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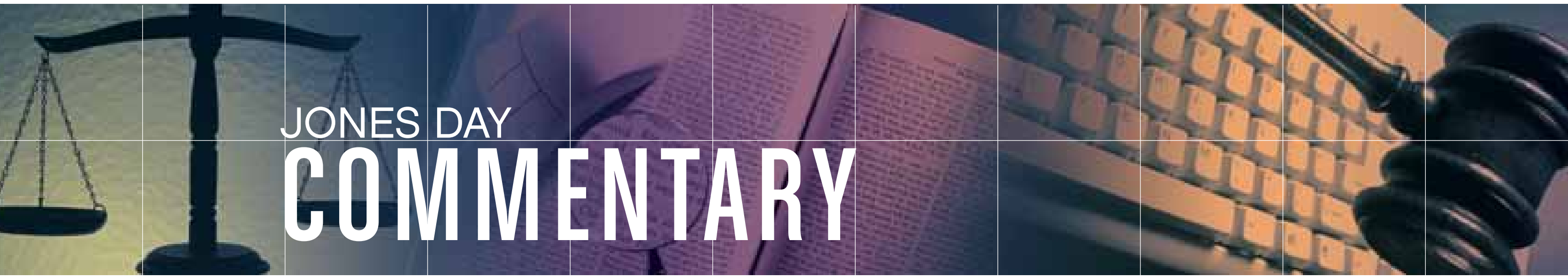

COLLEGES AND UNIVERSITIES: IS THERE IMPENDING INTERFERENCE WITH THE TAX PREFERENCES APPLICABLE TO INTERCOLLEGIATE SPORTS?

In May 2009, the Congressional Budget Office of the Congress of the United States (the “CBO”) released a report entitled “Tax Preferences for Collegiate Sports” (the “Report”). The Report had been requested in 2007 by Senator Charles Grassley (R-Iowa), a ranking member of the Senate Finance Committee. At that time, Senator Grassley had informed the CBO that he “would like to gain a better understanding of the economic benefits received from the tax-exempt status of college athletics.”

It remains to be seen whether Congress will use the Report as a springboard to alter one or more of the tax preferences currently enjoyed by public and private colleges and universities[1]—including, among others, exemption from federal income tax, eligibility for charitable contribution deductions, and access to tax-exempt debt—and whether any alteration of the tax rules may be applied universally to educational institutions, just to their athletic programs, or just to certain types of income.

COLLEGIATE ATHLETIC PROGRAMS CLEARLY FURTHER AN EXEMPT PURPOSE

For federal tax purposes, the income earned by colleges and universities from tuition, research grants, passive investment income (including royalties, interest, and capital gains), contributions, and athletics is

1. It is noted that for-profit colleges and universities generally do not have teams that participate in intercollegiate athletic programs. Although the University of Phoenix, a for-profit university, holds the naming rights to the University of Phoenix Stadium in Arizona, the university’s name designates its position as a corporate sponsor. The university itself has no intercollegiate athletic program.

considered related to their exempt purpose and thus exempt from federal income tax. Among other benefits, college athletic programs build leadership skills, teamwork, a sense of community, school name recognition, school reputation, and alumni support. Critics may argue, however, that student athletes reap less academic benefit from higher education than other students, an expensive infrastructure is required to maintain the programs, and academic tutoring programs are often necessary to assist the athletes. Notwithstanding the pros and cons of the social and educational benefits of college athletic programs, and various challenges over time to the "worthiness" of such programs for preferential tax treatment, Congress has historically looked favorably upon them.[2]

ARE COLLEGE ATHLETIC PROGRAMS BECOMING "SIDE BUSINESSES" FOR SCHOOLS?

The Report states that "concerns have arisen that some activities undertaken by colleges and universities are only loosely connected to educating students and might be viewed as unrelated to the schools' tax-favored purpose." The Report cites the "highly commercialized" nature of some athletic programs, along with the "large sums" of revenue that they generate,[3] and questions "whether those sports programs have become side businesses for schools and, if they have, whether the same tax preferences should apply to them as to schools in general." NCAA Division I schools are the primary focus of the Report because of the large size of their athletic programs and the disproportionately high share of revenue from so-called "commercial" activity in their athletic programs—including ticket sales, NCAA distributions, advertisements, media rights, items sold on game day, and other activities—compared to other parts of the institutions. The Report concludes that athletic departments in NCAA Division I schools derive a considerably larger share of their revenue from commercial activities than do other parts of the universities. A complication pointed out in the Report, however, is the correct allocation of revenue and expenses to athletic departments: "There are no rules or even standard practices delineating how schools divide revenue from parking, concessions, or licensing, for example, between the athletic department and the university." Therefore, ascertaining the true financial status of college athletic departments may be difficult.

CONGRESSIONAL OPTIONS–WILL CONGRESS SIDELINE ATHLETIC PROGRAM TAX PREFERENCES?

The Report discusses three primary paths that Congress may choose to follow should it decide that some or all of the activities undertaken by college athletic programs are primarily commercial in nature: (1) limiting the deduction of charitable contributions; (2) limiting the use of tax-exempt bonds; or (3) limiting the exemption from income taxation, either for all or for certain types of income. These options are discussed below.

- Limiting the Deduction of Charitable Contributions

Congress could choose to limit the deduction of charitable contributions to college athletic departments. Currently, a donor may take a deduction equal to 80 percent of the value of any contribution paid to or for the benefit of a college or university in return for the right to purchase tickets for seating at an athletic event at the institution receiving the contribution.[4] The Report indicates that "[Congress] could specify that contributions to universities' sports programs or to foundations that support them—either contributions given in exchange for certain benefits or all contributions—may not be deducted on the donor's federal tax return." The CBO's concern with this option, however, is that donations to college athletic programs could theoretically be made indirectly through the institution itself, thus circumventing any new limitations that may apply solely to athletic program donations.

2. *See*, *e.g.*, Professor John D. Colombo, University of Illinois College of Law, "The NCAA, Tax Exemption and College Athletics" (rev. May 5, 2009) ("for the IRS to reverse course and now take the position that big-time college athletic programs are subject to the UBIT would require the agency to overturn almost 60 years of precedents stating just the opposite, a highly unlikely scenario.").

3. The Report mentions that the NCAA men's basketball tournament alone garnered about $143 million in revenue for athletic departments in 2008.

4. Code § 170(l)(1), (2); Treas. Reg. § 1.170A-13(f)(14).

• Limiting the Use of Tax-Exempt Bonds

Congress could prohibit the use of tax-exempt bonds to finance the capital facilities of sports programs. Again, however, the Report notes that to some extent the effectiveness of this option may be limited by an institution's ability to increase borrowing unrelated to the capital facilities of its sports programs, while using other resources to fund sports-related capital expenditures.

• Limiting the Exemption From Income Taxation

Congress could choose to limit the exemption from income taxation for certain types of income. The Report acknowledges, however, that it may be impracticable to subject only the income of athletic departments to such limitations, primarily because of the potential for cost shifting within the larger institution. Thus, targeting broader categories of income on an institution-wide basis may make more sense. According to the Report, "Changing the treatment of income from specific sources, such as royalty income or income from corporate sponsorships, might be effective, especially if the changes applied to the entire university rather than just the athletic program." The Report considers the implications of these two specific types of income—royalty income and income from corporate sponsorships—potentially falling within the ambit of UBIT.

Currently, royalty income is excluded from UBIT, as are other forms of "passive" income. To the extent that a tax-exempt organization is actively involved in generating the revenue (such as by providing services), however, royalty income may be taxable. According to the Report, "Some types of royalty income may reasonably be considered more commercial than others." The Report explains that

> when colleges and universities license team names, mottoes, and other trademarks to for-profit businesses that supply apparel, accessories, and credit cards to the general public, they approve each product and use of their symbols and, in some cases, exchange information, such as donor lists, with the licensees to aid in their marketing.

The Report takes the position that when such activities are undertaken by colleges and universities, the "passive" element goes away, and taxability may be justified. "Schools' active involvement in generating licensing income could be the basis for considering such income as commercial and therefore subject to the UBIT." Congress will have to decide whether subjecting certain royalty income to UBIT makes sense and what the parameters of such taxability might be—applicable to all tax-exempt organizations, applicable to only colleges and universities, applicable to only those colleges and universities with large athletic programs, or some other parameters defining taxability.

Corporate sponsorship income was also discussed in the Report. Currently, an unrelated trade or business does not include the activity of receiving "qualified sponsorship payments"—generally, payments with respect to which there is no arrangement or expectation of any substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of a company in connection with the activities of an exempt organization. In the world of college athletics, corporate sponsorship payments can be quite substantial. According to the Report, "The NCAA estimated that corporate sponsorship payments to all athletic programs totaled $275 million in academic year 2004-2005." The Report questions the amount of return benefit being received from corporate sponsorship payments made in relation to college athletic events—"The fact that sponsors of athletic facilities and bowl games are willing to pay large sums in qualified sponsorship payments suggests that they derive some benefit from the prominent location and display of their corporate trademarks during athletic contests and national broadcasts." This position is reminiscent of the Mobil Cotton Bowl ruling in 1991 (which predated the current corporate sponsorship rules), wherein the IRS ruled in a Technical Advice Memorandum that Mobil Corporation received a substantial return benefit for naming and other rights received in association with its sponsorship of the Cotton Bowl, thus rendering its payment taxable.[5] The Report suggests that it would not be unreasonable for Congress to consider certain corporate sponsorship payments as taxable advertising income. This conclusion, however, ignores the accepted and

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5. Tech. Adv. Mem. 9147007 (Aug. 16, 1991). In the ruling, the IRS described the benefits received by the corporate sponsor as a "very valuable package of benefits" and determined that the charitable organization would provide a "substantial quid pro quo" in exchange for the payment.

not uncommon practice of various charities granting naming rights for large donations and perhaps signals a turnabout back to the controversial Mobil Cotton Bowl ruling.

Similar to its discussion of royalty income, the Report suggests that congressional action to tax only the corporate sponsorship payments of college athletic departments probably would not work, primarily because of potential cost shifting within the larger institution. Furthermore, the Report laudably recognizes that "a blanket determination of 'substantial benefit' from all sponsorships could be unreasonable." So it offers a targeted approach—"Title sponsors of widely televised events such as bowl games clearly receive a substantial benefit from their sponsorship. If the Congress determined that such transactions are commercial, it could specifically classify sponsorship payments for those particular athletic contests as taxable income." In general, the Report asserts that this approach would have a significant impact on only a small number of institutions. The Report, however, does not address the effect such a change may have on conference revenue-sharing arrangements.

CONCLUSIONS DRAWN IN THE REPORT–ARE ONLY THE "MOST COMMERCIAL TEAMS" AT RISK?

The Report concludes that removing the major tax preferences currently available to university athletic departments would likely not yield the results desired by Congress because of the opportunity for shifting revenue and/or costs. Rather, according to the Report, "Changing the tax treatment of income from certain sources, such as corporate sponsorships or royalties from sales of branded merchandise, would be more likely to affect only the most commercial teams; it would also create less opportunity for shifting revenue or costs."

IMPLICATIONS OF THE REPORT–THE BALL IS IN CONGRESS'S COURT

In light of the Report, Congress may be taking a closer look at the taxability of royalty and corporate sponsorship payments relating to college athletic programs. The scope of such changes could be very narrow (focusing only on certain types of income, or income from specific athletic events) or made to apply on a widespread basis (perhaps institution-wide or to all exempt organizations).

Naturally, if royalty and corporate sponsorship payments are taxed at any level, an immediate effect would be felt by those programs that traditionally receive a large share of such payments. It is doubtful, however, that the effect of new tax rules could be contained in a limited universe within college athletics. In other words, if net income is negatively impacted by the imposition of tax, so too are the activities funded by such income. The ripple effect of new tax rules could ultimately impact college athletic programs in various ways—whether intended or unintended. For example, not only could conference revenue distributions change, but much-needed funding for mid-majors and smaller schools, and for sports other than football and basketball, may decline.

Finally, it is not inconceivable that some other change may target college athletic programs, such as some sort of detailed disclosure that could be instituted in the form of a new schedule to Form 990 for disclosing certain information related to college athletic programs and requiring a similar filing by public institutions. Such a form may essentially attempt to capture information to ascertain how the athletic program justifies any tax preferences received (similar to Schedule H reporting for exempt hospitals).

RECOMMENDATIONS

In light of the Report, there are several actions that colleges and universities with athletic programs may want to undertake at this time:

- Draft royalty and corporate sponsorship agreements with the mindset that such arrangements could potentially be subject to UBIT.
- Review the allocation of revenue and expenses from athletic department activities.
- Consider how the athletic program justifies tax preferences received and institute some form of internal tracking mechanism to capture and document the social and educational benefits of the program.
- Be watchful for any congressional or Treasury action as a follow-up to the Report.

JONES DAY'S EXPERIENCE

We have assisted large tax-exempt institutions in assessing operations and providing guidance in light of proposed legislative changes, in best positioning themselves in contractual arrangements with potentially significant federal tax implications, in responding to congressional and IRS inquiries, and in maximizing the tax preferences to which they are entitled. We would be glad to talk with you regarding the matters discussed herein.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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