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Corporate Sponsorships of Charity Events and the Unrelated Business Income Tax: Will Congress or the Courts Block the IRS Rush to Sack the College Football Bowl Games?

I. INTRODUCTION

On August 16, 1991 the Internal Revenue Service (IRS) issued a technical advice memorandum (TAM) which imposed an unrelated business income tax (UBIT) on corporate title sponsorship payments to two tax-exempt college football bowl games (bowl games).¹ Because exempt organizations received an estimated \$1.1 billion from corporate sponsors in 1991,² the ruling created a wave of concern among all exempt organizations.³

The IRS must overcome several hurdles to impose UBIT on corporate sponsorships. First, exempt organizations can raise several legal challenges against the IRS position.⁴ Second, the IRS must distinguish between the corporate sponsorships that are subject to UBIT and those that are exempt.⁵ Finally, three bills are pending

1 Tech. Adv. Mem. 91-47-007 (Aug. 16, 1991). The IRS released the TAM to the public in late November 1991. The TAM has been referred to as the Cotton Bowl ruling, because the ruling applied specifically to the Mobil Cotton Bowl. The other bowl game initially affected was the John Hancock Bowl. See, e.g., Thomas S. Mulligan, *IRS Ruling May Force Business Out of Athletics; Sponsors: A Decision to Make Nonprofits Pay Taxes on Corporate Contributions Could Affect Events All the Way to the Olympics*, L.A. TIMES, Dec. 24, 1991, at D2.

Title sponsors refer to corporate sponsors whose names are included in the name of the exempt organization's event, such as Mobil and John Hancock above. Twelve of the eighteen 1991/92 bowl games had title sponsors. *Id.*

2 See Dennis Zimmerman, *Corporate Title Sponsorship Payments to Nonprofit College Football Bowl Games: Should They Be Taxed?*, 1992 Rep. Cong. (CSR) No. 157E at 2-3 (Feb. 11, 1992), available in LEXIS, FedTax Library, TNT File (92 TAX NOTES TODAY 41-18 (1992)) (In 1991 total corporate sponsorship payments to tax-exempt organizations was "\$1.1 billion, of which about \$64 million was paid to the college football bowl organizations. Of this \$64 million, an estimated \$19.6 million was received for corporate title sponsorships rather than as corporate royalty payments.").

3 See, e.g., Nancy Churnin, *IRS Move Threatens to Sack Key Stage Funding Source*, L.A. TIMES, Jan. 30, 1992, at F2; Mulligan, *supra* note 1; Dick Rosenthal & John D. Crow, *BACKTALK; Bowl-Game Taxes Hurt Charity, Schools and Business*, N.Y. TIMES, Feb. 9, 1992, § 8, at 11; Paul Streckfus, *Cotton Bowl Ruling Draws Fire at ASAE Roundtable Discussion*, 92 TAX NOTES TODAY 12-6 (1992), available in LEXIS, FedTax Library, TNT File.

4 See *infra* Parts III and V.

5 The IRS issued proposed examination guidelines to address this administrative

in Congress that would statutorily exempt corporate sponsorship income from UBIT.⁶

This Note examines whether the IRS should continue its attempt to impose UBIT on corporate sponsorships.⁷ Part II discusses the Internal Revenue Code (Code) sections and related Treasury regulations applicable to UBIT. Part III individually analyzes the three prongs of the UBIT test and then applies the test to corporate sponsorships of bowl games. Part IV evaluates the IRS proposed examination guidelines and discusses their ambiguities and open issues. Part V analyzes the royalty income exclusion from UBIT and whether the exclusion encompasses corporate sponsorship payments. Part VI discusses the policy considerations of whether the IRS should impose UBIT on corporate sponsorships. Finally, Part VII addresses pending legislation that would statutorily exclude corporate sponsorships of amateur athletics from UBIT. This Note concludes that although some corporate sponsorships appear taxable within the UBIT Code provisions, the IRS should nevertheless resist imposing UBIT on these corporate sponsorships due to policy considerations.

II. INTERNAL REVENUE CODE SECTIONS AND TREASURY REGULATIONS

Prior to 1950, exempt organizations were not subject to tax on any of their income, regardless of its source, as long as the exempt organization used the funds to further its exempt purposes.⁸

problem, but the guidelines failed to either clarify or address several important issues. See *infra* Part IV.

6 H.R. 2464, 102d Cong., 1st Sess. (1991); S. 866, 102d Cong., 1st Sess. (1991); H.R. 538, 102d Cong., 1st Sess. (1991); see *infra* Part VII.

7 This Note does not address the corporate sponsor's tax treatment of sponsorship payments as either a charitable deduction, under § 170 of the Internal Revenue Code, or a regular business expense deduction under § 162. 26 U.S.C. §§ 162, 170 (1988); see also *Hernandez v. Commissioner*, 490 U.S. 680 (1989); *United States v. American Bar Endowment*, 477 U.S. 105 (1986).

From a practical standpoint, the sponsor's preference is to deduct the sponsorship payment as a business expense, such as advertising, in order to avoid the charitable contribution limitations of Internal Revenue Code § 170(b)(2). Depending on the financial position of the sponsor, the sponsor may reap additional tax advantages by classifying the sponsorship cost as a business expense. However, because many, if not most, sponsors of charitable events are in a profitable financial position and can fully deduct their charitable contributions, the sponsor would receive no tax benefit from reclassifying the sponsorship payment as a regular business expense.

8 The court's focus on the use of the funds was termed the "destination of income" test. See *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924) ("[The statute] says nothing about the source of the income, but makes the destination

Accordingly, in areas where exempt organizations competed with taxable entities, exempt organizations enjoyed a tremendous economic advantage. With no tax expense, the exempt organization could either charge lower prices than its taxable competitors, and still remain profitable, or charge the same prices and reap larger profits. In response to this unfair competitive advantage, Congress, as part of the Revenue Act of 1950, enacted provisions imposing a tax on exempt organizations for their unrelated business income.⁹ Currently, the Code imposes UBIT on virtually all exempt organizations.¹⁰

Code sections 511 through 514 contain the UBIT provisions.¹¹ Section 511 imposes a tax on the "unrelated business taxable income (as defined in section 512)" of exempt organizations. Section 512(a)(1) states that "[e]xcept as otherwise provided in this subsection, the term 'unrelated business taxable income' means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it." Section 513(a) further provides that

[t]he term 'unrelated trade or business' means . . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.¹²

Treasury regulation section 1.513-1 summarizes the above Code sections and arrives at a three pronged test to determine whether income from an exempt organization activity is unrelated business taxable income:

the ultimate test of exemption."); *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951); see also Donald C. Haley, *The Taxation of the Unrelated Business Activities of Exempt Organizations: Where Do We Stand? Where Do We Seem To Be Headed?*, 7 AKRON TAX J. 61, 62 (1990); Richard L. Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430, 1432-37 (1980); Thomas N. Littman, Comment, *Advertising and the Unrelated Business Income Tax after United States v. American College of Physicians*, 49 OHIO ST. L.J. 625, 626-28 (1988).

9 See, e.g., *United States v. American College of Physicians*, 475 U.S. 834, 837-38 (1986).

10 See 26 U.S.C. § 511(a)(2) (1988). The UBIT provisions exempt § 501(c)(1) organizations (certain corporations which are instrumentalities of the United States). *Id.*

11 26 U.S.C §§ 511-14 (1988).

12 26 U.S.C § 513(a) (1988).

[U]nless one of the specific exceptions of section 512 or 513 is applicable,¹³ gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.¹⁴

III. THE UBIT THREE PRONG TEST

Corporate sponsorship income is subject to UBIT if the exempt organization's sponsorship activity (1) constitutes a trade or business; (2) is regularly carried on by the exempt organization; and (3) is not substantially related to the organization's tax-exempt purposes.¹⁵ Accordingly, if the exempt organization proves that any one of the above three prongs is not satisfied, the sponsorship income is exempt.

A. *When Does Sponsorship Activity Constitute a Trade or Business?*

Treasury regulation section 1.513-1(b) interprets the trade or business element.¹⁶ The regulation provides three components to

13 Code § 512(b)(2) provides that "[t]here shall be excluded all royalties" from the computation of unrelated business taxable income; see discussion of royalties *infra* Part V.

14 Treas. Reg. § 1.513-1 (as amended in 1983).

15 *Id.*; see also *United States v. American Bar Endowment*, 477 U.S. 105, 110 (1986); *United States v. American College of Physicians*, 475 U.S. 834, 838-39 (1986).

16 Treas. Reg. § 1.513-1 (as amended in 1983). Definition of unrelated trade or business:

(b) *Trade or business.* The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete [I]n general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162 . . . presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services [These activities] do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related

determine if an activity constitutes a trade or business. The first component, a threshold requirement, is whether the activity involves the *sale of goods or performance of services*.¹⁷ The second component, the “profit motive” test, is whether the exempt organization conducts the activity with the purpose of making a profit.¹⁸ The last component, the “unfair competition” test, is whether the activity gives the exempt organization an unfair advantage over potential competitors.¹⁹ After addressing the first component, sale of goods or performance of services, courts disagreed whether to apply the profit motive test, the unfair competition test, or both to determine if an activity constituted a trade or business. The Supreme Court addressed this uncertainty in *United States v. American Bar Endowment*.²⁰

1. *United States v. American Bar Endowment*

American Bar Endowment (ABE), an exempt organization, provided group insurance policies, underwritten by major insurance companies, to its members.²¹ Due to ABE's size and its ability to obtain experience-rated policies as a group representative, ABE negotiated lower policy rates for its members participating in the program.²² As ABE's premiums each year exceeded the insurance company's actual costs, the insurance company refunded part of this excess to ABE.²³ As a condition to their participation in the group insurance program, ABE required its members to per-

to the exempt purposes of the organization [N]o part of such trade or business shall be excluded from such classification merely because it does not result in profit.

Id.

17 *Id.* Within the context of sponsorships, the IRS has translated the requirement of a sale of goods or performance of services into a requirement that the exempt organization must provide the corporate sponsor with a “substantial return benefit.” The IRS acknowledges that “[p]ayments an exempt organization receives from donors are nontaxable contributions where there is no expectation that the organization will provide a substantial return benefit. Mere recognition of a corporate contributor as a benefactor normally is incidental to the contribution and not of sufficient value to the contributor to constitute unrelated trade or business.” I.R.S. Announcement 92-15, 1992-5 I.R.B. 51; *see infra* Part IV.

18 *See infra* note 29 and accompanying text.

19 *See infra* note 31 and accompanying text.

20 477 U.S. 105 (1986).

21 *Id.* at 107.

22 *Id.*

23 *Id.* at 108.

mit ABE to keep these refunds, called dividends.²⁴ ABE raised significant revenues through this insurance program.²⁵ In its final analysis, the Court found that ABE's insurance program constituted a trade or business, and therefore satisfied the first prong of the UBIT test.²⁶

In reaching its decision, the Court did not conclusively arrive at a test to determine what constitutes a trade or business. The Court merely held that "ABE's insurance program falls within the literal language of *these definitions*."²⁷ The Court first found that "[ABE's insurance] activity is both 'the sale of goods' and 'the performance of services.'"²⁸ The Court then recognized in a footnote that the standard test for a trade or business within the meaning of Code section 162 is the "profit motive" test, considering "whether the activity was entered into with the dominant hope and intent of realizing a profit."²⁹ However, the Court applied both the profit motive and unfair competition tests to reach its holding.

The Court first concluded that ABE engaged in an activity for profit. "ABE has a unique asset—its access to the ABA's members and their highly favorable mortality and morbidity rates—and it has chosen to appropriate for itself all of the profit possible from that asset, rather than sharing any with its members."³⁰ Second, the Court noted that ABE would have an unfair advantage over other potential competitors if it did not have to pay taxes:

The undisputed purpose of the unrelated business income tax was to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed. This case presents an example of precisely the sort of unfair competition that Congress intended to prevent [I]f ABE may escape taxes

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.* at 110. ABE conceded both the second and third prongs of the unrelated business taxable income test, that the insurance program was regularly carried on and not substantially related to its exempt function.

²⁷ *Id.* (emphasis added).

²⁸ *Id.*

²⁹ *Id.* n.1 (quoting *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984)). The Court noted several circuit court decisions that had "adopted the 'profit motive' test to determine whether an activity constitutes a trade or business for purposes of the unrelated business income tax." *Id.*; see *Professional Ins. Agents of Mich. v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984); *Carolinas Farm & Power Equip. Dealers v. United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982).

³⁰ *American Bar Endowment*, 477 U.S. at 113.

on its earnings, it need not be as profitable as its commercial counterparts in order to receive the same return on its investment. Should a commercial company attempt to displace ABE as the group policyholder, therefore, it would be at a decided disadvantage.³¹

Furthermore, the Court implicitly held that no specific finding of actual competition was necessary to prove unfair competition, but rather the mere likelihood of unfair competition was sufficient.³²

The Court made the additional point that an exempt organization cannot segregate the income received as a donation from the return activity of providing a good or service to the donor: "[T]he Claims Court failed to articulate a legal rule that would permit it to split ABE's activities into the gratuitous provision of a service and the acceptance of voluntary contributions, and we find no such rule in the Code or regulations."³³ Accordingly, the Court found that no legal basis existed for splitting ABE's activities into providing insurance on the one hand and receiving donations in the form of refunds on the other.

2. Cases Subsequent to *American Bar Endowment*

Subsequent to *American Bar Endowment*, some uncertainty still exists in determining what constitutes a trade or business. Courts generally agree that they must apply the "profit motive" test.³⁴ However, only some courts also apply the "unfair competition" test.³⁵ The Seventh Circuit attempted to reconcile the two tests as consistent with each other.³⁶ "Read carefully, the two lines of cas-

31 *Id.* at 114-15 (citations omitted).

32 *Id.* at 115 ("The Claims Court failed to find any taxable entities that compete with ABE and therefore found no danger of unfair competition. It is likely, however, that many of ABE's members belong to other organizations that offer group insurance policies.").

33 *Id.* at 116.

34 See *American Postal Workers Union v. United States*, 925 F.2d 480, 483 (D.C. Cir. 1991) ("The Supreme Court has suggested—and the parties agree—that the test for [trade or business] is whether the activity 'was entered into with the dominant hope and intent of realizing a profit.'") (citation omitted); see also *National Ass'n of Postal Supervisors v. United States*, 944 F.2d 859, 861 (Fed. Cir. 1991); *Fraternal Order of Police, Ill. State Troopers, Lodge No. 41 v. Commissioner*, 833 F.2d 717, 722 (7th Cir. 1987); *Illinois Ass'n of Prof'l. Ins. Agents v. Commissioner*, 801 F.2d 987, 991 (7th Cir. 1986); *California Farm Bureau Fed'n. v. United States*, 769 F. Supp. 332, 334 (E.D. Cal. 1991).

35 See *National Ass'n of Postal Supervisors*, 944 F.2d at 862; *Fraternal Order of Police, Ill. State Troopers, Lodge No. 41*, 833 F.2d at 722; *Illinois Ass'n of Prof'l. Ins. Agents*, 801 F.2d at 992.

36 See *Fraternal Order of Police, Ill. State Troopers, Lodge No. 41*, 833 F.2d at 722-23;

es are not in conflict. No court has yet created a general exception to the unrelated business income tax based solely on a showing that the tax-exempt organization did not compete, or threaten to compete, unfairly with tax-paying entities.³⁷ The court relied on Treasury regulation section 1.513-1(b), noting a conclusive presumption for unfair competition when an activity "constitutes 'trade or business' within the meaning of section 162" (profit motive test) and "is not substantially related to the performance of exempt functions."³⁸

To be safe, the IRS should address all three components in determining whether an activity constitutes a trade or business: (1) the activity must involve the sale of goods or performance of services, (2) the "profit motive" test, and (3) the "unfair competition" test.

3. IRS Application to Sponsorship Activity

In TAM 91-47-007, the IRS addressed all three factors and concluded that the exempt organization's sponsorship activity³⁹ constituted a trade or business.⁴⁰ The IRS first addressed whether the exempt organization provided a valuable good or service to the corporate sponsor as opposed to mere recognition of a corporate donor. The IRS concentrated on a "quid pro quo" analysis typically used to determine the deductibility of a charitable contribution. "The appropriate way to answer [whether the activity is a trade or business] is to look at all the facts and circumstances to see if the payment was made with an expectation of receiving from the [exempt] Organization a substantial return benefit."⁴¹ Accordingly, the IRS focused much of its attention on the

Illinois Ass'n of Prof'l. Ins. Agents, 801 F.2d at 991 n.4.

37 *Illinois Ass'n of Prof'l. Ins. Agents*, 801 F.2d at 991 n.4.

38 *Id.*; see also *Carolinas Farm & Power Equip. Dealers v. United States*, 699 F.2d 167, 170-71 (4th Cir. 1983).

39 Sponsorship activity is evaluated as an independent activity separate from the exempt event, such as the bowl game. See *infra* note 121 and accompanying text.

40 Tech. Adv. Mem. 91-47-007, at 20 (Aug. 16, 1991). The IRS has deleted all information that would disclose the identity of the parties. Due to the deletions, it is difficult to distinguish exactly what additional services the exempt organization provided to the corporate sponsor. "[David Jones, projects branch chief, IRS' exempt organizations technical division], explained that the 'very truncated form' of the TAM also limited the Service's options for alerting taxpayers as to the nature of its specific problems in the Cotton Bowl case. 'Basically we faced a disclosure problem in advising people what it was that was of concern to us.'" *IRS Official Explains Why IRS Issued Proposed Corporate Sponsorship Guidance*, Daily Tax Rep. (BNA) No. 29, at G-14 (Feb. 12, 1992).

41 Tech. Adv. Mem. 91-47-007, at 13 (Aug. 16, 1991).

sponsor's expectation. "[The IRS view] is that the [sponsorship] agreement clearly shows that the . . . payment is *commensurate in value with the benefits the [corporate sponsor] expects to receive* from the Organization."⁴²

Next, the IRS addressed whether the exempt organization actually provided the corporate sponsor with valuable services. The exempt organization had argued that the minimal effort required to generate any valuable benefit to the corporate sponsor evidences mere recognition of the corporate sponsor. The IRS rejected this argument and stated "that the relative ease, as a practical matter, for the [exempt] Organization . . . does not overcome the fact that providing such a benefit along with all the other benefits provided to [the corporate sponsor] amounts to a very valuable package of benefits."⁴³ The IRS concluded "that what the [exempt] Organization has provided to [the corporate sponsor] amounts to much more than mere recognition of . . . generosity. Indeed, we believe it amounts to a substantial return benefit."⁴⁴

The IRS then addressed the profit motive and unfair competition tests concurrently. "[W]here an organization (1) conducts an activity with a profit motive and (2) the activity is not substantially related to that organization's exempt purpose, then the organization's activity presents a sufficient likelihood of competition to be within the policy of the statute."⁴⁵ The IRS concluded that "[p]rofit is merely the gross proceeds of a transaction less the cost of the transaction. The [exempt] Organization generates more in proceeds from the questioned . . . [sponsorship] Agreement than it expends in providing services to [the corporate sponsor]."⁴⁶

The IRS further rejected the exempt organization's assertion that the IRS must prove a specific finding of unfair competition, and not merely the potential for unfair competition.⁴⁷ The IRS

42 *Id.* at 14 (emphasis added).

43 *Id.*

44 *Id.* at 13.

45 *Id.* at 16 (referencing *Carolinas Farm & Power Equip. Dealers v. United States*, 699 F.2d 167, 170-71 (4th Cir. 1983)).

46 *Id.*

47 *Id.* at 15 ("In the Service's view, there is no necessity to determine that the Organization actually competes with other advertisers."). The IRS argument is consistent with *American Bar Endowment*. See *supra* note 32 and accompanying text.

concluded that "the [exempt] Organization is in competition with other entities."⁴⁸

4. Application to College Football Postseason Bowl Games

Bowl games arguably are not involved in the sale of goods or performance of services when they merely recognize their corporate sponsors. Regardless of any expectations of value, any return benefit the corporate sponsor receives is only incidental to the recognition. However, additional services, beyond mere recognition to the corporate sponsors, would strongly indicate a trade or business. For example, if the bowl game only changed the name of the event to include the corporate sponsor's name, and did not provide any other additional services, arguably the bowl is still not conducting a trade or business.⁴⁹ But, if the bowl game displays the sponsor's name on the playing field, on the player's uniforms and throughout the stadium, the bowl game has actively participated in a trade or business.⁵⁰ The salient issue is to determine the point at which this recognition of the corporate sponsor becomes a trade or business. The IRS has tried to address this issue in its proposed examination guidelines.⁵¹

The IRS analysis of whether sponsorship activity involves the sale of goods or performance of services deviated from the Supreme Court's analysis in *American Bar Endowment*. In *American Bar Endowment* the Court also addressed a situation in which an exempt organization received income bordering on a charitable contribution. The Court did not focus on the donor's expectation of a substantial return benefit, but rather on the activity conducted by ABE. The Court only discussed the donor's expectation of a substantial return benefit when analyzing the deductibility of charitable contributions.⁵² The inference is that the contributor's ex-

48 Tech. Adv. Mem. 91-47-007, at 16 (Aug. 16, 1991)

49 The bowl game might classify these payments as royalty income. See *infra* Part V.

50 See Mulligan, *supra* note 1 (noting some of the services that the bowl games provided to the corporate sponsors). In many instances, the value of these services has surpassed the amount of the sponsorship payments. See, e.g., Michael Hiestand, *Sponsors Cash in on Bowl-Game Bonanza*, USA TODAY, Dec. 31, 1991, at C2 ("[A] single, cleverly placed sign can be rewarding: Among the 29 sponsors [of the Cotton Bowl] getting exposure, Hefty ranked fourth with a single scoreboard sign that had 1 minute, 36 seconds of air time, worth \$288,000.").

51 See *infra* Part IV.

52 The second issue in the *American Bar Endowment* case was whether the members could deduct, as charitable deductions, the dividends that ABE kept. The Court affirmed the principle that "[a] payment of money generally cannot constitute a charitable contri-

pectation is not applicable to the analysis of whether an activity is a trade or business, but only to the deductibility of a charitable contribution. Accordingly, the IRS should focus on the exempt organization, and whether the exempt organization, regardless of the sponsor's expectation, has actually provided the corporate sponsor with any goods or services other than mere recognition.

With respect to the profit motive test, it is difficult to argue that sponsorship activity is not conducted with the dominant hope and intent of realizing a profit. One possible argument is that a bowl game is providing the alleged promotional services without a profit motive but merely as a gratuitous exchange apart from the donation. However, *American Bar Endowment* expressly rejected this argument.⁵³ No legal basis exists for segregating the income from the sponsorship as a separate activity from any promotional services provided to the corporate sponsors. The open issue is whether bowl games can segregate the sponsorship activity into taxable trade or business components and nontaxable components, such as mere recognition of a donor. The IRS did not address this issue in its proposed examination guidelines.⁵⁴

Assuming that the bowl game cannot segregate any of the components of the sponsorship agreement, once the IRS establishes that the exempt organization has provided a "substantial return benefit" to the sponsor, the entire amount received from the sponsor arguably is taxable, regardless of the comparative value of the income received. Based on this "all or nothing" rationale, if the corporate sponsor receives a substantial return benefit, the IRS will impose UBIT on the entire sponsorship amount.⁵⁵ However, if the corporate sponsor receives return benefits that are not substantial, conceivably the entire amount is exempt. As the determination of "substantial" is based on the facts and circumstances, the standard leaves room for inconsistencies and administrative inefficiencies.⁵⁶ However, the IRS has apparently incorporated this "all or nothing" approach in its proposed examination guidelines.⁵⁷

bution if the contributor *expects a substantial benefit in return.*" *American Bar Endowment*, 477 U.S. at 116 (citations omitted) (emphasis added).

53 See *supra* note 33 and accompanying text.

54 See *infra* part IV.A.2.

55 This argument is based on the assumption that the activity has also met the second and third prongs of the UBIT test, regularly carried on and not substantially related.

56 See *infra* part VI.D for a discussion of administrative inefficiencies.

57 See *infra* Part IV.

The IRS "all or nothing" approach appears consistent with *American Bar Endowment*. The Court noted that "[w]ere ABE's insurance markedly more expensive than other insurance products available to its members, . . . we might plausibly conclude that generosity was the reason for the program's success."⁵⁸ Accordingly, the Court left open the possibility that a large disparity between income the exempt organization receives and the return value provided to the corporate sponsor could be considered gratuitous. However, bowl games would have difficulty arguing that a large disparity exists between the amount of the sponsorship and the value the corporate sponsor receives.⁵⁹ Furthermore, the IRS "quid pro quo" analysis indicates that the IRS will not tax any of the sponsorship income if the value of the benefits to the corporate sponsor is not commensurate in value with the sponsorship payment.⁶⁰

With respect to the unfair competition test, the IRS could prove unfair competition at two separate levels. First, the bowl game individually competes with profit-seeking entities—such as the television networks or magazine publications—directly involved with the particular bowl game. For example, the corporate sponsors could purchase air time on the television network during the game or purchase advertisements in the game program.⁶¹ Second, the bowl industry is comprised significantly, if not entirely, of exempt organizations. Accordingly, the bowl industry as a whole is competing directly with other industries—such as television, radio, publications and professional sports. As the competition between the different bowl games intensifies to attract the "best" college football teams, the need for additional income from corporate sponsorships also intensifies.⁶² Because the bowl organizations within the bowl industry enjoy a tax advantage over their non-bowl game competitors, the bowl games can theoretically attract additional sponsorship income.

58 *American Bar Endowment*, 477 U.S. at 112.

59 See, e.g., Zimmerman, *supra* note 2, at 8 ("John Hancock estimated that it received \$5.1 million of advertising services in exchange for its 1990 payment of \$1.6 million to associate its name with the game.") (footnote omitted).

60 See I.R.S. Announcement 92-15, 1992-5 I.R.B. 51, 51; Tech. Adv. Mem. 91-47-007, at 14 (Aug. 16, 1991).

61 See, e.g., John Lippman, *Advertisers Are Being Bowled Over: Corporate Sponsorships Are Hot, But a Tidal Wave of Post-Season Football Games Leaves Commercial Time to Spare and Networks Facing Losses*, L.A. TIMES, Jan. 1, 1991, at D1.

62 *Id.* (noting that bowl payouts increased from \$41.6 million in 1985-86 to \$58.7 in 1989-90).

B. When Is Sponsorship Activity Regularly Carried On?

Treasury regulation section 1.513-1(c) interprets the regularly carried on element.⁶³ This regulation provides three parts that comprise the regularly carried on test. The first part, frequency and continuity, requires the IRS to address three sub-steps.⁶⁴ First, the IRS must determine whether nonexempt commercial organizations normally conduct the income-producing activity on a year-round basis or a seasonal basis. Second, the IRS must determine the actual time span of the exempt organization's activity. Finally, the IRS must compare the actual time span of the activity

63 Treas. Reg. § 1.513-1 (as amended in 1983). Definition of unrelated trade or business:

(c) *Regularly carried on*—(1) *General Principles*. In determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete

(2) *Application of principles in certain cases*—(i) *Normal time span of activities*. Where income producing activities are of a kind normally conducted by non-exempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business

(ii) *Intermittent activities; in general*. In determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the section 512 requirement of regularity.

(iii) *Intermittent activities; special rule in certain cases of infrequent conduct*. Certain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis.

Id.

64 *Id.* § 1.513-1(c)(2)(i).

to the normal time span to determine if the activity is frequent and continuous, and thus regularly carried on. If the IRS proves the activity is frequent and continuous, the IRS has satisfied the regularly carried on prong of the UBIT test.⁶⁵ However, even if the exempt organization proves the activity is intermittent (not frequent or continuous), the exempt organization must still overcome the second and third parts of the regularly carried on test.

The second part, the manner in which the exempt organization conducts the intermittent activity, is comprised of two sub-steps. First, the IRS must compare the manner of the exempt activity with the manner in which nonexempt organizations normally pursue their commercial activities.⁶⁶ The focus is on the competitive and promotional efforts of the exempt organization. However, the second sub-step, a special rule, finds that an intermittent activity is not regularly carried on if the activity occurs infrequently.⁶⁷

The last part of the regularly carried on test addresses the underlying purpose of UBIT: the elimination of unfair competition.⁶⁸ The IRS must analyze the regularly carried on test in light of this underlying purpose.

The Supreme Court has not yet addressed the regularly carried on element, because the parties involved in the UBIT cases before the Supreme Court have conceded the regularly carried on element.⁶⁹ However, the Tenth Circuit recently addressed the regularly carried on element in *NCAA v. Commissioner*.⁷⁰

1. *NCAA v. Commissioner*

In the *NCAA* case, the Tenth Circuit held that income from advertising in a sports program distributed during a three week basketball tournament "was not regularly carried on within the

65 "[A year-round activity conducted] by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business." *Id.* However, "[a seasonal activity conducted] by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business." *Id.*

66 *Id.* § 1.513-1(c)(2)(ii).

67 *Id.* § 1.513-1(c)(2)(iii).

68 *Id.* § 1.513-1(c)(1); see, e.g., *NCAA v. Commissioner*, 914 F.2d 1417, 1424 (10th Cir. 1990).

69 See, e.g., *United States v. American Bar Endowment*, 477 U.S. 105, 110 (1986); *United States v. American College of Physicians*, 475 U.S. 834, 840 (1986).

70 914 F.2d 1417 (10th Cir. 1990), *nonacq.*, 1991-015 (July 15, 1991); see *infra* part III.B.2, for a discussion of the IRS nonacquiescence.

meaning of the Code.”⁷¹ The court first determined that the normal time span of the advertising activity was year-round, as opposed to seasonal.⁷² The court relied on *American College of Physicians*⁷³ to ascertain that advertising is a separate activity apart from the tournament itself, and the normal time span of advertising is year-round and not the seasonal time span of the tournament.⁷⁴ Accordingly, in determining the normal time span of an activity, the IRS must focus on the fragmented trade or business generating the income, not the time span of the exempt organization’s event.

The court next determined that the actual time span of the advertising activity was the period of the tournament itself, because the NCAA distributed the programs mainly to spectators.⁷⁵ The court excluded the time spent soliciting and preparing the advertisements when computing the actual time span.⁷⁶ The court then concluded that the actual time span of a few weeks, compared to the year-round normal time span of advertising activities, was intermittent.⁷⁷

The court then considered whether the intermittent activity was nevertheless regularly carried on due to competitive and promotional efforts typical of commercial endeavors.⁷⁸ However, the court bypassed this step and found that the advertising was an infrequent activity within the special rule exception:

The difficult question of whether the NCAA’s advertising is of the type envisioned as commercial in nature . . . is not one which we must answer now, however. For the final step in the process spelled out by the regulations requires us to consider whether, promotional efforts notwithstanding, an intermittent activity occurs “so infrequently that neither [its] recurrence nor the manner of [its] conduct will cause [it] to be regarded as trade or business regularly carried on.” We conclude that the

71 *NCAA*, 914 F.2d at 1426.

72 *Id.* at 1422.

73 475 U.S. 834 (1986). See *infra* note 121 and accompanying text for a discussion of *American College of Physicians* and the “fragmenting” of advertising activity as a separate trade or business independent of the exempt organization’s event.

74 *NCAA*, 914 F.2d at 1422.

75 *Id.* at 1423. The court recognized in a footnote that some programs were also sold to individuals not attending the tournament. *Id.* at 1423 n.7. The court implicitly indicated that these sales were not material to the holding. *Id.*

76 *Id.* at 1422-23.

77 *Id.* at 1423.

78 *Id.* at 1424; see also Treas. Reg. § 1.513-1(c)(2)(ii) (as amended in 1983).

advertising here is such an infrequent activity.⁷⁹

The NCAA court then discussed the underlying purpose of the UBIT test, "to place exempt organizations doing business on the same tax basis as the comparable nonexempt business endeavors with which they compete."⁸⁰ The court relied on its conclusion that the activity was infrequent, and determined that the NCAA did not enjoy an unfair competitive advantage.⁸¹

Despite the NCAA case, the regularly carried on element remains an area of great confusion.⁸² First, few reported cases have addressed the regularly carried on prong of the UBIT test.⁸³ Second, the IRS expressly disagreed with the NCAA decision and released an action on decision recommending nonacquiescence.⁸⁴

2. IRS Nonacquiescence in *NCAA v. Commissioner*

Subsequent to the NCAA decision, the IRS released an action on decision disagreeing with the Tenth Circuit's holding in three respects.⁸⁵ First, the IRS disagreed with the court's factual characterization of the advertisements as noncommercial: "NCAA's advertising activity is indistinguishable from that of many commercial businesses such as race tracks, professional sports teams and theater groups which similarly publish programs seasonally."⁸⁶ Second, the IRS disagreed that the actual "time span of the adver-

79 NCAA, 914 F.2d at 1424 (citation omitted).

80 *Id.* (citation omitted).

81 *Id.* at 1425 ("Viewed in this context, we conclude that the NCAA program, which is published only once a year, should not be considered an unfair competitor for the publishers of advertising.") (emphasis added).

82 See, e.g., *California Farm Bureau Fed'n v. United States*, 769 F. Supp. 332, 335 (E.D. Cal. 1991) ("The Court concludes that the language in *Veterans of Foreign Wars* and the other cases cited by the United States is not particularly helpful in defining exactly what was intended by the phrase 'regularly carried on.'").

83 See, e.g., *Veterans of Foreign Wars, Dep't. of Mich. v. Commissioner*, 89 T.C. 7, 30 (1987) ("There has been little case law on the 'regularly carried on' provision in the statute, even though the predecessor of the current statutory provision was enacted 37 years ago.") Cases evaluating the "regularly carried on" element since 1986 are as follows: *NCAA v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990), *rev'g*, 92 T.C. 456 (1989); *California Farm Bureau Fed'n. v. United States*, 769 F. Supp. 332 (E.D. Cal. 1991); *Veterans of Foreign Wars, Dep't. of Mich. v. Commissioner*, 89 T.C. 7 (1987).

Furthermore, no courts addressed the regularly carried on test until 1981. *Suffolk County Patrolmen's Benevolent Ass'n v. Commissioner*, 77 T.C. 1314, 1320 (1981) ("[T]here appear to be no decided cases specifically concerning the meaning of 'regularly carried on' in the context of [Code] sections 511 through 513.").

84 I.R.S. Action on Decision, 1991-015 (July 15, 1991) (*nonacq.*).

85 *Id.*

86 *Id.*

tising activity does not include the time soliciting the advertising and preparing the advertising for publication.⁸⁷ The IRS relied on Treasury regulation section 1.513-1(b), "which provides in part that the activities of soliciting, selling and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical."⁸⁸ Finally, the IRS disagreed that the activity occurs so infrequently to fall within the special rule of Treasury regulation section 1.513-1(c)(2)(iii): "The regulation was directed at annual fund-raising events like a charity dance, not an ordinary commercial activity such as the distribution of program guides."⁸⁹

3. IRS Application to Sponsorship Activity

The IRS applied the regularly carried on test in TAM 91-47-007 and concluded that the corporate sponsorship activity was regularly carried on.⁹⁰ The IRS first determined that "[a] fair review of the available information indicates that pursuant to the . . . [sponsorship] Agreement the [exempt] Organization provides services to the [corporate sponsor] over a relatively significant period of time In our view, the income generating activity is not of a short or infrequent duration."⁹¹ The IRS then addressed the second part of the regularly carried on test, which only applies to intermittent activities. The IRS noted that "the [exempt] Organization's services are provided in a manner consistent with competitive and promotional efforts typical of commercial endeavors."⁹² Since the IRS already determined that the sponsorship activity was not intermittent, the IRS was not required to address this step. However, the IRS may anticipate an appeal of its decision and may be laying the foundation for an alternative argument.⁹³

87 *Id.*

88 *Id.*

89 *Id.*

90 Tech. Adv. Mem. 91-47-007, at 17-18 (Aug. 16, 1991). Due to the truncated form of the TAM, it is difficult to distinguish which facts the IRS relied on in its ruling. See *supra* note 40.

91 Tech. Adv. Mem. 91-47-007, at 17 (Aug. 16, 1991).

92 *Id.* at 18.

93 See, e.g., *IRS Says Bowl Sponsors Must Pay Tax*, N.Y. TIMES, Dec. 5, 1991, at B23 ("The Cotton Bowl Committee, once the IRS ruling comes down, must decide whether to appeal in U.S. District Court or U.S. Tax Court, depending on which offers the better opportunity for victory, said Bruce Bernstein, a tax partner at Arthur Andersen & Co., which handles the Cotton Bowl's case.").

The IRS then addressed the *NCAA* case and reemphasized its disagreement with the Tenth Circuit's holding: "In our view the [Tenth Circuit's] factual analysis is faulty and its legal conclusions erroneous. As stated earlier, the Service will not follow this decision."⁹⁴ The IRS also noted that "this case is factually distinguishable from the situation considered in [*NCAA v. Commissioner*]."⁹⁵

4. Application to College Football Postseason Bowl Games

The IRS has treated sponsorship activity as advertising. Fragmenting the advertising activity from the bowl game activities, the normal time span of advertising is year-round.⁹⁶ The first open issue is the actual time span of the bowl game advertising activity. If the actual activity is the time period of the bowl game activities, which is in line with the reasoning in *NCAA*, the activity is intermittent. But, because the IRS disagrees with *NCAA*, the issue remains unclear. The point of disagreement is whether the actual time span should include the solicitation of the sponsorships and the preparation of the advertisements.

In TAM 91-47-007, the IRS argued that it could factually distinguish corporate sponsorships of bowl games from the *NCAA* case.⁹⁷ In *NCAA*, the NCAA did not actually perform any of the solicitation or preparation of advertisements. The NCAA contracted with a third party to print and publish the program, and the NCAA received a percentage of the third party's profits.⁹⁸ On the other hand, the bowl game organizations directly solicit sponsorships and prepare the advertisements. However, in *NCAA*, the Tenth Circuit did not rely on this fact in its analysis of the regularly carried on test,⁹⁹ which leaves the Tenth Circuit and the IRS in dispute.

The IRS argued in its nonacquiescence that the Treasury regulations include soliciting as part of the regularly carried on

94 Tech. Adv. Mem. 91-47-007, at 18 (Aug. 16, 1991).

95 *Id.*

96 Though the IRS argued in *NCAA* that the normal time span should be the event itself, the argument is not reconcilable with *American College of Physicians*. The IRS did not disagree with the Tenth Circuit on this point in its nonacquiescence. Accordingly, the IRS will probably not dispute that the normal time span for advertising and promotional activities is year-round.

97 Due to the truncated form of TAM 91-47-007, it is difficult to determine which facts could be distinguished from the *NCAA* case. See *supra* note 40.

98 *NCAA v. Commissioner*, 914 F.2d 1417, 1419 (10th Cir. 1990).

99 *Id.* at 1423.

activity.¹⁰⁰ However, the IRS relied on the Treasury regulations that interpret “trade or business,” the first prong of the UBIT test. Because the Treasury regulations that interpret “regularly carried on” do not include the solicitation or preparation time of the advertisements, exempt organizations can argue that the Treasury Department intended to exclude the solicitation and preparation time from the determination of regularly carried on. The Treasury regulations support this argument because they specifically state that “the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the regular carrying on of business.”¹⁰¹

Even if the bowl game can demonstrate that the sponsorship activity is intermittent, the bowl game must overcome the second part of the regularly carried on test: the manner of conducting intermittent activities. It is difficult to argue that renaming a football game after the corporate sponsor and displaying the corporate sponsor’s name throughout the stadium is “conducted without the competitive and promotional efforts typical of commercial endeavors.”¹⁰² Furthermore, the effect of this advertising at the event will result in systematic and consistent promotion of the corporate sponsor. The open issue is whether the bowl games conduct the advertising activity so infrequently that they satisfy the special rule exception for infrequent activities.¹⁰³

In its nonacquiescence, the IRS noted that the purpose of the special rule was to except from UBIT only annual fund raising events, such as charity dances, and not ordinary commercial activities.¹⁰⁴ The IRS analysis begs the question of when an activity is a fund raising event as opposed to an ordinary commercial activity. Many exempt organizations conduct fund raising activities with “the competitive and promotional efforts typical of commercial endeavors.” Applying the IRS rationale, these fund raising activities are within the scope of the UBIT provisions.¹⁰⁵

100 See *supra* notes 87-88 and accompanying text.

101 Treas. Reg. § 1.513-1(c)(2)(ii) (as amended in 1983).

102 *Id.*

103 *Id.* § 1.513-1(c)(2)(iii).

104 See *supra* note 89 and accompanying text.

105 However, many fund raising events fall within the volunteer labor exception from UBIT. 26 U.S.C. § 513(a)(1) (1988) (“[UBIT] does not include any trade or business—(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation.”).

The strongest argument college bowl games have against the IRS imposition of UBIT on corporate sponsorships is the language of the special rule exception. First, the Treasury regulations specifically state that "[c]ertain intermittent income producing activities occur so infrequently that neither their recurrence *nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on.*"¹⁰⁶ Accordingly, even if the exempt organization conducts the activity in a commercial manner, the activity could still fall within the special rule for infrequent activities.¹⁰⁷ Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis.¹⁰⁸ Finally, the bowl games can rely on the Tenth Circuit's analysis in *NCAA* and argue that bowl game activities occur at least as infrequently as a three week basketball tournament.

Legislative history and prior IRS treatment further support a finding that annual events are not regularly carried on. The Senate in 1950 noted that "in determining whether the income of an exempt organization from a trade or business is subject to the [UBIT], it is first necessary to determine whether it is income from a trade or business which is regularly carried on, *or is income from a sporadic activity.*"¹⁰⁹ Later, in 1969, the Senate stated that UBIT "does not apply unless the business is 'regularly' carried on and therefore does not apply, for example, in cases where income is derived from an annual athletic exhibition."¹¹⁰ Furthermore, because few reported cases have addressed the regularly carried on test, the IRS has implicitly acknowledged that annual events are not regularly carried on. Past IRS rulings support this contention.¹¹¹

Exempt organizations must still overcome the last obstacle: the regularly carried on test "must be applied in light of the purpose of the unrelated business income tax to place exempt organi-

106 Treas. Reg. § 1.513-1(c)(2)(iii) (as amended in 1983) (emphasis added).

107 See *Suffolk County Patrolmen's Benevolent Ass'n v. Commissioner*, 77 T.C. 1314, 1322-23 (1981) ("Assuming that the [activity] constituted a trade or business, they are commercial in nature, but that does not mean they were regularly carried on. Such infrequent, intermittent activity is not regularly carried on regardless of the manner in which it is conducted.") (citations omitted).

108 Treas. Reg. § 1.513-1(c)(2)(iii) (as amended in 1983).

109 S. REP. NO. 2375, 81st Cong., 2d Sess. 106 (1950) (emphasis added).

110 S. REP. NO. 552, 91st Cong., 1st Sess. 68 (1969).

111 See, e.g., Priv. Ltr. Rul. 9145-001, at 15 (Mar. 14, 1991) ("Furthermore, income from the sponsorship of the annual golf tournament is excluded from unrelated trade or business taxation because it is an activity conducted on an intermittent basis.").

zation business activities upon the same tax basis as the nonexempt business endeavors with which they compete."¹¹² The Tenth Circuit in *NCAA* found that an infrequently conducted activity will not place the exempt organization in an unfair competitive advantage sufficient to render it a regularly carried on activity.¹¹³ However, the court's interpretation of the UBIT's underlying purpose of eliminating unfair competition differs from the Treasury regulation. As discussed above, bowl games compete significantly with nonexempt businesses.¹¹⁴ Accordingly, based on the Treasury regulations, the IRS should impose UBIT on the bowl game corporate sponsorships to place the bowl games "upon the same tax basis as the nonexempt business endeavors with which they compete."¹¹⁵

*C. When Is Sponsorship Activity
Substantially Related to the
Organization's Tax-Exempt Purposes?*

Treasury regulation section 1.513-1(d) interprets the substantially related element—whether an activity is substantially related to its exempt purpose.¹¹⁶ The IRS must first determine which activi-

¹¹² Treas. Reg. § 1.513-1(c)(1) (as amended in 1983).

¹¹³ *NCAA*, 914 F.2d at 1425 ("While the operation of a parking lot on a weekly basis occurs sufficiently frequently [sic] to threaten rival parking lot owners, the hospital auxiliary's annual sandwich stand is too infrequent a business to constitute a threat to sandwich shop owners."); see also *supra* note 81 and accompanying text. The Tenth Circuit's argument that the IRS should not consider exempt organizations that conduct infrequent activities as unfair competitors raises an important policy consideration for statutorily excluding from UBIT all corporate sponsorships. See *infra* part VI.B.

¹¹⁴ See *supra* notes 61-62 and accompanying text.

¹¹⁵ Treas. Reg. § 1.513-1(c)(1) (as amended in 1983); see also *Veterans of Foreign Wars, Dep't. of Mich. v. Commissioner*, 89 T.C. 7, 36-37 (1987).

The legislative history includes the following comment as to the purpose of [the regularly carried on] requirement:

In order to eliminate the cases in which the unrelated business income is incidental, both the House bill and your committee's bill include a specific exemption of \$1,000. This, in addition to the requirement that such businesses must be carried on 'regularly' to be taxable, will dispose of most of the nuisance cases. Moreover, imposition of the tax in cases where the income is below \$1,000 would involve excessive costs of collection and payment.

The program's consistency, size, purposefulness, and impact on competition lead us to conclude that this is not one of the 'nuisance cases' that the Congress sought to eliminate from the unrelated business income tax.

(quoting S. REP. NO. 2375, 81st Cong., 2d Sess. 30 (1959)).

¹¹⁶ Treas. Reg. § 1.513-1 (as amended in 1983). Definition of unrelated trade or

ty to evaluate: the activity generating the income or the charity event that is being funded. Second, the IRS must determine whether the activity, based upon the facts and circumstances involved, contributes importantly to the exempt organization's exempt purpose. The Supreme Court addressed both of these considerations in *United States v. American College of Physicians*¹¹⁷

1. *United States v. American College of Physicians*

The American College of Physicians (the College), an exempt organization, published a monthly medical journal that contained scholarly articles as well as paid advertisements.¹¹⁸ The College only accepted advertisements that contained information about the use of medical products.¹¹⁹ The Court concluded that the advertising activity was not substantially related to the College's exempt purpose.¹²⁰

The Court first found that the advertising was a separate activity, independent from the journal. Relying on Treasury regulation section 1.513-1(b), the Court stated that this "regulation segregated the 'trade or business' of selling advertising space from the 'trade or business' of publishing a journal, an approach commonly

business:

(d) *Substantially Related*—(1) *In general*. Gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question—the activities, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.

(2) *Type of relationship required*. Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, . . . the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Id.

117 475 U.S. 834. (1986).

118 *Id.* at 836.

119 *Id.*

120 *Id.* at 849-50.

referred to as 'fragmenting' the enterprise of publishing into its components parts."¹²¹ Accordingly, the Court fragmented the advertising activity from the journal and then addressed whether the fragmented advertising activity contributed importantly to the organization's exempt purposes.

The Court found "that the Claims Court was correct to concentrate its scrutiny upon the conduct of the College rather than upon the educational quality of the advertisements."¹²² The Court relied on the Claims Court's findings and held that the advertisements did "not contribute importantly to the journal's educational purposes."¹²³

2. Application to Sponsorship Activity

In TAM 91-47-007 the IRS fragmented the sponsorship activity from the exempt event and ruled that "the Organization's activities are not substantially related to its exempt function."¹²⁴ As the principal purpose of corporate sponsorships is to fund the exempt organization, based on *American College of Physicians* and Code section 513(c), corporate sponsorships are not substantially related to an organization's exempt purposes. Accordingly, the IRS can easily demonstrate that corporate sponsorships are not substantially related to the exempt purposes of a bowl game, which satisfies without dispute the third prong of the UBIT test.

121 *Id.* at 839. The Court emphasized that this Treasury regulation had been codified in Code § 513(c): "Advertising, etc., activities . . . an activity does not lose identity as a trade or business merely because it is carried on . . . within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization." *Id.* at 840 (citing 26 U.S.C. § 513(c) (1988)).

122 *Id.* at 848.

123 *Id.* at 849. The Claims Court had "concluded that any correlation between the advertisements and respondent's educational purpose was incidental because 'the comprehensiveness and content of the advertising package is entirely dependent on each manufacturer's willingness to pay for space and the imagination of its advertising agency.'" *Id.* at 837 (citation omitted).

124 Tech. Adv. Mem. 91-47-007, at 16 (Aug. 16, 1991).

IV. IRS PROPOSED EXAMINATION GUIDELINES¹²⁵

On January 17, 1992, the IRS issued proposed examination guidelines (guidelines) to set a "framework for an analysis of the payments received by exempt organizations from corporate sponsorship arrangements and set forth specific indicators to be considered in making a determination as to whether an organization is engaged in an unrelated trade or business activity."¹²⁶ As proposed guidelines, the IRS is asking for public comments before issuing final guidelines.¹²⁷

The IRS guidelines first attempt to distinguish the point where mere recognition of a corporate sponsor rises to the level of taxable income from unrelated trade or business:

Payments an exempt organization receives from donors are nontaxable contributions where there is *no expectation* that the organization will provide a *substantial return benefit*. Mere recognition of a corporate contributor as a benefactor normally is incidental to the contribution and not of sufficient value to the contributor to constitute unrelated trade or business.¹²⁸

The guidelines did not state any per se situations where the activity is unrelated business taxable income, but rather, "all the facts and circumstances of the relationship between the sponsor and exempt organization must be considered."¹²⁹ The guidelines then listed four factors to consider when evaluating "substantial return benefit."

A determination of whether a substantial return benefit is present should include an analysis of: [1] the value of the service provided in exchange for the payment; [2] the terms under which payments and services are rendered; [3] the amount of control that the sponsor exercises over the event; and [4]

125 I.R.S. Announcement 92-15, 1992-5 I.R.B. 51 (Exempt Organization Donor Recognition is not Advertising). "[Marcus Owens, Director of the Internal Revenue Service's Exempt Organization Technical Division] said this is the first time the IRS 'has ever . . . published proposed audit guidelines for public comment.'" *IRS Said Weighing Proposed Exam Guidelines As Guidance Vehicle in Other 'Thorny' Areas*, Daily Tax Rep. (BNA) No. 30, at G-6 (Feb. 13, 1992). The proposed guidelines allow the IRS to quickly inform the public and obtain immediate feedback.

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

127 *Id.* at 53 ("Because this matter raises important and sensitive issues under present law with respect to section 501(c) organizations, the Service is soliciting public comment on the proposed examination guidelines.").

128 *Id.* at 52 (emphasis added).

129 *Id.*

whether the extent of the organization's exposure of the donor's name constitutes significant promotion.¹³⁰

The guidelines next addressed the scope of the UBIT application to sponsorship income. "As a matter of audit tolerance, the Service will not apply these guidelines to organizations that are of a purely local nature, that receive relatively insignificant gross revenue from corporate sponsors *and* generally operate with significant amounts of volunteer labor."¹³¹ Though the IRS has limited its scope, the potential number of exempt organizations that remain within the guidelines is still great. Because the guidelines use "and" instead of "or," the exempt organization arguably must meet all three criteria to fall outside the scope of the guidelines. The remaining organizations that fall within the guidelines must still address the UBIT analysis, which could result in substantial administrative costs, regardless of whether UBIT actually applies.¹³²

A. Ambiguities in the Proposed Examination Guidelines

The IRS guidelines incorporated much of the IRS analysis from TAM 91-47-007. Though the guidelines addressed some of the uncertainties, the guidelines remain ambiguous as to the following: (1) Whether the IRS will focus its attention on the exempt organization or the corporate sponsor in determining "substantial return benefit"; and (2) whether the exempt organization can segregate nontaxable components of the sponsorship arrangement from taxable components or whether the "all or nothing" approach applies.

1. IRS Focus: Exempt Organization or Corporate Sponsor

As in TAM 91-47-007, the IRS guidelines focused on the donor's expectations and not solely on the services provided.¹³³ As discussed previously, the Supreme Court in *American Bar Endowment* concentrated solely on the exempt organization in determining whether an activity is a trade or business subject to UBIT.¹³⁴

130 *Id.*

131 *Id.* (emphasis added).

132 See *infra* part VI.D for a discussion of administrative inefficiencies.

133 *Id.* ("Payments an exempt organization receives from donors are nontaxable contributions where there is *no expectation* that the organization will provide a substantial return benefit.") (emphasis added).

134 See *supra* note 52 and accompanying text.

Whether a sponsor expects a substantial return benefit should not affect the IRS determination.

An example best demonstrates this point. Suppose that a corporation pays an exempt organization one million dollars to sponsor an event. In return, the only service the exempt organization provides is to change the name of the event to include the corporate sponsor's name.¹³⁵ Even though the exempt organization does not advertise or promote the corporate sponsor, the corporate sponsor may still expect to receive a significant benefit through third parties. For example, third party vendors may sell shirts with the corporation's name associated with the event, and the media will refer to the corporate sponsor every time the event is mentioned. Because third parties provide the advertising services and the benefits are only incidental to the exempt organization's services, the IRS should not impose UBIT on the corporate sponsorship payment. However, the guidelines disagree.

The IRS guidelines state that "[m]ere recognition of a corporate contributor as a benefactor *normally* is incidental to the contribution and not of sufficient value to the contributor to constitute unrelated trade or business."¹³⁶ The word "normally" indicates that in the abnormal situations in which mere recognition is of sufficient value, the IRS will impose UBIT on the payments from the corporate sponsor. The guidelines further state that "[a]ssociating the name of the sponsor with the name of the exempt organization's event will not, in itself, trigger UBIT. Rather, all the facts and circumstances of the relationship between the sponsor and exempt organization must be considered."¹³⁷ Because the factors do not focus entirely on the exempt organization, the incidental benefits to the corporate sponsors will probably affect the IRS decision whether to impose UBIT on the corporate sponsorship income.

The IRS should revise the substantial return benefit factors to concentrate solely on the exempt organization and the actual services the exempt organization provided to the corporate sponsor. The IRS should include only the first and fourth factors in the final guidelines: "the value of the service provided [by the exempt organization] in exchange for the payment" and "whether

135 A payment received in exchange for associating the name or logo of the sponsor with the event is arguably a royalty and excluded from UBIT under Code § 512(b)(2). See *infra* Part V.

136 I.R.S. Announcement 92-15, 1992-5 I.R.B. 51, 52 (emphasis added).

137 *Id.*

the extent of the [exempt] organization's exposure of the donor's name constitutes significant promotion."¹³⁸ When evaluating these factors, the IRS should concentrate only on the services the exempt organization provided.

The IRS should exclude from the final guidelines the second and third factors, which focus on contractual obligations. Otherwise, the IRS is encouraging exempt organizations to enter into loose agreements with their corporate sponsors.¹³⁹ The exempt organization could then argue that no contractual obligation would indicate no substantial return benefit even though the exempt organization performed the exact same services. Accordingly, the existence of a contract, whether for mere recognition of the sponsor or for other services, should not affect the IRS determination, except for evidentiary purposes.

2. Segregating Taxable and Nontaxable Components

The IRS guidelines did not specifically address whether exempt organizations can segregate income received from corporate sponsors into taxable and nontaxable components. According to the guidelines, "[a]ssociating the name of the sponsor with the name of the exempt organization's event will not, in itself, trigger UBIT. Rather, all the facts and circumstances of the relationship between the sponsor and exempt organization must be considered."¹⁴⁰ The guidelines indicate that the IRS will apply an "all or nothing" approach. If the IRS determines that a substantial return benefit is present, the entire sponsorship income is subject to UBIT. If no substantial return benefit is present, none of the sponsorship income is taxable. The guidelines appear to be in line with the Supreme Court's opinion in *American Bar Endowment*.¹⁴¹

However, the IRS should allow exempt organizations to segregate nontaxable components from the taxable components. Specifically, the IRS should segregate sponsorship payments received in exchange for associating the corporate sponsor's name and logo

138 See *supra* note 130 and accompanying text.

139 See, e.g., Paul Streckfus, *News Analysis: Unmasking Corporate Sponsorship*, 53 TAX NOTES 1346, 1346 (1991) ("The [IRS] has indicated informally that contracts are a red flag, and well they should be. A donor doesn't usually enter into a contract to make a gift [A]n interesting point . . . [is] what should happen if a charity merely accepts a gift with no contractual obligations but the corporate donor then trumpets the fact of its sponsorship through conventional advertising media?").

140 I.R.S. Announcement 92-15, 1992-5 I.R.B. 51, 52.

141 See *supra* note 33 and accompanying text.

with the event from the other services of advertising and promoting of the sponsor, such as displaying the corporate sponsor's name throughout the stadium. Because the portion of the sponsorship agreement attributed to changing the name of the event is arguably not a trade or business,¹⁴² or excluded as a royalty,¹⁴³ that portion would not be taxable as unrelated business income.

If the IRS segregates the taxable components of the sponsorship agreement, the IRS could then impose UBIT on the taxable portions even if the exempt organization provides services that are not commensurate in value with the sponsorship payments received. For example, if the exempt organization receives two hundred thousand dollars from its corporate sponsor and only provides fifty thousand dollars of advertising services in return, under the current IRS guidelines, the entire two hundred thousand dollars is exempt from UBIT. If the IRS segregates the fifty thousand dollars in services from the sponsorship agreement, the IRS could tax this portion as unrelated business income. The above rationale is consistent with the dual character approach applied to charitable deductions¹⁴⁴ and the fragmenting of activities recognized in *United States v. American College of Physicians*.¹⁴⁵ The IRS has also segregated similar activities in past rulings.¹⁴⁶

142 See *supra* part III.A.3.

143 See *infra* Part V.

144 In *United States v. American Bar Endowment*, 477 U.S. 105 (1986), the Court noted that "[w]here the size of the payment is clearly out of proportion to the benefit received, it would not serve the purposes of § 170 to deny a deduction altogether. A taxpayer may therefore claim a deduction for the difference between a payment to a charitable organization and the market value of the benefit received in return, on the theory that the payment has the 'dual character' of a purchase and a contribution." *Id.* at 117.

145 475 U.S. 834 (1986). See *supra* note 121 and accompanying text for a discussion of fragmenting activities.

146 See, e.g., Rev. Rul. 81-178, 1981-2 C.B. 135, 136-37

[In situation 1], since the payments are for the use of the organization's trademarks, trade names, service marks, copyrights, and its members' names, photographs, likenesses, and facsimile signatures such payments are royalties within the meaning of section 512(b)(2) However, since the agreements in Situation 2 require the personal services of the organization's members in connection with the endorsed products and services, the payments received by the organization are compensation for personal services and therefore are not royalties within the meaning of section 512(b)(2). Accordingly, the receipts derived from, and the expenses incurred in, the endorsement activity in Situation 2 must be taken into account in computing the organization's unrelated business taxable income.

B. Issues Not Addressed by the Proposed Examination Guidelines

Though the IRS attempted to address the most pressing concerns—the scope of the TAM and the line between mere recognition and advertising—the IRS has not yet addressed other significant issues pertinent to whether income from corporate sponsorships is subject to UBIT. First, the IRS did not address the regularly carried on test.¹⁴⁷ Second, the IRS did not address whether to exclude certain sponsorship arrangements from UBIT as royalties.¹⁴⁸ Third, the IRS did not address which expenses the exempt organizations can deduct from the sponsorship income when calculating the UBIT.¹⁴⁹ As the IRS guidelines are princi-

¹⁴⁷ For a discussion of the related issues, see *supra* part III.B.

¹⁴⁸ For a discussion of the related issues, see *infra* Part V.

¹⁴⁹ Under Code § 512(a)(1), exempt organizations can deduct expenses from unrelated business income as long as the expenses are otherwise deductible by nonexempt organizations and also “are directly connected with the carrying on of such [unrelated] trade or business.” 26 U.S.C. § 512(a)(1) (1988). Treasury regulation § 1.512(a)-1(a) further states that “[e]xcept as provided in paragraph (d)(2) of this section, to be ‘directly connected with’ the conduct of unrelated business for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business.” Treas. Reg. § 1.512(a)-1(a) (as amended in 1984). The Treasury regulations further restrict deductions for unrelated activities, such as sponsorships, that exploit the exempt purposes of the exempt organization.

Treasury regulation § 512(a)-1(d), *exploitation of exempt activities*, states:

[i]n certain cases, gross income is derived from an unrelated trade or business activity which exploits an exempt activity . . . [I]n such cases, expenses, depreciation and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income. Since such items are incident to an activity which is carried on in furtherance of the exempt purpose of the organization, they do not possess the necessary proximate and primary relationship to the unrelated trade or business activity and are therefore not directly connected with that business activity.

Treas. Reg. § 1.512(a)-1(d)(1) (as amended in 1984). Because corporate sponsorship activity is incidental to the exempt purposes of a bowl game, the expenses incurred operating the bowl game, such as stadium expenses, are generally not deductible. However, Treasury regulation § 1.512(a)-(1)(d)(2) allows a deduction for the bowl game expenses to the extent that: “(i) The aggregate of such items exceeds the income (if any) derived from or attributable to the exempt activity; and (ii) The allocation of such excess to the unrelated trade or business activity does not result in a loss from such unrelated trade or business activity.” Treas. Reg. § 1.512(a)-1(d)(2) (as amended in 1984).

The IRS is considering proposed guidelines to address the deductibility of sponsorship expenses. See, e.g., *IRS Official Explains Why IRS Issued Proposed Corporate Sponsorship Guidance*, Daily Tax Rep. (BNA) No. 29, at G-15 (Feb. 12, 1992) (“[David Jones, projects branch chief, IRS’ exempt organizations technical division, stated that we] really are not certain whether we will incorporate instructions on the [issue of what deductions are appropriate] in this particular set of guidelines, or whether we issue a second set of

pally directed to the IRS agents, the guidelines may not be the appropriate place to address all of these issues. However, the IRS should discuss these concerns in other releases to the public.

V. ROYALTY INCOME

When Congress enacted the UBIT provisions, Congress included modification provisions that excluded payments received from passive activities, such as dividends, interest, and royalties.¹⁵⁰ The legislative history behind the modification provisions indicates that Congress intended to exclude from UBIT all payments received from any passive activities.¹⁵¹ "Whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case."¹⁵²

The IRS has already recognized that exempt organizations can license the use of their logo by corporate sponsors, and the exempt organization can exclude this income from UBIT as royalties.¹⁵³ For example, a corporate sponsor can purchase the right to advertise that they are the proud sponsor of the U.S. Olympics, or their product is the official widget of the U.S. Olympics, and the Olympic Committee can exclude this income from UBIT as royalties.¹⁵⁴

guidelines.").

150 26 U.S.C. § 512(b) (1988). Code § 512(b)(2) specifically excludes royalties from UBIT. "There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income." 26 U.S.C § 512(b)(2) (1988).

151 See, e.g., BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 784 (5th ed. 1987) (quoting S. REP. NO. 2375, 81st Cong., 2d Sess. 27 (1950) ("Dividends, interest, royalties, most rents, capital gains and losses and *similar items* are excluded from the base of the tax on unrelated income because your committee believes that they are 'passive' in character and are not likely to result in serious competition for taxable businesses having similar income."). "Nonetheless, the strict definitional classifications of the types of passive income are not dispositive of the question as to their treatment in relation to these rules." *Id.* Professor Hopkins concluded that "it seems unmistakable that passive income, regardless of type, is properly includible within the exclusion." *Id.*

152 Treas. Reg. § 1.512(b)-1 (as amended in 1981).

153 See, e.g., Rev. Rul. 81-178, 1981-2 C.B. 135, 136 ("However, since the payments are for the use of the organization's trademarks, trade names, service marks, copyrights, and its members' names, photographs, likenesses, and facsimile signatures such payments are royalties within the meaning of section 512(b)(2)."); Gen. Couns. Mem. 38,997 (June 10, 1983) ("Therefore, we conclude that the revenue from . . . unrelated trade or business of licensing its logo should be considered income from royalties and excluded from the computation of unrelated taxable income under section 512(b)(2)."); see also HOPKINS, *supra* note 151, § 38.1.

154 See, e.g., Zimmerman, *supra* note 2, at 12.

A. *IRS Application to Sponsorship Income*

In TAM 91-47-007, the bowl games argued that the corporate sponsorship income constituted royalties and should be excluded from the UBIT analysis. The IRS rejected the bowl games' royalty argument and concluded that "the payments are not royalties that are excluded from the computation of unrelated business taxable income under section 512(b)(2)."¹⁵⁵ The IRS first defined a royalty as "a payment for the use of a valuable right."¹⁵⁶ The IRS then found that "[the corporate sponsor] is not paying for the use of [a] valuable right; it is the [exempt] Organization that is required to [provide various services]."¹⁵⁷

B. *Application to College Football Postseason Bowl Games*

The IRS apparently did not distinguish between changing the name of the bowl game and other services, such as displaying the logo on the uniform and throughout the stadium.¹⁵⁸ Because the renaming of a bowl game is arguably a passive activity, the income seems excludable from UBIT.¹⁵⁹ However, the additional services of displaying the corporate sponsor's name on the field, on the player's uniforms, and throughout the stadium, constitute active involvement. Even if the IRS would recognize that renaming the bowl game is a royalty, the IRS has not indicated whether the exempt organization can segregate this nontaxable activity from taxable advertising activities.¹⁶⁰

VI. POLICY CONSIDERATIONS

In *United States v. American College of Physicians*,¹⁶¹ the Supreme Court summarized the policy behind the UBIT Code provisions:

155 Tech. Adv. Mem. 91-47-007, at 20 (Aug. 16, 1991).

156 *Id.* at 18 (emphasis added).

157 *Id.* at 19.

158 Due to the confidentiality of the parties, the IRS could not disclose the pertinent facts which concerned the IRS in their analysis. See *supra* note 40. But see, e.g., Mulligan, *supra* note 1 (noting that the Cotton Bowl displayed sponsors' logos on the field and throughout the stadium).

159 See *supra* text accompanying note 135.

160 See *supra* part IV.A.2.

161 475 U.S. 834 (1986).

The statute was enacted in response to perceived abuses of the tax laws by tax-exempt organizations that engaged in profit-making activities. Prior law had required only that the profits garnered by exempt organizations be used in furtherance of tax-exempt purposes, without regard to the source of those profits. As a result, tax-exempt organizations were able to carry on full-fledged commercial enterprises in competition with corporations whose profits were fully taxable. Congress perceived a need to restrain the unfair competition fostered by the tax laws.

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. 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.¹⁶²

However, the Supreme Court only addressed one of the two purposes underlying the UBIT Code provisions: the elimination of unfair competition. While eliminating unfair competition was the major underlying purpose,¹⁶³ Congress also enacted the UBIT provisions to generate tax revenues.¹⁶⁴ Though raising tax revenues was arguably not the primary purpose behind the UBIT provisions, tax revenues play a significant role in deciding whether to impose UBIT on corporate sponsorships.

On February 11, 1992, the Library of Congress released a Congressional Service Report (CSR)¹⁶⁵ that attempted to balance the pros and cons of imposing UBIT on corporate sponsorships.

162 *Id.* at 837-38 (citations omitted) (emphasis added); see H.R. REP. NO. 2319, 81st Cong., 2d Sess. 36-37 (1950); S. REP. NO. 2375, 81st Cong., 2d Sess. 28-29 (1950).

163 See Treas. Reg. § 1.513-1(b) (as amended in 1983) ("The *primary objective* of adoption of the unrelated business income tax was to *eliminate a source of unfair competition* by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.") (emphasis added); see also Haley, *supra* note 8, at 62.

164 See Kaplan, *supra* note 8, at 1433 (quoting *Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means*, 81st Cong., 2d Sess. 580 (1950) ("[E]ventually all the noodles produced in this country will be produced by corporations held or created by universities . . . and there will be no revenue to the Federal Treasury from this industry. That is our concern."); see also *NCAA v. Commissioner*, 914 F.2d 1417, 1425 n.9 (10th Cir. 1990); Haley, *supra* note 8, at 64.

165 Zimmerman, *supra* note 2.

Policymakers face a tradeoff when contemplating the imposition of UBIT on corporate sponsorship of amateur sports events. They must compare the detrimental effects of arguably unfair competition (subsidized advertising rates for sponsoring corporations) and the sacrifice of Federal revenue against the potential loss of social benefits.¹⁶⁶

A. *Forgone Federal Revenue*

The CSR noted three factors that affect the magnitude of lost tax revenue: "[T]he cost to the nonprofit of providing the advertising services; how broadly the IRS ruling is applied across all nonprofits; and whether the ruling is eventually applied to royalty income as well as title sponsorships."¹⁶⁷ Based on 1991 estimated corporate sponsorships of exempt events, the government would annually lose only five million dollars from title sponsorships of bowl games as compared to \$281 million for all corporate sponsorships of all nonprofit organizations.¹⁶⁸ The CSR then concluded that "the amount of money at stake here is not trivial if applied to nonprofit sponsorship payments in general."¹⁶⁹

The CSR failed to address several important points. First, the CSR ignored the legal significance between taxable and nontaxable sponsorships. The issue in TAM 91-47-007 was whether the IRS would impose UBIT on only the title sponsorship income.¹⁷⁰

166 *Id.* at 8.

167 *Id.* at 3.

168 *Id.* at 3

Assume corporate sponsorships would remain the same even if subjected to UBIT (the aftertax price to the corporation does not change). The college bowl organization contracts call for them to pay the colleges 75 percent of the sponsorship payments; therefore assume advertising expenses consume 25 percent of the payments. If the UBIT were applied only to college football bowl games, taxable net title sponsorship income would be \$14.7 million (75 percent of \$19.6 million), and tax revenue would be \$5 million (34 percent of \$14.7 million). If UBIT were applied to all nonprofits and included all sponsorship income, taxable net sponsorship income would be \$825 million (75 percent of \$1.1 billion), and tax revenue would be \$281 million (34 percent of \$825 million).

169 *Id.* at 3.

170 Assuming that the IRS will impose UBIT on only title sponsorships, the lost tax revenues are not that significant. "Jim Andrews, editorial director of Special Events Reports, a publication that follows sponsorships, estimated that corporations pay about \$110 million to tax-exempt organizations for title sponsorship of a variety of events." Richard Sandomir, *Tax Ruling Worries Officials of Bowls*, N.Y. TIMES, Dec. 6, 1991, at B9. After applying the thirty-four percent corporation tax rate, lost tax revenues would be only

The IRS proposed examination guidelines acknowledged that not all corporate sponsorships are subject to UBIT.¹⁷¹ Furthermore, several other legal obstacles, such as the regularly carried on test¹⁷² and the royalty income exclusion,¹⁷³ may inhibit the IRS from imposing UBIT on any corporate sponsorships. Finally, the CSR overlooked the additional costs involved in collecting the UBIT, such as legal costs defending against refund actions in the courts and administrative costs determining which corporate sponsorships constitute unrelated business taxable income.¹⁷⁴

B. *Unfair Competition*

Two components of unfair competition are significant in balancing the policies underlying UBIT. The CSR addressed only the first component, "Does the Potential for Unfair Competition Exist?"¹⁷⁵ The CSR concluded that the potential for unfair competition exists. Based on the value of the advertising services that the corporate sponsor receives, the potential for unfair competition is obvious.¹⁷⁶ However, the CSR did not discuss whether imposing UBIT would effectively eliminate unfair competition, the second component of unfair competition.¹⁷⁷

Professor Henry B. Hansmann evaluated unrelated trade or business activities "in terms of economic efficiency."¹⁷⁸ Professor Hansmann segregated activities "that exhibit economies of scope when undertaken jointly with the nonprofit's exempt function and those activities that exhibit no such economies of scope."¹⁷⁹ Bowl games arguably enjoy economies of scope when conducting corporate sponsorship activities.

\$37.4 million.

171 See *supra* part IV.A.2.

172 See *supra* part III.B.

173 See *supra* Part V.

174 See *infra* part VI.D.

175 Zimmerman, *supra* note 2, at 7.

176 See *supra* notes 61-62 and accompanying text.

177 In *NCAA v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990), the court addressed this distinction. See *supra* note 113.

178 Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 607 (1989).

179 *Id.* at 608. "Economies of scope are present if the activity is less costly when undertaken in combination with the nonprofit's exempt functions than when undertaken separately." *Id.* at 608-09. "[A] nonprofit can achieve economies of scope by engaging in a business activity that, while not in itself an exempt function, . . . can be undertaken at lower cost because it exhibits cost complementarities with the non-profit's exempt functions." *Id.* at 626-27.

Professor Hansmann noted some arguments for imposing UBIT on activities that exhibit economies of scope. First, "application of the tax will not discourage nonprofits from undertaking them; they will still provide a higher rate of return to the nonprofits than that provided by other unrelated business activities."¹⁸⁰ However, Professor Hansmann also raised this argument against imposing UBIT on these activities. Second, "application of the tax will have the desirable effect of discouraging excessive investment in such activities."¹⁸¹

Reasons for not imposing UBIT on activities that exhibit economies of scope are as follows:

Application of the tax in these cases is awkward and administratively costly for both the government and the nonprofit because it is difficult to allocate costs in any objective fashion between related and unrelated portions of the activities involved. Further, there is the possibility that, because the boundary between related and unrelated activities is vague, the tax will end up being applied also to some related activities. Finally, we can turn around the argument that *nonprofits will engage in these activities even if taxed*, and note that it follows that the *tax will therefore be unnecessary and ineffective at discouraging investment in such activities*.¹⁸²

Because bowl games incur relatively insignificant variable costs compared to the value of the corporate sponsorship payments, little doubt remains that the bowl games and other exempt organizations will continue seeking corporate sponsors.

On the other hand, because some bowl games could not survive if the IRS imposed UBIT on their corporate sponsorships, UBIT would eliminate some competition. However, the elimination of unfair competition is not synonymous with the elimination of exempt entities. Furthermore, bowl games provide the community additional economic benefits, such as tourist revenues. Whether bowl games should not receive exempt status is beyond the scope of the UBIT Code provisions.¹⁸³

180 *Id.* at 627.

181 *Id.*

182 *Id.* at 627-28 (emphasis added).

183 Professor Hansmann concluded that "[t]he truly difficult and important issue involving the tax treatment of nonprofits concerns not the UBIT but rather the scope of the basic exemption that underlies it, and that is where future debate should focus." *Id.* at 635.

C. *Social and Economic Benefits*

The CSR "does not attempt to determine whether college football bowl games do or do not provide adequate social benefits, for by their very nature social benefits cannot be measured with any numerical precision."¹⁸⁴ The CSR focused its analysis on the economic rationales for having exempt organizations and then applied this analysis to amateur athletics. The economic rationale applicable to bowl games "hinges on the usual public goods argument that justifies public provision of collectively consumed goods. Coalitions of minority voters, desirous of a higher level of collective consumption than provided by the majority, may fulfill these desires through preferentially taxed nonprofit organizations."¹⁸⁵

The CSR then shifted its focus to the activities and groups of people that the UBIT would affect.¹⁸⁶ The CSR listed three activities and groups that likely benefit from the subsidy:

[1] lower ticket prices and/or an increased quantity of college football bowl games (which would benefit primarily consumers of college football bowl games); [2] lower advertising rates or, phrased differently, smaller sponsorship payments (which would benefit primarily corporate sponsors); or [3] increased funding for universities (whose primary beneficiaries might include several different activities and groups).¹⁸⁷

The CSR did not estimate which activity or group would suffer the greatest impact. Because supply and demand theoretically determine the price of sponsorships, any tax will result in additional costs to the sponsorship recipients. Because bowl contracts require the bowl games to distribute a minimum of seventy-five percent of the corporate sponsorships to the participating universities, the university funding arguably suffers the greatest loss from the UBIT.¹⁸⁸

The CSR then speculated about which university activities receive the bulk of the bowl funding.¹⁸⁹ Though the CSR made an

184 Zimmerman, *supra* note 2, at 8.

185 *Id.* at 8-9.

186 *Id.* at 9 ("[I]t is possible to identify the subsidized activities and groups of people which constitute the social goods. It is these activities and groups that would experience cutbacks if the \$5 million subsidy is eliminated.").

187 *Id.* at 10 (footnote omitted).

188 See, e.g., Rosenthal & Crow, *supra* note 3, § 8, at 11.

189 These possible activities include nonsports activities (libraries and academic scholarships), sports that are not self supporting (e.g., rowing or golf), or the football depart-

excellent analysis of the alternative activities, the analysis should not apply to the question of whether to impose UBIT on corporate sponsorships. Because neither the IRS nor the bowl games currently impose restrictions on the use of the bowl proceeds, each university can use the funds as the university sees fit.¹⁹⁰ Moreover, how a university uses the funds from bowl game payouts may change significantly in the future, depending on each university's needs. Accordingly, the policy issue is whether Congress should endorse additional funding for universities in general.

The CSR then noted that college bowl games generate additional benefits to the universities other than bowl funding by increasing the visibility of college sports programs:

Many college administrators maintain that high visibility sports programs help sustain a large pool of student applicants and high levels of financial contributions. A large pool of applicants is an undeniable asset to any college or university, and a subset of students is probably going to be attracted to schools with successful athletic teams.¹⁹¹

The CSR rejected the argument that a large pool of student applicants is a social benefit because "[i]t may be an important issue to a particular school or a particular State, but it is of little consequence to the Nation."¹⁹² The CSR did not reject the financial contributions argument, but questioned the "magnitude of the impact on contributions," the activities and groups of people benefitted, and if "the Nation as a whole benefits even if a relationship between sports success and financial contributions to universities does exist."¹⁹³

D. Administrative Inefficiencies

The UBIT provisions require a facts and circumstances approach, which unavoidably causes administrative inefficiencies for both the IRS and the exempt organizations. For example, with corporate sponsorships, both sides will incur the ordinary legal

ment. Zimmerman, *supra* note 2, at 9.

190 The analysis would apply for assessing whether to place restrictions on bowl funds or whether to revoke the exempt status of certain university activities.

191 *Id.* at 9-10.

192 *Id.* at 10.

193 *Id.* The CSR also noted that the nation might gain if total contributions to nonprofit organizations increased, but not if contributions were merely reallocated from other nonprofit organizations. *Id.*

expenses defending their respective positions and factual characterizations in court.¹⁹⁴ However, the administrative costs will exceed these ordinary costs if the IRS continues to impose UBIT on corporate sponsorships.

If the courts agree with the IRS position to impose UBIT on certain corporate sponsorships, some of the administrative inefficiencies will not disappear, unlike other previous areas of dispute. For example, when the Supreme Court held in *United States v. American Bar Endowment* that the insurance program was subject to UBIT, all related insurance programs were subject to UBIT.¹⁹⁵ With corporate sponsorships, the IRS currently recognizes that only some of the sponsorships are subject to UBIT.¹⁹⁶ Even if the Supreme Court agreed with the IRS that some corporate sponsorships are subject to UBIT, the IRS and the exempt organizations must continue to determine which specific corporate sponsorships are not subject to UBIT. As this line is extremely blurry, the costs could be significant. Furthermore, the line between deductible and nondeductible expenses is currently undefined.¹⁹⁷

E. Summary of Policy Considerations

Through corporate sponsors, bowl games enjoy a unique opportunity to raise significant revenues while incurring only insignificant costs. Although the bowl games compete with profit-seeking entities for these advertising revenues, imposing UBIT on this revenue would not effectively eliminate the corporate sponsorship activity. The government is the principal party that would benefit, and the universities are the principal parties that would lose. Furthermore, administrative costs would diminish the government's tax benefits and increase the universities' expenses. Weighing these policy considerations, the IRS should not impose UBIT on corporate sponsorships of bowl games.

VII. LEGISLATIVE RESPONSES

As an administrative body, the IRS responsibilities include interpretive guidance for taxpayers and enforcement of the Internal Revenue Code and related Treasury regulations. If Congress

194 Because several legal issues remain, the exempt organizations will almost certainly challenge the IRS in court. See *supra* Parts III and V.

195 See *supra* part III.A.1.

196 See *supra* Part IV.

197 See *supra* note 149.

does not approve of the IRS actions, Congress can enact legislation to reverse the IRS. Currently, three bills are pending in Congress that would statutorily exempt corporate sponsorships of amateur athletic events from UBIT.¹⁹⁸

Two identical bills, H.R. 2464, sponsored by Representative Ed Jenkins, and S. 866, sponsored by Senator John Breaux, specifically exempt from UBIT "*the use of the name or logo of a sponsor in association with the amateur athletic event and related activities.*"¹⁹⁹ H.R. 538, sponsored by Representative Silvio Conte, also specifically exempts "*the use of the name or logo of a sponsor in association with the amateur athletic event and related activities.*"²⁰⁰ If Congress en-

198 H.R. 2464, 102d Cong., 1st Sess. (1991); S. 866, 102d Cong., 1st Sess. (1991); H.R. 538, 102d Cong., 1st Sess. (1991).

199 H.R. 2464, 102d Cong., 1st Sess., § 1(a)(i)(2)(B) (1991) (emphasis added); S. 866, 102d Cong., 1st Sess., § 1(a)(i)(2)(B) (1991) (emphasis added). The full text of these identical bills is as follows:

A BILL

To amend the Internal Revenue Code of 1986 to clarify that certain activities of a charitable organization in operating an amateur athletic event do not constitute unrelated trade or business activities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. OPERATION OF AMATEUR ATHLETIC EVENTS BY CHARITABLE ORGANIZATIONS.

(a) IN GENERAL.—Section 513 of the Internal Revenue Code of 1986 is amended by adding at the end thereof the following new subsection:

(i) AMATEUR ATHLETIC EVENTS.—

(1) IN GENERAL.—In the case of an organization described in section 501(c), the term "unrelated trade or business" does not include any of the organization's qualified amateur athletic event activities.

(2) QUALIFIED AMATEUR ATHLETIC EVENT ACTIVITIES.—The term "qualified amateur athletic event activities" means any activity in connection with the conduct of an amateur athletic event, including, but not limited to—

(A) the receipt of revenues from such event,

(B) the use of the name or logo of a sponsor in association with the amateur athletic event and related activities,

(C) the sale of the broadcasting rights for the amateur athletic event and related activities,

(D) the licensing to an unrelated third party of the right to produce and sell the program for the amateur athletic event and related activities, and

(E) the licensing to an unrelated third party of the right to use the name or logo of the organization or the amateur athletic event and related activities.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to any activities during any taxable year beginning on, before, or after the date of the enactment of this Act unless the application of such amendment is barred by any law or rule of law.

200 H.R. 538, 102d Cong., 1st Sess., § 1(a)(i)(1) (1991). The full text is as follows:

A BILL

acts either of these three bills, the statute would apply retroactively to all applicable activities.²⁰¹ Accordingly, these bills would effectively void TAM 91-47-007 and restrict the IRS proposed examination guidelines. However, these bills are limited to amateur athletics and would not assist exempt organizations conducting professional sporting events, such as golf, tennis, or marathons, or non-sporting events, such as theater or art.

One opposing bill, sponsored by Representative Paul B. Henry, is pending in Congress and potentially could directly or indirectly subject corporate sponsorship income to UBIT.²⁰² The bill

To amend the Internal Revenue Code of 1986 to clarify the exclusion from the unrelated business income tax of revenue received by 501(c) organizations that conduct amateur athletic events.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TREATMENT OF REVENUE RECEIVED BY AMATEUR ATHLETIC EVENTS.

(a) Section 513 of the Internal Revenue Code of 1986 is amended by adding at the end thereof the following new subsection:

(i) **AMATEUR ATHLETIC EVENTS.**—In the case of an organization described in section 501(c) that conducts amateur athletic events, and/or receives revenues from such events, the term "unrelated trade or business" does not include any of the organization's activities related to such event including, but not limited to—

(1) the use of the name or logo of a sponsor in association with the amateur athletic event and related activities,

(2) the sale of the broadcasting rights for the amateur athletic event and related activities,

(3) the licensing to an unrelated third party of the right to produce and sell the program for the amateur athletic event and related activities, or

(4) the licensing to an unrelated third party of the right to use the name or logo of the organization, or the amateur athletic event, and related activities.

(b) **EFFECTIVE DATE.**—The amendment made by subsection (a) shall apply to all taxable years beginning before, on or after the date of enactment of this Act.

201 H.R. 2464, 102d Cong., 1st Sess., § 1(b) (1991); S. 866, 102d Cong., 1st Sess., § 1(b) (1991); H.R. 538, 102d Cong., 1st Sess., § 1(b) (1991).

202 H.R. 969, 102d Cong., 1st Sess. (1991). The full text of the bill is as follows:

A BILL

To amend the Internal Revenue Code of 1986 to provide that the unrelated business tax on colleges and universities shall apply to revenues from broadcasting athletic events and to certain other athletics-related revenues and to provide that scholarships received for travel, research, and living expenses are excluded from gross income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. APPLICATION OF UNRELATED BUSINESS TAX TO BROADCASTING AND CERTAIN OTHER ATHLETICS-RELATED REVENUES OF COLLEGES AND UNIVERSITIES.

(a) **IN GENERAL.**—Subsection (b) of section 512 of the Internal Revenue Code of 1986 (relating to modifications to unrelated business taxable income) is amended by adding at the end thereof the following new paragraph:

(16) In the case of a college or university, there shall be included—

specifically imposes UBIT on "amounts contributed by a booster club or similar organization to, or for the use of, the athletic department or activities of such college or university." Although the bill applies "in the case of a college or university," the language could implicitly apply to a college football postseason bowl game that is directly related to universities. Even if the bill did not apply to bowl games, the bill would arguably impose UBIT on the minimum seventy-five percent payout²⁰³ of the sponsorships to the participating universities.

VIII. CONCLUSION

From a practical standpoint, bowl games and other exempt organizations rely on corporate sponsors for the financial ability to operate events. If the IRS taxes corporate sponsorships, exempt organizations will still continue the sponsorship activity unless they discontinue the event entirely. The principal benefactor will be the government by means of increased tax revenues. However, legal and legislative uncertainties, and additional administrative costs to

(A) all income derived directly or indirectly from the radio or television broadcasting of any athletic event,

(B) amounts which would not (but for section 170(m)) be allowable as a deduction under section 170 to the contributor,

(C) amounts contributed by a booster club or similar organization to, or for the use of, the athletic department or activities of such college or university, and

(D) all deductions directly connected with amounts included under the preceding provisions of this paragraph.

(b) **EFFECTIVE DATE.**—The amendment made by this section shall apply to taxable years beginning after December 31, 1990.

SEC. 2. EXCLUSION FROM GROSS INCOME FOR SCHOLARSHIPS FOR TRAVEL, RESEARCH, AND LIVING EXPENSES.

(a) **IN GENERAL.**—Paragraph (2) of section 117(b) of the Internal Revenue Code of 1986 (defining qualified scholarship) is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by adding at the end thereof the following new subparagraph:

(C) travel, research, and living expenses (including room and board).

(b) **TECHNICAL AMENDMENTS.**—

(1) Paragraphs (1) and (2) of section 117(b) of such Code are each amended by striking "qualified tuition and related expenses" and inserting "qualified educational expenses".

(2) The heading for paragraph (2) of section 117(b) of such Code is amended by striking "QUALIFIED TUITION AND RELATED EXPENSES" and inserting "QUALIFIED EDUCATIONAL EXPENSES".

(c) **EFFECTIVE DATE.**—The amendments made by this section shall apply to taxable years beginning after December 31, 1990.

203 See, e.g., Rosenthal & Crow, *supra* note 3, § 8, at 11.

both the IRS and exempt organizations support the argument that the IRS should not impose UBIT on corporate sponsorships.

First, exempt organizations can raise legal challenges in court against the IRS imposing UBIT on corporate sponsorships. Uncertainty exists whether sponsorship activity is a trade or business and whether it can be segregated into component parts, some of which may not be subject to the UBIT.²⁰⁴ More uncertainty surrounds whether corporate sponsorship activity is regularly carried on.²⁰⁵ Finally, several components of corporate sponsorship income are arguably royalties and excludable from the UBIT calculation.²⁰⁶

Second, Congress can specifically exclude corporate sponsorships from UBIT. Currently, three proposed bills are pending before Congress that would exclude corporate sponsorship income from UBIT.²⁰⁷ Even if these proposed bills are not passed, the potential for new legislation is always present.

Finally, the IRS has acknowledged that uncertainty exists in determining the line at which nontaxable recognition of a corporate sponsor rises to the level of a taxable substantial benefit.²⁰⁸ Also, the line is blurry between the expenses that the exempt organization can deduct from the taxable corporate sponsorship income and the expenses that are not deductible.²⁰⁹ Because each case is unique and must be evaluated by standards which have not yet been determined, both the IRS and exempt organizations would incur additional administrative costs supporting their positions.²¹⁰

Whether Congress or the courts will block the IRS rush to sack the college football bowl games is difficult to predict. However, based on the legal and legislative uncertainties and the policy considerations, the IRS should not continue its attempt to impose UBIT on corporate sponsorships and should just forfeit the game.

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204 See *supra* part III.A.

205 See *supra* part III.B.

206 See *supra* Part V.

207 See *supra* Part VII.

208 See *supra* Part IV.

209 See *supra* note 149.

210 See *supra* part VI.D.