National Collegiate Athletic Ass'n v. Commissioner, 92 T. C. 456 (1989)

Income from advertising sales in event programs by a tax-exempt organization is subject to unrelated business income tax if the organization, directly or through an agent, regularly carries on such sales.

Summary

The NCAA contracted with Lexington Productions to sell advertising in its Men's Division 1 Basketball Championship Tournament programs. The key issue was whether this income constituted unrelated business taxable income. The Tax Court held that it did because the advertising sales were regularly carried on through an agent, and the income did not qualify as a royalty. The decision underscores that tax-exempt organizations must carefully structure their income-generating activities to avoid unrelated business income tax, particularly when engaging agents to perform these activities.

Facts

The National Collegiate Athletic Association (NCAA) annually sponsors the Men's Division 1 Basketball Championship Tournament, which includes publishing game programs with commercial advertisements. In 1982, the NCAA contracted with Lexington Productions, a division of Jim Host & Associates, Inc. , as its exclusive agent to sell advertising for the tournament programs. The contract stipulated that Lexington would use its best efforts to secure advertising and that the NCAA would receive either $50,000 or 51% of net revenues from program and advertising sales, whichever was greater. The NCAA had minimal involvement in the actual sale of advertising but retained the right to approve all advertisements.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the NCAA's federal income tax for 1982, asserting that the income from program advertising was unrelated business taxable income. The NCAA petitioned the Tax Court for a redetermination of this deficiency. The court found in favor of the Commissioner, ruling that the income was indeed taxable and did not qualify as a royalty.

Issue(s)

1. Whether the income received by the NCAA from the sale of program advertising constituted unrelated business taxable income under section 512?
2. Whether such income, if deemed unrelated business taxable income, was excludable from tax as a royalty under section 512(b)(2)?

Holding

1. Yes, because the NCAA, through its agent Lexington Productions, regularly

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carried on the sale of advertising, making the income subject to unrelated business income tax.
2. No, because the income was not passive and did not constitute a royalty under section 512(b)(2).

Court’s Reasoning

The court applied a three-pronged test to determine if the income was unrelated business taxable income: (1) it must be income from a trade or business, (2) such trade or business must be regularly carried on, and (3) the conduct of the trade or business must not be substantially related to the organization’s exempt functions. The court found that the NCAA’s income met the first and third prongs, and the second prong was satisfied because Lexington Productions, as the NCAA’s agent, regularly conducted the advertising sales. The court emphasized that the nature of the relationship between the NCAA and Lexington was an agency relationship, not merely a passive licensing arrangement, thus the income did not qualify as a royalty. The court also noted the absence of evidence regarding the extent of Lexington’s activities, which led to the conclusion that the NCAA had not disproven regular conduct of the advertising business. The court referenced prior cases and regulations to support its interpretation of “regularly carried on” and “royalty” under the tax code.

Practical Implications

This decision impacts how tax-exempt organizations structure their income-generating activities, particularly when using agents to sell advertising. It clarifies that such activities can be deemed “regularly carried on” even if conducted through an agent, subjecting the income to unrelated business income tax. Legal practitioners advising tax-exempt entities must ensure that advertising sales are structured to avoid regular conduct or are incidental to exempt activities to minimize tax exposure. The ruling also affects how organizations classify income as royalties, requiring a genuinely passive role for such classification. Subsequent cases have cited this decision when analyzing the tax implications of advertising income for non-profits. Organizations must closely monitor their involvement and control over agents to maintain their tax-exempt status effectively.

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