

NATIONAL COLLEGIATE ATHLETIC ASSOCIATION (NCAA)

TAX LAW BASIS FOR
TAX EXEMPTION OF INTERCOLLEGIATE ATHLETICS

I. PREFACE

Intercollegiate athletics are carried on by colleges and universities, some of which are public and some of which are private nonprofit institutions. Nonprofit private institutions, and many public institutions, have been recognized by the Internal Revenue Service (“IRS”) as tax-exempt organizations described in section 501(c)(3)¹ of the Internal Revenue Code. Public and private institutions are treated the same for many purposes under federal tax law. For example, both public and private colleges and universities are subject to unrelated business income tax.² Accordingly, for purposes of this discussion, no distinction is drawn between public and private institutions, and a section 501(c)(3) analysis is applied to all such institutions.

II. INTRODUCTION TO SECTION 501(c)(3)

A. In General

Section 501(a) of the Internal Revenue Code provides that an organization described in section 501(c) or section 401(a) is exempt from federal income tax. There are currently 28 different subsections under section 501(c), each of which describes a different type of organization. This discussion is limited to those organizations described in section 501(c)(3).

B. History

The Statute of Charitable Uses is generally considered to be the genesis of modern laws governing charitable organizations. The Preamble to the Statute of Charitable Uses recognizes certain activities as having a charitable purpose: “...some for relief of aged, impotent and poor people, some for maintenance of sick and maimed soldiers and mariners, schools of learning, free schools, and scholars in universities, some for repair of bridges, ports, havens, causeways, churches, sea-banks, and highways, some for education and preferment of orphans, some for or towards relief, stock or maintenance for houses of

¹ Unless otherwise specified, all section references herein are to sections of the Internal Revenue Code of 1986, as amended, and the regulations in effect thereunder.

² See I.R.C. § 511(a)(2)(B).

correction, some for marriages of poor maids, some for supportation, aid and help of young tradesmen, handicraftsmen and persons decayed, and others for relief or redemption of prisoners or captives, and for aid or ease of any poor inhabitants concerning payments of fifteens, setting out of soldiers and other taxes; . . .”³

Almost since the earliest days of the federal income tax, Congress has exempted certain organizations from taxation. The exemption to entities organized and operated exclusively for charitable, religious, educational or other purposes carried on for charity is granted because of the benefit the public obtains from their activities and is based on the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.⁴

The Tariff Act of 1894 contained an exemption from federal income tax for nonprofit charitable, religious, and educational organizations, and allowed deductions for contributions given to such charitable organizations.⁵ The Tariff Act of 1909 imposed excise taxes on “every corporation, joint stock company, or association, organized for profit and having a capital stock represented by shares”; however, it exempted from the excise tax, among other organizations, “any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.”⁶ The Revenue Act of 1913 provided an exemption from federal income tax for any “association organized and operated exclusively for religious, charitable, scientific or educational purposes.”⁷

The Internal Revenue Code of 1939, the first codification of federal tax law, provided that any “[c]orporation, and any community chest or fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary or educational purposes or for the prevention of cruelty to children or animals” was exempt from federal income tax.⁸

³ Stat. 43 Eliz., ch. 4 (1601) (Eng.). See, also, *Special Comm’rs of Income Tax v. Pemsel*, 1891 A.C. 531, 583 (H.L. 1891) (Eng.), which states “‘Charity’ in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any of the preceding heads.”

⁴ *Christian Echoes Nat. Ministry, Inc. v. United States*, 470 F.2d 849, 853-854 (10th Cir. 1973) (quoting H.R. Rep. 75-1860 (1939)).

⁵ Tariff Act of 1894, ch. 349, 28 Stat. 509, 556 (1894). The Tariff Act of 1894 was overturned by the Supreme Court on constitutional grounds in *Pollock v. Farmers’ Loan & Trust Company*, 157 U.S. 428 (1895).

⁶ Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 112-13 (1909).

⁷ Revenue Act of 1913, ch. 16, § II(G), 38 Stat. 114, 172 (1913).

⁸ Internal Revenue Code of 1939, ch. 9, subch. C, § 1607(c)(7), 53 Stat. 183, 187 (1939).

The tax exemption for these organizations was recodified as section 501(c)(3) of the Internal Revenue Code of 1954.⁹

C. Section 501(c)(3)

Currently, section 501(c)(3) describes an organization organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office.

The term “charitable” is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of “charity” as developed by judicial decisions.¹⁰ The term charitable includes: relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.¹¹ The term “charitable” also has been said to include “any benevolent or philanthropic objective not prohibited by law or public policy which tends to advance the well-doing and well-being of man.”¹²

D. Organizational And Operational Tests

In order to qualify for exemption under section 501(c)(3), an organization must meet both an “organizational” and an “operational” test. The organizational test generally requires the organization’s articles of organization to limit the organization’s purposes to one or more purposes in section 501(c)(3), and to provide that the organization’s assets are

⁹ Internal Revenue Code of 1954, ch. 1, subch. F, § 501(c)(3), 68A Stat. 3, 97 (1954).

¹⁰ Treas. Reg. § 1.501(c)(3)-1(d)(2).

¹¹ *Id.*

¹² *Peters v. Comm’r*, 21 T.C. 55, 59 (1953) (contribution to organization that furnished free public swimming facilities was a charitable contribution; organization’s primary purpose was to provide swimming and recreation facilities and was within the broad meaning of the term “charitable”).

dedicated to such purposes.¹³ Under the operational test, an organization must engage primarily in activities that accomplish one or more of the exempt purposes specified in section 501(c)(3).¹⁴ Whether an organization meets this test generally is determined by focusing on the organization's purposes for conducting its activities, rather than solely on the nature of the activities themselves.¹⁵

An organization may operate a trade or business as a substantial part of its activities and still meet the operational test if the operation of such trade or business is in furtherance of the organization's exempt purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.¹⁶ In determining an organization's primary purpose, all the facts and circumstances are considered, including the size and extent of any unrelated trade or business activities in relation to the activities carried out in furtherance of exempt purposes.¹⁷ The proportion of an organization's income derived from business activities is not necessarily determinative of whether it meets the operational test, although it may be a factor taken into account in determining the organization's purposes for its activities. For example, in Rev. Rul. 64-182,¹⁸ the IRS ruled that an organization that derived most of its income from commercial rents met the organizational test because it used the income to engage in a charitable grant making program commensurate with its financial resources.¹⁹

E. Private Inurement

To be described in section 501(c)(3), no part of an organization's net earnings may inure to the benefit of any private shareholder or individual.²⁰ This principle has been incorporated in prior laws granting federal income tax exemption for charitable, religious, educational, etc. organizations.²¹ The term "private shareholder or individual" is defined for this

¹³ Treas. Reg. § 1.501(c)(3)-1(b).

¹⁴ Treas. Reg. § 1.501(c)(3)-1(c)(1).

¹⁵ *American Campaign Academy v. Comm'r*, 92 T.C. 1053, 1064 (1989).

¹⁶ Treas. Reg. § 1.501(c)(3)-1(e).

¹⁷ Treas. Reg. § 1.501(c)(3)-1(e)(1).

¹⁸ 1964-1 C.B. 186.

¹⁹ *See, also*, TAM 9711003 (Nov. 8, 1995). Under section 6110(k)(3), technical advice memoranda generally may not be used or cited as precedent. However, they generally may be relied upon as authority for purposes of avoiding accuracy-related penalties in section 6662. Treas. Reg. § 1.6662-4(d)(3)(iii). *See, also*, Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, 744-746 (8th Ed. 2003).

²⁰ I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(2). *See Birmingham Business College, Inc. v. Comm'r*, 276 F.2d 476 (5th Cir. 1950) (tax-exempt school that compensated its three employee shareholders in proportion to their stock ownership did not qualify for exemption because the net earnings of the organization inured to the benefit of its shareholders).

²¹ "In the United States, tax exemption is to be granted only in situations 'in which no man receives a scintilla of individual profit.'" Darryll K. Jones, *Restating The Private Benefit Doctrine For A Brave New World*, 1

purpose to refer to persons having a personal and private interest in the activities of the organization, as distinguished from members of the public with which the organization interacts in carrying out its exempt function.²² Such persons generally are referred to as “insiders” for purposes of the private inurement prohibition. “Insiders” would include, for instance, the organization’s founder, the members of its board and their families, as well as anyone else that fairly can be described as an insider under the facts and circumstances.²³ However, an organization will not fail to qualify merely because it is controlled by its founder (or family members), if it otherwise is operated exclusively for exempt purposes without private inurement of net earnings.²⁴

F. Private Benefit

To meet the operational test, an organization must establish that it is not organized or operated for the benefit of private interests.²⁵ The prohibited private benefits may include any “advantage; profit; fruit; privilege; gain; [or] interest.”²⁶ Economic benefits flowing to persons as an incidental consequence of an organization pursuing its exempt purposes (e.g., reasonable compensation paid by an organization for services necessary to carry out its exempt purposes) does not constitute prohibited private benefit.²⁷

The IRS has taken the position that private benefit is not disqualifying if it is incidental, both in a qualitative and a quantitative sense.²⁸ A private benefit is qualitatively incidental if it is a necessary concomitant of the organization’s activity which benefits the public at large (i.e., the benefit to the public from the organization’s activities cannot be achieved without necessarily benefiting certain private individuals). For example, most tax-exempt organizations could not accomplish their exempt purposes without compensating their employees.

A benefit is quantitatively incidental if it is insubstantial when compared with the overall public benefit conferred by the activity. This is a facts and circumstances test that balances public and private benefit.²⁹ For instance, Rev. Rul. 76-152 provides that an art gallery that displayed and sold the works of artists from a particular area provided more than an insubstantial private benefit because any artist whose work was sold received 90 percent of

Nw. J. Tech. & Intell. Prop. 1, n.23 (2003) (citing 44 Cong. Rec. S4150-51 (1909) (statement of Sen. Bacon) (regarding the enactment of the predecessor to I.R.C. § 501(c)(3))).

²² Treas. Reg. § 1.501(a)-1(c).

²³ *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1176 (7th Cir. 1999).

²⁴ *The Church of the Visible Intelligence That Governs the Universe v. United States*, 226 Ct. Cl. 529 (1981).

²⁵ Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

²⁶ *American Campaign Academy, supra*, 92 T.C. at 1065, 1066 (quoting from *Retired Teachers Legal Fund v. Comm’r*, 78 T.C. 280, 286 (1982)).

²⁷ *Id.* at 1066.

²⁸ GCM 37789 (Dec. 18, 1978).

²⁹ GCM 35701 (Mar. 4, 1974); GCM 39862 (Nov. 22, 1991).

the sales proceeds and the organization received the remaining 10 percent.³⁰ The Tax Court applied this balancing test in the case of a hospital, concluding that the hospital did not qualify for exemption under section 501(c)(3) because of the limited amount of charity care provided in relation to the benefits received by the doctors who founded the hospital and derived substantial laboratory fees from a private laboratory they operated within the hospital.³¹

G. Relationship Between Private Inurement And Private Benefit

The prohibitions against private inurement and private benefit share common elements, but they are not coterminous. The two are distinct requirements which must independently be satisfied.³² While the presence of private inurement would also violate the private benefit rule, the absence of private inurement does not eliminate the possibility that the private benefit rule is violated.³³ Thus, for instance, a transaction with a private person (*i.e.*, a non-exempt corporation, partnership, trust or individual) that is not an insider ordinarily would not be private inurement, although it may result in more than incidental private benefit.³⁴ An incidental amount of private benefit is permissible, whereas no amount of private inurement is permissible.

H. Reasonable Compensation As Prohibited Inurement Or Private Benefit

The Tax Court has stated, “The law places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts.”³⁵ Reasonable compensation for goods or services does not constitute prohibited private inurement, even if paid to an insider.³⁶ In addition, economic benefits, including reasonable compensation for services, flowing to persons as an incidental consequence of an organization pursuing its exempt purposes will not constitute prohibited private

³⁰ 1976-1 C.B. 151.

³¹ *Sonora Community Hospital v. Comm’r*, 46 T.C. 519 (1966), *aff’d*, 397 F.2d 814 (9th Cir. 1968).

³² *American Campaign Academy, supra*, 92 T.C. at 1068.

³³ *Id.*

³⁴ *See, e.g., United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1179 (7th Cir. 1999) (“There was no diversion of charitable revenues to an insider here, nothing that smacks of self-dealing, disloyalty, breach of fiduciary obligation or other misconduct of the type aimed at by a provision of law that forbids a charity to divert its earnings to members of the board or other insiders. What there may have been was imprudence on the part of UCC’s board of directors in hiring W & H and negotiating the contract that it did.”)

³⁵ *World Family Corporation v. Comm’r*, 81 T.C. 958, 969 (1983) (organization that provided financial assistance to missionaries of the Church of Jesus Christ of Latter-Day Saints offered commissions of up to 20 percent to fund raisers who procure contributions for the organization; court held that organization was operated for exempt purposes, and its commissions program does not result in private inurement notwithstanding that its president and incorporator received a 10 percent commission).

³⁶ *Id.*

benefit.³⁷ On the other hand, an organization will fail to qualify for exemption under section 501(c)(3) when its operations confer more than incidental benefit on private interests, even when it does not pay excessive amounts to the private interests.³⁸

1. Definition Of Reasonable Compensation

In determining whether compensation paid by tax-exempt organizations for services is reasonable (and therefore not prohibited private inurement or private benefit under the rules discussed above), the courts have considered, among other things, whether comparable services would cost as much if obtained from an outside source in an arm's length transaction and whether the compensation would qualify as a deduction under section 162 (relating to the deduction for ordinary and necessary business expenses).³⁹ For purposes of section 162, reasonable compensation is the amount that ordinarily would be paid for like services by like enterprises under like circumstances.⁴⁰ The determination of whether compensation is reasonable is essentially a question of fact, and is based on the sum of all compensation, deferred as well as current.⁴¹

The factors considered in determining whether compensation is reasonable may include the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the organization's gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of

³⁷ *American Campaign Academy, supra*, 92 T.C. at 1066.

³⁸ *See, e.g., P.L.L. Scholarship Fund v. Comm'r*, 82 T.C. 196 (1984) (organization formed by owners of lounge to raise funds for charity operated bingo games exclusively at lounge, which sold food and beverages to bingo players, failed to qualify because of private benefit to owners of lounge); *KJ's Fund Raisers, Inc. v. Comm'r*, T.C. Memo. 1997-424 (organization formed by owners of lounge to raise funds for charity sold lottery tickets exclusively at lounge failed to qualify because of private benefit to owners of lounge); *Westward Ho v. Comm'r*, T.C. Memo. 1992-192 (1992) (organization formed by business owners to rid area where businesses were located of disruptive homeless persons failed to qualify because of private benefit to business owners); *Housing Pioneers v. Comm'r*, T.C. Memo. 1993-120 (non-profit low-income housing organization formed by for-profit real estate partnerships to take advantage of state property tax benefits failed to qualify because of private benefit to partnerships).

³⁹ *John Marshall Law School v. United States*, 228 Cl. Ct. 902 (1981); *B.H.W. Anesthesia Foundation, Inc. v. Comm'r*, 72 T.C. 681 (1979); *Church of The Transfiguring Spirit v. Comm'r*, 76 T.C. 1 (1981); *Bill Wildt's Motorcycle Advancement Crusade v. Comm'r*, T.C. Memo 1989-93.

⁴⁰ Treas. Reg. § 1.162-7(b)(3). The circumstances to be taken into consideration are those existing at the date the contract for services was made, not those existing at the date the contract is questioned. *Id.*

⁴¹ *Heil Beauty Supplies v. Comm'r*, 199 F.2d 193 (8th Cir. 1952); *Edwin's, Inc. v. United States*, 501 F.2d 675 (7th Cir. 1974); *Mayson Manufacturing Co. v. Comm'r*, 178 F.2d 115 (6th Cir. 1949).

compensation paid to the particular employee in previous years.⁴² Although no single factor is determinative, in *Mayson Manufacturing Co. v. Commissioner*, the Court stated, “The action of the Board of Directors of a corporation in voting salaries for any given period is entitled to the presumption that such salaries are reasonable and proper.”⁴³

In *Mabee Petroleum Corp. v. United States*, the court concluded that the salary paid to an organization’s founder and president was not reasonable in relation to the services performed, and such payment constituted prohibited private inurement under section 501(c)(3), stating, “We think it doubtful whether comparable services would have cost as much had they been acquired in an arms-length transaction from an outside source.”⁴⁴ When insiders have unfettered access to the organization’s assets, or control the setting of their own compensation, payments are subject to a higher level of scrutiny in determining whether the resulting payments are reasonable compensation.⁴⁵

On the other hand, the payment of large salaries and other benefits can be reasonable, considering the nature of the services provided.⁴⁶ The IRS Office of Chief Counsel concluded that an unfunded deferred compensation arrangement provided by a university-affiliated foundation to the university’s football coaches, outside the university’s regular compensation system, was permissible. The foundation also paid additional salaries, life insurance, moving expenses, bonuses and payments of additional amounts when teams competed in post-season football bowl games. The Office of Chief Counsel concluded that the arrangement did not result in prohibited private benefit, in part because the arrangement was the result of arm’s-length bargaining.⁴⁷

2. Intermediate Sanctions Rules

In 1996, the Taxpayer Bill of Rights 2 added section 4958 to the Code.⁴⁸ Section 4958 imposes excise taxes (commonly referred to as “intermediate sanctions”) in cases when an “applicable tax-exempt organization” engages in an “excess benefit transaction” with a “disqualified person” (generally, a person with substantial influence over the organization at any time during the five-year period prior to the transaction at issue, and certain related persons). This excise tax is paid by the disqualified person, rather than the organization. In

⁴² *Mayson Manufacturing Co.*, *supra*, 178 F.2d at 119.

⁴³ *Id.*

⁴⁴ 203 F.2d 872, 876 (5th Cir.1953) (holding organization not exempt as charity).

⁴⁵ *See Founding Church of Scientology v. United States*, 412 F.2d 1197 (Ct. Cl.1969), *cert. denied*, 397 U.S. 1009 (1970) (church not entitled to exemption when founder was paid, in addition to his salary, commissions and royalties and where he and his family received unexplained payments in nature of loans and reimbursements); *Bubbling Well Church Of Universal Love, Inc. v. Comm’r*, 74 T.C. 531 (1980), *aff’d*, 670 F.2d 104 (9th Cir.1981) (similar facts and result).

⁴⁶ *See, e.g., B.H.W. Anesthesia Foundation, Inc. v. Comm’r*, 72 T.C. 681 (1979).

⁴⁷ GCM 39670 (Oct. 14, 1987).

⁴⁸ Taxpayer Bill of Rights 2 § 1311, 110 Stat. 1452, 1475-1479 (1996).

addition, excise taxes are imposed on any organization manager (generally, an officer, director, or trustee, or person with similar authority) who knowingly, willfully, and without reasonable cause participates in an excess benefit transaction.⁴⁹

An “applicable tax-exempt organization” generally is any tax-exempt organization described in section 501(c)(3) or section 501(c)(4), and any organization that was such an organization during the five-year period preceding the date of the transaction in question.⁵⁰ An applicable tax-exempt organization does not include a private foundation, nor does it include any governmental entity that is exempt from federal income taxation without regard to section 501(a) (generally, a state, or a political subdivision, or an integral part thereof, or an organization the income of which is excluded from gross income under section 115), or certain affiliates of governmental units that are not required to file annual returns.⁵¹

An “excess benefit transaction” generally is any transaction in which an economic benefit is provided by a tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received by the organization in return. This includes any compensation paid by the tax-exempt organization to a disqualified person that exceeds reasonable compensation for services provided by the disqualified person to the organization.⁵²

The legislative history of section 4958 states, “[T]he Committee intends that an individual need not necessarily accept reduced compensation merely because he or she renders services to a tax-exempt, as opposed to a taxable, organization.”⁵³ “Reasonable compensation” is defined as the amount that would ordinarily be paid for like services by like enterprises under like circumstances, using the existing tax-law standards of section 162 in determining the reasonableness of compensation.⁵⁴

⁴⁹ I.R.C. §§ 4958(a)(2), 4958(d)(2), 4958(f)(2).

⁵⁰ I.R.C. § 4958(e).

⁵¹ Treas. Reg. § 53.4958-2(a). Under Treas. Reg. § 1.6033-2(g)(6), the IRS Commissioner is given the authority to relieve any organization or class of organizations from filing annual returns that would otherwise be required under section 6033 where he (or she) determines that such returns are not necessary for the efficient administration of the internal revenue laws. This authority has been exercised in Rev. Proc. 83-23, 1983- 1 C.B. 687 and Rev. Proc. 95-48, 1995- 2 C.B. 418.

⁵² The legislative history of section 4958 states, “[E]xcess benefit transactions” subject to excise taxes include transactions in which a disqualified person engages in a non-fair-market-value transaction with an organization or receives unreasonable compensation, as well as financial arrangements (to the extent provided in Treasury regulations) under which a disqualified person receives payment based on the organization's income in a transaction that violates the present-law private inurement prohibition.” H.R. Rep. 104-506, at 56 (1996).

⁵³ H.R. Rep. 104-50, at 56, n.5.

⁵⁴ Treas. Reg. § 53.4958-4(b)(1)(ii)(A).

3. Benchmarking To For-Profits

In establishing what is reasonable compensation, comparability data from both taxable and tax-exempt organizations for functionally comparable positions may be used. The regulations under section 4958 setting the valuation standards for purposes of the intermediate sanctions provisions state, “The value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation).”⁵⁵

For purposes of section 4958, payments under a compensation arrangement will be presumed to be reasonable if certain procedural requirements are met.⁵⁶ In general, the parties to a transaction are entitled to rely on a rebuttable presumption of reasonableness with respect to a compensation arrangement between a tax-exempt organization and a disqualified person if such arrangement was approved by a board of directors or trustees (or committee thereof) that, *inter alia*, obtained and relied upon appropriate data as to comparability (e.g., compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys by nationally recognized independent firms; or actual written offers from similar institutions competing for the services of the disqualified person.⁵⁷ The IRS can rebut the presumption of reasonableness only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied on by the approving body.⁵⁸

III. EDUCATION AS AN EXEMPT PURPOSE UNDER SECTION 501(c)(3)

A. Definition Of Education

Under the common law of charity and charitable trusts, a trust to further educational purposes is considered charitable.⁵⁹ Recognition of the tax-exempt status of educational organizations under federal law dates as far back as the Tariff Act of 1894.⁶⁰

The term “educational”, as used in section 501(c)(3), relates to: (a) the instruction or training of the individual for the purpose of improving or developing his capabilities, or (b)

⁵⁵ *Id.*

⁵⁶ Treas. Reg. § 53.4958-6.

⁵⁷ Treas. Reg. § 53.4958-6(c)(2)(i) (emphasis added). *See, also*, H.R. Rep. 104-506, at 57.

⁵⁸ Treas. Reg. § 53.4958-6(b).

⁵⁹ Restatement (Third) of Trusts § 28 (2003).

⁶⁰ *See, generally*, Joint Committee on Taxation *Historical Development And Present Law Of The Federal Tax Exemption For Charities And Other Tax-Exempt Organizations*, 109th Cong. (2005).

the instruction of the public on subjects useful to the individual and beneficial to the community.⁶¹

B. Types Of Exempt Educational Organizations

1. Schools, Colleges, And Universities

One definition of a “school” for federal income tax purposes is an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on, such as, for example, public and private primary, secondary and high schools, colleges and universities, and vocational or trade schools.⁶²

2. Other Organizations That Further Educational Purposes

Organizations that conduct vocational or job skills training are recognized as educational.⁶³ An organization that grants scholarships to students furthers educational purposes.⁶⁴ An organization may further a school’s educational purposes by providing financial or other assistance to the school’s athletic program. Rev. Rul. 67-291 provides that a nonprofit organization that subsidized a “training table” for coaches and members of a university’s athletic teams furthered the educational purposes of the university.⁶⁵ Meals were prepared and served by the university’s personnel in a dining room separate from the university’s regular eating facilities. The organization provided funding for the program from dues and contributions from its members, who were university alumni. As the university’s athletic program was an integral part of its overall education activities, and the organization’s activities contributed to the operation of the university’s athletic program, the organization’s activities furthered the university’s educational purposes.

Alumni associations and similar organizations can further the advancement of education by fostering a spirit of loyalty and fraternity among students and alumni, and by effecting

⁶¹ Treas. Reg. § 1.501(c)(3)-1(d)(3).

⁶² I.R.C. § 170(b)(1)(A)(ii); Treas. Reg. § 1.170A-9(b)(1).

⁶³ See, e.g., Rev. Rul. 73-128, 1973-1 C.B. 222 (vocational training for unemployed individuals); Rev. Rul. 77-272, 1977-2 C.B. 191 (training in skilled trade to American Indians); Rev. Rul. 72-101, 1972-1 C.B. 144 (skills training for employment in a particular industry); Rev. Rul. 76-37, 1976-1 C.B. 149 (training employees of commercial businesses); Rev. Rul. 68-504, 1968-2 C.B. 211 (same); Rev. Rul. 67-150, 1967-1 C.B. 133 (training prisoners); Rev. Rul. 76-205, 1976-1 C.B. 154 (teaching and counseling recent immigrants).

⁶⁴ Rev. Rul. 69-257, 1969-1 C.B. 151; Rev. Rul. 66-103, 1966-1 C.B. 134.

⁶⁵ 1967-2 C.B. 184.

united action in promoting the general welfare of the college or university as an educational institution.⁶⁶

Other organizations may qualify for exemption if they are operated as an integral part of an educational organization's performance of its educational purposes. For example, an organization that operates a university book store⁶⁷ and an organization furnishing housing to students⁶⁸ qualify for exemption because they further the university's educational purposes.

In addition, many other types of organizations are recognized as furthering educational purposes within the meaning of section 501(c)(3), such as museums, zoos, planetariums, symphony orchestras, etc.⁶⁹ Other types of educational organizations and activities are discussed further below.

C. Physical Education As An Exempt Educational Purpose

It is axiomatic that education is not limited to the improvement and cultivation of the mind, but also includes the development of one's physical abilities. Since the time of the Greeks and Romans, at least, it has been accepted that physical education is an essential part of becoming an "educated" person.⁷⁰ As a result, almost all public and private elementary and secondary schools, colleges, and universities include physical education in their curricula. Many schools have academic programs leading to a degree in physical education.

The courts have long held that the goals of an educational institution include the mental, moral, and physical development of students, which includes athletic activities and the

⁶⁶ Rev. Rul. 56-486, 1956-2 C.B. 309; Rev. Rul. 60-143, 1960-2 C.B. 192.

⁶⁷ Rev. Rul. 58-194, 1958-1 C.B. 240. *See also Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951).

⁶⁸ Rev. Rul. 76-336, 1976-2 C.B. 143. *See also* Rev. Rul. 64-274, 1964-2 C.B. 141 (free housing, books and supplies); Rev. Rul. 63-220, 1963-2 C.B. 208 (low-interest college loans); and Rev. Rul. 61-87, 1961-1 C.B. 191 (same).

⁶⁹ Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii), *Examples* (2), (3), and (4); Rev. Rul. 79-369, 1979-2 C.B. 226 (organization records and sells symphonic and chamber music by new or under-appreciated composers primarily to schools is exempt as an educational organization); Rev. Rul. 73-45, 1973-1 C.B. 220 (organization sponsoring professional theater productions); and Rev. Rul. 65-271, 1965-2 C.B. 161 (promoting jazz).

⁷⁰ In Plato's imaginary ideal republic, the goal of education is to produce citizens schooled in philosophy and skilled in athletics, excellent in both mind and body, and the proper way to cultivate a temperate, well-balanced character is to carefully blend intellectual study and physical exercise. Plato, *The Republic of Plato* (Allan Bloom trans., Basic Books, 2d. ed. 1991). Later, the Romans adopted this ideal as "*mens sana in corpore sano*" ("a healthy mind in a healthy body").

necessary facilities for such activities, and that the physical development of a student is as essential to his well-being as is his mental development.⁷¹

Nonprofit organizations other than schools that sponsor or promote sports for children (e.g., Little League teams) generally are considered charitable and educational.⁷² For example, an organization that holds sports clinics for children in schools, playgrounds, and parks, and provides instruction, equipment, and facilities is charitable and educational.⁷³

There is no age limitation on physical education. An organization that provides instruction in a sport to individuals of all ages and skill levels qualifies as an educational organization. For example, Rev. Rul. 77-365 provides that an organization that instructed and educated individuals of all ages and skill levels in a particular sport, by conducting clinics, workshops, lessons and seminars at municipal parks and recreational areas, qualified for exemption under section 501(c)(3) as an educational organization.⁷⁴ “[T]he definition of ‘educational’ provided in section 1.501(c)(3)-1(d)(3) of the regulations contains no limitation with regard to age in defining that term. Therefore, by instructing individuals of all ages in a given sport in the manner described, the above organization is instructing or training individuals for the purpose of improving or developing their capabilities”).⁷⁵ Likewise, Rev. Rul. 64-275 provides that an organization formed for the purpose of training individuals in the techniques of racing sailboats in national and international competition, and thereby improving the caliber of candidates representing the United States in Olympic and Pan-American games, qualifies for exemption as an educational organization.⁷⁶

⁷¹ See, e.g., *German Gymnastic Ass’n of Louisville v. City of Louisville*, 80 S.W. 201 (Ky. Ct. App. 1904) (gymnastic association held to be educational institution exempt from state tax); *State ex rel. School District No. 56, Chelan County v. Superior Court of Chelan County*, 124 P. 484 (Wash. 1912) (condemnation of land for school athletic field upheld); *Shannon & Luchs Const. Co., Inc. v. Shillington*, 17 F.2d 219 (D.C. Cir. 1926) (condemnation of land for school athletic field upheld; such use held to be an “essential part of a modern educational institution”).

⁷² See, e.g., *Hutchinson Baseball Enterprises, Inc. v. Comm’r*, 73 T.C. 144, *aff’d*, 696 F.2d 757 (10th Cir. 1982), *nonacq.*, 1980-2 C.B. 2 (discussed below).

⁷³ Rev. Rul. 65-2, 1965-1 C.B. 227.

⁷⁴ 1977-2 C.B. 192.

⁷⁵ *Id.*

⁷⁶ 1964-2 C.B. 142. Rev. Rul. 64-275 presumably does not mention fostering national or international amateur sports competition as a ground for exemption because it predates the 1976 amendment of section 501(c)(3) discussed below.

D. Amateur Sports Competition As An Exempt Purpose

1. 1976 Amendment of Section 501(c)(3)

Currently, section 501(c)(3) expressly provides that organizations fostering national or international amateur sports competition may qualify for exemption. Prior to 1976, however, there was no specific language in section 501(c)(3) concerning amateur athletic competition, and there was a lack of clarity as to the circumstances under which amateur sports organizations could qualify for exemption under section 501(c)(3).⁷⁷ In 1976, Congress found that some amateur sports organizations were recognized as tax-exempt under section 501(c)(3), while others, apparently equally deserving, were recognized as tax-exempt under other provisions (e.g., section 501(c)(4) or section 501(6)), and, as a result, did not qualify to receive tax-deductible contributions.⁷⁸ To clarify the requirements for amateur athletic organizations to qualify for tax-exempt status under section 501(c)(3), Congress in 1976 decided that it is, in general, appropriate to treat the fostering of national or international amateur sports competition as a charitable purpose under section 501(c)(3). The Tax Reform Act of 1976 amended section 501(c)(3) to provide that an organization the primary purpose of which is to foster national or international amateur sports competition may qualify as a tax-exempt organization described in section 501(c)(3) and receive tax-deductible contributions, with the limitation that such an organization may not make available athletic equipment or facilities.⁷⁹ This limitation was intended to prevent tax-exemption under section 501(c)(3) of organizations (e.g., social clubs) that provide facilities and equipment for their members, and was not intended to adversely affect the qualification for tax-exempt status of any organization which would qualify under the standards of prior law.⁸⁰ In any event, this restriction was later modified.⁸¹

2. *Hutchinson Baseball Enterprises, Inc. v. Commissioner*

In *Hutchinson Baseball Enterprises, Inc. v. Commissioner*, the Tax Court considered the qualification for exemption under section 501(c)(3) of an organization that owned and operated an amateur baseball team, among other activities.⁸² The organization's amended

⁷⁷ See, e.g., Rev. Rul. 65-2, 1965-1 C.B. 227 (organization that holds sports clinics for children in schools, playgrounds, and parks, and provides instruction, equipment, and facilities is exempt under section 501(c)(3); Rev. Rul. 70-4, 1970-1 C.B. 126 (organization the purpose of which was to promote the health of the general public by, among other things, promoting and regulating a sport for amateurs did not qualify for exemption under section 501(c)(3), although it qualified for exemption under section 501(c)(4)).

⁷⁸ H.R. Conf. Rep. 94-1515, at 542 (1976).

⁷⁹ Tax Reform Act of 1976 § 1313, 90 Stat. 1520, 1730 (1976).

⁸⁰ Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 70-71 (1976).

⁸¹ See, discussion in Section III.D.3 below.

⁸² 73 T.C. 144, *aff'd*, 696 F.2d 757 (10th Cir. 1982), *nonacq.*, 1980-2 C.B. 2.

articles of incorporation provided that one of the purposes of the corporation was to “[p]romote, advance and sponsor baseball, which shall include Little League and Amateur Baseball, in the Hutchinson, Kansas area.” The organization owned and operated an amateur baseball team composed primarily of college baseball players. It leased a playing field from the city, which was used by the team. The organization also permitted Little League and American Legion baseball teams for youths 14 to 18 years of age, and a baseball camp for children 7 to 12 years of age operated by the city, to use the field at no charge. The organization also furnished instructors for the baseball camp and provided coaches for the Little League teams.

As a result of an examination of the taxpayer's activities for the fiscal years ended July 31, 1974, and July 31, 1975, the IRS concluded that the organization no longer qualified for exemption under section 501(c)(3) and revoked the organization's tax-exempt status. Although the Tax Court applied section 501(c)(3) as in effect prior to its amendment in 1976, the court analyzed the legislative history of the 1976 amendment of section 501(c)(3) and concluded that Congress has long considered amateur athletics to fall within the penumbra of section 501(c)(3) (i.e., even before the 1976 amendment).⁸³

On appeal, the IRS argued that, under the law as it existed prior to amendment in 1976, fostering amateur sports competition, without more, was not a charitable purpose - otherwise the amendment of section 501(c)(3) in 1976 would not have been necessary. The United States Court of Appeals for the Tenth Circuit affirmed the Tax Court's decision. The Court of Appeals agreed with the Tax Court that Congress considered that, under the law as it existed prior to amendment in 1976, the advancement of amateur athletics was a charitable activity. However, the Circuit Court did not base its conclusion about the state of the law prior to 1976 on the subsequent legislative history, but rather was persuaded by its analysis of the wording of the statute and its proper construction that the Tax Court reached the right conclusion in holding that the furtherance of recreational and amateur sports falls within the broad outline of charity and should be so classified.⁸⁴

3. 1982 Enactment Of Section 501(j)

In 1982, section 501(j) was added to the Code in order to relax the restriction in section 501(c)(3) against the provision of facilities or equipment that was added in 1976.⁸⁵ Congress believed that many amateur sports organizations provided facilities to their members, and concluded that such organizations should be encouraged to continue the sponsorship of, and training for, national and international sports competition.⁸⁶

⁸³ 73 T.C. at 153.

⁸⁴ 696 F.2d at 762.

⁸⁵ Tax Equity and Fiscal Responsibility Act of 1982 § 286, 96 Stat. 324, 569-570 (1982).

⁸⁶ Joint Committee on Taxation, Explanation of the Revenue Provisions of the Tax Equality and Fiscal Responsibility Act of 1982, 97th Cong., 438 (1982).

Section 501(j) provides that an organization that is organized and operated exclusively to foster national or international amateur sports competition may qualify under section 501(c)(3), whether or not the organization provides facilities or equipment to its members, if such organization is also organized and operated primarily to conduct national or international competition in sports or to support and develop amateur athletes for national or international competition in sports.

E. Intercollegiate Athletic Competition As An Exempt Educational Purpose

Congress has long recognized the educational value of athletic competition at the college and university level and that income derived from intercollegiate athletic competition is substantially related to the educational functions of colleges and universities. The legislative history of the Revenue Act of 1950⁸⁷ indicates that both the House and Senate agreed on this point. The Senate Report states, “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.”⁸⁸ The House Report states, “Of course, 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.”⁸⁹

The courts have held that sponsoring athletic competition at the college level furthers exempt purposes in section 501(c)(3). For example, in *Mobile Arts and Sports Ass’n v. United States*, the court held that an organization that sponsored an annual college all-star football game (the “Senior Bowl Classic”) qualified for exemption under section 501(c)(3).⁹⁰ The Senior Bowl game originated as a for-profit enterprise by residents of Tennessee. After the first two bowl games each resulted in a loss, a non-profit corporation was formed that would put on the bowl game and also would conduct other artistic and educational activities that would benefit the Mobile, Alabama, community. The corporation’s charter provided that the corporation was permitted to accumulate earnings, to be disbursed as its Board of Trustees directed “to or on behalf of persons, firms, associations, societies or corporations ... whose primary purpose is devoted to a betterment and advancement of the civic, social, cultural, recreational and artistic life of the Community of Mobile and its environs.”⁹¹ In addition to the Senior Bowl, the corporation also sponsored an annual collegiate basketball tournament, outdoor symphony concerts, ballet performances, choral performances, and (jointly with another tax-exempt organization) a recreational program for youth. The organization’s only activity that

⁸⁷ Revenue Act of 1950, 64 Stat. 906 (1950).

⁸⁸ S. Rep. 81-2375, 1950-2 C.B. 483, 505 (1950).

⁸⁹ H.R. Rep. 1-2319, 1950-2 C.B. 380, 458 (1950).

⁹⁰ 148 F. Supp. 311 (S.D. Ala. 1957).

⁹¹ 148 F. Supp. at 314.

resulted in any net income was the Senior Bowl game, which was broadcast on a national and international radio network.⁹²

The IRS asserted that the organization sponsored the Senior Bowl game for the purpose of making a profit, like any normal business venture. The court held that the organization qualified for exemption from federal income tax under the predecessors to section 501(c)(3) and section 501(c)(4), based on its finding that the annual Senior Bowl game resulted in considerable benefit to the community because of the favorable publicity for Mobile that the game engendered, the large number of out of town visitors it brought to the city, and “the inspirational value to the youths of the city of Mobile and surrounding community in respect to their own recreational activities.”⁹³ The court also held that the game was an integral part of the organization’s civic and educational program and therefore was substantially related to the organization’s furtherance of its exempt purposes.⁹⁴

F. Regulating Intercollegiate Athletic Competition As An Exempt Purpose

Organizations that set standards and regulate intercollegiate athletic competition further exempt purposes. Rev. Rul. 55-587 describes a nonprofit interscholastic athletic association formed for the purposes of promoting and protecting the health of high school athletes through uniform interscholastic competition under the direction and control of school officials, and cultivating the ideals of good sportsmanship, loyalty and fair play.⁹⁵ The organization’s members consisted of public high schools in a particular state. The association directed and controlled interscholastic high school athletic competition, prescribed eligibility rules for contestants and penalties for the violation of such rules, as well as the rules of play in the various sports, conducted sectional, district and state competition, arranged schedules for contests, trained and assigned game officials, and made suitable awards in state competitions. The organization’s income was derived from school dues, registration, membership fees, and a percentage of gate receipts from the competition events. Based on these activities, Rev. Rul. 55-587 held that the organization is organized and operated primarily for educational purposes in section 501(c)(3).

The Supreme Court has recognized the importance of regulating intercollegiate athletic competition in order to preserve amateurism in college sports. In *NCAA v. Board of Regents of the University of Oklahoma*, a case challenging NCAA’s plan for televising the college football games of its member institutions as a restraint of trade under federal anti-trust laws, the Supreme Court stated,

⁹² 148 F. Supp. at 316.

⁹³ 148 F. Supp. at 313.

⁹⁴ 148 F. Supp. at 316.

⁹⁵ 1955-2 C.B. 261.

The NCAA plays a critical role in the maintenance of a revered tradition of amateurism in college sports. There can be no question but that it needs ample latitude to play that role, or that the preservation of the student-athlete in higher education adds richness and diversity to intercollegiate athletics and is entirely consistent with the goals of the Sherman Act.⁹⁶

G. Other Charitable Purposes

In addition to “educational” purposes, educational activities, including those relating to intercollegiate athletics, can be said to further “charitable” purposes as well.

1. Advancement of Education Or Science

Educational or scientific organizations generally not only qualify as “educational” or “scientific” under section 501(c)(3) but also qualify as “charitable” under section 501(c)(3). It is generally acknowledged that there is no substantive difference between the term “education” and the term “charitable” for this purpose.⁹⁷ The IRS, in ruling that an organization is educational, frequently also finds it to be charitable.⁹⁸

2. Relief of the Poor or Distressed

As noted above, the term “charitable”, for purposes of section 501(c)(3) includes, in addition to advancement of education, relief of the poor and distressed or of the underprivileged, lessening neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights, and combating community deterioration and juvenile delinquency.⁹⁹ Many intercollegiate athletic programs further these purposes, as well as educational purposes.

3. Lessening the Burdens of Government

The term “charitable” in section 501(c)(3) also includes lessening the burdens of government.¹⁰⁰ Generally, in order to be considered to be lessening the burdens of government, an organization must be performing a function that the government has taken

⁹⁶ 468 U.S. 85, 120 (1984).

⁹⁷ See Treas. Reg. § 1.501(c)(3)-1(d)(2) (“The term ‘charitable’ is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of ‘charity’ as developed by judicial decisions.”).

⁹⁸ Hopkins, *supra*, at 167-168.

⁹⁹ See, discussion in Section II.C. above.

¹⁰⁰ Treas. Reg. § 1.501(c)(3)-1(d)(2).

on as its burden, and the organization's activities must actually lessen that burden.¹⁰¹ By founding and operating institutions of higher education, each of the states, countless political subdivisions of such states and even the federal government¹⁰² have indicated that they consider the education, past the high school level, of its citizens to be its obligation, which public colleges and universities lessen.

II. Unrelated Business Income Tax Treatment of Income From Athletic Events

A. Unrelated Business Income Tax, Generally

An organization that is exempt from federal income tax under section 501(a) is nevertheless subject to unrelated business income tax ("UBIT") on its unrelated business taxable income ("UBTI"), as provided in sections 511-514. Section 511(a)(2)(B) also imposes UBIT on the UBTI of state colleges and universities and corporations wholly owned by state colleges and universities.

UBTI is generally defined as gross income generated from any trade or business regularly carried on by the organization, the conduct of which is not substantially related (other than the organization's need for income or the use it makes of the profits derived) to the organization's exercise or performance of its exempt purpose or function, less the deductions allowed under Chapter 1 of the Code that are directly connected with the carrying on of such trade or business, and subject to the modifications provided in section 512(b).¹⁰³

A trade or business is considered to be substantially related to an organization's exempt purposes only where the conduct of the business activities has a causal relationship to the organization's achievement of its exempt purposes (other than through the production of income), and it is "substantially related" only if this causal relationship is a substantial one. Thus, in order for the conduct of a trade or business from which an item of gross income is derived to be substantially related to an organization's exempt purposes, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of such purposes. Whether

¹⁰¹ Various types of activities that assist state and local governments in carrying out their functions have been recognized as charitable on the basis that they lessen the burdens of government. *See, e.g.*, Rev. Rul. 85-1, 1985-1 C.B. 17 (providing funds to local police department to buy illegal drugs as part of its law enforcement activities); Rev. Rul. 85-2, 1985-1 C.B. 178 (recruiting, training, and providing support for guardians ad litem in state legal proceedings); Rev. Rul. 70-583, 1970-2 CB 114 (development and management of community correctional centers to rehabilitate prisoners in cooperation with local courts and custodial agencies).

¹⁰² *E.g.*, The Graduate School of The United States Department of Agriculture.

¹⁰³ I.R.C. § 512(a).

income-producing activities contribute importantly to the accomplishment of any exempt purpose depends in each case upon the particular facts and circumstances involved.¹⁰⁴

The fact that a tax-exempt organization carries on an unrelated trade or business as a substantial part of its activities does not jeopardize the organization's tax-exempt status, so long as the organization continues to be operated primarily for exempt purposes.¹⁰⁵ The UBIT is intended to "level the playing field" between taxable and tax-exempt organizations conducting business activities, and to remove the advantage a tax-exempt organization has in conducting unrelated business activities in competition with entities that must pay income tax. As the Supreme Court explained,

[In enacting the Revenue Act of 1950,] Congress perceived a need to restrain the unfair competition fostered by the tax laws. See H.R. Rep. No. 2319, 81st Cong., 2d Sess., 36-37 (1950). Nevertheless, Congress did not force exempt organizations to abandon all commercial ventures, nor did it levy a tax only upon businesses that bore no relation at all to the tax-exempt purposes of an organization, as some of the 1950 Act's proponents had suggested. See, e.g., 1950 House Hearings, at 4, 19, 165. Rather, in the 1950 Act it struck a balance between its two objectives of encouraging benevolent enterprise and restraining unfair competition by imposing a tax on the 'unrelated business taxable income' of tax-exempt organizations. 26 U.S.C. § 511(a)(1).¹⁰⁶

B. UBTI Exceptions And Exclusions

Certain types of business activities are excepted from the definition of unrelated trade or business, including (among others) any trade or business in which substantially all of the labor is performed for the organization without compensation, or which is the selling of merchandise, substantially all of which has been donated to the organization.¹⁰⁷ In addition, certain intermittent income producing activities are not treated as a trade or business that is regularly carried on. For example, income producing or fundraising

¹⁰⁴ Treas. Reg. § 1.513-1(d)(2).

¹⁰⁵ Treas. Reg. § 1.501(c)(3)-1(e)(1). See GCM 34682 (Nov. 17, 1971) ("[A]side from express statutory limitations on business activity, such as section 502 and the newly enacted provisions relating to private foundations, there is no quantitative limitation on the 'amount' of unrelated business an organization may engage in under section 501(c)(3), other than that implicit in the fundamental requirement of charity law that charity properties must be administered exclusively in the beneficial interest of the charitable purpose to which the property is dedicated.").

¹⁰⁶ *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986). See, also, *United States v. Dykema*, 666 F.2d 1096, 1102 (7th Cir. 1981) ("The post-1950 system was also more satisfactory than the old in that it permitted a tax-exempt organization to engage in an unrelated profit-making trade or business without risking the complete loss of tax-exempt status. Previously such status was jeopardized by engaging in substantial unrelated commercial operations.").

¹⁰⁷ I.R.C. § 513(a).

activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fundraising event for charity is not income from a trade or business regularly carried on.¹⁰⁸

Section 512(b) excludes other types of income from UBTI, including certain “passive” types of income such as dividends, interest, rents from real property, and gains from the sale of property other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of the trade or business.¹⁰⁹ In addition, all royalties are excluded, whether measured by production or by gross or taxable income from the property.¹¹⁰ Payments for the use of intangible property such as trademarks, trade names, service marks, patents and copyrights, are ordinarily classified as royalties for this purpose.¹¹¹

C. UBIT Treatment of University Income From Ticket Sales And Broadcast Rights

It has long been acknowledged that a university’s athletic program is substantially related to the university’s performance of its educational purposes, and the university’s income from its athletic program is not UBTI. As stated above, Congress has long recognized that income derived from intercollegiate athletic competition is substantially related to the educational functions of colleges and universities. The legislative history of the Revenue Act of 1950, cited above, indicates that both the House and Senate agreed on this point.

The IRS has generally taken the same view with respect to ticket sales. However, in 1977, the IRS attempted to tax the income from sales of broadcast rights to college football and basketball games, and notified several universities and the Cotton Bowl Athletic Association (a tax-exempt entity that presents the annual Cotton Bowl football game) that their revenue from the sales of such broadcasting rights is UBTI. The IRS agreed that ticket receipts were not subject to tax, based on the legislative history of the 1950 Act, but sought to distinguish broadcasting revenues on the basis that the legislative history was

¹⁰⁸ Treas. Reg. § 1.513-1(c)(2)(iii). See *Nat’l Collegiate Athletic Ass’n. v. Comm’r*, 914 F.2d 1417 (10th Cir. 1990) (“[T]he NCAA program [Official Souvenir Program for the 1982 Final Four], which is published only once a year, should not be considered an unfair competitor for the publishers of advertising. Application of the unrelated business tax here therefore would not further the statutory purpose. We hold that the NCAA’s advertising business was not regularly carried on within the meaning of the Code.”).

¹⁰⁹ I.R.C. §§ 512(b)(1), (3) and (5).

¹¹⁰ I.R.C. § 512(b)(2).

¹¹¹ A royalty generally is a payment for the use of a valuable right; payments for personal services are not royalties. Rev. Rul. 81-178, 1981-2 C.B. 135.

silent with respect to broadcasting revenues.¹¹² This resulted in an immediate public outcry from supporters of intercollegiate athletics.¹¹³

Shortly thereafter, the IRS conceded that there is no meaningful distinction between exhibiting a game to a limited, live audience and exhibiting the game on television to a much larger audience.¹¹⁴ The IRS concluded that a university's income from the sale of radio and television broadcast rights is not UBTI because -

an audience for a game may contribute importantly to the education of the student-athlete in the development of his/her physical and inner strength and to the education of the student body and the community-at-large in heightening interests in and knowledge about the participating schools. In regard to the student-athlete, the knowledge that an event is being observed heightens its significance, which raises the levels of both competitive effort and enjoyment. Attending the game enhances student interest in education generally and in the institution because such interest is whetted by exposure to a school's athletic activities. Moreover, the games (and the opportunity to observe them) foster those feelings of identification, loyalty, and participation typical of a well-rounded educational experience."¹¹⁵

In 1980, the IRS formally conceded the issue. Rev. Rul. 80-295 provides that income from the sale of broadcasting rights by an amateur athletic union is not an unrelated trade or business.¹¹⁶ Rev. Rul. 80-296 holds that the sale of broadcasting rights to a national radio and television network by an organization created by a regional collegiate athletic conference made up of universities to hold an annual athletic event is not an unrelated trade or business, stating, "An athletic program is considered to be an integral part of the educational process of a university, and activities providing necessary services to student athletes and coaches further the educational purposes of the university."¹¹⁷

D. Other Benefits Of Broadcasting Athletic Competition

Tax-exempt organizations conduct extensive activities for the purpose of enhancing their public image, attracting contributions, and earning income (see discussion of fundraising,

¹¹² See discussion in Hopkins, *supra*, at 778, n.345.

¹¹³ See James L. Musselman, *Recent Federal Income Tax Issues Regarding Professionalism and Amateur Sports*, 13 Marq. Sports L. Rev. 195, 207-208 (2003).

¹¹⁴ See GCM 37618 (July 28, 1978); TAM 7851002 (1978) (college football and basketball games); TAM 7851005 (1978) (same); TAM 7851006 (1978) (same); TAM 7851011 (1978) (same); TAM 7851003 (governing body for amateur athletics); TAM 7851004 (Aug. 21, 1978) (organization that conducts annual college football bowl game).

¹¹⁵ GCM 37618, *supra*; TAM 7851002, *supra*; TAM 7851004, *supra*; TAM 7851005, *supra*; TAM 7851006, *supra*; TAM 7851011, *supra*.

¹¹⁶ 1980-2 C.B. 194.

¹¹⁷ 1980-2 C. B. 195 (citing and quoting the legislative history of the Revenue Act of 1950).

below). Colleges and universities, for example, conduct extensive activities designed to attract students, while art museums seek to attract visitors. Collegiate and intercollegiate athletic competition generally heightens interest in and knowledge about the participating schools among viewers, enhances the schools' public image, attracts contributions, and makes the school more attractive to potential students. Attending the game enhances student and community interest in the institution and in recreational activities, generally.¹¹⁸ Broadcasting such athletic competition in mass media has the obvious effect of expanding these benefits.¹¹⁹ An organization's success in terms of audience reached and enhancement of its public image is not inconsistent with the organization's exempt purposes.¹²⁰

III. FUNDRAISING BY CHARITABLE AND EDUCATIONAL ORGANIZATIONS

A. Profit-Making Activities

Tax-exempt organizations described in section 501(c)(3) are permitted to carry on profit-making activities and use the profits to fund their activities in furtherance of their tax-exempt purposes. For example, in *Aid to Artisans, Inc. v. Commissioner*, the Tax Court held that an organization that purchased handicrafts made by disadvantaged artisans in developing countries and sold such handicrafts at a profit in museum stores qualified for exemption because its primary purpose in conducting the profit-making activities was to further exempt purposes in section 501(c)(3).¹²¹ The Tax Court noted that the presence of profit-making activities is not per se a bar to exemption if the activities further or accomplish an exempt purpose.¹²² The court found that the organization's activities furthered exempt purposes by alleviating poverty among the disadvantaged artisans, contributing to the achievement of economic stabilization in disadvantaged communities where handicrafts are central to the economy, contributing to the preservation of authentic handicraft production, and furthering the education of the American public in the artistry, history, and cultural significance of handicrafts from such communities.

Similarly, in *Industrial Aid for the Blind v. Commissioner*,¹²³ the Tax Court held that an organization qualified for exemption under section 501(c)(3) when the organization marketed and sold items created by blind individuals at a profit, distributed a percentage of the proceeds to the artists, and retained the remainder of the proceeds for its operations. "We begin by emphasizing 'that the presence of profit-making activities is not per se a bar to qualification of an organization as exempt if the activities further or accomplish an

¹¹⁸ *Mobile Arts and Sports Ass'n v. United States*, *supra*, 148 F. Supp. 311, 313.

¹¹⁹ TAM 7851002, *supra*.

¹²⁰ *Presbyterian and Reformed Pub. Co. v. Comm'r*, 743 F.2d 148, 158 (3rd Cir. 1984).

¹²¹ 71 T.C. 202 (1978).

¹²² 71 T.C. at 211.

¹²³ 73 T.C. 96 (1979).

exempt purpose.”¹²⁴ The Tax Court found that the organization’s profit-making activities were not inconsistent with exemption, because the organization’s principal purpose was to provide employment for blind individuals, thereby alleviating the hardship these individuals experience in securing and holding regular employment. Also, in *Pulpit Resource v. Commissioner*, the Tax Court stated, “The fact that petitioner intended to make a profit, alone, does not negate that petitioner was operated exclusively for charitable purposes...If the sale of religious literature was an integral part of and incidental to petitioner’s avowed religious purpose, that activity may be considered a part of the religious purpose or objective.”¹²⁵ The United States Court of Appeals for the Third Circuit stated in *Presbyterian and Reformed Pub. Co. v. Commissioner*, “On the one hand, the simple act of accumulating revenues may properly call into question the ultimate purpose of an organization ostensibly dedicated to one of the enumerated pursuits under § 501(c)(3). On the other hand, success in terms of audience reached and influence exerted, in and of itself, should not jeopardize the tax-exempt status of organizations which remain true to their stated goals.”¹²⁶

B. Raising Funds For Charity

Raising funds for charity is an accepted charitable purpose. A tax-exempt organization described in section 501(c)(3) may carry out its charitable purposes by raising funds for other section 501(c)(3) organizations.¹²⁷ For example, Rev. Rul. 64-182 describes an organization that derived most of its income from the rental of space in a large commercial office building that it owned, maintained and operated.¹²⁸ The organization met the organizational test of section 501(c)(3) because it used its income to engage in a charitable grant making program. The charitable purposes of the organization were carried out by aiding other charitable organizations, selected at the discretion of its governing body, through contributions and grants to such organizations for charitable purposes.

C. Corporate Sponsorships

1. Background

Corporate sponsorships have become an important source of revenue for the nation's nonprofit organizations. In many cases, corporate sponsorship revenues are being used to fund new charitable programs and initiatives. In others, the funds are merely helping to offset declines in other sources of public and private funding.

¹²⁴ 73 T.C. at 101 (quoting *Aid to Artisans, Inc.*, 71 T.C. at 211).

¹²⁵ 70 T.C. 594, 611 (1978).

¹²⁶ 743 F.2d 148, 158 (3rd Cir. 1984).

¹²⁷ Rev. Rul. 67-149, 1967-1 C.B. 149.

¹²⁸ 1964-1 C.B. 186.

The terms of corporate sponsorship arrangements vary widely, but, in general, a corporate sponsor makes a contribution to a nonprofit organization and, in return for the payment, the nonprofit organization acknowledges the sponsor's support in some way. Depending upon the arrangement, the corporate sponsor may receive, among others, naming rights to an event or facility of the organization; the sponsor's name and logos may be displayed at the organization's stadium or arena, or at another venue where the organization's event takes place; the sponsor may receive acknowledgement or advertising in the organization's publication, event programs, web site and/or signage; and the sponsor may receive tickets to the organization's events, preferred seating at such events, and admission to hospitality tents. The sponsor also may receive the right to use the organization's marks to promote its relationship with the organization and/or to develop and sell logo merchandise. Finally, sponsors sometimes receive the right to have the exempt organization's personnel attend events hosted by the sponsor or consult on products under development by the sponsor.

An exclusive provider arrangement is a corporate sponsorship arrangement in which the sponsor receives the exclusive right to sell, distribute or market its goods or services in connection with an exempt organization's activities. While there are many types of exclusive provider arrangements, two have generated the most publicity: those with beverage companies and those with athletic apparel and equipment companies. Other types of exclusive provider arrangements involve food service, bookstores, broadcast rights, cellular telephone service, credit cards, and automated teller machines, among others.

Under typical athletic apparel and equipment arrangements, an exempt organization and an athletic apparel or equipment manufacturer agree that the company will be the exclusive provider of athletic apparel or equipment to some or all of a school's athletic teams or to a particular event. Generally, the company provides uniforms or equipment at no cost or at a discount. In most cases, the company name and/or logo are displayed on the uniforms and other apparel worn by athletes and coaches, and/or on the athletic equipment.

2. History Of Tax Treatment Of Corporate Sponsorships

The IRS first addressed the issue of the taxation of corporate sponsorships in 1991, in TAM 9147007.¹²⁹ It is widely acknowledged that TAM 9147007 concerned the corporate sponsorship arrangement between the Cotton Bowl Athletic Association (“CBAA”) and Mobil Oil Corporation (“Mobil”).¹³⁰ The IRS reviewed the arrangement to determine whether the (apparently over \$1 million) sponsorship payment CBAA received from Mobil was a contribution to CBAA, or whether it was UBTI. CBAA’s corporate sponsorship agreement with Mobil included the following provisions:

- (1) CBAA must change the name of the Cotton Bowl to the Mobil Cotton Bowl, and add the Mobil logo to the Cotton Bowl logo. The new name and logo must be used exclusively and must be mentioned in all Cotton Bowl press releases.
- (2) At the site of the Cotton Bowl, CBAA must imprint the new logo in a prominent place on the field.
- (3) During the football game, CBAA must display Mobil's commercial messages on the electronic sign in the stadium and broadcast Mobil's commercial messages over the public address system.
- (4) If the Cotton Bowl is not televised, Mobil may cancel the contract.
- (5) CBAA, on behalf of Mobil, must arrange for hospitality suites and hotel rooms, tickets to the game, and tickets to event-related activities.
- (6) In return, Mobil must pay CBAA a sponsorship fee. If the Cotton Bowl achieves a Nielsen (television) rating above a stated level, CBAA is entitled to an additional sponsorship fee from Mobil.¹³¹

In TAM 9147007, the IRS found that the association provided a substantial *quid pro quo* for the payment and that the payment was more in the nature of corporate advertising than corporate benevolence. As a result, the IRS concluded that the payment was UBTI. The issuance of TAM 9147007 caused widespread concern among the higher education community as to the implications of the IRS’s reasoning in TAM 9147007 for their

¹²⁹ (Aug. 16, 1991).

¹³⁰ See, e.g., Paul Streckfus, *A Glimpse of Mobil-Cotton Bowl Contract Provisions*, 55 Tax Notes 447, 447 (1992).

¹³¹ *Id.*; see Musselman, *supra*, n.113, at 208-209.

fundraising efforts in connection with their athletic events. There also was a threat of Congressional action to reverse the IRS position.¹³²

Subsequently, the IRS issued proposed audit guidelines for determining when corporate sponsorship income received by exempt organizations are UBTI.¹³³ The audit guidelines stated that “where an exempt organization performs valuable advertising, marketing, and similar services, on a quid pro quo basis, for the corporate sponsor, payments made to an exempt organization are not contributions to the exempt organization, and questions of unrelated trade or business arise.” The guidelines stated that a sponsorship payment would not be subject to tax if there was no expectation that the organization would provide the sponsor with a “substantial return benefit” in consideration for its payment, and instructed agents to determine whether sponsors were provided with valuable advertising, marketing or similar services in return for sponsorship payments.

The IRS received over 300 written comments on the proposed audit guidelines and, in July 1992, held three days of hearings. Many commentators complained that the proposed “substantial return benefit” test was too vague and ambiguous and that the guidelines provided no clear guidance or certainty as to when and under what circumstances benefits provided to a sponsor rose to the level of a substantial return benefit. Others sought clarification on what allocation rule applied to corporate sponsorship payments and how expenses and deductions were to be allocated.¹³⁴

In January 1993, the IRS issued proposed regulations on corporate sponsorships.¹³⁵ In the proposed regulations, the IRS differentiated between advertising, which was subject to UBIT, and acknowledgements, which were not. The proposed regulations provided that acknowledgements, which were defined as “mere recognition of sponsorship payments,” included the display of sponsors' logos and slogans that did not contain comparative or qualitative descriptions of the sponsor's products, services, facilities or company.¹³⁶ These regulations were never issued in final form, in large part due to opposition from the charitable sector and its supporters to certain provisions of the regulations.¹³⁷

3. Section 513(i) – Qualified Sponsorship Payments

¹³² See 138 Cong. Rec. H6636-01, 6636-6639 (1992).

¹³³ Announcement 92-15, 1992-5 I.R.B. 51.

¹³⁴ Elizabeth M. Roberts, Note, *Presented To You By... Corporate Sponsorship and the Unrelated Business Income Tax*, 17 Va. Tax Rev. 399, 406-407 (1999).

¹³⁵ Prop. Treas. Reg. § 1.513-4, 58 Fed. Reg. 5687, 5690-5691 (1993).

¹³⁶ *Id.*

¹³⁷ Roberts, *supra*, n.134 at 413-414.

In 1997, Congress enacted The Taxpayer Relief Act of 1997, which added Section 513(i) to the Internal Revenue Code.¹³⁸ Under Section 513(i), “qualified sponsorship payments” received by exempt organizations are excluded from UBTI.¹³⁹

A “qualified sponsorship payment” is a payment by a person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of such person’s trade or business in connection with the activities of the organization that receives the payment. Such a use does not include advertising the sponsor’s products or services (including messages containing qualitative or comparative language, price information, or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use such products or services).¹⁴⁰

Permitted “use or acknowledgment” may include the following: exclusive sponsorship arrangements; logos and slogans that do not contain qualitative or comparative descriptions of the payor’s products, services, facilities or company; a list of the payor’s locations, telephone numbers, or Internet address; value-neutral descriptions, including displays or visual depictions, of the payor’s product-line or services; and the payor’s brand or trade names and product or service listings. Logos or slogans that are an established part of a payor’s identity are not considered to contain qualitative or comparative descriptions. Mere display or distribution, whether for free or for remuneration, of a payor’s product by the payor or the exempt organization to the general public at the sponsored activity is not considered an inducement to purchase, sell or use the payor’s product for this purpose and, thus, will not affect the determination of whether a payment is a qualified sponsorship payment.¹⁴¹

The term “qualified sponsorship payment” does not include any payment if the amount of such payment is contingent upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to one or more events.¹⁴² In addition, an arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization’s activity (e.g., an exclusive provider arrangement), generally results in a substantial return benefit (i.e., the payment is not excluded from UBTI as a qualified sponsorship payment),¹⁴³ although payments may be excluded from UBIT under other provisions of the tax law.¹⁴⁴

¹³⁸ Taxpayer Relief Act of 1997 § 965, 111 Stat. 788, 893-94 (1997).

¹³⁹ I.R.C. § 513(i)(1).

¹⁴⁰ I.R.C. § 513(i)(2)(A).

¹⁴¹ Treas. Reg. § 1.513-4(c)(2)(iv).

¹⁴² I.R.C. § 513(i)(2)(B).

¹⁴³ Treas. Reg. § 1.513-4(c)(2)(vi)(B).

¹⁴⁴ Treas. Reg. § 1.513-4(d)(1)(i).

If a single sponsorship payment is both a qualified sponsorship payment and a payment for advertising, the payment is allocated between the qualified sponsorship payment (which is not subject to UBIT) and the advertising payment (which is subject to UBIT).¹⁴⁵

Qualified sponsorship payments generally are treated as contribution income by the recipient tax-exempt organization.¹⁴⁶ This is so whether the payors treat qualified sponsorship payments as a deductible business expense under section 162 or as charitable contributions under section 170.¹⁴⁷

D. Treatment of Contributions In Connection With College And University Athletic Competition

In 1984 the IRS issued Rev. Rul. 84-132, which denied a charitable contribution tax deduction for a contribution to a university when the contribution permitted the donor to purchase preferred seating for university home football games.¹⁴⁸ Rev. Rul. 84-132 resulted in considerable concern by colleges and universities that benefited from such contributions. As a result of the chorus of disapproval, the IRS quickly withdrew Rev. Rul. 84-132.¹⁴⁹

In 1986, the IRS issued Rev. Rul. 86-63, which provides that if a taxpayer makes a contribution to a university athletic scholarship program, in return for which the donor receives the right to purchase season tickets that are not otherwise available, a charitable contribution deduction will be allowed only if (and to the extent that) the donor can show that the value of the contribution exceeded the fair market value of the right to buy the season tickets.¹⁵⁰ This imposed on the donor the burden of showing that the contribution exceeded the value of the right that was received in return, which was extremely difficult because of the nature of the benefit received.

In 1986, the Tax Reform Act of 1986 contained a special provision for The University of Texas and Louisiana State University that provided a full deduction for contributions to

¹⁴⁵ Treas. Reg. § 1.513-4(d).

¹⁴⁶ Treas. Reg. § 1.153-4(e)(3). *See, e.g.*, TAM 7851003 (1978) (corporate sponsorships treated as contribution or grant under section 509(d)(1)).

¹⁴⁷ Treas. Reg. § 1.153-4(e)(3).

¹⁴⁸ 1984-2 C.B. 55. *See also* PLR 8034081 (May 29, 1980) (deduction for gift to athletic program reduced by value of “nonincidental” benefits accorded donor). Under section 6110(k)(3), private letter rulings generally may not be used or cited as precedent. However, they generally may be relied upon as authority for purposes of avoiding accuracy-related penalties in section 6662. Treas. Reg. § 1.6662-4(d)(3)(iii).

¹⁴⁹ Announcement 84-101, 1984-45 I.R.B. 21. *See* Nina R. Murphy, “*Revenue Ruling 84-132: Sidelined, But Not Forgotten*,” 19 U. Rich. L. Rev. 301, 309 (1985).

¹⁵⁰ 1986-1 C.B. 88.

those universities in return for the rights to purchase preferred seating/season tickets.¹⁵¹ In 1988, Congress recognized the benefit that this provision would have to all colleges and universities. The 1986 provision was repealed and the benefit was extended to all colleges and universities. Section 501(l) (originally section 501(m)) provides that, if a taxpayer makes a payment to or for an institution of higher education, and the taxpayer thereby receives (directly or indirectly) the right to seating or the right to purchase seating in an athletic stadium of such institution, 80 percent of such payment (not including any amount separately paid for tickets) is treated as a charitable contribution.¹⁵²

IV. CONCLUSION

Historically, educational institutions, including colleges and universities and the organizations that support them, have received favored status in every income tax act passed by Congress. Amateur athletics, especially intercollegiate athletics, have been similarly favored. Presumably, this is a reflection of Congress's support for higher education and intercollegiate athletics, as demonstrated in the discussion above.

Tax-exempt organizations are permitted to pay reasonable compensation for services that are necessary in carrying out their exempt function. The determination of what is "reasonable compensation" must take into consideration the amount that ordinarily would be paid for the same services by taxable as well as tax-exempt organizations. The fact that the resulting compensation may be large does not necessarily mean that it is excessive or unreasonable under the circumstances. The payment of large salaries and other benefits can be reasonable, when the payments are the result of arms-length bargaining.

The education of the body as well as the mind is essential to becoming an educated individual, and therefore physical education, including athletic competition, is an integral part of the curriculum of most colleges and universities. As athletic competition is substantially related to the performance of educational purposes, a college's or university's revenues from such activities are not UBTI. Moreover, athletic competition tends to enhance a college or university's public image, and is an effective way to attract students and donations for the benefit of the institution.

Most tax-exempt educational organizations engage in various activities to raise funds. Some activities are designed to attract contributions, including corporate sponsorships, and others are designed to earn profits. Such activities are not inconsistent with tax-exempt status.

¹⁵¹ Tax Reform Act of 1986 § 1608, 100 Stat 2085, 2771 (1986); Carolyn M. Osteen, *UBIT Pressure Points, Royalties, Sponsorship Arrangements and Affinity Credit Cards*, C968 ALI-ABA 153, 163-164 (1994).

¹⁵² Technical and Miscellaneous Revenue Act of 1988 § 6001, 102 Stat 3342, 3683-3684 (1998).