September 11, 2018

The NCAA and the IRS: Life at the Intersection of College Sports and the Federal Income Tax

(forthcoming in *Southern California Law Review*, July 2019)

Richard Schmalbeck and Lawrence Zelenak, Duke Law School

Introduction

Few organizational acronyms are more familiar to Americans than those of the National Collegiate Athletic Association (NCAA) and the Internal Revenue Service (IRS). Although neither organization is particularly popular,[1] both loom large in American life and popular culture. Because there is a tax aspect to just about everything, it should come as no surprise that the domains of the NCAA and the IRS overlap in a number of ways. For many decades, the strong tendency in those areas has been for college athletics to enjoy unreasonably generous tax treatment–sometimes because of the failure of the IRS to enforce the tax laws enacted by Congress, sometimes because Congress itself has conferred dubious tax benefits on college sports. In just the past year, however, there have been signs of what may be a major attitudinal shift on the part of Congress–although so far there have been no signs of a corresponding change at the IRS.

This article offers an in-depth look at the history and current status of four areas of

[1] The IRS, however, may be less unpopular than conventional wisdom would have it. In a recent national survey, 58% of respondents expressed a favorable opinion of the IRS, while only 33% indicated an unfavorable opinion. Pew Research Center, Majorities Express Favorable Opinions of Several Federal Agencies, Including the FBI (February 14, 2018).

intersection between the federal tax laws and college sports. Part I considers the possible application of the tax on unrelated business income (UBI) to big-time college sports. It concludes that, even in the absence of any change in the statute, there is a strong argument that revenues from the televising of college sports should be subject to the UBI tax. Part II examines the tax status of athletic scholarships. It explains that athletic scholarships as currently structured are taxable under the terms of the Internal Revenue Code, and that the IRS seems to have made a conscious decision not to enforce the law. While the first two parts of the article address areas where the traditional sweetheart arrangement between the IRS and the NCAA remains in effect, the final two parts of the article consider areas where Congress has–very recently–intervened to increase the tax burden on college athletics. Part III describes how Congress, three decades ago, explicitly permitted taxpayers to claim charitable deductions for most of the cost of season tickets to college football and basketball games, and how Congress in 2017–to the surprise of many observers, including the authors of this article–repealed that special tax benefit. Finally, Part IV addresses issues of both statutory interpretation and policy raised by Congress's creation, in 2017, of a 21 percent excise tax on at least some universities paying seven-figure salaries to their football and basketball coaches. The article's conclusion suggests the IRS should follow the lead of Congress, and reconsider the administrative favoritism toward college sports described in Parts I and II.

I. Are College Athletics Related to a University's Exempt Purpose?

A. The Three Types of College Athletics: Intramurals, Nonrevenue Sports, and Revenue Sports

Athletics have long been part of university life, dating back to the nineteenth century, if not before.[2] These may be considered in ascending order of their economic significance. Within the four-year undergraduate experience (or five, if we count the red-shirt year[3]—and in this context, we surely should), there are at least three subdivisions of athletic activity that require somewhat separate consideration, and involve increasing cause for concern about the soundness of the current tax treatment.

The first, and least problematic, category is intramural athletics, in which teams of students from various houses, fraternities, or other affinity groups compete with teams of students representing other similar groups within the same university. These activities involve the use of some university resources—playing fields or courts, equipment, and usually one or more paid referees, along with some office support in creating and distributing schedules, compiling standings, and the like. A purist might observe that intramural sports are not strictly educational—they rarely involve any coaching or instruction--and so are not in pursuit of the exempt educational purpose of the university in a direct way. But that would be an unduly narrow view of exempt purpose. Students are not expected to spend every waking hour attending classes or studying; they have fuller lives, and not only may but should spend at least some time engaged in activities involving art, music, drama, and recreation, including athletics. Such activities make

---

[2] In 1876, representatives of Yale, Princeton, and several other universities created the Intercollegiate Football Association. *See britannica.com/EBchecked/topic/290039/Intercollegiate-Football-Association.*

[3] College athletes generally have four years of eligibility to compete in intercollegiate sports. However, they are liberally allowed to decline participation during one year (the "red-shirt" year, so called because they typically continue to practice with their teams if injuries do not prevent this, and, at least in some historic period, wore jerseys that indicated their nonparticipant status in that year). This privilege is frequently used in college football, leading to a common practice in which freshmen practice with their teams but do not play in that year, but maintain eligibility in the four following years.

students healthier and happier, and are quite reasonably regarded as an integral part of normal student life. This type of athletic endeavor thus raises few if any issues of appropriate relation to an exempt mission.

Much the same could be said—though less confidently—of the second category of college and university athletics. This category would consist of intercollegiate athletics—both of the "varsity" and "club" style[4]--that do not, and are not expected to, produce significant revenue, or at least not net income, after allowing for the often considerable costs of engaging in these sports. Traditionally, this "nonrevenue" category has consisted of virtually all intercollegiate athletics other than the football and men's basketball programs at the highest tier of the college sports hierarchy—the group of programs that the National Collegiate Athletic Association has denominated as "Division I."

Defense of nonrevenue intercollegiate athletics as within a university's exempt purposes is somewhat more challenging than it is for intramural athletics. In light of the fact that few universities in the world (though most in the U.S.) engage in intercollegiate athletics at all, it is difficult to maintain that such activities are even a normal, much less a necessary part of the university student experience. And although nearly every U.S. college or university does engage in intercollegiate athletics at some level, relatively few students at each institution participate in any intercollegiate sports. Furthermore, those who do frequently find that participation in these

[4] According to University of New Hampshire (UNH) Athletic Director Marty Scarano, the main difference between the "varsity" and "club" classification is university funding. Although the level of competition may be commensurate with varsity athletics, because most of UNH's funding goes to football, hockey, and basketball, many other sports are classified as "club" sports. Ryan Hartley, "Varsity Sports vs. Club Sports: It Comes Down to a Matter of Dollars and Cents," The New Hampshire (Feb. 13, 2013), www.tnhonline.com/sports/varsity-sports-vs-club-sports-1.1390663.

activities diminishes rather than enhances their overall educational experience, if only because of the demands of time and energy imposed on the student-athlete.[5]

The lack of a compelling connection to the educational mission, together with the distinct possibility that nonrevenue intercollegiate athletics may in some cases reduce the value of the educational experience of the student-athlete, are troubling on many grounds. However, they are not ultimately troubling in terms of any issues posed by federal tax law. Although the relevant statute requires that organizations seeking exempt status pursue their charitable purposes "exclusively," the Treasury Regulations implementing this provision have long interpreted this requirement to be satisfied as long as charitable purposes are primary.[6]

Thus, if nonrevenue intercollegiate athletics can be shown to be merely incidental activities of colleges and universities, and not primary, their presence on campus should not represent a threat to the institution's qualification for exemption.[7] In most cases, the incidental quality of nonrevenue sports would not be difficult to demonstrate. In the case of Duke University, for example, the array of intercollegiate teams includes twelve men's teams and, equitably, twelve

[5] The general NCAA guideline is that, during each sport's defined season, up to twenty hours per week of the student-athlete's time can be claimed by the team for practices, conditioning and related activities. This does not include travel time to games that are not staged on the student's own campus, and also involves artificial time-accounting rules. For example, the athletic event itself is presumed never to exceed three hours, even if the event is a 36-hole golf tournament that may take more than eight.

[6] Treas. Regs. §1.501(c)(3)-1(c)(1).

[7] Public universities are not subject to the income tax because they are instrumentalities of state governments, rather than nonprofit corporations. Accordingly, they do not need to demonstrate that they primarily serve an exempt purpose (though they presumably could do so if they needed to). See Ellen P. Aprill, *"Excluding the Income of State and Local Governments: The Need for Congressional Action,"* 26 Ga. L. Rev. 421 (1992).

women's teams.[8] This is a considerable roster of teams for a relatively low-enrollment university.[9] Nevertheless, the total expenditure for the athletics department—roughly $100 million in the 2016-17 year[10]--is only a small fraction of the university's overall budget (not including the Duke Health System) of over $5.5 billion.[11] And while the total number of students at Duke who engage in intercollegiate athletics in any year runs to around 650, that is only about ten percent of the total population of undergraduate students.[12] Thus, even if intercollegiate athletics were determined to be unrelated to the exempt purposes of the university, it would seem that they were incidental, and did not constitute a primary purpose of the university.

Of course, if they are unrelated to the exempt purposes, the possibility arises that these activities might generate unrelated business income. But these sports are called "nonrevenue" sports for a reason. In most cases, they are not literally without revenue: spectators ordinarily pay small admission charges to watch athletic events in some sports within the nonrevenue category, such as soccer, baseball, and lacrosse games.[13] And some television networks, in their continued quest to find the bottom of the public's appetite for college sports, have begun televising

---

[8] There are men's and women's teams in basketball, cross-country, fencing, golf, lacrosse, soccer, swimming, track and field, and tennis. In addition, there are men's teams in baseball, football, and wrestling, and women's teams in field hockey, rowing, and volleyball.

[9] Duke has about 6500 undergraduate students. "The Equity in Athletics Data Analysis Cutting Tool," U.S. Department of Education (last visited Sept. 13, 2013), ope.ed.gov/athletics.

[10] *Id.*

[11] Michael J. Schoenfeld, "Trustees Reappoint Brodhead, Approve Budget, Projects," Duke Today (May 12, 2012), today.duke.edu/2012/05/trusteesmay2012.

[12] See note 7 above.

[13] Practices with respect to admission charges in sports other than basketball and football vary widely. But at Duke University, charges in the range of five to ten dollars per ticket are the price of admission to the sorts of events noted in the text.

many of these events, including the College World Series (men's baseball), the counterpart tournament for women's softball, the final three rounds of the NCAA Division I lacrosse tournament, and even regular season women's basketball games, among many others.

So one is left thinking that the nonrevenue category is one to be watched; at any time, a sport may achieve a breakthrough level of popularity that will generate enough spectator interest—both live and on television--that it will need to be promoted to the "revenue sport" category. And the breakthroughs can be sudden: the University of Arizona baseball team, for example, had regular-season home gate receipts of $69,000 in 2011—a nontrivial amount, to be sure, but barely enough to cover even a few scholarships for the players who received them.[14] The box office boomed the following year, however, largely due to the construction of a new stadium: in 2012, Arizona's baseball team generated $350,000 in home gate receipts, more than a five-fold increase in a single year.[15]

But even though Arizona went on to win the College World Series in that year, its athletic director denied that the sport generated significant net income.[16] That denial is entirely plausible, because the scholarship, coaching, equipment and travel costs of fielding a 25-player team, and

[14] NCAA Division I permits 11.7 baseball scholarships per year. This means that a college can distribute partial and full scholarships totaling the value of 11.7 full scholarships per year. "College Athletic Scholarship Limits," (last visited Sept 18, 2013) scholarshipstats.com/ncaalimits.html.

[15] Alicia Jessop, "University of Arizona Baseball: Making the College World Series . . .and Money," Forbes On-Line (June 13, 2012), http://www.forbes.com/sites/aliciajessop/2012/06/13/university-of-arizona-baseball-making-the-college-world-series-and-money/.

[16] Arizona athletics director Greg Byrne has said: "It's not a big money-maker. We made a little bit of money on licensing from National Championship shirts . . . ." www.wildcat.arizon.edu/article/2012/08/greg-byrne-talks-facilities-olympics-college-world-series.

transporting them around the country to play its schedule, are considerable;[17] generating revenue in the six-figure or even low-seven figure range would not likely be enough to make the sport profitable.[18] And without profit, there would be no tax liability under the unrelated business income tax.

If the nonrevenue sports are put aside for the moment—subject to further review in the replay booth from time to time—we are left with the football and men's basketball programs at Division I universities. At the present time, there are 242 universities that compete in Division I football, and 340 universities that compete in Division I basketball.[19] Even within this category, not all programs enjoy net income in any particular year.[20] In particular, the teams in the five "power conferences"—the Atlantic Coast, the Big Ten, the Southeastern, the Big Twelve, and the Pac 12 conferences, plus the Big East in basketball--are the 64-75 institutions that are either

---

[17] According to "The Equity in Athletics Data Analysis Cutting Tool," U.S. Department of Education, Duke reports spending about $27.7 Million on all sports other than football or basketball in the 2016-2017 academic year. The number of baseball players in the Duke program was about six percent of the total of athletes in sports other than football and basketball; if their expenses are proportionate, this would suggest that about $1.66 million was spent on the baseball program.

[18] For example, the Cal- Berkeley baseball team nearly got dropped from the roster of Cal teams in 2010 because of the substantial financial losses the team had incurred in the preceding years. It was estimated that the expense of conducting their baseball program was approximately $1 million per year, but that it generated only $180,000 in revenue. It has since been resurrected, as a result of a successful $10 million fund-raising effort. See newscenter.berkeley.edu/2011/04/08/baseball-to-continue-at-cal/, and www.my.sportsdreams.com/youth-sports-fund-raiser-news.

[19] "About the NCAA," National Collegiate Athletic Association (last visited Sept. 14, 2013). www.ncaa.org/wps/wcm/connect/public/ncaa/about+the+ncaa/membership+new. For football, Division I is divided into the Football Bowl Subdivision (FBS) and the Football Championship Subdivision (FCS). Unlike the FBS, the FCS plays a full post-season playoff to crown a national champion, and the FBS schools tend to spend more money on their football teams.

[20] Charles T. Clotfelter, Big-Time Sports in American Universities supra note 20, at 95, 97; "2004-08 NCAA Revenues and Expenses of Division I Intercollegiate Athletics Programs Report," NCAA (Indianapolis, Aug. 2009), 8. Clotfelter cites *USA Today* Web site, financial data for 98 state universities, 2007-2008 fiscal year. An update to the site can be found at usatoday30.usatoday.com/sports/college/story/2012-05-14/ncaa-college-athletics-finances-database/54955804/1 with data for 227 public institutions.

actually or potentially profitable enough to be worthy of consideration for the unrelated business income tax.[21]

We have gone through the stages of increasing concern about the relationships of college sports to the institutions represented largely because this is a classic problem of the "slippery slope" variety.[22] Sports seem related to other things that colleges do, but seem less and less related the closer we get to a situation in which, for example, a basketball team consists largely of athletes who never intend to spend more than one semester actually attending classes.[23] At some point, one senses that one is no longer in the land of higher education, but is instead in the realm of national-audience entertainment. But where is the line to be drawn? Read on.

B. Are Big-Time College Athletics Related to a University's Exempt Purpose?

Having tightened the focus solely on the big-time sports of college football and men's college basketball, we can begin to consider one of the central questions in this field: Is pursuit of these sports within a university's exempt purpose? If the point of such an inquiry is to determine whether the university deserves exempt status, all the arguments in the preface can be

---

[21] If readers recall George Carlin's observation that it is odd that we drive on parkways, but park on driveways, they will find similarly strange the fact that the Big 10 conference has fourteen members, while the Big 12 conference only ten. But as long as conference membership continues to be remarkably labile, perhaps they are wise not to change their trademarks too quickly in response to what might be temporary membership changes.

[22] See Frederick Schauer, *Slippery Slopes*, 99 Harv.L.Rev. 361 (1985). Schauer's argument is that most things described as slippery slopes in fact have defensible stopping points, where the terrain is acceptably sticky. That is, in our view, precisely the situation we describe in this article.

[23] The 2012 national championship team from the University of Kentucky is the state-of-the-art model of the "one-and-done" business plan. And not to be outdone, Duke's 2015 national championship team also started four freshmen players, all of whom left the university for the NBA following their freshman year. Because eligibility is determined after the fact, the four freshman who were among the starting five in both cases did not really need to pay any attention to their spring semester classes, since they were—and at all times reasonably thought they would be—drafted into the NBA before any ineligibility was established.

mustered to support big-time athletics as well: many students participate, and a much larger number of students watch; colleges have always sought musicians to staff the orchestra, thespians to fill out the playbill, journalists to publish the student newspaper. Extracurricular activities are a part of campus life, and athletics not obviously less so than any other extracurricular activity. None of these activities is strictly necessary; but all contribute to the university community in their distinctive ways. And, in any event, there is the saving grace of the "primary" concept: in the aggregate, a university's budget will be dominated by the salaries of faculty and academic staff, construction and upkeep of the laboratories, classrooms and dormitories, management of the university's endowment, and many other functions. Large universities have budgets that run into the billions of dollars, so athletics budgets that run into the tens of millions will not detract from the primary mission of the university.

Instead, the primary impact of a determination that engaging in big-time sports is not within the exempt purpose is, of course, that these activities may then imaginably be subject to taxation as unrelated business activities.[24] And unlike fencing and volleyball, football and basketball can make enough money to cover their fully loaded costs, and still have a profit worth subjecting to an unrelated business income tax.

A brief description of the unrelated business income tax may be helpful for readers unfamiliar with this concept. An organization may qualify (or continue to qualify) as a tax-exempt organization, eligible to receive tax-deductible contributions, if its activities are primarily

[24] IRC §511(a)(2)(B) imposes the unrelated business income tax even on public universities, despite their general exemption from federal income taxes.

charitable. However, if the organization regularly carries on trade or business activities that are unrelated to its exempt purpose, the income from those activities is subject to federal income taxation at the same rates applicable to for-profit corporations. Following the dramatic cuts in corporate tax rates accomplished by the Tax Cuts and Jobs Act of 2017,[25] net corporate earnings are taxed at a rate of 21%.

There would certainly seem to be a *prima facie* case for the argument that Division I football and basketball should be subject to the unrelated business income tax. They would seem to be a business, in that they are operated in a business-like manner that appears to be designed to generate profit; they are regularly carried on; and they are (arguably) unrelated to the purposes for which exempt status was granted to the college or university that houses the particular program. These are the elements of unrelated business subject to the tax under section 511(a) of the Internal Revenue Code,[26] and each seems satisfied by the facts presented by most big-time programs.

That this is so has been amply documented by others, and there is little point of rehearsing the full details here.[27] But it may be useful to summarize the main observations on these points. As to whether big-time sports are a business, one would note that they generate a tremendous amount of revenue, through the sales of tickets, of television and radio rights, and merchandise, especially apparel, related to the sports programs.[28] The athletic activities are heavily promoted

[25] Pub. L. No. 115-97.

[26] *See also* Treas. Regs. §1.513-1(a).

[27] Clotfelter, supra, note 20, at 94 –107.

[28] Note that some merchandise is very directly related to the sports programs, e.g., replica jerseys with the names and numbers of particular players; shirts, etc., that carry legends like “Duke Basketball” of “2010 NCAA Basketball Champions;” and even, in Duke’s case, table-top models of Cameron Indoor Stadium, our local temple of

through a variety of media, especially including television. The salaries of head coaches are routinely two to four times the salaries of the university president, and ten times or more the median salary of full-time faculty members.[29] (And when these are questioned, the usual defense is that the coach is "worth it," which appears to be meant in a literal, monetary sense.) The games themselves are scheduled on dates and at times that are designed to maximize ratings for the broadcasts.[30] Tickets to the most popular big-time sports programs are allocated on the basis of seat licenses that are essentially auctioned off to would-be buyers—whether they have any relationship with the university or not--for whatever the market will bear.[31]

Although the big-time sports contests are seasonal—from late August to the bowl games in early December for football, and from late October until early April for basketball—they are carried on in that seasonal way year after year, which is sufficient to meet the "regularly carried on" leg of the unrelated business income tax rules.[32] And, in truth, though the games are played

basketball worship. It is also reasonable to assume that the Big-Time sports programs contribute to the market for more generalized university apparel and gifts. In Duke's case, the full array of merchandise can be viewed on the official athletics website of the university, goduke.com. The ".com" designation in itself seems an admission that some business is being transacted there.

[29] Duke basketball coach Mike Krzyzewski receives a salary of $8.89 million in the 2016-17 academic year. Chris Chavez, "Coach K, John Calipari Top the List of Highest Paid College Basketball Coaches," Sports Illustrated,

[30] Steve Eder, Richard Sandomir, and James Andrew Miller, "At Louisville, Athletic Boom Is Rooted in ESPN Partnership," The New York Times (Aug. 25, 2013), http://www.nytimes.com/2013/08/26/sports/at-louisville-an-athletic-boom-made-for-and-by-tv.html.

[31] Clotfelter, Big-Time Sports in American Universities, supra note 20, at 99 –103.

[32] This understanding of seasonal activities as being regularly carried on has been part of Congressional intent from the beginning, as explained in the legislative history of the Revenue Act of 1950, which created the unrelated business income tax: [I]f an organization owned a race track, this would not be considered an occasional activity even though the track was operated only a few weeks every year, since it is usual to carry on such a trade or business only during a particular season. H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37, 109 (1950), 1950-2 C.B. 380, 458

during only the intervals noted, various other activities—recruiting of players, setting of schedules, sales of tickets, etc., go on year around.

The only leg of the three-legged UBIT stool that could be said to be contestable would be the question of whether or not these activities are related to the broader educational enterprise housing them. Even as to this factor, the case for application of the unrelated business income tax seems clear enough. The "student-athletes" in these programs seem more like athletes than students: they are selected primarily for their athletic ability rather than their academic ability; they devote huge amounts of time to their sports, especially during the primary seasons for their sport, but even in their respective off-seasons; they are ordinarily expected not to engage in other intercollegiate sports, and not to take classes at times that would conflict with times set aside for practices or games; they travel extensively during which they necessarily miss classes; they receive extensive "academic support" from athletic department staff that frequently blurs the line between tutoring and actually doing classwork on behalf of the students so "supported;" they have generally poor graduation rates, and rarely choose any of the more challenging major fields of study available on their campuses.

Coaches are hired for their ability to win games and fired for any shortcomings in that metric. Their incentive pay may include a nod toward the academic side of the university (for example, a bonus for achieving a particular graduation rate), but those incentives pale in comparison with the incentives to field successful teams. Studies of the bonus structure faced by coaches have found that the rewards for success on the field are approximately twelve times as large as the rewards for success in the classroom.[33]

Expensive facilities for training, practice, and the actual games, are built for, typically, the exclusive use of athletes in the big-time programs. At many universities, the student-athletes are even housed and fed in facilities that are separate from (and invariably in such cases, superior to) the facilities available to students who are not athletes in one of the big-time sports.

C. The Applicability of UBIT to College Sports: the Views of Congress, the IRS, and the Courts

But despite the seemingly tangential relationship between a university's big-time sports programs and the educational institution whose name they share, all of the major sources of rules affecting the tax system--Congress, the Internal Revenue Service, and the courts--have universally declared big-time sports to be sufficiently related to the educational enterprise to avoid the status of unrelated business activity.[34]

This has been true from the very beginning—that is, from the date of enactment of the Revenue Act of 1950, which created the unrelated business income tax. Though big-time college sports are not specifically mentioned in the legislative language itself, the committee reports take considerable pains—one might almost say that they protest too much—to make it clear that Congress couldn't even conceive of the new tax applying to college sports. The Ways and Means Committee and the Finance Committee seem to have agreed to use something of a zone defense

[33] *See* Burton A. Weisbrod, Jeffrey P. Ballou, and Evelyn D. Asch, *Mission and Money: Understanding the University*, Cambridge University Press (2008), as cited in Clotfelter, *supra* note 20.

[34] Citations will follow in the specific paragraphs below.

of college sports, with the first specifically defending college football, and the latter college basketball[35]:

> Of course, [indeed!] income of an educational organization from charges for admissions to football games would not be deemed to be income from an unrelated business, since its athletic activities are substantially related to its educational program.[36]

> And

> Athletic activities of schools are substantially related to their educational functions. For example, a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were composed of students of other schools.[37]

The Internal Revenue Service did not immediately follow with its own pronouncements on the applicability of the unrelated business income tax to college sports, presumably because it did not feel that it needed to. It simply took no actions that would be inconsistent with the language of the legislative history, which sent an unambiguous message that the IRS should not and would not consider college sports as unrelated to the exempt purposes of the colleges that pursued those

[35] Their respective choices are a little odd, in light of the fact that college basketball was originally an urban sport, played in dank gymnasiums of Catholic high schools and colleges in New York, Philadelphia, and a few other cities. Football, in contrast, was of special interest to the fans of the big state universities of the West, Midwest, and South. In light of the malapportionment of the Senate in favor of states like Nebraska, Mississippi, and Oklahoma, one might have thought that football was their preferred sport. This reasoning presumably explains the misattribution of the two quotations in the text by the IRS in Rev. Rul. 80-296 (1980-2 C,B. 195, 196), which erroneously casts the House as the defender of basketball, and the Senate as the defender of football.

[36] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37, 109 (1950), 1950-2 C.B. 380, 458.

[37] S. Rep. No. 2375, 81st Cong., 2d Sess. 29, 107 (1950), 1950-2 C.B. 483, 505.

sports. Because the IRS did not attempt to assess any taxes on unrelated business income with respect to big-time athletics activities, the courts were not called on to make any determinations about the applicability of UBIT doctrines to this area. However, some older opinions could be found to support the idea that college sports were appropriately regarded as integral to educational experiences.[38]

Occasionally, the IRS issued rulings regarding qualification for exemption by athletic support groups at a variety of levels of amateur sports: In Rev. Rul. 55-587,[39] the IRS ruled that an interscholastic body to oversee high-school athletic competition could qualify as a charitable organization. In Rev. Rul. 64-275,[40] the IRS ruled that a sailing school designed to train teams of athletes for international competition, including the Olympics, could also qualify as a charitable organization. And in Rev. Rul. 67-291,[41] the IRS ruled that an alumni organization that supported a college's "training table" for feeding members of athletics teams could qualify as a charitable organization. None of these organizations produced significant revenue, however, so no unrelated business tax issues were discussed in any of these rulings. And of course even if UBIT issues had been raised, the findings that the activities described did constitute exempt purposes would presumably have answered any questions about whether the IRS regarded these activities

[38] See, e.g., Dist. Of Columbia v. Shannon & Luchs Const. Co, Inc., 17 F.2d 219 (D.C. Cir. 1927). (This case involved the exercise of eminent domain to acquire property for a school athletic field. The Court summarized the case law on the subject, noting that: "[C]ourts . . . uniformly hold that physical culture and development is an integral part of our educational system . . . .")

[39] 1955-2 C.B. 261.

[40] 1964-2 C.B.142.

[41] 1967-2 C.B. 184.

as related to exempt purpose.

1. Television and UBIT

During this time, the value of the rights to broadcast, and especially to televise some big-time sports events—especially college football bowl games and the NCAA basketball tournament—was growing. The 1979 basketball championship—featuring Larry Bird's Indiana State team playing Magic Johnson's Michigan State team—achieved a college-sports record single-game Neilson rating of 24.1, with a 38% audience share at its peak. This translated to a television audience of 18 million households—18 million households with a thirst for beer and soft drinks, a yen for pickup trucks, and a mighty appetite for fast food--at least in the judgment of the firms that decide to advertise their wares in this venue.

Perhaps spurred by this heightened attention, the IRS shortly thereafter ruled that television and radio revenue generated by college sporting events did not constitute unrelated business activity. In Rev. Rul. 80-296,[42] it opined, after a brief and very superficial analysis involving the facts of a college football game, that:

> [T]he educational purposes served by exhibiting a game before an audience that is physically present and exhibiting the game on television or radio before a much larger audience are substantially similar. Therefore, the sale of the broadcasting rights and the resultant broadcasting of the game contributes [*sic*] importantly to the accomplishment of

[42] 1980-2 C.B. 195.

the organization's exempt purpose.[43]

Really? The live audience and the television audience are "substantially similar?" Consider a typical football weekend at a Big Ten or Southeastern Conference university (Ohio State, Florida, Penn State, Alabama, etc.). The fun for the students begins on Friday night, with a pep rally, maybe a bonfire, and certainly major partying. On Saturday morning, while the students are sleeping off their hangovers, the alumni begin to arrive in their SUVs and station wagons for the tailgating that will precede the game. The alumni often join with classmates arriving from different directions, creating hundreds of mini-reunions scattered over the massive acreage of the stadium parking lot. Then, as kickoff approaches, the students and alumni file into the stadium, along with faculty, staff, and members of the community whose relationship with the university may be less intimate, but who are nevertheless loyal fans, willing to pay hundreds of dollars for their season tickets.

The university president, and the deans of the graduate and professional units, will take their particularly desirable seats, along with trustees and other major donors, or people who are targets for such status. After the game, the partying will resume, with more or less festivity, depending on the outcome of the game. Not all of this activity is appealing or healthy, but it does all have *some* connection with the operations of the university.

Compare this with the experience of the television audience. That group will, in the case of a nationally televised game, number in the millions, of which only a small percentage will have

[43] Id. at 4.

even the most remote connection with the university.[44] Most will not be even in the same state, much less the same zip code, as the host university. These viewers hope mostly to be entertained by the athletic display. Some may hope to be enriched, if they have wagers on the game with their on-line bookies in the Bahamas. Some may simply have nothing better to do. What they generally do not have is any interest in the educational enterprise that is associated with the universities whose student-athletes are on the field.

So these audiences are "substantially similar"? One wouldn't think so. Defenders of big-time college sports base their defense of existing practices largely in terms of building their university communities—fostering "school spirit," collective identity, and closer connections among and between the various constituent groups making up the university: students, administrators, trustees, and alumni, and perhaps as well people who operate businesses in the general vicinity of the university. *But much less of that is going on in the national television audience.* Rarely, if ever, would a university defend its sports programs on grounds that they serve to entertain a national audience of people who are largely strangers to the university community.

There may be one exception to this: university officials do sometimes mention that successful big-time sports programs may produce increased interest on the part of potential

[44] How small the percentage may be no doubt varies. Many of the universities in the "Power Five" conferences are large public schools with up to a few hundred thousand living alumni. Especially in the case of a regional telecast of a large state university's games, the percentage of viewers who have some connection with the university—as alumni, students, or parents, may be substantial. Even in those cases (which are not the ones that generate the most revenue for the networks), one doubts that "connected" viewers would constitute a majority of the audience. And at the other extreme, when a relatively small and new university such as Boise State is on national television, the "connected" viewers would almost certainly be a single-digit percentage of the total audience.

applicants for admission, which in turn may translate into an increase in applicant volume. The evidence on this is mixed, but the prevailing view seems to be that success does produce a modest (and transient) increase in applicant volume, but only for the very small number of universities at the very pinnacle of achievement in football or basketball—literally only the teams that win a major bowl game, or make it to the Final Four ® of the NCAA basketball tournament.[45]

So this effect is small, affects only a few universities, and even when present, may be a mixed blessing. If the marginal applications stimulated by athletic success are largely from students who are not well-qualified for admission to that university, there is little benefit at all.[46] But it is probably true that at least some of the marginal applicants are well enough qualified to be accepted, and perhaps enroll. However, if I were a provost at such a university, I would wonder whether it was necessarily a good thing that a few applicants whose interest in the university was based largely on its athletic success were displacing a similar number of applicants who were almost as well-qualified, and had been attracted to the university by its other qualities—qualities more closely associated with the things that universities claim to value.

A related argument is worth noting. Some universities apparently feel that participation in big-time sports is a way of putting their institution "on the map." It is likely that the visibility of Gonzaga University has been enhanced by its considerable success in several recent NCAA

[45] Clotfelter, *supra*, note 20, at 145-46. One study Clotfelter cites does find an effect, albeit a very small and transient one, resulting from finishing in the top 20 in football, or making the round of sixteen in the basketball tournament. Devin G. Pope and Jaren C. Pope, "*The Impact of College Sports Success on the Quantity and Quality of Student Applications,*" 75 Southern Economic Journal 750 (2009).

[46] One effect of increased applicant volume is that the apparent selectivity of the university may increase, as it accepts a smaller percentage of its fattened applicant pool. This may be slightly helpful; however, the US News methodology (as an example) weights acceptance rate as ten percent of the "selectivity score," which in turn is only fifteen percent of the overall score. Thus, acceptance rate is weighted at only 1.5% of the overall score.

basketball championships.[47] Similarly, Conference USA, a league that is just short of "power five" status, includes a number of teams representing younger and less nationally known universities, such as Florida International, the University of Texas at San Antonio, the University of North Carolina at Charlotte, and so on. The leadership at these universities clearly believe that participation in division I sports provides them with exposure to audiences that matter to them: potential students, potential faculty, perhaps potential grant-makers, and so on.

Because universities change status from small-time to big-time sports so infrequently, there are no data on the effects of such a change beyond the merely anecdotal. It is clear that universities can succeed at the highest academic levels with every conceivable approach to intercollegiate sports, from next-to-nothing (University of Chicago, New York University, Washington University, Emory), to being serious about only one or two non-revenue sports (Johns Hopkins), to being serious but not big-time across a wide range of sports (the entire Ivy League), to being nominally big-time, but seemingly content with no more than modest success (with apologies, Rice is the conspicuous example), and so on. If nothing else, this indicates that big-time sports are not *necessary* to a university's academic success and renown.[48] Even if pursuit of big-time sports has proven transformative in a few instances (Gonzaga, Butler), a few exceptional cases are a slender reed to support the relatedness of big-time sports to the primary educational mission of the university.

---

[47] See Dana O'Neill, How the Basketball Program Helped Gonzaga University Flourish," ESPN.com, March 29, 2017.

[48] It is worth noting, in fact, that only two of the universities in the top ten "National Universities" list—Stanford and Duke--are members of one of the power five conferences.

And in a way, this argument is beside the point in any case. Generating greater name recognition—even if it works that way--would not seem to be, in itself, sufficiently related to the university's exempt purposes to take an activity out of the range of the unrelated business income tax. Some degree of publicity—ads in the "Education Life" section of the Sunday New York Times, for example—are clearly appropriate, and within a university's exempt purpose. But pursuit of an entire line of business does not become "related" for purposes of the tax on unrelated business income merely because public recognition of the business may create recognition of the university as a by-product. If it turned out that a university's sponsorship of a traveling circus helped attract donations, and more and better students, would that qualify the circus as related to the college's exempt purpose? Similarly, if big-time sports are primarily about entertaining audiences with limited or no connection to the university, the fact that there might be ancillary benefits from becoming better known should not save the entertainment activities from being regarded as unrelated to the educational mission.

2.The Special Case of Advertising

One reason that it is important to distinguish between the live audience and the television audience is that the income produced by the attention of the television audience is largely advertising income.[49] Beginning in the late 1960s, the IRS developed a doctrine that an activity

[49] This may be changing. There are now special "networks" that operate by making games—such as all football games played by Big Ten schools—available only to subscribers who pay for the privilege of receiving these broadcasts through their regular cable or satellite television provider. In such an arrangement, the cable or satellite provider presumably keeps some of the subscription cost, and pays part of it to the conference that arranges the telecasts. There may be advertising sold in connection with these broadcasts as well, but at least a substantial part of the income received by the conference, and passed on to its member schools, would come from viewers, not advertisers. The impact of this will be considered below in the section of this essay on "Cable/Satellite Subscription Payments."

that may be within an organization's exempt purpose may also be viewed as a "content provider" (though of course that was not the lexicon of the time) of a sort that makes it an attractive platform for advertisers. When this situation arises, the IRS has argued, it is appropriate to view the advertising as a separate activity--one that is unrelated to the organization's exempt purpose, despite the fact that the underlying activity may be within its exempt purpose.

In the case of big-time college sports, the income does not come to the universities directly from the advertisers, but rather comes indirectly through the various television networks that sell the advertising opportunities in the market. Obviously, the magnitude of the available advertising revenue is the reason that networks are willing to pay substantial sums to the NCAA, or the various conferences, for the rights to televise big-time athletics contests. And the dollar amounts paid for advertising of college sports have grown in recent years to noteworthy levels. For example, it is estimated that the advertising revenue associated with the NCAA basketball tournament in 2013 exceeded one billion dollars![50]

Viewing the sale of television rights as implicitly advertising income has important implications for the application of the unrelated business income tax. First, as noted above, segregating the sale of advertising from the other aspects of an activity has been used, in effect, to require an independent justification of the relatedness of the advertising aspect; this means that it is possible that college sports could be exempt from UBIT because they are related to exempt

[50] "Kantar Media Releases March Madness Advertising Trends Report," Kantar Media (Mar. 6, 2013), http://kantarmediana.com/intelligence/press/2013-march-madness-advertising-trends-report. It does not appear that revenue has exceeded this number in subsequent years, though the total continues to be at approximately this level. See Tim Parker, "How Much Does the NCAA Make Off March Madness?" www.investopedia.com/articles/investing/031516/how-much-does-ncaa-make-march-madness.asp

purposes, while the sale of advertising opportunities might not be exempt, because it couldn't "borrow" the relatedness of the overarching activity.

Second, segregating an advertising element from the rest of the big-time sports elements would be much more likely to yield accounting results that would actually show unrelated business taxable income in substantial amounts. Even if the overall big-time sports picture for a university did not show an excess of revenue over expense (and it well might not, in light of the possibilities of generating deductions for major items like depreciation on stadiums and other facilities), the segregated business of televising college sports would likely show consistent, and large profits.[51] The television networks typically cover the costs of their operations themselves, so the amounts that are paid to the NCAA or the conferences, and then distributed to the universities, are nearly pure income.

Finally, the magnitude of television advertising revenue has ballooned in recent years. It was virtually nil in 1950, when the unrelated business income tax provisions were first added to the code. It had grown considerably by 1980, when the IRS issued Rev. Rul. 80-296, but it was even then miniscule compared with today's dollar volume. The continuing rise in the value of television rights continues to astonish: just when one thinks that one has gotten used to very large numbers, the numbers grow larger still. Writing in 1980, Richard Kaplan noted that the broadcast

[51] One highly respected commentator disputes this, saying that even if big-time college sports were considered an unrelated business activity, the availability of deductions for program costs would likely wipe out any net income. *See* John D. Colombo, *"The NCAA, Tax Exemption and College Athletics,"* ssrn.com/abstract+1336727 (2009). We disagree, and think that one of the purposes of the fragmentation rule was to split off the costs of the disaggregated activity—in this case, televising sporting events—from the overall activity. Indeed, if that is not the purpose, it is difficult to see any advantage in the fragmentation approach. Colombo concedes that some athletic programs would make money no matter how liberal the deduction rules might be; and we note as well (see infra, text accompanying notes 65-69) that the IRS has the power to amend the accounting rules to produce a better match of the actual expenses of televising sports with the revenue produced thereby.

package for the NCAA basketball tournament had doubled in size over just the preceding two years.[52] How much was it back then? With the addition of a $2,000,000 payment from the new Entertainment and Sports Programming Network (ESPN) for the rights to televise some early-round games, the total had grown to $10,500,000.[53] A tidy sum, no doubt; but only about one percent of the sum paid for the rights to the tournament in recent years.

The dramatic shape of this growth curve is important because it provides a powerful reason to re-examine conclusions reached earlier, on very different facts. Television barely existed in 1950, so no one in Congress could have imagined the revenue possibilities that would come to be more than sixty years later. By 1980, the IRS might have had a little more reason to think that growth in revenue was robust, and might continue. But no one in 1980 would likely have predicted a hundred-fold increase in television revenue over the following thirty or so years.[54]

The amount of money at stake has had some predictable consequences. Schedules and game times, for example, used to be the province of the conferences primarily, with input from the athletics directors of the member schools. Increasingly, the dates and times of games are dictated by the networks that will be televising the events.[55] If it once seemed that sports teams were appendages of the universities they represented (or vice versa!), it now seems that they are

[52] Richard Kaplan, "Intercollegiate Athletics and the Unrelated Business Income Tax," 80 Colum. L.Rev. 1430, 1445 (1980).

[53] Id.

[54] Note that only a small part of this growth is attributable to inflation. The Consumer Price index was at 86 when the IRS issued the ruling in 1980, and has grown to about 230 today. So a multiplier of about 2.7 is the appropriate adjustment for inflation. Thus, instead of a hundred-fold growth, it may be more appropriate to speak of a real growth of more like a 35-fold magnitude. That is still huge growth.

[55] See Sandomir and Miller, *supra* note 25.

increasingly the appendages of ESPN. So it is certainly worth asking: just how unrelated to higher education does televised big-time college sports have to get before we are ready to conclude that it should be subject to the unrelated business tax?

Before reaching any conclusions, a closer look at the relevant legal doctrines on segregation of advertising income from other aspects of a business conducted by a charitable organization is indicated. The law in this area stems primarily from United States v. American College of Physicians, a case involving the applicability of the unrelated business income tax to the income derived from selling advertising space in a publication of the College of Physicians entitled "Annals of Internal Medicine."[56] Decided in 1986, this case was the culminating event in a saga that went on for nearly twenty years.

In 1967, the Treasury promulgated a regulation that adopted a new approach to the unrelated business income tax.[57] The Treasury was no doubt concerned that in the case of some mixed activities, where some exempt purposes existed, but where unrelated business activities were going on as well, aggregating the related business activities with the unrelated ones would produce accounting opportunities to offset unrelated business income with the expenses that were incurred in pursuit of business interests that were related to the organizations' exempt purpose. Advertising was the chief target: the reasoning behind the regulation was that seeking (and finding) businesses that were interested in placing advertisements in publications of exempt organizations were businesses in themselves, and were businesses that had nothing to do with

[56] 475 U.S. 834 (1986).

[57] Treas. Reg. §1.513-1(b) T.D. 6939, 1968-1 C.B. 274.

exempt purposes of the organization. Instead, they were about generating revenue.

This somewhat aggressive position of the Treasury was the object of criticism, but Congress came to the rescue with uncommon speed. In the Tax Reform Act of 1969,[58] it amended section 513(c) of the Code to specifically endorse this "fragmentation" approach to advertising income.

The facts of American College of Physicians illustrate the application of this theory. The publication involved was clearly within the exempt purpose of the College of Physicians: it carried articles describing research outcomes of interest to a wide range of practicing physicians. The articles were scholarly in nature, and were not designed to advance the interests of any businesses that might have chosen to advertise in the journal.[59] The case could have been a test case of the fragmentation approach, but after that approach was endorsed by Congress, such a challenge would presumably have had to be on Constitutional grounds, which the College of Physicians may have thought too high a bar.

Instead, what was at stake in American College of Physicians was the specific application of the fragmentation rule to advertising in a professional journal. The government took the position that all advertising in such journals was unrelated to exempt purposes; the College of Physicians disagreed, and the Supreme Court found for the College on this point. But having won that battle, the College went on to lose the broader war. The Court declined the IRS proffered *per se* rule, but upon examining the facts in the particular case, found that there was little or no editorial

[58] Pub.L. 91-172, 83 stat. 487.

[59] That was the claim, anyway, and the IRS does not seem to have contested it.

control over the content of the advertising, and that the particular ads in each journal issue could not be said to be in those pages for the purpose of advancing any charitable purpose of the College of Physicians. They were mostly—and generally quite baldly—about selling drugs.

The language of Justice Marshall's opinion suggests that if the College had, for example, limited advertisers (mostly drug companies) to advertisements featuring new drugs, or only to advertisements that featured clinical findings that might have educational value for the physicians reading the journal, then the ads, and the revenue they produced, might have been found related to the exempt purpose of the College.[60] But of course this would have reduced the advertising opportunities significantly, so absorbing the unrelated business income tax was probably the more economically productive approach.

While the IRS enforcement pattern that is available on the public record—and indeed the text of the regulations themselves—suggests that the primary interest of the IRS was in print advertising in publications like the Annals, the text of section 513(c) is not so limited. At no point does it refer either to publications or advertising explicitly, but merely says, in relevant part:

> [A]n activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.[61]

---

[60] One imagines that the ads were of a more commercial sort: perhaps a picture of an unhappy-looking housewife, sitting at her kitchen table, staring into her cup of coffee, with text that reads: "Does she just have the blues, or is she suffering from a treatable medical condition?" Implicitly: Surely the latter, and here's just the drug she needs.

[61] IRC §513(c).

This is the sort of maddening draftsmanship that leads tax lawyers to say that resort to the code should only be undertaken in the event that the legislative history is unclear; and in this case, the legislative history is clear enough: Congress meant to endorse the IRS fragmentation approach, so that more-or-less free-standing, revenue-generating parts of an operation could be segregated for purposes of accounting for possible unrelated business income.

The precise targets were a matter of some debate. The House Report, while proposing language that was not limited to advertising income, mentioned only that in its report.[62] The Senate added an amendment that would have limited the scope of the provision, curiously, to three activities specified in its report: advertising, "sales of drugs by a hospital pharmacy to persons other than hospital patients," and "operation of a race track by an exempt organization."[63] The Conference report adopted the House version, with minor wording changes to make it clear that "no part of it [the unrelated activity] is to be excluded . . . merely because it does not result in profit."[64]

The more general language of section 513(c) would seem to make clear that even if the revenue paid by broadcasters were not considered advertising, it would not bar application of the fragmentation principle. However, even if one were to take the narrow view that section 513(c) applied only to advertising income, it would seem that much of the broadcast and telecast income would qualify as such. Consider, for example, whether the result in American College of

[62] H.R. Rep. 91-413, reprinted at 1969-3 C.B. 232.

[63] S. Rep. 91-552, reprinted at 1969-3 C.B. 472.

[64] Conf. Rep. 91-782, reprinted at 1969-3 C.B. 653.

Physicians would have been any different if the College, instead of publishing the Annals itself, had arranged to have a third party publish the Annals, with the understanding that the third party would be allowed to sell advertising, and would pay most of the difference between its advertising revenues and its cost of publication over to the College. Surely the injection of an intermediate agent into the production of the Annals would make little difference in the analysis.

This parallel version of the American College of Physicians facts is fairly close to what conferences and the NCAA have done with respect to big-time sports: they have agreed with CBS, ESPN, and others that those networks will be allowed to sell advertising that will be shown in connection with game broadcasts, with much of the net revenue derived from those sales being paid to the conferences or the NCAA. In fact, the recent creation of the Big Ten network indicates that business models involving even more direct sales of advertising are imaginable, and are in fact being pursued by some conferences.

But whether the advertising revenue is collected directly by a network owned by a conference or indirectly, though the medium of a more general broadcast network, it remains advertising revenue. To that extent, it could be subjected to a disaggregation analysis that would result in the recognition of substantial unrelated business taxable income.

Precisely what would this mean? The *American College of Physicians* case is opaque on the question of what deductions would be allowed against the advertising revenue, but Treasury Regulations provide some guidance. One provision, relating to "exploitation of exempt activities" is of particular interest.[65] Under these rules, if an unrelated income-producing activity simply

[65] Treas. Reg. §1.512-1(d)(1).

exploits an exempt activity, “expenses, depreciation and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income.”[66]

There is an exception to this general prohibition in cases in which the exempt activity that the unrelated activity exploits is “a type of activity normally conducted by taxable organizations.”[67] But it is unclear if this exception would apply in this case. It depends on whether college sports are of the same type as professional sports. Certainly there are many similarities; but there are important differences as well, as the NCAA and its member universities would normally be quick to point out.[68] The athletes, they would note, are primarily engaged in an academic program, and are not employees of the team. The sports are part of a group of student activities that are parts of campus life, rather than ends in themselves.

Because the question of whether college sports are of a type with professional sports within the meaning of the regulation is far from clear, it would seem that, to advance the purposes of the fragmentation rule, if the revenue from televising big-time college sports were considered to be unrelated business income, it would be prudent for the IRS to issue a revenue procedure—or possibly even promulgate additional material in the regulations—explaining its view of what expenses might be deductible.

Another regulation may be of interest here, though its relation to the “exploited activity”

---

[66] Id.

[67] Treas. Reg. §1.512-1(d)(2).

[68] One needn’t speculate about this. In the course of the recent litigation over the status of Northwestern University football players, the university and the NCAA fell over themselves emphasizing how different college sports were from professional sports. See text and notes at note 147 infra.

rule is unclear. Reg. section 1.512-1(c) deals with "dual use facilities or personnel." In some sense, a stadium in which a televised contest is staged is a dual use facility. As such, an allocated portion of the costs relating to the facility should be allowed as deductions against television revenue. But the portion would be quite small. The two or three announcers for the telecast occupy a small fraction of one percent of the space in the facility. A few videographers stationed along the sidelines or baseline occupy space that wouldn't be occupied at all but for their presence, but even if one counts that space, it is still very small. Most of the television crew is actually not in the stadium itself, but in a trailer parked in the parking lot outside the facility. So perhaps a deduction should also be allowed for a fraction of one percent of the costs of maintaining stadium parking lots. But all this is clearly quite trivial.

What about allocation of personnel costs? Some personnel clearly have a close relationship to the telecasts, such as the sports information director's staff. Not all of their time is accounted for by television activities, but some is, and an appropriate allocation should be made. Again, however, the rule relating to "exploitation of exempt activities" may bar any such allocation.[69] And, again, clarification by the IRS and Treasury would be required if the fragmentation rules are to be given meaningful effect.

Additional legislation on this point would not in our view be indicated, but it is worth noting that the Tax Cuts and Jobs Act of 2017 included a provision requiring separate accounting for each unrelated business activity of an exempt organization, in order to prohibit an organization

[69] Treas. Regs. §1.512-1(d)(1).

from using losses from one unrelated business to offset net income from another.[70] Although not directly applicable in the big-time sports context, it does indicate Congress' interest is limiting the ability of an exempt organization to cause its net income to disappear by expenses or losses involved in aspects of its operations other than the unrelated business in question.

3. Cable/Satellite Subscription Payments

To this point, no mention has been made of the fact that networks also receive revenue from a source other than advertising: payments from local television cable and satellite companies. The latter have contractual arrangements with subscribers under which monthly payments are made in exchange for delivery of a signal by cable or satellite into the viewers' homes. The basic rate for this service begins at around forty or fifty dollars per month, with add-ons for additional receivers, high-definition transmissions, optional programming, and other features. These subscription amounts come from the pockets of the viewers, and are more analogous to the purchase of a ticket than to advertising; just as is the case with payments for live admission to an event, they represent a payment from someone who wants to watch athletic contests. A possible inference from these facts might be that, to the extent that the funds that ultimately flow to universities are derived from subscription fees, rather than from advertising, they should be not be considered unrelated business taxable income under the fragmentation theory just advanced.

While such an inference is not facially unreasonable, it ignores the critical difference between live attendance and television viewing emphasized in the discussion above of the

[70] P.L. 115-97, §13703 of the Senate Amendment, amending §512(a) of the Code.

(defective) reasoning of Revenue Ruling 80-296: on-site viewing of events can be plausibly described as having something to do with community-building, providing social capital. Such a claim is not plausible in the case of a distant viewer who may have no connection with the universities represented on the field. Indeed, such viewers are normally not even able to select the particular games they would like to watch, except among the limited offerings that the networks that are part of that viewer's subscription provide from week-to-week. Unlike ticket buyers, the viewers at home are usually not even fans of the particular teams whose games are featured on any given day. The several million viewers of each year's regular-season football game of the century would for the most part not be enthusiasts of either school's athletic programs; they simply want to be entertained by what is expected to be an exciting football game, featuring players and coaches who had come to be nationally renowned.

We would therefore argue that the money whose source lies in subscription income from viewers is unrelated business taxable income for essentially the same reason that advertising income is: it is not derived from activities that have any reasonable relationship to the exempt purposes of the colleges and universities that ultimately receive the economic benefits that this business provides. The case may be marginally more difficult to sustain, because the case for UBIT treatment of advertising income draws support from Treasury Regulations, the Internal Revenue Code, and Supreme Court precedent. Subscription income is nevertheless conceptually similar to advertising income, in the sense that both come from sources too distant from the exempt purposes of a university to be considered related to those purposes.

4. Possible Defenses to Assertion of Unrelated Business Income Tax Liability?

The law on unrelated business income as it applies to big-time college sports contains a few other possibly relevant aspects that should be discussed, if only briefly. The first is the "sponsorship" controversy that swelled in the early 1990s, later to be quelled by both a more generous view by the IRS, and by subsequent legislation on this topic. In 1991, the IRS issued technical advice to the effect that payments by commercial interests to support college football bowl games constituted unrelated business income.[71] Though identifying information was redacted, it was widely known that the particular bowls were the Mobil Cotton Bowl and the John Hancock Bowl, and the IRS position came to be known as the "Cotton Bowl ruling."[72]

This position created a backlash, and the IRS ultimately backed down.[73] Congress secured a limited exemption for sponsorship gifts in section 513(i). It is possible to imagine that the sponsorship exemption could be used in lieu of some advertising as a means of avoiding unrelated business income if that concept were held to apply to television revenue generated by big-time sports. However, the rules of section 513(i) seem flatly inconsistent with the type of advertising commonly seen in telecasts of big-time sports. The prevailing preferences of advertisers are not of the general form of "This broadcast was brought to you by the generous contributions of Nike, Gatorade, Budweiser, and Ford Trucks." Rather, those sponsors seem clearly to prefer to make a direct pitch about the desirability of their products. As Yogi Berra supposedly said, it's hard to make predictions, especially about the future;[74] nevertheless, it seems

[71] Technical Advice Memorandum 9147007.

[72] Fishman & Schwarz, Nonprofit Organizations, Cases and Materials, (4th Ed. 2010), at 628.

[73] Id.

[74] But he also said that he never said a lot of the things he said, so who knows?

likely that advertisers and big-time sports would conclude that, if necessary, it was better to pay some amount of unrelated business tax than give up the opportunity to offer conventional advertising in connection with the broadcasts. Big-time sports have become one of the primary means of putting messages in front of young, especially male, audiences, and it seems unlikely that the unrelated business income tax would much deter advertisers from this mission.

Also to be noted is that the one attempt of the IRS to impose unrelated business taxes on advertising in connection with college sports was unsuccessful. In National Collegiate Athletic Association v. Commissioner,[75] the IRS sought to tax the advertising income generated by the magazine-like "program" published by the NCAA in connection with its annual Division I basketball tournament. Though the IRS prevailed at the Tax Court level,[76] that decision was reversed by the Tenth Circuit. One might well ask whether the IRS, having been rebuffed when it stuck a toe in these waters, can reasonably hope for better results if it were to jump in head first in the manner suggested in this essay.

There is every reason to think that it could get better results. Not only did the IRS win at the trial level in NCAA, but even the NCAA conceded that sale of the advertising was unrelated, and constituted a business.[77] The only missing element from a good UBIT case found by the court was that the activity was not "regularly carried on."[78] This was barely debatable in the case

[75] 914 F. 2d 1417 (10th Cir., 1990).

[76] 92 T.C. 456 (1989).

[77] 914 F.2d at 1421

[78] Id., at 1424.

of an annual three-week basketball tournament, but could hardly be debatable in the case of the regular seasons for college football and basketball, which extend, respectively, from August through January, and from October through April, of every year. If anything, the language of the opinion in this case supports the argument offered in this essay.

Finally, if one takes seriously the idea that big-time sports are conducted by amateur student-athletes, one must consider whether the general exemption from UBIT for activities conducted by unpaid volunteers might apply to big-time sports.[79] Without even going to the question of whether the student-athletes play "without compensation"[80] despite the fact that they receive scholarships that may be worth $60,000 or $70,000 per year (at private universities), one notes that the athletic contests inevitably involve a cadre of coaches, trainers, athletic directors and their staffs, numbering in the dozens. These individuals are clearly not volunteers, and in the cases of the head coaches and athletic directors, are typically the highest-paid employees of their institutions. This exemption would seem flatly unavailable in this context.

5. Prospects for Reform

Needless to say, universities are not likely to voluntarily declare unrelated business taxable income from televised big-time sports events, especially in light of the fact that Revenue Ruling 80-296 explicitly exempts such revenue from the tax. Further action from the IRS would be necessary to collect such a tax. Is this feasible?

---

[79] IRC §513(a)(1).

[80] Id.

It is certainly possible. The IRS does occasionally revoke earlier rulings, and in those cases it usually replaces them with new rulings that reflect more contemporary facts and current analysis. Revoking Revenue Ruling 80-296 would be a good idea, and entirely defensible both on grounds that it was defective *ab initio*, and on grounds that the truly stupefying infusions of revenue that big-time sports have begun to generate could not have been anticipated at the time that ruling was published. No changes in statutes or regulations would seem to be required to implement the view that television contracts generate unrelated business taxable income, since section 513(c) and its accompanying regulations already point to such a result, as argued above.

Is the IRS likely to revoke Revenue Ruling 80-296, and, if it does, is it likely to be able to sustain a position contrary to that ruling? As to the first, it certainly seems doubtful, especially in the short run. The IRS has limited political capital even in the best of times, and these are not the best of times. And the impetus for this action would presumably be initiated by the division with primary responsibility for exempt organizations, and that division is currently in a state of (largely undeserved) disgrace. So in the short run, do not expect this scenario to be playing out anytime soon at a big-screen sports bar near you.

But it may be worth bringing these arguments to the attention of the IRS, as part of a sustained campaign that might eventually lead it to reconsider Revenue Ruling 80-296. The revenue involved—unlike that which is at stake in most UBIT controversies—is substantial, and growing at a remarkable rate. It would seem that it would be healthy for both tax revenues and for colleges and universities themselves for the IRS to take a more realistic view of whether televised big-time sports are really related to the exempt purposes of a university.

If the IRS were persuaded eventually to take the view advocated here, it would probably be able to sustain that view in court, in view of strong Supreme Court precedent for disaggregation of advertising revenue from the otherwise exempt activity that provided the platform for it. And although Congress has generally been friendly to big-time college sports, it might be that Congress would decide not to intervene, as long as it didn't see the IRS action as imperiling the basic idea of big-time sports. Indeed, the recent repeal of section 170(*l*) suggests a changing mood in Congress that would not be inimical to the idea that television revenues could be considered unrelated business income.

There is no reason to think that taxing television revenues received indirectly by colleges and universities as unrelated business income would seriously damage college sports. Indeed, it might enhance competition. Only the most successful programs would generate enough revenue to have substantial net income from these activities. As every income tax inevitably is, this tax would be to some degree a tax on success, and would reduce by about a fifth the after-tax returns from that success. This in turn would lead to less money going into the most successful programs, which would mean that they would likely be unable to spend quite so much on coaching staffs, recruiting costs, lavish facilities, and so on. Would that be such a bad thing? It would probably have the effect of improving the competitive relationships between the most successful programs and the others in the same conference, thereby enhancing rather than damaging college sports.

II. The Exclusion of Athletic Scholarships from Gross Income (According to the IRS)

For a scholarship to be excludable from gross income under §117, it must not constitute "payment for . . . services by the student required as a condition for receiving the . . .

scholarship."[81] An informed observer of big-time college sports might conclude that athletic scholarships must then be taxable, because they are obviously awarded as compensation for playing big-time sports. The observer would be wrong, however, at least in the sense that everyone involved–the universities, the student-athletes, and the IRS itself–takes the position that athletic scholarships qualify for the §117 exclusion. But the observer might be right in a different sense, because there is a strong argument that everyone involved is wrong.

A. Early Athletic Scholarships

Before explaining that argument, we begin with some historical background. Athletic scholarships predate by several decades the 1913 introduction of the federal individual income tax. As Allen Sack and Ellen Staurowksy have recounted, athletic scholarships were common at American colleges and universities as early as the 1880s.[82] A landmark 1929 study sponsored by the Carnegie Foundation reported that some form of financial subsidy for varsity athletes–sometimes labeled as scholarships, sometimes not–existed at 81 of the colleges and universities studied.[83]

From its founding in 1906 until 1947, the NCAA opposed the granting of athletic scholarships as inconsistent with its principles of amateurism–although that did not stop numerous member schools from awarding athletic scholarships.[84] In 1947 the NCAA adopted

[81]IRC §117(c).

[82]Allen L. Sack & Ellen J. Staurowsky, College Athletes for Hire: The Evolution and Legacy of the NCAA's Amateur Myth 23 (1998).

[83]Howard J. Savage et al., American College Athletics, Carnegie Foundation Bulletin No. 26 (1929), at 201.

[84]Sack & Staurowksy, supra note 82, at 42.

what quickly became known as the “Sanity Code,” as an attempted compromise between member schools in favor of athletic scholarships (largely, but not exclusively, schools in the South) and schools opposed to athletic scholarships (including the members of the Ivy League and the Big Ten).[85] The Sanity Code permitted schools to award financial aid on the basis of athletic ability, but provided that aid could not be withdrawn if a recipient decided to quit the team.[86] The Sanity Code became a dead letter just three years after its adoption, when a vote to expel from the NCAA seven schools in open noncompliance with the Code fell short of the requisite supermajority.[87] Between the de facto end of the Sanity Code and 1956, there was no meaningful NCAA regulation of athletic scholarships.[88] That was the situation in 1954, when Congress enacted §117 of the Internal Revenue Code, providing for the first time a clear statutory basis for the exclusion of scholarships from gross income.

B. Athletic Scholarships and the Income Tax, Before and After 1954

Before Congress enacted the §117 scholarship exclusion in 1954, nothing in the Internal Revenue Code directly addressed the income tax status of scholarships, athletic or otherwise. As the Supreme Court noted in its 1969 opinion in *Bingler v. Johnson*, prior to 1954 scholarships were taxable unless they qualified as excludable gifts under the predecessor to §102.[89] Pre-1954

---

[85]Sack & Staurowsky, supra note 82, at 43-44; Walter Byers, Unsportsmanlike Conduct: Exploiting College Athletes 67-68 (1995).

[86]Sack & Staurowsky, supra note 82, at 44.

[87]Id. at 46; Byers, supra note 85, at 67-68.

[88]Byers, supra note 85, at 68.

[89]Bingler v. Johnson, 394 U.S. 741, 752 (1969).

Supreme Court interpretations of the gift exclusion were certainly sufficient to cast doubt on the excludability of athletic scholarships. In various cases the Court had pronounced that a "payment for services, even though entirely voluntary," was not a gift,[90] that a payment motivated by "anticipated benefit" to the payor was not a gift,[91] and that a payment made "in return for services rendered" was likewise not a gift.[92] There was no pre-1954 law directly on point, however, because the IRS had never asserted the taxability of athletic scholarships–or of any other scholarships, for that matter.

Before the lowering of exemption levels during World War II converted the income tax from a class tax to a mass tax, the Service's somnolence in this area might have been excused by the fact that few scholarships would have generated income tax liabilities for their recipients, even if not eligible for the gift exclusion. In 1936, for example, when the personal exemption amount for a single person was $1,000,[93] a full-ride scholarship (tuition plus room and board) at the University of Pennsylvania (presumably one of the more expensive universities in the country then, as it is now) would have been valued at less than the income tax exemption amount.[94] Of course, a scholarship might have been taxable to a scholarship recipient with significant income from other sources, but the tax dollars at stake with respect to scholarships

[90]Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 730 (1929).

[91]Bogardus v. Commissioner, 302 U.S. 34, 41 (1937).

[92]Robertson v. United States, 343 U.S. 711, 730 (1952).

[93]Tax Policy Center, Historical Individual Income Tax Parameters, 1913-2018.

[94]Mark Frazier Lloyd, Tuition and Mandatory Fees, Room and Board and Other Educational Costs at Penn Since 1900: 1930-1939, available at https:www.archives.upenn.edu/histy/features/tuition/1930.html ($400 undergraduate tuition, $11 mandatory fees, and $520 room and board).

prior to World War II must have been trivial, or nearly so. By the early 1950s, however, it would have been more difficult to invoke the personal exemption to excuse the IRS's continued lack of attention to the tax status of scholarships. In 1953, for example, the personal exemption for a single person was $600,[95] while a full-ride scholarship at Penn was worth more than $1,600.[96] After claiming both the $600 personal exemption and a standard deduction of $160 (the lesser of $1,000 or 10 percent of adjusted gross income) the recipient of a taxable scholarship of $1,600 would have had $840 of taxable income, even assuming no additional income from other sources.

Although the IRS continued to ignore the income tax status of scholarships in the early years of the mass tax era, Congress finally turned its attention to the issue in 1954. Section 117 of the 1954 Code provided, for the first time, a clear statutory basis for the exclusion of scholarships from gross income.[97] Under §117(a)(1), gross income did not include any amount received "as a scholarship at an educational institution." Although the statute did not define "scholarship," §117(b)(1) specified that the exclusion did not apply to "that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment, required as a condition to receiving the scholarship." In light of this limitation on the exclusion, the tax status of athletic scholarships remained uncertain. Despite the

[95]Tax Policy Center, supra note 93. In addition to the personal exemption, a single taxpayer was entitled to a standard deduction equal to the lesser of $1,000 or 10 percent of the taxpayer's adjusted gross income.

[96]Mark Frazier Lloyd, Tuition and Mandatory Fees, Room and Board and Other Educational Costs at Penn Since 1900: 1950-1959, available at https:www.archives.upenn.edu/histy/features/tuition/1950.html ($700 undergraduate tuition, $85 mandatory fees, and $835 room and board).

[97]Internal Revenue Code of 1954, Pub. L. No. 83-591, §117, 68A Stat. 1, 38 (1954).

fact that athletic scholarships were common in 1954, there had been no discussion at any point in the legislative process resulting in the 1954 Code–not in the House and Senate hearings, not in the committee reports, and not in the floor debates–of the application (or non-application) of new §117 to athletic scholarships. The closest thing to a contemporaneous interpretation appeared in a 1956 article by tax professor John Chommie:

> Normally services are not demanded in return for a scholarship, which is usually an undergraduate grant-in-aid. Therefore, few problems are anticipated here. This would seem to be true even in the case of the athletic scholarship, though the sophisticate may be skeptical here, where service on an athletic team may be an express or implied condition. It is extremely doubtful that this flow of benefits was intended to be embraced within the limits of Section 117(b)(1). In short, there seems to be little reason in drawing a distinction between athletic and academic performance often demanded as a condition of a scholarship grant.[98]

Although the IRS remained silent on the issue, its inactivity suggested it agreed with Chommie's conclusion.

C. The NCAA Revises Its Scholarship Rules

As noted earlier, since 1951 there had been no meaningful national regulation of athletic scholarships on the books of the NCAA. That changed in 1956, when the NCAA Convention amended the organization's rules to permit member schools to pay all "commonly accepted educational expenses" of their student-athletes, without regard to either need or academic potential.[99] The NCAA rules of the late 1950s also specified that an athletic scholarship could be awarded for up to four years, and that once awarded a scholarship could not be rescinded

[98]John C. Chommie, Services Rendered, Not Donative Intent, Governs Exemption of Study Grants, 4 J. of Tax'n 375, 375-76 (1956).

[99]Byers, supra note 85, at 72.

because the student quit the team.[100] Although the rule that a student who quit the team did not forfeit his scholarship was not tax-driven, it did not necessarily reflect high-mindedness on the part of the NCAA and its members. Rather, the primary motivation for the rule seems to have been not the making of a principled stand for amateurism, but the desire of member schools to avoid worker's compensation liability for injured players.[101]

Throughout the late 1950s and all of the 1960s, the IRS continued to pay zero attention to the tax status of athletic scholarships. Although there is no indication that qualifying athletic scholarships for exclusion under §117 played the slightest role in the NCAA's formulation of its scholarship rules during this period, a strong case could have been made–at least until 1967–that athletic scholarships issued in compliance with NCAA rules also satisfied §117. If a student-athlete awarded a four-year scholarship at entrance could quit the team in his first year and keep his scholarship for all four years, it would have been reasonable to conclude that his scholarship was not disqualified by §117(b)(1) as "payment . . . in the nature of part-time employment."[102]

In 1967 the NCAA changed its scholarship rules to permit immediate termination of financial aid for "fraudulent misrepresentation" by a student in connection with his application for an athletic scholarship.[103] If, after having been awarded an athletic scholarship, a student

---

[100]Id.

[101]Id. at 69-75; Sack & Staurowksy, supra note 82, at 48; Michael Oriard, Bowled Over: Big-Time College Football from the Sixties to the BCS Era 130 (2009).

[102]See Sack & Staurowsky, supra note 82, at 79-80 (concluding–albeit not with reference to §117–that "for the most part, the scholarships that existed before 1967 did not constitute employment contracts").

[103]NCAA, Proceedings of the 61st Annual Convention 122 (1967) (quoted by Sack & Staurowsky, supra note 82, at 83).

never showed up for practice, or made only a few token appearances, the school could treat that as evidence of fraudulent misrepresentation by the student in his scholarship application, and could cancel the scholarship without delay.[104] Allen Sack and Ellen Staurowsky have persuasively characterized the 1967 amendment as allowing the NCAA to "have it both ways" as to the effect of voluntary nonparticipation on athletic scholarships.[105] Although the NCAA rules still stated that an athletic scholarship could not be forfeited when a player quit a team, the rules also contemplated that–at least in some cases–quitting a team could be sufficient evidence of fraudulent misrepresentation to justify immediate loss of scholarship. Although the tax-exempt character of athletic scholarships looked considerably shakier after the NCAA rule change, the IRS gave no indication that it was paying attention.

In 1972 the NCAA–clearly not at all concerned about possible income tax implications of its scholarship rules–took the further step of permitting the cancellation of an athletic scholarship, even in the absence of fraudulent misrepresentation, if a student "voluntarily withdraws from a sport for his own personal reasons"–although in that case the cancellation could not take effect until the conclusion of the academic year in which the student quit the team.[106]

Neither the 1967 nor the 1972 amendment solved the problem of a four-year scholarship wasted (from the coach's point of view) on a player who remained on the team but proved to be

[104]Sack & Staurowsky, supra note 82, at 83.

[105]Id.

[106]NCAA, 1972-73 Manual of the National Collegiate Athletic Association 8-9, Constitution §3-1-(f)(2), effective August 1, 1972.

an athletic disappointment. Although NCAA rules permitted four-year scholarships, they did not prohibit scholarship awards for shorter periods. Thus, a school could have largely avoided this problem by awarding renewable one-year scholarships (and not renewing the scholarships of underperforming athletes), but that would have put the school at a recruiting disadvantage relative to other schools offering four-year scholarships. To solve that problem, in 1973 the NCAA approved a rule *mandating* that athletic scholarships be awarded for no more than one year at a time.[107] Writing in 2009, Michael Oriard viewed the 1973 ban on multi-year athletic scholarships as "a crucial event in the history of college football's fundamental contradiction and the foundation for the football world that has developed since then."[108] Oriard described the 1973 rule change as "absolutely put[ting] the lie to all pretenses about the primary importance of *student-athletes.* How can academics be the highest priority if a scholarship is contingent on satisfying the football coach?"[109]

D. The IRS Awakens (but not Fully)

Also in the early 1970s, for the first time ever the IRS was forced to pay some attention to the status of athletic scholarships under §117. In Tax Court cases decided in 1971 and 1974, professional athletes who had received athletic scholarships while in college attempted to take advantage of the (later repealed) income averaging provisions to reduce the tax rates applicable to their professional salaries.[110] Under the income-averaging rules, a taxpayer would qualify for

---

[107]Byers, supra note 85, at 163-64; Sack & Staurowsky, supra note 82, at 84.

[108]Oriard, supra note 101, at 128.

[109]Id. at 140.

[110]Heidel v. Commissioner, 56 T.C. 95 (1971); Frost v. Commissioner, 61 T.C. 488 (1974). The cases are discussed in Richard L. Kaplan, Intercollegiate Athletics and the Unrelated Business Income Tax, 80 Colum. L.

averaging only if he had provided at least half of his support during each of the four preceding years. The professional athletes argued they had furnished most of their own support during their college years, by earning their athletic scholarships. That argument was in considerable tension with the tax-exempt status of the scholarships under §117, but the statute of limitations had expired for the scholarship years (when the athletes had taken the position that the scholarships were tax exempt). The Tax Court, rejecting the athletes' attempts to have it both ways, held that tax-exempt scholarships could not be considered as self-support. In 1975 the IRS followed up on the two cases by issuing a revenue ruling holding that tax-exempt scholarships (athletic or otherwise) did not qualify as self-support for income-averaging purposes.[111]

Throughout this income-averaging saga, neither the IRS nor the Tax Court had challenged the tax-exempt status of athletic scholarships.[112] Perhaps concerned that colleges and student-athletes would wrongly conclude from the saga that there were no limitations whatsoever on the tax-exempt status of athletic scholarships,[113] the IRS finally issued guidance on the question–first in a 1976 private letter ruling (PLR), and then in a 1977 revenue ruling.

The 1976 PLR stated that the university requesting the ruling (the identity of which was

---

Rev. 1430, 1461-62 (1980).

[111]Rev. Rul. 75-40, 1975-1 C.B. 276.

[112]In *Heidel* the Court commented hypothetically, "[I]f we accept the premise that the grant-in-aid was received by petitioner in return for services as a football player . . . it would not qualify as an amount received as a scholarship, and excludable from income." 56 T.C. at 104. However, the Court did not accept the premise.

[113]Richard Kaplan, writing just a few years after the events described in the text, suggested this was the motivation for the Service's issuance of guidance. Kaplan, supra note 110, at 1461-62.

redacted) awarded athletic scholarships one year at a time ("an athletic scholarship is awarded for a given academic year"), and that once a scholarship is awarded "it cannot be terminated, even if the recipient unilaterally decides not to participate in intercollegiate athletics."[114] The stated facts were consistent with NCAA scholarship rules as of the February 1976 issue date of the ruling. Under the 1972 revision of the NCAA rules, cancellation of a scholarship for voluntary nonparticipation could not take effect until the conclusion of the academic year; and under the 1973 revision, an athletic scholarship could not be awarded for more than a single academic year.[115] The combined effect of the two revisions was that a scholarship could not be cancelled for nonparticipation, despite the fact that the cancellation rule–a relic of the era of the four-year scholarship–read in isolation indicated that scholarships could be cancelled for nonparticipation. Although the PLR correctly stated the bottom line of the NCAA rules, it did not explain the peculiar mechanism by which the rules produced that result.[116] The PLR framed the §117 question as whether the recipient of an athletic scholarship was "performing services for the university, or participating in part of the university's overall educational program." In concluding that the university's athletic scholarships qualified as tax-exempt scholarships, the PLR noted that the fact that a scholarship would not be cancelled because of a student-athlete's "unilateral decision not to compete" was an "important factor" in the analysis.

[114]PLR 76021220620A (February 12, 2016).

[115]NCAA, 1976-77 Manual of the National Collegiate Athletic Association 9 (Constitution §3-1-(g)-(2), as in effect prior to August 1, 1976), 14 (Constitution §3-4-(b)).

[116]The 1976 rules also featured the rule (introduced in 1967) permitting immediate cancellation of a scholarship for fraudulent misrepresentation, although the PLR did not mention that rule. 1976-77 Manual, supra note 115, at 9 (Constitution §3-1(g)-(2)).

The PLR's analysis, although defensible on the stated facts, had some obvious weaknesses, starting with its rather head-in-the-sand attitude toward the realities of big-time college sports, even as of the 1970s.[117] The PLR can also be criticized for failing to mention (let alone to consider the tax implications of) the immediate cancellation of scholarships for "fraudulent misrepresentation" evidenced by little or nothing more than a failure to show up for practice. Perhaps most dubiously, the PLR attached no significance to the fact that scholarships were awarded only on a year-by-year basis, despite the fact that four years of study were required for a student-athlete to earn a degree. The PLR might have taken the position–supported both by logic and by the pre-1973 NCAA rules–that the natural term of an undergraduate scholarship is four years, that what the NCAA described as nonrenewal of a single-year scholarship for voluntary nonparticipation was in reality the cancellation of a four-year scholarship, and that an award contingent on participation did not qualify for exclusion under §117.[118] By failing to take that position, the PLR implied, strangely enough, that the NCAA had solidified the tax-exempt status of athletic scholarships by its 1973 switch from cancellable four-year scholarships to formally noncancellable one-year scholarships–despite the fact that the switch actually *strengthened* the connection between scholarships and athletic participation. On the other hand, the PLR's ready acceptance of the one-year scholarship model

[117]For a contrary and roughly contemporaneous analysis of athletic scholarships under §117, based on the view that "intercollegiate sports have become a business venture," and that "athletic scholarships are presently 'pay for play,'" see Gary C. Randall, Athletic Scholarships and Taxes: Or a Touchdown in Taxes, 7 Gonz. L. Rev. 297, 297 (1972).

[118]For a later statement of this position, see Adam Hoeflich, The Taxation of Athletic Scholarships: A Problem of Consistency, 1991 U. Ill. L. Rev. 581, 596 (stating that the regulations under §117 do not "anticipate that the student-athlete's collegiate life will be split into a series of short term contracts, each of which the student must fulfill to guarantee continuing aid").

is understandable in the light of the tremendous significance generally attached to the annual accounting period under the federal income tax.[119]

Thinking the question addressed in the PLR of wide enough interest to justify a revenue ruling (applicable to all universities and to all student-athletes, rather than only to the university and student-athletes described in the PLR), in July 1977 the IRS issued Revenue Ruling 77-263, obviously inspired the previous year's PLR.[120] The Ruling's statement of facts was essentially the same as the PLR's: once a scholarship had been awarded for a given academic year, it could not be cancelled because the recipient quit the team.[121] Citing Treas. Reg. §1.117-4(c) for the proposition that a grant does not qualify as a tax-free scholarship if it represents compensation or payment for services, the Ruling concluded that the described athletic scholarships qualified under §117 because "the university requires no particular activity of any of its scholarship recipients."[122]

In addition to being subject to all the objections applicable to the PLR, the Ruling introduced two new problems. First, by describing a university that "expects but does not require the students [awarded athletic scholarships] to participate in a particular sport," the Ruling inadvertently suggested a conflict between its analysis and that of the Supreme Court in its 1969 decision in *Bingler v. Johnson*[123]–the only case in which the Court had interpreted §117.

[119]The obligatory citation on this point is to Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931).

[120]Rev. Rul. 77-263, 1977-2 C.B. 47.

[121]Id. at 47.

[122]Id. at 48.

[123]394 U.S. 741 (1969).

The taxpayers in that case were employees of Westinghouse Electric who were granted "educational leave" to pursue doctoral studies, who received cash stipends and tuition benefits from Westinghouse while on leave, and who were required to return to work at Westinghouse for at least two years following the conclusion of their studies. The Court upheld the validity of the statement in Treas. Reg. §1.117-4(c) that amounts received as "compensation" were not tax-exempt scholarships, and concluded that all amounts received by the taxpayers were taxable as compensation.[124] In reaching that conclusion, the Court placed particular weight on the fact that the taxpayer's were "obligated to return to Westinghouse's employ for a substantial period of time after completion of their leave."[125] In a footnote, the Court acknowledged that one of the taxpayers had not been required to commit in writing to post-leave employment with Westinghouse, but that he had been "formally advised . . . that he was 'expected' to return to Westinghouse . . . and he, in fact, honored that obligation."[126] Beyond the mention in the footnote, the Court made nothing of the distinction between the employees who had signed written agreements requiring them to return, and the one employee who was merely "expected" to return. In the text of the opinion, the Court twice described *all* the taxpayers as "obligated" to return.[127]

Under one plausible reading of the opinion, the Court interpreted §117 and the regulations as drawing no distinction between a contractually enforceable *quid pro quo*

---

[124]394 U.S. at 755-57.

[125]394 U.S. at 757.

[126]394 U.S. at 744, n. 7.

[127]394 U.S. at 743-44, 757.

arrangement and a mere expectation (or moral commitment) that the recipient would perform services in exchange for the grant; no less than an enforceable contract, an expectation of services would result in taxation of the grant.[128] The Ruling does not mention this aspect of *Bingler v. Johnson*, and thus does not consider the possibility that under the Court's analysis the mere fact that a student-athlete is expected but not required to play is fatal to qualification under §117. On the other hand, to read *Bingler v. Johnson* as equating mere expectations to contractual commitments is to put a great deal of weight on a point raised by the Court only in a footnote, and even then only in a way open to more than one interpretation. Rather than equating expectations with enforceable obligations, the Court may have meant only that an enforceable obligation may exist in the absence of a written agreement; that interpretation is suggested by the fact that the footnote describes the taxpayer who was "expected" to return as having an "obligation" to do so. Under that interpretation of the case, the expectation that a student-athlete would play would not trigger taxation of his grant as long as the expectation did not create a legal obligation to play. In short, although the Ruling should have addressed the implications of expectations of performance under the Court's analysis, it might reasonably have concluded that expectations without obligations did not result in taxation.

The second new problem with the Ruling was more serious; in fact, it made the Ruling factually obsolete from the day it was issued. At its 1976 meeting–held after the issuance of the PLR but before the issuance of the Rev. Rul. 77-263–the NCAA revised its rules to give substance to the right of schools to cancel scholarships for voluntary nonparticipation. Instead

[128]For a statement of this position, see Michael Schinner, Touchdowns and Taxes: Are Athletic Scholarships Merely Disguised Compensation?, 8 Am. J. Tax Pol'y 127, 147 (1989).

of stating that such a cancellation could not take effect until the end of the academic year (and thus could not really take effect at all, given the one-year rule), the 1976 revision stated that cancellation for quitting the team could take place as early as the end of the current term (quarter or semester).[129] Thus, a student who quit could lose as much as two-thirds of a one-year scholarship under a quarter system, or as much as one-half under a semester system. This change in the NCAA rules is decidedly *not* reflected in Rev. Rul. 77-263, which states that the single-year scholarships cannot be cancelled for voluntary nonparticipation. Apparently the drafters of the Ruling worked from the facts of the PLR, without bothering to check whether those facts had changed in the months between the two pronouncements.

Commenting on Rev. Rul. 77-263 in 1980, Richard Kaplan took the Ruling to imply that athletic scholarships differing from those described in the Ruling were taxable: "Presumably, therefore, the Service will tax athletic scholarships whenever the recipient *is* required, and not merely expected, to participate in college sports."[130] In other words, Kaplan interpreted the Ruling as indicating that under the actual NCAA scholarship rules as of 1977 (albeit rules of which neither the IRS nor Kaplan was aware) athletic scholarships *were* taxable. Although some commentators in more recent decades have noted that the NCAA rules are *no longer* consistent with the facts stated in the Ruling,[131] no one has previously pointed out that the NCAA rules were not consistent with the facts of the Ruling *even on the day it was issued.*

---

[129]1976-77 Manual, supra note 129, at 9 (Constitution §3-1-(g)-(2), revision effective August 1, 1976).

[130]Kaplan, supra note 110, at 1462 (emphasis in original).

[131]See, e.g., Daniel Nestel, Athletic Scholarships: An Imbalance of Power between the University and the Student-Athlete, 53 Ohio St. L. J. 1401, 1414 (1992) (discussed infra text accompanying note 144).

It is easy enough to understand how the Service failed to notice the discrepancy; the drafters of Rev. Rul. 77-263 assumed that the NCAA rules had not changed in the short time between the PLR and the Ruling. But what about the NCAA and the universities? Although many NCAA officials, athletic directors, and university counsels may have merely noted the conclusion of the Ruling without comparing the stated facts with the actual NCAA rules, it is hard to imagine that no one within the NCAA and its hundreds of member schools noticed the discrepancy and realized the Ruling was not worth the paper on which it was written. The obvious fix would have been to undo the 1976 rules change, and reinstate the rule that one-year scholarships could not be cancelled for nonparticipation. Although that change would have imposed some scholarship costs on member schools, there is no reason to think it would have been catastrophic–after all, schools had operated under that very rule for several years without disaster striking. Apparently, however, anyone who noticed the discrepancy decided the fix could be delayed until the time–if ever–that the IRS realized that Rev. Rul. 77-263 was based on a nonexistent state of affairs.

E. Changes in the Tax Laws and NCAA Rules Since Rev. Rul. 77-263

In 1986 Congress made a number of changes to §117–including some tweaking of the language providing that compensation for services cannot qualify as a tax-free scholarship[132]–but the only change of substance with implications for athletic scholarships was the elimination of the tax exemption for the room-and-board portion of a "full-ride" scholarship (athletic or

[132]Tax Reform Act of 1986, Pub. L. No. 99-514, §123(a), 100 Stat. 2085, 2112 (currently codified at IRC §117(c)).

otherwise).[133] Since 1986, athletes–as well as recipients of full-ride academic scholarships–have been taxable, in theory, on the room-and-board portions of their scholarships. That taxability has been, however, almost exclusively theoretical. In its Bluebook describing the 1986 Act, the Joint Committee on Taxation explained, "Under the Act, the IRS is not *required* to exercise its authority to require information reporting by grantors of scholarships," with respect to noncompensatory room-and-board scholarship benefits.[134] Instead, "The Congress anticipated that the IRS will carefully monitor the extent of compliance by grant recipients with the new rules and will provide for appropriate information reporting if necessary to accomplish compliance."[135] In Notice 87-31, the IRS announced both that it would not require information reporting for room-and-board scholarships (other than scholarships representing compensation for services), and that it would not treat such scholarships as wages subject to payroll taxation under Code §§3101 and 3111.[136] The information reporting exemption was promulgated as promised in the Notice, and remains in the regulations today.[137]

Thus, universities and other grantors of full-ride scholarships do not notify the Service of the existence or amount of the room-and-board portions of those scholarships, nor are they under any obligation to inform the recipients of the taxable status of those portions. No one knows

[133] Tax Reform Act of 1986, Pub. L. No. 99-514, §123(a), 100 Stat. 2085, 2112 (currently codified at IRC §117(b)(2)).

[134] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 44 (1987).

[135] Id.

[136] Notice 87-31, 87-1 C.B. 475.

[137] Treas. Reg. §1.6041-3(n).

what percentage of the total of room-and-board scholarships are voluntarily reported by recipients on their federal income tax returns, but an educated guess would be approximately zero. In 2018, the value of a full room-and-board scholarship would be in the neighborhood of the $12,000 standard deduction amount,[138] so a recipient of such a scholarship with no other taxable income would owe very little or no income tax, but the tax liability associated with an (almost certainly unreported) room-and-board scholarship could be substantial if the recipient had taxable income from another source (such as a summer job). The tax liability on a room-and-board scholarship could also be substantial, even in the absence of income from other sources, if the recipient qualified as a tax dependent of his or her parents, and so was allowed a standard deduction limited to the lesser of (1) $1,050, or (2) the sum of $350 and the individual's earned income.[139]

Has the IRS met Congress's expectation that it would "carefully monitor the extent of compliance by grant recipients with the new rules," and concluded that information reporting is not "necessary to accomplish compliance"? If it has, the evidence of that effort has somehow escaped our attention. In short, recipients of full-ride athletic scholarships, along with recipients of full-ride academic scholarships, continue to enjoy a de facto exclusion for the room-and-board portions of their scholarships, more than three decades after Congress eliminated the legal basis for the exclusion. We have not been able to track down statistics on the prevalence of non-

[138]IRC §63(d)(7)(A)(ii).

[139]IRC §63(c)(5); Rev. Proc. 2018-18, 2018-10 IRB 392, 396 (inflation adjustment for 2018). Because a room-and-board scholarship, although taxable, is not considered compensation for services (Notice 87-31, 87-1 CB 475), it should not be treated as earned income for the purpose of increasing the amount of the dependent standard deduction.

athletic room-and-board scholarships, but our impression is that such scholarships are rather rare. By contrast, room-and-board athletic scholarships are very common. It appears, then, that the non-enforcement of the taxability of room-and-board scholarships, although facially neutral as between athletes and other students, in fact mostly benefits the recipients of athletic scholarships.

So much for post-1977 tax law developments. What about post-1977 changes in the NCAA rules? In 2012, in response to a private antitrust suit and pressure from the Justice Department concerning the antitrust implications of the mandatory one-year scholarship rule,[140] the NCAA revised its rules to permit the awarding of multi-year athletic scholarships.[141] Universities did not display much interest in taking advantage of the rule change. In 2014 *cbssports.com* made open-record requests of forty-three public universities whose teams had finished in the top 25 in football, men's basketball, or both, and found that out of 11,482 scholarship athletes at those universities (in all sports, not just revenue sports), only 502–less than 5 percent–had multi-year scholarships.[142]

The other significant difference between the NCAA scholarship rules in 1977 and the current rules is that a school may now cancel an athletic scholarship *immediately* (rather than waiting until the end of the current term) if the recipient "[v]oluntarily (on his or her own

---

[140]See Allen L. Sack, Austin E. McComas, & Esin Cakan, The Revival of Multiyear Scholarships in the Twenty-First Century: Which Universities Supported and Opposed this Legislation and Why?, 7 J. of Issues in Intercollegiate Athletics 207 (2014) (recounting the developments that led to the 2012 revision of the NCAA rules); Ray Yasser, The Case for Reviving the Four-Year Deal, 86 Tulane L. Rev. 987 (2012) (examining the merits of the antitrust case against mandatory one-year athletic scholarships).

[141]NCAA, 2017-18 NCAA Division I Manual, at 203 (2017) (Constitution §15.3.3.1, providing that an athletic scholarship "shall neither be awarded for a period of less than one academic year nor for a period that would exceed the student's five-year period of eligibility").

[142]Jon Solomon, Schools Can Give Out 4-Year Athletic Scholarships, But Many Don't, cbssports.com, September 16, 2014.

initiative) withdraws from a sport at any time for personal reasons," subject only to the caveat that "the recipient's financial aid may not be awarded to another student-athlete in the academic term in which the aid was reduced or canceled."[143] Thus, the stated facts in Rev. Rul. 77-263–that an athletic scholarship could not be cancelled on account of a recipient's decision to quit the team–which were inconsistent with the NCAA rules in force when the Ruling was issued, remain inconsistent with the NCAA rules of 2018. If anything, the inconsistency is a bit more glaring in 2018, because the current rules do not protect the scholarship of the nonparticipating student for even the remainder of the term.

F. 2014: The IRS Ignores the Obvious

The other difference between the situation in 1977 and the situation today is that, to all appearances, in 1977 the IRS was honestly and understandably mistaken in its understanding of the NCAA rules governing the cancellation of athletic scholarships. Today, by contrast, the IRS has no such excuse. As early as 1992, a student note in the *Ohio State Law Journal* pointed out that "the assumption [in Rev. Rul. 77-263] that the university cannot terminate the scholarship agreement upon the student's unilateral decision to withdraw from the athletic program does not [comport] with the current NCAA rules."[144] It is conceivable that IRS officials do not regularly read either the *Ohio State Law Journal* or the NCAA rules, and that until recently the IRS remained unaware of–and remarkably uninquisitive about–actual NCAA scholarship rules. It is clear enough, however, that by 2014 at the latest the IRS was aware that the then-current NCAA

[143] 2017-18 NCAA Division I Manual, supra note 141, at 204-205 (Constitution §§15.3.4.2(d) (applicable to "nonautonomy" conferences), 15.3.5.1(d) (identical language; applicable to "autonomy" conferences).

[144] Nestel, supra note 131, at 1414.

scholarship rules were crucially different from the rules described in Rev. Rul. 77-263.

In March of 2014, a regional director of the National Labor Relations Board (NLRB) issued a decision concluding that Northwestern University football players receiving athletic scholarships were employees of Northwestern for purposes of federal labor law, and were entitled to be recognized as a bargaining unit under the National Labor Relations Act (NLRA).[145] The decision was covered extensively in the national media,[146] and also generated considerable discussion in law reviews and tax specialty journals of its implications for the tax status of athletic scholarships under §117.[147] The regional director found that scholarship football players

[145]Northwestern University and College Athletes Players Association (CAPA), No. 13-RC-121359 (March 26, 2014), reprinted as an appendix to the NLRB opinion in the same case on appeal, 362 NLRB No. 167.

[146]See, e.g., Ben Strauss & Steve Eder, College Players Granted Right to Form Union, New York Times, March 27, 2014, at A1.

[147]See, e.g., Justin Morehouse, When Play Becomes Work: Are College Athletes Employees?, 144 Tax Notes 1427 (September 22, 2014) (suggesting, at __, that the evidence in the Northwestern case "could prompt the IRS to reconsider the favorable tax treatment of athletic scholarships); Erik M. Jensen, "Student" Athletes Revisited, 32 J. Tax'n Inv. 43 (2014) (concluding, at __, that in light of the evidence in the Northwestern case, "the traditional justifications for excluding the full value of athletic scholarships from gross income under Section 117 have lost most of the force that we pretended–yes, pretended–that they once had"); A. L. Spitzer, Are Student-Athletes Winning Their Battles but Losing the (Tax) War?, 146 Tax Notes 253 (2015) (after noting the evidence that Northwestern could cancel a player's athletic scholarship if he voluntarily left the team, concluding, at 256, that if universities want to protect the tax-exempt status of their athletic scholarships, it is "most important . . . that athletic scholarships should be granted with no requirement that the student-athlete play on the team"); Omar A. Barreentto, NCAA, It's Time to Pay the Piper: The Aftermath of *O'Bannon v. NCAA* and *Northwestern v. College Athletes Players Association,* 12 Rutgers Bus. L. J. 3 (2015) (concluding, at 26, that the regional director's decision "seriously undermines the IRS's position with respect to athletic scholarships"); Patrick C. Johnston, Northwestern Football and College Athletes: Be Careful What You Wish For, 49 J. Marshall L. Rev. 655 (2015) (concluding, at 678, that the Northwestern players might face a "heavy tax bill" if they "continue down their current [NLRB] path"); Kathryn Kisska-Schulze & Adam Epstein, Northwestern, O'Bannon and the Future: Cultivating a New Era for Taxing Qualified Scholarships, 49 Akron L. Rev. 771 (2016) (noting, at 774, that "a crucial question following the original NLRB holding was whether the IRS can logically continue to treat qualified scholarships received by student-athletes as excludable from gross income").

The references to the O'Bannon litigation in the titles of the several of the above-cited articles merits an explanation. In that litigation, Ed O'Bannon, a former UCLA basketball player, sued the NCAA on the theory that NCAA rules prohibiting universities from paying their student-athletes for the use of their names, images, and likenesses (for example, in video games) was a restraint of trade in violation of the Sherman Antitrust Act (15 USC §1). Several of the tax commentators cited above thought that the O'Bannon litigation, like the Northwestern football NLRB saga, had implications for the application of §117 to athletic scholarships. The district court held that the NCAA rules did indeed violate the Sherman Act, and enjoined the NCAA from prohibiting full cost-of-

"performed services for the benefit of the employer for which they received compensation"; in fact, "each player receiv[es] total compensation in excess of one quarter of a million dollars throughout the four or five years they [sic] perform football duties for the Employer."[148] The regional director also found that "scholarships can be immediately canceled if the player voluntarily withdraws from the team."[149] The Northwestern football case ended in August of 2015, when the NLRB itself, in Northwestern's appeal from the decision of the regional director, declined to assert jurisdiction because it concluded that doing so would not effectuate the purposes of the NLRA–largely because the vast majority of Northwestern's football competitors were public universities over which the NLRB had no jurisdiction. Accordingly, the NLRB dismissed the players' petition without reaching the question of whether the players were employees for labor law purposes.[150]

Two days after the regional director issued his decision in the Northwestern case, Senator

attendance (COA) scholarships (covering all estimated living expenses, rather than only room and board), and also enjoined the NCAA from prohibiting its members from paying athletes up to $5,000 per year in deferred compensation. O'Bannon v. NCAA, 7 F.Supp.3d 1955 (N.D. Cal. 2014). On appeal, the Ninth Circuit affirmed the district court's finding of an antitrust violation and its injunction concerning full COA scholarships, but reversed as to the injunction concerning deferred compensation. O'Bannon v. NCAA, 802 F.3d 1049 (2015), cert. denied, 137 S.Ct. 277 (2016). Reacting to the legislation, the NCAA revised its rules to permit so-called "autonomy" members to award full COA scholarships, with the amount determined by the granting university based on the local cost of living. Marc Tracy, In NCAA's Varied Landscape, Some Open Floodgates While Others Fear Drought, New York Times, January 19, 2015, at D7 (describing the new rule as "rais[ing] scholarship values by several thousand dollars to cover the full cost of attendance"). Although the O'Bannon litigation *might* have had important implications for the §117 status of athletic scholarships, the ultimate result of the litigation has had no significant impact. For tax purposes, the full COA scholarship amounts are no different from the basic room-and-board scholarship amounts that have been around forever–clearly taxable under the post-1986 version of §117, but seldom if ever actually taxed.

[148]362 NLRB No. 167, at [14].

[149]Id. at [14-15].

[150]Id. at [6-7].

Richard Burr (R, NC)–who had attended Wake Forest University on a football scholarship in the 1970s–wrote to IRS Commissioner John Koskinen asking about the potential tax implications of the decision for athletic scholarships.[151] By this time, given the pointedness of Burr's inquiry and the ready availability of the regional director's decision, the Service in general and Koskinen in particular must have been aware of (or, at best, willfully ignorant of) the critical disconnect between the facts stated in Rev. Rul. 77-263 and the facts of athletic scholarships in 2014. Koskinen's reply, however, was remarkable for its disregard of the 2014 facts. Completely ignoring the facts developed in the Northwestern decision, Koskinen wrote:

> It has long been the position of the Internal Revenue Service that athletic scholarships can qualify for exclusion from income under section 117. Rev. Rul. 77-263 . . . addresses the tax treatment of athletic scholarships where the student athlete is expected to participate in the sport, and the scholarship is not cancelled in event the student cannot participate and the student is not required to engage in any other activities in lieu of participating in the sport. The ruling holds that the athletic scholarship awarded by the university is primarily to aid the recipients in pursuing their studies and, therefore, is excludable under section 117.[152]

And that was that. The implications of unionization for the income tax treatment of athletic scholarships became a moot point when the NLRB dismissed the Northwestern players' petition in 2015, and the IRS has persisted in its supreme indifference to the facts of athletic scholarships.

It does not seem possible, under the current NCAA scholarship regime, to construct a

[151]Letter from John A. Koskinen to Richard Burr, IRS Release No. 2014-0016 (April 9, 2014 (describing Burr letter). Contrary to what one might suppose based on his inquiry, Burr favored treating athletic scholarships as tax-free and opposed the unionization of college athletes; apparently he wrote to Koskinen in the hope that Koskinen would reply that scholarships would be taxable if athletes unionized, and that the prospect of taxable scholarships would cause the Northwestern players to abandon their quest to be certified as a collective bargaining unit. See Marc Edelman, From Student-Athletes to Employee-Athletes: Why a "Pay for Play" Model of College Sports Would not Necessarily Make Educational Scholarships Taxable, 58 B.C. L. Rev. 1137, 1148-49 (2017).

[152]Koskinen letter, supra note 151, at 2.

serious argument that athletic scholarships qualify as tax-free under §117, because it is so clear that a scholarship cancellable for voluntary nonparticipation constitutes compensation for services. As compensation for services, athletic scholarships should be subject not only to the federal income tax, but also to the employer and employee federal payroll taxes.[153]

And yet. The only parties directly affected by the IRS's failure to enforce the law–the student-athletes and their universities–have no reason to challenge the IRS's inaction, and good-government sorts who might like to challenge the IRS in court (intermeddling law professors, for example) lack standing to do so.[154] Given the absence of third-party standing to challenge administrative giveaways to lucky taxpayers, the IRS is free–as a matter of power, if not of right–to disregard the dictates of the Internal Revenue Code, as long as it does so in a taxpayer-favorable direction. As one of us has explained in an earlier article, the IRS has a significant history of pro-taxpayer "customary deviations" of this sort.[155] Perhaps the best-known example is the IRS's 2002 announcement–which remains in effect today–that it has no intention of enforcing the taxability of frequent-flier miles retained by employees resulting from employer-paid business travel.[156]

[153]IRC §§ 3101 (employee payroll tax), 3111 (employer payroll tax). As noted earlier (text accompanying note 136), payroll taxation does not follow from the taxability of noncompensatory room-and-board scholarships under the income tax. However, when the reason a benefit fails to qualify for exclusion under §117 is that it constitutes compensation for services, payroll taxation will generally follow.

[154]The leading cases on the lack of third-party standing on federal tax issues are Simon v. E. Ky. Welfare Rights Org., 426 U.S. 26 (1976), and Allen v. Wright, 468 U.S. 737 (1984).

[155]Lawrence Zelenak, Custom and the Rule of Law in the Administration of the Income Tax, 62 Duke L. J. 829 (2012).

[156]Announcement 2002-18, 2002-10 I.R.B. 621. For another striking example, see Rev. Rul. 93-73, 1993-2 CB 75, in which the IRS effectively renounced its Supreme Court victory in Hernandez v. Commissioner, 490 U.S. 680 (1989) (concerning the deductibility of Scientology auditing fees as charitable contributions).

In the case of athletic scholarships, the IRS's position–as stated in Rev. Rul. 77-263–did not start out as an intentional disregarding of the Code, but as (to all appearances) an honest and understandable misstatement of the facts. By the time of the Koskinen letter, however, the IRS could not reasonably have escaped knowledge of the facts of athletic scholarships. By clinging to Rev. Rul. 77-263 after it became aware that the Ruling was based on facts very different from the actual facts of 2014, the IRS transformed what began as an honest mistake of fact into intentional nonenforcement.

Although the IRS's customary deviations from the commands of the statute are always troubling from a rule-of-law perspective, in two respects the IRS's athletic scholarship nonenforcement seems worse than its frequent-flier nonenforcement. First, the 2002 frequent-flier Announcement at least had the virtue of forthrightness. It said, almost in so many words, that the IRS had decided not to enforce the law. By contrast, the 2014 Koskinen letter said no such thing; rather than openly declaring an intention not to tax taxable athletic scholarships, the letter concludes that athletic scholarships are not taxable by ignoring facts of which the IRS must have been aware.

Second, the don't-ask-don't-tell policy for frequent-flier miles is grounded in serious administrability concerns in a way that the IRS's athletic scholarship position is not. It is clear enough how worries about administrability led the IRS to issue its frequent-flier Announcement. As the IRS explained, its nonenforcement policy was driven by numerous unresolved "technical and administrative issues . . . including issues relating to the timing and valuation of income inclusions."[157] By contrast, there are no serious technical or administrative impediments to taxing athletic scholarships. Determining the fair market value of the tuition portion of an athletic scholarship could scarcely be easier; the value is equal to the tuition charged to a non-scholarship student at the university attended by the scholarship athlete. Rather than being based on legitimate technical or administrative issues, the IRS's position on athletic scholarships seems to be based on nothing more than a concern that the IRS would catch flak from some powerful interests if it were to enforce the law.

G. What to Do?

Given this unsatisfactory state of affairs, what is to be done? At least at first glance, it seems the IRS should issue a new revenue ruling, with facts consistent with current athletic scholarship rules and practices, and concluding that scholarships that can be withdrawn based on voluntary nonparticipation are not excluded from gross income under §117–and are subject to the payroll taxes as well as to the income tax. (There would be no need to withdraw Rev. Rul. 77-263, since the IRS would still reach the same result on the assumed facts of the old ruling.) If the IRS also announced that it would not apply the new ruling until some specified date in the future (probably about one year from the date of the ruling), that would give the NCAA and the universities time to conform their scholarship rules to the requirements of the new ruling.

Just as the NCAA in 2012 discarded its one-year scholarship rule to solve an antitrust problem, the NCAA and the universities would almost certainly revise their scholarship rules rather than run the risk that the IRS would assert–and the courts would uphold–the taxability of

[157] Announcement 2002-18, supra note 156.

every athletic scholarship. The extra cost to the universities of conforming with the new ruling would be modest, since the ruling would (in keeping with the analysis of Rev. Rul. 77-263) conclude that a single-year scholarship can qualify under §117, as long as it cannot be canceled for nonparticipation before the end of the current academic year. That cost would likely be orders of magnitude less than the costs (to both the student-athletes and the universities) of failing to comply with the IRS's requirements for exclusion from gross income. If things played out this way, the final result would be little or no increase in federal tax revenues, but a modest improvement in the rules governing athletic scholarships, and the end of the IRS's egregious refusal to enforce the law in this area.

All in all, the above is what we think the IRS should do. There are, however, two other approaches with enough plausibility to merit discussion. First, the IRS could revisit not only the facts of Rev. Rul. 77-263, but the legal analysis as well, by issuing a ruling holding that only noncancellable *multiyear* athletic scholarships satisfy the conditions of §117. As discussed above,[158] that would be a defensible–although less than compelling–interpretation of the statute. It would be a reversal of the IRS's long-standing position in Rev. Rul. 77-263 that one-year scholarships are permissible–a position based on an interpretation of the law, rather than on a misunderstanding of the facts. Both because of the reversal of long-standing policy, and because a switch to guaranteed four- or five-year athletic scholarships would be costly for universities, the IRS could expect an uproar from the NCAA and its members if it took this position. The IRS might feel compelled to back down, or Congress might overrule the IRS by

[158] Supra text accompanying notes 118-119.

legislation. Even if the IRS were able make its position stick, from a social engineering perspective it is far from clear that a diversion of limited scholarship dollars from academic scholarships to athletes who quit in the first year and keep their scholarships for the rest of their undergraduate careers is an improvement over the status quo. In short, this is probably not the hill for the IRS to die on.

The second possibility would be for the IRS to draw a distinction between scholarships in revenue sports (football and men's basketball) and nonrevenue sports. An oddity of almost all the commentary on the tax status of athletic scholarships is that it focuses entirely on scholarships in the two revenue sports, generally not even acknowledging that scholarships exist in nonrevenue sports.[159] According to the NCAA's website, its member schools annually provide athletic scholarships to more than 150,000 student-athletes, with total scholarships valued at $3.3 billion.[160] According to an unofficial source, annual scholarships total $175 million in Division I men's basketball, and $409 million in football's FBS Division.[161] Apparently less than 20 percent of all athletic scholarship dollars go to student-athletes in the two revenue sports–a state of affairs one would never suspect from all the tax commentary ignoring scholarships in nonrevenue sports.

Although it is reasonable enough to conclude that any athletic scholarship cancellable for nonparticipation is compensation for services, it is easier to reach that conclusion if the sport in

---

[159]See, e.g., the articles cited in note 147, supra.

[160]www.ncaa.org/about/resources/finances.

[161]Authors' calculations, based on data at www.scholarshipstats.com/average-per-athlete.html.

question is producing millions of dollars of gross revenue for the university than if the sport produces little or no gross revenue and is indisputably a money-loser for the university. Neither the statute nor the regulations limit the taxability of scholarships-for-services to scholarships connected with money-making activities of the grantor.[162] Nevertheless, it seems easier to conclude that a scholarship conditioned on participation is payment for services (and thus taxable) when the benefit to the university of the recipient's services is as obvious as the millions of dollars of gross revenue produced by a revenue sport.[163] According to the regulations, "A requirement that the recipient pursue . . . activities primarily for the benefit of the grantor is treated as a requirement to perform services," resulting in taxability of the scholarship.[164] While presumably a university believes it derives benefits of some sort from its golf, softball, and swimming teams, the benefits–whatever they may be–are considerably subtler than the piles of cash produced by football and men's basketball.[165]

If the IRS's interpretation of §117 draws no distinction between athletic scholarships in revenue and nonrevenue sports–thus concluding that a scholarship in a nonrevenue sport is taxable if cancellable for nonparticipation–that would have implications for some nonathletic scholarships as well. Performing arts scholarships are commonly conditioned on the recipient's

[162]IRC §117(c), Treas. Reg. §1.117-4(c).

[163]Of course, there may or may not be positive *net* revenue from a revenue sport. But the determination of net revenue is manipulable and debatable. Note, too, that seven-figure coaches' salaries play a prominent role in reducing universities' net revenue from revenue sports, and that those salaries merely shift the benefit of the student-athletes' efforts from the universities to the coaches.

[164]Treas. Reg. §1.117-4(c).

[165]Of course, in the case of women's sports, one of the benefits may be allowing a university to have a revenue-producing football team without violating Title IX (20 USC §§1681-1688).

participation in a performing group sponsored by the university.[166] If an athletic scholarship conditioned on participation in a nonrevenue sport is taxable because of the condition, a similarly conditioned performing arts scholarship would also be taxable–a result arguably inconsistent with the music of §117, even if not necessarily inconsistent with the lyrics.

In short, it would not be ridiculous for the IRS to announce that it had discerned in §117 a dividing line between revenue and nonrevenue sports, according to which conditional scholarships in revenue sports constitute payment for services (resulting in taxability of the scholarships), but identically conditioned scholarships in nonrevenue sports (as well as in the performing arts) do *not* constitute payment for services. On the other hand, the proposed distinction (1) does not exactly jump out at one from either the statute or the regulations, (2) creates line-drawing problems concerning what counts as a revenue sport,[167] and (3) would exempt scholarships received by mostly white student-athletes in nonrevenue sports while taxing scholarships received by mostly black student athletes in the two revenue sports.[168] Given the problems with drawing the distinction, it seems the better part of valor for the IRS not to distinguish between revenue and nonrevenue sports–keeping in mind that the proposed approach

---

[166]See, e.g., the scholarship rules of the Manhattan School of Music, available at www.msmnyc.edu/admissions/scholarships-financial-aid/financial-aid-faqs/#MSM%20Scholarships. Among other requirements for renewing a scholarship for the next academic year, a recipient must "[u]phold an exemplary performance and participation in all performances, ensembles, and classes." In addition, "If a Professional Studies or Doctor of Musical Arts student receives a scholarship, they [sic] may be required to participate in large ensemble performance cycles as assigned by the Office of Performance Operations."

[167]If the distinction is stated as being between football and men's basketball, on the one hand, and everything else, on the other, then University of Connecticut women's basketball is a nonrevenue sport, and the most poorly-attended and least-often-televised men's basketball team in Division I is a revenue sport.

[168]For detailed demographics of participants (with or without athletic scholarships) in the various NCAA sports, see web1.ncaa.org/rgdSearch/exec/saSearch.

would permit tax-free athletic scholarships in all sports, as long as the scholarships cannot be canceled in the current academic year for nonparticipation.

So much for our analysis of the tax consequences of athletic scholarships, assuming no fundamental change in the nature of the relationship between scholarship athletes and their universities. A different, more speculative, question has also generated commentary in the past few years–whether universities could reclassify their scholarship athletes as employees, and yet continue to provide the bulk of the athletes' compensation as various types of tax-free fringe benefits.[169] We do not find the question particularly pressing, because our crystal ball tells us that universities are not going to reclassify scholarship athletes as employees any time soon. Nevertheless, there is one issue in this area worthy of a brief detour.

Section 117(d) provides that gross income shall not include any "qualified tuition reduction" (QTR), and defines a QTR as "any reduction in tuition provided to an employee [of a college or university] for the education (below the graduate level) at such organization . . . of . . . such employee."[170] Would full-tuition scholarships for student-employee-athletes qualify for exclusion under §117(d)? The statute includes a nondiscrimination rule with respect to the provision of QTRs,[171] which at first glance suggests that tuition reductions available only to employee-athletes might not qualify for the exclusion. However, the rule prohibits only discrimination in favor of "highly compensated employees" (HCEs), and the definition of HCEs

[169]See, e.g., Morehouse, supra note 147, at __; Edelman, supra note 151, at 1161-67.

[170]IRC §117(d).

[171]IRC §117(d)(3).

provides that an employee's total compensation must exceed $120,000 for the employee to be considered an HCE.[172] We expect that all student-employee-athletes would be compensated well below that threshold, even at the most generous and most expensive universities.

But there is a second hurdle less easily overcome. According to the regulations, a QTR is fully excludable from gross income only if the university also pays the employee *taxable* compensation equal to or greater than "the rate of compensation ordinarily paid for similar services performed by an individual who is not the recipient" of a QTR; if there is no other taxable compensation, or if the other taxable compensation is less than the fair market value of the services, then the tuition reduction is partly or fully taxable (i.e., taxable up to the point that the other taxable compensation plus the taxable portion of the tuition reduction equals the fair market value of the services).[173]

It would be a nightmare to determine the fair market value of a student-employee-athlete's services; values could vary greatly across sports, and across individuals within sports. Suppose, though, that the IRS announced–perhaps with an eye toward compensation levels in minor league baseball, the NBA's G-League, and the Canadian Football League, among other places–that universities could use $35,000 as the fair market value of the services of all of its athletes, no questions asked. Suppose, also, that each athlete received other taxable compensation (cash, in-kind room-and-board) totaling $20,000. Finally, consider two full-

[172]IRC §414(q); Notice 2017-64, 2017-45 IRB 486 (inflation adjustment).

[173]Treas. Reg. §1.117-2(a)(1). This regulation predates the 1984 and 1986 revisions of §117, and thus does not directly address §117(d). Post-1986 proposed regulations (which, for some reason, have never been finalized) reflect the current statute and more explicitly call for the approach described in the text. Prop. Reg. §1.117-6(d), 53 Fed. Reg. 21668, 21692 (June 9, 1988).

tuition scholarships: one of $15,000 (covering in-state tuition at a public university), the other of $45,000 (covering tuition at a private university, or out-of-state tuition at a public university). On these assumed facts, the in-state public university tuition is fully taxable, because the sum of other taxable compensation ($20,000) and the scholarship ($15,000) does not exceed the fair market value of the athlete's services ($35,000). The same amount–$15,000–of the $45,000 scholarship is taxable (in order to bring the taxable compensation up to the fair market value of the services), but the other $30,000 qualifies for the §117(d) exclusion.

The bottom line is that, in the unlikely event that universities reclassify their scholarship athletes as employees, §117(d) should be reasonably effective in sheltering out-of-state and private university tuition scholarships from tax, but much less effective in sheltering in-state public university tuition scholarships. Another possibility is that universities (with or without the blessing of the IRS) might value the labor of its athletes in the suggested neighborhood of $35,000 in those sports with significant markets for the services of professional athletes, but value the services of athletes in other sports (for example, fencing, wrestling, and gymnastics) at zero or close to zero. This would have the interesting–and probably objectionable–effect of making tuition reductions largely taxable for athletes in those sports with professional (non-academic) markets, and entirely tax-free for athletes in sports without such markets.

III. The Eighty-Percent Solution

Among the provisions of the Tax Cuts and Jobs Act of 2017 was one that repealed section 170(*l*), which had been a part of the IRC since 1988. This provision allowed a deduction of 80% of the amount of donations to universities, where the donation was conditioned on the grant of rights to purchase tickets to university athletic events. In light of the repeal, this provision may seem now to be a dead letter. However, the history of this issue—which is characterized by considerable back-and-forth movements—coupled with Congress' demonstrated proclivity for favoring college sports, suggests that this is an area that warrants continued vigilance.

Under the rules of the erstwhile section 170(*l*), donors to college and university athletics programs were allowed to deduct 80% of the amount contributed even if the donor "receives (directly or indirectly) as a result of paying such amount the right to purchase tickets for seating at an athletic event . . . ."[174] This rather strange rule represented the culmination of an entertaining, but ultimately dispiriting, dispute between athletics boosters and the IRS that began in 1984, with the publication of Revenue Ruling 84-132.[175] That ruling examined a hypothetical situation in which a donor received, for a contribution of $300 per year—a comically small amount by today's standards—the right to purchase a season football ticket in a "preferred" location between the two forty yard lines. The ruling also hypothesized that there was a waiting list of potential donors who sought this privilege. Under the circumstances, the IRS rather easily concluded that the ticket-access privilege had "significant value," and that the donor could therefore deduct no part of the payment unless he could show that his donation exceeded the value of the ticket-access privilege.[176] (Implicitly, this would be exceedingly unlikely in a situation in which would-be donors were on a waiting list to be allowed the privilege.)

This was nothing more than a straightforward application of the well-established doctrine

---

[174] Section 170(l)(2)(B).
[175] 1984-2 C.B. 55.
[176] Id., at 56.

of disallowance of "gifts" that involved *quid pro quo* values returned to the donor as part of the exchange. This principle was most authoritatively established by the Supreme Court in Hernandez v. Commissioner,[177] a case decided a few years after the ruling itself. Although the IRS has decided, for reasons never fully disclosed, not to enforce Hernandez as to the actual facts that gave rise to it,[178] there can be little doubt that the *quid pro quo* doctrine was and is good law. Although it was decided after the IRS had issued its ruling on athletic ticket privileges, the IRS had had some previous success in establishing this doctrine. In United States v. American Bar Endowment,[179] the government had argued that amounts paid to the Endowment as premiums for life insurance policies were in no part deductible, despite the fact that the policies were priced at a level that allowed the Endowment, a charitable entity, to make a profit on the sales. The premiums were nevertheless at amounts not exceeding the cost of similar insurance available to the policyholders through commercial insurance companies, so no deduction was allowed. Although the final result in this case was not determined until the Supreme Court decided it in 1986,[180] the IRS had won the first round with the Claims Court decision which was announced on January 31, 1984; the IRS issued its ruling later that year.[181]

---

[177] 490 U.S. 680 (1989).

[178] The case involved payments for "auditing services" provided by the Church of Scientology. The IRS announced its intention to allow deductions for such contributions in Rev. Rul. 93-73, 1993-2 C.B. 75, notwithstanding its successful outcome denying such deductions in Hernandez.

[179] 4 Cl. Ct. 404 (1984), 53 AFTR 2d 84-942.

[180] United States v. American Bar Endowment, 477 U.S. 105 (1986).

[181] This case has a complicated procedural history, which can be briefly summarized as follows: both the Endowment and individual policyholders were parties to a consolidated case involving the IRS claims that the Endowment enjoyed unrelated business income from the sale of the insurance, and that the policyholders were entitled to no deductions for any part of their premiums. The Endowment prevailed at the Claims Court level, while the taxpayer/policyholders did not. The court of Appeals for the Federal Circuit affirmed the result as to the

The theory behind the ban on deductions of *quid pro quo* transactions is eminently reasonable: the charitable donation deduction is meant to reflect true donations, not exchanges of more or less equal value. If the latter were deductible, why wouldn't deductions be allowed for the payment of hospital bills by patients, or the payment of tuition by students? The IRS has gotten this right, and so has the Supreme Court, generally by wide margins.[182]

Despite the soundness of its position, the IRS responded to the firestorm of criticism of Revenue Ruling 84-132 by suspending it later in the same year.[183] Its announcement offered no new opinion on the merits, but simply indicated that the IRS would hold hearings on the question before finally deciding its position. A bit over a year later, the IRS, to its credit, stuck by its guns, and ruled again that contributions conditioned on the grant of seat privileges were not deductible.[184]

Several bills were introduced in Congress later in 1986 to reverse this result, and a provision to that effect was included in the House bill that became the Tax Reform Act of 1986.[185]

Endowment, but reversed as to the taxpayers/policyholders. 761 F.2d 1573 (Fed. Cir., 1985). However, this result was not announced until after the IRS had issued Rev. Rul. 84-132. Ultimately, the Supreme Court decided this case for the government on all points: the premiums were unrelated business income to the Endowment, and were no deductible by the taxpayer/policyholders.

[182] The single dissent in American Bar Endowment was by Justice Stevens, and related to the UBIT issue rather than to the *quid pro quo* gift issue. 477 U.S. 119. Hernandez was more complicated, with Justice O'Connor and Scalia dissenting on the only issue in that case, the charitable deduction. The dissenting opinion by Justice O'Connor emphasized the inconsistent treatment by the IRS of payments for religious benefits. 490 U.S. 704.

[183] Announcement 84-101, 1984-45 I.R.B. 21.

[184] Rev. Rul. 86-63, 1986-1 C.B. 88.

[185] *See* Conrad Teitell, "*Philanthropy and Estate Planning*"(column), 128 Trusts and Estates 58, 61 (1989) for a description of the legislative response to Rev. Rul. 86-63.

However, the provision was dropped in conference, and the IRS position survived for a time.[186] It survived, that is, as to all colleges and universities except the University of Texas and Louisiana State University, which benefited from a special "rifle shot" provision that had been slipped in through the back door of the legislative process by Senator Long of Louisiana and Representative Pickle of Texas.[187]

But in the next major tax act, the Technical and Miscellaneous Revenue Act of 1988[188] (which really was a major act, despite its diffident title), Congress overruled the IRS, adding section 170(*l*) to the Code.[189] Pointedly flexing its muscles, Congress even added a rather unusual provision allowing refund claims by anyone who lost his or her deduction due to this frolic of the IRS' during the previous four years, even as to tax years for which the statute of limitations on adjustments would otherwise have expired.[190] Congress meant not merely to overrule the IRS, but to obliterate any trace effects of the IRS attempt to rein in this abusive practice.

There is very little explanation of what Congress was thinking. Because it was added as an amendment, no "reason for change" appeared in any committee report. However, a Joint

---

186 Id. There was, however, an exception to the rule of nondeductibility for contributors to booster clubs at LSU and the University of Texas, due to a disguised "rifle shot" provision inserted by Senator Russell Long and Congressman J.J. Pickle. See Schmalbeck, Zelenak and Lawsky, Federal Income Taxation, 4th ed. at 448, 451-52 (2015).

187 This was a rifle shot of the classic form: the favored institutions were described in terms of such things as the date of their founding, or the date of their most recent stadium renovations, rather than by name. See Section 1608, Tax Reform Act of 1986. For a fuller explanation of the "rifle shot" approach, see Lawrence Zelenak, Are Rifle Shot Transition Rules and Other Ad Hoc Tax Legislation Constitutional?, 44 Tax L. Rev. 563 (1969).

188 Pub.L 100-647, §6001, 102 Stat. 3683 (1988).

189 This provision was added as subsection (m), of section 170, but later renumbered as subsection (l).

190 This provision was added by the Senate, and adopted by the Conference.

Committee explanation did the best it could:

> The proposal would eliminate otherwise unavoidable valuation controversies between the IRS and many individual taxpayers as to the proper treatment of payments to college athletic scholarship programs.[191]

Indeed, valuation controversies are not unimaginable under some circumstances. If a college sports program announced to its boosters that very generous donors would be rewarded with the opportunity to acquire good seats to football and/or basketball games, some donors might give large gifts, and then argue that they did so because of their large hearts, and that they could have given less and gotten similar favors. They might point to other donors who got good seats for smaller contributions, arguing that anything over the smallest donation that yielded good-seat privileges was deductible. The IRS might then need to evaluate the precise quality of the seats of the two donors, to assure that they were in fact comparable—that, for example, end-zone seats weren't being compared to sideline seats. These questions can get difficult, as the controversies over valuation of "skybox" seats for purposes of section 274 of the Code have shown.[192]

But it would not seem generally to be in the interest of universities to structure their seat privilege policies this way. Seekers of seats, or better seats, want to know what it takes to get them. Vagueness on this question would be annoying, and no university wants to annoy alumni and friends who are trying to give it money. It is possible that some booster organizations might

---

[191] Description of Proposed Amendment to H.R. 4333 as Amended, Joint Committee on Taxation, July 13, 1988, JCX-15-88, at 15.

[192] *See* Richard Schmalbeck and Jay Soled, *"The Cultural Symbolism of the Deductible Skybox,"* 126 Tax Notes 1524 (2010).

attempt some subterfuge, in which the precise dollar amount wasn't published, but could be whispered by the manager of the organization[193] to alumni and friends who call seeking this information. However, the IRS should be able to penetrate such a ruse fairly easily. It would observe that many contributions were of exactly the same amount, the presumptive minimum; it could also simply ask the university to tell it what that number is, or to state officially that no such number existed—a statement which would, if false, be a felony.

At Duke, there is no ambiguity. Football tickets have in recent years been available without any special contribution, because Duke's football team has a long history of mediocrity, or worse.[194] Basketball tickets, on the other hand, are a scarce and valuable resource. There are some breaks for students, faculty and other insiders, but a fan—even an alumnus--with no current connection to the university must make an annual contribution of $7000 to be entitled to buy two season basketball tickets, the purchase of which will incur an additional charge of $2000 or more, depending on the location of the tickets. Valuation of the seat privileges would not seem to be difficult under these circumstances, which are common among big-time sports.

The earliest version of this article was presented by Prof. Schmalbeck at a conference in 2014.[195] At that time, he suggested that the prospects for achieving this reform were poor, but

[193] At Duke we call this organization the Iron Dukes. It is a subdivision of our athletics department, staffed by university employees. Most colleges that participate in big-time sports have a counterpart organization.

[194] This has changed, with the Duke football team qualifying for a post-season bowl game in five of the last six seasons. Despite the recent success, football at Duke has still not found its audience, and, to date, football tickets are still available at list price (or sometimes less), as the university struggles to fill even its modestly-sized stadium. But if success continues, one can expect sometime soon that buying of seat licenses to football games will become the norm for football as well as basketball.

[195] The conference was sponsored by the National Center for Philanthropy and Law at the New York University Law School. The paper discussed only issues one and three contained in the current version of this

that it was barely possible that Congress could be persuaded to adopt a rule that was very clearly a positive tax reform, and would raise a modest amount of revenue. And, in fact, Treasury officials were in the audience at that conference, and they suggested that the Treasury Office of Tax Policy include repeal of section 170(*l*) in President Obama's budget message to Congress the following year. This was in fact done in both 2015 and 2016.

Later, when the House Ways and Means Committee was seeking revenue-increasing reform measures to add to what became the Tax Cuts and Jobs Act of 2017, it included a provision repealing the 80% rule. Somewhat surprisingly, it survived the legislative process, despite the absence of a counterpart provision in the Senate version of the bill, and became law, effective for 2018 and subsequent years. And while this reform obviously required the support of several people with actual power (that is, people other than academics), it seems fair to note that this issue had not been on the radar of tax reformers, and might have gone unnoticed but for the earlier draft of this article.

Will this reform endure? One hopes that it will. The 80% deduction was a terrible rule that should never have added to the IRC in the first place. But the vehemence with which Congress spoke to this question in 1988 (remember that it felt so strongly that it even added a provision effectively waiving the statute of limitations to impose the 80% rule retroactively) suggests that this issue may not yet be sincerely dead.

IV. The New Excise Tax on Excessive Compensation

---

article, of which Prof. Schmalbeck was the initial author. Prof. Zelenak was the initial author of the second and fourth issues discussed herein.

Everybody complains about the multi-million dollar salaries of college football and basketball coaches, but nobody does anything about them. Well, not anymore. In 2017 Congress added §4960 to the Internal Revenue Code, imposing a 21 percent excise tax on the compensation of an employee of a tax-exempt organization, to the extent the employee's compensation exceeds $1,000,000, if the employee is among the organization's five most highly-compensated employees.[196] In addition to organizations exempt from income taxation under §501(a), the new excise tax applies to organizations with "income excluded from taxation under section 115(1)."[197] Section 115(1) provides that gross income does not include "income derived from . . . the exercise of any essential governmental function and accruing to a State or any political subdivision thereof." It is the only income tax provision of the Internal Revenue Code expressly exempting income of state or local governments.

As the bill containing proposed §4960 worked its way through Congress and to the President's desk in late 2017, news reports on the provision stated that as drafted it would apply to both private universities (as organizations exempt from tax under §501(a)) and public universities (as organizations with income excludable under §115(1)), and that the major impact of the tax would be on universities paying seven- or even eight-figure salaries to their football and men's basketball coaches.[198] The authors of one article reported that, based on their

[196]Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §13602(a), __ Stat. __, __ .

[197]IRC §4960(c)(1).

[198]See, e.g., Steve Berkowitz, New Tax Bill Will Impact Sports World Starting with Millions in Costs for Colleges, USA Today, Dec. 20, 2017; Gabrielle McMillen, That New Tax Bill? It's Going to Hit College Athletics–Hard, Sporting News, Dec. 20, 2017; Associated Press, College Coaches' Salaries Increase Despite Threat of New Tax, USA Today, Dec. 13, 2017; Robert L. Lattinville & Roger Denny, How the New Excise Tax Impacts Coach Compensation, athleticdirector.com, December 2017 (written by two lawyers specializing in issues relating to compensation of college coaches).

analysis (done in partnership with *USA Today*), “there are at least 240 coaches and athletic directors across the FBS [Football Bowl Subdivision, including both public and private universities] that receive compensation in excess of $1,000,000.”[199]

A. Does the New Excise Tax Apply to Public Universities?

However, less than a week after President Trump signed the 2017 tax bill into law, tax law professor Ellen Aprill explained in a lengthy blog post that, “While the drafters evidently intended to impose a 21% excise tax on both public and tax-exempt private institutions . . . , they appear to have inadvertently left public universities off the hook.”[200] The problem, according to Aprill, was that–contrary to what one might conclude from simply reading the Internal Revenue Code–public universities generally owed their tax-exempt status *not* to §115(1), but to the until-then obscure doctrine of implied statutory immunity, according to which (as Aprill explained), “Unless otherwise specified in the Internal Revenue Code, states and their political subdivisions are not taxpayers under the Code, and their income is not gross income within the meaning of section 61.”[201] Because nothing in §4960 stated that the new tax applied to an organization exempt from tax by reason of implied statutory immunity, Aprill concluded that the tax did not apply to public universities.

Seven figure salaries of university presidents and other executives of nonprofit organizations are also subject to the new tax, but a special rule exempts amounts “paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional.” IRC §4960(c)(3)(B).

[199]Lattimore & Denny, supra note 198. According to *USA Today*, in 2017 fourteen *assistant* college football coaches were paid more than $1,000,000. sports.usatoday.com/ncaa/salaries/football/assistant.

[200]Ellen Aprill, Congress Fumbles the Ball on Section 4960, medium.com, Dec. 26, 2017.

[201]Id. Aprill cited Private Letter Ruling 7904006 as an example of the Service determining that a public university was tax-exempt by reason of implied statutory immunity, rather than by reason of §115(1).

But this was only the beginning. Another tax professor, Douglas Kahn, argued in *Tax Notes* that the tax *did* apply to public universities, even if Aprill was right about §115(1) and the immunity doctrine, because the tax expressly applied to organizations exempt under §§501(a) and 501(c)(3), and "all or almost all state universities are incorporated, and so section 501(c)(3) applies to them."[202] Aprill in turn replied that Kahn might be right with respect to any public university which had applied for and received from the Service a letter confirming its tax-exempt status under §501(c)(3)–which some public universities have done, primarily to reassure donors of the deductibility of their contributions–but not with respect to the many public universities which had not done so.[203] On the other hand, the rule that an organization must apply to the IRS for recognition of tax-exempt status as a condition of exemption applies only to an organization organized after October 9, 1969.[204] Certainly the vast majority of public universities paying seven-figure coaches' salaries are older than that, and thus would be exempt under §501(c)(3) as long as they satisfied the substantive requirements for exemption. In any event, as Aprill pointed out, even under Kahn's analysis a public university could avoid the new excise tax simply by voluntarily renouncing its §501(c)(3) status, and relying instead solely on implied statutory immunity for its income-tax exemption.[205]

Prominent exempt-organizations tax lawyer Marcus Owens also took issue with the

[202]Douglas A. Kahn, Does Excise Tax on Excessive Comp Apply to State Universities?, 158 Tax Notes 397 (Jan. 15, 2018).

[203]Ellen P. Aprill, Response to Professor Kahn: Tax Status of Public Universities, 158 Tax Notes 539, 539-40 (Jan. 22, 2018).

[204]IRC §508(a).

[205]Aprill, supra note 203, at 542.

analysis in Aprill's original blog post, for a reason distinct from Kahn's. Owens noted that, in a 1978 General Counsel Memorandum (GCM), the Service had "suggest[ed] the possibility that the 'related' income streams of all states colleges and universities escape taxation by virtue of section 115(1), rather than by notions of intergovernmental immunity."[206] If that suggestion was correct, Owens explained, the reference in §4960 to §115(1) would suffice to make public universities subject to the new tax.

In post-enactment informal public comments on §4960, government officials have expressed a range of views concerning whether the new tax applies to public universities. Elinor Ramey, an attorney-adviser in Treasury's Office of Tax Legislative Counsel, opined that the provision as enacted does not necessarily apply to all public universities, and that technical correction legislation may be needed to effectuate the congressional intent to apply the tax all universities.[207] Veena K. Murthy, legislation counsel at the Joint Committee on Taxation, also stated that §4960 "requires a technical correction" to make it applicable to public universities.[208] On the other hand, an unnamed Senate Finance Committee staffer told *Tax Notes* that §4960 as enacted covers public universities, and that there is no need for a technical correction.[209] Another possibility–halfway between the positions that no fix is needed and that only Congress

[206]Marcus Owens, Letter, EO Tax Journal 2017-251 (Dec. 28, 2017) (citing GCM 37657).

[207]Fred Stokeld, ABA Section of Taxation Meeting: Ideas for Guidance on New Tax Law Welcomed, 158 Tax Notes 1138 (Feb. 19, 2018).

[208]Allyson Versprille, NonProfit Executive Pay Glitch Needs Fix: Joint Tax Counsel, Bloomberg Law, Jan. 25, 2018.

[209]Stephanie Cumings, Will the Nick Saban Tax Apply to Nick Saban?, 158 Tax Notes 1569, 1570 (March 12, 2018).

can make the fix–is that Treasury could issue a valid regulation declaring that public universities are tax-exempt by reason of §115(1), and thus subject to the new tax.[210] Although such a regulation would be contrary to numerous IRS pronouncements issued over many decades, it might nevertheless be valid, given that (1) it would be entitled to *Chevron* deference;[211] (2) past IRS pronouncements are not entirely consistent in this area (as demonstrated by the conflict between the pronouncements cited by Aprill and by Owens[212]); and (3) the past IRS pronouncements, although numerous, have been exclusively in the form of lower-level "written determinations," which by statute "may not be used or cited as precedent."[213]

Before moving on to the broader question of whether a version of §4960 applicable to all universities would constitute good tax policy, we close the discussion of the public university question with two observations. First, in light of the facts (1) that Aprill's post-enactment blog commentary seemed to have taken everyone by surprise, and (2) that in the post-enactment discussions everyone (including Aprill) seemed to agree that Congress *intended* the new tax to apply to public universities as well as to privates, it is strange that there were, in fact, pre-enactment rumblings that the provision as drafted might not apply to publics. A story in *Inside Higher Ed* from November 2017 described proposed §4960 as "an excise tax on high earners at

[210]Aprill mentions (but does not endorse) this possibility in her reply to Kahn. Aprill, supra note 203, at 543, note 26.

[211]Chevron USA v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) (an agency may choose, by regulation, among reasonable interpretations of an ambiguous statute). See also Mayo Foundation v. United States, 562 U.S. 44 (2010) (*Chevron* applies to tax regulations).

[212]*Compare* Private Letter Ruling 7904006 (public university tax-exempt by reason of implied statutory immunity) *with* General Counsel Memorandum 37657 (public university tax exempt on its related income by reason of §115(1)).

[213]IRC §6110(k)(3).

private tax-exempt organizations," without any suggestion that Congress wanted to reach publics as well as privates.[214] Similarly, a mid-December story in the *Chronicle of Higher Education* on the proposed tax identified 158 million-dollar employees (excluding medical staff members) of private nonprofit universities, apparently on the assumption that only those institutions would be subject to the tax.[215] And, almost two months before Aprill's blog post, the *Washington Examiner* reported that tax professor Elaine Wilson found the bill ambiguous with respect to whether it covered both public and private universities.[216]

Second, the ambiguity in the scope of §4960 is the result of a decidedly unforced drafting error, given the readily available example of §511(a)(2)(B) of the Code. That provision, helpfully headed "State Colleges and Universities," states that the tax on unrelated business income of otherwise tax-exempt organizations "shall apply in the case of any college or university which is an agency or instrumentality of any government or political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions." As one would expect from that language, it is settled law that the tax on unrelated business income applies to public universities in the same way it applies to privates. If the drafters of §4960 had simply borrowed the language of §511, they could have spared everyone all the confusion–still

[214]Rick Seltzer, Excise Taxes on Colleges Spark Criticism but May Signal a Tough Future for Higher Ed, insidehighered.com, Nov. 6, 2017.

[215]Adam Harris & Dan Bauman, New Tax Law Takes Aim at Higher Education's Millionaire Club, Chronicle of Higher Education, December 19, 2017.

[216]David M. Drucker & Joseph Lawler, GOP Tax Plan Could Crimp Million-Dollar College Coaches, washingtonexaminer.com, Nov. 3, 2017.

far from resolved–recounted above. The story is an object lesson–one of many provided by the 2017 tax legislation–in the perils of hasty enactment of complicated tax laws.

B. But What about the Policy?

As difficult as it is to avert one's gaze from the train wreck aspect of the drafting of §4960, in the end the more important question is whether the provision constitutes good policy. Let us assume that Congress intended the provision to apply to both public and private universities, and that one way or another–by technical correction, by Treasury regulation, or simply by an interpretation by the IRS upheld by the courts–it is eventually settled that the provision does so apply. Although the new tax does not expressly target big-time college sports, and although it will certainly have some impact outside of university athletic programs, it is obvious that §4960 is–in both purpose and effect–largely a tax on universities paying seven- and eight-figure salaries to their football and men's basketball coaches. What, if anything, justifies the tax?

The tax is clearly related to Congress's 2017 decision to get serious about §162(m) of the Code. A big of background is in order here. In 1993 Congress enacted §162(m), supposedly denying publicly-held corporations business expense deductions for compensation paid to their top executives of more than $1 million per person (an amount which has never been adjusted for inflation).[217] We say "supposedly," because a broad exception for performance-based compensation made it child's play for corporations to avoid the provision.[218] In the 2017

[217]Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §13211(a), 107 Stat. 312, 469-70.

[218]Former (pre-2017) §162(m)(4)(C).

legislation, Congress removed the exception for performance-based compensation, thus giving the deduction disallowance real force for the first time in its existence.[219] The newly-invigorated §162(m) makes no particular policy sense; for top executives of publicly-held corporations, compensation in excess (in fact, *well* in excess) of $1 million would easily qualify as "ordinary and necessary" under the general business expense deduction rule of §162(a), thus making such compensation properly deductible if the goal is accurate measurement of a corporation's net income.[220] It may seem strange, then, that affected corporations did not raise an outcry over the 2017 strengthening of §162(m). The apparent explanation for the corporations that did not bark is that they understood the strengthening of §162(m) as part of a package deal which also reduced the corporate tax rate from 35 percent to 21 percent.[221] Realizing that the rate reduction was much more beneficial than the deduction denial was harmful, and that it would be churlish–or worse, self-defeating–to complain about the negative aspect of a very positive package deal, corporations did not complain.

As Congress was imposing a sort of tax penalty on executive compensation paid by for-profit corporations, it apparently occurred to Congress that some tax-exempt organizations also paid salaries of more than $1 million, and that if there was going to be (for the first time) a meaningful penalty tax in the one case, there should also be a penalty tax in the other. The

[219] Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §13601(a)(1), __ Stat. __, __.

[220] In its tax expenditure estimates, the Joint Committee on Taxation has long treated §162(m) as a negative (or reverse) tax expenditure, resulting in taxing affected corporations on more than their true net income. See, e.g., Staff of the Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020 (2017), at 37.

[221] Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §13001(a), __ Stat. __, __.

problem, of course, was that the tax penalty could not take the form of a deduction-denial provision, if the organization paying the seven- or eight-figure salary was exempt from tax. The solution–as obvious as the problem–was to impose the penalty by way of an excise tax on salaries over $1 million, rather than by way of disallowing deductions. Section 4960 was the result. But while for-profit corporations had been mollified by another, highly favorable, aspect of the 2017 legislation, for universities the introduction of §4960 was one more punitive feature of legislation they viewed as a very bad package deal–most notably for the new excise tax on the investment income from large endowments, and for the disallowance of charitable deductions for contributions giving donors the right to purchase tickets to football or basketball games.[222]

If we consider §162(m) and §4960 apart from their very different package-deal contexts, it is actually quite a bit easier to make a case for the excise tax than it is to make a case for the deduction denial. If one accepts (as our current Congress surely does) the basic tenets of twenty-first-century American capitalism, then there is nothing inherently objectionable about seven- or eight-figure compensation packages for top corporate executives. By contrast, one might well conclude that there is something deeply troubling about tax-exempt institutions of higher education providing multi-million-dollar compensation packages to their football and basketball coaches–and that the mere fact that the salaries are the result of market forces may not be justification enough. For someone thinking along those lines, §4960 might seem an appropriate legislative response–expressing disapproval (and raising some tax revenue in the bargain), while avoiding the much more draconian approach of a hard ceiling on the amount of

[222]Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §§13701(a) (enacting the §4968 tax on investment income), 13705(a) (amending §170(*l*)), __ Stat. __, __, __.

compensation consistent with a payor's tax-exempt status. The provision can be understood as targeting excessive coaches' salaries–not excessive in the sense of being more than the market value of coaches' services, but excessive based on widely-shared (albeit undeniably subjective) value judgments about what salary levels are contextually appropriate, the market be damned.[223] Interestingly, although §4960 reflects a market-be-damned attitude toward salaries of coaches (and university presidents), the statutory exemption for seven-figure salaries paid to medical professionals indicates congressional acceptance of market-driven salaries for physicians.[224] Understanding §4960 as reflecting a market-be-damned disapproval of seven-figure coaches' salaries (and assuming it applies to public universities as well as to privates), we think the provision is quite defensible on policy grounds.

A different policy defense–which we note here without endorsing it–might view the provision as an alternative to taxing the net income produced by big-time college sports as unrelated business income (UBI). From an expressive standpoint, it is arguably less radical--and so more acceptable--for the federal tax system to take a stand against seven-figure coaches' salaries than to take the position that big-time college sports have nothing to do with education.

We would resist this trade-off, however, largely on revenue grounds. If the unrelated business income tax were applied to the multi-billion dollar advertising and cable television

---

[223]Section 4958 of the Code imposes an excise tax on "excess benefit transactions" between a tax-exempt organization and a "disqualified person" (defined by §4958(f)(1)(A) to include "any person . . . in a position to exercise substantial influence over the affairs of the organizations"). Although some football and basketball coaches would arguably fit the definition of disqualified persons, an arms'-length salary–reflecting the market value of a coach's services–would not fit the §4958(c)(1) definition of a taxable excess benefit transaction, no matter how high the salary. Thus, if Congress wanted to penalize (and to express disapproval of) the salary levels of coaches in big-time college sports, it needed a new provision; §4958 would not have done the job.

[224]IRC §4960(c)(3)(B).

revenues generated by big-time college sports, with appropriate guidance disallowing the deduction of expenses related to the "exploited exempt activities"[225]—namely, all the expenses of actually fielding the teams—then the revenue potential of applying the unrelated business income tax to college sports would substantially exceed the very modest revenue that could be expected from the excise tax on high salaries.

We close with a comment on the incidence of the §4960 tax. Of course the tax formally falls on the universities, not on the coaches themselves. And we are confident that, in the short run, the economic incidence of the tax will not fall on coaches to any significant extent. A university with a coach under contract could not reduce its contractual salary obligations on account of the new tax. Beyond that, we are not confident about much of anything in terms of incidence. Taking a longer-term view, the tax might have *some* depressing effect on coaches' salaries, although we suspect that most of the burden of the tax will fall elsewhere–on major donors to athletic departments, on the departments themselves (and within the departments on both revenue and nonrevenue sports), and on the educational (that is, nonathletic) functions of the universities. From a policy perspective, §4960 may ultimately appear more attractive if the incidence of the tax falls largely on some combination of coaches, donors, and revenue sports, than if it falls largely on nonrevenue sports and core educational functions.

Conclusion

For decades college athletics has enjoyed favorable tax treatment justified by neither policy considerations nor (for the most part) the terms of the Internal Revenue Code. Two provisions of the Tax Cuts and Jobs Act of 2017–the elimination of the charitable donation for

---

[225] See Treas. Reg. §1.512-1(d)(1), and discussion at note 64 supra.

ticket purchases, and the excise tax on seven-figure coaches' salaries–indicate that Congress has had second thoughts about the sweetheart deal traditionally afforded college sports by the tax system. Given that attitudinal change on the part of Congress, now would be an excellent time for the IRS to reconsider those aspects of the sweetheart deal–relating to the UBI tax and to athletic scholarships–for which the IRS, rather than Congress, has been primarily responsible.