

Trade & Professional Association Bulletin

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IRS RULES FAVORABLY ON VARIOUS WEBSITE LINKS

Earlier this year the IRS issued an important private letter ruling relating to an exempt organization's various Internet activities. *Priv. Ltr. Rul. 03-03-062*. Specifically, the IRS held that links from an exempt organization's website to the websites of businesses that provide services to its members do not create unrelated business taxable income ("UBTI"). The IRS also ruled that such links will not affect the exempt status of royalties from licensing agreements or of qualified sponsorship payments. Similarly, the IRS held that receiving advertising revenue from service providers who also have licensing agreements will not affect the exempt status of royalties received under those licensing agreements. Finally, on a more technical level, the IRS ruled that the combined sale of periodical and online advertising would require allocation between periodical and general advertising UBTI, even if advertisers do not pay separate charges for online advertising. Although a private letter ruling is not legally binding on the IRS in subsequent cases, the analysis and conclusions presented in this ruling provide valuable insight into the current approach of the IRS to some important issues relating to Internet-based communications by tax-exempt organizations.

Background

The party requesting the ruling, M, was an exempt agricultural organization covered by Section 501(c)(5) of

the Internal Revenue Code of 1986 (the "Code"). In furtherance of its exempt purposes, M conducted meetings and conferences, published newsletters, and provided educational, regulatory and legislative information to its members. M also maintained a website with current information on its activities and programs.

M had arrangements with various commercial service providers for special discounts and benefits for its members. For instance, M had a rebate arrangement with an auto dealer, a discount program for prescription eyewear, and discount arrangements for certain industrial, farm and ranch equipment. M also had arrangements with two insurance providers, O and P, under which those providers would offer insurance to M's members. M had licensing agreements with O and P permitting them to use its name and logo in exchange for royalty payments. While M's website contained information regarding the various benefits available to its members from certain commercial service providers, the information was not promotional in nature and in most cases did not provide a link to the service providers' websites.

Links to Service Providers are not Trade or Business

M provided listings of its service providers and their available discounts to its members via its printed publications and its website. M requested a ruling as to whether providing online links to the websites of these

service providers, as opposed to mere listings with contact information, would generate UBTI. M provided these non-promotional links for the benefit of its members and did not charge service providers a fee for providing the links. The IRS held that providing such links is not a trade or business under Code Section 513(c) and, therefore, is not an unrelated trade or business under Code Section 513(a). Accordingly, M could provide such links as part of its online listings without generating UBTI.

Links to Service Providers will not Affect Exempt Status of Royalties

Code Section 512(b)(2) provides that royalties from licensing arrangements are not UBTI. In determining whether payments qualify as exempt royalties, the IRS generally looks to the amount of activity an organization engages in to earn the income. M requested a ruling as to whether its proposed online links to the websites of O and P, from whom M received exempt licensing royalties, would render any portion of those royalties taxable as UBTI. The IRS held that the provision of such links would not render any portion of those royalties taxable, relying on the representations by M that the non-promotional links would simply communicate to M's members the availability of insurance services from O and P and that M would not provide any other services to O and P in connection with the licensing agreements.

Links to Sponsors will not Affect Exempt Status of Qualified Sponsorship Payments

M requested a ruling as to whether providing links to the websites of its sponsors would affect the exempt status of qualified sponsorship payments. Under Code Section 513(i), qualified sponsorship payments are payments made to an organization without an expectation of substantial benefit in return beyond acknowledgment of the payor's name, logo and/or product line information in connection with the activities of the recipient organization. Relying on an example in the Regulations under Code Section 513, which characterizes links to sponsors as exempt acknowledgments if they are not promotional in

nature, the IRS ruled that M's provision of links to sponsors' websites would be only acknowledgments, and thus the sponsorship payments would not be treated as taxable advertising revenue.

Sale of Advertising will not Affect Exempt Status of Royalties

M also requested a ruling as to whether sales of advertising space to service providers with whom M had licensing agreements would affect the exempt status of its licensing royalties. The IRS ruled that the sale of advertising to licensees such as O and P would not affect the exempt status of royalty payments from these licensees, relying on the representations by M that the licensing and advertising agreements would be negotiated separately and independently and that licensees would not be given preferential advertising treatment or rates over non-licensees.

Online Banner Advertising is not Periodical Advertising

At the time of its ruling request, M did not sell advertising on its website to any service providers or other commercial entities. M proposed to add free online advertising for purchasers of advertising space in its print-periodicals, and requested a ruling as to whether all such advertising revenue could be characterized as periodical advertising revenue, or whether some would have to be treated as general advertising revenue because of M's inclusion of 'free' banner ads on its website.

While net advertising income is UBTI under Section 512(a)(1) of the Code, Regulation Section 1.512(a)-1(f) provides special guidance for calculating net periodical advertising income which can effectively reduce UBTI. The IRS ruled that because the online advertising would have an added value to advertisers, M must allocate its advertising revenues between periodical and non-periodical advertising. However, the IRS noted that if the online advertising appeared exclusively within periodicals published online by M, the advertising revenues would not have to be allocated between periodical and general advertising revenues.

Practical Application

Although this ruling is not technically binding on the IRS as legal precedent as to parties other than M, the fact that it is based very directly on concepts expressed in the Code and Regulations makes it quite valuable as an indicator of the current IRS approach to some key UBTI issues. Therefore, in light of the ruling, an exempt organization should feel much more confident

about providing links to the websites of businesses which provide services to members or from which the organization receives license royalties or sponsorship payments.

Should you have any questions regarding this bulletin, please contact Michael E. Reed at 312/609-7640 or William F. Walsh at 312/609-7730.

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About Vedder Price

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