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RECENT FEDERAL INCOME TAX ISSUES REGARDING PROFESSIONAL AND AMATEUR SPORTS

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I. INTRODUCTION

This article is not intended to be a complete treatment of all federal tax issues affecting professional and amateur sports. That would constitute a massive undertaking and could easily comprise a treatise. This article will instead provide a comprehensive treatment of certain federal tax issues affecting professional and amateur sports that have been the subject of recent debate or revisions of applicable law. This article will address the following topics: federal tax issues affecting the financing of professional sports facilities; applicability of the unrelated business income tax to the funding of college and university athletic programs; and deductibility of contributions to colleges and universities in exchange for the use of stadium skyboxes.

II. FEDERAL TAX ISSUES AFFECTING THE FINANCING OF PROFESSIONAL SPORTS FACILITIES

A. Introduction

Since the late 1960s, the construction of professional sports stadiums, arenas, and ballparks has literally exploded.² This explosion has resulted in an enormous amount of expenditure and a consequential need for financing for these facilities.³ The construction of such facilities has been primarily, if not

1. Professor of Law, South Texas College of Law.

2. See JAMES QUIRK & RODNEY D. FORT, *PAY DIRT: THE BUSINESS OF PROFESSIONAL SPORTS* 135 (1992); Daniel J. Lathrope, *Federal Tax Policy, Tax Subsidies, and the Financing of Professional Sports Facilities*, 38 S. TEX. L. REV. 1147, 1148 (1997).

3. See Lathrope, *supra* note 2, at 1149. "It has been estimated that new [facility] costs were approximately \$500 million in the 1960s, \$1.5 billion in the 1970s, and \$1.5 billion in the 1980s." *Id.* "[I]t is estimated that more than \$5 billion may eventually be expended on new stadiums, arenas, and ballparks in the latter part of the 1990s," and that the total cost of such facilities during all of the

exclusively, undertaken by local governments.⁴ The manner in which local governments have chosen to finance these facilities has been almost exclusively through the issuance of tax-exempt bonds.⁵ This method of financing is preferred because such bonds enjoy a below-market interest rate as a result of the exemption from federal taxation of the interest earned on the bonds by the bond-holders.⁶ Section II.B. of this article will discuss the mechanics of section 103 of the Internal Revenue Code (Code) as it relates to the federal tax exemption for interest on state and local bonds used to finance professional sports facilities. Section II.C. will discuss various criticisms that have been made of the availability of a federal tax exemption for interest on state and local bonds used for such purposes, and section II.D. will discuss various proposals for reform.

B. The Mechanics of Section 103 of the Internal Revenue Code

State or local bonds may be issued either as general purpose bonds or specific purpose bonds.⁷ While a "general purpose bond may be issued for any lawful purpose,"⁸ a specific purpose bond relates to a specific project, such as a professional sports facility.⁹ A state or local government can pay principal and interest on bonds from its general tax revenue (in which case the bond is a general obligation bond) or the revenue of the specific project (in

1990s will exceed \$8 billion. *Id.*

4. *Id.* There have been several reasons cited for this development. First, the "monopoly power of the major sports leagues," by limiting the supply of existing franchises, has conferred upon professional sports teams substantial bargaining power to seek construction of a new facility. *Id.* A team is able to threaten a move to another location if a city or county fails to meet its demands. *Id.* Second, "[t]he current state of the antitrust laws . . . provides a professional team with leverage [when] dealing with [local governments regarding] construction of a new facility." *Id.* "[A] professional sports league is potentially at risk for antitrust claims, including treble damages, if it denies a franchise permission to relocate to another city." *Id.*; see, e.g., L.A. Mem'l Coliseum Comm'n v. Nat'l Football League, 726 F.2d 1381 (9th Cir. 1984). Third, "evolving economic relationships in professional sports" contribute to the construction of new facilities by significantly increasing a team's need to maximize its stadium revenue. Lathrope, *supra* note 2, at 1150-51.

5. Many state or local projects are financed through the use of bonds due to the pressure on state or local governments to reduce, or at least not to increase, taxes. See Kevin M. Yamamoto, *A Proposal for the Elimination of the Exclusion for State Bond Interest*, 50 FLA. L. REV. 145, 148 (1998).

6. See I.R.C. § 103(a) (2002).

7. See Yamamoto, *supra* note 5, at 155. "A bond is essentially a loan from the purchaser of the bond to the seller." *Id.* at 147 n.3. Unlike stock, a bond "does not provide any equity interest in the [seller or any] property [of the seller]." *Id.* Bond interest is normally paid by the seller to the purchaser at predetermined dates periodically during the period until the bond matures. *Id.*

8. *Id.* at 155.

9. *Id.*

which case the bond is a revenue bond).¹⁰ In either case, interest paid on the bonds can be excludible under section 103 of the Code.¹¹

Section 103(a) specifically provides that, except as provided in section 103(b), “gross income does not include interest on any State or local bond.”¹² This interest exemption primarily explains why local governments have chosen to finance professional sports facilities almost exclusively through the issuance of bonds.¹³ The interest exemption allows the local government to competitively issue bonds at a lower interest rate than other non-tax-exempt bonds offered in the marketplace.¹⁴ The interest savings to state and local governments resulting from this tax exemption “amounts to an indirect federal subsidy to [the] state [and local] governments” issuing the bonds.¹⁵

Section 103(b) provides that section 103(a) “shall not apply to[:] (1) . . . [a]ny private activity bond which is not a qualified bond (within the meaning of section 141)[;] (2) . . . [a]ny arbitrage bond (within the meaning of section 148)[; or] (3) . . . [a]ny bond [that does not meet] the applicable requirements of section 149” (which deals with bonds not in registered form).¹⁶ Section 103(b)(1), the exception to section 103(a) for private activity bonds, has particular application to the financing of professional sports facilities. A private activity bond is defined in section 141 as any bond satisfying (1) the private business use test in section 141(b)(1)¹⁷ and the private security or payment test in section 141(b)(2),¹⁸ or (2) the private loan financing test in section 141(c).¹⁹ A qualified bond, to which section 103(a) will apply notwithstanding its status as a private activity bond, is defined in section 141(e),²⁰ which provides a specific list of which types of bonds meet the definition,²¹ and then provides a volume cap (set forth in section 146)²² for

10. *Id.*

11. *Id.* at 156. Section 103 can also apply to either general or specific purpose bonds. *Id.* at 155-56.

12. I.R.C. § 103(a).

13. *See supra* note 5 and accompanying text.

14. *See Yamamoto, supra* note 5, at 153.

15. *Id.*; *see supra* note 5 and accompanying text.

16. § 103(b). These exceptions to section 103(a) were created by Congress “[a]s a reaction to perceived abuses,” one of which was the “utilization of tax-exempt bonds to fund projects ultimately used by private business.” *See Yamamoto, supra* note 5, at 157.

17. I.R.C. § 141(b)(1).

18. *Id.* § 141(b)(2).

19. *Id.* § 141(c).

20. *Id.* § 141(e).

21. *Id.* § 141(e)(1).

those bonds included on the list.²³ Bonds used to finance professional sports activities are not included on the list, and thus cannot constitute qualified bonds.²⁴ As a result, to achieve tax-exempt status under section 103(a), bonds used to finance professional sports facilities must avoid satisfying (1) either the private business use test or the private security or payment test of section 141(b), and (2) the private loan financing test of section 141(c).

The private business use test is satisfied "if more than 10 percent of the proceeds of the [bond] issue are to be used for any private business use."²⁵ This will normally be the case for any bond issue used to finance a professional sports facility.²⁶ The facility will normally be used primarily, if not entirely, by the professional team, a private business entity. Thus, the private security or payment test will be the critical test to avoid in the case of a bond issue used to finance a professional sports facility.

"The private security [or payment] test is satisfied if the principal, or the interest payments, on more than 10% of the bond proceeds [of the issue] is either *directly* or *indirectly* (1) secured by property used for a private business use," or payments to be made with respect to such property (*e.g.*, the professional sports facility or payments to be made to the local government by the team for the use of such facility); "or (2) going to be derived from payments [with respect to] property used for a private business use" (*e.g.*, payments to be made to the local government by the team for the use of the professional sports facility).²⁷ As a consequence, state or local governments

22. *Id.* § 146.

23. *Id.* § 141(e)(2).

24. *Id.* § 141(e)(1). Bonds issued to finance sports arenas were at one time included on the list provided by section 141(e), and therefore constituted qualified bonds. Congress repealed that provision in the Taxpayer Relief Act of 1976. Brent Bordson, *Public Sports Stadium Funding: Communities Being Held Hostage by Professional Sports Team Owners*, 21 *HAMLIN L. REV.* 505, 523 n.174 (1998) (citing STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 1175 (Comm. Print 1987)). Congress was apparently "concerned that the large volume of tax-exempt bonds and [the] ability of higher income taxpayers to avoid the payment of taxes was eroding confidence in the tax system." *Id.* at 523 n.175 (citing THE TAX REFORM ACT OF 1986 LEGISLATIVE HISTORY, HOUSE WAYS AND MEANS COMMITTEE REPORT ON H.R. 3838, BNA 514 (1985)). The Committee was apparently seeking "to limit tax-exempt bonds to only those functions that were most essential to the general public." *Id.* In making this change, "Congress [apparently] assumed that tax-exempt funding of sports [facilities] would cease because taxpayers would not support paying at least 90 percent of the [cost of the facility] with general governmental revenues." *Id.* at 523. Obviously, such a result did not occur. *Id.*; see also Lathrope, *supra* note 2, at 1162; *supra* note 5 and accompanying text.

25. I.R.C. § 141(b)(1).

26. See Lathrope, *supra* note 2, at 1156.

27. I.R.C. § 141(b)(2); Lathrope, *supra* note 2, at 1157. An alternate test applies if the facility is to be used for both private business use and government use. I.R.C. § 141(b)(3).

constructing a professional sports facility must find a source of revenue (other than the facility itself, the revenue from such facility, or the team using or operating the facility) to pay at least 90% on the principal and interest payments of the bonds.²⁸ In addition, because of the language prohibiting more than 10% of the principal or interest payments on the bonds to *indirectly* be derived from payments with respect to the facility, total stadium revenue to be paid to the local government by the team may not exceed the 10% threshold.²⁹ As a result, the operation of these rules requires, as a practical matter, that local governments “offer favorable rental terms to the [professional sports] team using the facility.”³⁰

C. Criticisms

Various criticisms have been made of the availability of a federal tax exemption for interest on state and local bonds used to finance professional sports facilities.³¹ These include: (1) criticism of the practical requirement, discussed above, that local governments offer favorable rental terms to the professional sports team using the facility;³² (2) criticism of the federal tax exemption on federal policy grounds; and (3) criticism of the federal tax exemption on equity grounds.

1. State and Local Subsidies

As discussed above, the operation of sections 103 and 141 of the Internal Revenue Code requires, as a practical matter, that local governments “offer favorable rental terms to the [professional sports] team using the facility.”³³ It has been asserted that “state and local subsidies for professional sports [teams] generally are not economically justified.”³⁴ This assertion is based primarily

28. Lathrope, *supra* note 2, at 1157.

29. *Id.*

30. *Id.* This result has been criticized, primarily because “research indicates that state and local subsidies for professional sports [teams] generally are not economically justified.” *Id.* at 1153; see also *infra* notes 32-38 and accompanying text.

31. For a thorough and thoughtful analysis of the historical background of section 103 of the Internal Revenue Code, see Yamamoto, *supra* note 5. This article criticizes the underlying policy basis for section 103 and discusses various proposals for its repeal and replacement. *Id.*

32. See *supra* note 30 and accompanying text.

33. Lathrope, *supra* note 2, at 1157.

34. *Id.* at 1153; see also Bordson, *supra* note 24, at 507; Matthew J. Mitten & Bruce W. Burton, *Professional Sports Franchise Relocations from Private Law and Public Law Perspectives: Balancing Marketplace Competition, League Autonomy, and the Need for a Level Playing Field*, 56 MD. L. REV. 57, 144-45 (1997).

on research showing that a “professional sports [team] has only a small total economic effect” (approximately that of a new department store) on a local community.³⁵ In addition, “impact studies typically used to support [the construction of new professional] sports facilities are flawed [by the exaggeration of estimates of] . . . increased spending and economic development produced by [the] new facility.”³⁶ The research shows that the spending represented by the increased stadium revenue, rather than representing an expansion in the local economy, represents instead a shift from spending on other activities in the local community.³⁷ The flaw is compounded by the assumed multiple ripple effect of increased sports-related spending throughout the local economy.³⁸

2. Federal Tax Policy Considerations

As stated above, the interest savings to state and local governments resulting from the tax exemption provided by section 103 of the Code amounts to an indirect federal subsidy to the state and local governments issuing the bonds.³⁹ This federal subsidy has been justified on a policy basis by reasoning that the “benefits of [public capital facilities] extend beyond the jurisdiction that provides them,” and will therefore, without the subsidy, be provided at less than the optimum level.⁴⁰ Presumably, taxpayers of a given jurisdiction will not agree to subsidize nonresidents of the jurisdiction who receive the benefit of the public facilities.⁴¹ As discussed above, research has shown that a “professional sports [team] has only a small total economic effect” on a local community.⁴² As a result, there would be few benefits, if any, that would be provided at all by a professional sports facility, much less that would extend beyond the local governmental jurisdiction that constructed the facility.⁴³

35. See Lathrope, *supra* note 2, at 1153.

36. *Id.* at 1153-54.

37. *Id.* at 1154.

38. *Id.* Some experts have concluded that construction of a professional sports facility may actually have a negative economic effect on the local community. *Id.*

39. See *supra* note 5 and accompanying text.

40. See Lathrope, *supra* note 2, at 1159.

41. *Id.*

42. *Id.* at 1153.

43. See also Yamamoto, *supra* note 5, at 173-78 (arguing that section 103 of the Code in general is an inefficient method of subsidizing state and local governments).

3. Equity Concerns

The indirect federal subsidy provided by section 103 of the Code as it relates to the financing of professional sports facilities has also been attacked on equity grounds. Generally, the argument is that the subsidy “ultimately benefits . . . financially well-off owners and players in professional sports.”⁴⁴

D. Proposals for Reform

In 1996 and again in 1997, Senator Daniel Patrick Moynihan introduced legislation, entitled the Stop Tax-Exempt Arena Debt Issuance Act,⁴⁵ which “would [effectively] eliminate federal subsidization of stadium construction in most instances.”⁴⁶ Specifically, the Act would amend section 141 of the Code to include in the definition of private activity bond any bonds issued, “‘if the amount of the [bond] proceeds . . . which are to be used (directly or indirectly) to provide professional sports facilities exceeds the lesser of (a) 5 percent of such proceeds, or (b) \$5,000,000.’”⁴⁷ If enacted, this legislation would have effectively classified most (if not all) bonds issued to finance professional sports facilities as private activity bonds, meaning that the holders of the bonds would not be entitled to a tax exemption under section 103 for interest payments received on the bonds.⁴⁸ Senator Moynihan’s proposed legislation was not enacted in either instance.

In 1996, Senators Mike Dewine and John Glenn introduced legislation, entitled the Team Relocation Taxpayer Protection Act of 1996,⁴⁹ that “would deny the federal [tax] subsidy [for] a relocating NFL franchise [if the franchise] breaks an existing lease with a publicly owned facility,”⁵⁰ and all of the following apply: (1) “the team is currently in a publicly owned facility and its lease has not expired;” (2) the team is relocating to a publicly owned

44. Lathrope, *supra* note 2, at 1161; *see also* Bordson, *supra* note 24, at 525 (discussing the negative attitude many citizens possess regarding professional athletics and modern professional athletes in general); Mitten & Burton, *supra* note 34, at 145; Yamamoto, *supra* note 5, at 178-81 (discussing the lack of equity regarding section 103 of the Code in general).

45. Bordson, *supra* note 24, at 523; S. 1880, 104th Cong. § 1 (1996); S. 434 105th Cong. § 1 (1997).

46. Mitten & Burton, *supra* note 34, at 146.

47. Bordson, *supra* note 24, at 524 (quoting 142 CONG. REC. S6310 (June 14, 1996)). In introducing this legislation, Senator Moynihan stated that tax-exempt financing creates an unintended federal subsidy and primarily benefits professional athletes and sports team owners, who need no federal assistance of any kind. *See* Lathrope, *supra* note 2, at 1163.

48. I.R.C. § 103(b)(1); Mitten & Burton, *supra* note 34, at 146.

49. S. 1529, 104th Cong. (1996).

50. Lathrope, *supra* note 2, at 1164.

facility; (3) the team's average attendance in the preceding season was at least 75% of stadium capacity; and (4) the team's "current jurisdiction has voted [for] taxes to improve the existing facility or build a new facility."⁵¹ This legislation was also not enacted.

Rather than a nuclear strike, which was attempted under the Moynihan proposal, other more thoughtful proposals have been suggested for addressing the criticisms discussed above. Daniel Lathrope, in his most thorough article on this subject, suggested reclassifying bonds issued to finance professional sports facilities as qualified private activity bonds under section 141(e) of the Code.⁵² Lathrope concludes that

[t]his approach would have several benefits First, the volume cap [applicable to qualified] bonds would force bonds issued for sports facilities to compete with other forms of financing subject to the cap. [Second,] [t]he volume cap also has the effect of limiting the total amount of the federal subsidy to capped bonds so there would no longer be an open-ended subsidy for [bonds issued to finance] professional sports facilities. [Third,] [t]he total state and local subsidy [applicable] to professional sports [facilities] might also be reduced because [the bonds would no longer be subject to the private security or payment test under Section 141. Finally,] [c]lassifying bonds financing sports facilities as [qualified] private activity bonds would also subject those bonds to a number of other Internal Revenue Code provisions, [such as Section 147(e) prohibiting qualified bonds to be used to provide a skybox or other luxury box, and thus provide for more effective regulation of the issuance of such bonds].⁵³

Yet another proposal was made by Matthew Mitten and Bruce Burton in their article dealing with various issues involving the relocation of professional sports franchises.⁵⁴ Professors Mitten and Burton suggest that

Congress should [(1)] condition the availability of tax-exempt [bond financing for professional sports facilities] on a franchise owner's agreement that the minimum duration of its lease with a publicly owned . . . facility will be at least as long as the length of public debt service incurred to build or improve the facility for the benefit of the

51. *Id.*

52. *Id.* at 1163; I.R.C. § 141(e).

53. Lathrope, *supra* note 2, at 1163-64 (alteration in original) (citations omitted); *see also* Dennis Zimmerman, *Tax-Exempt Bonds and the Economics of Professional Sports Stadiums* 22 (Cong. Res. Serv. Rep. May 29, 1996).

54. Mitten & Burton, *supra* note 34, at 146-47.

franchise . . . [; (2)] provide federal courts with the express authority to enjoin a franchise from relocating, prior to the expiration of its lease with a publicly owned or subsidized . . . facility financed with tax-exempt bonds, absent clear and convincing evidence that the franchise is not financially viable and is unable to field a competitive league team in its current location[; (3)] [require a] team owner . . . to provide notice of an intent to relocate at least one year before a franchise's existing lease obligations will expire[, in part to allow] . . . community and business leaders to determine the feasibility of private financing of all or part of the cost to build or improve a . . . facility[; and (4) require a] franchise owner [to] negotiate exclusively and in good faith for a given time period . . . with local officials to keep the team in its host city.⁵⁵

As yet, none of the above proposals have been enacted or even seriously considered by Congress. While that may indicate that Congress does not consider the concerns and criticisms discussed above to be particularly important, the issue that seems to engender the most discussion and concern by Congress whenever it arises is the relocation of professional sports franchises. The probable cause for that is the intense personal interests of businesses and individuals affected by such relocations, coupled with the intense political desire of individual members of Congress to represent the interests of (or at least not raise the ire of) their constituents. As a result, that issue will most likely continue to surface, and legislation may eventually be enacted dealing with that issue that may affect tax-exempt bond financing of professional sports facilities, as discussed above.

III. APPLICABILITY OF THE UNRELATED BUSINESS INCOME TAX TO THE FUNDING OF COLLEGE AND UNIVERSITY ATHLETIC PROGRAMS

A. Introduction

Congress enacted the Unrelated Business Income Tax (UBIT) as part of the Revenue Act of 1950.⁵⁶ Prior to the enactment of UBIT, colleges and universities had enjoyed, under their general tax exemption,⁵⁷ tax-free use of

55. *Id.* at 146-48.

56. See Richard L. Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430, 1434 (1980) (citing Revenue Act of 1950, Pub. L. No. 81-814, §§ 301, 331, 64 Stat. 906, 947, 957 (1950)).

57. "I.R.C. § 501(a) (1982) provides generally that certain organizations are exempt from federal

all funds regardless of the source from which the funds were received.⁵⁸ The law prior to the enactment of UBIT “recognized only two possibilities—an organization was either entirely taxable or entirely tax-exempt.”⁵⁹ As a result, “the courts generally upheld the tax-exempt status of” activities conducted by colleges and universities, regardless of the relationship of those activities to the institution’s exempt purpose.⁶⁰ One of the leading cases in this regard was *C.F. Mueller Co. v. Commissioner*.⁶¹ The court in that case granted tax-exempt status to New York University’s revenue resulting from ownership of the C. F. Mueller company, a leading macaroni producer.⁶² The UBIT was enacted out of concern that the Treasury was in need of protection from loss of tax revenue in these cases,⁶³ and taxpaying entities were in need of protection from unfair competition from the colleges and universities.⁶⁴

B. *The Mechanics of the Unrelated Business Income Tax*

The UBIT imposes a tax, at rates applicable to taxable corporations,⁶⁵ on the “unrelated business taxable income”⁶⁶ (UBTI) of most tax-exempt

income tax.” Erik M. Jensen, *Taxation, the Student Athlete, and the Professionalization of College Athletics*, 1987 UTAH L. REV. 35, 44 n.41 (1987). Section 501(c)(3) includes colleges and universities within that list of organizations, subject to certain conditions stated therein. *Id.* In addition to receiving tax-exempt status, an organization described in section 501(c)(3) will enjoy the benefits of section 170, which will result in deductibility of contributions to such an organization, subject to certain limitations stated in that section. *Id.* One requirement for qualification under section 501(c)(3) is that a substantial portion of the organization’s revenue must not be derived from sources unrelated to its exempt purpose. *Id.* Unrelated income would likely be substantial if it constituted more than one-half of the organization’s annual revenue. *Id.*

58. Kaplan, *supra* note 56, at 1433.

59. *Id.*

60. *Id.*

61. 190 F.2d 120 (3rd Cir. 1951), *rev’g* 14 T.C. 922 (1950).

62. *Id.* at 122-23; Kaplan, *supra* note 56, at 1432-33.

63. In Congressional hearings considering enactment of the Revenue Act of 1950, Representative Dingell stated that “[e]ventually all the noodles produced in this country will be produced by corporations held or created by universities . . . and there will be no revenue to the Federal Treasury from this industry. That is our concern.” See Kaplan, *supra* note 56, at 1433 (citing *Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means*, 81st Cong., 2d Sess. 19, 580 (1950) (remarks of Rep. Dingell) [hereinafter *House Hearings*]).

64. *Id.* President Truman addressed this issue in his 1950 message to Congress, stating that “an exemption intended to protect educational activities has been misused in a few instances to gain competitive advantage over private enterprise through the conduct of business and industrial operations entirely unrelated to educational activities.” *Id.* at 1433 (citing Message of the President, 96 Cong. Rec. 769, 771, *reprinted in House Hearings*).

65. See I.R.C. § 511(a)(1).

66. *Id.*

organizations, including colleges and universities.⁶⁷ “Unrelated business taxable income” is generally defined as the “gross income [of] any organization from any unrelated trade or business . . . regularly carried on by [such organization], less [certain] deductions allowed . . . which are directly connected with the carrying on of such trade or business.”⁶⁸ This definition requires a determination of whether an activity is (a) a trade or business, (b) regularly carried on, and (c) an “unrelated trade or business.”⁶⁹ An “unrelated trade or business” is generally defined as a “trade or business [of a tax-exempt organization,] the conduct of which is not substantially related . . . to the [organization’s] exercise or performance . . . of its [exempt] . . . function” (*i.e.*, education in the case of a college or university).⁷⁰

1. Trade or Business

The term “trade or business” is defined in section 513(c) of the Code to “include[] any activity which is carried on for the production of income from the sale of goods or the performance of services.”⁷¹ The Treasury Regulations provide that the term “trade or business” in section 513 has the same meaning as in section 162 dealing with the deduction of ordinary and necessary business expenses.⁷² The Supreme Court has ruled that a taxpayer is “engaged in a trade or business [when he is] involved in [an] activity with continuity and regularity[, and his] primary purpose for engaging in the activity [is] for income or profit.”⁷³ “[R]esolution of this issue ‘requires an examination of the facts in each case.’”⁷⁴

2. Regularly Carried On

The Treasury Regulations provide, in determining whether an activity is “regularly carried on,” that “the frequency and continuity with which the activities . . . are conducted,” and whether they “are pursued in a manner, generally similar to comparable commercial activities,” are important

67. *Id.* § 511(a)(2).

68. *Id.* I.R.C. § 512(a)(1). Gross income and deductions are both computed with the modifications provided in section 512(b). *Id.*

69. *Id.*

70. *Id.* § 513(a). This definition is subject to certain narrow exceptions. See I.R.C. § 513(a)(1)-(3).

71. *Id.* § 513(c).

72. Treas. Reg. § 1.513-1(b) (1975).

73. *Comm’r v. Groetzinger*, 480 U.S. 23, 35 (1987).

74. *Id.* at 36 (quoting *Higgins v. Comm’r*, 312 U.S. 212, 217 (1941)).

factors.⁷⁵ Seasonal activities are regularly carried on if they are conducted during a "significant portion of the season."⁷⁶

3. Unrelated Trade or Business

As noted above, a trade or business is an "unrelated trade or business" if its conduct is not substantially related to the organization's exercise or performance of its exempt function.⁷⁷ The Treasury Regulations provide that a substantial relationship will be found if the activity in question contributes importantly to the accomplishment of the organization's exempt purpose.⁷⁸ This determination is made based upon the facts and circumstances involved in each case.⁷⁹ Important facts would include the level of profits generated by the activity (the higher the profit level, the more an activity would appear to be unrelated to the organization's exempt purpose); the size and extent of the activities involved in relationship to the nature and extent of the exempt function of the organization which the activity purports to serve (the larger the activity in proportion to the organization's exempt functions, the more unrelated the activity would appear to be); and the actual relationship of the content of the activity to the organization's exempt purpose.⁸⁰ Due to the liberality of this test, it is not particularly difficult for an exempt organization to show that an activity is substantially related to its exempt purpose.⁸¹

C. Application to College and University Athletic Programs

It is generally assumed that many college and university athletic programs seek profit, and thus constitute the conduct by those organizations of a trade or business, as that term has been defined by the courts.⁸² Any individual athletic program must be analyzed with respect to this issue on the basis of its own particular facts.⁸³ It is equally assumed that the activities conducted by those programs are "regularly carried on," within the meaning of the Treasury

75. Kaplan, *supra* note 56, at 1449 (quoting Treas. Reg. § 1.513-1(c)(1) (1975)).

76. *Id.* (quoting Treas. Reg. § 1.513-1(c)(2)(i) (1975)).

77. *Id.* at 1450.

78. Jensen, *supra* note 57, at 49 (citing Treas. Reg. § 1.513-1(d)(2) (1967)).

79. *Id.*

80. *Id.* at 49-50 (citing Treas. Reg. § 1.513-1(d)(3)-(4)).

81. Kaplan, *supra* note 56, at 1452. *But see* Carle Found. v. United States, 611 F.2d 1192 (7th Cir. 1979), *cert. denied*, 101 S. Ct. 85 (1980).

82. Jensen, *supra* note 57, at 48; Kaplan, *supra* note 56, at 1449.

83. Jensen, *supra* note 57, at 49.

Regulations,⁸⁴ even with respect to special postseason bowl games and tournaments that are conducted annually but only for a brief period each year.⁸⁵ The most difficult to apply of these three statutory elements is that the questioned activities not be substantially related to the institution's exercise or performance of its exempt function.⁸⁶

When UBIT was being considered by Congress, the House Ways & Means Committee and the Senate Finance Committee both perfunctorily stated that “[a]thletic activities of schools are substantially related to [the] educational functions” of the institutions, and concluded that “income of an educational organization from [admission] to football games” is accordingly not subject to UBIT.⁸⁷ This legislative history has resulted in a wide berth being given to college athletics in this regard.⁸⁸ In 1977, the Internal Revenue Service “notified several universities and the Cotton Bowl Athletic Association, a tax-exempt entity that [organized and operated] the annual Cotton Bowl football game, that revenue from the broadcasting rights to the game would [be subject to UBIT].”⁸⁹ After significant negative public reaction, the Service reversed its position by issuing a series of unpublished 1978 National Office Technical Advice Memoranda.⁹⁰ The Service stated in several of these memoranda that “there is no meaningful distinction between exhibiting the game in person [(the income from admissions is not subject to UBIT, as discussed above)] and exhibiting the game on television to a much larger audience where both groups of people [include students and nonstudents].”⁹¹ In addition, in several of these memoranda, the Service went

84. *Id.* at 50.

85. *Id.* at 48-49; Kaplan, *supra* note 56, at 1449-50. *Cf.* Nat'l Collegiate Athletic Ass'n v. Comm'r, 914 F.2d 1417 (10th Cir. 1990). The court held that the NCAA's advertising revenue earned from the semifinal and final rounds of the Men's Division I Basketball Championship was not subject to UBIT because advertising was not an activity that was regularly carried on by the NCAA. *Id.* at 1422. The court stressed that the NCAA's advertising activity was the applicable activity in question, rather than its organization and operation of the annual basketball tournament, because advertising was the business that the Commissioner contended was generating UBIT. *Id.* at 1422.

86. Kaplan, *supra* note 56, at 1450.

87. Jensen, *supra* note 57, at 51 (quoting H.R. REP. NO. 2319, 81st Cong., 2d Sess. (1950), reprinted in 1950-2 C.B. 380, 409; and S. REP. NO. 2375, 81st Cong., 2d Sess. (1950), reprinted in 1950-2 C.B. 483, 505).

88. *Id.* at 51.

89. *Id.* at 51 n.68 (citing BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 615, 637 (4th ed. 1983)).

90. *Id.* at 51 n.69 (citing Tech. Adv. Mem. 78-51-002 (1978), 78-51-005 (1978), 78-51-006 (1978), 78-51-003 (1978), and 78-51-004 (Aug. 21, 1978)).

91. *Id.* at 51 (quoting Tech. Adv. Mem. 78-51-002 (1978), 78-51-004 (Aug. 21, 1978), and 78-51-006 (1978)).

to great lengths discussing the close relationship of college athletics and education.⁹² In 1980, the Service issued two Revenue Rulings of similar effect.⁹³ In one of those Revenue Rulings,⁹⁴ the Service stated that “[a]n 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.”⁹⁵ The legislative history, coupled with the Service’s position on this issue described in the rulings identified above, would serve to indicate that this third statutory element will continue to be applied liberally to college and university athletic programs.⁹⁶

D. Sponsorship Payments

In 1991, the Internal Revenue Service issued a National Office Technical Advice Memorandum⁹⁷ dealing with the issue of whether a payment by Mobil Oil Corporation (Mobil) to the Cotton Bowl Athletic Association (CBAA), a tax-exempt entity, constituted advertising revenue to CBAA subject to UBIT.⁹⁸ Mobil and CBAA had entered into a contract whereby Mobil agreed to pay CBAA a substantial sponsorship fee (apparently well over \$1 million) in return for CBAA’s agreement to

“change the name of the Cotton Bowl to the Mobil Cotton Bowl[;] . . . imprint the new logo in a prominent place on the field[;] . . . display Mobil’s commercial messages on the electronic sign in the stadium[;] broadcast Mobil’s commercial messages over the [stadium’s] public address system[; permit] Mobil [to] cancel the contract [in the event the Cotton Bowl was not televised; and] . . . arrange for hospitality suites and hotel rooms, tickets to the game, and tickets to event-related

92. Jensen, *supra* note 57, at 52 n.73 (citing Tech. Adv. Mem. 78-51-002 (1978), 78-51-004 (Aug. 21, 1978), 78-51-005 (1978), and 78-51-006 (1978)).

93. *Id.* at 52 (citing Rev. Rul. 80-295, 1980-2 C.B. 194; Rev. Rul. 80-296, 1980-2 C.B. 195).

94. *Id.* (citing Rev. Rul. 80-296, 1980-2 C.B. 195).

95. *Id.* (quoting Rev. Rul. 80-296, 1980-2 C.B. 195)(emphasis omitted).

96. *But see* Kaplan, *supra* note 56, at 1455-60 (a well-reasoned and persuasive argument that many intercollegiate athletic programs are not substantially related to the institution’s exempt purpose).

97. Tech. Adv. Mem. 91-47-007 (Nov. 22, 1991).

98. The memorandum did not specifically name Mobil or the amount of the payment, but these facts were apparently well-known. *See* Richard F. Wall, Comment, *Section 513(i) of the Internal Revenue Code: Does it Clarify the Uncertainty Which Exists in the Law Governing the Taxation of Sponsorship Payments as Unrelated Business Taxable Income?*, 25 OHIO N.U. L. REV. 65, 72 n.38 (1999).

activities [on behalf of Mobil].”⁹⁹

The Service ruled that the payment by Mobil to CBAA under the contract provided Mobil with a substantial return benefit, and as a result the payment constituted advertising revenue to CBAA taxable under UBIT.¹⁰⁰

Subsequent to its issuance of the memorandum, the Service issued proposed examination guidelines consistent with its position set forth in the memorandum.¹⁰¹ The guidelines stated that “where an exempt organization performs valuable advertising, marketing, and similar services, on a quid pro quo basis, for the corporate sponsor, payments made to an exempt organization are not contributions to the exempt organization, and questions of unrelated trade or business arise.”¹⁰²

After extensive protest by a wide array of exempt organizations,¹⁰³ Congress responded to the Service’s ruling and proposed examination guidelines by issuing proposed regulations designed to liberalize the Service’s position.¹⁰⁴ The Service responded with a set of proposed regulations of its own which were not as generous as those proposed by Congress, but represented a complete diversion from its earlier position.¹⁰⁵

The Taxpayer Relief Act of 1997¹⁰⁶ enacted section 513(i) of the Code,¹⁰⁷ adopting in large part the Service’s proposed regulations. Section 513(i) creates and defines a new term, “qualified sponsorship payments.”¹⁰⁸ The

99. Cynthia G. Farbman, *Forced to be a Fan: An Analysis and History of the IRS’s Proposed Regulations Regarding Corporate Sponsorship*, 2 SPORTS LAW. J. 53, 54 (1995) (quoting Paul Streckfus, *A Glimpse of Mobil-Cotton Bowl Contract Provisions*, 55 TAX NOTES 447 (April 27, 1992)).

100. See *supra* note 98. If the payment had not provided Mobil with a substantial return benefit, it would have simply constituted a charitable contribution to CBAA by Mobil, resulting in no taxable consequences to CBAA.

101. Wall, *supra* note 98, at 72 (citing I.R.S. Announcement 92-15, 1992-5 I.R.B. 51).

102. *Id.* at 73 (quoting I.R.S. Announcement 92-15, 1992-5 I.R.B. 51). A traditional UBIT analysis would then be required. A determination would need to be made whether the advertising or marketing constituted a trade or business regularly carried on by such organization, and whether such trade or business was substantially related to its exempt purpose or function. Cf. *Nat’l Collegiate Athletic Ass’n*, 914 F.2d at 1417.

103. Farbman, *supra* note 99, at 55 n.11.

104. *Id.* (citing 138 Cong. Rec. H6637 (1992)).

105. Prop. Treas. Reg. § 1.513-4, 58 Fed. Reg. 5687 (Jan. 22, 1993). The Service’s position in its memorandum with regard to the Mobil/CBAA contract was apparently entirely reversed in its proposed regulations. See Prop. Treas. Reg. § 1.513-4(g), Example 4, 58 Fed. Reg. 5687, 5690-91 (Jan. 22, 1993).

106. Tax Payer Relief Act of 1997, Pub. L. No. 105-34, § 965(a), 111 Stat. 788, 893-94 (1997).

107. I.R.C. § 513(i).

108. *Id.* § 513(i)(2).

activity of "soliciting and receiving qualified sponsorship payments" is now specifically excluded from the definition of "unrelated trade or business,"¹⁰⁹ thereby precluding such payments from being subject to UBIT.¹¹⁰

A qualified sponsorship payment is defined as "any payment . . . with respect to which there is no arrangement or expectation . . . [of] any substantial return benefit other than use or acknowledgment of the [donor's] name or logo (or product lines)" by the organization receiving the payment.¹¹¹ This definition excludes advertising the donor's products or services, but does not define the meaning of "advertising."¹¹² Certain specific limitations to this definition are provided, including a provision excluding from the definition any payment which "is contingent upon the level of attendance . . . , broadcast ratings, or other [similar] factors."¹¹³ In addition, section 513(i) provides for allocation of a single payment into two separate payments in cases where a portion of a payment constitutes a qualified sponsorship payment and the remainder does not.¹¹⁴ This allocation rule effectively eliminates that portion of the Service's proposed regulations which became known as the "tainting rule."¹¹⁵ That rule had provided that "[i]f any activities, messages or programming material constitute advertising with respect to a sponsorship payment, then all related activities, messages or programming material that might otherwise be acknowledgments are considered advertising."¹¹⁶ The tainting rule had received substantial negative public reaction.¹¹⁷

Although section 513(i) leaves some key terms undefined and thus open to differing interpretations, it at least provides substantial guidance to institutions and organizations interested in entering into agreements like the one described above between Mobil and CBAA. By carefully structuring their agreement under section 513(i), any such institution that is a tax-exempt entity should be able to avoid taxation of payments received pursuant to such agreement under UBIT.¹¹⁸

109. *Id.* § 513(i)(1). If a payment does not meet the definition of qualified sponsorship payment, a traditional UBIT analysis would then be required.

110. *Id.* § 513(a)(1).

111. § 513(i)(2)(A).

112. *Id.*

113. *Id.* § 513(i)(2)(B)(i).

114. *Id.* § 513(i)(3).

115. Wall, *supra* note 98, at 78 (citing Prop. Treas. Reg. § 1.513-4(c)(2), 58 Fed. Reg. 5687, 5690 (Jan. 22, 1993)).

116. Prop. Treas. Reg. § 1.513-4(c)(2), 58 Fed. Reg. 5687, 5690 (Jan. 22, 1993).

117. See Farbman, *supra* note 99, at 70.

118. Wall, *supra* note 98, at 86.

IV. DEDUCTIBILITY OF CONTRIBUTIONS TO COLLEGES AND UNIVERSITIES IN EXCHANGE FOR THE USE OF STADIUM SKYBOXES

Section 170(l) of the Code¹¹⁹ allows donors to educational organizations¹²⁰ to deduct as a charitable contribution 80% of amounts contributed for the “right to purchase tickets for seating at an athletic event in an athletic stadium of such [organization].”¹²¹ A deduction is not allowed for the actual cost of purchasing the tickets for any such event.¹²²

In 1996, an Iowa State University booster deducted as a charitable contribution 80% of a large donation for which he received a ten-year skybox lease at Iowa State University’s renovated stadium.¹²³ The taxpayer’s 1996 tax return was audited and his deduction was challenged by the field agent conducting the audit.¹²⁴ This issue caused significant concern among colleges and universities, several of which have added, or are in the process of adding, skyboxes to their stadiums.¹²⁵ As a result, the National Collegiate Athletic Association, along with two athletic directors’ associations, requested clarification on this issue from the Service.¹²⁶

In 1999, the Service issued a National Office Technical Advice Memorandum¹²⁷ upholding the taxpayer’s deduction.¹²⁸ The field agent had denied the taxpayer’s deduction on the basis of section 274(l) of the Code,¹²⁹ which provides that the amount allowable as a deduction, where a skybox or other luxury box is leased for more than one event, “shall not exceed the sum of the face value of non-luxury box seat tickets for the seats in such box covered by the lease.”¹³⁰ Section 274(f),¹³¹ however, provides that section

119. I.R.C. § 170(l).

120. “Educational organization” is defined as an organization which is described in section 170(b)(1)(A)(ii) and is an institution of higher education as defined in section 3304(f). *Id.* § 170(l)(2)(A). Section 170 (b)(1)(A)(ii) describes “an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.” *Id.* § 170(b)(1)(A)(ii).

121. *Id.* § 170(l)(2)(B).

122. *Id.* § 170(l).

123. Jon Almeras, *Universities Score with IRS Skybox Ruling*, 84 TAX NOTES 531 (1999).

124. *Id.*

125. *Id.*

126. *Id.*

127. Tech. Adv. Mem. 00-04-001 (Jan. 28, 2000).

128. *Id.*

129. I.R.C. § 274(l).

130. *Id.* § 274(l)(2)(A).

274 is not applicable to “any deduction allowable to the taxpayer without regard to its connection with his trade or business.”¹³² The Service correctly held that section 274 is therefore not applicable in determining whether charitable contributions are deductible under section 170 of the Code.¹³³ As a result, the taxpayer was permitted to deduct that portion of his donation to the University allowable by section 170(1) of the Code.¹³⁴

V. CONCLUSION

As stated in the Introduction, this article is not intended to be a complete treatment of all federal tax issues affecting professional and amateur sports, but instead provides a comprehensive treatment of selected federal tax issues affecting professional or amateur sports that have been the subject of recent debate or revisions of applicable law. In that regard, this article provides a current description and analysis of the law respecting these issues and, where applicable, sharpens the debate and describes proposals for reform.

131. *Id.* § 274(f).

132. *Id.*

133. Tech. Adv. Mem. 00-04-001 (Jan. 28, 2000).

134. *Id.*