TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:
UIL: 512.01-01

LEGEND

Y =.
Unit =
Date "a" =

Dear :

We have considered your request for a ruling that the payments you expect to receive under a license agreement described below are royalties that are excluded from the definition of unrelated business income under section 512(b)(2) of the Internal Revenue Code.

FACTS

You are an unincorporated association of state entities, recognized as exempt under section 501(c)(3) of the Internal Revenue Code, and classified as a supporting organization pursuant to section 509(a)(3). You perform accounting, administrative, and other activities normally or previously performed by your members, and thereby lessen the burdens of state governments.

You have entered into a licensing agreement effective on Date "a" with a commercial enterprise, Y, allowing it to use certain intellectual property (or intangible assets) in return for payment. Certain names, themes and designs associated with your activities will be used in its commercial activity. However, you retain all right, title, and interest in the licensed property. (Section 10. Intellectual Property) The agreement gives you the right to review the designs and proposed uses of your intellectual property, and to inspect the facilities where the machines are manufactured, with some limitations. (Section 6 M. Inspection) Y must use "commercially

reasonable efforts to consult with you in the creation of the initial specifications and designs." (Section 6 A. Design Participation) Y must give you fifteen days to evaluate the completed design. Y must submit to you in writing all proposed uses of the property before using them in any commercial manner, and you have absolute discretion to reject the proposed uses. (Section 6.O Prior Approval) You also have the right to limit mass market advertising in any jurisdiction. (Section 6 N. Promotion)

The agreement forbids use of "any intellectual property that is confusingly similar" to your marks or otherwise infringes upon your property rights. (Section 6. B No Use of Confusingly Similar Marks) Y and its sub-licensees may not use the name in a manner that is likely to cause confusion, and must use commercially reasonable efforts to protect against such confusion by its customers. Each licensed product must have a notice that it is using the mark with your permission. If you cease using the property that is the subject of the agreement, Y has the option of continuing to use it or to begin exclusive use of your new property. (Section 6. E Continuation of Intellectual Property)

The agreement limits your participation in the activity. You are allowed to inspect the books and records related to the agreement, but you may only do so once per calendar year and upon the proffer of five days written notice. (Section 5. Audit) The agreement gives you only fifteen days to evaluate Y's design plans. You may only inspect the manufacturing facilities with prior written notice of ten business days and an executed confidentiality agreement, during regular business hours, and providing it does not unreasonably disrupt business.

Your revenue from the agreement is directly linked to Y's operation of units that display your intellectual property. (Section 4.D "Unit " Distribution and Compensation) You will receive advances that will be recoupable against actual royalties paid as certain numbers of units are sold or leased. Both the percentage of net revenue from leased units and the flat amount per unit sold increase with the number of units. For example, you earn 8% of the net daily revenue from the first 500 units operating on a fixed lease placement, but 20% of the revenue of the 3001st unit operating on such a basis. The agreement also provides for volume bonuses.

The proceeds from the agreement will be used to fund your operations and therefore reduce the allocations required from your members who are governmental entities.

LAW

Section 501(c)(3) of the Internal Revenue Code (the Code) exempts from federal income tax corporations organized and operated exclusively for charitable, educational, and other purposes, provided that no part of the net earnings inure to the benefit of any private shareholder or individual.

Section 511 of the Code provides that organizations recognized as exempt from federal income tax must pay tax on unrelated business income, as defined in section 512 of the Code.

Section 512 of the Code defines "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less the allowable deductions

that are directly connected to such trade or business. However, section 512(b)(2) modifies the term unrelated business taxable income by excluding, among other things, all royalties whether measured by production or by gross or taxable income from the property and all deductions directly connected with that income.

Section 513(a) of the Code defines "unrelated trade or business" as one which is not substantially related to the exercise or performance by an organization of its charitable, educational or other purposes or functions constituting the basis for its exemption under section 501(c)(3), with exceptions not here relevant.

Section 1.512(b)-1 of the Income Tax Regulations states that facts and circumstances will determine whether a particular item of income falls will fall within any of the modifications of section 512(b)(2) of the Code.

Rev. Rul. 81-178, 1981-2 C.B. 135, distinguished royalty income that is not subject to the tax on unrelated business income from compensation for services that is subject to the tax on unrelated business income. One organization was paid solely for the use of trademarks, trade names, copyrights, photographs, and facsimile signatures. The agreements setting the fees gave the organization the right to approve the quality and style of the licensed products, which did not change the character of the income as royalties. A second organization was compensated for active endorsement of products and services, including personal appearances and interviews by members of the organization. Such payment is compensation for services, and thus not within the royalty exception of Section 512(b)(2) of the Code.

The court in Sierra Club v. Commissioner, 86 F. 3d 1526 (9th Cir. 1996), aff'g T.C. Memo 1993-199 and rev'g on another issue 103 T.C. 307 (1994), thoroughly considered the definition of the term "royalties" as used in section 512(b) of the Code. It held that, in the context of section 512(b), royalties are defined as payments received for the right to use intangible property; and that a royalty is passive and cannot include payments for services rendered by the owner of the property.

The court in Oregon State University Alumni Association v. Comm., 193 F. 3d 1098 (9th Cir. 1999) asked whether the bank was paying the alumni associations for the good will associated with the schools' names, seals, colors, and logos or whether it was paying them for mailing list management and promotional services. The alumni associations provided mailing lists on magnetic tape. They spent perhaps 12 hours of clerical time per year, in addition to a meeting with the bank and did a little more promotion than required by the agreement. The bank paid them one percent of what members spent on their credit cards plus $4 to $7 for each new member and annual renewal. The court pointed out that the amount earned (between $223,566 and $357,998 depending upon the year and the organization) would have meant in excess of one million dollars in return for about fifty hours of mostly clerical work over the years at issue. The court thought it clear that the compensation was for the use of the property rights, not for the minimal services.

RATIONALE

As an organization recognized as exempt under section 501(c)(3) of the Code, you are exempt from federal income taxes on income that is related to your exempt purpose. Income resulting from a trade or business regularly carried on that is unrelated to your exempt purpose is potentially subject to tax under section 511. However, section 512(b) excludes royalty payments from taxation as unrelated business income, and thus an organization exempt under section 501(c)(3) does not pay federal income tax on royalty income.

The Service has long regarded as royalties the payment for licensing of trademarks, copyrights, photographs and similar intangible property. See Rev. Rul. 81-178, *supra.* Minimal services may accompany the licensing without changing its character. For example, an exempt organization may review and approve the quality or style of the products that are licensed. Rev. Rul. 81-178, Sierra Club, *supra.* However, personal appearances, endorsements, interviews or active participation in publication of a periodical are not considered passive or de minimus. The court in Sierra Club distinguished the regular renting of a mailing list supported by thousands of hours of time by the staff of the Disabled American Veterans devoted to maintaining the list, from the *de minimus* promotional activities of the Sierra Club staff. The allowable activities included approval of the bank's promotional material, a few telephone responses to members regarding problems with the program, and about fifty hours of mostly secretarial and clerical work over two years. Sierra Club, *supra.*

The licensing agreement that is the subject of this ruling request does not obligate you to an active role. You are not even required to continue using the intellectual property that is the subject matter of the agreement. You are permitted to review and approve or reject the proposed use of your trade and service marks, to evaluate design plans, and to inspect manufacturing facilities, under certain restrictions. As discussed above, retention of such quality control rights by the licensee does not change royalties into taxable revenue. The minimal review of the licensed activity afforded you by this agreement is clearly different than the personal appearances and interviews of Situation 2 in Rev. Rul. 81-178. It constitutes even less effort than the maintenance activities allowed by the court in Sierra Club.

In fact, the agreement limits your activities in several ways. You may only inspect books and records once per year, after five days of written notice and must give ten days notice to inspect manufacturing facilities. You only have fifteen days to evaluate completed designs.

However, the agreement protects your ownership of your intellectual property in many ways. It specifies that you retain all right, title, and interest. It gives you absolute discretion to reject proposed uses of the property, and forbids use of any property that is confusingly similar. Your licensee must display on every unit a notice that your mark is used with permission. You have the right to approve and to limit mass media advertising in any jurisdiction. These protections show that you tailored the licensing agreement very narrowly.

The financial terms of the agreement also support the view that you are being compensated for a passive licensing of intellectual property rather than for services that you perform. You are paid either a flat dollar amount per unit, or a percentage of the unit's revenue, depending upon whether the unit is sold, or the kind of lease under which it operates. You will receive volume bonuses. You and your licensee agree that its revenues will be increased by

use of your mark. Your compensation is linked to that expected increase. Like the organization analyzed in Oregon State, *supra*, the amount of money that you will realize from this agreement is vastly out of proportion with the time and effort that you will expend. It can only be compensation for the use of the intangible property.

RULING

Therefore, we conclude that the payments you expect to receive under the license agreement described above are royalties that are excluded from the definition of unrelated business income under section 512(b)(2) of the Internal Revenue Code.

This ruling is based on the understanding there will be no material changes in the facts upon which it is based.

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Lawrence M. Brauer
Acting Manager
Exempt Organizations
Technical Group 1

Enclosure
Notice 437