we want another opportunity to examine it. Should you have any questions about this memo, please contact [redacted] at [redacted]. A copy of this memorandum will be sent to the National office for 10 day post-review.

[redacted]

By: [redacted]