Rev. Rul. 81-178, 1981-2 C.B. 135

Unrelated income; labor organization; endorsement of business products and services. Payments an exempt labor organization receives from various business enterprises for the use of the organization's trademark and similar properties are royalties within the meaning of section 512(b)(2) of the Code and are not taken into account in determining unrelated taxable income. However, payments the organization receives for personal appearances and interviews by its members are not royalties but are compensation for personal services and must be taken into account in computing the organization's unrelated business taxable income.

ISSUE

Is income received by the organizations in the two situations described below unrelated business taxable income within the meaning of section 512 of the Internal Revenue Code?

FACTS

Situation 1: The organization is exempt from federal income tax under section 501(c)(5) of the Code. Its purposes are to improve the economic and working conditions of its members, who are professional athletes. It engages primarily in activities in furtherance of these purposes.

The organization solicits and negotiates licensing agreements with various businesses. The licensing agreements authorize the businesses to use the organization's trademarks, trade names, service marks, copyrights, and members' names, photographs, likenesses, and facsimile signatures in connection with the distribution, sale, advertising, and promotion of merchandise or services offered by such businesses. Before entering into a licensing agreement permitting a business to use its members' names, photographs, likenesses, and facsimile signatures, the organization obtains a written authorization and assignment for such use from its members.

Under the terms of the agreements, the organization has the right to approve the quality or style of the licensed products and services. The agreements also require the businesses to refrain from engaging in any activity that would adversely affect the reputation of the organization or its members, or the value of the licensed products or services.

The income received by the organization from the agreements is based in some instances on a percentage of the gross sales of the licensed products or services, while in other cases the organization receives a flat sum each year. The organization uses this income to help defray operating expenses.

Situation 2: The facts are the same as in Situation 1 except

that the agreements with the businesses are concerned solely with endorsing the products and services offered by such enterprises. The agreements require personal appearances by and interviews with members of the organization in connection with the endorsed products and services.

All the income from the agreements is paid directly to the organization.

LAW AND ANALYSIS

Section 511 of the Code imposes a tax on the unrelated business taxable income of certain exempt organizations including those described in section 501(c)(5).

Section 512(a) of the Code defines the term 'unrelated business taxable income' as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 513(a) of the Code defines the term 'unrelated trade or business' as any trade or business the conduct of which is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its exempt purposes.

Section 1.513-1(b) of the Income Tax Regulations provides that for purposes of section 513 of the Code the term 'trade or business' has the same meaning it has in section 162 and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is related to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income); and that it is substantially related, for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 512(b)(2) of the Code provides that all royalties and all deductions directly connected with such income shall be excluded from the computations of section 512(a). Thus, royalties and directly connected deductions will not be taken into account in determining an organization's unrelated business

taxable income.

Section 1.512(b)-1 of the regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) of the Code shall be determined by all the facts and circumstances of each case.

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. See, Commissioner v. Affiliated Enterprises, Inc., 123 F.2d 665 (10th Cir. 1941), cert. den. 315 U.S. 812 (1942); Commissioner v. Wodehouse, 337 U.S. 369 (1949); Rohmer v. Commissioner, 153 F.2d 61 (2d Cir. 1946); and Sabatini v. Commissioner, 98 F.2d 753 (2d Cir. 1938). Similarly, payments for the use of a professional athlete's name, photograph, likeness, or facsimile signature are ordinarily characterized as royalties. See, generally, Cepeda v. Swift & Co., 415 F.2d 1205 (8th Cir. 1969); Uhlaender v. Henricksen, 316 F. Supp. 1277 (D. Minn. 1970). On the other hand, royalties do not include payments for personal services.

In Situation 1, the licensing agreements do not directly improve the economic and working conditions of the organization's members. Therefore, such activity has no causal relationship to the performance of the organization's exempt purposes and does not contribute importantly to the accomplishment of those purposes within the meaning of section 1.513-1(d)(2) of the regulations. Accordingly, the income received by the organization from the licensing agreements is gross income from unrelated trade or business within the meaning of section 513 of the Code. However, since the payments are for the use of the organization's trademarks, trade names, service marks, copyrights, and its members' names, photographs, likenesses, and facsimile signatures such payments are royalties within the meaning of section 512(b)(2). Consequently, neither the receipts derived from, nor the expenses incurred in, the licensing activity are to be taken into account in computing the organization's unrelated business taxable income.

The fact that the organization has the right to approve the quality or style of the licensed products and services does not change this result. The mere retention of quality control rights by a licensor in a licensing agreement situation does not cause payments to the licensor under the agreements to lose their characterization as royalties. See Lemp Brewing Company v. Commissioner, 18 T.C. 586 (1952), acq. 1952-2 C.B. 2, and Rev. Rul. 76-297, 1976-2 C.B. 178.

For the same reasons as in Situation 1, the income received by the organization in Situation 2 is gross income from unrelated trade or business within the meaning of section 513 of the Code. However, since the agreements in Situation 2 require the

personal services of the organization's members in connection with the endorsed products and services, the payments received by the organization are compensation for personal services and therefore are not royalties within the meaning of section 512(b)(2). Accordingly, the receipts derived from, and the expenses incurred in, the endorsement activity in Situation 2 must be taken into account in computing the organization's unrelated business taxable income.

HOLDINGS

Income received by the organization in Situation 1 from the businesses for the use of certain property of the exempt organization is gross income from unrelated trade or business under section 513 of the Code. However, such income is royalty income within the meaning of section 512(b)(2). Thus, neither the income, nor related expenses, are taken into account in computing the organization's unrelated business taxable income under section 512.

However, in Situation 2, the payments received by the exempt organization for the personal endorsements by its members of products or services of the businesses are payments for personal services and, thus, are not royalties under section 512(b)(2) of the Code. Such income, and related expenses, must be taken into account in computing the organization's unrelated business taxable income under section 512.