I. UBIT: ROYALTY INCOME AND MAILING LISTS

by
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1. Introduction

Undertakings between exempt organizations and for-profits to sell goods and services, such as magazines, insurance, and credit cards, to the membership are commonplace today.

Exempt organizations provide a ready market for sellers. The exempt organization's members constitute a segmented market with generally known characteristics such as average income, consumer preferences, and the like. In addition, the explicit or tacit endorsement by the exempt organization of the products to be sold or services to be provided has influence with the members who have chosen to affiliate with the organization.

Coinciding with this surge in so-called "affinity" fundraising has been a growth in the number of transactions whereby some exempt organizations have attempted to characterize all, or most of such unrelated business taxable income from advertising, insurance services, or mailing lists as excludable royalty income.

This article is an update of past articles on royalty income that were printed in the 1989 and 1993 CPE texts. The article will review the royalty modification in computing unrelated business taxable income under IRC 512(b)(2) and discuss recent developments.

2. Code and Regulations

IRC 512(b)(2) excludes from unrelated business taxable income:

> [A]ll royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with that income.

The term "royalties" is not defined in either the Internal Revenue Code or the regulations. Reg. 1.512(b)-1 provides that whether a particular item of income falls within any of the modifications provided in IRC 512(b) (which includes "royalties") shall be determined by all the facts and circumstances of each case.

The regulation illustrates this point with the following example:

> [I]f a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment is not within the modification for rents.

A similar conclusion would be reached under the same facts in the example if the payment were termed a "royalty." The issue of whether income under certain types of arrangements constitutes a "royalty" has been the subject of revenue rulings and court decisions.

3. What a Royalty Is

Rev. Rul. 81-178, 1981-2 C.B. 135, holds that payments an exempt labor organization receives from various business enterprises (involving the organization's efforts to license its member professional athletes' names) for the use of the organization's trademark, trade name, service mark, or copyright, whether or not payments are based on the use made of such property, are classified as royalties for federal tax purposes. The revenue ruling states:

> To be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes.

The ruling also noted that, although excluded from UBIT as a royalty, the income from the licensing activity was income from unrelated trade or business since the licensing agreements did not directly promote the group's exempt purposes.

G.C.M. 38083 (September 11, 1979) describes an IRC 501(c)(3) organization whose purpose is to encourage support for, and participation in international athletic competition. The organization entered into an agreement with a marketing firm to commercially exploit its logo and identifying language. The marketing firm arranged with corporations to make payments of cash and equipment to the organization in return for the use of the name and logo. In some of the agreements, corporations also obtained the right to place advertisements in the organization's publications and/or the right to promotional assistance such as

tickets to be used as prizes. The G.C.M. concludes that the payments are income from an unrelated trade or business, but are excluded from UBIT under the royalty exception. Noting that the value of the organization's name and logo in a commercial context derives from the performance of its team (the fielding of the team being the conduct of the organization's exempt function), the G.C.M. states:

> When payments under a licensing agreement are properly defined as royalties, the section 512(b)(2) exclusion is operative whether or not the business activity involves exploitation of an exempt purpose. G.C.M. 38083 at pg. 15 (citing G.C.M. 37416 (February 14, 1978)).

The G.C.M. concludes, however, that the payments attributable to advertising in the organization's program are income from unrelated trade or business and are not excludable as royalties.

G.C.M. 38997 (June 10, 1983) involves a similar situation. The organization described, exempt under IRC 501(c)(4), was formed for the purpose of sponsoring, planning, and conducting an international sports competition in a city. To finance the games, the organization entered into a number of "sponsorship agreements" whereby corporations were granted the right to the organization's official mark and symbols in return for cash or payments in kind. The agreements imposed a number of obligations on the corporations designed to assist the organization in fulfilling its exempt purpose and conducting the games. The G.C.M. held that the obligations were merely additional consideration for the use of the name and logo and did not promote an exempt purpose. The G.C.M. concluded that the income was from unrelated trade or business, but was, however, excluded from UBIT as royalty income under IRC 512(b)(2).

4. What a Royalty is Not

A. Compensation for Services

Royalty treatment will often be precluded where there is an element of personal services performed in return for the "royalty."

One of the two license agreements described in Rev. Rul. 81-178, supra, required the organization, through its members, to endorse products or services in personal appearances and interviews. The ruling held that royalties do not include payments for personal services.

The Service takes the position that provision of a relatively minimal degree of services by the exempt organization will bar royalty treatment of the resulting income. For example, in PLR 93-06-030 (February 12, 1993), the IRS revoked a prior ruling and held that an organization was "directly and extensively involved" in an insurance program where it published advertisements for the insurance company in its magazine, granted the company access to its members once, and permitted representatives of the insurance company to attend its board meetings and meet informally with members.

B. Insurance Services

In National Water Well Ass'n, Inc. v. Commissioner, 92 T.C. 75 (1989), the Tax Court addressed the application of IRC 512(b)(2) to insurance plans sponsored by exempt organizations. National Water Well Association's insurance program in certain respects closely resembled the programs sponsored by the organization in United States v. American Bar Endowment, 477 U.S. 105, 110, n.1 (1988) (organization was engaged in an unrelated trade or business, as defined in IRC 513(c), because its insurance program ". . . was entered into with the dominant hope and intent of realizing a profit;" the organization selected the insurance carriers, negotiated the premiums for the group policies, held the group policies, maintained a membership list, solicited members to purchase insurance, administered the group insurance program, and netted substantial profits.)

The organization in National Water Well Ass'n provided its membership list to the insurance company, endorsed, promoted, advertised, and administered the program, and agreed to deal exclusively with one insurance company. The Tax Court held:

> These extensive services performed by petitioner demonstrate that petitioner played an active role in the insurance program. The income petitioner received was not passive income but more akin to compensation for services rendered and so was not royalty income.

In G.C.M. 39827 (August 20, 1990), Chief Counsel agreed with the revocation of a letter ruling (PLR 88-28-011 (March 31, 1988)) that had held income from the licensing of an organization's name and logo to an insurance company for the promotion of an insurance plan to its members constituted "royalties" as defined in IRC 512(b)(2).

The organization's group insurance plan consisted of five agreements under

which the organization delegated various tasks: 1) Agent Agreement: a for-profit corporation was appointed as exclusive agent to design, analyze, and recommend life insurance plans to the organization, and negotiate and implement the plans with insurance companies; 2) Administration Agreement: the same for-profit corporation was given responsibility for promoting the insurance plan, collecting premiums, keeping records, and processing claims; 3) Group Insurance Trust: a contract was entered into with a bank to hold, as trustee, the group life insurance policy, retain any experience rating refunds and dividends, and apply such to member refunds or to defray expenses; 4) Retention and Premium Stabilization Agreement: the insurance company provided a fund to stabilize premiums for the benefit of insured members; 5) Licensing Agreement: the organization agreed to permit the insurance company the use of its name and logo, to rent a mailing list to the company, and to provide assistance in promoting the plan to members.

The G.C.M. held that amounts received by the organization from the insurance plan were not "royalties" within the meaning of IRC 512(b)(2). The G.C.M. found that the organization was "directly and extensively involved" in the plan by publishing advertisements, granting access to members, and cooperating in the promotion of the plan including endorsing the plan in a president's letter to members, providing a mailing list, permitting the use of its name and logo, and reserving the right to determine the types of plans offered. Citing Rev. Rul. 81-178 and National Water Well Ass'n, the G.C.M. held the payments to be consideration for services, not royalties.

Furthermore, citing National Collegiate Athletic Ass'n v. Commissioner, 92 T.C. 456 (1989), rev'd on other grounds, 914 F.2d 1417 (10th Cir. 1990) [discussed below], the G.C.M. attributed the activity of the agents to the organization, giving more weight to its holding that the income was compensation for services.

Finally, the G.C.M. noted evidence that the agreement for the use of the name and logo was linked to the providing of the mailing list: charges for the name and logo were based on the number of times the mailing list was used, and terminating the mailing list lease automatically terminated the licensing agreement (but not vice versa). The G.C.M. also noted that because payments for the use of the organization's name and logo were "contingent upon and inseparable from" payments for the use of the organization's mailing list, the entire transaction was governed by IRC 513(h)(1)(B) and, hence, constituted unrelated business taxable income.

C. Advertising

Often, exempt organizations will attempt to characterize income from advertising in membership magazines prepared jointly with independent publishers as "royalty" income for tax purposes. (See, e.g., recent PLRs 93-09-002 (March 15, 1993) and 92-47-001 (November 20, 1992)).

Usually, it will develop that the organization, in fact, plays an active role in publishing the magazine, such as writing articles, or performing administrative tasks including accepting advertising payments. Also, the third party publisher, because of the ultimate control resting with the organization, may be the agent of the organization; in that event, the publishing activity is attributed to the organization.

In Fraternal Order of Police, Ill. State Troopers, Lodge No. 41 v. Commissioner, 87 T.C. 747, (1986), aff'd, 833 F.2d 717 (7th Cir. 1987), the Tax Court looked at an exempt organization's "royalty" income from a publisher of its membership magazine based on a percentage of the gross advertising revenues collected. The Appeals Court affirmed the Tax Court holding that the organization took an active, not passive role. The court noted the organization controlled editorial content, appointed the executive editor, wrote articles, and oversaw and controlled ad solicitations, bank accounts, and reprints. The court concluded the income was advertising income, not royalties.

National Collegiate Athletic Ass'n v. Commissioner, supra, concerned a case wherein the NCAA contracted with a publisher, as its exclusive agent, to sell advertising in NCAA's tournament programs, subject to NCAA's right to approve all advertising. The Tax Court held that the relationship between the publisher and NCAA manifested two elements of agency: the publisher was authorized to act on behalf of NCAA, and NCAA could control the publisher's actions. The activities of the publisher were attributable to NCAA. Thus, NCAA, through its agent, engaged in an unrelated trade or business, in this case, the sale of advertising. Hence, the payments to NCAA were in consideration of advertising services and not royalty income excludable from UBTI. On appeal, the 10th Circuit reversed the Tax Court, holding that the income was not UBTI because the activity was not regularly carried on. The appeals court stated that NCAA's involvement in the sale of advertising was not "sufficiently long-lasting" to make it a regularly carried on trade or business. Since the appeals court based its holding on the regularly carried on test, the 10th Circuit did not address the Tax Court's decision on the royalty income issue.

D. Mailing Lists

Generally, income from the sale or rental of mailing lists is subject to unrelated business income tax, and does not fall within the modifications under IRC 512(b), including the royalty exception.

Rev. Rul. 72-431, 1972-2 C.B. 281, holds that the regular sale of membership mailing lists by an exempt organization constitutes unrelated trade or business under IRC 513. The ruling reasons that the sale of the membership list constitutes the exploitation of an intangible resulting from the group's exempt function under Reg. 1.513-1(d)(4)(iv).

In Disabled American Veterans v. United States, 650 F.2d, 1178 (Ct. Cl. 1981) (hereinafter, DAV I), the Court of Claims considered an organization's practice of renting names on its mailing list to both tax-exempt and commercial organizations. The court held that the rental of the organization's donor list constituted a trade or business that is regularly carried on and that is not substantially related to the accomplishment of its tax-exempt purposes. Furthermore, the court held, the organization's receipts from the rental of its mailing list cannot be classified as "royalties" as that term is used in IRC 512(b)(2). The court stated:

> DAV's list rentals are the product of extensive business activity by DAV and do not fit within the types of "passive" income set forth in section 512(b). The "royalties" there referenced are those which constitute passive income, such as the compensation paid by a licensee to the licensor for the use of the licensor's patented invention . . . For the same reason that personal property rentals constituting unrelated business income are taxable, it is concluded that DAV's receipts from the rental of its mailing list cannot be classified as "royalties" as that term is used in section 512(b)(2) of the Code. Rather, DAV's list rental income constitutes UBTI pursuant to sections 511-513 of the Code.

Following the DAV I decision, Congress enacted a special exception to unrelated trade or business for certain exchanges and rentals of mailing lists by charities and veterans organizations. IRC 513(h)(1)(B) provides that for exempt organizations eligible to receive tax deductible contributions under IRC 170(c)(2) or (3), "unrelated trade or business" does not include exchanging or renting donor

or membership lists with or to other such organizations.

Based on the legislative history, the Service has taken the position that through its enactment of IRC 513(h)(1)(B), Congress purposely acquiesced in the taxation of mailing list transactions that are not specifically within that statutory exception. See, e.g., G.C.M. 39638 (May 28, 1987); G.C.M. 39727 (April 28, 1988).

In G.C.M. 39727, Chief Counsel agreed with the revocation of a letter ruling (PLR 87-47-066 (August 28, 1987)) to an organization which had entered into an agreement with a bank to solicit its members for credit cards. The bank agreed to pay the organization amounts based upon the number of credit card applications, credit charges, and renewals. The organization agreed to provide a mailing list. The ruling which was revoked by PLR 88-23-109 (March 17, 1988) held that the transaction constituted a licensing agreement for the use of the mailing list, hence the royalty exception applied. The latter ruling and G.C.M. stated that income to an exempt organization from a third party from the use of its membership list constitutes UBIT, unless it meets the specific statutory exception of IRC 513(h)(1)(B).

In Disabled American Veterans v. Commissioner, 94 T.C. 60 (1990) (hereinafter DAV II), rev'd 942 F.2d 309 (6th Cir. 1991), the same issue looked at by the then Court of Claims (but for different tax years), was brought before the Tax Court which reached a different conclusion. The Tax Court, concluding that the payments received by DAV for use of its mailing list were made in exchange for the right to use intangible property, held that those payments were royalties and, therefore, were excludable from unrelated business taxable income under IRC 512(b)(2).

However, the U.S. Court of Appeals for the Sixth Circuit reversed the Tax Court's DAV II decision on collateral estoppel grounds. Technically, the appeals court made no decision on the merits of the case. However, in its opinion the court indicated support for the position on royalty income adopted by the Service. Furthermore, the concurring opinion supported the Service's "negative inference" argument holding that IRC 513(h)(1)(B) controls, and therefore requires taxation of the income from the mailing list transaction.

In Sierra Club, Inc. v. Commissioner, T.C.M. 1993-199, again the question was placed before the Tax Court as to whether an exempt organization is required to include in UBIT amounts received from renting mailing lists, or whether such

amounts are excludable as royalties.

5. Sierra Club Decision

A. The Holding

On May 10, 1993, the Tax Court issued a memorandum opinion, Sierra Club, Inc. v. Commissioner, supra, granting Sierra Club's request for summary judgment on the mailing list question.

The court followed its decision in DAV II, and held that since Sierra Club's mailing lists were intangible property, payments for use of the lists constituted royalty income within the meaning of IRC 512(b)(2) and, therefore, were excludable from the computation of unrelated business taxable income.

Citing its decision in DAV II, the court reaffirmed its reasoning:

> In [***DAV II***], this Court considered the meaning of the term "royalties," as used in section 512(b)(2). That case involved the proper classification (as section 512(b)(2) royalties or something else) of payments received by an organization described in section 501(c)(4) in consideration of that organization making available to others its donor list for limited use by such others. ***We accepted the conventional definition of the term "royalties:" "payments for the use of valuable intangible property rights***." [emphasis added] ***Id.*** at 70. ***Sierra Club***, slip opinion, at 8.

Also, as in DAV II, the Tax Court rejected the argument that IRC 512(b)(2) "royalties" include only income from passive sources. Likewise, the court made clear its belief that Congress did not intend to exclude from IRC 512(b)(2), royalties derived from carrying on a trade or business.

B. Facts

The Sierra Club ("SC"), an organization exempt under IRC 501(c)(4), was formed for the purpose of protecting and restoring the natural and human environment and promoting the responsible use of the earth's ecosystem.

During the years at issue, SC, as part of its fundraising activity, developed and maintained mailing lists composed of the names, addresses, and related

information regarding its members, donors, catalog purchasers, and other supporters. SC had exclusive ownership rights in the lists, including the right to all net income from the lists. SC updated and maintained the lists regularly.

In order to acquire names of prospective members and supporters, SC sometimes engaged in list exchanges with other organizations. SC also permitted other tax-exempt organizations and commercial entities to use its mailing list on a one-time basis for a fee, as set forth in its rate schedule. SC hired independent professional managers and brokers to oversee and administer the mailing list transactions with other organizations. SC also hired a computer service bureau to maintain the mailing list and fill orders for the list. SC retained the right to refuse any request for the mailing list, review any mailings to be sent by a list user, and approve the mailing schedule of the user.

During the three tax years in dispute, SC reported total gross income of more than $900,000 from customer use of its mailing lists.

C. Argument by the Government

The Government made two main arguments: 1) The legislative history of the unrelated business income tax indicates that only investment income was intended to be excluded as "royalty" income under IRC 512(b)(2), and 2) By the addition of the IRC 513(h)(1)(B) exception (which does not apply to IRC 501(c)(4) organizations such as SC) to the Code, Congress indicated it had always viewed income from the licensing of mailing lists as constituting UBTI, absent an explicit exemption.

Regarding the first argument, the Government noted passages in the legislative history of IRC 512(b)(2), including the following, which states:

> The tax on unrelated business income does not apply to dividends, interest, royalties, and rents . . .
>
> Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are 'passive' in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, ***investment-producing income*** of these types have [sic] long been recognized as a proper source of revenue for educational and charitable organizations and

trusts. [Emphasis added.]

S. Rep. No. 2375, 81st Cong. 2d Sess.; 1950-2 C.B. 483, 504-506; reprinted at 1950-2 C.B. 483, 504-506.

Secondly, the Government argued, Congress's addition of IRC 513(h)(1)(B) to the Code in 1986 provided further evidence as to its intent to tax all mailing list transactions, except those specifically exempted. (See above, Section 4.D, Mailing Lists.)

D. Tax Court Decision

The Tax Court rejected the Government's argument that the term "royalties" of IRC 512(b)(2) includes only "investment" income.

The court stated that the legislative history cited by the Government describing "royalties" (as well as dividends, interest, rents, capital gains and losses, etc.) as "investment-producing income," was ambiguous and susceptible to two readings:

(1) That royalties (and the other categories of income specifically set forth) ***intrinsically*** fail to encompass other than investment income [emphasis in original], and

(2) That an investment quality characterizes those royalties (and other items in the categories set forth) constituting the endowment of an educational or charitable organization or trust.

The court found the second reading more likely. Furthermore, there was other legislative history indicating Congressional committees did not mean to exclude from the range of UBTI modifications represented by dividends, royalties, interest, etc., items that were not strictly income from investments:

> All dividends, interest, annuities, and royalties, and the deductions directly connected therewith, are excluded from the concept of unrelated business net income. ***This exception applies not only to investment income, but also to such items as business interest on overdue open accounts receivables***. * * * [S. Rept. 2375, ***supra***, 1950-2 C.B. at 560; cf. H. Rept. 2139, ***supra***, 1950-2 C.B. at 459;

emphasis added.]

The court also rejected the Government's negative inference regarding IRC 513(h)(1)(B). Citing language from the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986 stating that "no inference" was intended by Congress's enactment of the IRC 513 exception to UBIT, the court concluded that Congress did not intend to express a view on the prior state of the law.

Nevertheless, the Tax Court left open other "lines of attack" to reach situations involving abuse of the royalty exception. Citing its other decisions in National Collegiate Athletic Ass'n v. Commissioner (advertising revenues are not royalties); National Water Well Ass'n, Inc. v. Commissioner (payments of compensation for services are not royalties); and Fraternal Order of Police, Ill. State Troopers, Lodge No. 41 v. Commissioner (advertising revenues are not royalties), the court stated: "[w]e made it clear that we could distinguish payments for the use of an intangible, which constitutes a royalty, from payments for advertising, compensation for services, or other profits masquerading as royalties." Sierra Club, slip opinion, at 9-10, citing DAV II, at 77.

Furthermore, the Tax Court indicated its willingness to bifurcate the transaction and consider other income-generating activities that are conducted simultaneously with the activity generating the royalty income. In the Sierra Club case, the Tax Court granted only partial summary judgment on the royalty issue, leaving for trial two questions: whether some of the income was derived from: 1) the "sale of media" (i.e. sale of goods, such as the mailing labels, as opposed to intangible rights), and 2) the sale of substantial services in connection with the rental of the mailing lists.

At the time this article was being prepared, the Tax Court's opinion was being closely reviewed, and no decision had been made concerning what the Government's next step might be.