



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:

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UIL: 512.00-00

Dear :

We have considered your ruling request dated April 26, 2013, concerning the tax consequences under Internal Revenue Code (I.R.C.) §§ 501(c)(3) and 511, related to a proposed liquidation of your intellectual property rights in several IPv4 addresses.

Facts:

You are recognized as a tax-exempt supporting organization under § 501(c)(3) of the Code. You are governed by and support the public university system in the state in which you are incorporated. You provide research and development in the field of telecommunications and internet information technology. Your exempt activities included the initial research and development and operation of a non-profit telecommunications network serving your university system (later extended to other tax-exempt non-governing affiliates, including schools, colleges, libraries, law enforcement, non-profit hospitals).

Several decades ago, you received a distribution of several million IPv4 addresses, which you use as part of your tax-exempt activities. These IPv4 addresses were assigned to you to permit you to do your research and development work, and to develop and build this network to serve the exempt educational and research mission of you and your governing members (later extended to other tax-exempt non-governing affiliates). Your interest in these IPv4 addresses is the intellectual property rights to use the addresses and assign these rights subject to restrictions. You represented that you have never characterized or used your IPv4 addresses as inventory in any sense and never had reason to reflect these addresses on your balance sheet or property schedules. At the time of this distribution, and continuing into the present, IPv4 addresses were and still are distributed to public, private and governmental entities and individuals. Presently, the Internet Corporation for Assigned Names and Numbers ("ICANN"), a non-profit, continues to distribute IPv4 addresses globally. Distribution of IP addresses is conducted via regional registries: your region is governed by the American Registry for Internet Numbers ("ARIN").

You represented that the global supply of IPv4 addresses is finite, and the supply of

unallocated IPv4 addresses is diminishing due to increased demand for wireless internet communication. In response, IPv6 addresses are being "phased-in" to replace IPv4 addresses. However, IPv6 addresses are not "backwards compatible" to IPv4 addresses, and thus devices with addresses on one version can only communicate with devices with addresses of the same version. As such, internet service providers who wish to immediately offer customers full functionality must use IPv4 addresses in addition to IPv6 addresses, and will need to do so until some unknown future time.

You represented that of the IPv4 addresses that were distributed to you decades earlier, you have several million addresses that you did not use and will not be able to use in your exempt activities before the migration to IPv6 addresses; therefore, you propose to liquidate these unused IPv4 addresses. You represented that although you would prefer to liquidate all your surplus addresses to a single buyer in a single transaction, there are several legal and financial barriers, described below, that preclude a single-sale transaction.

Any transfer of IPv4 address must be approved by ARIN. You represented that the ARIN review process is detailed and has several requirements. One requirement of the ARIN review process is that the prospective transferee demonstrates to ARIN that they have a need for up to a 24 month supply of the IPv4 address before ARIN will approve the transfer. All transferees must adhere to ARIN rules and sign a service agreement with ARIN to this effect. Furthermore, the transferor will be ineligible to receive any further IPv4 address allocations from ARIN for a 12 month period after the transfer. You represented that you have no intent or interest to acquire any additional IPv4 addresses, and even if you did, the above described transfer restriction would preclude ARIN from assigning you any additional IPv4 addresses.

In addition to the ARIN review process, you represented that the lack of an established market for the sale of IP addresses is a barrier that makes it impossible to simply list and trade these addresses. Although information of two notable transfers of IPv4 addresses is publicly available because they were conducted by the United States Bankruptcy Court, you represented that generally, little or no public information is released regarding IPv4 address sales, other than limited registration information with ARIN. As such, you represented that you will utilize an outside firm that specializes in intellectual property to locate and negotiate with prospective buyers for the liquidation of your IPv4 addresses and you will not engage in any marketing activity. You represented that you will not undertake any action to improve or develop your interest in the right to use the IPv4 addresses you propose to liquidate. All transactions will be kept confidential under non-disclosure agreements.

Rulings Requested:

1. The IPv4 addresses are not property held primarily for sale to customers in the ordinary course of a trade or business regularly carried on by the taxpayer within the meaning of § 512(b)(5)(B).
2. That the income from the disposition of your IPv4 addresses does not constitute unrelated business income under § 512 and is not subject to unrelated business income taxation under § 511.
3. Your disposition of the IPv4 addresses will not adversely affect your current § 501(c)(3)

exempt status.

Law:

I.R.C. § 501(a) generally provides an exemption from federal income taxation for any organization described in § 501(c)(3).

I.R.C. § 501(c)(3) provides in part for the exemption of organizations that are organized and operated exclusively for educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Treas. Reg. § 1.501(c)(3)-1(a)(1) states that for an organization to be exempt under § 501(c)(3), it must be operated exclusively for one or more of the purposes specified in such section.

Treas. Reg. § 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as "operated exclusively" for an exempt purpose only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Treas. Reg. § 1.501(c)(3)-1(e)(1) provides, in part, that an organization may meet the requirements of § 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business as defined in § 513.

I.R.C. § 512(a)(1) defines "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (as defined in § 513(a)) regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both computed with the modifications provided in § 512(b).

I.R.C. § 512(b)(5) excludes from the computation of unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property other than (A) 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 (B) property held primarily for sale to customers in the ordinary course of the trade or business.

Rev. Rul. 55-449, 1955-2 C.B. 599, holds that the construction and sale of 80 houses by a foundation otherwise exempt under § 501(c)(3) over a period of 18 months for the sole purpose of raising funds for the support of a church constituted an unrelated trade or business within the meaning of § 513 because construction and sale of houses is a business of a kind ordinarily carried on for profit.

Rev. Rul. 59-91, 1959-1 C.B. 215, holds that where a taxpayer engages in extensive land development activities, such as lot subdivision, installation of utilities, and paving streets, all in order to facilitate the sale and derive the maximum proceeds from the disposition of the property, the taxpayer is holding property for sale to customers in the ordinary course of trade or

business.

In Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944), the taxpayer owned 500 acres of unimproved land used for grazing purposes. To facilitate the sale of land, the taxpayer subdivided the land into lots, built streets, installed storm sewers, constructed gas and electric lines and undertook other activities of the kind usually carried out by a real estate development company. Each year 20 to 30 lots were sold. The court held that taxpayer was holding lots for sale to customers in the regular course of business.

In Farley v Commissioner, 7 T.C. 198 (1946), the taxpayer purchased platted land to use in his nursery business. Twelve years later, the city built streets through the property that made it less useful for his business. Even though taxpayer made no active sales effort and made no improvements, he sold 26 and a half lots in one year. The court opined that the sales were essentially made "in the nature of a gradual and passive liquidation of an asset" and not in the ordinary course of a trade or business.

In Marat v. Riddell, 383 U.S. 569, 86 S. Ct. 1030 (1966), the Supreme Court defined the standard to be applied in determining whether property is held primarily for sale to customers in the ordinary course of business. The Court interpreted the word "primarily" to mean "of first importance" or "principally." By this standard, ordinary income would not result unless a sales purpose is dominant.

In Mauldin v. Commissioner, 195 F.2d 714 (1952), the taxpayer initially purchased land not for resale to customers, but throughout the years subdivided the land and resold parcels sporadically, primarily as the market dictated. The court indicated that the taxpayer engaged in continuous sales and concluded that the property was held primarily for sale to customers as part of the taxpayer's business. The court stated that "[t]here is no fixed formula or rule of thumb for determining whether property sold by the taxpayer was held by him primarily for sale to customers in the ordinary course of his trade or business. Each case must, in the last analysis, rest upon its own facts. There are a number of helpful factors, however, to point the way, among which are the purposes for which the property was acquired, whether for sale or investment; and continuity and frequency of sales as opposed to isolated transactions."

In Adam v. Commissioner, 60 T.C. 996 (1973), acq. in result, 1974-2 C.B., the Tax Court held that a taxpayer who purchased 11 parcels and sold 9 parcels of undeveloped land over four years was not engaged in the trade or business of buying and selling land for purposes of § 1221. The taxpayer utilized brokers to aid him in disposing of some of the land. However, neither the taxpayer nor the brokers ever sought out or solicited prospective buyers or advertised the properties for sale. The court analyzed the following factors to determine that the taxpayer was not engaged in the operation of the trade or business of buying and selling land:

- (1) the purpose for which the property was acquired;
- (2) the frequency, continuity, and size of the sales;
- (3) the activities of the owner in the improvement and disposition of the property;
- (4) the extent of improvements made to the property;
- (5) the proximity of sale to purchase; and
- (6) the purpose for which the property was held.

In Adam and subsequent cases, courts have found that no one of these factors is controlling but all are relevant to consider in determining whether the sale of property occurred in the regular course of a taxpayer's trade or business.

Analysis:

As an organization described under § 501(c)(3), you are exempt from federal income tax. See I.R.C. § 501(a). To maintain your tax-exempt status under § 501(c)(3), you must be operated exclusively for exempt purposes. Treas. Reg. § 1.501(c)(3)-1(a)(1). You will not be considered as operated exclusively for exempt purposes under § 501(c)(3) if you engage in a substantial amount of unrelated business activities. Treas. Reg. §§ 1.501(c)(3)-1(c)(1) and (e)(1). An organization that holds property "primarily for sale to customers in the ordinary course of [a] trade or business" within the meaning of § 512(b)(5) is considered engaging in an unrelated business activity. See also I.R.C. § 512(a)(1). Here, you propose to liquidate your intellectual property rights in several million IPv4 addresses.

The primary issue in this ruling is whether the liquidation of your IPv4 addresses will be treated as a sale of property held "primarily for sale to customers in the ordinary course of [a] trade or business" within the meaning of § 512(b)(5). Whether property is held "primarily" for sale to customers in the ordinary course of an organization's trade or business is a facts and circumstances determination. See Mauldin v. Commissioner, 195 F.2d 714 (1952), and Adam v. Commissioner, 60 T.C. 996 (1973), acq. in result, 1974-2 C.B. In Malat v. Riddell, 383 U.S. 569, 86 S. Ct. 1030 (1966), the Court interpreted the meaning of the word "primarily" to mean "of first importance or principally."

You represented that you received your right to use several million IPv4 addresses several decades ago for use as part of your exempt activities. Your exempt activities included the initial research and development and operation of a non-profit telecommunications network serving your university system (later extended to other tax-exempt non-governing affiliates, including schools, colleges, libraries, law enforcement, non-profit hospitals). However, you are unable to utilize all your IPv4 addresses in your exempt activities before the migration to IPv6 addresses; therefore, you propose to liquidate these unused addresses. You represented that you would be inclined to liquidate your surplus IPv4 address to a single buyer in a single transaction. However, the legal and financial barriers would preclude such a single sale. Specifically, ARIN restrictions, the lack of an established market for IPv4 addresses, and the huge volume of IPv4 addresses that you wish to liquidate, would, in essence, preclude a single buyer. You also represented that you have never characterized or used your IPv4 addresses as inventory in any sense and never had reason to reflect these addresses on your balance sheet or property schedules.

When determining whether a taxpayer is holding property "primarily" for sale to customers in the ordinary course of its trade or business, we consider the frequency, continuity and size of sales. We also consider the activities undertaken to improve the property, the proximity of sale to purchase and the purpose for which the property was held during the taxable year. You have not improved any rights you hold in the IPv4 addresses. The proposed sale of your IPv4 addresses is taking place several decades after you acquired them as donations, and at all times, you held these IPv4 addresses for use in your exempt activities. The long duration you held these IPv4 addresses, the lack of tax classification of these addresses as inventory or

property, and your initial receipt of these addresses as part of your exempt activities all indicate that you were not holding the property "primarily" for sale to customers in the ordinary course of its trade or business.

Your facts are distinguishable from those in Rev. Rul. 55-449, supra, in which a foundation constructed and sold 80 houses over a period of 18 months for the sole purpose of raising funds to support a church. They are also distinguishable from the facts in Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944), in which a taxpayer subdivided and developed property for the purpose of selling the property, then sold 80 lots. In both of these cases, the taxpayers' efforts in acquiring and developing the properties for sale suggested that they were holding the property primarily for sale to customers in the ordinary course of a trade or business. In contrast, your activities are similar to the taxpayer's activities in Farley v. Commissioner, 7 T.C. 198 (1946), in which the court held that the taxpayer's activities were "in the nature of a gradual and passive liquidation of an asset." The liquidation of your IPv4 address is governed by a third-party, ARIN, whose approval is required and precludes you from selling your IPv4 addresses on terms solely of your choosing. Your IPv4 addresses were received by you for use in your exempt activities and held for several decades. You have no plans to develop or improve these rights, you will utilize an outside firm specializing in intellectual property to locate and negotiate with prospective buyers, you will not engage in any marketing activity, and you will not acquire any additional IPv4 addresses after the liquidation.

Accordingly, based on your representations, under the primary purpose test of Malat v. Riddell, 383 U.S. 569, 86 S. Ct. 1030 (1966), and the facts and circumstances test of Adam v. Commissioner, 60 T.C. 996 (1973), acq. in result, 1974-2 C.B., we conclude that you do not hold your interests in IPv4 addresses primarily for sale to customers in the ordinary course of a trade or business. Therefore, your liquidation of IPv4 addresses will not generate unrelated business taxable income under §§ 511 and 512(b)(5), and will not adversely affect your exempt status under § 501(c)(3).

Conclusion:

1. Your IPv4 addresses are not property held primarily for sale to customers in the ordinary course of a trade or business regularly carried on by the taxpayer within the meaning of § 512(b)(5)(B).
2. The income from the disposition of your IPv4 addresses does not constitute unrelated business income under § 512 and is not subject to unrelated business income taxation under § 511.
3. Your disposition of the IPv4 addresses will not adversely affect your current § 501(c)(3) exempt status.

This ruling will be made available for public inspection under § 6110 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) 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 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,

Theodore R. Lieber
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437