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Are Student-Athletes Winning Their Battles but Losing the (Tax) War?

By A.L. Spitzer


A.L. Spitzer

A.L. "Lorry" Spitzer is a partner in Ropes & Gray LLP's Boston office, where he specializes in tax and in nonprofit organizations. He would like to thank his colleagues Kendi Ozmon and Daniel Mejia for their assistance and encouragement. He would also like to acknowledge two significant and helpful law review articles: Richard L. Kaplan, "Intercollegiate Athletics and the Unrelated Business Income Tax," 80 *Colum. L. Rev.* 1430 (1980), and John D. Colombo, "The NCAA, Tax Exemption, and College Athletics," 2010 *U. Ill. L. Rev.* 109 (2010).

In this article, Spitzer argues that student-athletes, despite winning a significant antitrust decision and receiving the right to unionize (both decisions are on appeal), may end up worse off economically than when they started if the tax-free status of their scholarships is lost. Spitzer suggests a reassessment of the terms of athletic scholarships and that greater attention be paid to the long-term educational needs of student-athletes.

A. Introduction

This is a period of unprecedented change and challenge for collegiate athletics, with potentially surprising tax consequences to the parties involved. Two developments, in particular, have the potential to completely change the tax treatment of both players and schools. During 2014:

- a federal district court held that the antitrust laws prevent the NCAA from restricting some payments to student-athletes; and
- a National Labor Relations Board regional director permitted Northwestern University's football players to unionize.

Even though student-athletes were nominally the winners in both the antitrust litigation and in the *Northwestern* NLRB decision, they may end up disadvantaged by these recent developments by receiving a relatively small increase in scholarship assistance and/or compensation but with dramatically worse tax results.

B. Summary of Developments

1. *O'Bannon* Decision. In August, the Federal District Court for the Northern District of California held that some NCAA rules violate antitrust laws because those rules prevent student-athletes from being compensated for the use of their names and likenesses.[1] The case began in July 2009 when former UCLA basketball star Ed O'Bannon filed suit against the NCAA after seeing his likeness in a popular video game, and he was later joined in the case by former and current college athletes. The court rejected the NCAA's arguments that preventing student-athletes from sharing in the revenue generated through the use of their names and likenesses is necessary to preserve the academic and amateur nature of college athletics, and made several holdings regarding student-athletes' rights to compensation:

- First, the court rejected the plaintiffs' proposal that student-athletes be permitted to endorse commercial products, out of concern for potential commercial exploitation of the student-athletes.
- Second, the court held that the amount of compensation available to student-athletes while in school may be capped by the NCAA as long as the cap is not less than the full cost of attending school (as opposed to the existing cap equal to "grant-in-aid," which is limited to tuition, fees, room and board, and books). This change likely would amount to an additional $2,000 to $5,000 per student.
- Third, the court held that some payments for the use of the students' names and likenesses, while not payable currently, may be held in trust for student-athletes and distributed after their NCAA eligibility expires. The court held that this "deferred compensation" may be capped by the NCAA as long as the cap is no lower than $5,000 per year per athlete.

The holding did not provide for any compensation for the class-action plaintiffs, and the holding

[1] *O'Bannon v. NCAA*, No. C-09-3329-CW (N.D. Cal., Aug. 8, 2014).

indicated that it would not take effect until the start of the next recruiting cycle. The NCAA maintains that it has not violated federal antitrust law and has filed an appeal with the Court of Appeals for the Ninth Circuit, which has agreed to hear the case on an expedited basis.

2. Possible unionization of Northwestern football players. In March, an NLRB regional director in Chicago ruled that Northwestern University football players who receive university scholarships are university employees and thus the players are eligible to form a union[2]:

- Using the common law control test for assessing employee status, the regional director recited in considerable detail the control exercised by Northwestern over the members of the football team.
- He stated that effective for the 2012-2013 academic year the NCAA changed its rules to permit universities to offer four-year scholarships to players and that Northwestern began awarding its football recruits four-year scholarships, with an option for a fifth year for players who ''redshirted'' their freshman year. The scholarship could be canceled for various reasons, including the student-athlete's voluntary withdrawal from the sport at any time for any reason.

The NLRB decision was followed by a sealed vote by 76 scholarship football players in April on whether to form a college athletes union:

- Northwestern University appealed the decision of the regional director, and the full NLRB has agreed to hear the case.
- The result of the football players' union vote remains sealed pending the outcome of the appeal.
- The NCAA supported Northwestern in its appeal and has filed an amicus brief arguing that the recognition of student-athletes as university employees rather than students would negatively affect intercollegiate athletics, particularly by isolating student-athletes from other students and undermining the educational aspects of college athletics.

C. Tax Considerations

1. Taxation of student-athletes. While it is not surprising that the payments permitted under *O'Bannon* will give rise to taxable income to the student-athletes, there has been very little focus on the *tax reporting*, the *amount*, or the *timing* of that income. These issues become all the more critical if student-athletes are characterized as employees.

Current law is a mishmash regarding the taxation of scholarships:

- A ''qualified scholarship'' (used to pay for tuition, fees, books, and supplies) is excluded from taxable income under section 117(a) as long as it is not provided as payment for required services by the student. Section 117(c).
- A scholarship for additional expenses, most notably room and board, constitutes taxable income to the student, although Congress in connection with the enactment of the Tax Reform Act of 1986 explicitly excluded this amount of income from required tax reporting on Form 1099, thus indirectly encouraging a generation of students to underpay their taxes. Notice 87-31, 1987-1 C.B. 475; reg. section 1.6041-3(n).

Despite this permissive IRS position on income reporting for scholarships, the additional support payments authorized by the NCAA, plus payments for the use of names and likenesses, would likely be reportable by the institution to the IRS and to the student-athlete, as described below. Further, to the extent the scholarship itself is conditioned on the student remaining on the team for which he was recruited, the otherwise tax-free scholarship for tuition, fees, and books could be subject to tax because it would constitute a payment for services rather than a qualified scholarship. In that event, it is entirely possible that even if a student receives the additional compensation permitted by the *O'Bannon* court, he would be in a much worse after-tax economic position.

a. IRS response to *Northwestern* decision. In light of the Northwestern union vote, Sen. Richard Burr, R-N.C., requested information from the IRS regarding its position on the taxability of college athletic scholarships. IRS Commissioner John Koskinen responded to the request by issuing a public letter in which he stated that the NLRB ruling with regard to labor law does not control the tax treatment of student-athletes. He confirmed the IRS position that a ''qualified scholarship'' for a student-athlete (which as noted above does not include support for room and board or other expenses) can qualify for tax-free treatment if the student is not required to serve on the team in exchange for the scholarship, even though that service may be expected.

While the commissioner's letter was no doubt reassuring to the senator, it is not possible to easily square the letter's reliance on Rev. Rul. 77-263 with the facts recounted in the NLRB's regional director's ruling. In Rev. Rul. 77-263, the IRS recited that in awarding athletic scholarships:

[2]*Northwestern University and College Athletes Players Association (CAPA)*, No. 13-RC-121359 (NLRB Regional Director's Decision and Direction of Election, Mar. 26, 2014).

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> a student must be accepted at the university according to admissions standards applicable to all students at the university and must be a full-time student. . . . Once an athletic scholarship is awarded for a given academic year,[3] it cannot be terminated in the event the student cannot participate in the athletic program, either because of injury or the student's unilateral decision not to participate.

The revenue ruling concluded that based on these factual premises the athletic scholarship in question was a tax-free scholarship.

The NLRB regional director suggested that in his view none of these three conditions may have been satisfied at Northwestern. First, the regional director concluded that the scholarships in question at Northwestern could be canceled if the players voluntarily withdrew from the team. The regional director further suggested that student-athletes are not in fact admitted under the same admission requirements applicable to all other students. Finally, the regional director concluded that student-athletes are expected to perform, on average, at least 40 to 50 hours per week of football-related activities during the season (with more in the summer and less in the spring), making full-time student status difficult to achieve, given that the student-athletes receive no academic credit for playing football.[4]

While all concerned parties, including the student-athletes, can find some short-term solace in Koskinen's letter, it is not a long-term solution to a very real problem. For the interested parties to view the commissioner's letter as resolving the issue of the taxation of athletic scholarships is to engage in a game of ''Let's Pretend,'' in which the mutual obligations of the parties are simply disregarded.

b. 'Deferred compensation' under *O'Bannon*. The deferred payments authorized by the *O'Bannon* court for the use of students' names and likenesses could have at least two disadvantageous tax results. First, depending on the conditions imposed for the receipt of these payments, they would either be reportable to the IRS on Form W-2 as wages (if the students are determined to be employees) or on Form 1099 as miscellaneous income,[5] resulting in increased compliance and reporting burdens for both students and schools. This would be a marked departure from the current rules regarding taxable scholarships noted above, which specifically provide that taxable scholarships are not reportable by the payer to the IRS. The second disadvantageous result of deferred payments is that these payments may result in the acceleration of taxable income to the student-athlete. If treated as deferred compensation for services from the university or from the NCAA, the compensation might be accelerated under section 457(f) (which applies to deferred compensation plans established by tax-exempt organizations) and would be subject to various ERISA requirements (such as funding and fiduciary obligations) as well. It is possible that the student-athletes for whom $5,000 (or more) each is set aside each year would be taxed currently on this amount of income even though no cash is received.

c. Student-athletes as employees, in general. If, in accordance with the NLRB decision in *Northwestern*, student-athletes are considered employees, several additional tax and economic consequences could ensue:

- The student-athletes could be eligible for the entire suite of employee benefits offered by a school.
- Under the Affordable Care Act, the student-athletes could be eligible for required health insurance.
- If a student-athlete is not deemed to be primarily a student, his wages from the school would not be eligible for the ''student-FICA exclusion'' contained in section 3121(b)(10).

2. Taxation of revenue generated by the college or university from ticket sales, broadcast revenue, and commercial sponsorships. The student-athletes aren't alone in facing much worse tax consequences because of the *O'Bannon* and *Northwestern* decisions. Periodic attempts by the IRS to tax revenue generated by schools from athletics (other than from the sale of tickets) historically have been unsuccessful. Time and again, the IRS has abandoned these efforts when pressured by affected schools or Congress.[6] Nonetheless, the perception

[3]It appears that athletic scholarships at that time were renewable annually.

[4]Reg. section 31.3121(b)(10)-2, regarding the application of the FICA tax exemption for students, explicitly provides that the exception does not apply to a full-time employee of a school, college, or university. Anyone whose normal work schedule is 40 hours or more per week is considered a full-time employee, regardless of any ''educational, instructional, or training aspect'' of the services performed.

[5]The additional payment for the use of the students' names and likenesses would not fall within the definition of the term ''scholarship'' contained in reg. section 1.117-3 or in prop. reg. section 1.117-6.

[6]It is interesting that two salient examples both pertain to the taxation of revenue from the Cotton Bowl, adding further support for the adage ''Don't mess with Texas.'' In 1977 the IRS asserted that the sale of broadcast rights to the Cotton Bowl game gave rise to unrelated business taxable income. Following a firestorm of criticism, the IRS backed off this position in

(Footnote continued on next page.)

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that at some schools collegiate-level football and basketball have become commercial enterprises — a perception bolstered by the recent developments described above — may cause the IRS to seek to define unrelated business taxable income to include the various forms of income generated by collegiate athletics that are conducted on a ''commercial'' basis, including the sale of broadcast rights and commercial sponsorships. Such a change would result in the taxation of this income at corporate rates, and, given the growing perception of commerciality in college athletics, Congress may be less inclined than in the past to object. In fact, the sweeping tax reform proposal released by House Ways and Means Committee Chair Dave Camp, R-Mich., in February would explicitly repeal the current exclusion from UBTI for royalty income, an exclusion relied upon by many colleges and universities for sports-related income.

A common rebuttal to the view that Division I football and basketball are commercial activities not substantially related to the education of students is that these ''big money'' sports subsidize all collegiate athletics, thus broadening the opportunities for all students, both men and women, to enjoy the clear benefits of playing collegiate-level sports. In short, ''if you tax football, then field hockey dies.'' While a sympathetic argument, and no doubt true once the not-insubstantial expenses of the basketball and football teams have been covered, it falls short as a legal argument. The so-called fragmentation rule of section 513(c) requires that each income-producing activity be examined separately in determining relatedness. Further, the ''destination of income'' standard for tax exemption,[7] which places the primary emphasis on the use or destination of income, has been gone for many years.

At the most extreme, the IRS could argue that a large and successful athletic program endangers the tax-exempt status of the entire school. Some have already reached just this conclusion, especially in light of the *O'Bannon* and *Northwestern* decisions.[8] Nonetheless, it is hard to imagine that even the largest athletics program today could jeopardize a school's tax-exempt status, even if the program in its entirety were found to be an unrelated trade or business. While a credible ''private benefit'' argument could perhaps be made by the IRS,[9] the far more likely approach by the IRS would be a combination of imposing unrelated business income tax and perhaps asserting the imposition of intermediate sanctions penalties under section 4958 for the compensation of coaches.[10]

D. Conclusion

Some of the adverse tax consequences described above, such as increased taxation of student-athletes, could happen immediately. Individual schools, working in concert with the NCAA, would be well advised to reinforce the tax-free nature of qualified scholarships by avoiding any indication that these scholarships are bargained-for consideration for services. What may be most important in this regard is that athletic scholarships should be granted with no requirement that the student-athlete play on the team. Additional education of student-athletes (and their parents) as to the tax consequences under existing law of nonqualified scholarships is also called for to avoid the imposition of substantial, and surprising, tax liabilities. Other tax issues, such as the IRS characterizing some income flows as UBTI, or the IRS (or Congress) determining that compensation for coaches has become unreasonable, may evolve more slowly.

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several private letter rulings, culminating in the issuance of Rev. Rul. 80-296, holding that an athletic conference is not taxable on its sale of broadcast rights. *See* Richard L. Kaplan, ''Intercollegiate Athletics and the Unrelated Business Income Tax,'' 80 *Colum. L. Rev.* 1430, at 1431, n.1 (1980). In 1991 the IRS was back at it, ruling in TAM 9147007 (commonly referred to as the Mobil Cotton Bowl ruling) that payments made by the corporate sponsor to the bowl organization for naming rights constituted taxable advertising income. Another firestorm of criticism ensued, and the IRS and Congress took turns reversing this result, culminating in the enactment of the favorable corporate sponsorship rules of section 513(i). *See* Frances R. Hill and Douglas M. Mancino, *Tax'n of Exempt Organizations*, Warren, Gorham & Lamont (2012), para. 22.11[7].

[7]Before enactment of the unrelated business income tax in 1950, the U.S. Supreme Court had held that the destination, not the source, of income determined its eligibility for tax exemption. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924).

[8]Former Sen. John Sununu asserted, ''If the universities are going to compensate athletes for supporting multi-million dollar sports programs, the idea that these organizations are tax-exempt nonprofits becomes absurd.'' John E. Sununu, ''College Sports Should Be Taxed,'' *The Boston Globe*, Aug. 18, 2014.

[9]The private benefit doctrine is derived from the requirement under section 501(c)(3) that a tax-exempt organization be organized exclusively and operated primarily for one or more qualifying exempt purposes (*e.g.*, religious, educational, or charitable). Although the term ''private benefit'' is not included in the statute, the IRS has stated that an organization will not qualify for tax exemption if it confers private benefits upon an individual that are more than incidental, quantitatively and qualitatively, to the furthering of its exempt purposes. *See* Andrew Megosh et al., ''Private Benefit Under IRC 501(c)(3),'' in *IRS Exempt Organizations Continuing Professional Education for the Fiscal Year 2001* at 136 (2001).

[10]Section 4958 imposes a 25 percent excise tax on the receipt of excessive compensation by some influential employees (and others) of a tax-exempt organization. The excessive compensation must be returned to the organization, or a further tax equal to 200 percent of the amount of compensation deemed excessive is imposed on the recipient of the compensation.

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All concerned parties (schools, student-athletes, NCAA, conferences) need to work together to permit collegiate athletics to continue to flourish but with the interests of the student-athletes protected. Neither stonewalling nor grandstanding is going to solve the difficult issues raised by recent legal developments. The concerns of student-athletes are legitimate and deserve a careful airing, as are the concerns of the NCAA and individual schools seeking to protect the integrity of these schools' educational and amateur athletic programs. Congress has an important role to play as well and could help convene this conversation. The IRS has an obligation to the tax system as a whole, and the tax-exempt sector in particular, to speak clearly and consistently when interpreting the important issues raised by these developments, including employee classification, characterization and reporting of income, UBTI, and the application of the intermediate sanctions rules.

And finally, a modest proposal. To bolster their argument that football and basketball are related activities for purposes of UBIT, schools should seek to demonstrate that the *education* of student-athletes is of paramount concern. No-show courses, or easy but irrelevant courses, undermine this argument. Academic programs should be designed that meet the specific needs of the student-athletes, including those athletes who choose to exercise a ''right of return'' (if one is granted) and finish their education following a period of playing professionally. These individuals, who may have failed to receive a proper education and who cannot ultimately support themselves playing professionally, are the biggest losers under the current system. Not only are their scholarships potentially taxable, but they may not be getting much in return. It is to these students, in particular, that schools, leagues, and associations owe a duty — a duty to help them complete their education through meaningful, well-designed programs that address their unique situations.

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