



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number: XXXXXX

Uniform Issue List
512.00-00

Dear _____ :

This is in response to your ruling request on whether income from the sale of intellectual property rights to a website is subject to unrelated business income tax under sections 511 and 512 of the Internal Revenue Code.

FACTS:

On Date 1, you were recognized as tax-exempt under section 501(c)(3) of the Code, and classified as a church under sections 509(a)(1) and 170(b)(1)(A)(i).

Between 2007 and 2008, an employee of your church designed and constructed computer software that runs Y. Y is an interactive communication system for your church and church members. In addition, you represent you developed Y for a non-commercial purpose.

You represent that because of widespread use of Y by your church and church members and positive reviews about Y, sister churches began asking how to set up similar websites. For-profit entities began making inquiries about purchasing the intellectual property rights to Y.

You represent that in order to focus more on your tax-exempt purpose, in the summer of 2008, you decided to sell the intellectual property rights to Y. For \$x, W entered into a purchase agreement ("Agreement") and purchased from you the intellectual property rights to Y on Date 2, with the understanding that you will have a perpetual license to use Y at no cost to you. Further, you represent that W may allocate up to \$z of the purchase price to a "no compete" clause in the Agreement; however, W has not specified the amount.

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You represent that you have no further duties in developing Y, and the Agreement restricts you from engaging in any further development relating to Y except as a user of Y. You ordinarily develop intellectual property as a by-product of performing your exempt functions through delivery of sermons, teaching materials, and music for internal use, and not for commercial purpose. Finally, you represent (1) that you plan not to engage in the future sale of computer software; (2) that the sale of the intellectual property rights to Y was a one-time only operation; and (3) that the sale of intellectual property rights to computer software will not be an on-going income producing activity by you.

RULING REQUESTED:

You have requested the following ruling:

That the income from your sale of the intellectual property rights to Y, intellectual property rights you developed for a non-commercial purpose but only to the extent needed to carry on your exempt activities does not constitute unrelated business income under section 512 of the Code and is not subject to unrelated business income taxation under section 511.

LAW:

Section 511(a)(1) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c), including organizations described in section 501(c)(3).

Section 512(a)(1) of the Code defines "unrelated business taxable income" generally as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 512(b) of the Code sets forth so-called "modifications" which are excluded from the computation of unrelated business taxable income. These modifications include dividends, interest, royalties, rent from real property, and gain from the sale of property.

Section 513(a) of the Code defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of the purpose or function constituting the basis for its exemption under section 501(a).

Section 513(c) of the Code provides that "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. An activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

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Section 1.512(b)-1(d) of the Income Tax Regulations ("regulations") provides that regarding sale of properties, there shall be excluded from unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property other than (1) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (2) property held primarily for sale to customers in the ordinary course of the trade or business.

Section 1.513-1(a) of the regulations provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code 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.

Section 1.513-1(b) of the regulations provides that for purposes of section 513 of the Code the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(c)(1) of the regulations provides that in determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. For example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of non-exempt organizations.

ANALYSIS:

The issue is whether income from your sale of the intellectual property rights to Y qualifies as unrelated business taxable income under section 511 of the Code. Section 511 imposes a tax on unrelated business income of section 501(c)(3) organizations otherwise known as tax-exempt organizations. Under section 512, unrelated business taxable income includes gross income derived from an unrelated trade or business activity or transaction that a tax-exempt organization carries on regularly. Further, under section 1.513-1(a) of the regulations, income derived from an activity is unrelated business taxable income, if the activity (1) is a trade or business; (2) is regularly carried on; and (3) is not substantially related to the tax-exempt organization's exercise or performance of its tax-exempt functions or purpose, a three part test. The activity must meet all three tests before income from the activity is taxable under section 512.

Under the first test of section 1.513-1(a) of the regulations, we must determine whether the income you received from your sale of the intellectual property rights to Y is a trade or business. Section 1.513-1(b) provides that any activity carried on for the production of income from the sale of goods or the performance of services, is a trade or business. The above facts indicate you sold the intellectual property rights to Y for \$x. Pursuant to the Agreement, upon the

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completion of the sale transaction, you will have no ownership of Y and no ownership of the intellectual property rights to Y except the right as a perpetual licensed user of Y. Thus, because you earned income from the sale of the entire intellectual property rights to Y, you performed or carried on a trade or business.

Under the second test of section 1.513-1(a) of the regulations, we must determine whether you regularly perform the trade or business of selling intellectual property rights or similar transactions. Section 1.513-1(c)(1) defines "regularly carried on" to mean a trade or business activity frequently and continuously pursued by a tax-exempt organization in a manner generally similar to comparable commercial activities of non-exempt organizations. Applying the above law, your sale of the intellectual property rights to Y is not a continuous and consistent income producing activity because you performed or carried on this activity once. You have not developed and sold intellectual property rights to computer software in the past. Further, the Agreement restricts you from further developing Y. Finally, you represent that you do not plan to engage in the future sale of computer software; that the sale of the intellectual property rights to Y was a one-time only transaction; and that the sale of intellectual property rights to computer software will not be an ongoing income producing activity by you. Thus, your sale of the intellectual property rights to Y failed to meet the second test of section 1.513-1(a).

Income from an activity is taxable under section 511 of the Code, as unrelated business income, if the activity meets all the tests enumerated under section 1.513-1(a) of the regulations, which includes the trade or business activity test, the regularity performance test, and the non-substantial relationship test. Because your sale of the intellectual property rights of Y did not meet the regularity performance test of section 1.513-1(a), though it met the trade or business activity test, it is not necessary for us to continue with the consideration on whether your sale of Y is not substantially related to your tax-exempt purpose. Having failed one of the tests, the regularity test, the income from your sale of Y is not taxable under sections 511 through 514.

RULING:

Based on the information submitted, we rule as follows:

The income from your one-time sale of the intellectual property rights to Y does not constitute unrelated business taxable income under section 512 of the Code, and thus, is not subject to unrelated business income taxation under section 511.

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

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

This ruling is based on the facts as they were presented and on the understanding that there will

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be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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

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

Sincerely,

Robert W. Malone
Acting Manager
Exempt Organizations
Technical Group 3

Enclosure
Notice 437