



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Identification Number:

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UIL:
501.03-08
512.01-01

Legend:

A =
B =
C =
D =
Publisher =
\$x =
\$y =

Dear _____ :

This letter is in reference to the letter from the authorized representative of A, in which A requested rulings that its sale of a half interest in its scholarly journal to a for-profit Publisher will not affect its Section 501(c)(3) exemption ruling, and that royalties and advertising income received by A will not constitute taxable unrelated business income.

A is a non-profit organization that has held a Section 501(c)(3) tax exemption ruling since 1976. A has about 700 members. It is an educational and literary organization whose principal aim is to honor, preserve, study and disseminate scholarship about the life and works of the author B. Its activities consist of educational conferences, a newsletter, a scholarly archive, and educational outreach. Its primary activity consists of publication of the scholarly journal, C.

Publisher wishes to purchase a half-interest in the A's scholarly journal C, and the publication D.

In return for such interest, Publisher would agree to pay to A on signing of the agreement the sum of \$x. Publisher and A would retain equal interests in the copyright and subsequent publication revenues. Publisher would provide C's editor with an annual stipend of \$y per year, and would publish and distribute the journal to all subscribers. In return, A will provide all journal content, make all editorial decisions, and provide Publisher with its list of subscribers.

Subscribers fall into two categories: institutions (primarily university libraries), and individuals. Institutions are not members of A, but individuals are. Publisher will manage all institutional subscriptions, set institutional subscription rates, and retain the revenues. A will manage all individual subscriptions, collect all individual dues, and pay Publisher \$25 per individual annually to compensate for publication and distribution costs.

Publisher will pay A a royalty of approximately 15 percent on revenues from institutional subscriptions. Publisher will also pay A a royalty of 25 percent on non-subscription revenue earned, including single and back issues sales, and rights and permissions to copy or republish. Publisher will also pay A a royalty of 25 percent on all advertising in the journal. A contemplates that it will conduct significant activities involved in generating such advertising revenues, although such revenues are contemplated to be de minimis.

None of the officers and directors of A has any financial interest in Publisher, and none is related to any officers or directors of Publisher. A has represented that the directors have performed due diligence in negotiating the proposed agreement with Publisher, and represent that they believe that the agreement represents a fair market value transaction.

LAW:

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

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions and modifications.

Section 512(b)(2) of the Code provides that there shall be excluded all royalties whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

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 such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the function constituting the basis of its exemption.

Section 513(c) of the Code provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(a) of the Income Tax Regulations provides that gross income of an exempt organization subject to tax imposed by section 511 of the Code is includable in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that, in general, any activity of an exempt organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162 of the Code is a trade or business for purposes of sections 511-513. Further, the term "trade or business" 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)(1) of the regulations provides that, in general, gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes; and it is "substantially related" only if the causal relationship is a substantial one. The regulation continues that for the conduct of 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.

Rev. Rul 81-178, 1981-2 C.B. 135, describes the treatment of income received by an organization in two situations. In the first situation, the organization is exempt from federal income tax under section 501(c)(5) of the Code. The organization engages primarily in activities in furtherance of these purposes. The organization also 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 in connection with distribution, sale, advertising, and promotion of merchandise or services offered by such businesses. 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 product. 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.

In the second situation set forth Rev. Rul. 81-178, *supra*, the facts are the same as in the first situation 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 income from the agreements is paid directly to the organization.

Under Rev. Rul. 98-15, 1998-1 C.B. 718, a section 501(c)(3) organization may form and participate in a partnership and meet the operational test of the statute if (1) participation in the partnership furthers a charitable or educational purpose, and (2) the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.

Rev. Rul. 2004-51, 2004-22 I.R.B. describes (1) whether an organization continues to qualify for exemption from federal income tax as an organization described in section 501(c)(3) of the Code when it contributes a portion of its assets to and conducts a portion of its activities through a limited liability company (LLC) formed with a for-profit corporation, and (2) whether the organization is subject to unrelated business income tax under section 511 on its distributive share of the LLC's income. The revenue ruling holds that when the facts establish that the activities conducted through the LLC are substantially related to the exercise and performance of the exempt organization, the exempt organization continues to qualify for exemption under section 501(c)(3) and is not subject to unrelated business income tax under section 511 on its distributive share of the LLC's income.

ANALYSIS:

In the past, A has conducted all of the operations in writing, publishing, and distributing its educational journal. Advertising revenues have been de minimis.

In order to more efficiently accomplish the publication and distribution of the journal, A proposes to enter into an agreement to sell a one-half interest in the journal to Publisher, a for profit corporation. Under the proposed agreement, A would receive a one-time payment of \$x for the one half interest; A would be responsible for virtually all editorial functions of the journal; and Publisher would be responsible for all printing and dissemination costs.

None of the officers and directors of A has any financial interest in Publisher, and none is related to any officers or directors of Publisher. A has represented that the directors have performed due diligence in negotiating the proposed agreement with Publisher, and represent that they believe that the agreement represents a fair market value transaction.

The sale and joint publication agreement is similar to a joint venture between A and Publisher. Under Rev. Rul. 98-15, 1998-1 C.B. 718, a section 501(c)(3) organization may form and participate in a partnership and meet the operational test of the statute if (1) participation in the partnership furthers a charitable or educational purpose, and (2) the partnership arrangement

permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.

In Rev. Rul 2004-51, 2004-22 I.R.B. (June 1, 2004), the Service applied this test and approved a joint venture where a large university provided educational material to a for-profit partner that disseminated the material through interactive video technology. However, in that case there was the additional fact that the partnership activity constituted only an insubstantial part of the exempt activities of the university. Here, by contrast, the publishing of the literary journal and the other activities under the agreement constitute a substantial part of the activities of A. We must then determine whether the agreement satisfies the two-part test of Rev. Rul. 98-15.

The activities under the agreement satisfy the first test, in that the agreement furthers the charitable educational purpose of A. A retains full control over the editorial content of the publications. It also receives compensation for the use of this content that is represented to constitute fair market value. The agreement allows A to concentrate on the core educational component of the journal and other publication, while leaving to the Publisher the conduct of the more mechanical aspects of publication and dissemination.

The activities under the agreement also satisfy the second part of the Rev. Rul 98-15 test. The agreement permits A to act exclusively in furtherance of its exempt purpose by creating the editorial content of the journal and the other publication. The Publisher's benefit is only incidental to this exempt purpose, giving it a negotiated share of the revenues as fair market compensation for the printing, publishing and dissemination services that it provides. Given the somewhat esoteric nature of the journal content, the limited demand for such material, and the due diligence negotiation for a fair market value agreement, there is realistically no way that the Publisher will obtain substantial monetary benefits.

The second issue is whether the royalties and advertising income that A will receive will constitute unrelated business taxable income. There is no question that the royalties and advertising activities constitute business that is regularly carried on. The only question is whether the advertising is substantially related to A's exempt purposes, and whether the royalties are excludable under section 512(b)(2).

It is acknowledged that A conducts all or most of the activities involved in soliciting and designing the advertising. There is no contention that the advertising is substantially related to A's exempt educational activities. Accordingly, under United States v. American College of Physicians, supra, the advertising income is taxable unrelated gross income.

By contrast, A receives the royalties—here approximately 15 percent of revenues from institutional subscriptions and 25 percent of revenues from non-subscription revenues, solely for use of its copyrighted materials. A performs no other services in return for such royalties. Under Section 512(b)(2) and Rev. Rul. 81-178, supra, such royalties are thus excluded from gross unrelated business income.

Accordingly, we rule that the sale of a half interest in the scholarly journal to Publisher will not affect A's exemption as an organization described in section 501(c)(3) of the Code, and that

royalties and advertising income received by A will not constitute taxable unrelated business income. This ruling takes no position on any other revenue that A may receive, either from Publisher or any other source.

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.

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

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.

Sincerely,

Mary Jo Salins
Acting Manager, Exempt Organizations
Technical Group 2

Enclosure
Notice 437