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New Direction for Team Ownership? The Memphis Redbirds Baseball Foundation

CRAIG A. SHARON AND LLOYD H. MAYER

Consider every loyal sports fan's worst nightmare. Your community invests millions of dollars to keep a professional sports team in town. Your local city and county governments not only provide various tax exemptions and subsidies, but they also build, expand, and maintain the team's stadium. But one day the voters balk at paying for a particularly expensive improvement. The team's owners are soon heard complaining that the community is not supporting the team. Rumors that the team will be

sold or moved begin to circulate. Then the team calls a press conference to announce that it will be moving to a new, more supportive city (in terms of dollars and cents). Your city begins scrambling to find a new team, but even assuming that your community is able and willing to spend the money necessary to attract a new team, your excitement is tempered by the knowledge that the new team may prove as disloyal as the old one.

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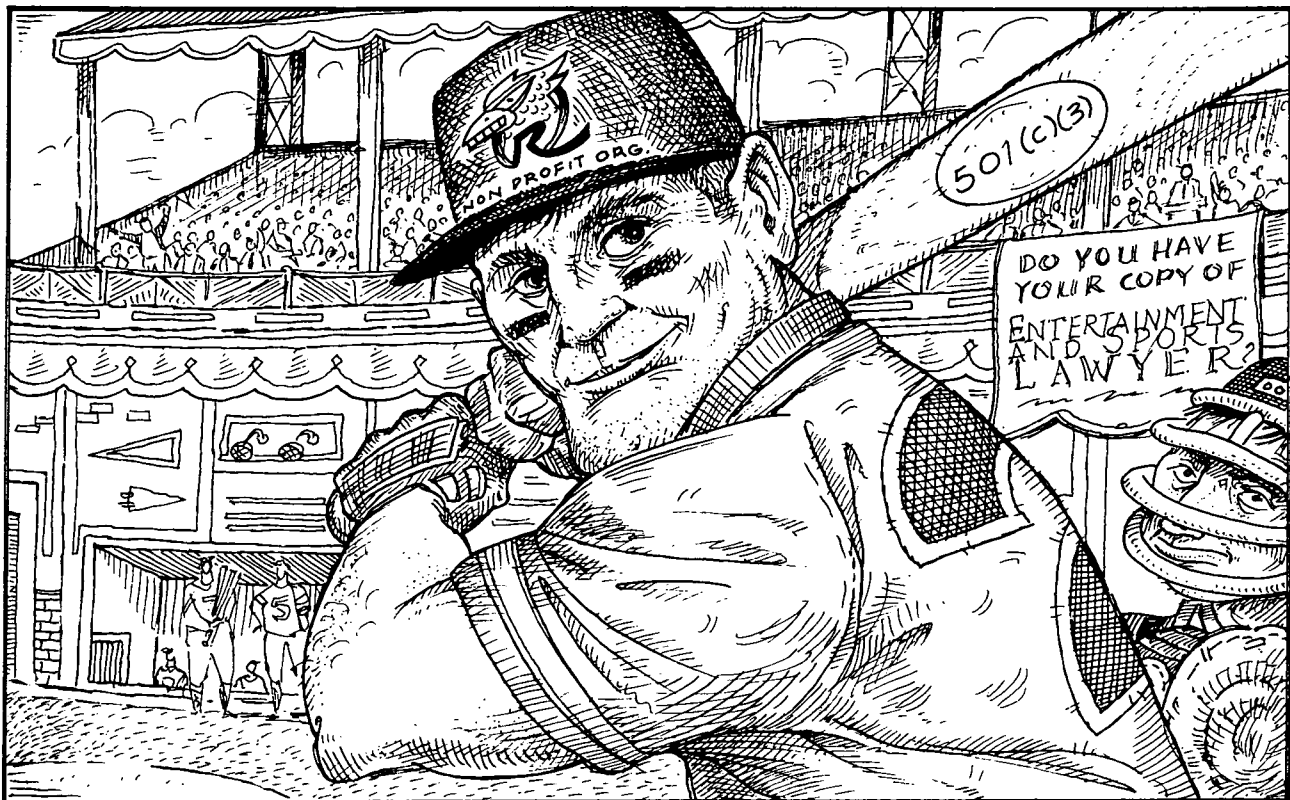


Illustration by Richard Laurent

LAURENT

MEMPHIS REDBIRDS

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The city of Memphis recently found itself in exactly this situation. The owners of the Memphis Chicks, a Double-A baseball team, were demanding substantial improvements to the existing stadium or construction of a new stadium, and the community was balking at the cost. The owners then announced that the team was moving to a new stadium in a new city at the end of the 1997 season, leaving Memphis without professional baseball for the first time in decades. Government and civic leaders tried to attract other baseball teams, but the costs appeared to be prohibitive.

Fortunately for the baseball fans of Memphis, the story does not end there. Through a combination of extraordinary dedication and good fortune, Memphis not only has a new Triple-A expansion team and a new baseball stadium under construction, but it also has a guarantee that the team will remain in Memphis without the necessity of continuing subsidies and tax breaks from the community. That guarantee takes the

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form of the owner of Memphis' new baseball team: the tax-exempt, nonprofit Memphis Redbirds Baseball Foundation (the Foundation).¹

The image of a tax-exempt, nonprofit organization owning a professional sports team may appear at first glance to be nonsensical. But assuming a willingness by the franchise holder to transfer the team to such an organization, it is possible for a professional sports team, and its stadium, to be owned by a tax-exempt entity if the right circumstances exist.

The Law of Tax-Exempt Organizations

For an organization to be tax-exempt under federal law, it must generally be described in Section 501(c) of the Internal Revenue Code.² Section 501(c) contains a long list of organizations that can be tax-exempt, including civic leagues, social clubs, fraternal societies, and credit unions, but by far the most well known are groups that are organized and operated exclusively for religious, charitable, scientific, or educational purposes (e.g., churches, schools, and relief organizations).³ These latter organizations are described in Section

501(c)(3) of the Code. In addition to being tax-exempt, Section 501(c)(3) organizations are also eligible to receive tax-deductible contributions.⁴

Notably, the definition of "charitable organization" is not strictly limited to organizations that help the poor and needy. Generally, any organization that serves a public purpose can qualify. Three public purposes applied to the Memphis Redbirds Baseball Foundation: (1) lessening the burdens of government; (2) combating community deterioration; and (3) combating juvenile delinquency.⁵

To lessen the burdens of government, and therefore qualify as tax-exempt, an organization must satisfy two requirements: (1) the activities of the organization must be activities that a governmental unit considers to be its burden; and (2) such activities must actually lessen that governmental burden.⁶ It is not enough that a government thinks it would be a good idea if an organization did something about a particular problem, or even that the government occasionally engages in the activities at issue. The government commitment must be demonstrable and ongoing.⁷ For example, law enforcement agencies regularly and frequently buy illegal drugs as part of their efforts to combat illegal drug traffic. An organization that provides the funds needed for these purchases therefore lessens the burden of government.⁸

An organization can combat community deterioration in a number of ways, but if the organization's activities are similar to those of for-profit entities, its activities must be aimed at rebuilding and revitalizing economically depressed areas. For example, a small business investment company can qualify as a tax-exempt organization, but generally only if its investment activities are targeted primarily or exclusively at economically depressed areas, such as government designated Empowerment or Enterprise Zones.⁹

An organization can also combat juvenile delinquency in various ways, but for its activities to fall within this provision, such activities must be aimed at helping children. For example, an organization that promotes and regulates sports for individuals under eighteen years of age can qualify as a tax-exempt organization because it is combating juvenile delinquency.¹⁰

The Memphis Redbirds Baseball Foundation

So how does a baseball team qualify as a charitable organization under these criteria? During the previous three decades, the City of Memphis and the surrounding County of Shelby spent tens of millions of dollars maintaining and expanding a baseball stadium (as well as maintaining other major sports venues) in Memphis for the primary purpose of attracting and retaining a

professional baseball team in the city. After the Double-A team announced it was leaving Memphis, the city and county governments became heavily involved in attempts to obtain a new Triple-A team, ultimately providing \$8.5 million to support construction of a new stadium and offering to use their condemnation powers to obtain the required property, if needed. A new stadium was required by the National Association of Baseball Leagues and the American Association League of Triple-A Baseball as a condition of awarding the franchise. This track record established that the two governments considered attracting and retaining a professional baseball team in Memphis to be their burden.

The Foundation significantly lessened this burden by taking over construction and operation of the new stadium. In addition to paying for the expansion and maintenance of the old stadium, the local governments provided the old stadium to previous teams for nominal rent and absorbed virtually all the utility costs for the stadium. As owner and operator of the new sta-



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dium, the Foundation took over responsibility for these activities and also accepted responsibility for raising the remainder of the funds needed to complete the new stadium, the total cost of which is now projected to be \$45 million.

By taking over ownership of the team, the Foundation also reduced the likelihood that public funds will be spent in the future to keep a team in Memphis. The Foundation's Board of Directors consists of local community members and two appointees of the local governments. Such a board is unlikely to move the team to another community simply because the other community offers a newer stadium.

The Foundation will also help combat community deterioration and juvenile delinquency. The proposed stadium site is a twelve-acre region of downtown Memphis occupied primarily by deteriorating buildings and parking lots. Even the Salvation Army was seeking to leave its building at the center of the site because of the building's poor condition. By constructing a stadium on this site, the Foundation will stimulate commercial activity in a depressed part

of downtown that the local governments have long sought to redevelop.

In addition, the Foundation will use any profit from team and stadium operations to fund a minor league baseball museum, restore baseball and softball programs to Memphis public schools (eliminated because of budget cuts), and support other youth programs in the local area. All of these activities are aimed at children and further charitable and educational purposes. Importantly, no profit earned by the Foundation will inure to any private individual.

Follow the Money

The lack of profit-taking is a key requirement for an organization to be classified as tax-exempt. While reasonable compensation may be paid to players, coaches, employees, vendors, and subcontractors, the profit generated by Foundation activities must be used only for charitable and educational purposes.

The organizers of the Foundation have gone to great lengths to meet this requirement. Local businesspeople Dean Jernigan and his wife, Kristi, were the driving forces behind attracting the new Triple-A franchise. The Jernigans stated from the outset that they had no intention of profiting from the team; they were motivated instead by the single desire to retain professional baseball for the community. Their statements led the Mayor of Shelby County to inquire whether the team could be owned by a tax-exempt, nonprofit organization.

As part of the creation of the new organization, the Jernigans agreed to various safeguards that guarantee no Foundation profit will reach them. The Jernigans will not serve as officers or directors of the Foundation, and no member of their family, or any entity controlled by them, has an interest in or will draw a salary from any entity that will do business with the Foundation—with one exception. At the insistence of the National Association of Professional Baseball Leagues and the American Association League of Triple-A Baseball, Dean Jernigan must remain involved with the management of the team. To satisfy this requirement, the Jernigans arranged for the Foundation to contract with Blues City Baseball, Inc., a company owned by the Jernigans, to manage the team and stadium at cost plus \$1. As an extra precaution, however, the Jernigans have agreed not to accept any compensation from Blues City for their services.

Although the presence of the above safeguards undoubtedly helped the Memphis Redbirds Baseball Foundation obtain its tax-exempt status, they are not necessarily required. The critical task is to ensure that any profits realized by the team and the stadium, and any appreciation in the value thereof, inure to the tax-

exempt owner and not to any private individuals or for-profit companies. Reasonable compensation can, of course, be paid to team and stadium employees, as well to outside contractors that provide management, construction, or other goods and services.

The Jernigans could therefore have served as employees (or even officers or directors) of the Foundation and received reasonable compensation for the services they provided, and Blues City could have charged fees reflecting a reasonable profit on the services it will be providing, without, in theory, threatening the tax-exempt status of the Foundation. But the IRS undoubtedly would have closely scrutinized any financial transactions with the Jernigans in order to ensure that the transfer of ownership to the Foundation was not a mere sham, with the profits that otherwise would have been realized (and taxed) merely being converted into other types of payments to the Jernigans. Before recognizing the tax-exempt status of a nonprofit team owner, the IRS is therefore likely to insist on at least some safeguards that limit the ability of the former owners to divert any profits from a team and stadium to themselves.

How Unique Is Memphis?

The Memphis situation is not unique. But what about the solution? Perhaps. There are several other teams that operate as nonprofits, although none of them has been recognized by the IRS as a charitable organization under section 501(c)(3), either because it

The Memphis situation is not unique. But what about the solution?

is exempt from tax as part of a local government or because it does not qualify as a charitable organization under the applicable rules.

The Single-A Batavia Muckdogs (formerly the Clippers), a 56-year old minor league affiliate of the Philadelphia Phillies, has been operated and owned for most of its history by the nonprofit Genessee County Professional Baseball, Inc. (GCPB). Facing pressures to provide a new stadium, GCPB is planning to transfer the team to the city-owned Batavia Regional Recreational Corp. (BRRC) after an IRS ruling is received recognizing that BRRC is an arm of the city government and so can issue tax-exempt bonds

(needed to build the aforementioned stadium). The Triple-A Columbus Clippers, a minor league affiliate of the New York Yankees, is owned by the county government and run by the nonprofit Columbus Baseball Team, Inc. All profits, after team and stadium expenses, go into county coffers. And the Green Bay Packers are owned by fans, grandfathered from a National Football League rule that prohibits nonprofit teams from owning franchises.

To the extent that league rules do not prohibit nonprofits from owning teams, other teams and facilities may be candidates for tax-exempt status.¹¹ Of particular note, the "single-entity" ownership structure being used in many new sports leagues might prevent ownership by nonprofits. For example, all Major League Soccer (MLS) teams are owned by the league itself (a limited liability company), with investors in turn owning the league (typically coupled with a right to operate one or more of the teams under a management agreement with the league). Unless the nonprofit entity functions entirely as a passive investor (i.e., is not involved in the day-to-day management of the league, including operation of a team), the nonprofit will have a difficult time retaining its tax-exempt status. Tax-exempt entities are generally barred from contributing tax-exempt assets to joint ventures in which they are actively involved unless the venture serves exempt purposes and the tax-exempt entity retains sufficient control to ensure that exempt purposes continue to be served.¹² Furthermore, even if the nonprofit acts only in a passive manner, much of the income that it receives from the league is likely to be subject to tax as unrelated business income.¹³

Advantages and Disadvantages of Tax-Exempt Status

The advantages from the local community perspective are clear. Like the Foundation, most tax-exempt owners would be run by boards of directors consisting of local community leaders. Such boards are more likely to funnel profits back into the local community and less likely to move the team to another city.

There are business advantages as well. Nonprofit teams may find it easier to attract private and public funds for new projects or to cover deficits than for-profit teams. In addition, unlike for-profit entities, tax-exempt organizations have the ability to issue tax-exempt bonds. Such bonds can significantly reduce borrowing costs because the interest paid thereon is received tax-free by investors.¹⁴ The Foundation is relying primarily on tax-exempt bonds to finance its new stadium. Although local and state governments are able to issue tax-exempt bonds as well, public acceptance of such debt for professional

sports franchises appears to be on the wane. Attempts to get public funding for stadiums in Minneapolis and Columbus, Ohio recently failed, and over the past several years, voters have rejected taxpayer funding of stadiums in Pittsburgh, San Jose, and Seattle, although the teams in those cities may still be successful in obtaining public funding through other governmental channels. Voters in Minnesota also passed a measure requiring voter approval of any sports project that will use more than \$10 million in public funds. Although a number of other ballot initiatives for stadium funding passed during the same time period, approval of such funding is not nearly as automatic as it once was. This result could reflect a growing awareness that the economic return to a community from a local team and stadium may be less than previously believed.¹⁵

There are disadvantages to a tax-exempt structure, apart from having to avoid any private inurement. Income that is unrelated to an organization's exempt purpose is subject to tax as unrelated business income.¹⁶ For example, income generated by the use of the stadium for a rock concert could be subject to tax.¹⁷ And if a third or more of an organization's income is from activities unrelated to its exempt purpose, the IRS could question the tax-exempt status of the entire organization.¹⁸ This concern places obvious limits on the team's business activities.

In addition, tax-exempt organizations are required to file annual information returns (IRS Form 990) and make them available to the public.¹⁹ Such public disclosure helps keep tax-exempt organizations accountable to the public, but in the case of sports teams, it could also create numerous armchair administrators for the team's finances.

Conclusion

The circumstances necessary to give rise to the possibility of tax-exempt ownership of a sports team—an idealistic franchise holder, a track record of governmental support, and favorable league rules—may be rare. But when the necessary circumstances are present, such ownership, while remaining consistent with tax-exempt purposes, represents a legitimate alternative to private ownership and can significantly reduce financing costs, especially for new stadiums. It should also allow local sports fans to sleep a little easier.

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Endnotes

1. The Foundation was originally named the Memphis Chicks Baseball Foundation, but was renamed the Redbirds after the team became affiliated with the St. Louis Cardinals.

2. All section references in this article are to the provisions of the Internal Revenue Code of 1986, as amended, and all regulatory references are to the regulations thereunder.

3. Organizations that promote sports can also qualify for tax-exempt and deductible contribution status based on their promotion of sports, but only if they promote *amateur* sports. See I.R.C. §§ 501(c)(3), (j).

4. Such contributions are deductible under sections 170 (income tax), 2055 (estate tax), and 2522 (gift tax) of the Internal Revenue Code.

5. Treas. Reg. § 1.501(c)(3)-1(d)(2).

6. Rev. Rul. 85-2, 1985-1 C.B. 178; Rev. Rul. 85-1, 1985-1 C.B. 177.

7. See, e.g., Gen. Couns. Mem. 39682 (Sept. 14, 1987) (governmental burden will be found if the activity has been engaged in by a governmental unit on a regular basis for a significant length of time, or if a governmental unit has made budgetary and/or legal provision for the activity); Gen. Couns. Mem. 39347 (Oct. 20, 1982) (certain activities were not considered burdens of government even though a city government had engaged in a few of the activities in the past).

8. Rev. Rul. 85-1, *supra* note 6.

9. See, e.g., Rev. Rul. 81-284, 1981-2 C.B. 130; Rev. Rul. 74-587, 1974-2 C.B. 162; see also Priv. Ltr. Rul. 8536099 (June 17, 1985) (renovation of a building in a blighted area served charitable purposes by combating community deterioration).

10. See Rev. Rul. 80-215, 1980-2 C.B. 174.

11. Unlike the National Football League, other leagues, e.g., the National Hockey League, do not prohibit nonprofit organizations from owning teams.

12. See Rev. Rul. 98-115 (relating to joint ventures between tax-exempt and for-profit organizations in the health care field).

13. See I.R.C. §§ 511-514. As a result, the nonprofit entity must have something other than its investment in the league as the basis for its tax-exempt status.

14. I.R.C. § 145. Senator Daniel P. Moynihan (D-NY) has proposed legislation banning the use of tax-exempt bonds to pay for professional sports facilities. As currently drafted, the legislation would apply regardless of whether the bonds were issued by a local government or a section 501(c)(3) organization.

15. See SPORTS, JOBS, AND TAXES: THE ECONOMIC IMPACT OF SPORTS TEAMS AND STADIUMS (Roger G. Noll and Andrew Zimbalist eds., 1997).

16. See I.R.C. § 511.

17. See, e.g., Tech. Adv. Mem. 9147008 (revenue from rock concerts and similar events at a university's athletic facility that were indistinguishable from operations at for-profit, commercial facilities held to be taxable as unrelated business income).

18. See *Orange County Agricultural Society, Inc. v. Commissioner*, 893 F.2d 529 (2d Cir. 1990) (upholding the revocation of the tax-exempt status of a previously section 501(c)(3) organization when unrelated business income grew to a third of the organization's income). *But see* Gen. Couns. Mem. 39108 (suggesting that a section 501(c)(6) business league could still qualify for tax-exempt status under certain circumstances even if unrelated business income constituted 50 percent of its income).

19. I.R.C. § 6104(e).