

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-133427-17

Director
Appeals

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:

Date of Conference: [No Conference]

LEGEND:

Organization =
Publisher =
Journal =
Year 1 =
Year 2 =
Year 3 =
Year 7 =
\$A =
B% =
\$C =
\$D =
\$E =
F% =
G% =
H% =
\$I =
\$J =

K =
 \$L =
 \$M =
 \$N =
 \$O =
 P% =
 Q% =

ISSUE(S):

Whether Organization received unrelated business taxable income from advertising under the terms of the agreement with Publisher in connection with publishing Journal, and if the income is taxable, whether the Service's method of calculating the unrelated business income was correct and reasonable.

CONCLUSION(S):

Organization did not receive unrelated business taxable income from advertising under the terms of the agreement with Publisher in connection with publishing Journal.

FACTS:

Organization is a section 501(c)(6)¹ professional society formed for the purpose of enhancing the field of . Journal is the official, scholarly journal of Organization published under a contract with Publisher, a for-profit entity. Journal is an international, peer-reviewed publication that provides articles on clinical advances and techniques, case reports, literature reviews, editorials, and other types of coverage of recent progress in the field of . Journal is published monthly, receives over manuscripts for publication consideration annually, and maintains rigorous acceptance standards. Journal is one of the primary educational resources for Organization members in the field of at large. Preparation of editorial content in Journal is one of Organization's core tax-exempt activities.

Publisher is a multinational company that publishes over journals and more than books. In Year 1, Organization entered into an agreement with Publisher to publish Journal for a term covering Year 2 through Year 7. The agreement provides that the relationship between Publisher and Organization is that of independent contractors.

The agreement provides that Organization has complete responsibility for all of the editorial content of Journal. This control is exercised through an editor selected by and

¹ All references to "section" refer to sections of the Internal Revenue Code (Code) of 1986, unless otherwise specified.

serving as an agent of Organization. The editor will be assisted by an editorial board composed of candidates nominated by the editor and officially appointed (or removed) by Organization.

Organization covers all expenses of gathering and preparing editorial material for publication in Journal; however, the agreement provides that Publisher will pay an annual stipend for salaries and expenses of Journal's editorial office and expenses for the annual editorial board meeting. The amount of the stipend for Year 2 is \$A and is increased by B% each subsequent year.

The agreement provides that Publisher will publish, produce, sell, distribute, and internationally promote Journal at its own expense. Publisher is responsible for fulfilling subscription orders for Journal. The three types of subscribers are: (a) individual members of Organization, (b) individuals who are not members of Organization, and (c) corporations, libraries, institutions, organizations, and all other institutional subscribers.

The agreement provides that Organization will order one subscription for each individual member at the annual individual member rate of \$C for the term of the agreement and provide Publisher with the full names and addresses of individual member subscribers, which will be used by Publisher to fulfill individual member subscription orders.

For Year 2, the individual non-member subscriber rate is \$D and the institutional subscriber rate is \$E. Publisher sets the yearly rate, provided that an increase in the individual non-member subscriber rate greater than F%, or the institutional subscriber rate greater than G%, requires Organization's prior approval.

Pursuant to the agreement, Publisher is solely responsible for selling advertising space in Journal at rates determined at Publisher's sole discretion. However, the agreement provides that Publisher shall not publish any advertisement in Journal that fails to meet Organization's reasonable advertising standards. The agreement further provides that the editor has the right to ensure the appropriate application of Organization's advertising standards. In practice, Publisher sent copies of advertisements for each issue to the editor for approval as complying with Organization's advertising standards. There is no indication that the editor ever failed to approve an advertisement.

The agreement provides that Publisher pays Organization H% of "revenues" as an "earned royalty" for the publishing and distribution rights of the journal. The agreement defines "revenues" as total revenues less deductions for commissions, discounts, returns and taxes. The agreement specifically excludes advertising revenues from the definition of "revenues" for purposes of calculating the "earned royalty."

In addition, the agreement provides that Publisher pays Organization a "minimum guaranteed royalty" ranging from \$I to \$J for Year 2 through Year 7 provided that Organization enters a minimum of K individual member subscriptions each year. The

agreement provides that the “minimum guaranteed royalty” is deducted from and reduces the “earned royalty” in a given year, but not below the amount of the “minimum guaranteed royalty.” If Organization enters fewer than K individual members, then the “minimum guaranteed royalty” is reduced proportionally.

For all of the tax years at issue, the “minimum guaranteed royalty” that Publisher paid to Organization exceeded the “earned royalty” calculated under the agreement, but the “minimum guaranteed royalty” never exceeded “revenue.” For example, in Year 3 Organization’s “earned royalty” was \$L, calculated as H% of Journal’s Year 3 “revenue” (\$M). Journal’s Year 3 advertising revenue was \$N. Pursuant to the agreement, Publisher paid Organization the “minimum guaranteed royalty” of \$O. O was equal to P% of “revenue” or Q% of total sales (“revenue” plus advertising revenue), but there is no indication that \$O was measured or determined by reference to “revenue” or total sales.

Publisher provided an affidavit stating that all advertising activity associated with Journal was conducted solely by Publisher without assistance from Organization. Additionally, the affidavit provided that none of the payments to Organization included any portion of the advertising revenue from Journal. Furthermore, the affidavit provided that Publisher reported all advertising revenue from Journal on its tax return and paid appropriate taxes on net advertising income.

LAW AND ANALYSIS:

Section 511 imposes a tax upon the unrelated business income of certain exempt organizations.

Section 512(a) defines the term “unrelated business taxable income” as the gross income derived by an organization from any “unrelated trade or business” (as defined in section 513), regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 513(a) defines the term “unrelated trade or business” as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of its tax-exempt purpose.

Section 513(c) provides that an activity does not lose its 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 endeavors which may, or may not, be related to the exempt purpose of the organization.

Section 1.513-1(a) provides, in part, that the gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) it is income from 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 activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.

In Arkansas State Police Association, Inc. v. Commissioner, 282 F.3d 556 (8th Cir. 2002), a section 501(c)(5) organization received payments under an agreement with a commercial publisher to publish a magazine three times per year. The publisher paid the organization \$25,200 each year to publish the magazine plus 25-26% of the advertising revenue. The publisher bore all the costs of producing and distributing the magazine and solicited advertisements by saying they were calling "on behalf of" the organization. The magazine has no subscription cost and publisher distributed copies free of charge to organization's members, to advertisers who paid at least \$100 for advertisements, and to Arkansas state legislators. The court concluded that the organization's income from publishing the magazine was not a royalty because the publisher was acting to benefit the organization, not paying for the use of the organization's name to promote its own separate product.

In State Police Association of Massachusetts v. Commissioner, 125 F.3d 1 (1st Cir. 1997), a section 501(c)(5) organization received payments under an agreement with a commercial publisher to publish an annual yearbook sometimes called the "ad book." Telemarketers jointly employed by the organization and the publisher solicited advertisements by saying they were calling "on behalf of" the organization using a canned solicitation format approved by the organization. Payments for ads were made to organization and deposited into organization's bank account, out of which organization paid telemarketers and the publisher. The yearbook has no subscription cost and the organization distributed copies free of charge at various state troopers' barracks, the organization's annual picnic, and other occasions. Based on the organization's control over the manner and means of performing the work, the financial aspects of the arrangement, the use of the organization's name, the advertising formats, and the contents of the yearbook, the court concluded that publisher was an agent of the organization for purposes of the advertising activities.

In National Collegiate Athletic Association (NCAA) v. Commissioner, 92 T.C. 456 (1989), *rev'd on other grounds*, 914 F.2d 1417 (10th Cir. 1990), the court attributed a contractor's advertising activities to the exempt organization based on the agency relationship between the two entities. The written contract explicitly provided that the

contractor was the organization's "exclusive agent for the sale of advertising," and required the contractor to conduct advertising sales in an "efficient and workmanlike manner." Additionally, the contract placed limits on the types of advertisers and provided the organization with the unqualified right of final approval for all advertising. The contractor had the duty to account for all profits from its activities and the organization was entitled to examine the contractor's financial records at any time.

Organization is subject to the tax imposed by section 511 on its unrelated business taxable income (as defined in section 512). Producing editorial content for publication in Journal is substantially related to the performance of Organization's exempt purpose. However, activities of soliciting, selling, and publishing commercial advertising do not lose identity as an unrelated trade or business because the advertisements are published in Journal. See Treas. Reg. § 1.513-1(b).

As such, the publication of commercial advertising is a trade or business that is not substantially related (other than through the production of funds) to the performance of Organization's exempt purpose. See Treas. Reg. § 1.513-1(a). In this case, the issue is whether the trade or business of publishing commercial advertising is regularly carried on by Organization. See id.

As provided in the agreement, Organization is not engaged directly in the activities of soliciting, selling, and publishing commercial advertising. However, Publisher's regularly carried on activities of soliciting, selling, and publishing commercial advertisements would be attributed to Organization if Publisher acted as Organization's agent with respect to those activities. See State Police Ass'n of Massachusetts v. Commissioner, 125 F.3d 1, 7 (1st Cir. 1997); NCAA v. Commissioner, 92 T.C. 456, 466 (1989), *rev'd on other grounds*, 914 F.2d 1417 (10th Cir. 1990).

In NCAA v. Commissioner, the contract specifically provided that the publisher was the NCAA's "exclusive agent for the sale of advertising." While the contract's designation of that relationship was not controlling, the Tax Court found that the contract's provisions manifested the intent for the publisher to engage in advertising activities for NCAA's benefit and under its control consistent with the description of the publisher as an agent. See NCAA, 914 F.2d at 467.

By contrast, the agreement in this case provided that Publisher is an independent contractor and the provisions of the agreement are consistent with the description of the publisher as an independent contractor. The substance of the contractual relationship between Organization and Publisher does not meet any of the factors listed by the court in State Police Association of Massachusetts as indicating an agency relationship with respect to advertising in an exempt organization periodical. See 125 F.3d at 7.

First, the agreement suggests that Organization did not retain tight control over the method and manner of the solicitation of advertisements. The agreement provides that

Publisher is solely responsible for the advertising content of Journal, subject only to the restriction that advertisements will not violate Organization's advertising standards. Consistent with the agreement, the editor reviews advertisements for compliance with Organization's advertising standards.

Unlike the unqualified final right of approval described in NCAA, Organization had only the right of quality control for purposes of maintaining the Journal's quality as an official exempt organization journal. See id.

Second, Organization is not like the organization in State Police Association of Massachusetts, where telemarketers were employed jointly by the organization and publisher and the solicitation format was subject to the organization's approval. See 125 F.3d at 7.

Third, the financial arrangement between Organization and Publisher does not indicate that Publisher acted as Organization's agent. Consistent with the affidavit, there is no indication that checks for advertising are made payable to Organization or are collected by Organization, unlike the organization in State Police Association of Massachusetts. See id. at 7.

In NCAA, the Tax Court concluded that the compensation structure, which shifted risk of loss to the publisher, did not negate the agency relationship established under the contract. By contrast, the compensation structure here reinforces the other aspects of the agreement indicating that Publisher was not Organization's agent for advertising activities. Because advertising revenues are specifically excluded from the calculation of the "earned royalty" and the "minimum guaranteed royalty" is fixed, the payment to the organization does not vary based on advertising revenue. As such, the compensation structure in this agreement distributes all potential for gain and risk of loss from advertising sales to Publisher.

Unlike the contract in NCAA, the agreement does not provide that Publisher is required to account for advertising profits and does not provide Organization the right to examine Publisher's financial records at any time. See NCAA, 914 F.2d at 46. Under the agreement, Publisher is only required to provide a "reasonably detailed annual financial statement" showing Journal revenue and expenses. Revenue is defined under the agreement as excluding advertising revenues; thus, Publisher is not required to account for advertising profits. Although Publisher's report to Organization included the status of advertising sales, Organization did not have the contractual right to obtain that information.

Fourth, unlike the contracts in NCAA and State Police Association of Massachusetts, the agreement does not establish that Publisher solicits, sells, and publishes commercial advertisements on behalf of Organization as its agent. See State Police Ass'n of Massachusetts, 125 F.3d at 7; NCAA, 914 F.2d at 46. No provision of the

agreement requires Publisher to seek out advertising to publish in Journal or grants Organization the right to control the manner in which Publisher seeks out advertising. Although Publisher is permitted to mention its collaboration with Organization in connection with promoting and distributing Journal, there is no indication that Publisher purports to act “on behalf of” Organization in soliciting advertising.

Arkansas State Police Association v. Commissioner does not alter this conclusion. Like the arrangement in State Police Association of Massachusetts, the publisher in Arkansas State Police Association solicited advertising by calling “on behalf of” the organization and advertisers made checks payable to the organization, not the publisher. See 282 F.3d 556, 557 (8th Cir. 2002). Unlike the agreement in this case, the publisher in Arkansas State Police Association paid the organization a specific percentage of advertising revenue in addition to a fixed payment that was also based on advertising revenue because the magazine’s only source of revenue was advertising. See id. at 557. Furthermore, the issue in Arkansas State Police Association was whether the payments were royalties. Thus, the analysis is not applicable here because the issue of whether Publisher acted as Organization’s agent with respect to advertising activities is separate from the question of whether the payment was nonetheless excluded from unrelated business income tax as a royalty under section 512(b)(2).

Activities that are carried on within a larger aggregate of similar activities or within a larger complex of endeavors are considered separately to determine whether the activity is an unrelated trade or business. See Treas. Reg. § 1.513-1(b). Thus, within the larger complex of publishing an exempt organization periodical, advertising activities are considered separately from the activities of producing editorial material. As such, Organization’s significant control over editorial activities related to Journal, including Organization’s control over the editor, are not relevant to determining whether Publisher acted as Organization’s agent with respect to advertising activities.

Absent extenuating circumstances, the agreement of contracting parties as to the services to be performed and the compensation to be received for each service cannot be ignored. There is no indication that, in conflict with the agreement, Organization engaged in any advertising activities or any portion of the payment from Publisher is attributable to advertising. As such, there is no basis for reallocating advertising income to Organization. Therefore, Organization did not receive unrelated business taxable income from advertising because commercial advertising was not regularly carried on by Organization within the meaning of section 512(a).

Accordingly, because we conclude that Organization did not receive unrelated business taxable income from advertising under the terms of the agreement with Publisher in connection with publishing Journal, it is unnecessary to address whether the Service’s method of calculating the unrelated business income was correct and reasonable.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.