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Tax-Exempt Organizations and Internet Commerce: The Application of the Royalty and Volunteer Exceptions to Unrelated Business Taxable Income

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**TAX-EXEMPT ORGANIZATIONS AND INTERNET
COMMERCE: THE APPLICATION OF THE ROYALTY
AND VOLUNTEER EXCEPTIONS TO UNRELATED
BUSINESS TAXABLE INCOME**

Leeanna Izuel[†] and Leslie Y. Park^{††}

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I. INTRODUCTION

The Internet has created new opportunities for both large and small tax-exempt organizations (EOs)¹ to raise funds through relationships with online vendors and “charity malls.” EOs provide hyperlinks to online vendors’ websites through affiliate arrangements. In return, EOs receive payments based on a percentage of sales made at the vendor websites attributable to the EOs’ hyperlinks. EOs also enter into payment arrangements with charity malls. Charity malls are commercial websites that provide hyperlinks to online vendors and attract consumers by pledging to donate a percentage of any purchases made through the malls to charity. There is no express authority stating how such payments should be characterized for unrelated business taxable income (UBTI) purposes when affiliate and charity mall arrangements are regularly carried on and not substantially related to an EO’s exempt purpose.

This article proposes two Internal Revenue Service (IRS) Revenue Rulings.² The Rulings establish that, in certain instances, the payments to an EO attributable to relationships with online vendors and charity malls should be treated as royalty income

1. All references to “EOs” refer to organizations exempt from taxation under § 501(c) (excluding organizations described in § 501(c)(1)) and § 501(d) and organizations described in § 511(a)(2)(B) of the Internal Revenue Code of 1986, as amended. *See* I.R.C. §§ 501(c),(c)(1),(d), 511(a)(2)(B). Unless otherwise indicated, all references and citations in this article to the Internal Revenue Code (“Code”) refer to the Internal Revenue Code of 1986, as amended. I.R.C. (1986) (currently codified at 26 U.S.C.A. (West Supp. 2004)). All references to “section” refer to a section of the Internal Revenue Code.

2. *See infra* Exhibit A, B.

exempt from unrelated business income tax (UBIT) under § 512(b)(2) of the Internal Revenue Code (the Code).³ The proposed Revenue Rulings would recognize the circumstances under which payments from online vendors and charity malls to EOs constitute nontaxable royalty income, rather than UBTI.

Additionally, EOs raise funds directly through their own Internet-based sales. This article proposes a third IRS Revenue Ruling⁴ concluding that even if such sales are regularly carried on and not substantially related to an EO's exempt purpose, the "volunteer exception" under § 513(a)(1) applies to exempt sales income from UBIT if substantially all of the work relating to the sales is performed without compensation.⁵ Under certain circumstances this result will occur regardless of whether compensated individuals design, create, or maintain the EO's retail website.

II. CHARACTERIZATION OF PAYMENTS FROM ONLINE VENDORS

The IRS should advise EOs that even if affiliate arrangements between EOs and online vendors are regularly carried on and not substantially related to an EO's exempt purpose, payments received pursuant to such agreements may be exempt from UBIT under the exception for royalty income in § 512(b)(2).⁶ When an EO places a hyperlink to an online vendor on its website, royalty treatment is appropriate if the EO receives payments characterized as royalties under an agreement between the EO and the online vendor and attributable to sales made through the hyperlink, and the EO does not provide services to the online vendor. The proposed Revenue Ruling attached as Exhibit A will clarify the circumstances under which such an arrangement between an EO and an online vendor will give rise to royalty income.⁷ The result achieved by the proposed Revenue Ruling is consistent with the Ninth Circuit

3. I.R.C. § 512(b)(2).

4. *See infra* Exhibit C.

5. I.R.C. § 513(a)(1).

6. *See* § 512(b)(2).

7. *See infra* Exhibit A. The proposed Revenue Ruling assumes that the agreement between the online vendor and the EO generates income from a trade or business that is regularly carried on and not substantially related to the EO's exempt purpose. *Id.* This assumption has been made for convenience and clarity; the provision of a hyperlink may be a separate trade or business which is not regularly carried on.

Court of Appeals' decision in *Sierra Club, Inc. v. Commissioner*⁸ and Private Letter Ruling 2003-03-062, a ruling specifically applicable to Internet activities.⁹

A. *An Overview of Existing EO Arrangements*

EOs have begun to enter into mutually beneficial affiliate arrangements with online vendors.¹⁰ Under an affiliate arrangement, when an online vendor makes a sale attributable to an EO's hyperlink to the vendor's website, the EO is entitled to a payment based on a percentage of the sale.

A variety of names such as "Affiliate Program,"¹¹ "Associate

8. 86 F.3d 1526 (9th Cir. 1996).

9. Priv. Ltr. Rul. 2003-03-062 (Oct. 22, 2002).

10. Primarily, smaller charities have entered into affiliate agreements. For example, The Aristos Foundation (organized to deepen public understanding of art and traditional values in the arts); Seaturtle.org (organized to support research and conservation with respect to sea turtles); and Sirenian International, Inc. (organized to promote manatee and dugong research, education and conservation) have entered into affiliate arrangements with Amazon.com. See <http://www.aristos.org/arisfoun.htm> (last visited Oct. 1, 2004); <http://www.seaturtle.org/books> (last visited Oct. 1, 2004); <http://www.sirenian.org/bookstore.html> (last visited Oct. 1, 2004).

Many commentators have suggested how to treat such payments. See, e.g., Richard Lipton, *ABA Tax Section Members Suggest Areas for Guidance on EO Internet Use*, 2001 TAX NOTES TODAY 41-57 (Mar. 1, 2001); Am. Inst. of Certified Pub. Accountants, *AICPA Supports Using Current EO Rules to Answer Web Issues*, 2001 TAX NOTES TODAY 33-46 (Feb. 16, 2001); Am. Soc'y of Ass'n Executives, *Comprehensive Guidance on EO Internet Activities Unnecessary, Says ASAE*, 2001 TAX NOTES TODAY 31-26 (Feb. 14, 2001); D.C. Bar, The Exempt Org. Comm., Section of Taxation, *D.C. Bar's EO Committee Asks IRS for Clarity in EO Internet Guidance*, 2001 TAX NOTES TODAY 34-65 (Feb. 20, 2001); Indep. Sector, *Use Past EO Rules to Resolve EO Internet Issues, Says Independent Sector*, 2001 TAX NOTES TODAY 31-27 (Feb. 14, 2001). The IRS has begun to develop guidance with respect to Internet activities of EOs and UBIT, such as the Treasury Regulations applicable to corporate sponsorship payments; nevertheless, additional guidance is necessary. See Treas. Reg. §1.513-4(f) (as amended in 2002).

11. See, e.g., Affiliate Advertising Agreement, at https://www.connectcommerce.com/secure/partner_app.html?ccmid=K31502#start (last visited Oct. 1, 2004) (sears.com Affiliate Program) [hereinafter Sears.com Affiliate Agreement]; Affiliate Agreement, at <http://www.officemax.com/max/solutions/corpinfo/affLogin.jsp> (last visited Oct. 1, 2004) (OfficeMax.com Affiliate Program) [hereinafter OfficeMax.com Affiliate Agreement]; Affiliate Participation Agreement, at <http://www.kmart.com/affiliate/terms.jsp> (last visited Mar. 25, 2004) (kmart.com Affiliates Program) [hereinafter Kmart.com Affiliate Agreement]; target.com Affiliate Program Agreement, at http://merchant.linksynergy.com/fs/declares/2860_45020.txt (last visited Oct. 1, 2004) (target.com Affiliate Program) [hereinafter Target.com Affiliate Agreement].

Program,”¹² and “Partner Program”¹³ are given to payment arrangements between an online vendor and an EO under which the EO agrees to place the vendor’s hyperlink on the EO’s website. Under a typical affiliate agreement, the vendor provides an EO with the technical computer code and graphics for the hyperlink.¹⁴ The online vendor handles the actual sales and payments back to the EO.¹⁵

The terms used to describe online vendors’ payments to the EOs vary widely. Many agreements use the term “referral fees,”¹⁶ while others use terms such as “commissions,”¹⁷ “revenue share,”¹⁸ and “advertising.”¹⁹ Some online vendors use terms in their agreements that differ from the terms described in their website literature.²⁰ Despite the differences in terms, all of the payment arrangements work in essentially the same way: an EO is entitled to a payment based on a percentage of sales that can be traced to a hyperlink placed on the EO’s website.²¹

12. See, e.g., Operating Agreement, at <http://associates.amazon.com/exec/panama/associates/join/operating-agreement.html> (last visited Mar. 25, 2004) (amazon.com Associates Program) [hereinafter Amazon.com Operating Agreement].

13. See Operating Agreement, at <http://www.powells.com/partners/agree.html> (last visited Mar. 25, 2004) (powells.com Partner Program) [hereinafter Powells.com Operating Agreement].

14. See, e.g., Affiliate Partners Agreement, at <http://www.barnesandnoble.com/affiliate/agreement.asp> (last visited Mar. 25, 2004) (barnesandnoble.com Affiliate Network) [hereinafter BarnesandNoble.com Affiliate Agreement]; Amazon.com Operating Agreement; fields.com Affiliate Program Agreement, at <http://merchant.linksynergy.com/fs/declares/2861449832.txt> (last visited Mar. 25, 2004) (marshallfields.com Affiliate Program) [hereinafter MarshallFields.com Affiliate Agreement]; OfficeMax.com Affiliate Agreement; Powells.com Operating Agreement; Target.com Affiliate Agreement.

15. See, e.g., Amazon.com Operating Agreement; BarnesandNoble.com Affiliate Agreement; MarshallFields.com Affiliate Agreement; OfficeMax.com Affiliate Agreement; Powells.com Operating Agreement; Target.com Affiliate Agreement.

16. See Amazon.com Operating Agreement; BarnesandNoble.com Affiliate Agreement; MarshallFields.com Affiliate Agreement; Target.com Affiliate Agreement.

17. See OfficeMax.com Affiliate Agreement; Powells.com Operating Agreement.

18. See Kmart.com Affiliate Agreement.

19. See Sears.com Affiliate Agreement.

20. Sears.com refers to “commissions” or “bounties” in its literature, but uses the term “advertising” in its agreement. See Sears.com Affiliate Agreement. Kmart.com uses the term “referral fees” in its literature, but calls such payments “revenue share” in its agreement. See Kmart.com Affiliate Agreement.

21. See Amazon.com Affiliate Agreement; BarnesandNoble.com Operating

B. *The Royalty Exception to UBTI*

An EO is taxed on its unrelated business taxable income (UBTI) pursuant to § 511.²² Section 512(a)(1) defines UBTI as an organization's net income derived from any regularly carried on unrelated trade or business.²³ An unrelated trade or business, as defined in § 513(a), is any trade or business not substantially related to the exempt purpose of an organization.²⁴

Section 512(b)(2), however, excludes royalties from UBTI.²⁵ The Code provides no guidance as to what constitutes "royalties" for the purposes of UBTI. Currently no law directly addresses whether a payment to an EO from sales attributable to Internet vendor affiliations constitutes a royalty. Nonetheless, a series of mailing list rental and affinity credit card cases help to clarify when certain payments to an EO qualify as royalty income.

In a key line of mailing list rental cases, EOs have successfully established that payments received in exchange for the use of an EO's mailing list are royalty payments excluded from UBTI under § 512(b)(2). The Ninth Circuit Court of Appeals held that payments made by a bank to tax-exempt alumni associations were not payments for promotional and management services associated with the exempt organizations' mailing lists, but were royalty payments excluded from unrelated business taxable income under § 512(b)(2).²⁶ Furthermore, the Tax Court has ruled that when parties to a mailing list rental agreement among the list manager, the list owner, the company that stored the rental list, and the list brokers engaged in activities to exploit and protect the mailing list, with the exception of the list brokerage activities, the list rental transaction activities were royalty-related.²⁷ Therefore, each rental

Agreement; OfficeMax.com Affiliate Agreement.

22. I.R.C. § 511.

23. *See id.* § 512(a)(1) (stating that net income is calculated by calculating gross unrelated trade or business income less deductions allowed under § 512(b)).

24. *Id.* § 513(a).

25. *But see* § 512(b)(13)(A) (including in UBTI all royalties received by an organization from an entity that it controls, to the extent such payments reduce the net unrelated income of the controlled entity or increases the net unrelated loss of the controlled entity); § 514 (providing that a percentage of unrelated income attributable to debt-financed property is taxable). The discussion ignores the effect of § 512(b)(13)(B) and § 514 for purposes of this analysis.

26. *Or. State Univ. Alumni Ass'n v. Comm'r*, 193 F.3d 1098, 1101-02 (9th Cir. 1999).

27. *Common Cause v. Comm'r*, 112 T.C. 332 (1999).

payment constituted a royalty.²⁸

Affinity credit card cases also help to clarify when certain payments to an EO qualify as royalty income. In a line of cases litigated by Sierra Club, Inc. (Sierra Club),²⁹ the Tax Court has ruled that when a credit card company makes a payment to an EO for the use of the EO's name and logo on a credit card, and an EO's activities relating to such affinity credit card program are directed at preserving and exploiting the EO's intangible assets (rather than promoting or endorsing the credit cards or issuer), the income generated by the program constitutes nontaxable royalties rather than a payment for services subject to UBIT.³⁰

Sierra Club entered into an affinity credit card arrangement with a for-profit company. Under the arrangement, the company was entitled to use Sierra Club's mailing list to market credit cards and to use Sierra Club's name and logo on the cards. Although Sierra Club had the right to approve promotional materials, the company was responsible for all marketing relating to the cards. In return, Sierra Club received fees, labeled "royalty fees" in the agreement, structured as monthly payments that were a percentage of the sales made by Sierra Club cardholders.

The Ninth Circuit Court of Appeals in *Sierra Club, Inc. v. Commissioner*³¹ held that a royalty is a payment received in exchange for the right to use intangible property. Furthermore, the Ninth Circuit stated that a royalty is by nature passive and, therefore, "cannot include compensation for services rendered by the owner of the property."³² With respect to income derived from Sierra Club's mailing list rental, the court held that such income was royalty income under § 512(b)(2) and was not payment for services.³³ On remand, the Tax Court applied the Ninth Circuit's definition of royalties to income derived from Sierra Club's affinity credit card program. The Tax Court concluded that the income generated from the affinity credit card program was payment for

28. *Id.*; see also *Planned Parenthood Fed'n of Am., Inc. v. Comm'r*, T.C.M. (RIA) 99,206 (1999).

29. *Sierra Club, Inc. v. Comm'r*, 103 T.C. 307 (1994), *aff'd in part and rev'd in part*, 86 F.3d 1526 (9th Cir. 1996), *motion for reh'g denied* (9th Cir. Aug. 16, 1996), *remanded to T.C.M.* (RIA) 99,086 (1999); *Sierra Club, Inc. v. Comm'r*, T.C.M. (RIA) 93,199 (1993).

30. *Sierra Club, Inc. v. Comm'r*, T.C.M. (RIA) 93,199 (1993).

31. 86 F.3d 1526 (9th Cir. 1996).

32. *Id.* at 1532.

33. *Id.* at 1536.

the use of Sierra Club's name and logo, its intangible property, rather than payment for services. Therefore, such income constituted royalties within the meaning of § 512(b)(2) and was exempt from UBIT.³⁴

Recently, the IRS issued Private Letter Ruling 2003-03-062,³⁵ a ruling where the IRS applied the *Sierra Club* line of cases to the Internet activities of a 501(c)(5) agricultural organization.³⁶ The organization had entered into licensing arrangements with insurance companies under which the organization received royalty payments in exchange for the use of its name and logo. The IRS ruled that the licensing revenue would continue to be treated as royalty income under § 512(b)(2) regardless of whether the organization provided hyperlinks on its website to the websites of the insurance companies.³⁷ Under this private letter ruling it is clear that the interposition of Internet hyperlinks does not affect the nature of a payment between an EO and a for-profit company for the use of the EO's name or logo; the payments remain royalties. The implication of this ruling is that the hyperlinks themselves are intangibles that give rise to royalty income, or, at a minimum, that the hyperlinks are an extension of the use of the exempt organization's name, logo, and goodwill, which are clearly intangible property rights.³⁸ The exploitation of such intangible property rights, therefore, gives rise to royalty income.

C. Characterization of an EO's Income from Affiliate Agreements

If an EO enters into an affiliate agreement with an online vendor and such business arrangements are a regularly carried on trade or business not substantially related to the EO's exempt purpose,³⁹ the income the EO receives from the affiliate

34. *Sierra Club, Inc. v. Comm'r*, T.C.M. (RIA) 99,086 (1999).

35. Priv. Ltr. Rul. 2003-03-062 (Oct. 22, 2002).

36. While private letter rulings are not binding on the IRS against other than the taxpayer to whom the letter was addressed and cannot be cited as precedent, they indicate the IRS's interpretation of the Code. *See, e.g.*, Priv. Ltr. Rul. 2003-03-062 (Oct. 22, 2002).

37. Priv. Ltr. Rul. 2003-03-062 (Oct. 22, 2002). The existence of a hyperlink would not constitute a substantial return benefit under the qualified sponsorship regulations. *See* Treas. Reg. § 1.513-4(f) (2004).

38. It is well-established that goodwill is an intangible asset. *See* I.R.C. § 197 (2000).

39. In fact, the actual creation and placement of the hyperlink on the EO's website may be considered a separate trade or business from the affiliate arrangement between the EO and the online vendor. *See, e.g.*, Nat'l Collegiate

arrangement will be UBTI under § 512(a)(1) unless an exception applies. If the income received by the EO can be properly characterized as royalty income, the income will qualify for the exception to UBTI under § 512(b)(2). For consistency with the cases described above, as long as the EO merely provides a hyperlink and does not provide any services to the online vendor, such income should be treated as nontaxable royalty income under § 512(b)(2).⁴⁰

In a typical affiliate agreement, the online vendor agrees to make payments to the EO, and, in exchange, the EO places a hyperlink on the EO's website to the online vendor's website. The hyperlink itself should be considered an intangible.⁴¹ In any case, the hyperlink creates a direct connection between an EO and a vendor that exploits the EO's name, logo, and goodwill—the intangible property of the EO to market the vendor's products. Individuals visiting an EO's website may be induced to use the hyperlink to visit the vendor because they understand that a portion of any sales will benefit the EO; certainly, that is the hope of the parties in entering into the affiliate arrangement.

The positive association with the EO encourages shoppers to travel virtually through the hyperlink to the online vendor's website; this positive association is not due to any services provided by the EO to the online vendor. It is this positive association that causes individuals to sign up for an affinity credit card or causes members of an agricultural organization to use a hyperlink to visit featured insurance company websites. Such access exploits the EO's name, logo, and goodwill. As with the insurance company's Internet access to an EO's members through the use of website

Athletic Ass'n v. Comm'r, 914 F.2d 1417 (10th Cir. 1990); Priv. Ltr. Rul. 88-20-061 (Feb. 22, 1988); Priv. Ltr. Rul. 84-33-010 (May 7, 1984). If so, the creation and placement of the hyperlink may not be regularly carried on. See *Nat'l Collegiate Athletic Ass'n*, 914 F.2d at 1421-22; *Ohio Farm Bureau Found. v. Comm'r*, 106 T.C. 222, 235-36 (1996). The hyperlink is only set up once and the activity involved in setting up the hyperlink requires minimal time. The user of the hyperlink (the purchaser of products) is the only active participant. In that case, the royalty analysis is unnecessary, as the arrangement will not generate UBTI because the arrangement is not regularly carried on.

40. This analysis assumes that neither the text nor the graphics of the website contain any advertising, as defined in Treasury Regulation § 1.513-4(c)(2)(iv) (2004).

41. Catherine E. Livingston, *Tax-Exempt Organizations and the Internet: Tax and Other Legal Issues*, 2001 TAX NOTES TODAY 137-30 (July 17, 2001).

hyperlinks described in Private Letter Ruling 2003-03-062,⁴² the exploitation of intangible property rights through Internet access should give rise to royalty income in this context.

Furthermore, any efforts to maintain or activate the hyperlink by the EO would be activities to manage, exploit, or protect the EO's intangible property.⁴³ The management, exploitation, and protection of such intangible property is royalty-related and not payment for services. Thus, such efforts should not give rise to UBTI.

In conclusion, because an EO's name, logo, and goodwill are intangible property, the payments arising from the exploitation of such property by the online vendor is royalty income. Such payments, therefore, should be nontaxable under § 512(b)(2) as long as the EO does not provide services to the online vendor.

III. CHARACTERIZATION OF PAYMENTS FROM CHARITY MALLS

The IRS should issue guidelines as to the treatment of payments from charity malls and electronic scrip programs to EOs. The characterization of such payments will differ depending on whether the payment is deductible as a charitable contribution.

If a purchaser makes a purchase through a charity mall, pays an amount for an item that exceeds its fair market value, and gives the excess payment to an EO, the excess payment to the EO should be deemed a charitable contribution that gives rise to a charitable deduction for the purchaser, regardless of any arrangement between the online vendor and the EO.⁴⁴ If, however, the amount paid is equal to the fair market value of the item, the payment should not be a deductible charitable contribution.

If no charitable contribution treatment is appropriate, the

42. Priv. Ltr. Rul. 2003-03-062 (Oct. 22, 2002).

43. In this context, the vendor usually provides the EO with the programming code for the hyperlinks, as well as any graphics. See Amazon.com Operating Agreement; BarnesandNoble.com Affiliate Agreement; MarshallFields.com Affiliate Agreement; OfficeMax.com Affiliate Agreement; Powells.com Operating Agreement; Target.com Affiliate Agreement.

44. To deduct a charitable contribution of \$250 or more, a donor must receive contemporaneous written acknowledgement of the contribution that satisfies substantiation requirements under I.R.C. § 170(f)(8). The written acknowledgement requirement may be met through electronic communications such as an e-mail addressed to the donor. *Charitable Contributions – Substantiation and Disclosure Requirements*, I.R.S. Publication 1771, available at <http://www.irs.gov/pub/irs-pdf/p1771.pdf> (last visited on Mar. 25, 2004).

payments to the EO need to be analyzed to consider whether they are UBTI. Under circumstances in which the charity mall or electronic scrip arrangement is regularly carried on and is not substantially related to the EO's exempt purpose, the payments may be treated as royalties exempt from UBIT under § 512(b)(2). To take advantage of such royalty treatment, the charity mall or electronic scrip program must enter into an agreement with the EO. Under the agreement, the mall or scrip program must list the name or logo of the EO. Then, the agreement must characterize the payments to the EO as royalties, and the payments must be attributable to purchases made through a hyperlink from the charity mall to an online vendor. In addition, the EO may not provide services to the charity mall or online vendor.

The proposed Revenue Ruling attached as Exhibit B describes the taxation of payments arising from arrangements with charity malls and clarifies the circumstances under which an arrangement with a charity mall will give rise to royalty income.⁴⁵ Although for clarity and brevity the proposed Revenue Ruling does not address electronic scrip programs, a similarly reasoned Revenue Ruling would be beneficial to resolve uncertainty with respect to the treatment of such programs.

A. *An Overview of EOs' Arrangements with Charity Malls*

Large and small EOs are becoming involved in payment arrangements with charity malls.⁴⁶ Generally, a charity mall is a third-party website that hosts a collection of hyperlinks to online vendors. The charity mall entices shoppers to make purchases at the websites of featured vendors by agreeing to give a portion of the sales to an EO selected by the purchaser. The purchaser may

45. The proposed Revenue Ruling assumes that the agreement generates income from a trade or business that is regularly carried on and not substantially related to the EO's exempt purpose. This assumption has been made for convenience and clarity. Further, the Revenue Ruling does not address the tax consequences to the purchaser with respect to payments made for purchases at the charity mall.

46. For example, the charity mall MyCause.com has relationships with large charities such as the ASPCA, the March of Dimes, the Corporation for Public Broadcasting, the National Audubon Society, and Amnesty International. See www.MyCause.com (last visited Mar. 25, 2004). It also lists small charities on its website such as the Kihei Canoe Club, the Louisa May Alcott Memorial Association, the Dixieland Jazz Society of the Desert, the American Ferret Association, and the Women's Crisis Shelter in Southern Humboldt. *Id.*

designate an EO to support by either selecting from a list of EOs posted on the charity mall's website,⁴⁷ or by filling in the name of an EO.⁴⁸ In some cases the EO may enter into an agreement with the charity mall to receive payments. Where an EO's name is not listed on the charity mall's website, however, but a purchaser may fill in the name of any EO instead, the EO may not be a direct party to an arrangement with the charity mall. It will, however, receive payments from the charity mall attributable to the purchase.

B. Characterization of Payments to EOs from Charity Malls

1. Consequences to the Purchaser

In some instances, payments from a charity mall to an EO should be treated as charitable contributions to the EO and as a charitable deduction for the purchaser. The purchaser should be allowed a deduction if the price of the goods is greater than the fair market value and the purchaser intends the excess amount to be a charitable contribution.⁴⁹ One charity mall, iGive.com, has attempted to structure its arrangements in this manner to allow its members to receive charitable deductions. When an iGive user purchases an item from a vendor in iGive's charity mall, a portion of the purchase price is treated as a rebate. iGive holds the rebate in an account for the purchaser. The purchaser can choose to either receive the rebate in cash or contribute the rebate to charity.⁵⁰

The 2000 Continuing Professional Education Text,⁵¹ citing two rulings,⁵² suggests that a donation is deductible when an entity

47. See, e.g., www.benevolink.com (last visited Mar. 25, 2004); www.BuyforCharity.com (last visited Mar. 25, 2004); www.CharityUSA.com (last visited Mar. 25, 2004); www.CountOnMe.com (last visited Mar. 25, 2004); www.FlowersBeCause.com (last visited Mar. 25, 2004); www.GreaterGood.com (last visited Mar. 25, 2004); www.iGive.com (last visited Mar. 25, 2004); www.MyCause.com; www.ShopForChange.com (last visited Mar. 25, 2004).

48. See, e.g., www.benevolink.com; www.MyCause.com.

49. Livingston, *supra* note 41; see *United States v. Am. Bar Endowment*, 477 U.S. 105 (1986); I.R.S. Chief Counsel Advisory 1999-39-021 (Oct. 1, 1999).

50. See www.iGive.com.

51. Cheryl Chasin, Susan Roth & Robert Harper, *Tax Exempt Organizations and World Wide Web Fundraising and Advertising on the Internet*, in Exempt Organization Continuing Professional Education Technical Instruction Program for FY 2000 (1999), at <http://www.irs.gov/pub/irs-tege/topici00.pdf> (last visited Mar. 25, 2004).

52. Rev. Rul. 85-184, 1985-2 C.B. 8; Priv. Ltr. Rul. 93-35-022 (June 3, 1993).

collects a charitable contribution from its purchasers as an agent for the charity. Some commentators suggest, however, that whether the agent is acting on behalf of the charity or on behalf of multiple donors should not make a difference.⁵³ Given this analysis, when charity malls give purchasers the option to receive a rebate in lieu of directing a portion of the sales to charity, payments to an EO should be treated as charitable contributions from the purchasers.

Notwithstanding the foregoing, most charity malls have arrangements whereby the contributions to the EOs are not optional and the cost of the goods purchased equals the fair market value of the goods. These charity malls do not represent that the payments to the EOs are tax deductible.⁵⁴ Under these arrangements, the payments to the EOs should not be deemed as charitable contributions and the purchasers should not be entitled to charitable deductions.

2. *Consequences to the EO*

If payments to an EO are treated as charitable contributions from the purchasers, they should not be characterized as payments from the charity mall or the vendor. In the event that such payments are not charitable contributions, it is necessary to determine whether such activities constitute a regularly carried on unrelated trade or business. If so, the EO may, under certain circumstances, take advantage of the royalty exception from UBIT. To do so, the EO must enter into an agreement with the charity mall that characterizes the payments to the EO generated by sales made through the charity mall's hyperlink as royalty payments. Then, the charity mall must use the EO's name or logo on its website to attract purchasers and the EO must not provide services to either the online vendors or charity mall.⁵⁵ If these criteria are met, payments to the charity should be treated as royalty payments arising from the use of intangible property under the mailing list and affinity credit card cases described earlier.

When a charity mall lists the names or logos of EOs as potential recipients of a portion of purchases made through the

53. Jennifer S. Gorovitz et al., *Getting Connected: Business and Politics of Charities on the Internet*, 2001 TAX NOTES TODAY 183-42 (Sept. 20, 2001).

54. See www.BuyforCharity.com; www.GreaterGood.com; www.MyCause.com.

55. This analysis assumes that the EO does not engage in any advertising, as defined in Treasury Regulation § 1.513-4(c)(2)(v) (2004).

charity mall, it exploits the EOs' goodwill and benefits from the use of such EOs' intangible property rights. Shoppers are induced to make purchases through a charity mall by the charity mall's promise to make a payment to the named EOs. Similar to the online vendor model, this method of attracting consumers is analogous to the way in which a credit card company induces customers to sign up for affinity credit cards. In either situation, the charity mall or credit card company benefits from an association with an EO by attracting customers. In a charity mall arrangement, the EO does not provide any services to the charity mall or online vendor. The charity mall handles the payments to the EO and administers all arrangements between purchasers and online vendors. The EO supplies only its name, logo, and goodwill, which are intangible property. The payments the EO receives pursuant to this form of charity mall arrangement are most appropriately characterized as nontaxable royalty income.

In contrast, some charity malls allow purchasers to fill in the name of a charity to benefit.⁵⁶ The charity mall may not have an agreement with every possible EO that a purchaser could choose. Without an agreement between the EO and the charity mall, the EO is not engaged in any business activity, and thus has no UBTI. Furthermore, when a purchaser has to take the initiative to fill in the name of an EO, any payment made from the charity mall to the EO cannot be construed as a royalty payment. The payment is not in exchange for the use of the EO's intangible property rights because the charity mall does not list the EO's name or logo, and, therefore, the charity mall does not exploit the EO's goodwill. Rather, the charity mall attracts customers with the promise that a purchaser may direct a portion of his or her purchase to charity.

C. *A Variation of the Charity Mall—Electronic Scrip*

The tax treatment of charity mall payments to EOs requires the same analysis as electronic scrip programs because they work in essentially the same way. Electronic scrip traces its roots to traditional scrip, which are gift certificates that EOs (typically schools) buy from vendors at a discount and sell to supporters at fair market value.⁵⁷ In contrast, electronic scrip websites host

56. See www.BuyforCharity.com; www.GreaterGood.com; www.MyCause.com.

57. See Chasin et al., *supra* note 51, at 129.

hyperlinks to online vendors.⁵⁸ When charitable-minded individuals shop with these online vendors, a portion of the proceeds of their purchases is paid to an EO designated by the individuals.⁵⁹

Given the functional similarity between an electronic scrip program and a charity mall arrangement, electronic scrip websites should be analyzed in the same manner. If an electronic scrip website customer pays more than the fair market value for a product and intends the excess amount to be a charitable contribution, then the excess should be treated as a charitable contribution. If the payments are not charitable contributions, the EO should evaluate the arrangement with the electronic scrip program. It is necessary to consider whether an agreement characterizes the payments as royalty payments and whether the scrip program profits from the EO's goodwill. If the electronic scrip website lists the name or logo of the EO and does not receive services from the EO, the payment should be deemed a royalty exempt from UBIT. If the electronic scrip website does not use the EO's name or logo, or if there is no agreement in place, the payment should not be classified as a royalty.⁶⁰

IV. APPLICABILITY OF THE VOLUNTEER EXCEPTION UNDER § 513(A)(1) TO ONLINE SALES MADE BY EOS

The IRS should issue guidance that, under certain circumstances enumerated below, the volunteer exception to UBTI under § 513(a)(1) applies to income made by EOs from online sales if substantially all of the work is performed by volunteers. This rule should apply even though paid individuals build, maintain, and upgrade an EO's sales website.

The application of the volunteer exception is appropriate for three reasons. First, the setup and maintenance of the sales website is not part of the "work" involved in carrying on the unrelated trade or business generating the income. Instead, the Internet retail

58. See, e.g., www.schoolpop.com (last visited Mar. 25, 2004).

59. See *id.*; see generally Christina L. Nooney, *Tax Exempt Organizations and the Internet*, 27 EXEMPT ORG. TAX REV. 33, 36-37 (Jan. 2000) (describing referral payments from commercial sites and e-commerce benefits to charities).

60. In some instances, electronic scrip websites suggest that EO supporters market the electronic scrip program to the EO's support base using printed literature. In that case, royalty treatment may be available depending on the content of the printed material.

sales themselves constitute the work of carrying on the unrelated trade or business. The setup and maintenance of a website is akin to the construction and maintenance of a physical store. Because the IRS does not consider the construction and maintenance of a physical store when determining whether the volunteer exception is available,⁶¹ the construction and maintenance of a website by paid individuals should not prevent a finding that substantially all of the “work” involved in carrying on the unrelated trade or business is performed by volunteers. Second, even if the setup and maintenance of the sales website is considered part of the “work” involved in carrying on the unrelated trade or business, it is unrealistic to expect volunteers to be capable of performing website construction and maintenance, given its highly technical nature. Finally, as long as the percentage of time spent on compensated sales website construction and maintenance is minimal, relative to the time spent on uncompensated Internet sales operations, substantially all of the “work” in carrying on the unrelated trade or business should be deemed as being performed by uncompensated individuals.

A proposed Revenue Ruling describing the circumstances under which the volunteer exception applies to Internet sales is attached as Exhibit C below.⁶² The proposed Revenue Ruling provides guidance as to when the volunteer exception would be available.

A. *An Overview of EOs’ Direct Internet Sales*

EOs, both large and small, are increasingly raising funds through direct Internet sales to consumers.⁶³ EOs set up websites

61. See *infra* Part IV.B.1.

62. See *infra* Exhibit C. The proposed Revenue Ruling assumes that the “work” performed to set up and maintain the online sales website of an exempt organization is part of the “work” contemplated by § 513 and that substantially all of such work must be performed by volunteers in order for the organization to be eligible for the volunteer exception. *Id.* This assumption has been made for convenience and clarity; as noted *infra* Part IV.B, the “work” to construct and maintain the online sales website may more appropriately be separated from the “work” involved in carrying on the unrelated trade or business of retail sales.

63. Smaller charities that have online retail stores include such organizations as Decatur Memorial Hospital Gift Shop (<http://dmhcares.org/services/giftshop/>), Clark Memorial Hospital (<http://www.clarkmemorial.org/giftshop.asp>), Old North Church Gift Shop (<http://www.oldnorth.com/cata.htm>), Saints Peter and Paul Mission (<http://www.sspp-tucson.org/giftshop.html>) and The National Shrine of St. Francis of Assisi Franciscan Centre Gift Shop

to facilitate retail sales over the Internet.⁶⁴ In most cases, the design, creation, and maintenance of a secure sales website require technical skills beyond the capacity of ordinary volunteers. Volunteers, however, can easily perform substantially all other tasks such as processing sales, shipping items, and updating descriptions and listings of goods and prices on the website.

B. The Volunteer Exception to UBTI

As stated above, an EO's income derived from any regularly carried on unrelated trade or business is subject to UBIT pursuant to § 512(a)(1).⁶⁵ Section 513(a)(1), however, provides that the term "unrelated trade or business" excludes any trade or business in which substantially all the work in carrying on the unrelated trade or business generating the income is performed for the organization without compensation.⁶⁶ Section 1.513-1(e) of the Treasury Regulations provides an example of the kind of trade or business that is not included in the term "unrelated trade or business" under § 513(a)(1) of the Code.⁶⁷ In the example, an exempt orphanage operates a retail store that sells to the general public.⁶⁸ Substantially all the work in carrying on the business is performed for the organization by volunteers without compensation.⁶⁹

This exception to UBTI is commonly known as the "volunteer exception."⁷⁰ Currently, there is no bright-line test to determine when the volunteer exception applies. The IRS has issued Treasury Regulations and numerous rulings and memoranda that evaluate each situation on its facts and circumstances. The reasoning of some of that advice, although not binding, is helpful in analyzing the proper treatment of income from an EO's Internet sales.

(<http://www.shrinesf.org/giftshop/834.htm>). Larger charities which operate online retail shops include the Metropolitan Museum of Art (<http://www.metmuseum.org/store/index.asp>), the Smithsonian Institution (<http://www.smithsonianstore.com/home.asp>), the American Diabetes Association (<http://store.diabetes.org/>), and the American Lung Association (<http://lung.usptgear.com/>).

64. See sources cited *supra* note 63.

65. I.R.C. § 512(a)(1).

66. § 513(a)(1).

67. Treas. Reg. § 1.513-1(e) (2004).

68. § 1.513-1(e)(3).

69. *Id.*

70. See, e.g., Suzanne Ross McDowell, *Exempt Organizations' Use of the Internet*, SJ039 A.L.I. 291, 306 (Dec. 4-5, 2003).

1. *Courts ignore the work needed to acquire the facilities where the unrelated trade or business activities occur.*

In *Waco Lodge No. 166 v. Commissioner*,⁷¹ a fraternal lodge conducted bingo games. One paid worker and four unpaid volunteers operated the games.⁷² The Fifth Circuit Court of Appeals held that a paid bartender's work on the bingo nights was part of the work of the bingo games because the operation of the bar was important to the success of the nights.⁷³ Accordingly, substantially all of the work was not performed by volunteers and the volunteer exception was inapplicable.⁷⁴ The Fifth Circuit did not address the work required to acquire the facility where the bingo games were held.⁷⁵

2. *The IRS does not require volunteers to perform technically specialized tasks.*

In Private Letter Ruling 83-43-101,⁷⁶ a church proposed building homes on lots it owned and then selling the improved lots. Although volunteers would perform most of the construction work, local building ordinances required that paid professionals perform certain tasks such as: excavation, site preparation, and electrical and plumbing work.⁷⁷ The IRS ruled that the volunteer exception applied to the income generated by the improvement and sale of the lots because substantially all of the work was performed by volunteers.⁷⁸

3. *The IRS compares the time spent on technical tasks performed by paid workers to the time spent on nontechnical tasks performed by volunteers.*

In Technical Advice Memorandum 82-11-002,⁷⁹ the IRS found that the publication and sale of a cookbook fell under the

71. 696 F.2d 372 (5th Cir. 1983), *aff'd* 42 T.C.M. (CCH) 1202 (1981).

72. *Id.* at 373.

73. *Id.* at 375.

74. *Id.*

75. *See id.*

76. Priv. Ltr. Rul. 83-43-101 (July 28, 1983).

77. *Id.*

78. *Id.* The IRS has ruled that where a paid employee performs administratively specialized tasks, the volunteer exception may still be available. Priv. Ltr. Rul. 97-04-012 (Jan. 24, 1997).

79. Tech. Adv. Mem. 82-11-002 (1982).

volunteer exception because substantially all of the work performed for the organization was without compensation.⁸⁰ Volunteers gathered the materials for, laid out, and edited the cookbook.⁸¹ The volunteers did not undertake the actual printing of the cookbook,⁸² but they processed orders and shipped books.⁸³ The IRS found that the actual trade or business in question was the publication and sale of a cookbook.⁸⁴ When determining whether substantially all of the work was performed by volunteers, however, the IRS chose to take into account the volunteer prepublishing time.⁸⁵

In Technical Advice Memorandum 79-05-003,⁸⁶ an organization's members performed all of the work to compile a cookbook without compensation including: submitting, testing, and selecting the recipes; providing artwork and typing formats; and proofreading, promoting, and distributing the cookbook.⁸⁷ Although paid independent contractors performed tasks "such as bookbinding, printing and art layout,"⁸⁸ the IRS held that the volunteer exception applied because members did not possess the skills required to complete those tasks.⁸⁹ The IRS highlighted the fact that the percentage of compensated time was likely small in comparison to the uncompensated time.⁹⁰

C. *Application of the Volunteer Exception to EOs' Direct Sales*

Three justifications emerge from the above examples in support of applying the volunteer exception to income generated by an EO's online retail store. Even if paid individuals design and maintain the retail website:

(1) the compensated services do not constitute the "work" involved in carrying out the unrelated trade or business giving rise to the UBTI;⁹¹

80. *Id.*

81. *Id.*

82. *See id.*

83. *Id.*

84. *Id.*

85. *Id.*

86. Tech. Adv. Mem. 79-05-003 (1979).

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. Priv. Ltr. Rul. 97-04-012 (Jan. 24, 1997).

(2) if the compensated services do constitute the “work” giving rise to the UBTI, the compensated services are for tasks that volunteers cannot perform because they lack technical expertise;⁹² and

(3) if the compensated services do constitute the “work” giving rise to the UBTI, the compensated website work is minimal in comparison with the uncompensated work.⁹³

First, the setup and maintenance of a website for Internet retail sales is not the work that constitutes the unrelated trade or business that generates UBTI. The design and creation of a website is like the planning, construction, and interior design of a physical store. An Internet sales website is, after all, a proxy for a bricks-and-mortar store. The need to repair, troubleshoot, and update a website to reflect changes in the Internet and computer technology are analogous to the need to maintain the plumbing, roofing, and interior appearance of a physical store. The Treasury Regulations and IRS advice are silent about requirements that volunteers perform the construction and maintenance of a physical retail store. Similarly, in *Waco Lodge*, the court did not discuss how the lodge in which the bingo games were conducted was acquired.⁹⁴ One may assume from the silence that construction and maintenance of the facility is not itself part of the work of the unrelated trade or business. Instead, the actual conduct of the retail sales is the work that generates income. As a result, if an EO compensates individuals for the design, creation, and maintenance of a website for retail sales, such compensation should be disregarded when determining whether substantially all of the work is performed by volunteers. Assuming that substantially all of the retail sales work is performed by uncompensated individuals, the volunteer exception should apply despite the paid website services.

Second, the design and establishment of a usable Internet sales website that is secure for credit card transactions requires skilled expertise. In the same way that volunteers are not expected to excavate real property lots, perform electrical and plumbing work,⁹⁵ or expected to print cookbooks themselves,⁹⁶ a volunteer

92. Tech. Adv. Mem. 82-11-002 (1982).

93. Tech. Adv. Mem. 79-05-003 (1979).

94. *Waco Lodge v. Comm’r*, 696 F.2d 372 (5th Cir. 1983).

95. See Priv. Ltr. Rul. 83-43-107 (July 28, 1983).

96. See Tech. Adv. Mem. 82-11-002 (1983); Tech. Adv. Mem. 79-05-003 (1979).

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should not be expected to provide website expertise. For this reason, the volunteer exception should apply to the income from an EO's Internet sales if volunteers perform substantially all of the work other than the technical work necessary to build and maintain the website.

Third, IRS advice indicates that if the compensated work is minimal when compared with the uncompensated work, it is appropriate to find that substantially all of the work is performed by volunteers.⁹⁷ Generally, the amount of time involved in having a paid professional create and maintain a website is small relative to the amount of time volunteers devote to retail sales activities. As long as such compensated website time is minimal relative to the uncompensated time devoted to retail sales activities, it is appropriate to find that substantially all of the work relating to the sales is performed by volunteers.⁹⁸

EXHIBIT A—ONLINE VENDOR PROPOSED REVENUE RULING

Section 512.—Unrelated Business Taxable Income

PROPOSED ISSUE

Is income received by the organization in the situation described below unrelated business taxable income within the meaning of § 512 of the Internal Revenue Code? *See* I.R.C. § 512 (2000).

PROPOSED FACTS

The organization is exempt from federal income tax under § 501(c)(3) of the Code. *See* § 501(c)(3) (West 2004). Its purpose is to promote children's literacy in City X. In furtherance of its exempt purpose, it sponsors various educational and social welfare programs. To raise money to fund such programs, the organization provides a hyperlink on its website to an online home improvement store. The website describes the arrangement between the online vendor and the organization. The organization does not otherwise promote sales of items sold by the online vendor.

97. Tech. Adv. Mem. 79-05-003 (1979).

98. *See id.*

Under the terms of an affiliate agreement between the organization and the online vendor, the online vendor pays the organization a “royalty” based on the percentage of sales attributable to the organization’s hyperlink to the online vendor. The payments to the organization are not dependent on whether the sales are attributable to items related to the organization’s purpose.

PROPOSED LAW AND ANALYSIS

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from tax under § 501(c). I.R.C. § 511 (2000).

Section 512(a)(1) of the Code defines the term “unrelated business taxable income” to mean “the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed . . . which are directly connected with the carrying on of such trade or business.” § 512(a)(1).

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 . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.” § 513(a).

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.” § 513(c).

Section 1.513-1(a) of the Treasury Regulations provides that:

unless one of the specific exceptions [or modifications] to section 512 or 513 is applicable, gross income of an exempt organization . . . is includible 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.

Treas. Reg. § 1.513-1(a) (2004).

Section 1.513-1(d)(2) of the Treasury Regulations provides

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that a trade or business is substantially related to an organization's exempt purposes only in those circumstances under which the conduct of the business activities has a substantial causal relationship to the achievement of the exempt purposes (other than through the production of income). § 1.513-1(d)(2). It states:

[F]or the conduct of [the] trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which [an organization's] 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.

Id.

Section 512(b)(2) of the Code excludes from the computation of unrelated business taxable income "all royalties . . . whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income." I.R.C. § 512(b)(2) (2000).

Section 1.512(b)-1 of the Treasury 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." Treas. Reg. § 1.512(b)-1 (2004).

In *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996), *aff'g* T.C.M. (RIA) 93-199 (1993) and *rev'g on other grounds* 103 T.C. 307 (1994), the court held that royalties under § 512(b)(2) of the Code are defined as "payments received for the right to use intangible property rights, and that such definition does not include payments for services." *Id.* at 1535. With respect to income derived from the use of Sierra Club's mailing list, the court held that such income was royalty income under § 512(b)(2) and not payment for services. *Id.* at 1536.

With respect to income derived from Sierra Club's affinity credit card program, the court remanded for findings of fact as to whether the amounts in question constituted royalties under § 512(b)(2). *Id.* at 1537. The Tax Court subsequently concluded that such amounts were royalties and, therefore, not taxable under § 511. *See* *Sierra Club, Inc. v. Comm'r*, 77 T.C.M. (CCH) 1569 (1999).

Organizations described in § 501(c)(3) of the Code are subject to tax on their unrelated business income under § 511 if all three of the following requirements are met: (1) the income is from a trade or business; (2) the trade or business is regularly carried on; and (3) the conduct of the trade or business is not substantially related to the organization's exempt function. I.R.C. § 511 (2000). If each of these requirements is met, then it is necessary to determine whether any exceptions or modifications to this rule are available.

Neither the receipts derived from nor the expenses incurred in connection with an agreement between such an organization and an online vendor are to be taken into account in computing the organization's unrelated business taxable income if the following requirements are met: (1) the agreement characterizes the payments to the organization as royalties; (2) payments received by the organization are based on the revenues attributable to sales generated through the organization's hyperlink to the online vendor's website; (3) the organization's website includes its name or logo; (4) the hyperlink is visible to nonmembers of the organization; (5) the organization merely describes the agreement between the online vendor and the organization on its website; and (6) the organization does not provide any services to the online vendor.

The agreement between the online vendor and the organization generates income from a trade or business that is regularly carried on. The agreement is not substantially related to the organization's exempt purpose because the agreement does not directly improve children's literacy in City X. Therefore, the agreement has no causal relationship to the performance of the organization's exempt purpose and does not contribute importantly to the accomplishment of those purposes. Accordingly, the income received by the organization from the agreement with the online vendor is gross income from an unrelated trade or business within the meaning of § 513 of the Code.

The agreement contemplates that the payments under the agreement are royalties. The payments under the agreement are based on the online vendor's revenues that are attributable to sales generated through the hyperlink located on the organization's website. The organization's website includes its name and logo. Because the hyperlink is visible to non-members, its use exploits the

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organization's goodwill. Because the organization's website merely describes the arrangement between the online vendor and the organization, and the organization does not provide any services to the online vendor, the payments to the organization are not payments for services rendered.

The payments under the agreement are for the use of the organization's name, logo, and goodwill. Such payments are, therefore, royalties within the meaning of § 512(b)(2). Neither the receipts derived from nor the expenses incurred in connection with the agreement with the online vendor are to be taken into account in computing the organization's unrelated business taxable income.

PROPOSED HOLDING

Income received by the organization from the online vendor for the use of the name, logo, and goodwill of the organization is gross income from an unrelated trade or business under § 513. Because such income is royalty income within the meaning of § 512(b)(2), neither the income nor any related expenses are taken into account in computing the organization's unrelated business taxable income under § 512.

EXHIBIT B—CHARITY MALL PROPOSED REVENUE RULING

Section 512.—Unrelated Business Taxable Income

PROPOSED ISSUE

Is income received by the organization in the situation described below unrelated business taxable income within the meaning of § 512 of the Internal Revenue Code? *See* I.R.C. § 512 (2000).

PROPOSED FACTS

The organization is exempt from federal income tax under § 501(c)(3) of the Code. *See* I.R.C. § 501(c)(3) (West 2004). Its purpose is to promote children's literacy in City X. In furtherance of its exempt purpose, it sponsors various educational and social

welfare programs. To raise money to fund such programs, the organization has entered into an agreement with an online charity mall. The organization describes the relationship among the charity mall, the online vendor, and itself on its website.

The charity mall maintains a website that provides hyperlinks to online vendors. The charity mall informs potential purchasers that if they make purchases through the charity mall website at one of the linked vendors, the purchasers may direct that a portion of the proceeds of their purchases be given to charity. The charity mall lists the organization as one of many charities the purchasers may choose to benefit.

The agreement between the charity mall and the organization contemplates that the payments under the agreement are royalties. The charity mall does not indicate that any portion of the customer's purchases is eligible for deduction as a charitable contribution. The charity mall does not give the purchasers the option of receiving any portion of the purchase price as a rebate. Such portion of the purchase price must be contributed to the organization or a similar charity.

PROPOSED LAW AND ANALYSIS

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from tax under § 501(c). I.R.C. § 511 (2000).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean "the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed . . . which are directly connected with the carrying on of such trade or business." § 512(a)(1).

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 . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption." § 513(a).

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." § 513(c).

Section 1.513-1(a) of the Treasury Regulations provides that:

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unless one of the specific exceptions [or modifications] to section 512 or 513 is applicable, gross income of an exempt organization . . . is includible 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.

Treas. Reg. § 1.513-1(a) (2004).

Section 1.513-1(d)(2) of the Treasury Regulations provides that a trade or business is substantially related to an organization's exempt purposes only in those circumstances under which the conduct of the business activities has a substantial causal relationship to the achievement of the exempt purposes (other than through the production of income). § 1.513-1(d)(2). It states:

[F]or the conduct of [the] trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which [an organization's] 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.

Id.

Section 512(b)(2) of the Code excludes from the computation of unrelated business taxable income "all royalties . . . whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income." I.R.C. § 512(b)(2) (2000).

Section 1.512(b)-1 of the Treasury 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." Treas. Reg. § 1.512(b)-1 (2004).

In *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996), *aff'g* T.C.M. (RIA) 93-199 (1993) and *rev'g on other grounds* 103 T.C. 307 (1994), the court held that royalties in § 512(b)(2) are defined as "payments received for the right to use intangible property rights, and that such definition does not include payments

for services.” *Id.* at 1535. With respect to income derived from the use of Sierra Club’s mailing list, the court held that such income was royalty income under § 512(b)(2) and not payment for services. *Id.* at 1536.

With respect to income derived from Sierra Club’s affinity credit card program, the court remanded for findings of fact as to whether the amounts in question constituted royalties under § 512(b)(2). *Id.* at 1537. The Tax Court subsequently concluded that such amounts were royalties and, therefore, not taxable under § 511. *See* *Sierra Club v. Comm’r*, T.C.M. (RIA) 99,086 (1999).

Organizations described in § 501(c)(3) of the Code are subject to tax on their unrelated business income under § 511 if all three of the following requirements are met: (1) the income is from a trade or business; (2) the trade or business is regularly carried on; and (3) the conduct of the trade or business is not substantially related to the organization’s exempt function. I.R.C. § 511 (2000). If each of these requirements is met, then it is necessary to determine whether any exceptions or modifications to this rule are available.

Neither the receipts derived from nor the expenses incurred in connection with the agreement with the charity mall are to be taken into account in computing the organization’s unrelated business taxable income if the following requirements are met: (1) the agreement characterizes the payments to the organization as royalties; (2) payments received by the organization are based on the revenues attributable to sales generated through the charity mall’s hyperlink to the online vendor’s website; (3) the charity mall’s website lists the organization’s name or logo; (4) the organization merely identifies the relationship among the organization, the charity mall, and the online vendor; and (5) the organization does not provide services to the charity mall or online vendor.

The agreement between the charity mall and the organization generates income from a trade or business that is regularly carried on. The agreement is not substantially related to the organization’s exempt purpose because the agreement does not directly improve children’s literacy in City X. Therefore, the agreement has no causal relationship to the performance of the organization’s exempt purpose and does not contribute importantly to the accomplishment of those purposes. Accordingly, the income received by the organization from the agreement with the charity

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mall is gross income from an unrelated trade or business within the meaning of § 513 of the Code.

The agreement contemplates that the payments under the agreement are royalties. The payments under the agreement are based on the online vendor's revenues that are attributable to sales generated through the hyperlink on the charity mall's website. The charity mall's website lists the organization's name. Because the name of the organization is visible to nonmembers of the organization, its use to attract nonmembers exploits the organization's goodwill. Because the organization merely describes the arrangement between the charity mall, the online vendor, and the organization, and the organization does not provide services to the charity mall or online vendor, the payments to the organization are not payments for services rendered.

The payments to the organization are for the use of the organization's name and goodwill. Such payments are, therefore, royalties within the meaning of § 512(b)(2). Neither the receipts derived from nor the expenses incurred in connection with the agreement with the charity mall are to be taken into account in computing the organization's unrelated business taxable income.

PROPOSED HOLDING

Income received by the organization from the arrangement with the charity mall for the use of the name and goodwill of the organization is gross income from an unrelated trade or business under § 513 of the Code. Because such income is royalty income within the meaning of § 512(b)(2), neither the income nor any related expenses are taken into account in computing the organization's unrelated business taxable income under § 512.

EXHIBIT C—VOLUNTEER EXCEPTION PROPOSED REVENUE RULING

Section 512.—Unrelated Business Taxable Income

PROPOSED ISSUE

Is income received by the organization in the situation described below unrelated business taxable income within the

meaning of § 512 of the Internal Revenue Code? *See* I.R.C. § 512 (2000).

PROPOSED FACTS

The organization is exempt from federal income tax under § 501(c)(3) of the Code. *See* § 501(c)(3) (West 2004). Its purpose is to promote children's literacy in City X. In furtherance of its exempt purpose, it sponsors various educational and social welfare programs. To raise money to fund such programs, the organization operates an online store that sells clothing and souvenirs bearing the name and logo of the organization.

The organization hires independent contractors to design and build the website for its online store. The organization also pays the independent contractors to maintain and upgrade the website hosting the online store. Volunteers perform, without compensation, all other tasks relating to the organization's Internet sales. The activities performed by volunteers include processing the sales; packaging and shipping sold items; and updating descriptions and listings of the goods and prices of items sold on the organization's sales website.

PROPOSED LAW AND ANALYSIS

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from tax under § 501(c). I.R.C. § 511 (2000).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean "the gross income derived by any such organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed . . . which are directly connected with the carrying on of such trade or business." § 512(a)(1).

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 . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption." § 513(a).

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.” § 513(c).

Section 1.513-1(a) of the Treasury Regulations provides that: unless one of the specific exceptions [or modifications] to section 512 or 513 the code is applicable, gross income of an exempt organization . . . is includible 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.

Treas. Reg. § 1.513-1(a) (2004).

Section 513(a)(1) of the Code provides that the term “unrelated trade or business” excludes any trade or business “in which substantially all the work in carrying on such trade or business is performed for the organization without compensation.” I.R.C. § 513(a) (2000).

Section 1.513-1(e) of the Treasury Regulations provides an example of the kind of trade or business that is not included in the term “unrelated trade or business” under § 513(a)(1) of the Code. Treas. Reg. § 1.513-1(e)(3)(2004). In the example, an exempt orphanage operates a retail store that sells to the general public, where substantially all the work in carrying on the business is performed for the organization by volunteers without compensation. *Id.*

The online sales website generates income from a trade or business that is regularly carried on. The sales are not substantially related to the organization’s exempt purpose because the sales do not directly improve children’s literacy in City X and, therefore, have no causal relationship to the performance of the organization’s exempt purpose and do not contribute importantly to the accomplishment of those purposes. Accordingly, the income received by the organization from the online sales is gross income from an unrelated trade or business within the meaning of § 513 of the Code.

All the work required to operate the online store is performed by uncompensated volunteers. The only tasks performed by paid workers are those technical services required to design, build, operate, and maintain the structure of the website itself. The

volunteers are precluded from assisting in those activities performed by the paid workers by the technical nature of the activities. In addition, the compensated services are minimal in comparison with the ongoing uncompensated services. As a result, substantially all the work performed in carrying on such trade or business of the sales is performed for the organization without compensation within the meaning of § 513 of the Code.

Neither the receipts derived from nor the expenses incurred in connection with the organization's online store are to be taken into account in computing the organization's unrelated business taxable income.

PROPOSED HOLDING

Because unpaid volunteers perform substantially all the work with respect to the online sales from which they are not precluded due to lack of technical expertise and because the compensated work is minimal in comparison with the uncompensated work, neither the income nor any related expenses are taken into account in computing the organization's unrelated business taxable income under § 512.