Proskauer

Tax Reform’s Effect on the Sports Industry

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On Friday, December 22, 2017, President Trump signed into law H.R. 1, the $1.5 trillion tax reform law known as the Tax Cuts and Jobs Act (the "Tax Reform Act"). This alert describes provisions of the Tax Reform Act that we expect will have the most significant impact and immediate effect on the sports industry. Unless otherwise noted, all proposals described below will be effective for taxable years beginning after December 31, 2017.

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20% deduction (equivalent to a 29.6% maximum effective tax rate) for "qualified business income" of certain pass-through business owners

Under the Tax Reform Act, a maximum effective tax rate of 29.6% will apply to an individual’s domestic "qualified business income" earned from a partnership, S corporation or sole proprietorship. This reduced rate results from a 20% deduction that is applied to "qualified business income" that would otherwise be taxed at the (newly reduced) maximum ordinary income rate of 37%. Net qualified business losses will carry forward, and will reduce the amount of qualified business income included in determining the amount of the "qualified business income" deduction for the next taxable year.

Critically, the deduction is not available for income from "specified service trades or businesses" of taxpayers with taxable income above a certain threshold (noted below). In other words, income from those trades and businesses is not treated as "qualified business income" and therefore will not benefit from the new deduction. For the sports industry, it is noteworthy that the list of "specified service trades or businesses" includes any trade or business activity involving the performance of services in the field of athletics and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.[1]

The scope of this exclusion is not entirely clear. We are reviewing whether the deduction (and thus the reduced maximum effective tax rate) will be available to qualified business income of pass-through entities that are engaged in the trade or business of licensing or distributing sports programming or licensing other sports-related intellectual property to sponsors, apparel manufacturers and other licensees.

For those businesses that would otherwise be eligible for the lower effective rate on qualified business income, there are other limitations that could apply:

- The amount of the deduction above the income threshold (noted below) will be subject to limitations as income increases, based on the amount of employee wages paid by the business, and, in certain cases, by the acquisition basis of depreciable property owned by the business. Specifically, the limitation will equal the greater of (a) 50% of the taxpayer's share of the employee wages paid by the entity with respect to the qualified trade or business or (b) the sum of 25% of the employee wages paid by the entity with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property" (generally, depreciable tangible trade or business property).[2]
- Qualified business income generally includes only foreign-source income to the extent it is effectively connected with the conduct of a U.S. trade or business.[3]
- Qualified business income excludes certain types of "investment" income (e.g., capital gain, most dividends, and interest that is not allocable to a qualified trade or business). However, rental income and royalties are not excluded and should qualify for the deduction (and hence the lower maximum rate) if they are derived from the conduct of an otherwise qualified trade or business.

The income threshold (noted above) is $157,500 for single filers and $315,000 for joint return filers, indexed for inflation. The deduction sunsets for taxable years beginning after December 31, 2025.

21% tax rate on corporate income

The Tax Reform Act permanently reduces the corporate tax rate from 35% to 21%. To the extent pass-through business owners are unable to take advantage of the 20% deduction discussed above, the reduced corporate tax rate may provide opportunities for use of C-corporations in certain circumstances.

Temporary 100% expensing for certain business assets; other cost recovery changes; no change to amortization of goodwill and certain other intangibles

The Tax Reform Act allows 100% expensing for certain business property placed in service after September 27, 2017 and before December 31, 2022. For assets placed in service beginning in 2023, the amount of expensing allowed declines by 20 percentage points per year until it phases out for property placed in service after December 31, 2026. The 100% expensing allowance applies to most assets that are currently covered by the bonus depreciation rules (including certain tangible property with a recovery period of 20 years or less) and expands those rules to include used assets that are acquired by a taxpayer for the first time. The immediate expensing rules are only applicable to taxpayers that are subject to the net business interest deduction limitation (discussed below); therefore, real estate-related trades and businesses electing out of the interest deduction limitation rules will not be entitled to immediate expensing of business property.

The Tax Reform Act also standardizes the recovery period at 15 years for "qualified improvement property" (including qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property). The cost recovery periods for residential rental and nonresidential real property are unchanged.

Up to $1,000,000 of the cost of certain tangible personal property and "qualified real property" placed into service after December 31, 2017 may be immediately expensed. The definition of qualified real property eligible for this increased expensing cap is expanded to include certain improvements (e.g., roofing, heating and alarm systems) made to nonresidential real property after the property is first placed in service. Such expensing benefits will be reduced (but not below zero) to the extent the value of the property exceeds $2,500,000 for the tax year.

There has been no change to the general provision entitling taxpayers to amortize intangible assets acquired in connection with a sports franchise, including player contracts, sponsorship agreements, media rights and the franchise itself, ratably over a 15-year period.

Net business interest deductions limited to 30% of earnings before interest and taxes

The Tax Reform Act limits net business interest deductions to 30% of a taxpayer's adjusted taxable income, which before January 1, 2022 is calculated under a formula similar to earnings before interest, taxes, depreciation and amortization ("EBITDA"), and on or after January 1, 2022, under a formula similar to earnings before interest and taxes ("EBIT"). Excluded interest deductions can be carried forward indefinitely (with certain restrictions for partnerships). "Business interest" will include any interest paid or accrued on indebtedness properly allocable to a trade or business, but will not include certain investment interest.

The limitation will not apply to taxpayers with gross receipts of $25 million or less, or to certain regulated public utilities. Additionally, real property development, construction, acquisition, conversion, rental property management or similar companies may elect out of this limitation.

In the case of partnerships, the limitation on interest deductions is determined at the partnership level. Where a partnership has business interest that is less than the permitted deduction amount for a taxable year (less than 30% of the partnership's adjusted taxable income), the "excess taxable income"[4] is allocated to the partners. To the extent a partnership has business interest that is greater than the permitted deduction amount for a taxable year, the excess is not carried forward by the partnership but, instead, is allocated to each partner as "excess business interest." The partner may deduct its share of the partnership's excess business interest in any future year, but *only* against excess taxable income allocated to the partner by such partnership. Any excess business interest allocated to a partner immediately reduces the partner's basis in its partnership interest; however, any amounts that remain unused upon disposition of the partnership interest (including pursuant to a nonrecognition transaction) are restored to basis immediately prior to disposition.

Limitation on losses for noncorporate taxpayers

The Tax Reform Act provides that deductions for "excess business losses" of noncorporate taxpayers for a taxable year will not be permitted. Rather, these losses will be treated as net operating losses ("NOLs") and carried forward into subsequent tax years. An "excess business loss" is defined as the excess of a taxpayer's aggregate deductions attributable to trades or businesses of the taxpayer, over the sum of (1) the taxpayer's aggregate gross income and (2) a threshold amount ($250,000 for single filers and $500,000 for joint return filers, indexed for inflation). In the case of a pass-through entity, the determination of whether a net business loss exceeds the threshold amount is made at the individual partner or shareholder level. This new limitation applies in addition to the other existing loss limitation rules, including the passive activity rules and the at-risk rules. In calculating the allowable losses from any activity, taxpayers must apply the at-risk rules first, then the passive activity rules, and finally the new excess business loss rules.

Deduction for state and local income, property and sales taxes limited to $10,000

Under the Tax Reform Act, individuals can only deduct up to $10,000 for state and local income, property and sales taxes paid (in the aggregate) from their federal taxable income. The same $10,000 cap applies to all individual filing statuses (including joint filers) and is not indexed for inflation. Prepayments of 2018 state and local income taxes are not deductible.

Despite the reduction of the maximum ordinary income rate to 37% (from 39.6%), the limitation on the state and local tax deduction could result in higher effective tax rates for individuals living in high-tax states and municipalities, such as New York City and New York State, California, Massachusetts and New Jersey. As a result, owners and employees of professional sports teams located in high-tax jurisdictions could be affected by these changes, as could employees principally located in other jurisdictions but who are subject to tax in such high-tax locations on a portion of their incomes (as a result of working in various locations for game days, practice days, or other professional commitments).

No deduction by employers for entertainment activities

The Tax Reform Act repeals the exception to the deduction disallowance for entertainment, amusement or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50% limit to such deduction). Consequently, a taxpayer may no longer be able to take a deduction for the cost of tickets to sporting events purchased to entertain clients or other business prospects.

Taxpayers still may generally deduct 50% of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel). The Tax Reform Act also expands this 50% limitation on the deduction to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringe benefits and for the convenience of the employer; however, this deduction will be disallowed entirely in tax years beginning after December 31, 2025.

No deduction for amounts paid in exchange for college athletic seating rights

The Tax Reform Act denies a charitable deduction for any payment made to an institution of higher education in exchange for the right to purchase tickets or seating for athletic events. Thus, the existing rule that previously allowed the purchaser to claim a charitable deduction equal to 80% of the amount paid for the right to purchase the tickets is effectively repealed.

Tax-exempt status for professional sports leagues remains intact

Professional sports leagues remain eligible for tax-exempt status. Repeal of this exemption was considered by Congress, but not included in the final legislation.

Expansion of excise tax on tax-exempt organizations

The Tax Reform Act expands the existing provisions governing excess benefit transactions ("intermediate sanctions") for tax-exempt organizations, which result from employing certain highly-paid employees. A new 21% excise tax is imposed on compensation of more than $1 million that is paid by a tax-exempt organization to any of its top five highest-compensated employees (including all wages and many benefits, but not contributions to certain tax-advantaged retirement plans). The excise tax is paid by the employer, not the employee.

This new rule effectively parallels the existing $1 million deductibility limitation for executive compensation paid by publicly-traded companies. There are no specific exclusions for employees whose duties are primarily related to sports.

Excise tax on net investment income of private colleges and universities

A 1.4% excise tax is imposed on the annual net investment income of private institutions of higher education owning assets with an aggregate fair market value of at least $500,000 per student (other than those assets which are used directly in carrying out the institution's exempt purpose) with a student population of at least 500 students (more than 50% of whom are located in the United States), and on related tax-exempt organizations. This provision effectively parallels the existing excise tax on the net investment income of private foundations.

UBTI separately computed for each trade or business

The Tax Reform Act requires tax-exempt organizations to separately compute unrelated trade business income ("UBTI") for each separate unrelated trade or business. This requirement could limit an organization from using losses from one unrelated business to offset income from a separate profitable unrelated business.

No inclusion of name and logo licensing income for tax-exempts in taxable UBTI

A provision that would have classified royalty income derived from the licensing of a tax-exempt organization's name or logo as UBTI was considered by Congress but not included in the final legislation. Current law with respect to such income generally remains in effect.

Repeal of exemption for advanced refunding bonds; exemption for private activity bonds retained

The Tax Reform Act repeals the tax exemption for interest earned on "advanced refunding bonds," which under previous law were used to refinance tax-exempt bonds issued by state and local governments and certain charitable activities of Section 501(c)(3) organizations.

There has been no change to the exemption for interest earned on private activity bonds, or on bonds, the proceeds of which are used to finance or refinance professional sports stadiums. A previous version of the legislation had proposed to repeal the exemption for these bonds.

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Taxpayers should consider the effects of the Tax Reform Act and plan accordingly. Please contact your usual Proskauer lawyer, or any member of Proskauer's Tax Department, to discuss any of these issues.

[1] Health, law, accounting, performing arts, consulting, financial services and brokerage services also are "specified services trades or businesses."

[2] In both cases, the employee wages are based on "W-2 wages" paid by the qualified trade or business as the employer. Amounts reported on IRS Form 1099 to independent contractors and amounts paid to employees not engaged in the qualified trade or business generally do not count for determining this limitation. The entity is required to file a report with the Social Security Administration of the amount of "W-2 wages" paid.

[3] This determination is made under the same standard applied in determining whether a foreign corporation has income effectively connected with a U.S. trade or business (without regard to the availability of an income tax treaty).

[4] The "excess taxable income" with respect to any partnership is the amount which bears the same ratio to the partnership’s adjusted taxable income as (a) the excess of (i) 30% of the adjusted taxable income of the partnership, over (ii) the amount (if any) by which (x) the business interest expense, minus "floor plan financing interest," exceeds (y) the business interest income of the partnership, bears to (b) 30% of the adjusted taxable income of the partnership.

Related Professionals

- **Amanda H. Nussbaum**
  Partner
- **Amy Zelcer**
  Special Tax Counsel