NCAA Revenue Pooling: Wading into Tax Uncertainty?

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. The authors of this column are Paul DePasquale, Partner, Baker & McKenzie, New York, NY, paul.depasquale@bakermckenzie.com; Mathew Slootsky, Associate, Baker & McKenzie, Miami, FL, mathew.slootsky@bakermckenzie.com; and Sade Oseni, 3L Student at SMU Dedman School of Law, University Park, Texas. Readers are invited to write to the editors: Richard M. Lipton, Senior Counsel, Baker McKenzie, Dallas, Texas, richard.lipton@bakermckenzie.com; Samuel P. Grilli, Partner, Baker & McKenzie, Chicago, Illinois, samuel.grilli@bakermckenzie.com; and Anne G. Batter, Partner, Baker & McKenzie, Washington, DC, anne.batter@bakermckenzie.com.

Revenue sharing in college sports has never been closer to reality. In a new world of revenue sharing between schools and student athletes, how will the relationship between the school and the student athlete be treated for tax purposes?

The NCAA and the Power Five[1] athletics conferences agreed to a landmark settlement with student athletes. The proposed settlement covers the lead case, *House v. NCAA*, and two other cases. If approved, student athletes would get $2.8 billion in monetary damages. The monetary damages include damages for student athletes who were denied compensation for use of their names, images, and likenesses ("NIL") and for athletic services from June 15, 2016, through November 3, 2023. The settlement would pave the way for an unprecedented revenue sharing framework that would allow NCAA Division I schools to share up to 22% of athletic program revenues with student athletes. Universities should design program guidelines to minimize tax uncertainty to benefit the school and the student athletes.

The relationship between the school and the student athlete is at the core of college sports. Rapidly changing legal and business aspects of that relationship force schools to confront novel tax issues - starting with, what will the relationship be for tax purposes?

WADING INTO THE POOL

The *House* settlement would allow Division 1 schools to share up to 22% of the Power Five[2] schools's average athletic revenues each year (the "Pool" amount). This would also apply to non-Power Five schools. All Division 1 schools could pay up to the Pool amount even though the Pool amount is based on the average shared revenue of the Power Five schools.

The Pool amount would include revenue from ticket sales, participation in away games, media rights, NCAA distributions, conference distributions (non-media and non-football bowl), conference distributions of football bowl generated revenue, royalties, licensing, advertisement and sponsorships, and football bowl revenues. Under the terms of the proposed settlement, the Pool would increase 4% each year and the average would be recalculated every three years.

The Pool benefits would be over and above any benefits that NCAA rules currently allow schools to provide, such as scholarships. The Pool benefits would also be in addition to any permitted third-party benefits, such as third-party NIL payments.

The Pool would last for ten years starting from the academic year following the court's approval of the settlement. The parties submitted the settlement agreement to the Northern District of California on July 26, 2024, and Judge Wilken held a fairness hearing for the settlement on September 5, 2024. Judge Wilken did not preliminarily approve the settlement but the parties will be working on a revised settlement. If the court approves the settlement by the end of 2024, the Pool could be in effect for August 2025.

Schools can decide whether to offer Pool benefits. It is not mandatory. But the decision to offer Pool benefits will have major consequences for the schools, student athletes, and the overall competitive landscape of college sports. The 2024-2025 College Football Season features an expanded 12-team playoff for the first time. The expanded playoff will increase both revenues and competition. Whether and how a school offers Pool benefits will play into both. How will schools that do not offer Pool benefits be affected by these changes? Might smaller schools feel pressure to take financial risks that could have long-term consequences?

The potential for complex new relationships between student athletes and schools is here. When it comes to tax, the first question is how those relationships should be treated for tax purposes.

DOES THE POOL CREATE A PARTNERSHIP FOR TAX PURPOSES?

Whether an arrangement gives rise to a partnership for tax purposes is a question of federal tax law. A joint undertaking can give rise to a separate entity for federal tax purposes. This may be the tax result even if there is no separate legal entity. A joint venture or contractual arrangement can give rise to a separate entity for tax purposes if the participants carry on a trade or business, financial operation or venture and divide the profits.

In *Commissioner v. Tower*, the Supreme Court said that a partnership is created "when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses."[3] The Court looked to whether the partners really intended to join together to carry on a business and share in the profits and losses or both. In *Commissioner v. Culbertson*, the Court required that the partners in good faith and with a business purpose intend to join in the present conduct of a business enterprise.[4] In *Culbertson*, the Court emphasized that the parties must have an intent to share net profits.

A school and its student athletes should not be considered partners in a partnership solely because the school shares Pool revenues with the student. Revenue sharing arrangements have some characteristics of a partnership. The school and the student athlete are both contributing to the activity that generates the revenue. However, revenue sharing based on the Pool lacks several key features of a tax partnership.

The revenue inputs to the Pool calculation in general are gross revenue numbers and not profits or losses. There are no expenses charged to the student athletes that would reduce the amount the student athletes are allocated. In both *Tower* and *Culbertson*, the sharing of profits and losses were necessary for a partnership to exist. In the Pool as proposed, there is only an intent to share gross revenues. Sharing gross revenues should not create a tax partnership and it does not alone create the kind of economic relationship that springs a tax partnership. Furthermore, the Pool would not entail joint ownership of any contributed assets and would not be a mechanism to share losses. As such, we would expect minimal risk of the Pool creating a partnership for tax purposes. The details of the Pooling arrangement should still be closely analyzed in this regard.

There is also a question whether college sports are even a business enterprise. The commercial opportunities associated with college sports are undeniable and growing. However, the fundamental nature of the athletic function remains tied to the educational function of the university. This is evident in schools generally not treating most revenues from athletic programs as unrelated business taxable income.

AVOIDING PARTNERSHIP FORMATION

There has been an exponential increase in the number of students using the transfer portal to change schools. The NCAA reports that 13,025 Division I athletes entered the transfer portal in 2023, which was a 32% increase from 2021.[5] The increased use of the transfer portal is a part of the evolving NIL and player landscape in college sports. These numbers make accounting and reporting for revenue sharing as a partnership for tax particularly difficult.

If revenue sharing created a partnership for tax purposes, issuing Schedule K-1s to student athlete-partners would be cumbersome considering the rate and number of transfers. Auditing such partnerships would be difficult for the same reason. Under the centralized audit regime, an audit would take place at the partnership level. If student athletes were considered partners with the schools, it would be difficult to implement the audit regime in light of transfers and graduations. Cumbersome reporting, however, does not preclude a tax result if that is what the law provides.

If the Pool creates a tax partnership there would be potentially adverse tax consequences beyond just the reporting. A partnership is subject to Subchapter K rules which have far-ranging tax consequences that affect trade or business determination (and partner filing requirements), character, holding period, and special loss provisions. Thus, avoiding unintended partnership status is generally desirable.

Schools offering benefits to student athletes based on the Pool framework should design their programs to reduce the risk of creating a tax partnership. They can do so by creating programs where the school keeps full control over income and capital. Benefit programs should clearly reflect the intent of the schools to avoid creating a partnership. Programs should give student athletes a clear understanding of the benefits they may receive. This should involve guidelines and proactive communication with student athletes and other stakeholders. Student athletes should not have a proprietary interest in any net profits. They should not have rights to withdraw funds from the program and should not have input on business decisions beyond the field of play. The program guidelines should reinforce that Pool-based benefit programs are not partnerships for tax purposes and are not sharing of any net profits or losses.

ARE STUDENT ATHLETES EMPLOYEES?

If student athletes are not partners, are they employees of the school? This question has significant tax and non-tax implications. The full implications of employee status are beyond the scope of this article. The Pool is not the only (or even the deciding) factor in whether a student athlete is an employee of the school for tax purposes. But the size of potential Pool payments and new ways of compensating student athletes puts this question at the center of the discussion.

If student athletes are employees, schools would be subject to W-2 reporting obligations. In such case, schools would have to report cash wages and taxable fringe benefits, withhold and remit Federal and state income taxes and the employee share of FICA taxes, as well as pay employer FICA and FUTA taxes. Common law determines whether an individual is an employee. This determination depends on the degree of control that the employer has over the worker. In February 2024, a National Labor Relations Board Regional Director ruled that members of the Dartmouth men's basketball team were employees of the college under the National Labor Relations Act because the college had the right to control their work and because they worked for compensation.[6]

The College Athlete Right to Organize Act (the "CARO Act") has been introduced in Congress to clarify the student athlete and school relationship for purposes of the National Labor Relations Act.[7] The CARO Act provides that a student athlete is an employee of a school if "(A) the individual receives any form of direct compensation, including grant-in-aid, from the institution of higher education; and (B) any terms or conditions of such compensation require participation in an intercollegiate sport."[8] The CARO Act specifically provides that it would not cause the student athlete to be an employee for tax purposes and would not a affect the tax treatment of qualified scholarships.

The IRS has also expressed in a letter to a senator that the NLRB's decision regarding employee status of Northwestern University football players does not control for tax purposes.[9]

The CARO Act suggests that it does not intend to change the tax consequences for student athletes under current law. Congress appears not to intend for student athletes to be taxable on their academic and room and board, etc. scholarships. It would be more helpful if legislation affirmatively provided that student athletes are not employees for purposes of the Code or that, even if they are treated as employees for some tax purposes, that the academic, as well as the room and board, scholarships they receive will not be treated as taxable wage income.

What are schools paying student athletes for through the Pool framework? Where the school is receiving royalties and payments with respect to broadcasting contracts, those payments are not payments for services but are arguably payments in exchange for IP rights owned by the school. Where the student athlete receives an amount calculated by reference to such payment, the student athlete perhaps should be viewed as getting an NIL payment rather than a payment for services. This further suggests that the student athlete is not an employee; although, this would require clearly establishing that the payment has a character other than a wage.

Professional sports franchises pay professional athletes for services per their player contracts. Those contracts are complex legal arrangements involving professional services. The player contract provides the levers of control which characterize the employment relationship. There is no corollary to the player contract in college sports, even under the Pool framework. However, a contract is not needed for an employment relationship to exist.

UNIVERSITIES MUST CONSIDER TAX CONSEQUENCES IN THE RAPIDLY CHANGING STUDENT ATHLETE LANDSCAPE

With *House v. NCAA* on path to settlement and a busy NCAA athletic calendar, legislative fixes may not be as immediate or comprehensive as desired to reduce the uncertainties discussed. Universities should consider and proactively address tax matters in designing revenue sharing arrangements to avoid undesired tax consequences.

End Notes

[1] The Power Five athletic conferences are the ACC, the Big Ten, the Big 12, the Pac-12, and the SEC.

[2] Including Notre Dame.

[3] *Commissioner v. Tower*, 327 U.S. 280 (1946).

[4] *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

[5] https://www.ncaa.org/sports/2022/4/25/transfer-portal-data-division-i-student-athlete-transfer-trends.aspx

[6] *Trustees of Dartmouth College*, Case 01-RC-325633 (NLRB) (Feb. 5, 2024) (Decision and Direction of Election), https://apps.nlrb.gov/link/document.aspx/09031d4583c5ebe4 (last accessed September 1, 2024).

[7] S. 3415, 118th Cong. (2023); H.R. 6616, 118th Cong. (2023).

[8] *Id.* § 3(2).

[9] IRS Information Letter 2014-0016, 2014 WL 2958209 (June 27, 2014).