Game On! Recent Legal Developments and Tax Issues for Collegiate Athletics

This is a period of unprecedented change for collegiate athletics, with potentially surprising tax consequences to the parties involved. Within the past six months, a federal district court held that the antitrust laws prevent the NCAA from restricting certain payments to student-athletes, the National Labor Relations Board has permitted Northwestern University's football players to unionize, a major concussion-related class-action lawsuit brought by college athletes against the NCAA has been settled, and the NCAA has proposed fundamental changes to its governance. These developments have a variety of tax implications, including in particular the taxation of student-athletes, the potential taxation of schools on revenue related to their athletics programs, the possible loss of tax-exempt treatment of bonds issued to finance projects related to college athletics and the setting of compensation for coaches.

Summary of Developments

O'Bannon Decision

Last month, the Federal District Court for the Northern District of California ruled that certain NCAA rules violate antitrust laws because those rules prevent student-athletes from being compensated for the use of their names and likenesses. 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 revenues 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. First, in order to protect against commercial exploitation of student-athletes, the court rejected the plaintiffs' proposal that student-athletes be permitted to endorse commercial products. Second, the court held that the amount of compensation available to student-athletes while in school may be capped by the NCAA so 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 would amount to an additional $2,000-$5,000 per student. Third, the court held that certain payments with respect to 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 "deferred compensation" held in trust can be capped by the NCAA so long as the cap is no lower than $5,000 per year per athlete. The ruling did not provide for any compensation for the class-action plaintiffs, and it will not take effect until the start of the next recruiting cycles. The NCAA maintains that it has not violated federal antitrust law and has filed a notice of appeal with the Court of Appeals for the Ninth Circuit.

Possible Unionization of Northwestern Football Players

In March, an NLRB regional director in Chicago ruled that Northwestern University football players who receive university scholarships could be considered university employees, and thus the players are eligible to form a union. The decision was followed by a vote by seventy-six 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 National Labor Relations Board has agreed to hear the case. The results of the football players' union vote is sealed pending 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.

Concussion-Related Class Action Settlement

In July, a settlement agreement was proposed for a 2011 class-action lawsuit in which former college athletes accused the NCAA of ignoring and mishandling athletes' concussion-related injuries. As part of the proposed settlement, the NCAA will set aside $70 million for concussion testing and diagnosis for all current and former NCAA athletes, and an additional $5 million will be earmarked for concussion research. In addition, the NCAA will implement certain changes to its concussion-management policies and will institute return-to-play guidelines for member institutions, including a prohibition that would prevent a student-athlete from returning to play or practice on the same day on which he or she is diagnosed with a concussion. The settlement agreement is subject to approval by U.S. District Court Judge John Lee in Chicago who will conduct a fairness hearing prior to ruling on the settlement.

NCAA Governance Changes

Last month, the NCAA Division I Board of Directors voted to approve a restructuring of Division I governance. The structural changes provide more autonomy in decision- and policy-making for the five most prominent Division I conferences. The areas of increased autonomy for these conferences include (i) financial aid, including the ability to provide full cost of attendance and scholarship guarantees; (ii) insurance, including policies that protect future earnings; (iii) academic support, particularly for at-risk student-athletes; and (iv) other support, such as travel for families, free tickets to athletic events, and expenses associated with practice and competition. The structural changes also attempt to give student-athletes more input by including student representatives at each level of governance. The new governance model is expected to be fully implemented by mid-2015, pending approval by the membership.

Tax Considerations

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 such income

Under current law, a student who receives a scholarship covering room and board and other expenses has taxable income to the extent such scholarship exceeds the amount of a "qualified scholarship" covering the cost of tuition, books and fees. Part or all of the additional support payments authorized by the NCAA described above, however, would likely be reportable by the institution to the IRS and to the student-athlete on Form 1099. Further, to the extent the scholarship itself is conditioned on the student remaining on the team for which he or she was recruited, the scholarship is potentially subject to tax because it would constitute a payment for services rather than a qualified scholarship.

In light of the Northwestern union vote, Senator Richard Burr 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, and he confirmed the IRS's position that a "qualified scholarship" for a student-athlete (which 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 such service may be expected. Despite these reassurances, a negotiated agreement with the student that involves additional cash and a share of royalties could cause the IRS to conclude that an athletic scholarship is part of a larger compensation package and that the entire package is therefore taxable. If the student is represented by a union, this result may be even more likely as the qualified scholarship would presumably become a negotiated term of the contract. The well-advised student will insist on a tax gross-up

provision in his or her agreement with the school, which would significantly increase costs to schools as they try to recruit the most talented athletes.

In addition, the deferred payments authorized by the *O'Bannon* court with respect to the use of the 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 on Form W-2 as wages (if the students are determined to be employees) or on Form 1099 as miscellaneous income, 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, which specifically provide that such scholarships are not reportable by the payor to the IRS, even though taxable. Second, these payments may result in the acceleration of 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 Internal Revenue Code 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) is set aside each year would be taxable currently on this amount of income even though no cash is received.

Taxation of Revenue Generated by the College or University from Ticket Sales, Broadcast Revenues and Commercial Sponsorships

Periodic attempts by the IRS to tax revenue generated by schools from athletics historically have been unsuccessful. Time and again, either the IRS has voluntarily abandoned these efforts or Congress has forced them to do so. Nonetheless, the perception 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 ("UBTI") to include the various forms of income generated by collegiate athletics that are conducted on a "commercial" basis, including 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 the commerciality in college athletics, Congress may be less inclined than in the past to ride to the rescue. In fact, the sweeping tax reform proposal recently released by Congressman David Camp would explicitly repeal the current exclusion from UBTI for royalty income. At the most extreme, the IRS could argue that a large and successful athletic program endangers the tax-exempt status of the entire school.

Tax-Exempt Bonds

To the extent the IRS successfully argues that a school's athletic program constitutes an unrelated business, the school would likely no longer be able to use tax-exempt bonds to finance stadium construction or improvements, as such use would constitute "private use" that is sharply limited by the tax-exempt bond rules.

Compensation of Coaches

As college athletic programs have become more competitive, the salaries paid to coaches by colleges have in some instances approached those paid by professional teams. At some point, the IRS may step in to assert the application of "intermediate sanctions" penalties on such compensation, or assert that this diversion of funds to the coaching staff constitutes either prohibited "private inurement" or "private benefit." With the escalation in some coaching salaries relative to other salaries at schools, care should be taken to support compensation decisions.

Conclusion

Some of the adverse tax consequences described above, such as increased taxation of student-athletes, could happen immediately and steps should be taken by individual schools, working in concert with the NCAA, to reinforce the tax-free nature of qualified scholarships by avoiding any indication that these scholarships are bargained-for consideration for services. Additional education of student-athletes (and their parents) as to the tax consequences under existing law of non-qualified scholarships is also called for, in order to avoid the imposition of substantial, and surprising, tax liabilities. Other tax issues, such as the IRS characterizing certain income flows as unrelated business income, or the IRS (or Congress) determining that compensation for coaches has become unreasonable, may evolve more slowly and probably do not pose an immediate threat. Nonetheless, schools should address these issues defensively right away by substantiating the relatedness of these programs to the core educational mission of the school, by carefully monitoring compensation arrangements, and by substantiating the reasonableness of those salaries that are paid.

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