Internal Revenue Service

memorandum

Aug. 14, 2001

To: Director, EO Examinations T:EO:E

(Signed) Thomas J. Miller
From: Acting Director, EO Rulings & Agreements T:EO:RA

Subject: Exclusive Provider Arrangements and UBIT

The question whether income from exclusive provider arrangements is subject to the unrelated business income tax (UBIT) has arisen in several exempt organizations examinations. The purpose of this memorandum is to describe various types of exclusive provider arrangements and to suggest a framework for handling issues that may arise in these cases. Though the examples in this memorandum describe universities, the principles discussed apply to all exempt organizations subject to UBIT.

As you know, proposed regulations on corporate sponsorship were issued in March 2000. See Prop. Treas. Reg. 1.513-4. Consistent with I.R.C. 513(i), the proposed regulations distinguish between advertising and the mere use or acknowledgment of a sponsor's name or logo. The proposed regulations also distinguish between exclusive sponsorship arrangements, which qualify for the safe harbor of I.R.C. 513(i), and exclusive provider arrangements, which do not and are subject to the normal UBIT rules.

There is concern that the proposed corporate sponsorship regulations create an implication that exclusive provider contracts are automatically subject to UBIT because they fall outside the scope of I.R.C. 513(i). This assumption is incorrect, and as explained below, there are various ways an exclusive provider arrangement may not give rise to UBIT.

This memo discusses how to analyze basic exclusive provider arrangements under the existing UBIT rules. Although the income from some exclusive provider arrangements may be includable in unrelated business taxable income (UBTI), not all contracts will meet the criteria for inclusion in UBTI pursuant to I.R.C. 511-513. Take, for example, a university that enters into a multi-year contract with a soft drink company to be the exclusive provider of soft drinks on campus in return for an annual payment. If the company agrees to provide, stock and maintain on-campus vending machines as needed, leaving little or no obligation on the university's part to perform any services or conduct activities in connection with the enterprise, then based on this contract alone the university may not have the requisite level of activity to constitute a trade or business under I.R.C. 513(a). In determining the level of activity, however, any promotional or marketing efforts by the university pursuant to the contract should be considered. If the contract grants the company a license to market its products using the university's name and logo, the portion of the total payment attributable to the value of the license may be excludable as a royalty under I.R.C. 512(b)(2). In some cases, payments in connection with the grant of

an exclusive concession, such as for the operation of a campus bookstore or cafeteria, may be treated as rental income under I.R.C. 512(b)(3).

When an exempt organization agrees to perform substantial services in connection with the exclusive provider arrangement, income received by the organization may be includable in UBTI. For example, assume that a university enters into a multi-year contract with a sports drink company under which the company will be the exclusive provider of sports drinks for the university's athletic department and concessions. As part of the contract, if the university agrees to perform various services for the company, such as guaranteeing that coaches make promotional appearances on behalf of the company (e.g., attending photo shoots, filmed commercials, and retail store appearances), assisting the company in developing marketing plans, and participating in joint promotional opportunities, then the university's activities are likely to constitute a regularly carried on trade or business. These activities are unlikely to be substantially related to the university's exempt purposes. Furthermore, the income received by the university for those services is not excludable as a royalty under I.R.C. 512(b)(2). See Rev. Rul. 81-178, 1981-2 C.B. 135, situation 2.

When a university negotiates discounted rates for the soft drinks it purchases for its cafeterias, snack bars and concessions as part of a larger exclusive provider arrangement, the question has been asked whether the amount of the discount is includable in UBTI. Generally, discounts (and rebates) are considered an adjustment to the purchase price and do not constitute gross income to the purchaser. See Rev. Rul. 84-41, 1984-1 C.B. 130; Rev. Rul. 76-96, 1976-1 C.B. 23. Thus, the amount of the negotiated discount is not includable in UBTI.

Finally, public elementary and secondary schools have inquired about the tax consequences of entering into exclusive provider arrangements similar to those entered into by colleges and universities. Treas. Reg. 1.511-2(a)(2) provides that, in contrast to colleges and universities, public elementary and secondary schools are not subject to UBIT. Therefore, there are no UBIT consequences from these schools entering into an exclusive provider arrangement.

If you have any questions, please feel free to contact me, or members of your staff may contact Charles Barrett at (202) 283-8944 or Judith E. Kindell at (202) 283-8964.