THE FEDERAL TAX RAMIFICATIONS OF PAYING STUDENT-ATHLETES: HOW *O'BANNON V. NCAA* MAY BE COSTLIER THAN EVERYONE ENVISIONS

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INTRODUCTION

Nearly five years after collegiate athlete Ed O'Bannon initiated an antitrust class action lawsuit against the National Collegiate Athletic Association ("NCAA"), United States District Court Judge Claudia Wilken issued a 99-page opinion holding that the NCAA violated federal antitrust laws by adopting and enforcing the association's rules that prohibit any compensation to student-athletes.[1] The opinion embraced the concept that universities should be permitted to pay their respective student-athletes either by "allow[ing] schools to award stipends[] derived from specified sources of licensing revenue" or by "allow[ing] schools to deposit a share of licensing revenue into a trust fund for student-athletes which could be paid after the student-athletes graduate or leave school for other reasons."[2] Although the opinion does not stipulate exactly how much compensation student-athletes should receive, Judge Wilken uses $5,000 as the minimum amount universities must be free to set aside per student-athlete each year.[3]

The *O'Bannon* ruling poses numerous complications for the NCAA and its member universities. The direct complications include the Title IX ramifications and costs to universities, while the NCAA's larger, indirect concern is the deterioration of the amateur framework of collegiate athletics.[4] In its appeal to the Ninth Circuit, the NCAA estimates that the compensation

[1] O'Bannon v. Nat'l Collegiate Athletic Ass'n, 7 F.Supp.3d 955 (9th Cir. 2014).
[2] *Id.* at 982–84.
[3] *Id.* at 1008.
[4] NCAA bylaws place significant restrictions on student-athlete conduct which are designed to distinguish student-athletes from their professional counterparts. Among the more critical rules of the NCAA's amateurism framework is the prohibition on any student-athlete receiving compensation based on their athletic skills, whether such payment

model suggested by Judge Wilken will cost universities approximately $30,000 per athlete over four years, or $735,000 per year based on the 98 maximum scholarships permitted in mens basketball and football.[5] But the actual cost of Judge Wilken's proposals will ultimately be much higher than any of the parties envision.

I. THE INTERSECTION OF FEDERAL TAX LAW AND STUDENT-ATHLETES

Under § 117 of the Internal Revenue Code (the "Code"), a student can exclude any amount of a qualified scholarship from their gross income, which exempts scholarships from state and federal income taxation.[6] A "qualified scholarship" includes any funds for tuition, fees, books, and supplies.[7] The Treasury Department has promulgated several regulations concerning when money received from a university constitutes a qualified scholarship. Under Treasury Regulation § 1.117-4(c), any amount paid to a student to pursue individual studies or research constitutes a qualified scholarship only if the primary purpose is the furtherance of the student's education and training.[8] Any amount paid to a student as compensation for past, present, or future employment services, for services under the control of the university, or for studies or research for the primary benefit of the university do not qualify as scholarships, which means the recipient must include the benefit in their gross income.[9] On its face, the excludability of athletic scholarships from a student-athlete's gross income may seem questionable under such standards. However, in 1977 the Internal Revenue Service ("IRS") issued Revenue Ruling 77-263 which directly addressed the

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occurs while enrolled in school or is a promise to pay the student-athlete following their completion in intercollegiate athletics. NCAA, 2014–2015 Division I Manual, Bylaw 12.1.2 (2014).

[5] Brief for Appelant at 55, O'Bannon v. Nat'l Collegiate Athletic Ass'n, No. 14-16601 (9th Cir. Nov. 14, 2014).

[6] 26 U.S.C. § 117(a) (2012).

[7] 26 C.F.R. § 1.117–3 (2014); § Prop. Treas. Reg. 1.117-6.

[8] *Id.* at § 1.117–4(c).

[9] *Id.*

application of Code § 117 to student-athletes, specifically ruling that the value of athletic scholarships is excludable from the recipient's gross income.[10]

Revenue Ruling 77-263 was based on the application of the three most common tests for determining whether payments to students constitute qualified scholarships. The first test is the primary purpose test. This analysis requires a determination whether the primary purpose of the payments are to further the student's education and training, in which case the payments are exempt from taxation, or whether the primary purpose of the payments are actually to serve the interests of the university.[11] The second test, the quid pro quo test, comes from the Supreme Court opinion in *Bingler v. Johnson*,[12] where the Court interpreted the term qualified scholarships as meaning "relatively disinterested, 'no-strings' educational grants, with no requirement of any substantial quid pro quo from the recipients." The quid pro quo test asks whether the institution provides the benefits for the recipient's past, present, or future services. In such a case, the quid pro quo nature of the relationship dictates that the payments are not excludable from the student's gross income. Lastly, courts may apply the control test in determining whether a university's payments to a student constitute a qualified scholarship. Under the control test, the key inquiry is whether the student is "under the excessive control or supervision" of university.[13]

While the IRS has not addressed the excludability of athletic scholarships since Revenue Ruling 77-263, the ruling has attracted considerable criticism.[14] First, the Ruling was justified, at least in part, by the finding that "athletic scholarships are awarded by the agency of the university

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[10] Rev. Rul. 77-263 (1977).
[11] "Amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity . . . ."
[12] 394 U.S. 741, 751 (1969).
[13] 26 C.F.R. § 1.117–4(c) (2014).
[14] *See generally* Michael Schinner, *Touchdowns and Taxes: Are Athletic Scholarships Merely Disguised Compensation?*, 8 AM. J. TAX POL'Y 127 (1990).

that is responsible for awarding scholarships to students in general."[15] While that may have been true in 1977, there is little question who is responsible for awarding athletic scholarships today: the athletic department and the head coaches of the respective teams. In addition, it is the university athletic departments that typically fund the athletic scholarship, not the university department that is responsible for need-based and academic-based grants.[16]

The second questionable finding in the Ruling is that athletic-scholarships are "not cancelled in the event the student cannot participate."[17] In reality, athletic-scholarships are merely one-year scholarships which are renewed each year in the discretion of the athletic department. If a student-athlete is unable to perform at the standards set by the coaches, the coach may simply choose not to renew the scholarship. The Revenue Ruling also rests on the faulty notion that "the university requires no particular activity of any of its scholarship recipients." In reality, a student-athlete enters into an athletic aid agreement or scholarship agreement with the university prior to enrolling in school. These agreements generally condition a student-athlete's scholarship on, among other things, compliance with all rules and policies of the athletic department and the particular team.[18] Because of this contractual relationship, if a student-athlete does not participate in required athletic activities like practices, games, strength and conditioning training programs, or team meetings, then the athletic department can terminate the student-athlete's scholarship.[19] In summation, while athletic scholarships have long been considered as qualified scholarships

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[15] Rev. Rul. 77-263 (1977).
[16] *See, e.g.*, UNIVERSITY OF WASHINGTON ATHLETIC DEPARTMENT, ENDOWMENT PROGRAM, *available at* http://gohuskies.com/pdf9/2561060.pdf (noting that the athletic department is responsible for funding all athletic scholarships).
[17] Rev. Rul. 77-263 (1977).
[18] *See, e.g.*, Example Athletic Aid Agreement, *available at* http://www.athleticscholarships.net/wp-content/uploads/2013/01/Example-Athletic-Aid-Agreement.pdf.
[19] *See* Taylor v. Wake Forest University, 16 S.E.2d 379 (N.C. Ct. App. 1972).

which are excludable from a student's gross income, the reasoning behind that determination is questionable at best.

II. The Federal Tax Ramifications of *O'Bannon*

Judge Wilken's opinion in *O'Bannon* held that universities must be allowed to pay student-athletes stipends derived from licensing revenue and to create "trust fund" accounts for student-athletes, using licensing revenue, which would be paid out after the student-athletes graduate or leave school for other reasons.[20] Each of these options will likely have significant federal tax ramifications.

A. Stipend Payments

The payment of stipends derived from licensing revenue to student-athletes would be subject to significant federal tax consequences. First, the IRS will likely consider the stipend payments as non-scholarship income which must be included in the student-athlete's gross income and would, therefore, be subject to state and federal income taxes. Judge Wilken's opinion expressly describes the stipend payments as "compensation" for the use of the student-athletes' names, images, and likenesses.[21] Any payments to a student for use of their name, image, and likeness would not be payments for tuition, fees, books, and supplies and, thus, would not be excludable from the student's gross income as qualified scholarships.[22]

An even worse situation for both student-athletes and universities occurs if the Code treats the stipend payments as compensation for services. Under § 61 of the Code, a taxpayer's gross income includes any compensation for services received during the year.[23] A characterization as compensation for services will create potential payroll tax liability in addition to state and federal

[20] O'Bannon v. Nat'l Collegiate Athletic Ass'c., 7 F.Supp.3d 955, 982–84 (9th Cir. 2014).
[21] *Id.* at 1008.
[22] 26 C.F.R. § 1.117–3 (2014); Prop. Treas. Reg. § 1.117-6.
[23] 26 U.S.C. § 61(a)(1) (2012).

income tax liability. Under the Federal Insurance Contributions Act ("FICA"), both employees and employers are each taxed 7.65% of wages, which in turn funds social security and Medicare entitlements.[24] This treatment would subject both the university and student-athlete to combined FICA taxes of 15.3%. Using the opinion's proposed $5,000 minimum,[25] universities which used the 98 maximum total allowed scholarships for men's basketball and FBS football would incur $37,485 a year in FICA taxes. Universities would likely assert that payments to student-athletes are exempt from FICA taxes under Code § 3121(b)(10), which excludes from taxation any wages paid by a university to a student enrolled and regularly attending classes at the university.[26] However, the Treasury Department regulations cast some doubt on whether student-athletes would qualify as students eligible for the exemption. Specifically, the regulations stipulate that a student is considered a full-time employee not eligible for the exclusion if their normal work schedule is 40 hours or more per week.[27] In a challenge to the regulations, the Supreme Court held that medical students enrolled in a residency program do not qualify for the exclusion.[28] The NCAA and its member institutions would likely point to NCAA rules which limit a student-athlete's participation to twenty hours per week.[29] Those NCAA rules, however, count any competition and associated activities as three hours, regardless of how long the competition actually lasts.[30] The rules also do not count any time associated with medical treatment and rehabilitation, travel to and from events, or voluntary sport-related activities.[31] In addition, a survey conducted by the NCAA in 2011 revealed that participants in men's basketball and FBS football spent more than 39

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[24] *Id.* at § 3121.
[25] O'Bannon, 7 F.Supp.3d 955, 1008 (9th Cir. 2014).
[26] 26 U.S.C. § 3121(b)(10) (2012).
[27] 26 C.F.R. § 31.3121(b)(10)-2(d)(3)(iii) (2014).
[28] Mayo Foundation for Medical Educ. and Research v. United States, 562 U.S. 44 (2011).
[29] NCAA, 2014–2015 Division I Manual, Bylaw 17.1.7.1 (2014).
[30] *Id.* at 17.1.7.3.2.
[31] *Id.* at 17.02.1 (2014).

hours and 43 hours per week, respectively, on athletic activities.[32] Thus, it is conceivable that universities and student-athletes would be subject to FICA taxes on any stipend payments made by universities to student-athletes.[33]

The student-athletes and universities may be able to avoid FICA taxes by characterizing the payments as royalties, which are not considered wages subject to FICA taxes.[34] The payments may still ultimately be subject to the self-employment tax, however. Whether royalty payments are taxable self-employment income turns on whether the individual is engaged in the trade or business the royalties are derived from.[35] The fact that student-athletes would be receiving the stipend payments each year they participate on the team supports the notion that the royalties are part of an ongoing course of conduct, which will subject the payments to self-employment tax liability. That would allow the universities to escape the additional FICA tax liability while making the student-athletes responsible for the entire 15.3% FICA tax rate on income from self-employment.

The foremost threat for both student-athletes and universities is an IRS election to use the occasion for a reexamination of the tax treatment of athletic scholarships resulting in a conclusion that athletic scholarships are not within Code § 117. The determination of whether a payment is excludable from the recipient's gross income as a qualified scholarship is a fact specific question, determined on a case-by-case basis.[36] The university's payments of stipends may be a key fact

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[32] EXAMINING THE STUDENT-ATHLETE EXPERIENCE THROUGH THE NCAA GOALS AND SCORE STUDENTS (Jan. 13, 2011), *available at* http://www.ncaa.org/sites/default/files/%E2%80%A2Examining%20the%20Student-Athlete%20Experience%20Through%20the%20NCAA%20GOALS%20and%20SCORE%20Studies.pdf.

[33] Because the universities that participate in FBS football and Division I basketball are tax-exempt organizations under the tax code, they would avoid incurring unemployment tax liability under the Federal Unemployment Tax Act. 26 U.S.C. § 3306(c)(6)(B) (2012).

[34] *Id.* at § 3121.

[35] 26 C.F.R. § 1.1402(a)–1 (2014).

[36] Bingler v. Johnson, 394 U.S. 741, 751 (1969) (noting that "case-by-case determinations regarding grantors' motives" are necessary).

which, in combination with the already questionable nature of athletic scholarships,[37] shifts the IRS stance towards a determination that the university's relationship with student-athletes is more analogous to an employment relationship. At a minimum, the possibility the IRS revisits whether athletic-scholarships are qualified scholarships should significantly concern universities. Since Revenue Ruling 77-263 ruled that athletic scholarships constituted qualified scholarships, the commercial success of intercollegiate athletics has exploded. For example, in 2010, the broadcasting rights for the NCAA basketball tournament sold for more than $11 billion over a fourteen-year term,[38] a substantial increase from the less than $50 million, three-year deal the NCAA signed in 1982,[39] while ESPN paid $5.64 billion for the rights to broadcast the first College Football Playoff.[40] Such significant commercial implications suggest that the primary purpose of athletic scholarships is to benefit the universities through increased exposure and revenues, rather than to aid the student-athlete's educational development.

B. Trust Accounts

The second proposal embraced in the district court's opinion in *O'Bannon* was the creation of trust accounts for each student-athlete. Like the stipend payments, the payments to the trust accounts would be subject to federal tax implications, specifically as deferred compensation. Under the quid pro quo test, the trust fund payments exemplify compensation for past services

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[37] *See supra* Part I.
[38] Thomas O'Toole, *NCAA Reaches 14-Year Deal with CBS/Turner for Men's Basketball Tournament, Which Expands to 68 Teams for Now*, USA TODAY, Apr. 22, 2010, http://content.usatoday.com/communities/campusrivalry/post/2010/04/ncaa-reaches-14-year-deal-with-cbsturner/1#.VPNVTPmjPMw.
[39] Gary Jacobson, *Inside the Final Four finances: The march toward $1 billion in revenue*, DALL. MORNING NEWS, Apr. 3, 2014, http://www.dallasnews.com/sports/college-sports/ncaa-tournament/the-scene/20140403-inside-final-four-finances-cuban-ncaa-tournament-won-t-get-fat-like-nfl.ece.
[40] Rachel Bachman, *ESPN Strikes Deal for College Football Playoff*, WALL ST. J., Nov. 21, 2012, http://www.wsj.com/articles/SB10001424127887324851704578133223970790516.

performed by the student-athlete and thus would not be part of a qualified scholarship excludable from the student-athletes' gross income.[41]

The tax ramifications of the trust accounts would depend on whether they constituted qualified or nonqualified deferred compensation. If the trust accounts were treated as deferred compensation, the student-athletes would not be required to recognize any income until the trust funds vested, meaning trust funds were not subject to a substantial risk of forfeiture.[42] Under § 457 of the Code, the universities may be able to establish the trust funds as a qualified deferred compensation plan. In order for student-athletes to be eligible for a deferred compensation plan, they must be categorized as either employees or independent contractors.[43] This categorization would create FICA or self-employment tax liability. Under such a scenario the deposited funds could be invested with any return-on-investment accruing tax-free, though the student-athletes would still be required to recognize any withdrawals from the trust accounts as part of their gross income.[44] The deferred compensation plan approach under § 457 would allow the student-athletes to take withdrawals from the plan upon their severance from the university, subject only to income taxation on the amount withdrawn, or a student-athlete could keep the funds in the § 457, where they would accumulate tax-free until withdrawal. However, the student-athletes would not have the option to rollover the deferred compensation plan into a new retirement account after graduation, unless the transfer was to another § 457 tax-exempt organization plan.[45]

Alternatively, if the trust funds constituted nonqualified plans, the student-athletes would be required to recognize the payments into their respective trust fund accounts as income each

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[41] *See* Bingler v. Johnson, 394 U.S. 741, 751 (1969).
[42] 26 U.S.C. § 457(f)(3)(B) (2012).
[43] *Id.* at § 457(e)(2).
[44] DEP'T OF TREASURY, IRS PUB. 4484, PLAN FEATURE COMPARISON CHART (2015).
[45] *Id.*

year.[46] This could create complications for student-athletes as they would face the potential of owing taxes to the IRS without having actual possession of the income to use towards the related tax payments. If the purpose of *O'Bannon* is to provide compensation to student-athletes, it would be an undesirable outcome for any student-athlete to incur tax liability, and potentially fines and interest penalties, as a result of trust accounts that fail to meet qualified deferred compensation requirements.

CONCLUSION

While the final outcome from *O'Bannon* depends on the appeals process and the ultimate decisions of the NCAA and its member universities, the decision creates the potential for significant federal tax consequences. If a university elects to provide student-athletes with stipend payments, those payments will likely be taxable. While the upfront payments may seem desirable to student-athletes, there is a substantial risk that the payments could be considered wages subject to employment taxes or royalties subject to self-employment taxes, which would diminish the ultimate benefit the student-athletes receive. If a university elects to establish trust fund accounts for student-athletes, then those accounts will likely result in tax liability for the student-athlete each year, despite not having access to those funds until they graduate or, alternatively, imposition of FICA taxes on the payments.

[46] 26 U.S.C. § 457(f) (2012).