D. ROYALTIES

1. Introduction

From the enactment of the tax on unrelated business income in 1950 (the "Supplement U Tax"), the modification for royalties has been one of the cornerstones of this complex statutory scheme. The purpose of this topic is to provide a basic understanding of what royalties are, explain how the Service and the courts have interpreted and applied the royalty provision, and describe what changes are being considered with respect to royalties, as Congress continues its comprehensive review of the entire area of unrelated business taxable income. Issues as varied as oil, gas and mineral interests, patents, and credit cards will be discussed in the context of the applicability of the royalty exclusion.

2. Background

A. Code and Regulations

Under IRC 511 a tax is imposed on the unrelated business taxable income of most exempt organizations. The term "unrelated business taxable income" is defined in IRC 512(a)(1) as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less directly connected deductions. Both the unrelated trade or business and the directly connected deductions must be computed with the modifications contained in IRC 512(b).

The royalty modification is contained in IRC 512(b)(2), which excludes from the computation of unrelated business taxable income "...all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income." This modification is essentially the same as that contained initially in section 301 of the Revenue Act of 1950.

Other statutory provisions affecting the royalty modification can be found in IRC 512(b)(13), which discusses controlled organizations, and IRC 514, which discusses unrelated debt-financed income. Issues concerning controlled organizations under IRC 512(b)(13) and unrelated debt-financed income under IRC 514 are beyond the scope of this article, but both provisions have been the subject of previous CPE topics. See the 1987 CPE Text, Topic D, beginning at p. 52 for a discussion of controlled organizations; see also the 1986 CPE Text, Topic

N, beginning at p. 171 for a discussion of unrelated debt-financed income. In summary, the exclusion for royalty income is not available to an exempt organization, where such income is derived from a controlled organization, or from debt-financed property.

Reg. 1.512(b)-1 contains a general provision affecting all the modifications contained in IRC 512(b), including royalties. In general, the regulation provides that whether a particular item of income falls within any of the IRC 512(b) modifications must be determined by all the facts and circumstances of each case. An example given by the regulations is where 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 exempt organization or is a share of the profits retained by such organization as a partner or joint venturer. Under these circumstances, such payment is not within the modification for rents. The same conclusion would be reached if such payments were characterized as "royalties."

The specific regulatory provision that discusses royalties is found in Reg. 1.512(b)-1(b) and reads as follows:

> "Royalties, including overriding royalties, and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income. However, for taxable years beginning after December 31, 1969, certain royalties from, and certain deductions in connection with, either debt-financed property (as defined in section 514(b) or controlled organizations (as defined in paragraph (1) of this section) shall be included in computing unrelated business taxable income. Mineral royalties shall be excluded whether measured by production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded. To the extent not treated as a loan under section 636, payments in discharge of mineral production payments shall be treated in the same manner as royalty payments for the purpose of computing unrelated business taxable income. To the extent treated as a loan under section 636, the amount of any payment in discharge of a production payment which is the equivalent of interest shall be treated as interest for purposes of section 512(b)(1) and paragraph (a) of this section."

It should be noted that neither the Code nor the regulations provides an actual definition of the term "royalties." Such definition has been left to the courts and, in some instances, to the dictionary. For purposes of IRC 512(b)(2), probably the best definition of "royalties" can be found in Rev. Rul. 81-178, discussed below.

B. Revenue Rulings

1. Endorsements and Personal Appearances

Rev. Rul. 81-178, 1981-2 C.B. 135, describes two situations involving an IRC 501(c)(5) labor organization formed to improve the economic and working conditions of its members, who are professional athletes. In Situation 1, 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. Each of these things would be used by the businesses in connection with selling, promoting and advertising goods or services. The organization has the right to approve the quality or style of the licensed goods or services. Income from the agreements is sometimes based on a percentage of gross sales of the goods or services, while in other instances an annual flat fee is paid to the organization. In Situation 2, the agreements are concerned with endorsing products and services and require personal appearances by and interviews with the organization's members.

The revenue ruling contains the following significant statement with respect to royalties:

> "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."

This finding is supported by references to a number of court cases including Commissioner v. Affiliated Enterprises, Inc., 123 F.2d 665 (10th Cir. 1941) cert. den. 325 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). The revenue ruling also notes that payments for the use of a professional athlete's name, photograph, likeness or

facsimile signature are ordinarily characterized as royalties. See Cepeda v. Swift & Co., 415 F.2d 1205 (8th Cir. 1969) and Uhlaender v. Henricksen, 316 F. Supp. 1277 (D.C. Minn. 1970).

On the basis of these precedents, Rev. Rul. 81-178 holds that in Situation 1, since the payments from the licensing agreements are for the use of the organization's trademarks, trade names, service marks, copyrights, and its members' names, photographs, likenesses, and facsimile signatures, such amounts are royalties under IRC 512(b)(2). This conclusion is not altered by the organization's right to approve the quality or style of the licensed products and services, since the mere retention of quality control rights does not cause payments to lose their characterization as royalties. The revenue ruling also holds that in Situation 2, since the agreements require the personal services of the organization's members, the payments received are compensation for personal services and not royalties under IRC 512(b)(2).

2. Patents

Rev. Rul. 73-193, 1973-1 C.B. 262, describes an IRC 501(c)(3) scientific research organization which evaluates, processes, promotes, develops, and manages the inventions of faculty and staff members of educational and scientific institutions. The organization requires that it be assigned title to the inventions, for which it obtains patents, introduces the patents for public use, and negotiates licenses. The organization collects royalty income from licenses, retains a portion of such amounts, and distributes 2the remainder to the institutions and inventors.

Citing Reg. 1.512(b)-1, set forth above, the revenue ruling states that the organization holds only bare legal title to the inventions for the purpose of performing patent development and management services on behalf of the beneficial owners of the inventions - the institutions and inventors. Under these circumstances, although the amounts are derived from royalties, they do not retain their character in the hands of the organization and, therefore, do not constitute royalties under IRC 512(b)(2).

Three years later, Rev. Rul. 73-193 was distinguished by Rev. Rul. 76-297, 1976-2 C.B. 178. This revenue ruling describes an IRC 501(c)(3) scientific organization that accepts inventions of individuals associated with a university for evaluation and possible patent consideration. When the organization files a patent application, the inventor assigns both legal and beneficial rights in the invention to the organization, which agrees to pay a specified percentage of royalties received

from licensees. The revenue ruling concludes that since the organization is both the beneficial and legal owner of the patents, amounts paid pursuant to licensing agreements are royalties which fall within IRC 512(b)(2). Rev. Rul. 76-297 distinguishes Rev. Rul. 73-193 on the basis that the organization described in Rev. Rul. 73-193 held only bare legal title to the patents, while the organization described in Rev. Rul. 76-297 is both the beneficial and legal owner of its patents.

3. Mineral Interests

Rev. Rul. 69-179, 1969-1 C.B. 158, describes an exempt organization that derives income from a working interest in an oil and gas property. In the situation described, although the organization is relieved of the development costs, it is liable for the operating costs associated with its interest. Under these circumstances the revenue ruling holds that the amounts derived from the mineral interest are not royalties under IRC 512(b)(2).

The general rule under Reg. 1.512(b)-1(b) provides that mineral royalties are excluded from the computation of unrelated business taxable income. However, mineral royalties are included in such computation if an organization (1) owns a working interest in a mineral property, and (2) is not relieved of its share of development costs. The revenue ruling notes that a royalty interest is a right to a mineral in place that entitles its owner to a specified fraction of the total production from the property free of expense of both development and operation. Although the regulations are silent as to the effect of liability for operating costs, the reference to relief from development costs is only by way of illustration, and to be a royalty interest, the right to payment must be free of both development and operating costs.

C. Court Cases

1. Advertising Income

In Fraternal Order of Police, Illinois State Troopers, Lodge No. 41 v. Commissioner, 833 F.2d 717 (7th Cir. 1987), an IRC 501(c)(8) organization entered into an agreement with another organization for the publication of a magazine known as the Trooper. Under the agreement, the exempt organization received 23 percent of the gross advertising revenues collected. One of the organization's officers served as executive editor of the magazine, and the organization had the right to censor text, editorials, and business listings, as well as to control any reprints. The organization argued, in part, that amounts received

from the sale of advertising constitute "royalties" under IRC 512(b)(2). The Court of Appeals affirmed the Tax Court holding that the organization took an active, not passive, role in the publication of the Trooper. The court noted that the organization had final authority over the editorial content of each issue of the Trooper, could appoint the magazine's executive editor, prepare editorials and feature articles, and oversee and control the soliciting of advertising, the program's bank account, and the reprint of materials published in the Trooper. On the basis of these facts, the court concluded that amounts from advertising do not constitute royalties.

2. Collection Services

In Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982), an IRC 501(c)(6) organization engaged in a number of income-producing activities, including collection services. The court concluded that such services are not substantially related to the exercise or performance of the IRC 501(c)(6) organization's exempt purpose. In a footnote the court also stated that income from collection services is not royalty income under IRC 512(b)(2).

3. Mailing Lists

In Disabled American Veterans v. United States, 650 F.2d 1178 (Ct. Cl. 1981), the court considered whether a number of activities engaged in by an IRC 501(c)(4) organization resulted in unrelated business taxable income. Among these activities was the organization's renting of names from its donor list. The organization, as a continuing, on-going activity, rented names on its list to both tax-exempt and commercial organizations. The organization's purpose in renting its mailing list was to gain additional revenue, particularly in view of substantial costs it incurred in the regular maintenance of its donor list. Rental rates were set at a level consistent with rates which the organization was paying to rent lists from other organizations.

With respect to whether amounts derived from the rental of the organization's mailing list constitute royalty income, the court first noted that in the direct mail industry receipts from list rentals are called either rents or royalties. However, the industry terms are not controlling. The court stated that the organization's list rentals are the product of extensive business activity by the organization and do not fit within the types of "passive" income set forth in IRC 512(b). In the court's view, royalties are those items which constitute passive income, such as the compensation paid by a licensee to a licensor for the use of a

patented invention. The court concluded that the organization's receipts from the rental of its mailing list cannot be classified as royalties under IRC 512(b)(2).

4. Working Interests

In United States v. Robert A. Welch Foundation, 334 F.2d 774 (5th Cir. 1964), an exempt foundation received income from two corporations of which the foundation was the controlling stockholder. The court considered whether such income was derived from a working interest in oil and gas properties, or whether the income was received from overriding royalties. If the income was received from a working interest in oil and gas properties, it would constitute unrelated business taxable income. If the income was received from overriding royalties, it would be excluded from the computation of unrelated business taxable income under IRC 512(b)(2). The Court of Appeals noted that the District Court determined that the contracts under which the foundation received the income in the form of overriding royalties "...did in truth and in fact, create income from overriding royalties and not income from working interests." In reviewing the contracts the Court of Appeals concurred with the District Court's holding. The court rejected the Government's argument that the contracts, though framed as to create the appearance of overriding royalties, were in substance working interests. The court concluded that the amounts involved were royalties and therefore not subject to tax on unrelated business income.

In Rev. Rul. 69-162, 1969-1 C.B. 158, the Service announced that it would not follow the decision in Welch, but would continue to review exempt organizations' transfers of mineral properties to controlled corporations. The revenue ruling states that if, in substance, the income received by an exempt organization is from a working interest, characterization of the income as a royalty will not be accepted by the Service.

It should be noted that the Welch decision preceded the amendment to IRC 512(b)(13) as part of the Tax Reform Act of 1969, which precludes the use of the royalty modification where such amounts are received by an exempt organization from a controlled organization.

3. Congressional Developments

Topic C, Update on Unrelated Business Taxable Income, discusses various developments that have occurred during the past two years as part of the extensive review being undertaken by Congress in the area of unrelated business taxable

income. The royalty provision has not escaped Congressional scrutiny and, on March 31, 1988, as one of its "discussion options" the Oversight Subcommittee of the House Ways and Means Committee announced the following:

> "Apply UBIT to royalties measured by net or taxable income derived from the property; or royalties received by an organization for use of property if such organization, or closely related organization either: (1) created such property, or (2) performed substantial services or incurred substantial costs with respect to the development or marketing of such property. Retain present law for certain nonworking property interests, and exception for products that are part of the organization's exempt function."

On June 24, 1988, proposed recommendations on unrelated business taxable income were made public in BNA's Daily Report. These proposed recommendations, although not approved by the Oversight Subcommittee, may provide an indication of future legislative changes affecting royalties. The proposed recommendation essentially builds upon the aforementioned "discussion option" with certain refinements and expanded applicability. The proposed recommendation would tax royalty income measured by net or taxable income derived from licensed property, with two basic exceptions for research and nonworking interests. It would also tax royalty income measured by net or gross income if the exempt organization created the property right or was active in its marketing. Again, there are exceptions for research and for arrangements in furtherance of an organization's exempt function.

These Congressional proposals may indicate a certain degree of unhappiness with respect to the current royalty provision. Congress may be concerned that organizations have taken the position that any payment for the right to use intangible property constitutes a royalty. Thus, a portion of the earnings of an unrelated trade or business activity can escape taxation through "royalty" arrangements, despite the fact that the trade or business does not further the organization's exempt purpose or function. In accordance with the proposed recommendation, non-research activities that produce income from the sale of goods or services but do not further an exempt function would not receive favorable tax treatment simply because the organization's participation in the income-producing activities is structured as a royalty. Of course, if the use of a product being licensed furthers an organization's exempt purpose, then the royalty income would be excluded from the tax on unrelated business income. The

proposed recommendation contains the following illustrations of how the rule would work:

> A. Licensing organization's trademark or logo in order to foster name recognition does not, in and of itself, further the organization's exempt function, but is more in the nature of commercial exploitation of the organization's goodwill that was created from carrying on its exempt activities.
>
> B. If an organization formed to promote education of children licenses its name or other intangible property it has created for use on books and educational video cassettes, royalties received in connection with the sale of such items would be excluded from the computation of unrelated business taxable income.
>
> C. Royalties would be taxable where they were received by an organization for use of its name on furniture, clothing, or sports equipment.
>
> D. Royalties would not be subject to tax where they were received by a symphony orchestra paid in connection with sales of its recordings, or by a professional association in connection with sales of professional or technical manuals.

It should be remembered that these proposed recommendations have not been approved by the Oversight Subcommittee, and may be the subject of additional changes and further refinements. Nevertheless, if any legislative changes emerge from the Congressional review of unrelated business taxable income, it is quite possible that the royalty modification will be one of the provisions being changed.

4. Credit Cards

A. Background

Last year's CPE Text beginning at p.97 briefly discussed the issue of credit cards and unrelated business taxable income. The Topic noted that exempt organizations have been entering into agreements with banks that send credit cards to the organizations' members. As part of this arrangement exempt organizations receive agreed upon amounts, which may constitute unrelated business taxable

income. The Topic also noted that the issue of royalty income under IRC 512(b)(2) should be considered.

B. PLR 8747066

On August 28, 1987, a ruling was issued to an IRC 501(c)(10) organization concerning its credit card program. The organization proposed to participate in the solicitation of its members by a bank for credit card applications. The organization would receive a fee of $6.00 per applicant plus one-half of one percent of total charges made to the card by the member. Renewals of credit cards would also result in an amount being received by the organization. As part of the proposal, the organization's membership list could only be used for credit card solicitation purposes. Amounts derived from this activity were to be devoted to charitable purposes. The August 28 ruling concluded that income received from the credit card program was royalty income under IRC 512(b)(2), which is excluded from the computation of unrelated business taxable income. The ruling stated that the organization's agreement with the bank is a licensing agreement for the use of the organization's membership list. The conclusion reached was that the royalty exclusion is applicable because the right to use membership lists is a valuable right similar to patents, copyrights, goodwill, and franchises.

The ruling was made available to the public as PLR 8747066. (**NOTE:** private letter rulings are only directed to the organization that receives them; they cannot be cited or used as precedent.) The public version of the private letter ruling contains the following caveat: **"NOTE:** This ruling is currently under reconsideration." In fact, soon after its issuance, the August 28 ruling was the subject of reconsideration.

This ruling does not reflect the current Service thinking, which is that income received from the use of the membership lists in the credit card solicitation program is subject to tax on unrelated business income. The royalty exclusion is not applicable in this case. The rationale for the Service's thinking can be found in G.C.M. 39727 (April 28, 1988). (G.C.M.s cannot be cited or used as precedent.) The G.C.M. describes the relevant statutory construction whereby, because the activity concerns the receipt of income from a third party's use of an exempt organization's membership lists, the resolution of the issue is governed solely by IRC 513(h)(1)(B). This provision contains an exception to unrelated trade or business for exchanging or renting donor or membership lists by organizations described in IRC 501, contributions to which are deductible under IRC 170(c)(2) or (3). Such an organization's exchange or rental of its mailing list can only occur

with or to other such organizations, i.e., organizations that are described in IRC 501, contributions to which are deductible under IRC 170(c)(2) or (3). G.C.M. 39727 states that revenues derived from a third party by an exempt organization from the use of its membership or donor list constitute unrelated business taxable income, unless they meet the specific statutory exception under IRC 513(h)(1)(B).

Here, since the IRC 501(c)(10) organization is eligible to receive contributions under IRC 170(c)(4), and not under IRC 170(c)(2) or (3) and, since the bank is a for-profit entity, the exception under IRC 513(h)(1)(B) is not applicable. The G.C.M. also notes that the transaction does not involve the "exchange" and probably not the "rental" of members' names and addresses. Under these circumstances, amounts derived from the credit card activity are subject to tax. PLR 8747066 was revoked by PLR 8823109, which holds that income derived from the organization's credit card solicitation program constitutes unrelated business taxable income. The organization was granted relief under IRC 7805(b), and the Service's adverse position was effective only from the date of issuance of the letter.

C. Affinity Credit Cards/Affinity Merchandising

The use of so called "affinity" credit cards has been receiving extensive publicity during the past year. The May 16, 1988 edition of USA Today reported that affinity cards will account for 15% of all bank cards in 1990, up from 8% in 1987. Explaining the popularity of affinity credit cards, the article states that banks find they can use such cards to lure customers, and exempt organizations find it easy to make money from the cards. An example given in this article is that of the University of New Hampshire, whose graduates can sign up for a bank card that helps an alumni group. The bank pays the group $5 when a member signs up, then 1% of the amount charged on the cards. According to the article, 1,200 alumni have taken the cards, and the alumni group expects profits of $30,000 to $40,000 in 1988. The value of the credit cards to the consumer was also discussed and, according to the head of a consumer group: "If you're feeling charitable, you're better off writing a check."

The March 1988 issue of Consumer Reports also focused on the proliferation of affinity credit cards. The Consumer Reports article states that banks are willing to provide credit cards to exempt organizations' members because of the saturated credit card market. Because many people have more than one credit card, the object of the bank is to convince cardholders to use a particular card, and holders of affinity cards might be more inclined to use such a card. Also,

affinity credit cardholders tend to charge more to their cards. According to Consumer Reports, Sierra Club cardholders charge an average of $3,600 a year compared with an average of $2,000 a year charged by cardholders on regular bank cards. The article states the following: "For whatever reason, the cause-card market has exploded from a handful of groups in 1986 to more than 1,600 organizations sponsoring credit cards today."

USA Today and Consumer Reports list the following nonprofit organizations that offer affinity credit cards together with their interest rate and annual fee:

Organization	Annual Fee	Interest Rate
American Dental Association	$ 20	15.9%
American Heart Association	$ 20	16.9%
C.A.R.E.	$ 20	17.5%
Child Welfare League	$ 20	17.49%
Defenders of Wildlife	$ 25	17.9%
Easter Seals	$ 20	17.49%
International Wildlife	$ 20	17.75%
Juvenile Diabetes Foundation	$ 20	17.25%
M.A.D.D.	None	20.9%
Muscular Dystrophy Association	$ 20	16.75%
National Rifle Association	$ 20	17.70%
National Wildlife Federation	$ 20	17.9%
People for the American Way	$ 20	17.49%
Sierra Club	$ 20	18.00%
Special Olympics	$ 20	17.5%
UNICEF	$ 20	17.5%
U.S. Amateur Softball Association	$ 20	16.95%
Vietnam Veterans of America	$ 20	16.8%
The Wilderness Society	$ 25	17.9%
Working Assets	$ 20	17.5%

In addition to affinity credit cards, the phenomenon of affinity group merchandising has also been publicized in the press. The June 5, 1988 edition of the Washington Post reported that affinity group merchandising is being extended beyond credit cards to insurance, mutual funds, travel services, motor clubs, and automobile insurance. The article describes an affinity group as any collection of people with something in common. A group may consist of members of an alumni

organization, or people with a specific interest. The article makes the following point: "Marketers are particularly fond of people who back causes because they are receptive to a pitch that gives them a way to support the cause while using a product or service they want anyway."

D. Congressional Developments

In 1987, ten days after the release of PLR 8747066, Rep. Donnelly introduced H.R. 3739 which was intended to overturn the ruling (which was subsequently revoked by the Service). This proposal would amend IRC 512(b) by stating that amounts received in connection with the sale, lease, rental, or other grant of a right to use a list of members, customers, or contributors will be included as an item of gross income derived from unrelated trade or business. The proposal would not affect the exception under IRC 513(h). H.R. 3739 was referred to the Ways and Means Committee. At that time the Oversight Subcommittee of the Ways and Means Committee was extensively engaged in its comprehensive review of the tax on unrelated business income.

On March 31, 1988, the Oversight Subcommittee, as one of its "discussion options," announced the following: "Apply UBIT to income from affinity credit card/catalog endorsements."

On June 24, 1988, proposed recommendations were made public in BNA's Daily Report. As noted previously, these proposed recommendations, although not approved by the Oversight Subcommittee, may provide an indication of future legislative changes. The proposed recommendation provides that income derived from affinity credit card or other affinity merchandising activities should be treated as unrelated business taxable income. Such conclusion would be reached whether or not such income is labeled as royalties.

The Oversight Subcommittee may be concerned that under so-called "affinity" arrangements, exempt organizations are furnishing their membership or contributor mailing list to a bank or merchandising business, and entering into contractual agreements for the exclusive use of the organization's name or logo. The exempt organization also promotes or endorses obtaining and using a particular company's credit card, ordering catalog items from the merchandising company, or using services of the commercial business. The proposed recommendation distinguishes affinity credit cards and affinity merchandising activities from so-called "cause related fundraising." Under the latter practice, charitable contributions are made by a business which merely informs the public

that an amount will be donated to a charity based on the sale of its products or use of its services. As part of "cause related fundraising" no contractual agreement is entered into between the business and the charity, and the business receives no consideration from the charity, such as the exclusive right to use the charity's name or logo on a particular type of product.

Once again it should be emphasized that the proposed recommendations have not been approved by the Oversight Subcommittee and may be changed in the future. What is apparent, however, is that Congress is aware of the affinity credit card/affinity merchandising phenomenon, and is considering possible changes to the tax on unrelated business income to address this new development.

5. Application of Principles

(Please note that G.C.M.s and private letter rulings may not be cited or used as precedent)

A. Symbols, Identifying Language and Logo

G.C.M. 38083 (September 11, 1979) describes an IRC 501(c)(3) organization formed to encourage and promote national and international athletic competition. The organization entered into a marketing agreement to exploit commercially the organization's symbol and identifying language. Under the agreement, a marketing firm arranged for corporations to make payments to the organization, in return for which the corporations were allowed to use the organization's symbol and identifying language. The agreements permitted commercial businesses to use the organization's symbol in connection with the advertising and display materials and consumer level promotion campaigns. The use of the organization's symbol and identifying language resulted in the organization's receiving substantial revenues.

The G.C.M. contains a discussion of the royalty provision and states that in order to be characterized as a royalty, payments need not be based on the use made of all valuable rights. Since the payments made to the subject organization for the right to use its symbol and identifying language are payments for the privilege of using intangible property, such payments constitute royalties under IRC 512(b)(2).

G.C.M. 38997 (June 10, 1983) discusses an IRC 501(c)(4) organization that sponsors, plans and conducts international sports competition. This organization entered into sponsorship agreements with various corporations, which were granted the exclusive right to use the organization's official marks and symbols.

The number of sponsors allowed to use the organization's logo was limited, and sponsors had to meet a number of requirements. In part, sponsors must have a recognized and broadly developed network for promotion of the organization and must evidence a commitment to undertake an extensive program of promotion using the organization's marks and symbols. The G.C.M. states that the activity of licensing the use of the organization's logo is a trade or business that is regularly carried on and is not substantially related to the performance of the organization's exempt purpose or function. However, since the revenues received from the sale of the right to use the organization's logo are royalties, such amounts are excluded from the computation of unrelated business taxable income.

B. Quality Control

G.C.M. 37416 (February 14, 1978) describes an IRC 501(c)(3) organization that evaluates educational television and radio programming for children, develops instructional and teaching materials in connection with such broadcasting, and conducts related research. The organization assigned the right to market certain items using the name of its educational program. Pursuant to licensing agreements, the organization received royalty payments based on a percentage of the manufacturers' sales. These agreements also reserved extensive supervision rights over matters of product quality control and educational value. In addition to a percentage of sales, the organization also required an annual advance on royalties.

The G.C.M. discusses whether the agreements between the organization and the licensees result in a joint venture based on the retention of quality control supervision rights by the organization. The G.C.M. concludes that no joint venture is present based on the following factors: there is no capital contribution by the organization; the risk of loss is on the licensees; and, the business is generally conducted in a manner reflecting a licensing agreement. Citing Lemp Brewing Company v. Commissioner, 18 T.C. 586 (1952) acq. 1952-2 C.B. 2, (a personal holding company case), the G.C.M. states that the organization's quality control rights do not rise to the level of a joint venture. Also, the retention of such rights is consistent with the organization's exempt educational status. Under these circumstances, payments made pursuant to the licensing agreements are royalties under IRC 512(b)(2).

C. Net Profits Interest

G.C.M. 38216 (December 28, 1979) describes an IRC 501(c)(3) university that purchased whole and fractional working interests in oil and gas leases. Where

the university owned the entire working interest in a lease, it would sell a portion of the interest to an operator and then assign the remainder to the same operator, reserving 100% of the net profits from interest assigned. Where the university owned a fractional working interest in a lease, it would assign an interest to an operator and reserve 100% of the net profits. Net profits were computed by crediting a single "net profits" account with the gross income from all the properties assigned and charging the account with the fractional portion of certain costs, including overhead, maintenance and operational costs. The university was never personally liable for any costs in excess of gross income. The university excluded amounts received from "net profits interest" as royalty income under IRC 512(b)(2).

The G.C.M. notes that a "net profits interest" has characteristics common to both overriding royalties and working interests. IRC 512(b)(2) includes overriding royalties, while Reg. 1.512(b)-1(b) provides that royalties do not include amounts from a working interest, where an organization is not relieved of development costs. The G.C.M. states that a net profits interest will generally constitute a royalty under IRC 512(b)(2) and not a working interest, where the organization has no control over operations and is not required to pay out, advance, or become personally liable for any of the costs of development or operations in excess of gross income.

D. Insurance/Logos

On March 31, 1988, the Service issued PLR 8828011 to an IRC 501(c)(3) organization. The ruling concerned a proposed transaction in which the organization intended to change the method of offering a group life insurance program to its members. The organization entered into a trust agreement with a bank to establish a group insurance trust, with the bank as the trustee. The organization and the bank then entered into an agreement with an insurance company, which markets insurance programs and underwrites insurance plans for the organization's members. The organization also entered into an agreement with an administrator, which manages insurance coverage for the organization's members. The administrator prepares and mails to the organization's members insurance solicitations with the organization's name and logo. The agreement with the administrator permits the organization to review the type of insurance offered and the mailings to members that use the organization's name and logo. The organization receives excess funds generated by the insurance program after all expenses are paid. The insurance company and the administrator receive compensation for services rendered.

The proposed agreement between the organization, the bank, and the insurance company provides, in part, that the administrator will pay a royalty to the organization for the use of the organization's name and logo in connection with the promotion of the group insurance program. The agreement also provides that the organization will lease a current list of its members to the insurance company, which in turn will provide the list to the administrator. The agreement between the organization and the administrator provides that the administrator will pay a royalty to the organization for the use of its name and logo in conjunction with the insurance program, together with $.10 per name and address each time the organization leases its membership list.

PLR 8828011 states that income received by the organization in exchange for permitting the use of its name and logo is unrelated business taxable income. However, such income is not subject to tax because it is a royalty. The private letter ruling concludes as follows:

> "Income to be derived by you for the use of your name and logo in the group insurance program to be conducted pursuant to the proposed contracts will constitute royalty income within the meaning of section 512(b)(2) of the Code and will, therefore, be excludable from the computation of unrelated business taxable income and the tax imposed under section 511."

The private letter ruling is currently being reconsidered. If the amounts involved are attributable to the use of the organization's mailing list, then the royalty exclusion would not be applicable, and such amounts would constitute unrelated business taxable income. Like the situation described in G.C.M. 39727 (credit cards), supra, the resolution of this issue would be governed by the special exception for mailing lists contained in IRC 513(h)(1)(B). Since this provision's requirements appear not to have been met in this case, it is possible that the amounts involved will be subject to tax. However, if the organization can somehow establish that the use of its name and logo in the insurance program is separate and independent from its mailing list, then the royalty exclusion might be available. If it is determined that PLR 8828011 is incorrect, it will be revoked.

6. Conclusion

The royalty modification under IRC 512(b)(2) is an important component part of the tax on unrelated business income. Issues concerning royalties can arise

in a wide variety of situations, including patents, endorsements, and oil, gas and mineral properties. Over the years these issues have received extensive consideration, and guidance is available from published revenue rulings and other sources. At this time the royalty area is not static, and this can be seen from newly identified issues such as affinity credit cards and affinity merchandising. Congress is also quite aware of royalties, and any proposed legislation resulting from the comprehensive review of unrelated business taxable income might include revisions to the royalty exclusion. When confronted with issues involving royalties, such as credit cards and insurance logos, for which there is no published precedent, consideration should be given to requesting technical advice in accordance with IRM 7(13)12.