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# Taxation, the Student Athlete, and the Professionalization of College Athletics

Erik M. Jensen\*

## I. INTRODUCTION

Nothing could be more professional than big-time college football and basketball teams:<sup>1</sup> colleges recruit and compensate coaches and athletes,<sup>2</sup> impose admission charges for games, and de-

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1. For purposes of this Article, “big-time college football and basketball teams” should be understood to mean those teams with aspirations for national collegiate championships and the financial success associated with such championships. In general—but with exceptions—the colleges are those whose football teams compete in National Collegiate Athletic Association (“NCAA”) Division I-A. Membership in the NCAA is divided into three divisions, I, II, and III, with Division I further subdivided for football. Under the NCAA Bylaws, Division I has the most stringent requirements with respect to the number of varsity sports and the quality of opposition that the college must maintain, and it is the least restrictive in the number of athletic scholarships that may be awarded. At the other extreme, Division III schools offer no purely athletic scholarships. For a football team to qualify for Division I-A, the college must also generally meet attendance and stadium size requirements. See NCAA Bylaws arts. 10-11, reprinted in 1985-86 MANUAL OF THE NATIONAL COLLEGIATE ATHLETIC ASSOCIATION 127-43 [hereinafter 1985-86 NCAA MANUAL].

The NCAA is a voluntary association, whose more than 800 members include almost all major colleges in the United States. See Waicukauski, *The Regulation of Academic Standards in Intercollegiate Athletics*, in LAW & AMATEUR SPORTS 161, 162, 182 n.14 (R. Waicukauski ed. 1982). Only 105 of those colleges compete in Division I-A football, however. NCAA, 1986 NCAA FOOTBALL 293-340 (1986).

The NCAA was formally organized as the Intercollegiate Athletic Association in 1906, after President Theodore Roosevelt threatened to abolish college football by executive order because of numerous incidents of brutality. Waicukauski, *supra* at 181 n.12; S. FIGLER, SPORT AND PLAY IN AMERICAN LIFE 117-18 (1981); S. FLEXNER, LISTENING TO AMERICA 245-46 (1982). The NCAA’s originally stated purpose was to maintain athletics “on an ethical plane in keeping with the dignity and high purpose of education.” Waicukauski, *supra* at 182 n.13.

2. The compensation provided to athletes consists, at least in part, of athletic scholarships. The value of such a scholarship, representing required tuition, fees, and supplies, will not ordinarily be included in the athlete’s gross income for federal income tax purposes. The Internal Revenue Service has ruled that an athletic scholarship, the value of which does not exceed tuition, fees, room, board, and necessary supplies, is excludable from gross income under I.R.C. § 117(a) (1982) when the college (1) expects but does not require the student’s participation in a particular sport, (2) requires no particular activity in lieu of participation, and (3) does not cancel the scholarship if the student cannot participate. Rev. Rul. 77-263,

rive substantial revenue from broadcasting. But the term "professional" is studiously avoided. Professionalism is inconsistent with the "myth of the 'student athlete,'"<sup>3</sup> the idea that college athletes are Frank Merriwells<sup>4</sup> "who, in the off hours away from dedication to the books, happen to participate in organized sports."<sup>5</sup>

Insofar as it purports to describe reality, the myth may no longer have many believers; it is more common today to read of "horrors, indignities, and waste of human resources"<sup>6</sup> in connection with intercollegiate athletics. The myth nevertheless continues to have enormous influence in shaping views about what college athletics should be,<sup>7</sup> and therefore it directly affects such matters

1977-2 C.B. 47. The Tax Reform Act of 1986 has narrowed the range of excludable amounts—expenses for room and board, for example, cannot constitute "qualified tuition and related expenses"—but it did not change the analysis involved in determining whether an award is a scholarship. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 123(a), 100 Stat. 2085 (amending I.R.C. § 117).

The Revenue Ruling implies that an athletic scholarship is taxable if the scholarship is conditioned on athletic participation, but no cases have been reported on point, presumably because the Service has not aggressively pursued college athletes. Professor Kaplan has called the Ruling "naive . . . since athletic awards are made to secure the athlete's services and generally are maintained subject to his participation in college athletics." Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430, 1462 (1980). See also Lee, *The Taxation of Athletic Scholarships: An Uneasy Tension Between Benevolence and Consistency*, 37 U. FLA. L. REV. 591 (1985) (concluding that, under current law, athletic scholarships are subject to taxation, but recommending statutory changes).

3. See Austin, *Book Review*, 58 N.C.L. REV. 660, 663 (1980).

4. Created by Gilbert Patten (using the pen name Burt L. Standish), Frank Merriwell was a fictional Yale student athlete whose exploits from 1896 until about 1913 were avidly devoured by readers of popular periodicals. The stories generally extolled Merriwell's "manly virtues, righteousness, and accomplishment." S. FIGLER, *supra* note 1, at 114. Merriwell had "a body like Tarzan's and a head like Einstein's," Patten, Gilbert, in TWENTIETH CENTURY AUTHORS 1083 (S. Kunitz & H. Haycraft eds. 1942), and he exemplified college athletes as "clean-living, idealistic students who played only for the love of the game and the glory of their schools." S. FLEXNER, *supra* note 1, at 251. However, Merriwell's lengthy tenure at Yale presaged the difficulties in graduating that later generations of athletes would have. See *infra* notes 26-27 and accompanying text.

5. Austin, *supra* note 3, at 663. The "amateur student-athlete is one who engages in a particular sport for the educational, physical, mental and social benefits derived therefrom and to whom participation in that sport is an avocation." NCAA CONST. art. 3, § 1, reprinted in 1985-86 NCAA MANUAL, *supra* note 1, at 9; see also *infra* notes 18-31 and accompanying text.

6. Austin, *Bringing Free Enterprise to Big-Time College Sports*, CHRON. HIGHER EDUC., Mar. 23, 1981, at 25; see also *infra* notes 18-31 and accompanying text.

7. The goal is amateurism, and that goal is sometimes given mystical significance. Pure amateurism can be traced to "the Victorian ideal . . . the rationale for which is no longer the class prejudice which disdained professional athletes, but rather a respect for the 'ritual tie' which once bound ancient sport to the realm of the sacred, an affinity which is now threatened by the decline of amateurism." J. HOBERMAN, *SPORT AND POLITICAL IDEOLOGY* 152 (1984) (discussing Johan Huizinga's cultural philosophy of sport). Sport as religion (or a

as the level of legal compensation for athletes.<sup>8</sup>

Not everyone believes that the myth describes a worthwhile set of goals. Goals that are unattainable, and perhaps unapproachable, may have undesirable effects, including the breeding of cynicism. Recently, a number of commentators who believe that the effect of the myth has been pernicious have suggested that it be discarded.<sup>9</sup> Colleges, they argue, should be able to hire athletes openly, without regard to whether the athletes are also scholars. Because belief in the student athlete is a fundamental tenet of the National Collegiate Athletic Association,<sup>10</sup> however, the debate on the open hiring of college athletes is already vigorous.<sup>11</sup>

This Article considers an issue that should play a role in the debate on the hiring of college athletes, but that has been previously ignored: what effect, if any, would the creation of an openly professional athletic team have on the federal income tax posture of an otherwise tax-exempt college?<sup>12</sup> This issue is not a trivial

religious substitute) is a common theme in the literature. See, e.g., M. NOVAK, *THE JOY OF SPORTS* 284 (1976): "In varsity sports, universities give the nation the most profound and nourishing popular art accessible to all our citizens. Our other religions are all, despite their universal aims, sectarian; their symbols and liturgies cannot unite as many as sports do." See also Austin, *supra* note 3, at 860 ("If Marx were alive, he would preach that sports, not religion, is the debilitating opiate of the masses.").

8. For example, to preserve the "nonprofessional" nature of college athletics, the NCAA regulates the number and size of athletic scholarships an institution may offer and the compensation that may be paid to athletes for summer employment. See NCAA CONST. art. 3, § 1, reprinted in 1985-86 NCAA MANUAL, *supra* note 1, at 9.

9. See *infra* notes 32-39 and accompanying text.

10. See *supra* note 1. In a section headed "Fundamental Policy," the NCAA Constitution provides:

The competitive athletics programs of the colleges are designed to be a vital part of the educational system. A basic purpose of this Association is to maintain intercollegiate athletics as an integral part of the educational program and the athlete as an integral part of the student body and, by so doing, retain a clear line of demarcation between college athletics and professional sports.

NCAA CONST. art. 2, § 2, reprinted in 1985-86 NCAA MANUAL, *supra* note 1, at 7-8.

Sportswriter Red Smith wrote:

Whenever a college football game is on radio or television, it is accompanied by edifying words about student athletes, about the importance of intercollegiate athletics in a rounded educational program and about the vital role played by the National Collegiate Athletic Association. The edifying words are composed by writers for the N.C.A.A.

Smith, *The Student Athlete*, N.Y. Times, Nov. 12, 1979, at C3, col. 4, quoted in Austin, *The Legality of Ticket Tie-Ins in Intercollegiate Athletics*, 15 U. RICH. L. REV. 1, 9 n.35 (1980).

11. See, e.g., *Should College Athletes Be Paid Salaries?*, U.S. NEWS & WORLD REP., Dec. 23, 1985, at 56 (interviews with George Sage, who favors salaries for athletes, and NCAA President John Davis, who opposes such salaries).

12. For a significant article that decidedly did not ignore the relationship between intercollegiate athletics and federal income taxation, see Kaplan, *supra* note 2. Kaplan's arti-

one. The tax liability at some institutions could exceed one million dollars.<sup>15</sup> And the risk is real: this Article concludes that a college operating a professional team would almost certainly subject itself to the tax on unrelated business income.

In the following section, the Article briefly discusses the relationship of major college athletics to higher education<sup>14</sup> and then, in the third section, it describes one of the reactions to that relationship, the suggestion that athletes be openly hired.<sup>15</sup> The fourth section of the Article considers the application of the tax on unrelated business income to an acknowledged system of collegiate professional athletics.<sup>16</sup> The fifth section discusses an uncertainty that remains in determining how an institution's tax liability would be computed.<sup>17</sup>

## II. ATHLETICS AND EDUCATION

At far too many colleges the term "student athlete" is an oxymoron. Although nominally students, many intercollegiate athletes are unprepared for, and uninterested in, higher education.<sup>18</sup> For those athletes who do wish to participate in the life of the mind—to gain some idea, perhaps, why their academic institutions were founded—the time required by athletics precludes full atten-

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cle is the beginning point for all analysis, and the ending point for most analysis, in this area.

13. For example, the football team of Florida State University earned \$6.5 million (not including contributions) in 1985 on expenditures of \$2.5 million. Goodwin, *When the Cash Register Is the Scoreboard*, N.Y. Times, June 8, 1986, at S8, col. 1. If the football team is treated as a trade or business subject to the tax on unrelated business income, see *infra* notes 81-92 and accompanying text, with an applicable tax rate of 46%, see *infra* note 42, the tax liability on the \$4 million of net revenue would be \$1.84 million. Even with a reduction in the maximum corporate rate to 34% for future years, see *id.*, the tax liability would be \$1.36 million.

14. See *infra* text accompanying notes 18-31.

15. See *infra* text accompanying notes 32-39.

16. See *infra* text accompanying notes 40-80.

17. See *infra* text accompanying notes 81-92.

18. The academic standards mandated by the NCAA for athletic participation are not rigorous. For example, effective August 1, 1986, athletes at NCAA Division I schools, see *supra* note 1, who are to compete during their freshman year, must have attained a combined Scholastic Aptitude Test ("SAT") score of at least 700 and a high school grade point average of at least 2.0 (a "C" average) in certain core courses. See Gladwell, *Dunk and Flunk*, NEW REPUBLIC, May 19, 1986, at 13, 14; Monaghan, *Remedial Studies for University of Georgia Athletes May Be a Thing of the Past*, CHRON. HIGHER EDUC., Feb. 19, 1986, at 29, 30. Although less than overwhelming, these standards are nonetheless intended to strengthen the earlier NCAA "2.0 rule," which included no minimum SAT requirement. The rule required only that a student have maintained a high school average of "C" for freshman eligibility. See Gladwell, *supra*, at 13-14.

tion to scholarly pursuits.<sup>19</sup>

The conflict between educational ideals and intercollegiate athletics is not a newly discovered phenomenon,<sup>20</sup> but recent manifestations of the conflict have been particularly striking. For example, Jan Kemp, an instructor in remedial English at the University of Georgia, was fired in 1982 at least in part because she refused to give preferential treatment to athletes.<sup>21</sup> Kemp not only resisted institutional pressure, a noteworthy event in itself, but also successfully sued the University and its administrators.<sup>22</sup> At trial the

19. University of Maryland Chancellor John B. Slaughter, in the aftermath of the drug-related death of basketball star Len Bias, noted that "intercollegiate athletics demands a great deal from a person who is involved in it, and it is perhaps too much." *Bias Case May Spur Reform*, N.Y. Times, June 26, 1986, at B12, col. 1. Five of the twelve members of the Maryland basketball team flunked out of school during the 1986 spring semester, a period during which the team was, among other things, participating in its own Atlantic Coast Conference tournament and the NCAA tournament. *Id.*; see also *Maryland's Athletes Fail at "Catch-up,"* USA Today, June 26, 1986, at 6C, col. 1 (discussing college athletes' difficulties with academic pursuits).

Longtime University of Alabama football coach Paul "Bear" Bryant addressed the relative weight given to athletics and academics:

I used to go along with the idea that football players on scholarship were "student-athletes," which is what the NCAA calls them. Meaning a student first, an athlete second. We were kidding ourselves, trying to make it more palatable to the academicians. We don't have to say that and we shouldn't. At the level we play, the boy is really an athlete first and a student second.

Quoted in J. MICHENER, *SPORTS IN AMERICA* 203 (1976).

20. See, e.g., H. SAVAGE, *AMERICAN COLLEGE ATHLETICS* (Carnegie Foundation for the Advancement of Teaching 1929) (criticizing college "commercialized sports"); Turner, *To the Alumni on Football*, reprinted in *CHRON. HIGHER EDUC.*, July 9, 1986, at 56 (1906 speech to University of Wisconsin alumni, noting that football "has become a business, carried on far too often by professionals, supported by levies on the public, bringing in vast gate receipts, demoralizing student ethics, and confusing the ideals of sport, manliness and decency"); *supra* note 1 (formation of NCAA). No article on this subject should be written without quoting Andrew Dickson White, the first president of Cornell University. In 1873 White forbade 30 Cornell football players from travelling to Cleveland, Ohio, to compete with the University of Michigan: "I will not permit 30 men to travel 400 miles merely to agitate a bag of wind." Quoted in S. FLEXNER, *supra* note 1, at 235.

Excessive optimism is also not new. See, e.g., H. SAVAGE, J. MCGOVERN & H. BENTLEY, *CURRENT DEVELOPMENTS IN AMERICAN COLLEGE SPORT* 53 (Carnegie Foundation for the Advancement of Teaching 1931):

The deflation of American football has begun. In many respects it is an unpleasant process. Yet the poverty that results from a decline in football gate receipts will lighten parts of the task of those who administer college athletics. The return to a more sincere appreciation of the values of sports and sportsmanship is under way. The road, at times, seems long, but the American college will not weary in well-doing.

21. The University's Division of Developmental Studies has served a disproportionately high percentage of scholarship athletes in the past several years—15% versus about 1.2% of the overall student population. Monaghan, *supra* note 18, at 30.

22. The federal court jury found that Kemp had been improperly dismissed from her position and awarded her more than \$2.5 million, including \$2.3 million in punitive dam-

University made no attempt to camouflage its policy: the president and athletic director testified that denying admission to academically unqualified student athletes would constitute "unilateral disarmament" in the intercollegiate athletic wars.<sup>23</sup>

Jan Kemp prevailed, but Clemson University President William Atchley did not. In early 1985 several former Clemson coaches were indicted on charges of illegally possessing and distributing steroids to athletes. Atchley sought to remove the athletic director and to reorganize the athletic department. For his efforts, the Clemson board of trustees suggested that he look elsewhere for employment.<sup>24</sup>

The Kemp and Atchley cases are merely dramatic examples of a deep-seated tension in academia.<sup>25</sup> Data on the day-to-day educational performance of athletes at the nation's collegiate sports factories are even more disturbing. Graduation rates nationally for athletes appear to be lower than for nonathletes.<sup>26</sup> At some schools the timely graduation of athletes, and in particular black athletes, is the exception rather than the rule. For example, only about 15 of the 200 black athletes who have represented the University of Georgia since 1969 have graduated.<sup>27</sup>

ages. Monaghan, *Fired Teacher Wins Suit Against Officials at University of Georgia, Is Awarded \$2.5 Million*, CHRON. HIGHER EDUC., Feb. 19, 1986, at 29 [hereinafter Monaghan I]. The trial judge subsequently reduced the award to \$680,000. Monaghan, *Award to Ex-Teacher at U. of Georgia Cut from \$2.58 Million to \$680,000*, CHRON. HIGHER EDUC., Apr. 30, 1986, at 33. But Kemp and the University officials later reached an agreement under which she would receive \$1.08 million and be reinstated in her old position. Monaghan, *Georgia Attorney General Chides University But Finds No Evidence of Illegal Activities*, CHRON. HIGHER EDUC., May 28, 1986, at 28.

23. Monaghan I, *supra* note 22, at 30.

24. N.Y. Times, Mar. 7, 1985, at B9, col. 1.

25. The incidents at the University of Georgia and Clemson University are used in this Article merely as examples. It is not the author's intention to suggest that conditions at those schools are any worse—or any better—than at others. See, e.g., *Recent Scandals in College Sports*, USA Today, June 27, 1986, at 10C, col. 1 (describing 32 "problems in Division I athletic programs since Jan. 1, 1985").

26. See Kaplan, *supra* note 2, at 1459 & n.173. A study conducted by Richard Lapchick of the Center for the Study of Sport in Society, Northeastern University, determined that less than one-third of the participants in revenue-raising sports eventually graduate. Becker, *College Athletes Should Get Paid What They're Worth*, Bus. Wk., Sept. 30, 1985, at 18.

The data are not totally one-sided on this issue; there is great uncertainty in determining what the appropriate comparisons are. See S. FIGLER, *supra* note 1, at 125-27. The NCAA president, citing a study by the American College Testing Program, has stated that the graduation rates for male athletes were 10% higher than for students generally for a five-year period ending in 1980. See *Should College Athletes Be Paid Salaries?*, *supra* note 11 (interview with John Davis).

27. Gladwell, *supra* note 18, at 13. According to the Georgia athletic director, between

The reason for the separation of athletes from the educational side of their institutions is no secret.<sup>28</sup> Many colleges have become dependent on the revenue produced by their nonstudent students. "Universities have generally harvested more benefits than problems from their athletic departments and . . . [have been] content to leave the athletic departments alone."<sup>29</sup> Football teams in particular may generate enormous revenue for their schools from ticket sales, from broadcasting contracts, and indirectly from contributions.<sup>30</sup> As Jackie Sherrill bluntly put it when his salary as football coach at Texas A&M University was criticized,

Football pays for a lot of things here . . . . It pays for the other sports. The salaries and the facilities come from the gifts, the scholarship fund, our fund-raising apparatus. Professors who complain, why, they don't spend their summers raising money for the school. Football is a business. Let's get our heads out of the sand.<sup>31</sup>

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1974 and 1984 Georgia graduated 84% of the white males who had participated in intercollegiate athletics for four years; the corresponding figure for black male athletes was only 37%. Monaghan, *supra* note 18, at 30. Only one-quarter of the nation's black athletes graduate from college, and three-quarters of those who do graduate receive degrees in physical education. Gladwell, *supra* note 18, at 13.

28. See Austin, *supra* note 10, at 1: "The dynamics of operating a 'major' intercollegiate sports program have a tenuous nexus with academic ideals. Intercollegiate athletics is now a big business, dominated by the balance sheet of gate receipts, T.V. revenues, and talent recruiting."

29. Goodwin, *supra* note 13.

30. The 1985 University of Michigan football team produced approximately \$11 million in gross revenue (of an overall athletic budget of more than \$15 million):

Ticket sales	\$8,500,000
Television & radio	550,000
Participation in Fiesta Bowl	475,000
Share of conference Rose Bowl proceeds	450,000
Concessions	300,000
Publications	250,000
Parking	125,000

Goodwin, *supra* note 13. Goodwin provides gross revenue and expense data for many other schools as well. See, e.g., *supra* note 13.

31. Quoted in W. MORRIS, *THE COURTING OF MARCUS DUPREE* 335 (1983). Sherrill moved to Texas A&M in 1982 from the head coaching position at the University of Pittsburgh. His A&M contract provided for approximately \$267,000 per year in cash and fringe benefits, paid in part by the university and in part by alumni. At the time that was the highest compensation paid for any position at an American college. *Id.* at 332-33.

Academics' condescending resentment of college athletics has a long history, see *supra* note 20 (quotation of A.D. White), but Novak argues that much of the academic feeling of superiority is unjustified. The professoriate overestimates the intellectual level, and the societal value, of its own pursuits:

Most of the faculty and graduates of universities engage in quite pedestrian and workaday intellectual tasks . . . . Most . . . think their work is more important than that of coaches and players. Economically and socially, however, it would be difficult

Some heads may have been buried in the sand when Sherrill spoke, but they were not the heads of administrators at the major athletic colleges.

### III. OPEN PROFESSIONALISM: AN END TO HYPOCRISY?

Can colleges with big-time athletic programs reconcile their crass practices in student athletics with the noble educational purposes for which they were founded? Should they even try? Many prominent commentators, including a leading Chicago School economist,<sup>32</sup> the editors of *The New York Times*,<sup>33</sup> and novelist James A. Michener,<sup>34</sup> have recently argued that colleges should stop seeking a reconciliation of practice and purpose and should instead openly hire athletes, athletes who need not pretend to be scholars.<sup>35</sup>

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for them to prove that their work does have larger public significance. Indeed, that difficulty is the source of much resentment.

M. Novak, *supra* note 7, at 282-83.

32. Becker, *supra* note 26, at 18. Becker convincingly argues that the NCAA, through its restrictions on scholarships and other compensation to athletes, "reduce[s] the competition among colleges for players in football and basketball." *Id.* This classic labor-market cartel is blessed by Congress and the courts, even though it has the effect of "lower[ing] the earnings of young black and other athletes with limited opportunities." *Id.*; see also Koch, *A Troubled Cartel: The NCAA*, 38 *LAW & CONTEMP. PROBS.* 135 (1973) (viewing NCAA as cartel); McCormick, *Colleges Get Their Athletes for a Song*, *Wall Street J.*, Aug. 20, 1985, at 28 (NCAA limits competition between colleges to "prevent the monetary value generated by fine athletes from going to the athletes"). McKenzie and Sullivan respond that college athletes are not materially underpaid "in any absolute or relative sense" when the present value of expected future earnings is taken into account, and that an organization like the NCAA with more than 800 members cannot operate as a classic cartel. McKenzie & Sullivan, *Is the NCAA a Cartel? Absolutely Not.*, *NAT'L L.J.*, May 5, 1986, at 13. However, few college athletes join professional teams. "The skills they possess that have a market value may only be sold while they are in the college athletic market." McCormick, *supra*.

33. "But if the country won't go cold honest, let it at least recognize that many players are not serious students, need to be recruited with money and paid at least something while in school." *N.Y. Times*, Apr. 17, 1985, at A26, col. 1.

34. Michener stated:

It is quite obvious that intercollegiate football and basketball, as now played, are semi-professional sports in most schools and professional in others. This should be publicly acknowledged; I see nothing to be gained by denying it and much to be lost. My concern is therefore how best to administer a professional entertainment program within the normal guidelines that now operate, and I would wish to hear no complaint that "Things oughtn't to be this way in a self-respecting institution of higher learning," because they are that way and our society intends that they remain that way.

J. MICHENER, *supra* note 19, at 196.

35. Some elected officials have made similar suggestions. For example, for several years Nebraska State Senator Ernest Chambers has introduced legislation that, if enacted, would treat University of Nebraska football players as state employees. Goodwin, *Proposals*

Professional college athletic programs could arguably provide several benefits. The reconstituted programs would continue to generate income for the institutions while reducing the present hypocrisy of college athletics.<sup>36</sup> Moreover, athletes, particularly those from poor backgrounds, could be provided much needed funds in return for the services that they provide their colleges.<sup>37</sup> If a college could support its physics department, reduce hypocrisy, and alleviate hardship by fielding a professional football team, why should it not do so?

The combination of money, honesty, and social services would be hard to beat—if in fact that combination could be realized. For a number of reasons, however, an openly professional athletic program could actually diminish revenues. Moreover, whatever the overall effect on revenue, it is almost certain that little or nothing would be generated to aid academic departments.

To begin with, the popularity of college athletics may depend on the hypocrisy. It is impossible to prove in advance, but enthusiasm might wane if we were to stop pretending that the people wearing the helmets are common, everyday college students.

In addition, at many an institution the direct revenue from football and men's basketball (the only serious revenue-raisers for most schools) merely supports the rest of a bloated athletic pro-

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*for Reform*, N.Y. Times, June 12, 1986, at D25, col. 1; see Cross, *The College Athlete and the Institution*, 38 LAW & CONTEMP. PROBS. 151, 164-65 (1973) (college athletes not generally "employees" under existing law). But see Yasser, *Are Scholarship Athletes at Big-Time Programs Really University Employees?—You Bet They Are!*, 9 BLACK L.J. 65 (1984).

36. Compensation packages could be tailored to accommodate those with, as well as those without, serious academic desires. Austin has described two basic compensation plans that could be provided to athlete employees. For the serious would-be scholar, the college could provide free education (and maybe more), with graduation expected to occur within five or six years. During his working athletic season, the athlete would not be required to attend classes. For the athlete with no scholarly aspirations, the employment relationship would be full-time. During the off-season, the employee would be expected to perform other functions for the college. Austin, *supra* note 6, at 25; see also *Punt the Pretense*, NEW REPUBLIC, Sept. 8, 1986, at 8 (arguing for a position "[b]etween outright professionalism and small-college amateurism," including tailoring educational requirements to athletes' abilities, and providing annual payment to athletes equal to cash value of their scholarships, with receipt of half of the payment deferred until completion of degree programs).

Another commentator has suggested a variation on the employment relationship: colleges should be able to sign athletes to long-term contracts, not to protect the athlete, but so that a professional team interested in the services of the athlete would be required to purchase the contract from the college. At least some of the costs of training for the openly professional athletic activity would be shifted, therefore, from the college to the professional sports enterprise. Koch, *supra* note 32, at 149; Koch, *The Economics of "Big-Time" Inter-collegiate Athletics*, 52 Soc. Sci. Q. 248, 260 (1971).

37. See *supra* note 32.

gram.<sup>38</sup> If benefits to the physics department are provided at all, they are indirect, through increased alumni donations, student applications,<sup>39</sup> and legislative appropriations.

Finally, those who advocate open professionalism seem to have ignored something the rest of us can never ignore: taxes. As the rest of this Article explains, adoption of an overtly professional athletic system may result in colleges' becoming subject to the tax on unrelated business income, thereby depleting the funds available for other uses.

#### IV. THE TAX ON UNRELATED BUSINESS INCOME

Even in those unusual fiscal years in which a tax-exempt college has net revenue,<sup>40</sup> the college does not pay federal tax on tuition and other income attributable to its educational activities.<sup>41</sup>

38. See Hanford, *Controversies in College Sports*, 60 *EDUC. REC.* 351, 363-64 (1979). In recent years a number of university athletic departments (such as those of Michigan, Georgia, and Stanford) have been separately incorporated. These departments (and many others that are not distinct legal entities) are expected to be economically self-sufficient, paying their universities for services provided but otherwise making no cash contributions that directly affect academic departments. Goodwin, *supra* note 13. NCAA President John P. Davis notes, "A lot of people wish to turn the clock back to where the game on Saturday was just a game between bona fide students. But it's a fact of life that we just can't support all of the sports without the gate receipts and television money we're getting." *Quoted in* Goodwin, *supra* note 35, at D30, col. 1.

39. For example, applications to Auburn University increased by 38% from 1983 to 1986, the period during which Heisman Trophy winner Bo Jackson was playing football for the school. *It Pays to Win . . . Or To Lose*, *N.Y. Times*, June 8, 1986, at S8, col. 1. A recent study conducted at Clemson University concluded that the spillover effects of a successful athletic program are substantial: "[D]ollars invested in the athletic program reap rewards in terms of success and national exposure that benefit the entire university." Clemson's athletic successes have, among other things, increased the amount of the average donation. See Clark, *The Business of Education: Does Athletics Help or Hurt?*, *Wall Street J.*, Aug. 26, 1986, at 25 (discussing paper by McCormick & Tinsley, "Athletics vs. Academics," published by the Center for Policy Studies, College of Commerce and Industry, Clemson University).

40. This assumes that the concept of "net revenue" has meaning in this context. However, measuring the net revenue of a nonprofit enterprise is a difficult conceptual task because basic accounting principles "rest on the premise that the organization seeks to maximize its profit." Bittker & Rahdert, *The Exemption of Nonprofit Organizations From Federal Income Taxation*, 85 *YALE L.J.* 299, 307 (1976). What expenses should be deductible, for example, to an organization that by definition does not have "ordinary and necessary" business expenses? *Id.* at 309-12.

41. I.R.C. § 501(a) (1982) provides generally that certain organizations are exempt from federal income tax. Among the protected organizations are the so-called "501(c)(3)" organizations, a category that includes most colleges:

Corporations [or other organizations] . . . organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . , no part of the net earnings of which inures to the benefit of any private share-

Like other tax-exempt institutions, however, a college is taxed, at the rates applicable to corporations,<sup>42</sup> on "unrelated business taxable income." "Unrelated business taxable income" in general is income from (1) a "trade or business" that is (2) "regularly carried on," but that is (3) "not substantially related" to the institution's exempt purposes<sup>43</sup>—for a college, its educational purposes.<sup>44</sup>

The tax on unrelated business income has two overlapping purposes, protecting the Treasury from loss of revenue and protecting taxpaying entities from unfair competition. First, the tax is intended to prevent otherwise taxable activities from being insulated from taxation, thereby denying the Treasury its share of the

holder 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 any candidate for public office.

I.R.C. § 501(c)(3) (1982) (emphasis added). The effect of section 501(c)(3) status is not merely to make an institution generally tax-exempt. More important, contributions made to such an organization will be deductible, subject to certain statutory limitations. I.R.C. § 170(a), (c) (1982).

If a substantial part of an institution's revenue comes from sources unrelated to its exempt purposes, either the institution may not qualify as a "501(c)(3)" organization in the first place, or its exempt status may be subject to revocation. One commentator has suggested that denial or revocation is likely if more than one-half of the annual revenue is regularly derived from unrelated activities. B. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS 1986 SUPPLEMENT 250* (citing Gen. Couns. Mem. 39,108 (May 28, 1982)). This Article, however, assumes that the level of professional athletic activity at any college will not be so great that denial or revocation of tax-exempt status is likely.

42. I.R.C. § 511(a)(1) (1982). For taxable years beginning before July 1, 1987, corporations are generally subject to a graduated rate structure, rising from 15% on the first \$25,000 of taxable income to 46% on taxable income above \$100,000. However, corporations with taxable income of more than \$1 million lose some or all of the benefits of graduation. If taxable income exceeds \$1.4 million, all of the income will be taxed at the maximum 46% rate. I.R.C. § 11(b) (1982 & Supp. 1985). For taxable years beginning after June 30, 1987, the Tax Reform Act of 1986 generally reduces the rate structure, with a top rate of 34%, but the benefits of graduation are phased out at lower levels, beginning at a taxable income of \$100,000. Pub. L. No. 99-514, § 601, 100 Stat. 2085 (amending I.R.C. § 11(b)).

43. I.R.C. §§ 511(a), 512(a)(1), 513(a) (1982). The statute, subject to certain modifications, requires computing the gross income derived from the unrelated trade or business and subtracting those deductions directly connected with the unrelated trade or business. I.R.C. § 512(a)(1) (1982). The modifications provided in section 512(b) protect college endowment income from application of the tax by excluding most passive investment income (among other things) from the computations of a section 501(c)(3) organization. *But see* I.R.C. § 514 (1982) (including unrelated debt-financed income in unrelated business income).

44. "Educational" is defined in the regulations as relating to:

- (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or
- (b) The instruction of the public on subjects useful to the individual and beneficial to the community.

Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) (1986).

profits. When Congress considered this provision as part of the Revenue Act of 1950,<sup>45</sup> it was influenced by the close economic ties between New York University and various commercial enterprises, including the C.F. Mueller Company.<sup>46</sup> Mueller, the country's largest producer of macaroni and other pasta products, assigned all of its income to the benefit of the NYU law school. Because, as a so-called "feeder" organization, Mueller simply transferred its net income to a tax-exempt educational enterprise, Mueller took the position that it, too, was not subject to federal income taxation. Although Mueller lost in the Tax Court,<sup>47</sup> it prevailed before the Third Circuit in 1951.<sup>48</sup>

While *Mueller* was wending its way through the federal court system, many congressmen became concerned about the effect of a decision adverse to the government. In Representative Dingell's words, if such feeder organizations are tax-exempt,<sup>49</sup> "[e]ventually all the noodles produced in this country will be produced by corporations held or created by universities . . . and there will be no

45. Pub. L. No. 81-814, §§ 301, 331, 64 Stat. 906, 947, 957. The present form of the statute can be traced to the 1950 Act. The class of organizations to which the tax may apply was extended by the Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(a)(1), 83 Stat. 487, 536, to include nearly all tax-exempt institutions. See B. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 615-16 (4th ed. 1983); Donahue, *Unrelated Business Income of Tax Exempt Organizations*, 37 *INST. ON FED. TAX'N* § 27.03, at 27-6 (1979).

46. See *United States v. American Bar Endowment*, 106 S. Ct. 2426, 2435 (1986) (Stevens, J., dissenting); Bittker & Rahdert, *supra* note 40, at 318-19; Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 *HARV. L. REV.* 1280, 1281 (1968); Comment, *Colleges, Charities, and the Revenue Act of 1950*, 60 *YALE L.J.* 850, 850 (1951).

47. *C.F. Mueller Co. v. Commissioner*, 14 T.C. 922 (1950).

48. *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951). In effect, the Third Circuit applied the "destination of income" test enunciated by the Supreme Court in *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924) (statutory provision "says nothing about the source of income, but makes destination the ultimate test of exemption").

The Tax Court announced that it would not follow the Third Circuit's decision in *Mueller*. See *Joseph B. Eastman Corp. v. Commissioner*, 16 T.C. 1502, 1509 (1951); Myers, *Taxing the Colleges*, 38 *CORNELL L.Q.* 368, 372-73 (1953). Under the curious jurisdictional rules applicable in the tax area, the Tax Court can (and often does) refuse to follow a contrary decision of a court of appeals in subsequent cases, unless those cases would be appealable to the same circuit. See generally Geier, *The Emasculated Role of Judicial Precedent in the Tax Court and Internal Revenue Service*, 39 *OKLA. L. REV.* 427 (1986).

49. Prior to the Revenue Act of 1950, a number of courts had held that an organization feeding a tax-exempt organization was itself exempt from federal income tax. See, e.g., *Roche's Beach v. Commissioner*, 96 F.2d 776 (2d Cir. 1938) (income of bathing beach corporation fed to exempt foundation held exempt); Comment, *supra* note 46, at 862-63. The Third Circuit in *Mueller* followed the decision in *Roche's Beach*. *Mueller*, 190 F.2d at 122. See Note, *supra* note 46, at 1281 ("Mueller Company differed only in scale from Roche's Beach").

revenue to the Federal Treasury from this industry.”<sup>50</sup> The 1950 Act took two steps to guard the Treasury from a significant loss of revenue. First, it eliminated the tax protection of feeder organizations.<sup>51</sup> Second, to keep an institution like NYU from merely moving macaroni production in-house, the Act provided for theoretically identical treatment for unrelated trades or businesses that are operated directly by tax-exempt organizations. Thus, macaroni profits would be taxed whether produced by a separate legal entity or by the otherwise tax-exempt organization itself.<sup>52</sup>

The tax on unrelated business income was intended not only to protect Treasury revenues, but also to prevent tax-exempt organizations from gaining a competitive advantage over taxpaying entities by engaging in similar profit-making activities. If, for example, Columbia University were able to operate a department store in mid-Manhattan and pay no federal tax on the income from the store, one fear is that Columbia could undercut Macy's and Bloomingdale's. Whether price undercutting would in fact occur in a competitive market is not clear.<sup>53</sup> But even if Columbia's store did not lower its prices, it would still be able to accumulate capital more rapidly than its nonexempt competitors—to “use [its] profits tax-free to expand operations.”<sup>54</sup> The tax on unrelated business in-

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50. *Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means*, 81st Cong., 2d Sess. 580 (1950).

51. I.R.C. § 502(a) (1982) provides that “an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation . . . on the ground that all of its profits are payable to one or more organizations exempt from taxation.”

Although a feeder corporation that transfers funds to a section 501(c)(3) organization might be entitled to a deduction for charitable contributions, *see supra* note 41, I.R.C. § 170(b)(2) (1982) limits a corporation's deduction to 10% of its taxable income. If there were no such percentage limitation, a nominally taxable feeder could effectively achieve exempt status through the charitable deduction.

52. The congressional committee reports make it clear that tax results should not depend on whether income is earned by a charitable organization directly or earned by a distinct legal entity and “fed” to the charitable organization. H.R. REP. No. 2319, 81st Cong., 2d Sess. (1950), *reprinted in* 1950-2 C.B. 380, 409; S. REP. No. 2375, 81st Cong., 2d Sess. (1950), *reprinted in* 1950-2 C.B. 483, 505.

53. Pricing decisions are subject to complex economic considerations beyond the scope of this Article. A number of commentators have suggested that price cutting is unlikely. *See, e.g.,* Bittker & Rahdert, *supra* note 40, at 319 & n.47; Kaplan, *supra* note 2, at 1465-66; Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1020-21 (1982).

54. H.R. REP. No. 2319, *supra* note 52, *reprinted in* 1950-2 C.B. at 409; S. REP. No. 2375, *supra* note 52, *reprinted in* 1950-2 C.B. at 504. *See* Treas. Reg. § 1.513-1(b) (1975); *United States v. American Bar Endowment*, 106 S. Ct. 2426, 2435 & n.1 (1986) (Stevens, J., dissenting); *United States v. American College of Physicians*, 106 S. Ct. 1591, 1594 (1986) (“Congress perceived a need to restrain the unfair competition fostered by the tax laws.”);

come is intended to eliminate this possible competitive disparity.

Would income from professional athletics be unrelated business income to a college? Of the three statutory requirements for imposition of the tax,<sup>55</sup> only one is subject to serious doubt, at least at a threshold level.<sup>56</sup> Even without open professionalism, it is reasonably clear that all or part of the athletic program today at some institutions rises to the level of a "trade or business," characterized by a search for profit,<sup>57</sup> and that the constituent parts of a

H.R. REP. NO. 413, 91st Cong., 1st Sess. (1969), reprinted in 1969-3 C.B. 200, 232 ("business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function"); Kaplan, *supra* note 2, at 1466; Note, *supra* note 46, at 1281-82. Indeed, it may be that nonprofit institutions have competitive advantages even without favorable tax treatment—because of favorable public images, lower labor costs, and subsidies through government grants and private donations. Copeland & Rudney, *Business Income of Nonprofits and Competitive Advantage*, 33 TAX NOTES 747, 748 (Nov. 24, 1986); see also Copeland & Rudney, *Business Income of Nonprofits and Competitive Advantage—II*, 33 TAX NOTES 1227 (Dec. 29, 1986) (discussing competitive advantage of mutuals and cooperatives). But see Rose-Ackerman, *supra* note 53, at 1036-39 (arguing for repeal of tax on unrelated business income because tax encourages a nonprofit institution to concentrate in areas "related" to its tax-exempt status, thus potentially harming for-profit firms doing business in those areas); Comment, *Preventing the Operation of Untaxed Business by Tax-Exempt Organizations*, 32 U. CHI. L. REV. 581, 591-92 (1965) (tax-exempt business has no competitive advantage in practice).

55. See *supra* text accompanying note 43.

56. But see *infra* notes 81-92 and accompanying text for a discussion of what the taxable trade or business might be.

57. "[T]rade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services." I.R.C. § 513(c) (1982), added by Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(c), 83 Stat. 487, 542-43; see Kaplan, *supra* note 2, at 1438-39. "[F]or purposes of section 513 the term 'trade or business' has the same meaning it has in section 162"—that is, the ordinary and necessary business expense section. Treas. Reg. § 1.513-1(b) (1975). The critical test for "trade or business" under I.R.C. § 162 is profit motive. *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984); see *United States v. American Bar Endowment*, 106 S. Ct. 2426, 2430 & n.1 (1986); see generally *Professional Ins. Agents v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984) (selection of specific insurance program based on amount of insurance premiums shared by tax-exempt organization subjects organization to unrelated business tax); *Carolinas Farm & Power Equip. Dealers v. United States*, 699 F.2d 167 (4th Cir. 1983) (rebates from group insurance program are unrelated business income to tax-exempt organization).

Passive investment income thus may not be attributable to a "trade or business" because neither the sale of goods nor the performance of services is involved. However, the use of "includes" rather than "means" in I.R.C. § 513(c) is equivocal. See *Hopkins & Kaplan, Could Ditunno and Hoopengartner Result in Expanding the Scope of Unrelated Business?*, 60 J. TAX'N 40, 41 (1984). Passive income is in any case generally removed from the tax computations of a section 501(c)(3) organization by I.R.C. § 512(b) (1982). See *supra* note 43.

The statute also specifically excludes from taxation certain activities that rise to the level of a trade or business but that Congress nonetheless thought were entitled to protection: those activities (1) in which substantially all the work is performed without compensation; (2) that are carried on primarily for the convenience of the organization's "members,

full-fledged athletic program are "regularly carried on."<sup>60</sup> The critical inquiry, therefore, will usually be whether the activity is "substantially related" to the institution's exempt purposes. Under regulations promulgated in 1967, the dispositive question is whether the trade or business, although motivated in part by a desire for income, "contribute[s] importantly to the accomplishment of [the exempt] purposes."<sup>60</sup>

As a theoretical matter, determining whether a trade or business "contributes importantly" requires an analysis of the facts of each case.<sup>60</sup> Significant facts include the level of profits (the greater the profits, the more likely the trade or business is unrelated);<sup>61</sup> the scope of the activity in comparison with the organization's exempt purposes (the more the activity overwhelms the clearly exempt functions of the enterprise, the greater the prob-

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students, patients, officers, or employees," such as a college's operation of a laundry to wash dormitory linen; or (3) that involve the selling of merchandise, substantially all of which was received by the organization as gifts or contributions. I.R.C. § 513(a) (1982); Treas. Reg. § 1.513-1(e) (1971). Only the first exception can even arguably apply to intercollegiate athletics and "student athletes," and its application is unlikely. Athletic scholarships may not constitute taxable compensation to the recipients, *see supra* note 2, but they may well constitute compensation for purposes of I.R.C. § 513(a). Even if the scholarships are not compensation, any college athletic department has other "clearly compensated employees" among its coaches, administrators, and support staff. *See Kaplan, supra* note 2, at 1460-63.

58. The regulations state that ordinarily a trade or business will be treated as "regularly carried on" if the business activities "manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations." Treas. Reg. § 1.513-1(c)(1) (1967). The fact that a football team's season is limited to a less-than-annual period thus should not affect the conclusion that the team's operations are "regularly carried on." *See Kaplan, supra* note 2, at 1449-50.

59. Treas. Reg. § 1.513-1(d)(2) (1967). For taxable years beginning prior to December 13, 1967, the regulations provided that an activity was "substantially related" only "if the principal purpose of such trade or business is to further . . . the purpose for which the organization is granted exemption." Treas. Reg. § 1.513-2(a)(4) (1968) (emphasis added). Under this standard, an activity was unrelated unless its primary objective was furthering the exempt purpose. *See Iowa State Univ. v. United States*, 500 F.2d 508, 520 (Ct. Cl. 1974) ("the commercial aspects and the emphasis on revenue maximization were the overwhelming goals of the operation of the [television] station; and, thus, the business was not substantially related to the educational purposes of the University"); *Kaplan, supra* note 2, at 1450-51. The new regulatory standard thus liberalized the protection for profit-making activities of exempt organizations.

60. Treas. Reg. § 1.513-1(d)(1) (1968). *See United States v. American College of Physicians*, 106 S. Ct. 1591, 1599-1600 (1986) (emphasis in original): "[T]he statute provides that a tax will be imposed on 'any trade or business the conduct of which is not substantially related,' . . . directing our focus to the manner in which the tax-exempt organization operates its business."

61. *See, e.g., Carle Foundation v. United States*, 611 F.2d 1192, 1198 (7th Cir. 1979), *cert. denied*, 449 U.S. 824 (1980).

lem);<sup>62</sup> and the content of the activity (the less the educational or other tax-exempt component, the more likely the imposition of the tax).<sup>63</sup> If big-time intercollegiate athletic programs in their present forms were to be carefully analyzed under these principles, many would fare poorly:

The available evidence does show . . . that a great many athletic programs probably do have the characteristics of an "unrelated trade or business." . . . [T]hese programs are profit-motivated, at least in part; they are regularly carried on; and they have ventured far beyond the club sports model generally thought to promote educational values.<sup>64</sup>

As a practical matter, however, college athletic programs have not been carefully analyzed, except by one commentator.<sup>65</sup> Language in the legislative history of the Revenue Act of 1950 has been given an interpretation so favorable to colleges that nothing was left to decide—or so it has seemed.

When the unrelated business taxing scheme was being implemented, Congress only perfunctorily considered the application of the tax to intercollegiate athletics. The House Ways and Means Committee and the Senate Finance Committee heard no testimony

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62. Treas. Reg. § 1.513-1(d)(3) (1968) provides:

[T]he size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where . . . activities . . . are conducted on a larger scale than is reasonably necessary for performance of such functions the . . . portion . . . in excess of the needs of the exempt functions constitutes . . . [an] unrelated trade or business.

63. For example, a university that sponsors professional theater companies and symphony orchestras will not have unrelated business income from the activities even though the productions are open not only to students and faculty but also to the general public. "[T]he presentation of such drama and music events contributes importantly to the overall educational and cultural function of the university." Treas. Reg. § 1.513-1(d)(4)(iv), *ex. (2)* (1968).

Activities performed in a commercial manner may be treated as unrelated trades or businesses. *See, e.g.*, Treas. Reg. § 1.513-1(d)(4)(iii) (1967) ("asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor"); *cf.* Rev. Rul. 85-110, 1985-2 C.B. 166 (revenue from laboratory testing performed for private patients of exempt hospital's staff physicians held unrelated business income if laboratory services otherwise available in community). Two courts have recently rejected the government's argument that income from scientific research that could have been undertaken by commercial laboratories was necessarily unrelated business income. *IIT Research Inst. v. United States*, 9 Cl. Ct. 1, 85-2 U.S. Tax Cas. (CCH) ¶ 9734 (1985); *Midwest Research Inst. v. United States*, 554 F. Supp. 1379 (W.D. Mo. 1983), *aff'd per curiam*, 744 F.2d 635 (8th Cir. 1984); *see Simpson & Powell, Does Income of Exempt Scientific Research Organizations Come From Unrelated Business?*, 64 J. TAX'N 210 (1986).

64. Kaplan, *supra* note 2, at 1471.

65. *See id.*

on the issue, but reports of both committees nevertheless baldly asserted that "[a]thletic activities of schools are substantially related to their educational functions."<sup>66</sup> Accordingly, without apparent hesitation, the committees concluded, "*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."<sup>67</sup>

That conclusion should not have been an easy one even in 1950. Nevertheless, as a result of the conclusory statements in the legislative history, college sports have since enjoyed an exalted tax position. In 1977 the Internal Revenue Service briefly tried to carve out an area of taxability for revenues from broadcasting sports events.<sup>68</sup> The Service's aggressive posture was short-lived, however. College athletics are extremely popular, and public reaction was instantaneous. After a firestorm of protest, the Service decided, in a series of unpublished 1978 National Office Technical Advice Memoranda,<sup>69</sup> that "there is no meaningful distinction between exhibiting the game in person to 100,000 people and exhibiting the game on television to a much larger audience where both groups of people may be made up not only of students."<sup>70</sup> With

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66. H.R. REP. No. 2319, *supra* note 52, reprinted in 1950-2 C.B. at 409; S. REP. No. 2375, *supra* note 52, reprinted in 1950-2 C.B. at 505.

67. H.R. REP. No. 2319, *supra* note 52, reprinted in 1950-2 C.B. at 458 (emphasis added); S. REP. No. 2375, *supra* note 52, reprinted in 1950-2 C.B. at 559 (emphasis added). Moreover, a college "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." H.R. REP. No. 2319, *supra* note 52, reprinted in 1950-2 C.B. at 409; S. REP. No. 2375, *supra* note 52, reprinted in 1950-2 C.B. at 505; see Kaplan, *supra* note 2, at 1436. The committees perhaps considered college athletic events to be like the presentation of plays and musical events by students and faculty, activities now specifically protected by the regulations. See Treas. Reg. § 1.513-1(d)(4)(i), *ex. (1)* (1967).

68. The Service notified several universities and the Cotton Bowl Athletic Association, a tax-exempt entity that presents the annual Cotton Bowl football game, that revenue from the broadcasting rights to the game would constitute unrelated business income. See B. HOPKINS, *supra* note 45, at 637. Feeling bound by the legislative history, the Service conceded that gate receipts were not subject to the tax. The committee reports were silent on the broadcasting issue, however, presumably because revenues from such sources were inconsequential in 1950, see Tech. Adv. Mem. 78-51-002 (no date given), and the Service tried to take advantage of this gap in the legislative history.

69. The memoranda held that unrelated business income was not created by university sales of broadcast rights to football and basketball games, Tech. Adv. Mem. 78-51-002 (no date given), 78-51-005 (no date given), and 78-51-006 (no date given); by the sale of broadcasting rights by an amateur athletic union, Tech. Adv. Mem. 78-51-003 (no date given); and by the sale of broadcasting rights by a football bowl association, Tech. Adv. Mem. 78-51-004 (Aug. 21, 1978).

70. Tech. Adv. Mem. 78-51-002 (no date given), 78-51-004 (Aug. 21, 1978), and 78-51-

these memoranda and two similar Revenue Rulings published in 1980,<sup>71</sup> the Service admitted defeat, at least temporarily, and adopted a hands-off position toward intercollegiate athletics.

It is altogether too easy to conclude from the history of the past thirty-seven years that college athletic programs are necessarily immune from the tax on unrelated business income. It is clear, however, that the Internal Revenue Service's concession on broadcasting revenue, like the longtime exemption of gate receipts, was premised on the *student* nature of the activities. In one of the published rulings, for example, the Service stated, "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."<sup>72</sup> Moreover, the 1978 technical advice memoranda eloquently, almost reverently, extolled the student athlete in providing justifications, which the 1950 congressional committee reports had failed to provide, for connecting intercollegiate athletics with education:

[A]n 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.<sup>73</sup>

The rationale for not taxing major college athletic programs is

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006 (no date given).

71. Rev. Rul. 80-295, 1980-2 C.B. 194 (sale of broadcasting rights by amateur athletic union not unrelated trade or business); Rev. Rul. 80-296, 1980-2 C.B. 195 (sale of broadcasting rights to annual intercollegiate event by tax-exempt body not unrelated trade or business). See generally Thompson & Young, *Taxing the Sale of Broadcast Rights to College Athletics—An Unrelated Trade or Business?*, 8 J. COLL. & U.L. 331 (1982).

72. Rev. Rul. 80-296, 1980-2 C.B. 195, 195 (emphasis added); see Rev. Rul. 67-291, 1967-2 C.B. 184 (nonprofit organization that subsidizes training table for university's athletic teams furthers educational program of university and may be an I.R.C. § 501(c)(3) organization).

73. Tech. Adv. Mem. 78-51-002 (no date given), 78-51-004 (Aug. 21, 1978), 78-51-005 (no date given), and 78-51-006 (no date given).

thus grounded in quicksand. A reader of the proffered justifications must pretend that the state of major college athletics is something other than what he knows it to be.<sup>74</sup> The pretense is quite valuable for supporters of college athletics because it helps insulate the institutions from the inquiries of the Internal Revenue Service, but it is nonetheless a pretense. The effect of openly professionalizing college athletics would be to undo those thirty-seven years of favorable history. If colleges stop pretending that their athletic programs are related to the greater educational enterprise—that is, if the athletic teams are composed of acknowledged professionals, with no direct educational connection to the colleges except revenue-raising—the tax on unrelated business income will necessarily come into play.

A college establishing a professional team would have little in the way of defenses against a government challenge.<sup>75</sup> To be sure, the revenue produced might be used for educational purposes, but that could be said about the revenue from any profit-making activity undertaken by a college—NYU's macaroni operation and Columbia's hypothetical department store, for example. That the revenue will be put to good use, and that the burden of any tax would therefore fall on deserving persons,<sup>76</sup> will not protect a college from the tax on unrelated business income.<sup>77</sup> Neither of the purposes

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74. See *supra* notes 18-31 and accompanying text.

75. Certainly the college would have forfeited any argument that its athletic program was not an unrelated trade or business because "substantially all the work in carrying on such trade or business is performed . . . without compensation." I.R.C. § 513(a)(1) (1982). Even without open professionalization, however, that argument was unlikely to prevail. See *supra* note 57.

76. Bittker and Rahdert point out that

[b]y reducing the amount that the exempt organization can apply to its charitable . . . purposes, the tax necessarily burdens the beneficiaries of these activities, and their ability to pay ought to be considered in deciding whether and to what extent to impose the tax. Yet it was evidently never suggested during the 1950 and 1969 debates that the tax on the unrelated business income of charitable organizations reflected the ability to pay of those affected by it. Almost certainly . . . it did not, and thus made the income tax more regressive.

Bittker & Rahdert, *supra* note 40, at 325-26 (footnote omitted).

77. The statute requires determining whether the conduct of the activity is not "substantially related" to the organization's tax-exempt purpose without regard to "the need of such organization for income or funds or the use it makes of the profits derived." I.R.C. § 513(a) (1982).

If the organization uses "unrelated" funds to further "related" projects, it might seem that the unrelated business income should be reduced by the amount of a deemed charitable contribution. However, it is unclear that such a deemed transfer constitutes a "contribution" at all. See I.R.C. § 170(c) (1982). Even if it does, the amount of any deductible charitable contribution may not exceed 10% of the unrelated business taxable income (computed

behind the tax, protecting the Treasury and preventing unfair competition,<sup>78</sup> would be served if the tax could be so easily circumvented.

Nor will a college that establishes a professional sports program be able to defend successfully on the basis that there are no other, competing professional teams in the vicinity of the campus. It will not be sufficient, that is, to argue that one of the purposes behind the tax, preventing unfair competition, would not be served by the tax's application. As an initial matter, the "no competition" model is probably not accurate: regardless of location, a college team does, in fact, compete with professional teams through broadcasting. More important, the terms of the Internal Revenue Code do not require that actual competitors exist for the tax to apply; the Treasury regulations suggest that the likelihood of unfair competition can be inferred if the statutory requirements are met.<sup>79</sup> Judicial authority is to the same effect: the tax is not limited to income earned by a trade or business that operates in competition with taxing entities.<sup>80</sup>

Under existing law, colleges quite simply have no clear protection from taxation of income attributable to professional sports. A college considering the creation of an openly professional sports team should be aware, therefore, that the step may have far-reaching and undesirable tax consequences. And as the next section discusses, the consequences are not fully predictable. What are the dimensions of the "unrelated trade or business" to which the tax applies?

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without regard to the contribution). I.R.C. § 512(b)(10) (1982). *Cf. supra* note 51 (limit on deductibility of charitable contributions by corporation).

78. *See supra* notes 45-54 and accompanying text.

79. Treas. Reg. § 1.513-1(b) (1975) (activity meeting statutory requirements "presents sufficient likelihood of unfair competition to be within the policy of the tax"). Indeed, as the Supreme Court noted in its most recent pronouncement on the unrelated business income tax, the lack of competitors may evidence the competitive advantages provided the exempt entity. *See United States v. American Bar Endowment*, 106 S. Ct. 2426, 2431 & n.2 (1986) ("ABE's tax-exempt status would make it difficult for private firms to compete").

80. *Clarence LaBelle Post No. 217 v. United States*, 580 F.2d 270, 273-74 (8th Cir. 1978) (income from bingo game operated by social welfare organization is unrelated business income); *see Smith-Dodd Businessman's Ass'n v. Commissioner*, 65 T.C. 620, 624 (1975) ("unfair competition plays a relatively insignificant role in the application of the . . . unrelated business tax"); Kaplan, *supra* note 2, at 1467-68. Acutely aware of the special place of bingo in American life, Congress provided statutory relief in 1978, overruling the specific result in *Clarence LaBelle Post No. 217*. *See Pub. L. No. 95-502*, § 301(a), 92 Stat. 1693, 1702 (1978) (adding I.R.C. § 513(f)).

## V. THE TAXABLE ACTIVITY

The analysis, to this point, is easily summarized: a college that establishes an openly professional sports program will have a trade or business that is regularly carried on and that is not substantially related to the college's exempt educational purposes. Accordingly, a tax will be imposed on any unrelated business taxable income of the activity. That does not, however, end the analysis. The identity of the taxable activity is not so clear, particularly if a college does not professionalize its entire athletic program.<sup>81</sup>

If the appropriate trade or business is deemed to encompass the school's entire athletic program, the losses and other deductions attributable to nonrevenue sports may be used to offset income from the revenue-raisers.<sup>82</sup> Most big-time schools expend all or substantially all of their athletic revenues to support athletics generally,<sup>83</sup> and any tax liability might therefore disappear. If this is the proper analysis, the tax on unrelated business income would be merely an irritant to a college, resulting in no additional dollars flowing to the Treasury. Moreover, because all unrelated trades and businesses are aggregated in computing unrelated business income,<sup>84</sup> a college with an overall loss from an athletic program in a particular year could use the loss to offset income from other unrelated enterprises. Treating the entire athletic program as an unrelated trade or business in these circumstances could therefore even provide a temporary benefit to a college.<sup>85</sup>

If, however, the unrelated trade or business is determined to be only a single revenue-raising team or a group of revenue-raising teams, the tax results are obviously quite different. Football teams

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81. Because few sports are revenue producers, it is unlikely that all of a college's athletic teams would be openly professionalized.

82. See I.R.C. § 512(a)(1) (1982); Treas. Reg. § 1.512(a)-1(a) (1976). This assumes that the losses and deductions would be treated as "directly connected with the carrying on of the trade or business."

83. See *supra* note 38.

84. Treas. Reg. § 1.512(a)-1(a) (1976) provides:

In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities.

See B. HOPKINS, *supra* note 45, at 618.

85. The fact that other income may be offset by athletic program losses in particular taxable years does not permit a college to shelter such income forever. Because a trade or business is characterized by a search for profit, see *supra* note 57 and accompanying text, an athletic program generating perpetual losses might well not be treated as a trade or business to begin with.

by themselves are often hugely profitable;<sup>86</sup> a tax imposed on the revenue of such an enterprise could severely deplete university coffers.<sup>87</sup>

Determination of the boundaries of a trade or business is dependent on the facts of each case, and it is therefore impossible to state a conclusion applicable in all situations. Nevertheless, there is little doubt that the Internal Revenue Service would seek to treat any profitable component of a larger athletic program as a separate trade or business, and would therefore measure the tax by the net revenue of that component alone.

Each activity of an exempt organization is potentially a trade or business. Under an amendment made by the Tax Reform Act of 1969, the Internal Revenue Code gives the Service authority to "fragment" the activities of an otherwise exempt organization: "an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization."<sup>88</sup> Thus, the Service may break down even an apparently integrated operation into smaller parts.<sup>89</sup>

The fragmentation can result in some very fine particles. For example, the Service has ruled that an exempt blood bank's commercial sales of blood plasma had to be further subdivided: plasma acquired for resale generated income from an unrelated trade or business, but plasma produced as a by-product of providing blood products to hospitals did not.<sup>90</sup> Similarly, sales made by university bookstores must be fragmented into educational and noneducational components.<sup>91</sup> Sales made by the store of an exempt mu-

86. See *supra* notes 28-31 and accompanying text.

87. See *supra* note 13 and accompanying text.

88. I.R.C. § 513(c) (1982) (as added by Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(c), 83 Stat. 487, 542-43). The Code was amended to clarify that advertising revenues from publications of exempt organizations were potentially subject to tax.

The "fragmentation" approach was first promulgated in regulations in 1967, Treas. Reg. § 1.513-1(b) (1975), but the regulations were held invalid under the then existing form of the statute. See *Massachusetts Medical Soc'y v. United States*, 514 F.2d 153 (1st Cir. 1975); *American College of Physicians v. United States*, 530 F.2d 930 (Ct. Cl. 1976). Congress subsequently validated the fragmentation approach by amending the Code in 1969. See *United States v. American College of Physicians*, 106 S. Ct. 1591, 1595 (1986); Donahue, *supra* note 45, at § 27.04[1]; Shillingburg, *American College of Physicians v. United States: An Ending—A Beginning—Or?*, 64 TAXES 539, 541-43 (1986).

89. See *Hopkins & Kaplan*, *supra* note 57, at 41.

90. Rev. Rul. 78-145, 1978-1 C.B. 169.

91. See B. HOPKINS, *supra* note 45, at 641. The required fragmentation would in fact lead to three categories of businesses. The sale of directly educational material, such as

seum also must be broken down into "utilitarian" and "non-utilitarian" categories.<sup>92</sup>

If sales made by an exempt organization—even sales of fungible items such as blood plasma—do not constitute a single trade or business, there is no reason to believe that a college's athletic program could avoid fragmentation. The intercollegiate teams themselves provide one obvious basis for an accounting breakdown, and other components (such as broadcasting) can be imagined as well. Under the fragmentation approach, the Internal Revenue Service could reasonably single out certain teams (those concerned with revenue-raising) for treatment as unrelated trades or businesses and consequently impose the tax on the net revenue attributable to those teams. The colleges would not be permitted to offset that income with the expenses and losses attributable to other parts (the "substantially related" parts) of the athletic program. Under this analysis, a college that chose to professionalize its athletic program would be subject to the most painful application of the tax—to the net revenue of its money-making sports. With the current state of the law and the judicial deference generally accorded to the Service, a significant risk exists that such an application would be upheld in court.

One final point deserves mention. A college is placed in a strategic quandary if application of the tax on unrelated business income becomes a real possibility. The college will generally prefer that no part of the athletic program be treated as an unrelated trade or business and it will frame its litigation position accordingly. Once a determination is made that a revenue-raising sport is an unrelated trade or business, however, the college has an incentive to argue that the nonrevenue-raising sports are also unrelated trades or businesses. Only if such an argument prevails can the losses from those sports offset the income from the revenue-raisers. Yet the arguments in support of this alternative position are diametric to those the college must advance in support of its primary

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books and supplies, would be treated as substantially related to the exempt purposes; the sale of some other items, such as sundry goods, would probably be protected from tax under the convenience doctrine, *see supra* note 57; and the sale of still other items, such as clothing and plants, would generate unrelated business income. B. HOPKINS, *supra* note 45, at 641.

92. *See* B. HOPKINS, *supra* note 41, at 111. Hopkins cites Gen. Couns. Mem. 38,949 (July 16, 1982): "If the primary purpose of the article is utilitarian and utilitarian aspects are the predominant reasons for the production and sale of the article, it should not be considered related." *See also* Rev. Rul. 85-110, 1985-2 C.B. 166 (laboratory work done at exempt hospital for private patients of staff physicians is unrelated trade or business).

litigation position; the college cannot press the alternative without undercutting its primary contention. Thus, the effects of the tax on unrelated business income, when application of the tax to a college's athletic program becomes more than a theoretical possibility, are impossible to escape and difficult to contain.

## VI. CONCLUSION

An openly professional system, in which colleges hire athletes to represent them in competition, would open the door to the Internal Revenue Service's reconsideration of the tax status of major college athletics. The present system is characterized by hypocrisy, but it is hypocrisy that colleges discard at their peril.

If the hypocrisy is discarded, colleges may be subjected to the tax on unrelated business income. The unrelated trades or businesses that will be taxed may be limited to the profitable portions of the overall athletic enterprise, thereby substantially reducing the revenues available to the colleges.

Of course, none of this necessarily means that a big-time athletic college should not establish a professional football team. The tax on unrelated business income is only one of a number of factors for a college to consider, and other considerations—such as the purpose of the institution—are ultimately far more important than the effects of the Internal Revenue Code. Nevertheless, the effects of the tax should not be ignored. Many steps that seem full of economic promise appear considerably less favorable when the tax consequences are analyzed.