

November 13, 2006



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Dear Chairman Thomas:

Thank you for the opportunity to respond to your questions regarding how intercollegiate athletics furthers the educational, tax-exempt purpose of the NCAA and higher education. We have responded to your questions as completely as possible. In a few instances, we do not have certain data you requested, nor do we know of any group or agency that has the data. Occasionally, we have offered an undocumented estimate, but we have clearly labeled it as such. We have also attached to this letter, as Appendix A, a discussion that examines the tax law basis for the tax-exempt status of intercollegiate athletics under section 501(c)(3) of the Internal Revenue Code of 1986.

Before turning to the specific questions, I would like to offer a few general thoughts about the relationship of intercollegiate athletics to higher education and to inform you about certain initiatives underway to strengthen that relationship.

The linking of athletics with education is a uniquely American experience. No other country binds the two the way it is done at the scholastic and collegiate levels in this country. The relationship is both real and visceral. The passion that athletics can generate within a population, the loyalty of fans to specific teams, and the feelings of reconnection between alma mater and her alumni have all made college sports popular at every level and phenomenally popular at some levels. Athletics has also been the ticket for many student-athletes to attend college. Divisions I and II intercollegiate sports provide \$1.5 billion annually in athletics scholarships to help pay the cost of education – including for many low-income students who would otherwise have to forgo the college experience. The range and scale of intercollegiate athletics in America are as diverse as higher education itself. Often, the scale alone distorts perceptions about the purpose for which athletics are conducted by those who observe it, as well as – occasionally – those who are engaged in the enterprise.

As a university president for nearly 15 years and an academician for more than 40, I have observed, set policy for or provided leadership to intercollegiate athletics at a number of universities. I can attest with unqualified conviction that college sports makes a significant contribution to the university experience for all

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students and provides educational value to those specific students who participate. Today, more than 380,000 male and female student-athletes participate in as many as three dozen sports at many levels of competition at more than a thousand colleges and universities. Athletics can and does add to the knowledge and skills that develop young people into productive citizens in a wide range of careers beyond sports. Very few student-athletes become professional athletes. Many more become doctors, lawyers, engineers, teachers or even Members of Congress.

Intercollegiate athletics, of course, is not perfect. Like higher education generally, it requires careful management and persistent leadership. Fifteen years ago, the Knight Foundation Commission on Intercollegiate Athletics called for greater presidential control of college sports and recommended a certification process, similar to institutional accreditation that higher education has undergone for decades, that would provide periodic institutional scrutiny and peer review to ensure that program implementation is aligned with academic mission. Since the early 1990s, every Division I university has been through the certification process twice and some have undergone additional institutional self-studies. Further, the Association's governance structure has been reformed to ensure presidential control.

In the mid-1980s, the NCAA began collecting data on the academic performance of student-athletes. The question before the Association was simple enough: Were student-athletes achieving academically as well as their counterparts in the general student population? Clearly, some were not. On average, student-athletes in Division I trailed the rest of the student body in graduation rates. A series of initiatives were undertaken to correct the problem, and the results brought hope. Graduation rates rose and by the early 1990s surpassed the rate for students in general.¹

The NCAA has developed a comprehensive national database on college student academic performance, beginning in the 1990s. The NCAA also provided analysis of the data that led to a three-pronged academic reform initiative two years ago that has and will significantly improve the academic success of student-athletes. (1) The requirements for high school academic preparation for incoming freshmen to participate in athletics have increased dramatically. The academic requirements for enrolled student-athletes to continue athletics participation have increased so that they are on track to graduate in five years rather than the six-year window anticipated by the U.S. Department of Education. (2) New metrics have been developed that measure progress year-by-year and provide more accurate graduation information. (3) Sanctions have been put in place by the NCAA that will penalize poor academic performance by a particular team.

Using the Graduation Success Rate (GSR), a new metric that counts transfer students (as well as students whose education takes place at only one institution) who both succeed and fail academi-

¹ Note: According to NCAA data collected using the methods of the Integrated Postsecondary Education Data System (IPEDS) graduation rate survey, student-athletes who entered in 1984 graduated at a rate of 52 percent, one percentage point below the rate for the general student body. By 1992, the graduation rate for student-athletes, according to IPEDS, was 58 percent, two points above the rate for the general student body.

cally, the latest average graduation rate for student-athletes in Division I is 77 percent. There is no way to compare this figure to the federal rate, because the U.S. Department of Education does not track transfer students. However, even if the more inaccurate federal rates are used, student-athletes in Division I graduate at 63 percent, two points better than the general student population. Of note, African-American male student-athletes graduate 11 percentage points higher than African-American males in the student body, and African-American female student-athletes graduate at a rate 16 points higher than their counterparts in the general student population. Clearly, the reform measures of the last 15 years are working. [Note: A complete description of the academic reform initiative is also attached to this letter as Appendix B.]

Two weeks ago, we released the report of the NCAA Presidential Task Force on the Future of Division I Intercollegiate Athletics. The result of an 18-month examination by 50 college chancellors and presidents, the report, entitled *The Second-Century Imperatives: Presidential Leadership~Institutional Accountability*, challenges the Association's member colleges and universities to assume greater control of the financial underpinnings of athletics on a campus-by-campus basis. The Task Force developed improved and more transparent financial reporting procedures and created a number of "dashboard indicators" that will assist chancellors and presidents in achieving greater accountability. There is no crisis in athletics finances. Operating budgets for athletics represent a small percentage of overall higher education spending, 3.5 to 4² percent on average. The purpose of the Task Force initiative is to provide tools and recommend practices that will diminish the potential for financial stress and provide access to information that leads to better decision-making.

Your letter, Chairman Thomas, comes at an opportune time. Over the last 15 years, the NCAA and intercollegiate athletics have undergone careful self-study and implemented initiatives that will ensure intercollegiate athletics' continued purpose of educating student-athletes in a responsible way.

The following are responses to the questions you have posed:

Questions Relating to the NCAA's Educational Mission

1. The annual return filed by the NCAA with the Internal Revenue Service states that the primary tax-exempt purpose of the NCAA is to "maintain intercollegiate athletics as an integral part of the educational program and the athlete as an integral part of the student body." How does the NCAA accomplish its purpose of maintaining "the athlete as an integral part of the student body"?

The purpose of higher education is to develop the knowledge and skills in students so that they become productive members of society and good citizens. Much of that is done in the

² Litan, Bob, and Orszag, Jon and Peter, "*The Empirical Effects of Collegiate Athletics*," 2003.

classroom, lecture hall and library; but not all of it. Higher education also imparts knowledge and skills in various other ways. Participation in a symphony orchestra, working on student newspapers and participation in theater productions are all examples of ways in which students go beyond the classroom to develop educational skills that will serve them throughout their lives in the same way as traditional classroom learning. Development of these skills is integral to the educational experience students take with them from the campus.

Participation in varsity athletics programs is another key way in which young men and women enrich their educational experience beyond the classroom. What they learn on the playing field or court is integral to their educational experience as well. Lessons on leadership and how to follow, on self-discipline and self-sacrifice, on teamwork and hard work, and learning to pursue excellence are all values imparted through participation in athletics. Although the vast majority of the more than 380,000 student-athletes who compete in college sports each year go “pro” in something other than sports, the words of Indianapolis Colts quarterback Peyton Manning are particularly appropriate. The former University of Tennessee, Knoxville, football Academic All-America was honored in 1998, at the NCAA Convention as one of Today’s Top VIII student-athletes, and in his response to the assembled delegates, he talked about being a student-athlete:

“It is popular today to ask if big-time college sports are even compatible with higher education.

“The critics ask if athletics are consistent with the educational missions of colleges and universities. Frankly, those people see the walls that limit us without seeing the spaces that allow us to expand. The reality is that collegiate sports have a lot more to do with learning than they do with winning.

“As student-athletes, we learn more than most people...the blessings of...camaraderie and shared sacrifice, collective responsibility and commitment to excellence, and time management and life management. It would have been easy to have been a football player and not a student, and conversely, it would be much easier to have been just a student and left football for some other day in time.

“But it wouldn’t have been as joyous, as rich or, quite candidly, as humbling to have been one without the other. I would bet you that each and every one of tonight’s honorees would say without hesitation that he or she is a better man or woman and a better leader because of those experiences.”

Mr. Manning’s comments on his and other student-athletes’ experiences as participants in intercollegiate athletics – as candid and unrehearsed as they were within their context – are

consistent with the tax law in this area that recognizes the educational value of athletics competition at the college and university level.³

Peter Likins, president emeritus of the University of Arizona, a former professor of engineering, and a Fellow of the American Institute of Aeronautics and Astronautics, is more succinct but no less eloquent or to the point in his comments about the educational value of being a collegiate wrestler at Stanford University: “As a university president and former professor of engineering, I have often said that I learned how to be a professor in the classroom, but I learned how to be a university president on the wrestling mat.”

2. The annual return also states that one of the NCAA’s purposes is to “retain a clear line of demarcation between intercollegiate athletics and professional sports.” Corporate sponsorships, multimillion dollar television deals, highly paid coaches with no academic duties, and the dedication of inordinate amounts of time by athletes to training lead many to believe that major college football and men’s basketball more closely resemble professional sports than amateur sports. The NCAA has no control over two of the differences between professional and amateur sports: the level of play and the tax exemption for college athletics revenue. Beyond rules prohibiting compensation for college athletes, what actions has the NCAA taken to “retain a clear line of demarcation” between major college sports and professional sports?

There are clear distinctions between the collegiate and professional models of athletics. Professional sports’ sole purposes are to entertain the public and make a profit for team owners. The purpose of the collegiate model is to enhance the educational development of student-athletes. Those who participate in professional athletics are employees, a commodity to be traded from team to team, often with little or no input from the participant. Those who participate in college sports are students and are not employed to play sports, nor are they traded from school to school. The teams in professional sports are aligned with a community only so long as the community provides facilities and support to keep the teams with them. The teams in collegiate sports are embedded within the college or university that sponsors the teams and cannot leave if they are not satisfied with the facilities or levels of support.

These points of difference are critical to the demarcation between college and professional sports beyond the amateur status of student-athletes. While intercollegiate athletics is very entertaining, entertainment is not the primary purpose of the enterprise. While football and men’s basketball at the Division I levels are enormously popular with the public and attractive to the entertainment media, they are as distinct from their professional counterparts as student musical groups are from professional symphonies. They are demarcated by their purpose and motivation rather than their scale of public or media fiscal support.

³ See Appendix A.

It is also incorrect to assume that the popularity of Division I football and men's basketball sets them apart from other sports on campus in terms of time and commitment for the student-athletes or from other divisions. Student-athletes and their coaches are extremely committed individuals regardless of their sport or the division in which they play. Coaches, themselves, are as committed to teaching the development skills learned through sports participation as faculty members are to importing academic knowledge. There are no differences in the expectations for practice or competition among the sports. Indeed, football student-athletes generally have less missed class time than any others on campus because they have only one game each week, at least half of which are at home. The most important point, again, is that all of the participants are students.

In addition, there are a series of rules designed by the member schools themselves that are intended to provide limits that support the mission of educating student-athletes. These rules include grant-in-aid limits, season limits, in-season and out-of-season practice limits, safety requirements, and academic-eligibility requirements for initial and continuing participation.

3. Some representatives from college athletic organizations have justified the tax-exempt status of college sports based on claims that high-visibility programs help sustain a large pool of student applicants and generous financial contributions. Neither of these arguments is valid from a Federal standpoint. Federal taxpayers have no interest in increasing applicant pools at one school opposed to another. Furthermore, if financial contributions to universities increase based on athletic success, contributions to other worthy charities may decline.

Before responding to your specific questions, we would like to point out the far-reaching implications of the statements made in the introduction to these questions. First, while federal taxpayers, in the abstract, may have no interest in increasing applicant pools at one school as opposed to another, individual taxpayers surely do. Presumably, this is one of the reasons that taxpayers, including many Members of Congress, support and contribute to their alma maters and to their local schools – to help the schools improve the quality and, in some cases, the quantity of their student bodies; to improve their physical plants; and for other purposes. Further, schools attempt to increase their visibility in many ways – by building new classrooms, libraries and performing arts centers; by recruiting renowned academicians and researchers; by adding timely subjects to their curriculums; and even by advertising. Of course, this activity is not limited to schools. Many nonprofits engage in activities designed to increase membership, visitors and revenues. Symphony orchestras schedule “old warhorses” that attract more patrons, visibility and contributions than less-“accessible” works. Similarly, art museums schedule “blockbuster” shows of popular artists or artistic movements designed to draw crowds, raise visibility and, again, to encourage membership and contributions. Many charitable organizations advertise in one form or another – on television, on radio, in the print media and by direct mail.

- a. From the standpoint of a Federal taxpayer, what benefits does the NCAA provide taxpayers in exchange for its exemption?

Those who represent the federal taxpayer, Members of Congress, have long recognized the educational value of athletics competition at the college or university level, and that income derived from intercollegiate athletics competition is substantially related to the educational functions of colleges and universities. In the Revenue Act of 1950, both the House and Senate agreed on this point. The Senate Report noted, "Athletic activities of schools are substantially related to their educational functions. For example, a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were composed of students of other schools." The House Report states, "Of course, income of an educational organization from charges for admissions to football games would not be deemed to be income from an unrelated business, since its athletic activities are substantially related to its educational program."⁴

More recently, the U.S. Supreme Court recognized the importance of the regulatory role of the NCAA in preserving amateurism in college sports. In *NCAA v. Board of Regents of the University of Oklahoma* 468 U.S. 85 (1984), the Supreme Court said:

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

Specifically, federal taxpayers through their representatives have recognized the educational value of athletics as a benefit to them and the regulatory role of the NCAA as important to the maintenance of that benefit.

- b. From the standpoint of a Federal taxpayer, why should the Federal government subsidize the athletic activities of educational institutions when that subsidy is being used to help pay for escalating coaches' salaries, costly chartered travel, and state-of-the-art athletic facilities?

It should be pointed out that colleges and universities apply the "tax subsidy" to offer a broad range of athletics participation opportunities for hundreds of thousands of young men and women at more than a thousand institutions.

Without trying to address every instance, coaches' compensation packages, especially those with seven-figure packages, include institutional salaries commensurate with other

⁴ See Appendix A.

highly paid and highly recruited faculty and staff. The salaries are negotiated at arm's length and are within the range of reasonable compensation as defined for federal tax purposes. Coaches also earn outside income from television programs, shoe and apparel endorsements, speaking engagements, and teaching camps. The majority of the total income of these highly compensated coaches does not come from an institution's tax-exempt dollars. This is exactly the same method that colleges and universities use to compete for top academicians in selected disciplines. The majority of their compensation packages, which in some cases exceed seven figures, is derived from income outside of the institution. In all cases, the institutions strive to maintain compensation at a level that is reasonable as that term is used for federal income tax purposes.⁵

Travel for athletics teams is a relatively modest portion of athletics operational budgets, on average around seven percent. Travel for teams is often made less expensive by chartering rather than using commercial flights and typically gets student-athletes back to the campus and in class sooner. Additionally, the size of the squad and staff makes the use of commercial air travel often impractical and frequently impossible.

Athletics facilities, state-of-the-art or otherwise, are necessary for the support of the activity for which there is a tax exemption. These facilities, often paid for through bonds or charitable contributions, also generate revenue that offsets the operational cost of athletics that might otherwise be provided through institutional funds.

4. Officials from the NCAA, athletic conferences, and universities have explained that college football and basketball should be tax-exempt because some universities generate a profit from these sports that is used for other university-sponsored sports. To be tax-exempt, however, the activity itself must contribute to the accomplishment of the university's educational purpose (other than through the production of income). How does playing major college football or men's basketball in a highly commercialized, profit-seeking, entertainment environment further the educational purpose of your member institutions?

The fact that some intercollegiate athletics programs at some schools generate revenues in excess of expenses is not inconsistent with the fact that such programs contribute to the schools' overall educational programs. The modern comprehensive university and, indeed, American higher education would not exist without the ability of some disciplines and activities to generate income that helps pay for other disciplines and activities. Not all disciplines and activities are in equal demand or enjoy the same appeal. Athletics and a few other activities are more interesting – and entertaining – to the general public and media than others. The ability of some to generate revenue is not insignificant to the rest of the campus. Higher education takes in revenue from all its sources and then redistributes those resources to meet its mission. For example, revenue from Psychology 101 classes (because of their

⁵ See Appendix A.

number and size) typically generates more revenue and, in effect, subsidizes philosophy classes, which cannot draw enough students to pay for themselves. This is the business model for higher education (and for other types of tax-exempt organizations), and intercollegiate athletics works the same way. Revenue from football and men's basketball is redistributed to pay for sports that generate little or no revenue.

Nonetheless, all of these activities have educational value. The scale of their popularity and the revenues they generate do not diminish the importance of their educational value. The lessons learned on the football field or men's basketball court are no less in value or importance to those student-athletes than the ones learned on the hockey rink or softball diamond – nor, for that matter, than those learned in theater, dance, music, journalism or other non-classroom environments. Indeed, if institutions could generate new revenue streams from the televising of large lectures or small seminar discussions and use the revenues to offset the cost of other classroom programs, they would be permitted and should do so.

The fundamental purpose of intercollegiate athletics is the education of student-athletes in both the classroom and on the field or court. The scale of the sport does not alter the fundamental purpose. And the most successful programs in terms of generating revenue share the same educational goals with the least successful. Unlike other campus activities of educational value, the visibility of athletics models developmental characteristics of sports to non-athletes, as well.

5. Educational institutions in other NCAA divisions spend a fraction of the amount Division I-A schools spend on their football and men's basketball programs. These higher expenditures are ostensibly for educational purposes. What additional educational value is received by participation in Division I-A athletics beyond that which is received by participation in other division or intramural athletics? If additional educational value is derived from participation in Division I-A athletics, does the additional educational value justify the higher expenditures?

Generally speaking, educational institutions in other NCAA divisions spend a fraction of the amount Division I-A schools spend on any of their other educational programs. For example, the budget for the mathematics department, as well as the athletics department, at Ohio State University is larger than the budget for the mathematics department, or athletics, at Defiance College in Ohio. Even though each institution has invested to a considerably different level, both are providing a quality educational experience and meeting the expectations of their students. In fact, because of higher amounts of outside revenue to support athletics at Ohio State, the athletics budget at Defiance – or any other Division II or III institution – is considerably higher as a percentage of institutional resources than at Division I schools.

Is the difference in the educational experience of students at a large public university quantitatively better than at a small private college? It may or may not be, but we generally

don't try to make that quantitative differentiation. We understand that there are different approaches for a variety of reasons and to accommodate a diversity of circumstances. A more robust athletics program is often identified as one of the advantages of attending a larger school.

The range and cost of programs – in athletics as well as in academics – are largely responsive to expectations of students, parents, alumni and others, as well as the financial circumstances of each institution and are difficult to quantify. Nonetheless, all NCAA member institutions conduct their athletics programs consistent with the academic missions of their respective campuses.

6. According to studies, incoming athletes at many universities have lower average SAT scores and high school grades than those of the general student body. Do the minimum initial eligibility standards currently in place adequately ensure that high school athletes can succeed academically at universities?

As noted earlier, the NCAA has collected and analyzed data for the last 20 years to observe the behavior of hundreds of thousands of successful student-athletes and modeled our standards on that behavior. Any studies that assume student-athletes enter Division I colleges and universities less well prepared than non-student-athletes are either out of date or erroneous. Data from 2004 entering freshmen, the latest available information, show that Division I scholarship student-athletes averaged a score of 1096 on the SAT. This is higher than the national average of 1026 for all college-bound test takers. Similarly, the athletes averaged a core grade point average (GPA) of 3.400, which exceeds the national average GPA of 3.280 reported by the College Board for all students.

7. In order for a high school student to become eligible to compete in intercollegiate athletics, the NCAA requires high school athletes to take a core curriculum of academic courses and earn a minimum grade-point average while in high school. Why does the NCAA not have similar requirements for athletes during their collegiate careers?

The NCAA does have minimum academic performance requirements for student-athletes during their college careers. Enrolled student-athletes must meet progress-toward-degree requirements on a term-by-term basis in order to maintain academic eligibility to compete in athletics. Under these requirements, each student-athlete must make specific, measurable progress (at least 20 percent per year) toward a declared degree at the institution in which he or she is enrolled. In addition, each student-athlete must annually acquire a predetermined percentage of the cumulative GPA toward graduation. These standards serve as a proxy for the “core curriculum” approach used for high school athletes.

8. In recent years, there have been many reports of athletes taking college courses that lack academic rigor. Several schools have reportedly steered athletes toward professors and academic majors that are less challenging.

a. What actions has the NCAA taken to assess the substance of the courses athletes are taking and, more generally, the quality of the education athletes receive?

The NCAA is in the process of collecting survey data in two projects with both recently graduated student-athletes and those who have graduated over the last decade about what degrees they selected, why those degrees were selected and whether they were steered toward specific degree programs. Those data have not been fully compiled and will not be available until the spring of 2007.

It is important, however, to understand that the faculty of each college or university, rather than the NCAA, determines the courses that will be taught, the standards for instruction and the requirements for degrees. They are also responsible for monitoring against academic abuse or fraud, and they take these responsibilities seriously. It is unlikely that any intrusion by the NCAA into this realm would be either practical, successful or welcomed.

b. Does the NCAA collect information from its member institutions to determine whether athletes are disproportionately taking certain professors, courses, or academic majors at individual schools?

Although the results are not available at the time of this writing, the NCAA is collecting data on the majors of student-athletes through our Academic Performance Program.

c. Would requiring the public disclosure of the professors, courses, and academic majors of athletes help ensure that they receive a quality education?

Privacy provisions of the Family Education Right to Privacy Act (FERPA)⁶ would prohibit such public disclosure, and it is not clear that such public disclosure would, in fact, ensure a better quality education. Likewise, if more student-athletes major in a specific discipline, it does not follow that such students receive an education of less quality or are subject to less rigorous academic standards, much less that there is academic fraud. As noted earlier in this letter, the standards for instruction and the integrity of academic offerings are the purview of the faculty and their responsibility, rather than the NCAA. Moreover, it would be contrary to the freedom of choice accorded all students to require that student-athletes take certain majors and not others.

⁶ Note: FERPA allows schools to release academic majors as directory information without the consent of the student. Only if the student affirmatively requests this information not be shared is the institution prohibited from giving it out.

9. At Division I-A schools, only 55 percent of football players and 38 percent of basketball players graduate - compared to 64 percent of the general student body. These figures understate the gap between the graduation rates of the general student body and athletes, since many regular students fail to graduate for financial reasons, which is not an issue for athletes on full scholarships.

a. Are the NCAA's member institutions accepting athletes who would not otherwise be admitted but for their athletic prowess?

It must be emphasized that "special admissions" are not limited to student-athletes. Most colleges and universities offer special admissions opportunities to a variety of students who have not met the academic standards generally applied to the student body. These special admissions are used to admit a small number of students, often low income non-athlete students with promise from disadvantaged educational environments. Special admission standards are also applied to admit some students with talents that offset their academic shortcomings; e.g., musicians, artists, dance and drama majors, and athletes. We do not know the exact numbers nor how many institutions offer such special admissions opportunities.

b. For twenty years, the Federal graduation rate for male basketball players has remained basically unchanged at about 40 percent. Why has the NCAA made no progress in ensuring that athletes who play on the court also graduate from the schools for which they are playing?

Male basketball student-athletes in Division I who entered universities in 1984 – the first year the Department of Education began requiring the collection of graduation data – graduated at a rate of 38 percent. The most recent data (for the cohort entering in 1999) show male basketball student-athletes in Division I graduating at a rate of 46 percent. Over the last two years, the NCAA has also collected data on transfer student-athletes who are not included in the federal rate (nearly 30,000 annually). Based on those data, the more accurate graduation rate for Division I male basketball student-athletes is 59 percent. The NCAA believes that when male basketball student-athletes who entered under the current and more rigorous academic standards graduate, the rates will be significantly higher. Nonetheless, graduation rates for male basketball and football student-athletes continue to be of concern and the focus of NCAA-led academic reform efforts.

c. The defending Division I-A national champion in football graduated 29 percent of its players compared to 74 percent of the university's student body for the class entering in 1998. Similar large differences in graduation rates exist at other colleges and universities. Considering this gap, how well is the NCAA accomplishing its tax-exempt purpose of maintaining "the athlete as an integral part of the student body"?

On average, Division I-A football student-athletes graduate at a federal rate of 55 percent, compared to 62 percent for the male student body. The more accurate Graduation Success Rate that includes transfers is 66 percent. Over the next few years as the new standards and sanctions take place⁷, teams in any sport must have a projected graduation rate of 60 percent or better or will not be permitted to compete in postseason championships. It is frustrating that there continue to be instances of low graduation rates for any teams, but progress on average is clearly being made and more will be.

- d. To improve the graduation rates of athletes, has the NCAA considered adopting a rule tying the number of grants-in-aid that can be awarded to a member institution's graduation rates?

Rather than tying grants-in-aid only to graduation rates that measure the academic success of student-athletes who enrolled six years earlier and are gone by the time we know the rates, the sanctions in fact in place tie grants-in-aid to year-by-year academic (not athletics) success of student-athletes. This standard is designed to achieve, at a minimum, a 60 percent graduation rate for all students in a specific sport.

10. The NCAA recently created the Academic Progress Rate to measure the cumulative progress made by athletic teams towards a degree. Based on the new measure, the NCAA will take away scholarships from teams that do not meet a threshold that is equivalent to a 50-percent graduation rate, which is an extremely low standard.

- a. Why is a team penalized only when more than half of its players fail to graduate?

There are two very important points to consider: (1) Penalties (and rewards) are tied to the performance of currently enrolled student-athletes – Academic Progress Rate (APR) – rather than those who did or did not graduate; and (2) the more accurate Graduation Success Rate (GSR), which includes transfer student-athletes, is 60 percent where penalties are applied. The goal of the NCAA academic reform initiatives is to change behavior and improve academic performance, with a target of 80 percent GSR on average for all Division I student-athletes. We are clearly making progress overall (77 percent is the current rate) and with each individual sport.

- b. Should athletes who are not advancing toward a degree be eligible to participate in college sports?

No, and they are not. Here are the specific requirements to remain eligible for athletics participation: (1) Student-athletes must successfully complete 24 hours of course work in

⁷ For fuller explanation, see Appendix B.

their first year to remain eligible; (2) student-athletes must achieve 40 percent of a specific degree requirement by the end of their second year, 60 percent by the end of their third year and 80 percent by the end of their fourth year (the average time required to earn a degree in higher education for all students currently is nearly five years); (3) student-athletes must achieve 90 percent of the cumulative grade point average required for graduation by the end of the first year, 95 percent by the end of the second year and 100 percent by the end of the third and fourth years; and (4) student-athletes must earn 18 semester or 27 quarter hours during the regular academic year, not including summer. If student-athletes do not meet these standards that move them toward a specific degree, they cannot compete.

These standards are based on data that show that student-athletes who satisfy these requirements are likely to graduate.

11. During the last few decades, the NCAA has increased the maximum number of football and men's basketball games that each member institution can play. This year, the NCAA changed the rules to allow schools to play an additional, twelfth football game. Also this year, the NCAA approved an increase in the maximum number of basketball games teams can play in a season and lengthened the season by one week. Including preseason and postseason tournaments, basketball teams can now play more than forty games in a season.
- a. Why did the NCAA make these rule changes?
 - b. How do these rule changes further the educational mission of the NCAA and your member institutions?
 - c. How do these proposals help athletes improve academic performance?
 - d. At what point does playing additional games have a detrimental impact on academic performance?

These are all fair and important questions to ask, and they are the same questions the NCAA membership must ask itself as it addresses issues around playing and practice seasons. It may be helpful to respond to these questions as a group rather than individually.

NCAA member colleges and universities clearly believe there is educational value to having athletics as part of the comprehensive campus experience. Previous responses address this belief specifically. As discussed in Appendix A, the Congress, the courts and the Internal Revenue Service also share this belief. Athletics contests are the laboratory for lessons taught in practice in the same way theatrical or musical performances provide practical application of the lessons taught in rehearsals. Since graduation rates and academic performance have continued to make steady progress over the last

two decades, there is little reason to believe that the current length of practice and playing seasons is detrimental to academic performance. In fact, graduation rates for both football and male basketball student-athletes have steadily risen over the last five years as the number of contests increased.

It is also true that the increase in the number of contests in football and men's basketball will grow revenue that helps support a broad range of sports that might not otherwise exist. Athletics, like every other department on campus, cannot operate without sufficient revenues to meet expectations. Increasing revenue, however, is not the only reason. Some but not all teams were already playing 12 games in football. Permitting a 12th game for all teams was more fair. The stabilization of games in basketball eliminated similar unfair practices in that sport.

The length of practice and playing seasons, however, will continue to be a carefully monitored subject for the leadership of intercollegiate athletics, and it was identified by the Presidential Task Force, noted earlier in this letter, as an issue for further review.

12. In 1973, the NCAA adopted a rule prohibiting financial aid from being awarded to an athlete for more than one academic year. This rule allows schools and coaches to withdraw financial assistance from athletes who do not perform well on the field, which may overemphasize athletics at the expense of academics.

a. Why did the NCAA adopt this rule?

The change was made to bring grants-in-aid for athletics in line with the way in which other financial aid is awarded or renewed. Most merit-based financial aid on campus – as well as many government-approved financial aid awards – have criteria for renewal and is awarded on a year-by-year basis. As is the case with other forms of institutional aid, the renewal is made by the financial aid office, rather than coaches. However, in the case of athletics when renewal is not approved, student-athletes are notified of their right to a hearing by an impartial committee independent of the athletics department.

b. How does this rule further the educational mission of the NCAA and your member institutions?

The term of athletically related financial aid continues to be a subject for discussion by various committees and at numerous levels within the Association's governance structure. The awarding of financial aid for athletics exactly mirrors the objective of financial aid awarded for other purposes within higher education, namely, to support the academic pursuits of student-athletes. Criteria for annual awarding of financial aid in other disciplines, from physics and philosophy to music and theater, are similarly merit

based. This is another instance in which intercollegiate athletics is fully integrated into the practices of higher education as a whole.

Questions Relating to NCAA Finances

[Note: The source of financial data provided below is from institutional data provided to the NCAA by its member institutions. The institutional data have been reviewed by an independent third party in accordance with NCAA requirements.]

1. How much total revenue does college sports generate each year? How much do your member institutions spend each year on college sports?

Total annual operating revenues for all NCAA divisions are approximately \$7.8 billion. Of this amount, \$4.2 billion is generated from athletics sources such as ticket revenues, contributions and the like. The remaining \$3.6 billion are funds allocated by the institution, state or other governmental entities for the benefit of student-athletes.

Total annual operating expenses for all three divisions are approximately \$7.75 billion. Approximately \$1.5 billion of these dollars provide athletically related financial aid for Divisions I and II student-athletes. The average annual cost per student-athlete for the 380,000 who compete in all three divisions is approximately \$20,000.

Without the support of institutionally allocated funds to close the gap between athletics-generated revenue and total expenses, intercollegiate sports operates at an annual shortfall of approximately \$3.6 billion.

2. For Division I-A football programs, please provide the following information for the most recent year for which you have statistics:

- a. Total annual revenue;

In the 2004-05 academic year, the total operating revenue for the 117 Division I-A football programs was approximately \$1.6 billion, an average of \$14.1 million per institution. This includes monies generated by the athletics program as well as monies allocated by the university or other entities for athletics purposes.

- b. Largest amount of revenue generated by one school;

The largest amount of operating revenue reported by a Division I-A football program is \$53 million. The median operating revenue for Division I-A football programs is \$10 million.

c. Total annual expenditures; and,

Total annual operating expenditures for 2004-05 by Division I-A football programs were approximately \$1 billion, an average of \$8.7 million per institution.

d. Largest annual expenditure by one school.

The largest amount of annual operating expenditure by a Division I-A football program is \$26 million. The median operating expense amount for Division I-A programs is \$7.6 million.

Approximately 53 percent of Division I-A institutions reported operating revenues in excess of operating expenditures for football when allocated university funds are removed. These excess revenues are redistributed to support other sports programs that do not generate revenues sufficient to cover expenses in the same way revenues from some academic disciplines and services are redistributed to subsidize other academic programs and services that have insufficient revenues to meet expenses.

3. For Division I basketball programs, please provide the following information for the most recent year for which you have statistics:

a. Total annual revenue;

In the 2004-05 academic year, the 326 Division I men's basketball programs reported total operating revenues of approximately \$789 million, an average of \$2.42 million per institution. As in the case of football, this includes monies generated by the athletics program, as well as allocated funds from the university or other entities.

b. Largest amount of revenue generated by one school;

The largest reported amount of operating revenue reported by one school was \$18.5 million per institution. The median amount of operating revenue for Division I programs is \$1.1 million.

c. Total annual expenditures; and,

Total annual operating expenditures for the same reporting period were \$571 million, an average of \$1.75 million.

d. Largest annual expenditure by one school.

The single highest reported basketball program operating expenditure was \$9 million. The median amount of operating expenses for Division I programs is \$1.2 million.

Like football, only about 28 percent of all Division I basketball programs reported revenues in excess of expenses when university allocated funds are removed. Excess revenue from basketball is used to assist other, non-revenue sports including financial aid.

4. How many of your member institutions generate a net profit on the operations of their athletic departments (excluding university subsidies such as student fees or general school funds and services)? Of the institutions that generate a net profit, how many use the profit for purposes unrelated to the athletic department?

Intercollegiate athletics is not offered to generate a profit. That is the fundamental difference in purpose between intercollegiate athletics and professional sports. If profitability were the standard for college sports, only 23 Division I institutions (based on data reported for the 2004-05 academic year) would conduct athletics programs. Furthermore, if profit were the motive, even those 23 (of more than 1,000 member institutions) would likely only conduct football and men's basketball programs.

The data that identify these two dozen institutions with positive net revenues do so without accounting for depreciation. Under generally accepted accounting principles, however, depreciation of athletics facilities should be deducted to determine a true profit. While we do not have data to know the exact number that would still report net revenues if depreciation were included, we estimate it would be fewer than 10 institutions of more than 1,000 member colleges and universities.

5. At Division I-A schools, what is the average annual expense (including the cost of grants-in-aid):

- a. Per athlete?
- b. Per football player?
- c. Per men's basketball player?
- d. Per women's basketball player?

The cost of education for a student-athlete vary from sport to sport and institution to institution much in the same way they do for students in general. For example, the costs

for educating engineering or nursing students are substantially more than for educating students majoring in English or history. The costs associated with an athletics program are dependent on the specific sport and its related costs for equipment, facility needs or staffing, for example.

With that as background, the average expense for a Division I student-athlete is approximately \$39,000. Expenses for Division I-A football participation amount to approximately \$74,000 per student-athlete, while Division I (there is no Division I-A category) men's and women's basketball amount to approximately \$158,000 and \$75,000, respectively.

6. According to NCAA expenditure reports, public universities spent as much as \$600,000 per men's basketball player during the 2004-05 school year.
 - a. How does spending hundreds of thousands of dollars on each men's basketball player further the educational mission of universities?
 - b. How much money must be spent by athletic departments to ensure that athletes receive an educational benefit from the activity?

There is no unit-cost standard for providing a quality educational experience in higher education. The methodology used in the question to calculate the cost per student is significantly misleading because there is a failure to distinguish between fixed and variable costs. Institutions assume these fixed costs as a part of running any of their various programs, including intercollegiate athletics. To use such expenses in calculating a unit cost as exaggerated as the one cited in the question, it must be noted, distorts the facts. For example, according to data reported by the U.S. Department of Education for 2003-04, the average cost per student for education at the top five expensive schools in the country in 2003 was \$462,000. This figure, however, includes a number of variables that balloon the unit cost.

The same is true in athletics. The average cost per male basketball player in Division I is \$158,000; and, like in the case of academic departments, there are fixed and variable expenses that distort the unit cost. Are the figures in either academic or athletics appropriate amounts to spend to further the educational mission of either? Could these institutions meet their mission for less? The answer to both questions might be 'yes.' Each institution, however, will determine the level of excellence it will pursue in accordance with the expectations of those who choose their programs, taking into account the institution's available resources.

The scale of cost per student in academics is not the best determinant for whether educational mission is being met.

7. According to NCAA data, athletic department budgets are growing several times faster than the university budgets of your member institutions. In addition, athletic department expenses are increasing at a higher rate than athletic department revenues.
 - a. Why are athletic department budgets increasing faster than university budgets?
 - b. Why are athletic departments spending money at an increasing rate?
 - c. How does spending even more money on Division I-A football and men's basketball further the educational mission of universities?
 - d. What actions can the NCAA take to control rising spending?

Although it is true that total athletics spending has outpaced the rate of increases in university spending over the last four years, athletics spending has not exceeded athletics revenues. Over the last two decades, revenues have dramatically increased as a result of rising ticket revenues, demand for radio and television broadcasts (partly due to changes in technology; e.g., cable and satellite television) and related income streams. Costs have also risen significantly and have been led by increases in scholarship costs, additional personnel for compliance purposes, increased interest among students for participation opportunities, new training personnel to ensure better health and safety of student-athletes, rising travel and insurance costs and increased salaries. Many, but not all, of these factors are outside the control of the athletics department.

The ability of the NCAA to influence spending is limited. One court has found that the NCAA's attempt to cap certain costs (compensation of assistant coaches) violates the antitrust laws.⁸ At the end of October, the NCAA unveiled a report from the NCAA Presidential Task Force on the Future of Division I Intercollegiate Athletics, entitled *The Second-Century Imperatives: Presidential Leadership~Institutional Accountability*. The focus of the 18-month task force initiative was the need to address fiscal responsibility in intercollegiate athletics on a campus-by-campus basis. To assist in this effort, the NCAA, with the help of the National Association of College and University Business Officers, has developed more consistent and clear definitions for reporting of financial data and requires an independent, third-party review of the data prior to submission. These data will be made available to presidents, along with aggregate peer group data, to assist universities in examining their spending behaviors and to improve campus decision-making. Also included in the reports will be new metrics that will alert presidents to areas in which their spending history may indicate abnormalities or risk. Moreover, these aggregate data, by category, will be made transparent to the public.

⁸ *Law v. NCAA*, 902 F. Supp. 1394 (D.Kan.) (1995)

8. The NCAA has entered into an agreement with CBS to televise the men's basketball tournament. According to the terms of the agreement, CBS will pay the NCAA an average of \$545 million per year in tax-free money. The president of CBS Sports was quoted as saying, "There is no more important event at CBS, not just CBS Sports, than the men's basketball championship."
 - a. How does the transformation of the NCAA men's basketball championship into commercialized entertainment further the educational purpose of the NCAA and its member institutions?
 - b. The NCAA receives 85 percent of its revenues from the sale of television rights. What is the influence of television networks on the NCAA's decisions? Please include a description of the influence television networks have on the scheduling of games and on the maximum number of games allowed to be played in a season.

The fact that television networks are interested in purchasing the rights to telecast college events is the result of the popularity of these events to American taxpayers. Television networks purchase the rights to meet a demand, and pay for the purchase with their own sale of advertising time on the telecasts to commercial entities. None of these circumstances makes the purpose of intercollegiate athletics anything other than educational in nature for those who participate. If the educational purpose of college basketball could only be preserved by denying the right to telecast the events, students, university faculty and staff, alumni, the institutions of higher education themselves, and even the American taxpayer would ultimately lose.

Furthermore, if the American public also had the same popular interest in French lectures or accounting classes as they do in athletics, television would be just as eager to telecast those events and to sell commercial time to pay the rights fees. Transforming those academic offerings into commercialized events would not undermine the educational purpose for which the offerings are made.

CBS and ESPN also purchased the right to telecast or otherwise distribute all of the NCAA's 88 championships – not just men's and women's basketball – and they sell commercial time to pay for their purchase. We assume it is not being suggested that the educational purpose and value of these sports and championships would be similarly jeopardized by their popularity to the public. The scale of popularity and the media attention given to football and men's basketball do not forfeit for those two sports the educational purpose for which they exist.

The sale of broadcast rights to CBS and ESPN brings with it no influence by those companies on NCAA decisions. Indeed, many decisions by the NCAA are contrary to the best interests of these networks, including limitations on the number and type of

advertising, the number of television timeouts, and on game times for championship events. There are no data on the degree of influence television has on the scheduling of games, but television networks have had no impact on the number of games allowed in a season.

9. Each year, the NCAA distributes more than \$100 million from its Basketball Fund to Division I institutions. These monies are distributed based on performance in the NCAA tournament; each tournament victory earns more money for the winning team's athletic conference. Rewarding athletic instead of academic performance seems to be contradictory to the NCAA's tax-exempt mission, and sends a message to member institutions and athletes that athletics is more important than academics. Why does the NCAA distribute more than \$100 million each year based on athletic rather than academic performance?

The NCAA's tax-exempt mission is, in part, to promote intercollegiate athletics competition, and it is entirely consistent with that mission for the NCAA to award funds to institutions on the basis of athletics performance. As discussed elsewhere, including in Appendix A, promoting athletics competition furthers tax-exempt purposes in section 501(c)(3). In furtherance of its tax-exempt mission, the NCAA sponsors 88 championships in 24 sports. It is in no way improper for the NCAA to distribute funds based on appearances in these championships.

Less than half of the funds from the Division I Men's Basketball Championship is distributed based on appearances in the tournament. Most of the funds are distributed based on the number of sports sponsored and the number of athletics scholarships awarded to all student-athletes on an institutional basis. More than three-quarters of a billion dollars will be distributed over the term of the CBS contract for direct support, including academic support, of student-athletes. A large portion of the three-quarters of a billion dollars to student-athletes is need-based, with some of the remainder distributed for academic support. Further, the dollars that are distributed through the conferences and based on appearances in the championship are distributed to all institutions, including those that do not appear in the tournament, and are used in various ways, including the academic support of student-athletes.

10. What percentage of NCAA revenue is spent by your member institutions on solely academic matters?

We do not collect data on expenditures for academic support by member schools in sufficient detail to respond to this question. However, we know that Division I institutions provide \$1.2 billion annually in scholarships to student-athletes to pay for their education. Additionally, over the life of the CBS contract, the NCAA will distribute \$750 million (Special Assistance Fund, Student-Athlete Opportunity Fund, Academic Enhancement Fund) to its member institutions that can be spent only on student-athletes.

11. Coaches' salaries account for one of the biggest expenses of Division I-A athletic departments. According to reports, more than 35 college coaches receive salaries of at least one million dollars per year. Sources of revenue to pay these rising salaries include student fees, corporate sponsorships, and television deals. Paying coaches excessive compensation also makes less revenue available for other sports, causes many athletic departments to operate at a net loss, and may call into question the priorities of educational institutions.

Compensation packages are negotiated at arm's length in a very competitive environment and should not be considered "excessive compensation" under tax law principles.⁹ Further, it is incorrect to assume that the compensation packages of the three or four dozen football and men's basketball coaches that exceed a million dollars are the major contributors to their institutions' athletics budgets. Indeed, the average athletics budgets for the institutions with "million dollar coaches" is approximately \$50 million, in which the compensation package represents 3.1 percent of the budgets. In most cases, only a small percentage of the coaches' overall compensation packages are being paid by the institution. In addition to salaries, coaches earn income from television appearances, shoe and apparel contracts, endorsements, speaking engagements, and sports camps. This approach parallels the way in which many of the top faculty at these same institutions are compensated. There are likely to be as many as two dozen "million dollar faculty" members on each of these campuses who earn a relatively small salary from the institution with the balance coming in the form of clinical and private practices, patent royalties, consulting contracts, books, speaking engagements and other sources. It should be noted, however, that faculty members have the protection of tenure while coaches are employed at will and can be dismissed for lack luster win-loss records or the inappropriate behavior of 18- to 22-year olds.

- a. Several Division I-A schools pay their men's basketball coaches four to five times more than their women's basketball coaches. What additional educational benefit do men's basketball coaches provide beyond that which is provided by women's basketball coaches?

Coaches' compensation packages, like others within an institution's faculty, are driven by market forces. The competition for the top men's basketball coaches is intense. Similarly, the competition for top faculty in medicine, engineering, law and some other disciplines is also intense. Because of market demand, these faculty will be compensated considerably higher than faculty in the humanities. None of these salaries are quantified by the educational benefit they bring, but rather by the competitive market from which they are hired.

⁹ See discussion of Reasonable Compensation in Appendix A.

- b. What actions has the NCAA taken to encourage its member institutions to curb excessive compensation for college coaches?

Through speeches, articles and most recently through the work of the Presidential Task Force on the Future of Division I Intercollegiate Athletics, we have urged moderation in the growth rate of athletics budgets. However, the NCAA's ability to influence them is limited. One court found a cap on the compensation of assistant coaches to violate the antitrust laws.¹⁰

- c. In 2000, the NCAA repealed a rule requiring all athletics-related coaches' income to be reviewed and approved by the university. Why did the NCAA repeal this rule?

On the contrary, there was little change in the implementation of the requirement. Coaches and staff still must provide written detailed accounts annually of all outside income, and approval must be consistent with the institution's policy related to outside income and benefits applicable to all full-time or part-time employees. There is no change in the need for approval, but approval should conform to the policy already in place on each campus for other faculty or staff.

The rule was modified to better conform to common practice at member institutions for all employees.

12. Current law allows donors to deduct charitable contributions to educational institutions, including contributions to university athletic departments. If the donor receives the right to purchase tickets in exchange for a charitable contribution, current law allows the donor to deduct 80 percent of the amount of contribution.

- a. What percentage of athletic department revenue at Division I-A institutions comes from charitable donations, including donations given for the right to purchase tickets?

Donations and contributions represent 21 percent of total operating revenue for Division I-A athletics departments, as reported for 2004-05.

- b. How much money was donated to Division I-A athletic departments in 2005, including donations given for the right to purchase tickets?

The total donations and contributions to Division I-A athletics departments for 2004-05 were approximately \$845 million.

¹⁰ *Law v. NCAA*, 902 F. Supp. 1394 (D.Kan.) (1995)

13. In 1997, Congress passed a law exempting from taxes qualified corporate sponsorship payments received by tax-exempt organizations.

- a. How has this law affected the use of corporate sponsorships by the NCAA and your member institutions? Have corporate sponsorships become more prevalent?

Corporations have demonstrated over time an affinity for aligning with higher education, including intercollegiate athletics. The major impact of the 1997 tax law change was to discontinue, for those few institutions doing so, the use of sponsorships for promoting sponsors' products and services. A large majority of corporate sponsorships and contributions for colleges and universities are dedicated to programs other than athletics (business and bio-medicine, for example).¹¹

- b. How much revenue do corporate sponsorships generate annually for your member institutions?

Corporate sponsorships generate approximately \$275 million in annual athletics revenues.

Thank you, again, Mr. Chairman, for the opportunity to respond.

Sincerely,

Myles Brand
President

MB:ckr

Attachments

¹¹ See Appendix A for further discussion of the corporate sponsorship rules.

NATIONAL COLLEGIATE ATHLETIC ASSOCIATION (NCAA)

TAX LAW BASIS FOR
TAX EXEMPTION OF INTERCOLLEGIATE ATHLETICS

I. PREFACE

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

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

A. In General

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

B. History

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

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

² See I.R.C. § 511(a)(2)(B).

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

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

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

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

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

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

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

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

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

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

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

C. Section 501(c)(3)

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

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

D. Organizational And Operational Tests

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

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

¹⁰ Treas. Reg. § 1.501(c)(3)-1(d)(2).

¹¹ *Id.*

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

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

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

E. Private Inurement

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

¹³ Treas. Reg. § 1.501(c)(3)-1(b).

¹⁴ Treas. Reg. § 1.501(c)(3)-1(c)(1).

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

¹⁶ Treas. Reg. § 1.501(c)(3)-1(e).

¹⁷ Treas. Reg. § 1.501(c)(3)-1(e)(1).

¹⁸ 1964-1 C.B. 186.

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

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

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

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

F. Private Benefit

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

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

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

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

²² Treas. Reg. § 1.501(a)-1(c).

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

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

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

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

²⁷ *Id.* at 1066.

²⁸ GCM 37789 (Dec. 18, 1978).

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

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

G. Relationship Between Private Inurement And Private Benefit

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

H. Reasonable Compensation As Prohibited Inurement Or Private Benefit

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

³⁰ 1976-1 C.B. 151.

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

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

³³ *Id.*

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

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

³⁶ *Id.*

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

1. Definition Of Reasonable Compensation

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

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

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

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

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

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

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

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

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

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

2. Intermediate Sanctions Rules

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

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

⁴³ *Id.*

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

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

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

⁴⁷ GCM 39670 (Oct. 14, 1987).

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

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

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

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

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

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

⁵⁰ I.R.C. § 4958(e).

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

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

⁵³ H.R. Rep. 104-50, at 56, n.5.

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

3. Benchmarking To For-Profits

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

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

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

A. Definition Of Education

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

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

⁵⁵ *Id.*

⁵⁶ Treas. Reg. § 53.4958-6.

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

⁵⁸ Treas. Reg. § 53.4958-6(b).

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

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

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

B. Types Of Exempt Educational Organizations

1. Schools, Colleges, And Universities

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

2. Other Organizations That Further Educational Purposes

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

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

⁶¹ Treas. Reg. § 1.501(c)(3)-1(d)(3).

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

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

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

⁶⁵ 1967-2 C.B. 184.

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

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

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

C. Physical Education As An Exempt Educational Purpose

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

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

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

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

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

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

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

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

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

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

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

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

⁷³ Rev. Rul. 65-2, 1965-1 C.B. 227.

⁷⁴ 1977-2 C.B. 192.

⁷⁵ *Id.*

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

D. Amateur Sports Competition As An Exempt Purpose

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

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

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

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

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

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

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

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

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

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

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

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

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

3. 1982 Enactment Of Section 501(j)

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

⁸³ 73 T.C. at 153.

⁸⁴ 696 F.2d at 762.

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

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

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

E. Intercollegiate Athletic Competition As An Exempt Educational Purpose

Congress has long recognized the educational value of athletic competition at the college and university level and that income derived from intercollegiate athletic competition is substantially related to the educational functions of colleges and universities. The legislative history of the Revenue Act of 1950⁸⁷ indicates that both the House and Senate agreed on this point. The Senate Report states, “Athletic activities of schools are substantially related to their educational functions. For example, a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were composed of students of other schools.”⁸⁸ The House Report states, “Of course, income of an educational organization from charges for admissions to football games would not be deemed to be income from an unrelated business, since its athletic activities are substantially related to its educational program.”⁸⁹

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

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

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

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

⁹⁰ 148 F. Supp. 311 (S.D. Ala. 1957).

⁹¹ 148 F. Supp. at 314.

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

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

F. Regulating Intercollegiate Athletic Competition As An Exempt Purpose

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

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

⁹² 148 F. Supp. at 316.

⁹³ 148 F. Supp. at 313.

⁹⁴ 148 F. Supp. at 316.

⁹⁵ 1955-2 C.B. 261.

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

G. Other Charitable Purposes

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

1. Advancement of Education Or Science

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

2. Relief of the Poor or Distressed

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

3. Lessening the Burdens of Government

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

⁹⁶ 468 U.S. 85, 120 (1984).

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

⁹⁸ Hopkins, *supra*, at 167-168.

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

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

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

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

A. Unrelated Business Income Tax, Generally

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

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

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

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

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

¹⁰³ I.R.C. § 512(a).

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

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

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

B. UBTI Exceptions And Exclusions

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

¹⁰⁴ Treas. Reg. § 1.513-1(d)(2).

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

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

¹⁰⁷ I.R.C. § 513(a).

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

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

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

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

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

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

¹⁰⁹ I.R.C. §§ 512(b)(1), (3) and (5).

¹¹⁰ I.R.C. § 512(b)(2).

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

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

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

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

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

D. Other Benefits Of Broadcasting Athletic Competition

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

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

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

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

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

¹¹⁶ 1980-2 C.B. 194.

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

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

III. FUNDRAISING BY CHARITABLE AND EDUCATIONAL ORGANIZATIONS

A. Profit-Making Activities

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

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

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

¹¹⁹ TAM 7851002, *supra*.

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

¹²¹ 71 T.C. 202 (1978).

¹²² 71 T.C. at 211.

¹²³ 73 T.C. 96 (1979).

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

B. Raising Funds For Charity

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

C. Corporate Sponsorships

1. Background

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

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

¹²⁵ 70 T.C. 594, 611 (1978).

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

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

¹²⁸ 1964-1 C.B. 186.

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

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

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

2. History Of Tax Treatment Of Corporate Sponsorships

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

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

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

¹²⁹ (Aug. 16, 1991).

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

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

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

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

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

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

3. Section 513(i) – Qualified Sponsorship Payments

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

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

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

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

¹³⁶ *Id.*

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

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

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

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

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

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

¹³⁹ I.R.C. § 513(i)(1).

¹⁴⁰ I.R.C. § 513(i)(2)(A).

¹⁴¹ Treas. Reg. § 1.513-4(c)(2)(iv).

¹⁴² I.R.C. § 513(i)(2)(B).

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

¹⁴⁴ Treas. Reg. § 1.513-4(d)(1)(i).

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

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

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

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

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

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

¹⁴⁵ Treas. Reg. § 1.513-4(d).

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

¹⁴⁷ Treas. Reg. § 1.153-4(e)(3).

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

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

¹⁵⁰ 1986-1 C.B. 88.

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

IV. CONCLUSION

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

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

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

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

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

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

**Executive Summary
NCAA Academic Reform**

The NCAA is committed to the quality education of student-athletes; it is fundamental to our mission and values.

1. The adoption of the academic reform “package” by the Division I membership has shown it is serious about reaffirming the emphasis on “student” in the student-athlete equation.
2. The NCAA and its member institutions continually strive to ensure that academic success is a primary goal of intercollegiate athletics.

The academic reform package is highlighted by:

1. Enhanced academic standards, requiring incoming student-athletes to be better prepared for college and continuing students to perform better academically in order to stay eligible and graduate.
2. Improved measurements of academic success through the creation of the NCAA Division I Academic Progress Rate (APR) and a Graduation Success Rate (GSR).
3. Increased accountability for the academic success of student-athletes through a penalty and recognition structure impacting individual teams.

This initiative is research driven and based on analysis of data collected on the academic behavior of student –athletes over the last two-and-a-half decades.

1. Enhanced Academic Standards.

It is clear that students will be better prepared for college if they take more college preparatory courses while in high school. To this end, the Association increased the required number of high school core courses from 14 to 16, to be fully implemented by fall 2008. Under the new NCAA regulations, student-athletes will be required to take one additional unit in mathematics and one additional unit in any core area (e.g., science).

Incoming students are required to present a test score from either the SAT or ACT for initial-eligibility purposes. A “sliding scale” is employed, as a student’s grade-point average in his or her core academic curriculum will dictate the test score they need to be eligible as a freshman.

The Association also has taken steps to make student-athletes and their colleges/universities more accountable for making steady progress toward a degree. These standards include the following:

- a. Freshmen in college are required to complete 24 hours of coursework and have at least a 1.80 grade-point average.
- b. Student-athletes entering college are required to complete 40 percent of their degree requirements by the end of their second year, 60 percent by the end of year three and 80 percent by the end of year four.

2. Improved Academic Measures.

The NCAA has developed two specific measures of academic success, in addition to the federally mandated Federal Graduate Rate.

- a. **APR. Developed as a more real-time assessment of teams' academic performance than the six-year graduation rate calculation provides, the APR awards two points each term to student-athletes who meet academic-eligibility standards and who remain with the institution. A team's APR is the total points earned by the team at a given time divided by the total points possible.**

The APR was developed to provide a more accurate, real time "snapshot" of a team's academic success and to serve as a primary measurement on which incentives and disincentives will be based. The APR is not intended to replace the federal measure or GSR; rather, it is a fairer measure that will help provide accurate, real-time data on academic progress on which the NCAA will base its reform principles.

The APR provides a much clearer picture of the current academic "culture" in each sport; and includes eligibility, retention and graduation as factors in the rate calculation.

APR data collection began with the 2003-04 academic year and the first data report was issued in February 2005 for all Division I member institutions, assessing the previous year of academic performance. The latest report was issued March 1, 2006. Division I schools are currently submitting their third year of APR data, to be released May 2007.

- b. **GSR. The GSR is an alternative graduation-rate methodology the NCAA launched last year. The new rate, which supplements rather than replaces the federal methodology, takes into consideration transfer students in a more appropriate manner. For example, if a student-athlete elects to transfer to another school and the student was in good academic standing at the time of their departure, the student will not count against the graduation success rate of the team. Further, if a transfer student enrolls at a Division I campus and ultimately graduates, the student will count as a graduate for the awarding institution.**

c. Increased Accountability.

The NCAA has developed a penalty and recognition program that rewards sports teams that do well academically and penalizes those that do not. College presidents have mandated the development of this system of accountability, which will take into account the various institutional characteristics of our member institutions.

- Penalties and recognition are tied to a team's APR.

(1) Contemporaneous penalties. These are the most immediate penalties in the academic-reform structure, and they occur when a team under an APR of 925 loses a student-athlete who would not have been academically eligible had he or she returned (an "0/2" player). A contemporaneous penalty means that teams cannot reaward that grant-in-aid to another player. In effect, a team's financial aid limit is reduced by the amount of countable aid awarded to the student-athlete who did not earn eligibility and was not retained. A contemporaneous penalty is not automatically applied when teams fall below the APR cut point; it is applied only when teams below that line do not retain an academically ineligible player.

(2) Historical penalties. While contemporaneous penalties are designed to be rehabilitative in nature, the historically based penalties carry a more significant punitive hit for teams that the APR identifies as "chronic" under-performers. The penalties will be incremental in nature, beginning with a warning once teams fall below a 900 APR cut score, and progressing to practice, and/or recruiting/financial aid restrictions, postseason bans and restricted membership status on subsequent occasions.

Historical penalties begin in 2006-07 based on three years of APR data.

(3) Public Recognition. The NCAA formally recognized the top 10 percent of teams by sport based on their team's APR.

More detailed information on academic reform is available on the NCAA Web site at www.ncaa.org.

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, DC 20515

October 2, 2006

Dr. Myles Brand
President
National Collegiate Athletic Association
700 West Washington Street
Indianapolis, IN 46206

Dear Dr. Brand:

Since 2004, the Committee on Ways and Means of the U.S. House of Representatives has been conducting a broad review of the tax-exempt sector. As the sector increases in size, scope, and economic impact, the need for Congress to conduct comprehensive oversight grows as well.

Educational organizations comprise one of the largest segments of the tax-exempt sector, and most of the activities undertaken by educational organizations clearly further their exempt purpose. The exempt purpose of intercollegiate athletics, however, is less apparent, particularly in the context of major college football and men's basketball programs.

As you know, the National Collegiate Athletic Association (NCAA) represents intercollegiate athletics in legislative matters before the Federal government. As the Committee continues its review, I am writing to request information on whether major intercollegiate athletics further the exempt purpose of the NCAA and, more generally, educational institutions. Your responses to the following questions will assist the Committee in this matter.

Questions Relating to the NCAA's Educational Mission

1. The annual return filed by the NCAA with the Internal Revenue Service states that the primary tax-exempt purpose of the NCAA is to "maintain intercollegiate athletics as an integral part of the educational program and the athlete as an integral part of the student body." How does the NCAA accomplish its purpose of maintaining "the athlete as an integral part of the student body"?

2. The annual return also states that one of the NCAA's purposes is to "retain a clear line of demarcation between intercollegiate athletics and professional sports." Corporate sponsorships, multimillion dollar television deals, highly paid coaches with no academic duties, and the dedication of inordinate amounts of time by athletes to training lead many to believe that major college football and men's basketball more closely resemble professional sports than amateur sports. The NCAA has no control over two of the differences between professional and amateur sports: the level of play and the tax exemption for college athletics revenue. Beyond rules prohibiting compensation for college athletes, what actions has the NCAA taken to "retain a clear line of demarcation" between major college sports and professional sports?
3. Some representatives from college athletic organizations have justified the tax-exempt status of college sports based on claims that high-visibility programs help sustain a large pool of student applicants and generous financial contributions. Neither of these arguments is valid from a Federal standpoint. Federal taxpayers have no interest in increasing applicant pools at one school opposed to another. Furthermore, if financial contributions to universities increase based on athletic success, contributions to other worthy charities may decline.
 - a. From the standpoint of a Federal taxpayer, what benefits does the NCAA provide taxpayers in exchange for its tax exemption?
 - b. From the standpoint of a Federal taxpayer, why should the Federal government subsidize the athletic activities of educational institutions when that subsidy is being used to help pay for escalating coaches' salaries, costly chartered travel, and state-of-the-art athletic facilities?
4. Officials from the NCAA, athletic conferences, and universities have explained that college football and basketball should be tax-exempt because some universities generate a profit from these sports that is used for other university-sponsored sports. To be tax-exempt, however, the activity itself must contribute to the accomplishment of the university's educational purpose (other than through the production of income). How does playing major college football or men's basketball in a highly commercialized, profit-seeking, entertainment environment further the educational purpose of your member institutions?
5. Educational institutions in other NCAA divisions spend a fraction of the amount Division I-A schools spend on their football and men's basketball programs. These higher expenditures are ostensibly for educational purposes. What additional educational value is received by participation in Division I-A athletics beyond that which is received by participation in other division or intramural athletics? If additional educational value is derived from participation in Division I-A athletics, does the additional educational value justify the higher expenditures?

6. According to studies, incoming athletes at many universities have lower average SAT scores and high school grades than those of the general student body. Do the minimum initial eligibility standards currently in place adequately ensure that high school athletes can succeed academically at universities?
7. In order for a high school student to become eligible to compete in intercollegiate athletics, the NCAA requires high school athletes to take a core curriculum of academic courses and earn a minimum grade-point average while in high school. Why does the NCAA not have similar requirements for athletes during their collegiate careers?
8. In recent years, there have been many reports of athletes taking college courses that lack academic rigor. Several schools have reportedly steered athletes toward professors and academic majors that are less challenging.
 - a. What actions has the NCAA taken to assess the substance of the courses athletes are taking and, more generally, the quality of the education athletes receive?
 - b. Does the NCAA collect information from its member institutions to determine whether athletes are disproportionately taking certain professors, courses, or academic majors at individual schools?
 - c. Would requiring the public disclosure of the professors, courses, and academic majors of athletes help ensure that they receive a quality education?
9. At Division I-A schools, only 55 percent of football players and 38 percent of basketball players graduate – compared to 64 percent of the general student body. These figures understate the gap between the graduation rates of the general student body and athletes, since many regular students fail to graduate for financial reasons, which is not an issue for athletes on full scholarships.
 - a. Are the NCAA's member institutions accepting athletes who would not otherwise be admitted but for their athletic prowess?
 - b. For twenty years, the Federal graduation rate for male basketball players has remained basically unchanged at about 40 percent. Why has the NCAA made no progress in ensuring that athletes who play on the court also graduate from the schools for which they are playing?
 - c. The defending Division I-A national champion in football graduated 29 percent of its players compared to 74 percent of the university's student body for the class entering in 1998. Similar large differences in graduation rates exist at other colleges and universities. Considering this

gap, how well is the NCAA accomplishing its tax-exempt purpose of maintaining “the athlete as an integral part of the student body”?

- d. To improve the graduation rates of athletes, has the NCAA considered adopting a rule tying the number of grants-in-aid that can be awarded to a member institution’s graduation rates?
10. The NCAA recently created the Academic Progress Rate to measure the cumulative progress made by athletic teams towards a degree. Based on the new measure, the NCAA will take away scholarships from teams that do not meet a threshold that is equivalent to a 50-percent graduation rate, which is an extremely low standard.
- a. Why is a team penalized only when more than half of its players fail to graduate?
 - b. Should athletes who are not advancing toward a degree be eligible to participate in college sports?
11. During the last few decades, the NCAA has increased the maximum number of football and men’s basketball games that each member institution can play. This year, the NCAA changed the rules to allow schools to play an additional, twelfth football game. Also this year, the NCAA approved an increase in the maximum number of basketball games teams can play in a season and lengthened the season by one week. Including preseason and postseason tournaments, basketball teams can now play more than forty games in a season.
- a. Why did the NCAA make these rule changes?
 - b. How do these rule changes further the educational mission of the NCAA and your member institutions?
 - c. How do these proposals help athletes improve academic performance?
 - d. At what point does playing additional games have a detrimental impact on academic performance?
12. In 1973, the NCAA adopted a rule prohibiting financial aid from being awarded to an athlete for more than one academic year. This rule allows schools and coaches to withdraw financial assistance from athletes who do not perform well on the field, which may overemphasize athletics at the expense of academics.
- a. Why did the NCAA adopt this rule?
 - b. How does this rule further the educational mission of the NCAA and your member institutions?

Questions Relating to NCAA Finances

1. How much total revenue does college sports generate each year? How much do your member institutions spend each year on college sports?
2. For Division I-A football programs, please provide the following information for the most recent year for which you have statistics:
 - a. Total annual revenue;
 - b. Largest amount of revenue generated by one school;
 - c. Total annual expenditures; and,
 - d. Largest annual expenditure by one school.
3. For Division I basketball programs, please provide the following information for the most recent year for which you have statistics:
 - a. Total annual revenue;
 - b. Largest amount of revenue generated by one school;
 - c. Total annual expenditures; and,
 - d. Largest annual expenditure by one school.
4. How many of your member institutions generate a net profit on the operations of their athletic departments (excluding university subsidies such as student fees or general school funds and services)? Of the institutions that generate a net profit, how many use the profit for purposes unrelated to the athletic department?
5. At Division I-A schools, what is the average annual expense (including the cost of grants-in-aid):
 - a. Per athlete?
 - b. Per football player?
 - c. Per men's basketball player?
 - d. Per women's basketball player?
6. According to NCAA expenditure reports, public universities spent as much as \$600,000 per men's basketball player during the 2004-05 school year.
 - a. How does spending hundreds of thousands of dollars on each men's basketball player further the educational mission of universities?
 - b. How much money must be spent by athletic departments to ensure that athletes receive an educational benefit from the activity?

7. According to NCAA data, athletic department budgets are growing several times faster than the university budgets of your member institutions. In addition, athletic department expenses are increasing at a higher rate than athletic department revenues.
 - a. Why are athletic department budgets increasing faster than university budgets?
 - b. Why are athletic departments spending money at an increasing rate?
 - c. How does spending even more money on Division I-A football and men's basketball further the educational mission of universities?
 - d. What actions can the NCAA take to control rising spending?
8. The NCAA has entered into an agreement with CBS to televise the men's basketball tournament. According to the terms of the agreement, CBS will pay the NCAA an average of \$545 million per year in tax-free money. The president of CBS Sports was quoted as saying, "There is no more important event at CBS, not just CBS Sports, than the men's basketball championship."
 - a. How does the transformation of the NCAA men's basketball championship into commercialized entertainment further the educational purpose of the NCAA and its member institutions?
 - b. The NCAA receives 85 percent of its revenues from the sale of television rights. What is the influence of television networks on the NCAA's decisions? Please include a description of the influence television networks have on the scheduling of games and on the maximum number of games allowed to be played in a season.
9. Each year, the NCAA distributes more than \$100 million from its Basketball Fund to Division I institutions. These monies are distributed based on performance in the NCAA tournament; each tournament victory earns more money for the winning team's athletic conference. Rewarding athletic instead of academic performance seems to be contradictory to the NCAA's tax-exempt mission, and sends a message to member institutions and athletes that athletics is more important than academics. Why does the NCAA distribute more than \$100 million each year based on athletic rather than academic performance?
10. What percentage of NCAA revenue is spent by your member institutions on solely academic matters?

11. Coaches' salaries account for one of the biggest expenses of Division I-A athletic departments. According to reports, more than 35 college coaches receive salaries of at least one million dollars per year. Sources of revenue to pay these rising salaries include student fees, corporate sponsorships, and television deals. Paying coaches excessive compensation also makes less revenue available for other sports, causes many athletic departments to operate at a net loss, and may call into question the priorities of educational institutions.
 - a. Several Division I-A schools pay their men's basketball coaches four to five times more than their women's basketball coaches. What additional educational benefit do men's basketball coaches provide beyond that which is provided by women's basketball coaches?
 - b. What actions has the NCAA taken to encourage its member institutions to curb excessive compensation for college coaches?
 - c. In 2000, the NCAA repealed a rule requiring all athletics-related coaches' income to be reviewed and approved by the university. Why did the NCAA repeal this rule?

12. Current law allows donors to deduct charitable contributions to educational institutions, including contributions to university athletic departments. If the donor receives the right to purchase tickets in exchange for a charitable contribution, current law allows the donor to deduct 80 percent of the amount of the contribution.
 - a. What percentage of athletic department revenue at Division I-A institutions comes from charitable donations, including donations given for the right to purchase tickets?
 - b. How much money was donated to Division I-A athletic departments in 2005, including donations given for the right to purchase tickets?

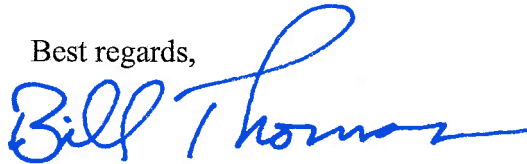
13. In 1997, Congress passed a law exempting from taxes qualified corporate sponsorship payments received by tax-exempt organizations.
 - a. How has this law affected the use of corporate sponsorships by the NCAA and your member institutions? Have corporate sponsorships become more prevalent?
 - b. How much revenue do corporate sponsorships generate annually for your member institutions?

Dr. Myles Brand
October 2, 2006
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If the NCAA is unable to respond to any of the questions in this letter due to lack of information, please explain why the NCAA does not compile such information to determine whether its tax-exempt mission is being accomplished.

The information you provide will assist the Committee in its oversight efforts. I would appreciate receiving your responses by October 30, 2006. Thank you for your cooperation and assistance in this matter.

Best regards,



Bill Thomas
Chairman

WMT/mr

cc: The Honorable Charles Grassley