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COMMENT

DO COACHES' SHOE CONTRACTS THREATEN UNIVERSITIES' TAX EXEMPT STATUS?

JOYCE E. ACKERBAUM*

The extreme popularity of sports in the college arena has turned football and basketball into more than just games; today, college sports are more likely viewed as businesses. These sports have not only generated a tremendous amount of money for universities, coaches, and endorsement companies, but also a great deal of attention and scrutiny from the Internal Revenue Service ("IRS" or "Service").

What may be the most current controversy, and the subject of this paper, are shoe contracts, the effect they may have on colleges and universities, and the way this type of compensation should be treated in a tax sense. The term "shoe contracts" refers to the lucrative endorsement deals that coaches have with various shoe manufacturers, such as Nike, Reebok, and Converse.¹ Generally, the shoe contracts are negotiated directly between the coach and the shoe company.² The company agrees to pay the coach a certain sum of money as a consultant, and provides a supply of shoes,

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1. It is estimated that Nike has contracts with over 60 college coaches, while Converse and Reebok have, respectively, 41 and 26 coaches under contract. SPORTS LAW PRACTICE, COLLEGE COACHES' CONTRACTS §6.07 (7)(c) at 507 (citing D. HOFFMAN AND M. GREENBERG, SPORT\$BIZ 101, 102 (1989)).

2. *Id.* at 506. However, there does appear to be a trend away from this type of contract negotiation to one where the school and the athletic departments are more directly involved. See *infra*, note 87.

clothes, and gym bags in exchange for the coach's team players wearing the shoes.³

These compensation arrangements between the coach and the shoe companies originated through simple principles of supply and demand. Successful coaches with winning records warrant a great deal of money—money that universities cannot always afford to pay, either because of budget limitations or, more plausibly, because of the desire to avoid difficulties with other employees (i.e., professors and faculty members who are not paid nearly as much⁴), not to mention the IRS. So where does that leave the university? Usually in an untenable situation with a phenomenal coach that the school cannot afford to lose, but realistically, cannot afford to keep either.

Enter the shoe companies. They offer to subsidize the income paid to the coaches in order to alleviate the problems encountered by the schools. These companies have no difficulty providing this "indirect compensation."⁵ Nike Director of Sports Marketing, Steve Miller, simply puts it, "Why the sham? The bottom line is we believe our relationship with a university is no different than companies that provide endowments for a school of business"⁶ These arrangements seem to benefit all interested parties, and everyone is safe and satisfied: the coach receives a large check for his efforts, the shoe companies gain exposure and increased revenue from the high-profile teams advertising their product at every game, and, most importantly, the university does not jeopardize its tax-exempt status by paying its employees too much.⁷ The IRS, however, is not so easily convinced that these indirect compensation agreements are benign. Indeed, the IRS is concerned not only about shoe contracts, but also about a number of different compensation issues arising in the context of colleges and universities.

The Service's concern is a rather recent development. It was not until the late 1980's that the IRS decided to target its audit efforts towards large and complex tax-exempt organizations like

3. *Id.*

4. When the coach's income is measured against others on campus, such as highly respected professors in arts and sciences, statistics show the professors sometimes make one-fifteenth of what the coach does. John Weistart, *How Colleges Can Cash In on Their Coaches*, WALL ST. J., Sept. 11, 1992 at A18.

5. The concept of indirect compensation is explained *infra*, at pp. 13-22.

6. Rudy Martzke, *Nike Says It's OK Starter's On Screen*, USA TODAY, Apr. 5, 1994 at 3C.

7. The consequences of paying employees of a tax-exempt organization unreasonable compensation are discussed *infra* at pp. 11-13.

universities.⁸ The reason for this concentration, as James J. McGovern, an IRS Associate Chief Counsel, stated in a speech before the District of Columbia Bar Counsel on September 12, 1992, stemmed from the fact that "escalating expenses, declining revenues, and rising demand for services [have caused] many tax-exempt organizations . . . to operate in a much more business-like fashion."⁹ It was obvious that these large tax-exempt organizations were resembling commercial entities and should be treated accordingly.¹⁰

As a result of this commercial sophistication, and in response to the need for policing of some exempt organizations, the IRS decided to conduct audits of these organizations in the same way as those conducted for "for-profit" corporations.¹¹ True to their word, on August 25, 1994, the IRS released final examination guidelines to be used by its agents during investigations of colleges and universities "Guidelines".¹² These Guidelines explore in

8. *Attention Class! IRS Issues Examination Guidelines for Colleges and Universities*, 7 EXEMPT ORG. TAX REV. 33 (Jan. 1993). The IRS launched large-scale audits at some tax-exempt organizations; the first of these occurred in 1990 and was aimed at hospitals. *Id.* The Service used teams of agents and industry specialists to probe all aspects of hospital operations, particularly compliance with the community benefit standard and financial arrangements with physicians. Milton Cerny and Eileen M. Mallon, *Extensive New IRS Audit Guidelines Intensify Scrutiny of Colleges and Universities*, 78 J. TAX'n 298 (May 1993). After the Service had begun these audits, a set of hospital audit guidelines was released. See IRM 7 (10) 69. The proposed hospital guidelines are reprinted in 5 EXEMPT ORG. REV. 697 (Apr. 1992).

9. Cerny, *Id.* at 2.

10. In addition to conducting business like for-profit businesses, it was problematic that there were no checks on disbursements in an exempt organization, as there existed in a taxable corporation. Jean Wright and Jay H. Rotz, *IRS Exempt Organizations CPE Technical Instruction Program Textbook: Chapter I—Reasonable Compensation* (Oct. 1, 1992); available at 94 TNT 70-23. Theoretically, investors in a public corporation want the highest return possible on their investment, and therefore have an incentive to examine closely the expenditures made. *Id.* In a closely-held corporation, there is a deterrent built in regarding the possibility that the IRS may recharacterize excessive compensation to directors, officers, and employees as a dividend which would be non-deductible. *Id.* The only checks imposed on an exempt organization are the "inadequate oversight by volunteer boards of directors, the occasional media inquiry, [and] some activist state attorneys general . . ." *Id.*

11. *Id.*

12. Announcement 94-112, 1994-37 I.R.B. 1, available electronically at 94 TNT 168-6 (hereinafter "Guidelines"). The Guidelines will apply with respect to three categories of colleges and universities: (1) private institutions that are tax-exempt and are not private foundations; (2) public institutions the income of which, other than unrelated business income, is excluded from federal taxation; and (3) public institutions the IRS has recognized as tax exempt. BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS*, JW-TAXEXEM §37.10 (6th ed. 1993).

The first seven universities selected for review were reported to be the University of Michigan, Michigan State University, University of Nebraska, Princeton

depth the structure, activities and operations of educational institutions.¹³ Special attention will be paid to compensation issues—for instance, whether the type of compensation plan offered by the organization is consistent with its exempt status,¹⁴ and whether its officers, directors, or employees are being paid “unreasonable” salaries.¹⁵

The response to the Guidelines was widespread as many universities, American Bar Association members, and other individuals responded and set forth their criticisms.¹⁶ However of all these reactions, one of the most interesting, and possibly most controversial, issues raised by the Guidelines barely received any attention from outsiders. That issue is the one calling for disclosure of all outside income by university coaches. Section 342.31 (9) of the Guidelines reads as follows:

Coaches disclosure of outside income—The National Collegiate Athletic Association requires coaches to disclose to the institution’s chief executive officer (via the athletic director) all ‘athletically-related income from sources outside the institution’ (e.g., annuities, housing benefits, sports camps, complimentary-ticket sales or sporting-goods endorsements). *Some of this ‘outside’ income may, in fact be derived from the institution or its facilities or from affiliated organizations.*¹⁷

While this particular issue is granted nominal space and is scarcely discussed in the Guidelines, there is enough of a hint from the text to raise major tax implications for colleges and universities. It is apparent that the Service intends to devote time and study to the way coaches’ compensation packages are structured, as well as determine who is responsible for the income payment.

This Article will explore the possible repercussions resulting from examination of these arrangements, particularly shoe contracts, and address the question of how these deals pose an issue

University, St. John’s University (N.Y.), Stanford University, and Vanderbilt University. *Attention Class! IRS Issues Examination Guidelines for Colleges and Universities*, 7 EXEMPT ORG. TAX REV. 33 (Jan. 1993).

The Guidelines specifically define what type of institution qualifies as a “college,” a “university,” and a “school.” For purposes of this paper, the author will employ such terms synonymously.

13. See Cerny, *supra* note 8.

14. See Gen. Couns. Mem. 39674 (Oct. 23, 1987).

15. See *supra* note 10.

16. See, e.g., *Universities Comment on Proposed Examination Guidelines*, 93 TNT 169-11; *ABA Members Criticize University Audit Guidelines*, 93 TNT 162-40.

17. Guidelines, *supra* note 12 (emphasis added).

for American universities who wish to continue to qualify for tax-exempt status.¹⁸ Specifically, the author will give an overview of the purposes and policies surrounding §501 (c)(3) of the Internal Revenue Code (IRC), the provision granting tax-exempt status to certain organizations that meet the outlined qualifications. This article will then describe the doctrine of private inurement and explore under what circumstances an organization's exempt status may be jeopardized when applying this doctrine. Finally, the author will illustrate the concept of indirect compensation and explain why this form of compensation to coaches may directly contribute to the eventual revocation of a university's tax-exempt status.

SECTION 501(c)(3)

An organization is entitled to exemption from federal income tax under §501(a) of the IRC if it fits one of the descriptions given in the subparagraphs of §501(c).¹⁹ The most widely recognized type of tax-exempt organization is the charitable or educational institution, described in §501(c)(3).²⁰

Having established that the IRC will allow tax-exemption to universities, one must look further to see what the Treasury Regulations "Regulations" require in order to qualify as a §501(c)(3) institution. The necessary components of a tax-exempt university can be broken down into two major categories: the organization must be organized, and as well as operated, exclusively for one or more exempt purposes.²¹ As long as these two requirements are met, an educational facility will not confront any exemption problems.

The first requirement is that every university must be organized exclusively for an exempt purpose.²² Because the subject is how coaches' compensation issues affect a university's status, the

18. The purpose of this Article is not to question the payment of taxes by the individual coaches. There is no evidence from this author's research that the coaches are failing to disclose their total income on their tax returns.

19. Bertrand M. Harding, Jr. and Edgar D. McClellan, *Unreasonable Compensation: The Hidden Issue in the IRS College and University Guidelines*, 20 J.C. & U.L. 111 (1993).

20. *Id.* IRC §501 (c) states:

The following organizations referred to in subsection (a):

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for . . . educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual.

21. See Treas. Reg. §1.501(c)(3) - 1(a).

22. *Id.*

appropriate inquiry is whether athletic programs serve to further the exempt purpose of the school, that is, education. It has long been established that "[c]ollege and university athletics organizations that promote certain aspects of athletic competition have generally been held to be educational and are thus exempt from federal income tax."²³ An athletic program is considered to be an integral part of the overall educational activities if it is conducted for the physical development and betterment of the students.²⁴ In addition, a 1978 technical advice memoranda specifically pointed out the connection between intercollegiate athletics and education by stating:

[A]n audience for a game may contribute importantly to the education of the student-athlete in the development of his/her physical and inner strength and to the education of the student body and the community-at-large in heightening interests in and knowledge about the participating schools. In regard to the student athlete, the knowledge that an event is being observed heightens its significance, which raises the level of both competitive effort and enjoyment. Attending the game enhances student interest in education generally and in the institution because such interest is whetted by exposure to a school's athletic activities. Moreover, the games (and the opportunity to observe them) foster those feelings of identification, loyalty, and participation typical of a well-rounded educational experience.²⁵

Overall, it is a firmly rooted tenet that athletics promote the welfare of not only the student-athletes, but also of the student body as a whole, and therefore do not raise any issue with regard to jeopardizing an educational facility's exempt status.

THE DOCTRINE OF PRIVATE INUREMENT

The second requirement necessary to maintain tax-exempt status is that a university must be operated exclusively for one or more exempt purposes.²⁶ When considering the compensation

23. Rev. Rul. 80-296, 1980-2 C.B. 195. See also Erik M. Jensen, *Taxation, The Student Athlete, and the Professionalization of College Athletics*, 1987 UTAH L. REV. 35, 50 (1987) (stating that in 1950, the House Ways and Means Committee and the Senate Finance Committee asserted that "athletic activities of schools are substantially related to their educational functions").

24. Rev. Rul. 67-291, 1967-2 C.B. 184.

25. Jensen, *supra* note 23, at 52 (quoting Tech. Adv. Mem. 78-51-002 (no date given), 78-51-004 (Aug. 21, 1978), 78-51-005 (no date given), and 78-51-006 (no date given)).

26. See *supra* note 21.

being paid to coaches, this is the area that could raise significant problems for universities. The Regulations clearly state that "an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals."²⁷ In simpler terms, "private inurement" in any instance is prohibited.

The policies against private inurement were initially established to protect charitable organizations.

A charitable organization is viewed under common law and the Internal Revenue Code as a trust whose assets must irrevocably be dedicated to achieving charitable purposes. The inurement prohibition serves to prevent anyone in a position to do so from siphoning off any charity's income or assets for personal use.²⁸ Historically, inurement applied in situations where the value flow was clear and direct. The most blatant instance of inurement was found in cases of greed, where a traceable flow of cash went from contributors to founders of a charitable organization.²⁹ Throughout the years, this constricted view of inurement has expanded beyond the inclusion of mere formal relationships and direct cash flows. Today, the IRS looks for inurement in several different contexts.

To understand the mechanics of inurement, it is first necessary to delineate when the principles of private inurement are utilized, as opposed to those of "private benefit", as both principles have legal ramifications that are drastically different. Primarily, the inurement proscription has no *de minimis* exception.³⁰ This means that the smallest finding of inurement, even "a dollar's worth,"³¹ in a charitable organization can lead to revocation of its tax-exempt status.³² Conversely, private benefit is tested against

27. *Id.*

28. See Gen. Couns. Mem. 39862 (Nov. 22, 1991), available at 1991 IRS GCM LEXIS 39, at *17.

29. HILL AND KIRSCHTEN, *FEDERAL AND STATE TAXATION OF EXEMPT ORGANIZATION*, ¶2.03[3][b] at 2-84. See, e.g., *Bubbling Well Church of Universal Love, Inc. v. Commissioner*, 74 T.C. 531 (1980). The founders of the church and their family members were the only employees of the church. The church received \$61,170, a significant amount of which was spent on the family for large salaries and living allowances. The Tax Court found inurement because the church could not give any legitimate reasons to describe the expenditures or detail how they furthered exempt purposes.

30. See *supra* note 28, at *24.

31. See *supra* note 19.

32. See *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1202 (Ct. Cl. 1969); *Unitary Mission Church of Long Island v. Commissioner*, 74 T.C. 507, 513 (1980).

an "insubstantiality" threshold.³³ If the private benefit passes this threshold test, then the organization's exempt status will not be jeopardized.

The second main difference between inurement and benefit involves to whom the rules apply. When conducting private benefit analysis, the prohibition applies with respect to all kinds of persons and groups.³⁴ On the other hand, the inurement prohibition only applies to particular people—namely, those referred to by the IRC as a "private shareholder or individual" as defined under §1.501(a)-1(c). This definition states that a "private shareholder or individual" is one "having a personal and private interest in the activities of the organization."³⁵ These people are often referred to as "insiders" because due to "their particular relationship with an organization, [they] have an opportunity to control or influence its activities."³⁶

Through various rulings, the IRS has further broadened the definition and application of the term "insiders."³⁷ The first of these rulings occurred with regard to hospital employees.³⁸ The IRS was faced with the question of whether a hospital that was exempt under §501(c)(3) "jeopardize[d] its [tax] exempt status by forming a joint venture with members of its medical staff and selling to the joint venture the gross or net revenue stream derived from operation of an existing hospital department or service for a defined period of time."³⁹ The IRS reached several conclusions.

33. See Hopkins, *supra* note 12. Any private benefit arising from a particular activity must be "incidental," in both a qualitative and quantitative sense, to the overall public benefit achieved by the activity in order for the organization to remain exempt. To be qualitatively incidental, a private benefit must occur as a necessary concomitant of the activity that benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting private individuals. Such benefits might also be characterized as indirect or unintentional. To be quantitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit conferred by the activity. It is noteworthy that, even though exemption of the entire organization may be at stake, the private benefit conferred by an activity or arrangement is balanced only against the public benefit conferred by that activity or arrangement, not the overall good accomplished by the organization. See *supra* note 28, at *35-36 (quoting GCM 37789 (Dec.18, 1978)).

34. See *supra* note 28, at *31.

35. Treas. Reg. §1.501 (a)-1(c).

36. See *supra* note 28, at *17-18.

37. See generally Gen. Couns. Memos. 39,498 (April 24, 1986), available in 1986 IRS GCM LEXIS 35; 39670 (Oct. 14, 1987), available in 1987 IRS GCM LEXIS 76; and 39862 (Nov. 22, 1991), available in 1991 GCM LEXIS 39.

38. *Id.* at GCMs 39498 and 39862.

39. See *supra* note 28, at *1.

First, it embraced a broad definition of "insiders" and stated that "all physicians on the medical staff of a hospital, as employees or persons with a close professional working association with the hospital, are persons who have a personal and private interest in the activities of the hospital, and are subject to the inurement proscription."⁴⁰ Having established that the physicians were "insiders," the Service then found that the sale of the revenue stream from the hospital allowed the net profits to *inure to the benefit of* physician investors.⁴¹ The Service likened the structure of these joint ventures to paying dividends on stock, in that the hospital was giving or selling physicians a proprietary interest in the hospital's net profits.⁴² The reasons supporting the IRS's decision were grounded in the belief that the hospitals engaged in these ventures largely as a means "to retain and reward members of their medical staffs, to attract their admissions and referral, and to pre-empt the physicians from investing in or creating a competing provider."⁴³ Unfortunately for the hospital, none of these reasons were seen as legitimately furthering its exempt purpose.

As a result of rulings like these, the Service has clearly established the position it will take when applying its definition of "insiders." That position is as follows:

[E]mployees or other individuals who have a "close professional working relationship" with the organization with which they are affiliated have a personal and private interest in the organization sufficient to make them subject to the inurement proscription, even if they were recruited under arm's length contracts and are not directors, officers or otherwise in control of the organization.⁴⁴

Besides hospital employees, there have also been specific findings that bring college athletic coaches within the realm of this "insider" definition.⁴⁵ As a result, coaches will be subject to the

40. See *supra* note 28, at *18; see also GCM 39,498, note 39.

41. See *supra* note 28, at *29.

42. *Id.*

43. *Id.*

44. See *supra* note 10.

45. Gen. Couns. Mem. 39670 (Oct. 14, 1987), available at 1987 IRS GCM LEXIS 76. In this situation, the IRS considered several issues, one of which was whether a deferred compensation plan established by a §501(c)(3) organization, set up for the benefit of athletic coaches employed by another §501(c)(3) organization, constituted prohibited inurement of income. The discussion directly focused on whether the coaches, as persons performing services, were insiders and therefore subject to the inurement proscription. The Service clearly announced that "all persons performing

inurement proscription, and, therefore, the compensation they receive must comply with the applicable rules. When examining any coach's compensation package to see if inurement is present, a three-pronged test must be applied:

[I]t is necessary to examine the entire compensation package . . . and determine 1) whether that compensation package is not merely a device to distribute profits to principals or transform the organization's principal activity into a joint venture, 2) whether the package is the result of arms-length bargaining and 3) whether the compensation constitutes reasonable compensation.⁴⁶

The thrust of any inurement argument in the context of university coaches receiving indirect compensation falls within the third prong of the test, and, therefore, that is where the focus of this analysis shall lie.

The basic principle of reasonable compensation can be stated simply: an organization can make "reasonable" compensation payments to its employees without violating the private inurement doctrine and jeopardizing its tax-exempt status.⁴⁷ The Tax Court has established that "[t]he law places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts."⁴⁸ This statement clearly encompasses college coaches. However, excessive compensation paid to individuals in a tax-exempt organization can result in private inurement.⁴⁹ This is a question of

services for an organization have a personal and private interest and therefore possess the requisite relationship necessary to find private benefit or inurement." *Id.* at *8.

46. See *supra* note 10.

47. *Id.* A statutory basis for the reasonableness requirement has been developed based on I.R.C. §162, which imposes a reasonableness requirement for deductibility of compensation as a business expense. *Id.* In *Enterprise Equip. Co. v. United States*, 161 F. Supp. 590 (Ct. Cl. 1958), the Court of Claims applied the reasoning of §162 to exempt organizations. *Id.* The general reasonableness "concept has two prongs: 1) an amount test, focusing on the reasonableness of the total amount paid; and 2) a purpose test, examining the services for which the compensation was paid." *Id.* These two prongs are not separate issues, focusing on different facts. *Id.* Rather, the various factors in a particular situation taken together determine whether either or both of the tests are satisfied. *Id.* See also *Truth Tabernacle Church, Inc. v. Commissioner, T.C.M. (CCH) 1989-451*, available at 1989 Tax Ct. Memo LEXIS 451. For a list of the factors considered in the reasonableness of compensation analysis, see *infra* note 50.

48. See *Wright and Rotz, supra* note 10.

49. See *Hopkins, supra* note 12.

fact to be decided on a case-by-case basis.⁵⁰ It is important to note that even if one is paid a reasonable salary, inurement can still be found based on the fact that the total compensation package is not reasonable.⁵¹ All income must be considered in determining whether compensation is excessive.⁵² For coaches, this means that the elements of their "package" which are *paid by the university* must be taken into account and examined against the reasonableness threshold. The source of the income is crucial because if the money is not derived from the school, it does not get factored into the inurement equation.

The next section of this article will discuss coaches' compensation packages in the context of indirect compensation arrangements. In doing so, it will describe how the income derived from shoe contracts may be attributable to a university and the possible ramifications of such a finding.

INDIRECT COMPENSATION

The Guidelines call for university coaches to reveal to the Service all remuneration provided them and the sources from which they derive. These items usually comprise what is known as the coach's compensation "package,"⁵³ which includes such things as annuities, housing benefits, proceeds from sports camps, complimentary-ticket sales, and sporting good endorsements.⁵⁴

The idea of coaches divulging the various components of their compensation packages is not a novel one. The National Collegiate Athletic Association (NCAA) "requires annual disclosure by a coach to the university president through the athletic director

50. *Id.* There are several factors the IRS looks at when examining the reasonableness of compensation in exempt organizations. These can be divided into two categories: those relating to the employee and those relating to the organization. When examining the employee, the Service looks at things like control by a family or founder, availability of comparable services from a third party, nature of the employee's duties, employee's background and experience, employee's salary history, employee's contribution to the organization's success, and time devoted to the job. Factors that are considered relating to the organization include the salary scale of others in the same line of business, size of the organization, salary scale for employees generally, and amount of an organization's income devoted to compensation. See generally Wright and Rotz, *supra* note 10.

51. See *Church of Scientology of Calif. v. Commissioner*, 83 T.C. 381, 492 (1984), *aff'd*, 823 F.2d 1310 (9th Cir. 1987), *cert. denied*, 486 U.S. 1015 (1988).

52. *Id.* at 1319.

53. SPORTS LAW PRACTICE, § 6.01(6) at 454.

54. Guidelines, *supra* note 12.

of all athletically-related income."⁵⁵ The purpose of the NCAA's requirement, however, is distinct from that of the IRS. The NCAA wants "to monitor the sources of a coach's outside income and to increase and maintain university control over intercollegiate athletic programs."⁵⁶ This rule is intended to protect the integrity of college athletics by ensuring that university presidents are "informed of possible conflicts of interest and commercial influences on coaches."⁵⁷ There exists between the coach and the university a fiduciary relationship which inherently carries a duty of loyalty, owed by each to the other, that must continuously be preserved.⁵⁸ Basically, the NCAA wants to keep the coaches' judgments honest and independent, and, above all, have them accountable only to their respective universities, not to any outside interest groups.⁵⁹

On the other hand, the IRS sees things from a different perspective. While the NCAA is using its disclosure requirements to ensure that coaches' activities are legal, the IRS' narrower motive is to determine who is really paying the coaches' compensation. Is the endorsement income that coaches are receiving merely the result of a great deal struck with one of the shoe companies, or is it something more? Could it be that the indirect compensation arrangements from these outside sources are actually just a disguised method which enables the university to pay the coach addi-

55. SPORTS LAW PRACTICE §6.07 (8) at 510 (citing FN 262—1991-92 NCAA Division I Bylaws, Art. 11.2.2). In 1987, the NCAA passed a rule requiring coaches to inform their institution's chief executive officer of all athletically related income they receive from sources outside the university. Debra E. Blum, *Reform Movement Helps Institutions Take Control of Lucrative Deals Proposed by Shoe Companies*, CHRON. OF HIGHER EDUC., Sept. 8, 1993, at A35. "Five years later, the rule was [supplemented] to require coaches in the NCAA's Divisions I and II to receive prior written approval each year from their college presidents for all athletically related income from outside sources, and for any use of the institution's name or logo in the endorsement of products or services for personal gain." *Id.*

56. SPORTS LAW PRACTICE § 6.07(8) at 512.

57. *Id.*

58. Martin Greenberg, *College Coaching Contracts: A Practical Perspective*, 1 MARQ. SPORTS L.J. 207 (1991).

59. *Id.* See also NCAA Division I Bylaws, Art. 11.1.1, which lists the expected conduct of athletics personnel. The Bylaws state:

individuals employed by or associated with a member institution [must] administer, conduct, or coach intercollegiate athletics . . . with honesty and sportsmanship at all times so that intercollegiate athletics as a whole, their institutions and they, as individuals, represent the honor and dignity of fair play and the generally recognized high standards associated with wholesome competitive sports.

tional income?⁶⁰ That inherently difficult question is the crux of the new IRS Guidelines, and one issue this paper will attempt to unravel. After all, the Guidelines directly state that "[s]ome of this outside income may, in fact, be derived from the institution or its facilities or from affiliated organizations."⁶¹ The implications of this notion are staggering for many reasons, but most importantly it comes down to this: if some of a coach's outside compensation, such as the income from shoe contracts, is deemed to be paid by the university, and if this total package is unreasonable, the

60. The idea of indirect compensation has arisen in other contexts besides that of a university and its coach. Most notable is the situation emanating from the National Football League which involved Deion Sanders and his decision to sign with the San Francisco 49ers. In the 1994 season, Sanders played 14 regular-season games with the 49ers for only \$1.13 million, with a \$750,000 bonus when the team won the Super Bowl. Ira Miller, *Deion's Decisions*, SPORTING NEWS, Feb. 20, 1995, at 23; see also WASH. POST, Feb. 17, 1995. According to Bob Dorfman's scouting report, "[t]he all-pro defensive back has plenty of marketing smarts—he took less money to play for a high visibility team with strong championship potential." John Flinn, *Somewhere Out There—The Next Wheaties Coverboy*, CHI. TRIB. Jan. 29, 1995, at 6. But did he really receive less money, or was the deal that Nike would cover the additional expenses necessary to get Sanders to sign so that the 49ers would remain beneath the salary cap?

The 49ers had a total salary cap allowance of \$32,985,000, and already had to make room underneath the cap by reworking the contracts of Ken Norton and Gary Plummer. Ken Denlinger, *This Cap Fits the 49ers Just Fine*, WASH. POST, Sept. 21, 1994, at D1, 5; see also Larry Weisman, *Planning Helps 49ers Sidestep Cap Hurdles*, USA TODAY, Jan. 18, 1995, at 5C. Obviously, at first glance, Sanders accepted a smaller contract with the 49ers than he was being offered elsewhere. Most significant was the \$17.1 million, four-year offer from the New Orleans Saints, who were ready to get rid of four players just to get Sanders to sign. Joseph A. Reaves, *Salary Cap—A Games-Breaker*, CHI. TRIB., Oct. 4, 1994, at 1. But complaints were filed by NFL teams, including the Saints, that the 49ers had to be cheating. Specifically, there were charges that "escalators in Sanders' endorsement contract would make up the difference for a lower paying deal with the 49ers." Ira Miller, *Deion's Decisions*, SPORTING NEWS, Feb. 20, 1995, at 23. League sources reported that "Sanders has told too many people he's going to get his money for him not to get it—somewhere." Ira Miller, *Saints are Fuming—Deion's Deal Angers Owner*, S.F. CHRON., Sept. 23, 1994, at E1. Many insisted that "Nike . . . is kicking in a couple of million dollars to make up the difference, believing its worth it to have Sanders' high profile in the large Bay Area market." *Id.* at E5.

The NFL looked into these claims and found nothing. Paul Tagliabue, the NFL Commissioner, emphatically approved Deion's contract. *Sanders' Contract Gets Final Approval*, OTTAWA CITIZEN, Sept. 24, 1994, at D6. Tagliabue said he had been assured that Sanders was not receiving supplemental money from Nike, and directly stated that "there is an absence of any linkage with any such organization" (referring to Nike). *Id.*

The truth is, how does anybody know that the shoe contract Deion received was not part of his original contract with San Francisco? The public will probably never know, but it is interesting to contemplate these indirect compensation arrangements and be able to recognize them when they arise.

61. Guidelines, *supra* note 12 Section 342.31(9).

university could be held in violation of the inurement proscription and could lose its tax-exempt status. With that in mind, it is necessary to consider what college coaches are actually receiving in terms of their compensation packages and examine these items within the context of the inurement rules.⁶²

College coaches have the potential to earn a lot of money. Some have fully realized this potential, season after season, and as a result are sometimes paid more than the university president.⁶³ Joe Paterno, the head football coach for Pennsylvania State University, once said, "What the hell's the matter with a society that offers a football coach a million dollars?"⁶⁴ The compensation is sometimes justified by the fact that coaching is a profession filled with enormous pressure to win and minimal job security if in fact this goal is not attained.⁶⁵ Whether or not coaches deserve high levels of compensation is not the issue; the relevant fact is that coaches are, in many instances, receiving them.

The incomes of university coaches vary widely.⁶⁶ One view of a typical compensation package, however, looks like this: \$130,000 salary from the university; \$230,000 for hosting summer camps; \$175,000 in shoe endorsement contracts; and \$175,000 from local radio and television shows.⁶⁷ Coaches also receive fees for speaking engagements and public or personal appearances. In addition, there are bonuses gained from conference or national championship titles⁶⁸ and "related perquisites such as housing, insurance

62. See *supra* pp. 7-13.

63. "The university-related income of [elite football and basketball] coaches often exceeds that of the college president by five times or more. See *supra* note 4. For example, the University of Illinois paid its head football coach, John Mackovic, who also doubled as athletic director, a total of \$229,950 in 1991, \$149,950 more than it was paying President Stanley Ikenberry. Ed Sherman, *University of Illinois Pays President Less Than Two Coaches*, CHI. TRIB., May 15, 1991 at 1.

64. Ray Yasser, *A Comprehensive Blueprint for the Reform of Intercollegiate Athletics*, 3 MARQ. SPORTS L.J. 123, *22 (1993).

65. There are several sources that discuss the pressures of the coaching profession and inability for college coaches to receive tenure. *Id.* See also Steven Poskanzer, *Spotlight on the Coaching Box: The Role of the Athletic Coach within the Academic Institution*, 16 J.C. & U.L. 1, 22-23 (1989).

66. The various statistics on coaches' compensation may not be exact, as the details of many of these actual figures are closely guarded. However, the author is using numbers based on sources that reported such information. The exactness of the numbers is not as important as the general idea that compensation to college coaches can be quite sizeable.

67. Weistart, *supra* note 4.

68. If a program wins a national championship, the coach can expect an additional \$300,000 or \$400,000 from endorsements, increased summer-camp attendance and speaking fees. *Id.*

premiums, membership in health and country clubs, financial gifts from alumni and boosters, . . . and the use or the gift of automobiles."⁶⁹

For purposes of this paper, the primary interest is the amount of income generated by coaches on behalf of shoe companies. Therefore, consider a few of the following compensation arrangements. For instance, Mike Krzyzewski, who coached Duke University to two consecutive NCAA championships, more affectionately known as "Coach K,"⁷⁰ is at the top end of the compensation spectrum. He signed a deal with Nike for a \$1 million bonus plus \$375,000 a year for the next fifteen years, totaling \$6.6 million over the life of the contract.⁷¹ In addition, Coach Krzyzewski received options on 200,000 shares of Nike.⁷² In 1993, University of North Carolina basketball coach Dean Smith switched over to Nike for "a \$1.7 million, four-year contract . . . after having endorsed Converse shoes for most of his 32-year career at Carolina."⁷³ Jerry Tarkanian, currently with Fresno State University, had a \$150,000 per year deal with Nike while at UNLV. Other Nike signers include the coaches of Georgetown, Wake Forest, Florida State, Georgia Tech, Temple, Purdue, Nebraska, Oklahoma State, and Southern Methodist.⁷⁴ Compensation packages with shoe companies other than Nike also reach considerable sums. For example, Bobby Knight, the basketball coach of the Indiana Hoosiers, contracted for \$200,000 annually from Adidas, while L.A. Gear was paying Dale Brown, LSU coach, \$300,000 a year.⁷⁵

Evidently, shoe contracts provide an enormous amount of money to the coaches. So where does the idea originate that this money could actually be deemed to be paid by the university? Perhaps it comes from the notion that any money the coach is generating by using his connection with the university should rightfully go to the school. After all, the coach is utilizing school assets, such as its goodwill and the value of its name, to get these contracts in the first place.⁷⁶ One might wonder why the school does not demand part of the income derived from these deals with shoe

69. SPORTS LAW PRACTICE, COLLEGE COACHING CONTRACTS §6.01 (6) at 454.

70. Rick Reilly, *That's Shoe Business*, SPORTS ILLUSTRATED, Apr. 26, 1993, at 76.

71. *Id.*

72. Elizabeth Comte, *Rich as Coaches*, Forbes, May 24, 1993 at 18.

73. Robert Lamme, *The Old Soft Shoe—Converse*, Business North Carolina, Apr. 1994 at 45.

74. See *supra* note 72.

75. SPORTS LAW PRACTICE, COLLEGE COACHES' CONTRACTS § 6.07(7)(c) at 507.

76. See *supra* note 64 at *23.

companies, or alternatively, what the university is getting in return for deciding to "forgo" this income and confer the benefit on coaches. The answer is not clear.

However, a perfectly logical explanation would be that the schools and the coaches realize that the assets, and therefore some of the profit, belong to the school, but have devised a system whereby both parties prosper. Under such a system, the school can avoid any participation in these contracts and have the money paid directly by the shoe companies to the individual coaches. Technically, the school is acting as a conduit through which the money indirectly flows, but the payments are treated as direct compensation to the coach in which the school has no part. Otherwise, the school would have to receive payment first from the endorsement companies, then disburse the money to the coach. This method would raise red flags of inurement from excessive compensation and embroil the school in taxing difficulties.

The current indirect form of compensation could become a problem should the Service decide to make it one. The Service may determine that the university reasonably could have demanded a certain sum as a result of the endorsement contract, yet purposefully chose not to do so; effectively, it could find that the school, in walking away from this potential income, has made an additional salary payment to its coach.⁷⁷

Such a finding by the Service would not be the first of its kind. In *Old Colony Trust Co. v. Commissioner*,⁷⁸ the Service was faced with the issue of how to treat payments of income taxes, *owed* by the employee, but *paid for* by the employer. In *Old Colony*, the American Woolen Company adopted a resolution whereby it agreed to "pay any and all income taxes, State and Federal, that [became] due and payable upon the salaries of all the officers of the company"⁷⁹ The resolution further provided that officers "shall receive their salaries or other compensation in full without deduction on account of income taxes"⁸⁰ William M. Wood, president of the company, was a natural recipient of this benefit. Pursuant to these resolutions, the company paid Mr. Wood's federal income tax and surtaxes owed on salary and commissions paid to him by the company for two consecutive years.⁸¹

77. See *supra* note 19, at 117.

78. 279 U.S. 716 (1929).

79. *Id.* at 719.

80. *Id.* at 720.

81. *Id.*

The Board of Tax Appeals found that these tax payments were actually additional income to Mr. Wood for those two years. On review, the Supreme Court was faced with the question of whether "the payment by the employer of the income taxes assessable against the employee constitute[d] additional taxable income to such employee."⁸² The Court held that, in fact, the payments constituted income to the employee. The logic provided by the Court was that the "payment of the tax by the employers was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor; *the form of the payment is expressly declared to make no difference.*"⁸³ The Court went on to say that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."⁸⁴ The situation presented in *Old Colony* is a perfect example of the way indirect value flows operate. Moreover, it is a lesson that the IRS will look at form over substance and not permit individuals or business entities to disguise forms of payment in an effort to achieve a desired tax consequence. Just as Mr. Wood in *Old Colony* was forced to recognize the tax payments as additional income, a similar argument could be made whereby a university would have to recognize money being paid to its coaches by the shoe companies.

An added factor that supports the theory of indirect compensation arrangements is that most universities do not take part in the negotiation of any contract between the shoe company and the coach. There are very few schools that have the athletic director or other officials entering directly into an agreement with a shoe company and then, in turn, compensating the individual coaches.⁸⁵ There have been explicit recommendations in this area

82. *Id.*

83. *Id.* at 729 (emphasis added).

84. *Id.*

85. In 1989, the University of Miami became the first institution to enter into a direct arrangement with Nike to provide shoes and apparel for all of its intercollegiate teams. The arrangement was reached between the athletic department and Nike, and the athletic director then compensated individual coaches. This deal was renewed in 1993. Larry Wahl, *The Shoe Fit*, THE SPORTING NEWS, Nov. 7, 1994. The second school to follow UM's example was the University of Southern California. *Id.*

Overall, there appears to be a growing trend in the area of direct school involvement. "In response to increased public scrutiny of the big-money deals between shoe manufacturers and coaches, and a reform movement in college sports intended to tighten institutions' control over their athletic programs, many shoe deals are no longer a coach's private affair." Blum, *supra* note 55. John Swofford, athletic director at the University of North Carolina at Chapel Hill, sees the trend as more of an overall "change in philosophy" and feels that these kind of shoe deals should be

by the Knight Foundation Commission on Intercollegiate Athletics (Knight Foundation), a panel of college presidents, business people, and lawmakers who set out to provide a blueprint for reforming college sports.⁸⁶ In its 1991 report,⁸⁷ the Knight Foundation called for a ban on shoe and equipment contracts with individual coaches.⁸⁸ The report said, "If a company is eager to have an institution's athletes using its product, it should approach the institution, not the coach."⁸⁹ Obviously, most schools disagree with the Knight Foundation and prefer a hands-off approach to these contract negotiations. This is a wise and sensible position for the schools to take; otherwise, such involvement by the school would provide additional ammunition for establishing a case of inurement due to indirect compensation.

In light of all the information presented, it seems that a strong argument could be made in favor of the IRS finding inurement to a university's athletic coaches. The framework for building this type of argument requires an initial finding that the money paid by the shoe companies to the coaches is actually income deemed to be paid by the university. Additionally, all aspects of the coaches' compensation package provided by the school must be evaluated against a reasonable compensation standard. If in fact the compensation is excessive, the Service can find that the earnings of the school have inured to the benefit of the individual coach and, thus, has grounds for revocation of the school's tax-exempt status.

In all fairness to the universities, the penalty of revocation does seem like a drastic measure; it would appear that this is a situation where the "punishment would not fit the crime," so to say. However, the law currently provides no other options given a finding of inurement. There have been proposals by the Treasury Department of "intermediate sanctions" that do give an alternative course of action.⁹⁰

part of a group effort and under institutional oversight. *Id.* UNC is expected to be the third school, behind Miami and USC, to enter into a program-wide deal. *Id.*

86. Blum, *supra* note 55.

87. The Knight Foundation Commission Report on Intercollegiate Athletics was entitled "Keeping Faith With the Student Athlete: A New Model for Intercollegiate Athletics," Mar. 8, 1991.

88. Blum, *see supra* note 57.

89. *Id.* (citing the Knight Foundation Commission Report, *supra* note 87).

90. *See generally* Robert A. Boisture and Milton Cerny, *Treasury Proposes Intermediate Sanctions on Public Charities and Section 501(c)(4) Organizations*, EXEMPT ORG. TAX REV., Vol. 9, No. 4 (Apr. 1994).

Under the Treasury proposal, sanctions would apply to transactions in which "insiders" receive "excess benefits."⁹¹ "Excess benefits" are defined as either payments of unreasonable compensation or non-fair-market-value sales, leases, or other exchange transactions in which the value of the benefit transferred to the insider exceeds the value of consideration received by the organization.⁹² Violations would trigger a first-level penalty tax on the insider and an obligation to correct the violation that, if not discharged within a specified period, would subject the insider to a much more severe second-level penalty tax.⁹³ This proposal would make it extremely difficult for the IRS to successfully challenge a compensation agreement negotiated with reasonable care and at arm's length by a charity.⁹⁴

The intermediate sanctions proposal has been well-received, since it would serve as a tool for the IRS to meaningfully enforce the law without having to resort to revoking an academic institution's exempt status. The final resolution of the proposal still remains to be seen.

CONCLUSION

In the Service's attempt to alleviate some of the difficulties of auditing universities and colleges, the Service has simultaneously tapped into some new and controversial issues as a result of its most recent Guidelines. Perhaps the Service will never reach the issues discussed in this article for fear of opening the proverbial "can of worms." After all, it is doubtful that the Service or the colleges will know how to undertake the multitude of problems that may result, or will even have the desire to implement the sanctions that are required. On the other hand, the Service may choose to tackle the possible hurdles raised by the Guidelines and, as a result, set in motion what very well could be the demise of the long-standing tradition of tax-exempt universities. Either way, only time will tell the outcome of this very significant issue.

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.*