V. ROYALTIES AND EXPLOITATION INCOME: AN UNRELATED TRADE OR BUSINESS INCOME MODIFICATION

Introduction

In the performance of its exempt function an exempt organization may develop valuable intangible property such as a membership list, a distinctive logo or insignia, general good will, or a reputation for excellence or expertise in a specific field. Such intangible property may be used or exploited to generate income for the organization. Such income shall be referred to as "exploitation income" in this discussion.

IRC 511(a)(1) imposes a tax on the unrelated business taxable income of certain exempt organizations.

IRC 512(a) defines "unrelated business taxable income" as "gross income derived by any organization from any unrelated trade or business (as defined in IRC 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b)."

IRC 513(a) defines "unrelated trade or business" as "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501...."

IRC 512(b)(2) modified IRC 512(a) by excluding from unrelated business taxable income "all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property...."

Regs. 1.512(b)-1 provides that, "Whether a particular item of income falls within any of the modifications provided in IRC 512(b) shall be determined by all the facts and circumstances of each case."

Regs. 1.513-1(d)(4)(iv) provides that commercial activities of an exempt organization which exploit good will or other intangibles generated by performance of exempt functions will be unrelated trade or business unless the

commercial activities themselves contribute importantly to the accomplishment of an exempt purpose.

"Exploitation income" may be nontaxable under IRC 511(a)(1) because the activities of the exempt organization contribute importantly to the accomplishment of an exempt purpose and thus constitute related trade or business. Regs. 1.513-1(d)(4)(iv).

Assuming that the activity constituting exploitation of an intangible is not related trade or business, the income generated may nonetheless be nontaxable on the basis that such income constitutes royalties under IRC 512(b)(2). The following discussion will concern the applicability of the royalties modification under IRC 512(b)(2) to activities constituting exploitation of an intangible. No mention will be made of situations where the royalties are generated by the exploitation of tangible property, such as timber or oil and gas deposits.

1. Definition of Royalties

Neither IRC 512(b)(2) nor the regulations under the section is that "the words of statutes -- including revenue acts -- should be interpreted where possible in their ordinary, everyday senses." Malat v. Riddel, 383 U.S. 569 (1966). In the Malat case, the Supreme Court went on to limit this general rule by observing that "departure from a literal reading of statutory language may, on occasion, be indicated by relevant internal evidence of the statute itself and necessary in order to effect the legislative purpose." A careful examination of IRC 512(b)(2) and its legislative history does not reveal any substantial basis for interpreting the term "royalties" other than its "ordinary, everyday" sense.

The term "royalties" is generally defined as being the share of his property. See Webster's Third New International Dictionary, 1982 (1961), Commissioner v. Clarion Oil Co., 148 F. 2d 671, 673 (D.C. Cir. 1945), and Black's Law Dictionary, 1496 (4th ed. 1968). Given these definitions, a workable meaning of "royalty" for purposes of IRC 512(b)(2) would be composed of two elements: to be a royalty, a payment first, must relate to the use of a valuable right, and second, must be measured in some manner by the use which is made of that right.

2. Legal Rationales Precluding Characterization of Income as Royalties

a. Compensation for Services

Income received by an exempt organization does not constitute royalties within the meaning of IRC 512(b)(2) if such income is compensation for services rather than for the use of the organization's good will or other intangible property.

Product endorsements provide a good example of the above principle. The income received by a scientific organization from endorsements of laboratory equipment does not constitute royalties if the term "endorsement" refers to personal appearances by the organization's employees in television commercials. The income may be royalties if the endorsement is simply a stamp on each item of equipment showing the organization's approval of the capabilities of the equipment.

Rev. Rul. 78-43, 1978-1 C.B. 164, and Rev. Rul. 73-193, 1973-1 C.B. 262, describe situations where the exempt organization is being compensated for the performance of services and the income received is therefore not royalties.

Rev. Rul. 78-43, 1978-1 C.B. 164, concerns an organization whose basis for exemption under IRC 501(c)(3) is the promotion of education by assisting a university, both financially and otherwise, and their immediate families. Under this program the organization works with various travel agencies in planning package tours, mails out promotional brochures to its members, and receives reservations. Each travel agency it uses pays it a per person fee. The promotional brochures may, in effect, constitute endorsements of the travel agencies by the exempt organization. While income from endorsements may be royalties, as was noted above, the organization in the Ruling is not merely endorsing the travel agencies but is also performing extensive services (planning tours, mailing out promotional brochures, and receiving reservations) and the fees received are in large measure compensation for such services.

Rev. Rul. 73-193, 1973-1 C.B. 262, concerns an organization whose basis for exemption under IRC 501(c)(3) is the making of grants for scientific research. The organization performs extensive services for individual inventors and the institutions they are associated with. Such services include evaluating ideas for inventions, obtaining patents, and licensing patents to industrial firms. The crucial fact in the Ruling is that the organization has bare legal title to the inventions while the individual inventors and the institutions are the beneficial owners. The organization collects royalties from the licensees and is entitled to keep agreed upon amounts for itself after making payments to the beneficial owners. The Ruling holds that the amounts earned by the organization represent compensation for services and are therefore not royalties, notwithstanding the fact that the

amounts collected by the organization may constitute royalties, since paid by licensees for the use of patents.

b. Amounts Paid to Exempt Organization as Partner or Joint Venturer with For-Profit Business

Income received by an exempt organization does not constitute royalties within the meaning of IRC 512(b)(2) if the organization is a partner or joint venturer engaging in business with a for-profit entity. See Lemp Brewing Company v. Commissioner, 18 T.C. 586 (1952), acq. 1952-2 C.B. 2, which holds that the retention of quality control rights by a licensor in a licensing agreement situation does not indicate a joint venture relationship and does not cause payments to the licensor to lose their characterization as royalties.

Apart from the royalties issue, there is a significance to the presence of a partnership or joint venture relationship between an organization and a for-profit entity. Such a relationship tends to be incompatible with exemption under section 501(c)(3), since the very nature of a partnership is such that the organization's activities may promote the private interests of the other partner, a for-profit entity. Also, a private foundation's holdings in a partnership constituting a "business enterprise" may constitute excess business holdings under IRC 4943(c).

c. Income From Sales

Income received by an exempt organization does not constitute royalties if the organization has sold rather than licensed or leased intangible property. This principle follows from the definition of royalties as payments to the owner of property for the right to use or exploit such property. If the exempt organization has sold property then it is no longer the owner of such property and the payments it receives are not payments to the owner but rather proceeds from the sales.

The issue of sale versus lease or license arises frequently, because the proceeds from a sale may be capital gain income while income under a lease or license is ordinary income referred to as rent or royalties. Rev. Rul. 60-226, 1960-1 C.B. 26, holds that the consideration received by a proprietor of a copyright for a grant transferring the exclusive right to exploit the copyrighted work in a medium of publication throughout the life of the copyright, is treated as proceeds from the sale of property rather than rents or royalties, regardless of whether the consideration received is measured by a percentage of the receipts from the sale, performance, exhibition, or publication of the copyrighted work, or whether such

receipts are payable over a period generally conterminous with the grantee's use of the copyrighted work. Though not stated, the rationale for this holding probably is that in transferring the exclusive right to exploit the copyrighted work in a given medium of publication throughout the life of the copyright, the grantor has transferred a substantial property interest separable from the other property interests not transferred, namely the transferor's rights in the work with respect to other media of publication. Thus, the transferee must be regarded as the owner of a property interest rather than one who merely has the right to use another's property.

The significance of Rev. Rul. 60-226 is that a transaction may be a sale even though the manner in which the payments are measured is more characteristic of a lease or license. This Revenue Ruling modifies Rev. Rul. 54-409, 1954-2 C.B. 174, which implies that the consideration received by the proprietor of a copyright for a grant of the exclusive right to exploit the copyrighted work in a medium of publication is to be treated as proceeds from a sale of property only if the consideration is not measured by the publication, use, or sale of the copyrighted work, and is not payable over a period generally conterminous with the grantee's use of the copyrighted work.

While the proceeds from a sale of intangible property cannot be excluded from the unrelated business taxable income computation as royalties under IRC 512(b)(2), such sales proceeds may be excludable under IRC 512(b)(5), which excludes all gains or losses from the sale, exchange, or other disposition of property other than --

(a) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(b) property held primarily for sale to customers in the ordinary course of the trade or business.

d. Income Measured Other Than By Use Made of Property Right Granted

Income received by an exempt organization does not constitute royalties within the meaning of IRC 512(b)(2) if the payments to the exempt organization are not measured in some manner by the use which is made of the property right granted. This principle is implicit within the definition of royalties given above and is in accord with the language of IRC 512(b) referring to royalties as being measured "by production or by gross or taxable income from the property."

Payments in this form may be royalties but will not be royalties if the transaction is a sale, as indicated in the discussion above of Rev. Rul. 60-226, 1960-1 C.B. 26, and Rev. Rul. 54-409, 1954-2 C.B. 174. To put the matter simply, a certain form of payments is required if the payments are to be regarded as royalties but will not guarantee their being characterized as royalties.

The above principle will be illustrated in a Revenue Ruling concerning flat sum payments received by an exempt organization under a licensing agreement granting authorized parties the right to use the organization's name and logo in connection with the advertising and sale of specific products. The proposed Revenue Ruling holds that the payments are not royalties because they are in the form of flat sums per year. They therefore do not meet the requirement of being related to the extent of the use made of the right granted to licensees.

3. Application of the Legal Rationales Discussed in 2. Above -- Cases Implicity Involving The Issue of Royalties

Three T:C Revenue Rulings raise the issue of royalties in the context of payments by a for-profit business to a charitable organization. The Rulings are concerned with the issue of characterizing the payments as business expenses under IRC 162 or charitable contributions under IRC 170 and do not characterize the income received by the charitable organizations. We shall speculate on the nature of such income in light of royalty characteristics discussed above.

a. In Rev. Rul. 72-314, 1972-1 C.B. 44, a stock brokerage firm paid six percent of all brokerage commissions to a charitable organization whose purpose was to reduce neighborhood tensions where the firm was located. The payments were made to compensate the charitable organization for giving the firm permission to advertise the fact that it was supporting the charitable organization through such payments. The Ruling holds that the payments are business expenses but does not characterize the payments as received by the charitable organization. These payments may likely constitute royalties because they are paid for the organization's good will and the right to use its name in connection with advertising and are measured by a percentage of sales.

b. Rev. Rul. 63-73, 1963-1 C.B. 35, concerns an agreement between a for-profit business and an organization described in IRC 170(c)(2). Under the agreement, the business is to pay the charitable organization a certain amount on each unit of a product manufactured by it for which a label is mailed to the organization by a purchaser of the product. In return for these payments, the

organization agrees to permit the use of its name in connection with the advertising and, through its president, undertakes to secure testimonial letters from prominent individuals for use in the campaign. The Ruling characterizes the payments as business expenses but does not characterize the income to the charitable organization. Such characterization is difficult, since the payments were both for the services of the organization's president and for the use of the organization's good will. Unless the payments for the good will were clearly separable and distinguishable from the payments for the services, all payments should likely be considered nonroyalty income. If such an allocation between payments for services and payments for good will could be made, then the payments for the good will could be considered royalties, since measured by sales.

c. In Rev. Rul. 54-3, 1954-1 C.B. 67, a newspaper publisher paid a portion of the subscription price on each sale to a charitable organization in return for being allowed to advertise the fact of such payments to potential subscribers. These facts appear to be legally indistinguishable from those of Rev. Rul. 72-314, 1972-1 C.B. 44, supra, and the income to the organization would probably constitute royalties, since paid for its good will and measured by sales.

4. Rulings Published Under Section 6110 of the Code

Section 6110(j)(3) of the Code provides that written determinations subject to disclosure may not be used or cited as precedent. However, such determinations may have value as illustrations of factual contexts where the issue of royalties may arise. For example, in Letter Ruling 7817002, dated December 30, 1977, the fee received by an exempt organization for allowing a nonexempt thrift store to use its name was held to constitute royalties under IRC 512(b)(2). Letter Ruling 7844030, dated August 7, 1978, and Letter Ruling 7841001, undated, give examples of situations where income received by an exempt organization from product endorsements was held to constitute royalty income.

5. Conclusion and Summary

a. Royalties under IRC 512(b)(2) are payments received by the owner of intangible property for the right to use or exploit such property measured in some manner by the use made of the property right granted.

b. "Exploitation income" described in Regs. 1.513-1(d)(4)(iv) may constitute royalties.

c. Income does not constitute royalties if -

(1) received as compensation for services,

(2) paid to an exempt organization having the status of partner or joint venturer with a for-profit business,

(3) derived from a sale of property rather than a lease or license (however, sales income may be excludable under IRC 512(b)(5)), or

(4) measured other than according to the use made of the property right granted.