# C. SPORTS ORGANIZATIONS - CURRENT ISSUES

**by**
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## 1. Introduction

This article addresses issues involved in the exemption from tax of organizations involved in operating athletic events. While its primary focus is on exemption and other issues relating to fundraising organizations (Part 3), deductibility issues will also be noted (Part 4). Amateur athletic organizations are discussed briefly in Part 2.

## 2. Amateur Athletic Organizations

Previous CPE articles have dealt extensively with amateur athletic organizations. An article in the 1977 CPE text, at p. 16, discussed 1976 amendments to IRC 501(c)(3) which added the promotion of amateur athletics to the list of exempt purposes in that section. The 1980 CPE text, at pp. 62-69, further discussed amateur athletic organizations, including unrelated business income tax considerations. The 1982 CPE text, at pp. 83-87, briefly compared the sections under which an organization involved in promoting amateur sports may qualify for exemption, and discussed the difference between educational, amateur athletic, and competitive purposes. Finally, the 1987 CPE text, at pp. 74-83, concerned the exemption from tax of amateur athletic organizations under IRC 501(c)(3) and IRC 501(j).

The National Office is currently considering several issues involving compensation of athletes and private benefit in amateur athletic organizations. Given that final decisions have not been reached on the issues presented, extended discussion of the facts of particular cases would be inappropriate. However, in general terms, the issues under under consideration include:

1. To what extent may professional athletes be involved in amateur athletic organizations, consistent with the exempt status of those organizations?

2. To what extent and in what form may benefits be provided to designated private parties (athletes and others) in connection with the operation of amateur athletic organizations?

3. Fund-Raising Organizations

Sports "fund-raisers" - organizations that conduct sporting events for the purpose of raising funds for charity - come in various forms. The case of Golf Life World Entertainment Golf Championship, Inc. v. United States, 65-1 U.S.T.C. Paragraph 9,174 (S.D. Cal. 1964), involved one such form - the organization that, using volunteer resources and amateur players, presents a community event to raise funds for distribution to charitable organizations. See also Mobile Arts & Sports Association v. United States, 148 F. Supp. 311 (S.D. Ala. 1957) (college football bowl organization qualified for exemption under IRC 501(c)(3) and 501(c)(4)). Increasingly, however, organizations conducting professional sporting events, or otherwise using significant non-volunteer resources, are also seeking recognition of exemption on the basis that the proceeds of the events they conduct will be donated to charitable organizations.

G.C.M. 38742 (June 3, 1981) discussed whether an organization that conducted a professional golf tournament and donated the profits to charitable organizations might be described in IRC 501(c)(3). Chief Counsel concluded the organization might qualify if it carried on a charitable program that is "commensurate in scope" with its resources, see Rev. Rul. 64-182, 1964-1 (Part 1) C.B. 186. The G.C.M. does not conclude that all such organizations qualify for exemption, however.

The National Office is considering several issues related to sports fund-raiser organizations which have received or are seeking exemption under IRC 501(c)(3). Given that final determinations have not been made on many of these issues, the specialist should coordinate cases presenting these issues with the National Office.

To be described in IRC 501(c)(3), an organization must be "organized" and "operated" "exclusively" for exempt purposes. The operational test has several facets of particular relevance to sports fundraisers:

(1) Substantial non-exempt purpose: An organization will not be regarded as operated exclusively for exempt purposes if more than an insubstantial part of its activities does not further an exempt purpose. Reg. 1.501(c)(3)-1(c)(1).

(2) Private benefit: An organization is not operated exclusively for exempt purposes unless it serves a public rather than a private interest. Reg. 1.501(c)(3)-1(d)(1)(ii).

(3) Inurement: No part of the organization's net earnings may inure to any private shareholder or individual. Reg. 1.501(c)(3)-1(c)(2).

***Substantial Non-Exempt Purpose***

Under Reg. 1.501(c)(3)-1(c)(1), an organization will not be regarded as operated exclusively for exempt purposes if more than an insubstantial part of its activities does not further an exempt purpose. See also Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945). This standard is sometimes referred to as the non-exempt purpose test.

The case of Copyright Clearance Center v. Commissioner, 79 T.C. 793 (1982), illustrates one type of non-exempt purpose. The organization in that case operated a clearinghouse for licensing of copying of copyrighted publications, and as a conduit for transfer of license fees to copyright holders. A division of a publishers' trade association had initiated the organization's formation, and provided its initial funding. The facts indicated that a motivating factor in creating and operating the organization was the publishers' desire to avoid government regulation of unauthorized copying and to prevent lower royalty fees. In discussing the non-exempt purpose test, the Tax Court stated, at pp. 803-04:

> Although an organization might be engaged in a single activity, such activity may be directed toward multiple purposes, both exempt and nonexempt. But, in the case of multiple purposes, it must be kept in mind that qualification for exemption depends upon whether the entity in question is organized and operated "exclusively" for one or more of the exempt purposes specified in the statute. While it is true that the word "exclusively" has not been given a literal interpretation, and that a nonexempt purpose even perhaps somewhat beyond a de minimis level has been permitted without loss of exemption [footnote omitted], it is nevertheless plain that the word "exclusively" places a definite limit on the "purpose" at issue. ...

Given the circumstances of the organization's creation and operation, the court in the Copyright Clearance Center case concluded it had the substantial non-exempt purpose of creating a device to protect the publishers' business interests. See id., at 805.

Similarly, in est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), the Tax Court held that an organization that, in essence, provided seminars as a franchisee of

a for-profit entity had the substantial non-exempt purpose of operating a commercial business. Relevant factors included that the for-profit entity, through contractual arrangements, exerted "considerable control" over the franchisee's activities, in matters such as fees, training, scheduling, and management; that the for-profit entity's existence depended on the tax-exempt status of the franchisee, and that it was, thus, trading on the exempt status; and that the for-profit entity benefited substantially from the franchisee's activities. See also Church by Mail, Inc. v. Commissioner, T.C. Memo. 1984-349, aff'd, 765 F.2d 1387 (9th Cir. 1985) (organization had substantial non-exempt purpose of providing market for direct mail fund-raising business of for-profit corporation controlled by related parties); International Postgraduate Medical Foundation v. Commissioner, T.C. Memo. 1989-36 (organization had substantial non-exempt purpose of promoting tour business of related parties).

Thus, where an organization's activities are controlled to a significant degree by a for-profit or other non-501(c)(3) entity, the facts and circumstances should be carefully scrutinized to determine if a substantial non-exempt purpose exists. The relevant questions are these: Do the arrangements between the parties permit the 501(c)(3) organization/applicant to pursue its exclusively charitable purposes? Does the organization, in fact, pursue such purposes? If not, then a non-exempt purpose exists.

The existence of a substantial non-exempt purpose does not depend solely on the existence of private benefit or inurement. As discussed below, non-existence of impermissible private benefit or inurement are separate requirements for exemption.

Relevant factors in determining whether a substantial non-exempt purpose exists may include the following:

1. Affiliation contract: Is there a contract with a professional sports organization or other non-501(c)(3) entity that sanctions the sporting event? If so, does that contract give the entity control over key matters affecting the profitability of the event (for example, pricing, significant expenditures such as prizes, selection of contractors to perform services)?

2. Management contract: Will the exempt organization retain a professional sports organization or other non-501(c)(3) entity to operate the event? If so, are controls over key matters (as described in #1) present?

3. Board composition: Is the exempt organization's board controlled by parties having commercial interests that may conflict with those of the exempt organization?

4. Exercise of independent judgment: Where decision-making authority has not been formally delegated to parties with adverse commercial interests (as described in #1-3), does the exempt organization's independent board actually control its activities? See, e.g., Hancock Academy of Savannah, Inc. v. Commissioner, 69 T.C. 488 (1977) (officers who were in position to gain personally from organization's activities controlled those activities, without oversight from board of directors exercising independent judgment).

5. Creation of organization: Was the exempt organization created by parties having commercial interests adverse to the interests of the exempt organization? If so, what evidence is there concerning their reasons for creating the organization? (See Copyright Clearance Center, supra.)

6. Benefits of operation: Does the sporting event, in operation, provide significant benefits to non-501(c)(3) controlling parties? In other words, where a substantial non-exempt purpose is suggested by the fact that non-501(c)(3) parties control the organization, is that suggestion negated by actual operations?

In making these determinations, the specialist should be cautious of arguments that particular arrangements with or concessions to non-501(c)(3) entities were necessary for the event to take place. A fund-raising organization's claim to exemption rests on having a primary purpose of distributing funds to charity, not on conducting a particular event.

***Private Benefit***

Reg. 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not operated for exempt purposes unless it serves a public rather than a private interest. Even where a sports fund-raiser does not have a substantial non-exempt purpose as discussed above, private benefit may be present.

As discussed in the 1990 CPE text at pp. 32-39, prohibited private benefit is that which is not incidental to accomplishing the organization's exempt purposes.

This test for prohibited private benefit has both a quantitative and a qualitative aspect. To be qualitatively incidental, private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals. To be quantitatively incidental, private benefit must be insubstantial, measured in the context of the overall public benefit conferred by the activity.

In the context of a sports fund-raiser, the following types of private benefit may be present; each must be analyzed to determine whether it is prohibited by Reg. Section 1.501(c)(3)-1(d)(1)(ii), using the qualitative/quantitative analysis outlined above:

1. Compensation for goods/services rendered: Particularly where related parties provide goods and services to an exempt organization, commercial arrangements should be examined to determine whether they resulted from arm's length negotiations and resulted in no more than reasonable compensation. Transactions falling into this category include facility leases (club facilities, for example); administrative services agreements; concession agreements; and the like.

2. Intangible benefits: Sponsors, facilities, and other parties associated with a sporting event may benefit significantly from that affiliation. Where the exempt organization's activities contribute to providing such benefits - where it is required, by contract or otherwise, to provide services to sponsors, for example - the facts should be examined to determine whether those benefits constitute prohibited private benefit.

3. Selection of events: A sporting event may last several days, and include several events. A golf tournament, for example, may include - in addition to the tournament itself - a "Pro-Am" event, a junior golf clinic, sponsor parties, and volunteer recognition events. Each event should be examined to determine whether the benefits provided to private parties are incidental to accomplishing the organization's exempt purposes. In analyzing this issue, one should remember that the organization's exempt purpose is to distribute funds to charity; assertions that a particular event is necessary to present a "quality" event or to attract top players should be examined to determine whether offering a "quality" even or attracting top players primarily serves that purpose.

***Inurement***

As an additional requirement for exemption under IRC 501(c)(3), the Code and regulations prohibit the inurement of net earnings to any private shareholder or individual. The 1990 CPE text, at pp. 16-71, discusses inurement at length.

As the 1990 CPE article notes, inurement may take many forms. Of particular interest in the sports fund-raiser context may be the following:

1. Unreasonable compensation: Particularly where related parties are involved, compensation for goods and services rendered to the organization should be carefully scrutinized to determine if amounts paid are unreasonable. For additional discussion of unreasonable compensation issues, see the Reasonable Compensation topic in this text.

2. Percentage compensation: The payment of reasonable compensation for goods or services is permissible even if in the form of a percentage of revenue. See Rev. Rul. 69-383, 1969-2 C.B. 113 (compensation of hospital-based radiologists). And reasonable compensation is not transmogrified into inurement merely because it is paid to an insider, see World Family Corporation v. Commissioner, 81 T.C. 958, 969-70 (1983). On the other hand, a payment that would otherwise be inurement does not become permissible merely because it is "reasonable." See, e.g., Gemological Institute of America v. Commissioner, 17 T.C. 1604, 1609-10 (1952).

   Note, however, that percentage compensation, like other forms of compensation, must be shown to be reasonable in relation to goods or services provided to the organization. Where a percentage arrangement relates, not to gross revenue (as in Rev. Rul. 69-383, supra), but to net revenue; or where the arrangement is otherwise not tied to performance (a sales commission, for example), the arrangement may constitute inurement, and not reasonable compensation.

3. Other benefits to "insiders": An organization may provide benefits to related parties, other than unreasonable compensation for goods or services, which may constitute inurement.

***Unrelated Trade or Business and Private Foundation Classification***

A sports fund-raiser's sources of support may include receipts from ticket sales, concession income, television royalties, and contributions. In many cases, payments from corporate sponsors constitute a large proportion of the organization's total support; the treatment, for unrelated business income tax purposes, of corporate sponsorship payments is discussed elsewhere in this text. (The deductibility of the sponsor's payment is beyond the scope of this article. See, e.g., IRC 274(l)(1)(B), concerning the deductibility, as business expenses, of payments for tickets to charitable sports events.)

In determining the unrelated business income tax treatment of a sports fund-raiser's income, the focus will generally be on two issues: whether the activity generating the income is "regularly carried on;" and whether the income is within the "volunteer labor" exception in IRC 513(a)(1). The extent to which the organization's major sources of support are subject to UBIT will, in turn, influence whether it may be classified as other than a private foundation, by reason of IRC 509(a)(2). (In appropriate cases, of course, some other classification may be available. Note also that similar considerations may apply with other "fund-raising" organizations which engage in substantial business activities to produce income for their charitable purposes.)

This article will not discuss these concepts at length. The concept of "regularly carried on" is discussed in the article on corporate sponsorships, this text. The application of the IRC 513(a)(1) exception in this context also presents issues of particular concern. In applying that exception, the specialist may need to resolve the following issues:

1. What is the "work in carrying on" the activity (which must be included in determining whether "substantially all" such work is performed "without compensation")? The Service is currently considering whether the "work" involved in producing income in this context should be deemed to include the labor of all service providers whose activities contribute to the production of income received by the exempt organization. For a particular fund-raiser, this might include planning personnel, administrative personnel (including outside attorneys and accountants), ticket-takers, parking lot attendants, event officials (such as referees), and paid athletes.

2. What work is performed "without compensation"? See generally Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner,

T.C. Memo. 1981-546, aff'd, 696 F.2d 372 (5th Cir. 1983), discussed in 1982 CPE text, at pp. 126-27; G.C.M. 39786 (Oct. 26, 1988) ("de minimis" food and beverages provided bingo workers may be disregarded in determining whether work is performed "without compensation").

Fund-raiser organizations sometimes characterize as "contributions" amounts that are directly tied to the quantum of labor of members of the "donees" in connection with the sporting event. Such payments would appear to be "compensation" for the labor provided. See Reg. 1.61-2(c) (addressing assignment of income concerns arising from such arrangements).

3. Is "substantially all" the work identified performed without compensation? In this regard, see generally 1982 CPE text, at pp. 124-25.

***501(c)(4) Exemption***

In Rev. Rul. 74-298, 1974-1 C.B. 133, the Service concluded that an organization whose sole activity was the sponsorship of an annual professional golf tournament did not qualify for exemption under IRC 501(c)(4). The ruling reasoned that the tournament was operated in a manner similar to a business for profit, and, therefore, exemption was precluded by Reg. 1.501(c)(4)-1(a)(2)(ii). Thus, 501(c)(4) exemption may not be available where 501(c)(3) status is denied to sports fund-raiser organizations. The requirements for exemption under IRC 501(c)(4) relate to an organization's operations or activities, not its "purposes."

4. Deductibility Issues

Cases involving exempt organizations that promote amateur athletics and that have other sports activities frequently present issues concerning deductibility of contributions under IRC 170. Two such issues are discussed below.

Where deductibility issues are present, it may be appropriate to apply the procedures outlined in the Charitable Solicitations Compliance Improvement Study. See Manual Supplement 7(10)G-59 (Dec. 20, 1991).

## ***Contributions Earmarked for the Benefit of Particular Athletes***

A recent magazine advertisement made the following plea:

> Anyone wishing to make a **tax deductible** contribution to [Individual Athlete's] [international amateur athletic competition] campaign can make a check payable to [Exempt Organization] and send it to:
>
> Exempt Organization
> c/o Individual Athlete
> Address

(Emphasis in original.) This advertisement suggests the organization is accepting contributions that are earmarked to benefit particular individuals.

The effect earmarked contributions may have on the 501(c)(3) status of amateur athletic organizations is discussed in the article on Athletic Booster Clubs, this text. Earmarked contributions also raise deductibility concerns. In Rev. Rul. 79-81, 1979-1 C.B. 107, the Service concluded that contributions earmarked by the donor for a particular individual are treated as gifts to the designated individual and are not deductible as charitable contributions. However, a deduction is allowable where it is established that a gift is intended by a donor for the use of the organization and not as a gift to an individual. Rev. Rul. 62-113, 1962-2 C.B. 10. Rev. Rul. 68-484, 1968-2 C.B. 105, states that for purposes of determining that a contribution is made to or for the use of the donee organization rather than to a particular individual who ultimately benefits from the contribution, the organization must have full control of the use of the donated funds; and the contributor's intent in making the payment must have been to benefit the charitable organization itself and not the individual recipient.

Whether the criteria established by these rulings are satisfied will depend on the facts of the particular case. An example of the careful examination which should be made of possible earmarking situations is provided by Tripp v. Commissioner, 337 F.2d 432 (7th Cir. 1964).

## ***Sports Travel Tours***

A second sports-related deductibility issue concerns the treatment of travel expenses incurred in connection with "good will ambassador" travel programs involving sporting events. IRC 170(j) [IRC 170(k), prior to 1990] provides that no contributions deduction shall be allowed for traveling expenses (including expenses

for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation involved in such travel. This provision is discussed in the 1989 CPE text, at pp. 183-84.

Even absent this provision (which is effective for tax years beginning after December 31, 1986), however, the deductibility of payments for expenses of such tours may be questionable. In Seed v. Commissioner, 57 T.C. 265 (1971), the Tax Court concluded the taxpayers' payments for transportation, accommodations, greens fees, and other charges in connection with a "sports ambassador" program were not deductible, since the taxpayers were paying for personal benefits, which were not merely "incident to the rendition of services" to the exempt organization which sponsored the tour (see also Reg. 1.170A-1(g)).

Elements of both earmarking and "quid pro quo" issues were present in Babilonia v. Commissioner, T.C. Memo. 1980-207, aff'd, 681 F.2d 678 (9th Cir. 1982). That case involved the deductibility of amounts paid by parents of a figure skater for skating lessons, and travel expenses (of both the athlete and parents). The Tax Court first concluded that amounts the parents paid for their daughter's lessons and other expenses were primarily for the daughter's personal benefit:

> It is possible that Tai's [daughter's] performances [at competitions] may have indirectly benefited the several exempt organizations with which she was connected. However, her performances primarily helped her to attain recognition, fame, personal satisfaction, and a future career in professional skating through participation in international competitions, and any benefits to [the exempt organizations] were merely incidental to those personal benefits. Accordingly, petitioners' expenses for skating lessons and attendant travel for Tai in preparation for those performances, after she made the World and Olympic Teams, were incurred primarily to maintain and improve her skating ability and chances of winning at the competitions. As such, the lessons and travel herein conferred a substantial, direct, personal benefit to Tai which is fatal to petitioners' claim for a charitable contribution. [Citations omitted.]

Expenses incurred by the athlete's mother in accompanying her daughter to international competitions were not deductible for similar reasons. In addition, the court held, the mother herself received substantial personal benefit from accompanying her daughter.