Section 513.—Unrelated Trade or Business

26 CFR 1.513–4: Certain sponsorship not unrelated trade or business.

T.D. 8991

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Taxation of Tax-Exempt Organizations' Income From Corporate Sponsorship

AGENCY: Internal Revenue Service (IRS), Treasury Department.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the tax treatment of corporate sponsorship payments received by tax-exempt organizations. The final regulations affect exempt organizations that receive sponsorship payments.

DATES: *Effective Date*: These regulations are effective April 25, 2002.

Applicability Date: These regulations are applicable for payments solicited or received after December 31, 1997.

FOR FURTHER INFORMATION CONTACT: Stephanie Lucas Caden or Barbara E. Beckman of Office of Associate Chief Counsel (TE/GE), (202) 622–6080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Exempt organizations generally must pay tax on unrelated business taxable income, as defined in section 512. Section 512(a)(1) defines *unrelated business taxable income* (UBTI) 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 deductions that are directly connected with the carrying on of the trade or business, both computed with the modifications provided in section 512(b).

Section 513(a) defines *unrelated trade or business* as any trade or business the conduct of which is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. Section 513(c), captioned "Advertising, etc., activities," provides that the term *trade or business* includes any activity carried on for the production of income from the sale of goods or the performance of services, and that 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. See § 1. 513–1(b).

The IRS first published a notice of proposed rulemaking (EE–74–92, 1993–1 C.B. 708) (1993 proposed regulations) on January 22, 1993 (58 F.R. 5687), proposing that the regulations under section 513 be amended to provide guidance on the proper tax treatment of sponsorship payments received by an exempt organization. The 1993 proposed regulations focused on the nature of the services provided by the exempt organization rather than the benefit received by the sponsor, and distinguished advertising, which is an unrelated trade or business activity, from acknowledgments, which are the mere recognition of a sponsor's payment and therefore do not result in UBTI. In a so-called "tainting rule," the 1993 proposed regulations provided that if any activities, messages or programming material constituted advertising with respect to a sponsorship payment, then all related activities, messages, or programming material that might otherwise be acknowledgments would be considered advertising. The 1993 proposed regulations also proposed to amend the regulations under section 512(a) by adding examples of the allocation rule governing exploitation of exempt activities in cases involving sponsorship income.

The Taxpayer Relief Act of 1997, Public Law 105–34, section 965 (111 Stat. 788, 893–94), amended the Internal Revenue Code (Code) by adding section 513(i). Section 513(i) governs the treatment of certain sponsorship payments by providing that qualified sponsorship payments are not subject to the unrelated business income tax (UBIT). Section 513(i) defines *qualified sponsorship payments* as payments made by a person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the exempt organization's activities. Section 513(i) further provides that use or acknowledgment does not include advertising (including messages containing qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use a sponsor's products or services).

Section 513(i) specifically provides that, to the extent a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, that portion of such payment and the other portion of such payment are treated as separate payments. Whether a separate transaction that falls outside of the section 513(i) safe harbor is subject to the UBIT depends on the application of existing rules under sections 512, 513, and 514.

Section 513(i) applies to payments solicited or received after December 31, 1997. Section 513(i) does not apply to qualified convention and trade show activities (described in section 513(d)(3)(B)) or to the sale of an acknowledgment or advertising in exempt organization periodicals. For this purpose, the term *periodicals* means regularly scheduled and printed material published by or on behalf of an exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization.

To reflect the differences between the 1993 proposed regulations and section 513(i), and in response to comments submitted on the 1993 proposed regulations, new proposed regulations (REG–209601–92, 2000–1 C.B. 829) (2000 proposed regulations) were issued on March 1, 2000 (65 F.R. 11012).

The 2000 proposed regulations amend the regulations under section 513, and provide that qualified sponsorship payments within the meaning of section 513(i) are not UBTI. The 2000 proposed regulations define the phrase "substantial return benefit" to mean any benefit other than (1) a use or acknowledgment of the payor's name or logo in connection with the exempt organization's activities, or (2) certain goods or services that have an insubstantial value under existing IRS guidelines. Generally, according to the 2000 proposed regulations, benefits such as complimentary tickets, pro-am playing spots, and receptions for donors have an insubstantial value only if they have a fair market value of not more than 2% of the payment, or $74 (adjusted for inflation for tax years beginning after calendar year 2000 pursuant to section 1(f)(3)), whichever is less. See § 1.170A–13(f)(8)(i)(A); Rev. Proc. 90–12 (1990–1 C.B. 471), as adjusted for inflation (for calendar year 2002, the amount is $79, see Rev. Proc. 2001–59 (2001–52 I.R.B. 623) (December 26, 2001)).

The 2000 proposed regulations clarify that for an exempt organization to avail itself of the section 513(i) safe harbor, it must establish that some portion of the payment exceeds the fair market value of any substantial return benefit received by a payor in return for making the payment. In a sponsorship arrangement, the fair market value of the substantial return benefit may equal the entire amount of the sponsorship payment. The burden of establishing the fair market value of any substantial return benefit falls on the exempt organization. The 2000 proposed regulations state that the exempt organization's determination of the fair market value of a substantial return benefit provided to the payor will not be set aside

for purposes of applying the section 513(i) safe harbor so long as the organization makes a reasonable and good faith valuation of the substantial return benefit received by the payor.

The 2000 proposed regulations provide that the right to be the only sponsor of an activity, or the only sponsor representing a particular trade, business, or industry is generally not a substantial return benefit. Any portion of the payment attributable to the exclusive sponsorship arrangement, therefore, may be a qualified sponsorship payment. However, if in return for a payment, the exempt organization agrees that products or services that compete with the payor's products or services will not be sold or provided in connection with one or more activities of the exempt organization, the payor has received a substantial return benefit and the portion of the payment attributable to the exclusive provider arrangement is not a qualified sponsorship payment. Consistent with the allocation rule described above, when a payor receives both exclusive sponsorship and exclusive provider rights in exchange for making a payment, the fair market value of the exclusive provider arrangement and any other substantial return benefit is determined first (*i.e.*, without regard to the existence of the exclusive sponsorship arrangement).

The 2000 proposed regulations clarify that qualified sponsorship payments in the form of money or property (but not services) are treated as contributions received by the exempt organization for purposes of determining public support to the organization under section 170(b)(1)(A)(vi) or section 509(a)(2). The exclusion of contributed services for purposes of determining public support is consistent with the general rule regarding donated services. See §§ 1.509(a)–3(f), 1.170A–9(e)(7)(i) and 1.170A–1(g).

A public hearing was held on June 21, 2000. After consideration of all the comments, the proposed regulations under section 513(i) are revised as follows. The major areas of the comments and revisions are discussed below.

Explanation of Provisions and Discussion of Comments

Like the 2000 proposed regulations, the final regulations define the phrase *substantial return benefit* to mean any benefit other than (1) a use or acknowledgment of the payor's name or logo in connection with the exempt organization's activities, or (2) certain goods or services that have an insubstantial value. If a payor receives a substantial return benefit in exchange for a payment, the section 513(i) safe harbor does not apply to the payment (or portion thereof) attributable to the substantial return benefit. In that case, whether the payment (or portion thereof) is subject to UBIT must be determined under existing principles and rules. Thus, the payment may not be subject to UBIT because the exempt organization's activity is not an unrelated trade or business within the meaning of section 513(a) (for example, because substantially all of the work in carrying on the trade or business is performed by volunteers) or is not regularly carried on within the meaning of section 512(a)(1), or because one of the section 512(b) modifications applies. See also Rev. Rul. 77–367 (1977–2 C.B. 193) (inurement) and Rev. Rul. 66–358 (1966–2 C.B. 218) (private benefit).

Many comments were received regarding the disregarded benefits standard contained in the 2000 proposed regulations. Commentators generally believe that valuing insubstantial benefits places an undue administrative burden on exempt organizations. Commentators also believe that the disregarded benefits standard in the proposed regulation is too low and significantly diminishes an exempt organization's ability to appropriately thank its sponsors. While the $79 ceiling (as adjusted for 2002) is an appropriate amount for exempt organizations to thank individual donors, the Treasury Department and IRS agree with the commentators that the $79 ceiling is too low with respect to corporations or persons engaged in a trade or business. In response to these concerns, the final regulations eliminate the $79 ceiling placed on the fair market value of benefits that may be disregarded for purposes of section 513(i).

Several commentators suggest that in addition to eliminating the $79 ceiling, the final regulations should increase the level of disregarded benefits to 10% or 15% of the amount of the payment. The Treasury Department and IRS believe 2% is an appropriate level for several reasons. The 2% threshold is used in other areas of the Code and regulations to describe insubstantial amounts. The 2000 proposed regulations allow the full amount of qualified sponsorship payments (except for payments in the form of services) to be treated as contributions for purposes of the public support test under sections 170(b)(1)(A)(vi) and 509(a)(2), without reduction for the amount of disregarded benefits. The 2% ceiling keeps the level of disregarded benefits low enough so that the entire amount of a qualified sponsorship payment may be treated as a contribution for public support purposes. Accordingly, the final regulations disregard benefits having a fair market value of not more than 2% of the payment.

Many commentators to the 2000 proposed regulations object to a requirement that exempt organizations must value benefits provided to payors where the payment does not affect the organization's tax liability, *e.g.*, where the payment attributable to the benefit constitutes income from a trade or business that is substantially related to the organization's exempt purposes. The Treasury Department and IRS note that organizations described in section 170(c) (other than section 170(c)(1)) are required to account for benefits provided to donors under section 6115. See Publication 1771, "*Charitable Contributions—Substantiation and Disclosure Requirements*." Pursuant to section 6115, a section 170(c) organization that receives a quid pro quo contribution in excess of $75 is required to inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the amount by which the payment exceeds the value of goods or services (except as provided in § 1.170A–13(f)(8)(i)) furnished by the charity, and is required to provide a good faith estimate of the value of those goods or services. Therefore, for exempt organizations eligible to receive tax deductible contributions, there is no additional tax administrative burden imposed by the disregarded benefits provision of either the 2000 proposed regulations or the final regulations.

The final regulations provide that in determining whether the 2% threshold has been exceeded in any year, all return

benefits (other than use or acknowledgment) must be considered. For example, if in exchange for a payment the exempt organization provides both a license and advertising the combined fair market value of which does not exceed 2% of the total payment, the entire payment (even the portion attributable to the advertising) may be treated as a qualified sponsorship payment, and the entire amount (except any payment in the form of services) constitutes public support under section 509. Alternatively, if the combined fair market value exceeds 2% of the total payment, the value of both the license and advertising is not disregarded and constitutes a substantial return benefit. In that case, the portions of the payment attributable to the license and advertising each must be analyzed separately under sections 512, 513, and 514. Only the portion of the payment, if any, that exceeds the fair market value of the substantial return benefit constitutes a qualified sponsorship payment.

Consistent with the 2000 proposed regulations, the final regulations provide that the right to be the only sponsor of an activity, or the only sponsor representing a particular trade, business or industry is generally not a substantial return benefit. The portion of any payment attributable to the exclusive sponsorship arrangement, therefore, may be a qualified sponsorship payment. However, if in return for a payment, the exempt organization agrees that products or services that compete with the payor's products or services will not be sold or provided in connection with one or more activities of the exempt organization, the payor has received a substantial return benefit and the portion of the payment attributable to the exclusive provider arrangement is not a qualified sponsorship payment.

Some commentators express concern that the definition of exclusive provider arrangements contained in the 2000 proposed regulations may include vendor contracts negotiated as part of a competitive bidding process required by state law. Both the 2000 proposed regulations and the final regulations provide that unless the exempt organization agrees to limit distribution of competing products in connection with the payment, the exempt organization has not entered into an exclusive provider arrangement. For example, when the nature of the goods or services to be provided necessitates the use of only one provider because of limited space or because the competitive bidding process requires only the lowest bid be accepted, the exempt organization has not entered into an exclusive provider arrangement unless it agrees to limit distribution of competing products.

In particular, these commentators express concern about the tax-treatment of discounts and rebates negotiated with vendors as part of the competitive bidding process. 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). For example, when a university negotiates discounted rates for the soft drinks it purchases for its cafeterias, snack bars, and concessions, the amount of the discount is not includible in UBTI.

Many commentators suggest that the exclusive provider provisions in the 2000 proposed regulations create an implication that exclusive provider arrangements are automatically subject to UBIT because they fall outside the scope of section 513(i). This assumption is incorrect; although the income from some exclusive provider arrangements may be includible in UBTI, not all contracts will meet the criteria for inclusion in UBTI pursuant to sections 511, 512, and 513. 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 is not necessarily subject to UBIT on that 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 section 513(a). This example assumes no agency relationship exists between the company and the university. 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 section 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 section 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 includible 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 section 512(b)(2). See Rev. Rul. 81–178 (1981–2 C.B. 135), situation 2.

The 2000 proposed regulations solicited comments on the application of the rules governing periodicals and trade shows to an exempt organization's Internet sites, and whether providing a link to a sponsor's Internet site is advertising within the meaning of section 513(i). The comments received generally suggest that a link to a corporate sponsor's Internet site as part of a sponsorship arrangement is not a message, but a convenient feature of the Internet that can only be activated by the viewer, and thus constitutes a permissible form of acknowledgment. With regard to periodicals, most commentators expressed the view that the term "periodical", for purposes of the section 513(i) exclusion, includes material published

electronically. Some commentators suggest that an exempt organization's Internet site should not be treated as a periodical simply because it has text that changes from time to time. Other commentators suggest criteria for analyzing whether an Internet site is a periodical.

Only a few comments were received on the application of the trade show exclusion in section 513(i) to an exempt organization's Internet site. These comments generally suggest that trade shows conducted over the Internet be treated the same as trade shows conducted in person. That is, payments made in connection with Internet-based trade shows would not be exempt from UBIT as qualified sponsorship payments, but would be exempt from UBIT as income generated by qualified convention and trade show activity.

Many options for addressing the Internet in the final regulations were considered. The final regulations take the approach that, where possible, answers are provided. However, the Treasury Department and IRS note that the analysis of particular Internet issues, such as the use of hyperlinks, may be different for purposes of section 513(i) than other sections of the Code. The Treasury Department and IRS also conclude that some Internet issues addressed in comments are beyond the scope of section 513(i).

For purposes of section 513(i), the issue of whether a hyperlink constitutes an acknowledgment or advertising is addressed in the final regulations with two new examples. In the first new example, the exempt organization posts a list of its sponsors on its website, including the sponsor's Internet address, which appears as a hyperlink from the exempt organization's website to the sponsor's website. The example concludes that posting the sponsor's website address constitutes an acknowledgment, even though it appears as a hyperlink. In the second new example, a charity maintains a website that contains a hyperlink to a sponsor's website where an endorsement by the charity for the sponsor's product appears. The charity approved the endorsement before it was posted on the sponsor's website. The example concludes that the endorsement is advertising. These two examples address hyperlinks for purposes of section 513(i) only, and do not suggest how hyperlinks are treated under other sections of the Code.

With respect to periodicals, section 513(i) mentions periodicals only in the sense that the safe harbor does not apply to any payment which entitles the payor to the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in exempt organization periodicals. Such payments are analyzed instead under the existing UBIT rules. Section § 1.512(a)–1(f) provides special rules for determining the amount of UBTI attributable to the sale of advertising in exempt organization periodicals. After considering the comments, the Treasury Department and IRS conclude that the regulations under section 512 are the more appropriate place for an analysis of issues relating to electronic periodicals. Nevertheless, the Treasury Department and IRS clarify that periodicals may include some forms of electronic publication. The final regulations state that the term *periodical* means regularly scheduled and printed material published by or on behalf of the exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization, and for this purpose, printed material includes material that is published electronically.

As noted above, relatively few comments were received on the trade show exclusion. Because of the small sampling of comments received, and because trade show rules impact many different industries and typically involve large sums of money, the final regulations do not change the rules on what constitutes a qualified convention and trade show activity. Existing guidance on trade shows is found in section 513(d) and § 1.513–3, and any reference to trade shows in the final regulations under section 513(i) is intended to be consistent with these rules.

Many commentators wrote regarding the valuation of substantial return benefits, and suggest that the 2000 proposed regulations do not offer enough guidance on how to make a reasonable and good faith valuation of a substantial return benefit. Commentators also assert that the valuation provisions do not further administrative convenience and simplicity. The fair market value of any substantial return benefit provided as part of a sponsorship arrangement is the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit, neither being under any compulsion to enter into the arrangement and both having reasonable knowledge of relevant facts, and without regard to any other aspect of the sponsorship arrangement. While the Treasury Department and IRS appreciate the difficulty an exempt organization has in valuing substantial return benefits, the final regulations retain the valuation standard contained in the 2000 proposed regulations. Several commentators suggest incorporating safe harbors into the final regulations to determine the value of a substantial return benefit. For example, one commentator suggests that a safe harbor be added to provide that an exempt organization's valuation would not be challenged if it were determined based on the face amount of the tickets, cost of the dinner, or any reasonably comparable measure. Another commentator suggests that the fair market value be based on data provided by the payor, or as agreed by the parties. Another commentator favors predicting values of yearly benefits based on actual benefits provided over a three-year period. After considering these comments, the Treasury Department and IRS conclude that the safe harbors suggested by the commentators either are inconsistent with the general rule, do not provide any additional guidance, or are prone to abuse. For this reason, no safe harbors were added to the final regulations with respect to valuation.

Clarification is provided, however, with respect to the valuation date. The 2000 proposed regulations provide that in allocating a sponsorship payment, the fair market value of the substantial return benefit is to be determined on the date the parties enter into the sponsorship arrangement. The final regulations take the same approach for binding, written sponsorship contracts. This rule, which is illustrated by two new examples, provides exempt organizations the advantage of only having to value substantial return benefits once, even if the value of the substantial return benefit increases over the term of the contract. If the parties make a material change to a sponsorship contract, it is treated as a new contract as of the date the material change is effective. A material change is defined as an extension or

renewal of the contract, or a more than incidental change to any amount payable (or other consideration) under the contract. If there is no binding, written contract, the fair market value of the substantial return benefit is determined when the benefit is provided. The reason for distinguishing between written and oral agreements in the final regulations is to allow smaller exempt organizations to arrange sponsorship informally on a year-to-year basis and value those benefits each year as they occur.

Few comments were received on the § 1.512(a)–1(e) example relating to expense allocation. Of the comments received, most state that the 1993 proposed regulations did not interpret the exploitation exception too broadly, and request that the prior examples be reinstated. The commentators also suggest that the new example is factually unrealistic. Despite these comments, the final regulations do not change the § 1.512(a)–1(e) example. The comments received generally do not contain substantive suggestions for change, and the Treasury Department and IRS believe that the current example in the final regulations correctly amplifies the technical provisions of the regulation, which is very limited in scope.

Special Analyses

It has been determined that this decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the final rule does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these regulations were previously submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Stephanie Lucas Caden, Office of Division Counsel/Associate Chief Counsel (Tax Exempt/Government Entities), Internal Revenue Service. However, personnel from other offices of the Service and the Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.170A–9, a sentence is added to the end of paragraph (e)(6)(i) to read as follows:

§ 1.170A–9 Definition of section 170(b)(1)(A) organization.

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(e) * * *

(6) * * * (i) * * * For purposes of this paragraph (e), the term *contributions* includes qualified sponsorship payments (as defined in § 1.513–4) in the form of money or property (but not services).

* * * * *

Par. 3. Section 1.509(a)–3 is amended by:

1. Adding a sentence to the end of paragraph (f)(1).

2. Revising the paragraph heading and introductory text for paragraph (f)(3).

3. Redesignating the current *Example* in paragraph (f)(3) as *Example 1* and revising the heading.

4. Adding *Example 2* and *Example 3* to paragraph (f)(3).

The revisions and additions read as follows;

§ 1.509(a)–3 Broadly, publicly supported organizations.

* * * * *

(f) * * * (1) * * * For purposes of section 509(a)(2), the term *contributions* includes qualified sponsorship payments (as defined in § 1.513–4) in the form of money or property (but not services).

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(3) *Examples*. The provisions of this paragraph (f) may be illustrated by the following examples:

Example 1. * * *

Example 2. Q, a performing arts center, enters into a contract with a large company to be the exclusive sponsor of the center's theatrical events. The company makes a payment of cash and products in the amount of $100,000 to Q, and in return, Q agrees to make a broadcast announcement thanking the company before each show and to provide $2,000 of advertising in the show's program (2% of $100,000 is $2,000). The announcement constitutes use or acknowledgment pursuant to section 513(i)(2). Because the value of the advertising does not exceed 2% of the total payment, the entire $100,000 is a qualified sponsorship payment under section 513(i), and $100,000 is treated as a contribution for purposes of section 509(a)(2)(A)(i).

Example 3. R, a charity, enters into a contract with a law firm to be the exclusive sponsor of the charity's outreach program. Instead of making a cash payment, the law firm agrees to perform $100,000 of legal services for the charity. In return, R agrees to acknowledge the law firm in all its informational materials. The total fair market value of the legal services, or $100,000, is a qualified sponsorship payment under section 513(i), but no amount is treated as a contribution under section 509(a)(2)(A)(i) because the contribution is of services.

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Par. 4. Section 1.512(a)–1 is amended by:

1. Revising the paragraph heading and introductory text for paragraph (e).

2. Redesignating the current *Example* in paragraph (e) as *Example 1* and revising the heading.

3. Adding *Example 2* to paragraph (e).

The revisions and additions read as follows:

§ 1.512(a)–1 Definition.

* * * * *

(e) *Examples*. This section is illustrated by the following examples:

Example 1. * * *

Example 2. (i) P, a manufacturer of photographic equipment, underwrites a photography exhibition organized by M, an art museum described in section 501(c)(3). In return for a payment of $100,000, M agrees that the exhibition catalog sold by M in connection with the exhibit will advertise P's product. The exhibition catalog will also include educational material, such as copies of photographs included in the exhibition, interviews with photographers, and

an essay by the curator of M's department of photography. For purposes of this example, assume that none of the $100,000 is a qualified sponsorship payment within the meaning of section 513(i) and § 1.513–4, that M's advertising activity is regularly carried on, and that the entire amount of the payment is unrelated business taxable income to M. Expenses directly connected with generating the unrelated business taxable income (*i.e.*, direct advertising costs) total $25,000. Expenses directly connected with the preparation and publication of the exhibition catalog (other than direct advertising costs) total $110,000. M receives $60,000 of gross revenue from sales of the exhibition catalog. Expenses directly connected with the conduct of the exhibition total $500,000.

(ii) The computation of unrelated business taxable income is as follows:

(A) Unrelated trade or business (sale of advertising):		
Income	$100,000	
Directly-connected expenses	(25,000)	
Subtotal	75,000	$75,000
(B) Exempt function (publication of exhibition catalog):		
Income (from catalog sales)	60,000	
Directly-connected expenses	(110,000)	
Net exempt function income (loss)	(50,000)	(50,000)
Unrelated business taxable income		25,000

(iii) Expenses related to publication of the exhibition catalog exceed revenues by $50,000. Because the unrelated business activity (the sale of advertising) exploits an exempt activity (the publication of the exhibition catalog), and because the publication of editorial material is an activity normally conducted by taxable entities that sell advertising, the net loss from the exempt publication activity is allowed as a deduction from unrelated business income under paragraph (d)(2) of this section. In contrast, the presentation of an exhibition is not an activity normally conducted by taxable entities engaged in advertising and publication activity for purposes of paragraph (d)(2) of this section. Consequently, the $500,000 cost of presenting the exhibition is not directly connected with the conduct of the unrelated advertising activity and does not have a proximate and primary relationship to that activity. Accordingly, M has unrelated business taxable income of $25,000.

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Par. 5. Section 1.513–4 is added to read as follows:

§ 1.513–4 Certain sponsorship not unrelated trade or business.

(a) *In general*. Under section 513(i), the receipt of qualified sponsorship payments by an exempt organization which is subject to the tax imposed by section 511 does not constitute receipt of income from an unrelated trade or business.

(b) *Exception*. The provisions of this section do not apply with respect to payments made in connection with qualified convention and trade show activities. For rules governing qualified convention and trade show activity, see § 1.513–3. The provisions of this section also do not apply to income derived from the sale of advertising or acknowledgments in exempt organization periodicals. For this purpose, the term *periodical* means regularly scheduled and printed material published by or on behalf of the exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization. For this purpose, printed material includes material that is published electronically. For rules governing the sale of advertising in exempt organization periodicals, see § 1.512(a)–1(f).

(c) *Qualified sponsorship payment*—(1) *Definition*. The term *qualified sponsorship payment* means any payment by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit. In determining whether a payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the recipient organization's exempt purpose. It is also irrelevant whether the sponsored activity is temporary or permanent. For purposes of this section, payment means the payment of money, transfer of property, or performance of services.

(2) *Substantial return benefit*—(i) *In general*. For purposes of this section, a *substantial return benefit* means any benefit other than a use or acknowledgment described in paragraph (c)(2)(iv) of this section, or disregarded benefits described in paragraph (c)(2)(ii) of this section.

(ii) *Certain benefits disregarded*. For purposes of paragraph (c)(2)(i) of this section, benefits are disregarded if the aggregate fair market value of all the benefits provided to the payor or persons designated by the payor in connection with the payment during the organization's taxable year is not more than 2% of the amount of the payment. If the aggregate fair market value of the benefits exceeds 2% of the amount of the payment, then (except as provided in paragraph (c)(2)(iv) of this section) the entire fair market value of such benefits, not merely the excess amount, is a substantial return benefit. Fair market value is determined as provided in paragraph (d)(1) of this section.

(iii) *Benefits defined*. For purposes of this section, benefits provided to the payor or persons designated by the payor may include:

(A) Advertising as defined in paragraph (c)(2)(v) of this section.

(B) Exclusive provider arrangements as defined in paragraph (c)(2)(vi)(B) of this section.

(C) Goods, facilities, services or other privileges.

(D) Exclusive or nonexclusive rights to use an intangible asset (*e.g.*, trademark, patent, logo, or designation) of the exempt organization.

(iv) *Use or acknowledgment*. For purposes of this section, a substantial return

benefit does not include the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in connection with the activities of the exempt organization. Use or acknowledgment does not include advertising as described in paragraph (c)(2)(v) of this section, but may include the following: exclusive sponsorship arrangements; logos and slogans that do not contain qualitative or comparative descriptions of the payor's products, services, facilities or company; a list of the payor's locations, telephone numbers, or Internet address; value-neutral descriptions, including displays or visual depictions, of the payor's product-line or services; and the payor's brand or trade names and product or service listings. Logos or slogans that are an established part of a payor's identity are not considered to contain qualitative or comparative descriptions. Mere display or distribution, whether for free or remuneration, of a payor's product by the payor or the exempt organization to the general public at the sponsored activity is not considered an inducement to purchase, sell or use the payor's product for purposes of this section and, thus, will not affect the determination of whether a payment is a qualified sponsorship payment.

(v) *Advertising*. For purposes of this section, the term *advertising* means any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product. A single message that contains both advertising and an acknowledgment is advertising. This section does not apply to activities conducted by a payor on its own. For example, if a payor purchases broadcast time from a television station to advertise its product during commercial breaks in a sponsored program, the exempt organization's activities are not thereby converted to advertising.

(vi) *Exclusivity arrangements*—(A) *Exclusive sponsor*. An arrangement that acknowledges the payor as the exclusive sponsor of an exempt organization's activity, or the exclusive sponsor representing a particular trade, business or industry, generally does not, by itself, result in a substantial return benefit. For example, if in exchange for a payment, an organization announces that its event is sponsored exclusively by the payor (and does not provide any advertising or other substantial return benefit to the payor), the payor has not received a substantial return benefit.

(B) *Exclusive provider*. An arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity generally results in a substantial return benefit. For example, if in exchange for a payment, the exempt organization agrees to allow only the payor's products to be sold in connection with an activity, the payor has received a substantial return benefit.

(d) *Allocation of payment*—(1) *In general*. If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment. However, if the exempt organization does not establish that the payment exceeds the fair market value of any substantial return benefit, then no portion of the payment constitutes a qualified sponsorship payment.

(i) *Treatment of payments other than qualified sponsorship payments*. The unrelated business income tax (UBIT) treatment of any payment (or portion thereof) that is not a qualified sponsorship payment is determined by application of sections 512, 513, and 514. For example, payments related to an exempt organization's providing facilities, services, or other privileges to the payor or persons designated by the payor, advertising, exclusive provider arrangements described in paragraph (c)(2)(vi)(B) of this section, a license to use intangible assets of the exempt organization, or other substantial return benefits, are evaluated separately in determining whether the exempt organization realizes unrelated business taxable income.

(ii) *Fair market value*. The fair market value of any substantial return benefit provided as part of a sponsorship arrangement is the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit, neither being under any compulsion to enter into the arrangement and both having reasonable knowledge of relevant facts, and without regard to any other aspect of the sponsorship arrangement.

(iii) *Valuation date*. In general, the fair market value of the substantial return benefit is determined when the benefit is provided. However, if the parties enter into a binding, written sponsorship contract, the fair market value of any substantial return benefit provided pursuant to that contract is determined on the date the parties enter into the sponsorship contract. If the parties make a material change to a sponsorship contract, it is treated as a new sponsorship contract as of the date the material change is effective. A material change includes an extension or renewal of the contract, or a more than incidental change to any amount payable (or other consideration) pursuant to the contract.

(iv) *Examples*. The following examples illustrate the provisions of this section:

Example 1. On June 30, 2001, a national corporation and Z, a charitable organization, enter into a five-year binding, written contract effective for years 2002 through 2007. The contract provides that the corporation will make an annual payment of $5,000 to Z, and in return the corporation will receive no benefit other than advertising. On June 30, 2001, the fair market value of the advertising to be provided to the corporation in each year of the agreement is $75, which is less than the disregarded benefit amount provided for in paragraph (c)(2)(ii) of this section (2% of $5,000 is $100). In 2002, pursuant to the sponsorship contract, the corporation makes a payment to Z of $5,000, and receives the specified benefit (advertising). As of January 1, 2002, the fair market value of the advertising to be provided by Z each year has increased to $110. However, for purposes of this section, the fair market value of the advertising benefit is determined on June 30, 2001, the date the parties entered into the sponsorship contract. Therefore, the entire $5,000 payment received in 2002 is a qualified sponsorship payment.

Example 2. The facts are the same as *Example 1*, except that the contract provides for an initial payment by the corporation to Z of $5,000 in 2002, followed by annual payments of $1,000 during each of years 2003–2007. In 2003, pursuant to the sponsorship contract, the corporation makes a payment to Z of $1,000, and receives the specified advertising benefit. In 2003, the fair market value of the benefit provided ($75, as determined on June 30, 2001) exceeds 2% of the total payment received (2% of

$1,000 is $20). Therefore, only $925 of the $1,000 payment received in 2003 is a qualified sponsorship payment.

(2) *Anti-abuse provision*. To the extent necessary to prevent avoidance of the rule stated in paragraphs (d)(1) and (c)(2) of this section, where the exempt organization fails to make a reasonable and good faith valuation of any substantial return benefit, the Commissioner (or the Commissioner's delegate) may determine the portion of a payment allocable to such substantial return benefit and may treat two or more related payments as a single payment.

(e) *Special rules*—(1) *Written agreements*. The existence of a written sponsorship agreement does not, in itself, cause a payment to fail to be a qualified sponsorship payment. The terms of the agreement, not its existence or degree of detail, are relevant to the determination of whether a payment is a qualified sponsorship payment. Similarly, the terms of the agreement and not the title or responsibilities of the individuals negotiating the agreement determine whether a payment (or any portion thereof) made pursuant to the agreement is a qualified sponsorship payment.

(2) *Contingent payments*. The term *qualified sponsorship payment* does not include any payment the amount of which is contingent, by contract or otherwise, upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity. The fact that a payment is contingent upon sponsored events or activities actually being conducted does not, by itself, cause the payment to fail to be a qualified sponsorship payment.

(3) *Determining public support*. Qualified sponsorship payments in the form of money or property (but not services) are treated as contributions received by the exempt organization for purposes of determining public support to the organization under section 170(b)(1)(A)(vi) or 509(a)(2). See §§ 1.509(a)–3(f)(1) and 1.170A–9(e)(6)(i). The fact that a payment is a qualified sponsorship payment that is treated as a contribution to the payee organization does not determine whether the payment is deductible by the payor under section 162 or 170.

(f) *Examples*. The provisions of this section are illustrated by the following examples. The tax treatment of any payment (or portion of a payment) that does not constitute a qualified sponsorship payment is governed by general UBIT principles. In these examples, the recipients of the payments at issue are section 501(c) organizations. The expectations or arrangements of the parties are those specifically indicated in the example. The examples are as follows:

Example 1. M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to winners of the event. M recognizes the assistance of the corporation by listing the corporation's name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. M changes the name of its event to include the name of the corporation. M's activities constitute acknowledgment of the sponsorship. The drinks, refreshments and prizes provided by the corporation are a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 2. N, an art museum, organizes an exhibition and receives a large payment from a corporation to help fund the exhibition. N recognizes the corporation's support by using the corporate name and established logo in materials publicizing the exhibition, which include banners, posters, brochures and public service announcements. N also hosts a dinner for the corporation's executives. The fair market value of the dinner exceeds 2% of the total payment. N's use of the corporate name and logo in connection with the exhibition constitutes acknowledgment of the sponsorship. However, because the fair market value of the dinner exceeds 2% of the total payment, the dinner is a substantial return benefit. Only that portion of the payment, if any, that N can demonstrate exceeds the fair market value of the dinner is a qualified sponsorship payment.

Example 3. O coordinates sports tournaments for local charities. An auto manufacturer agrees to underwrite the expenses of the tournaments. O recognizes the auto manufacturer by including the manufacturer's name and established logo in the title of each tournament as well as on signs, scoreboards and other printed material. The auto manufacturer receives complimentary admission passes and pro-am playing spots for each tournament that have a combined fair market value in excess of 2% of the total payment. Additionally, O displays the latest models of the manufacturer's premier luxury cars at each tournament. O's use of the manufacturer's name and logo and display of cars in the tournament area constitute acknowledgment of the sponsorship. However, the admission passes and pro-am playing spots are a substantial return benefit. Only that portion of the payment, if any, that O can demonstrate exceeds the fair market value of the admission passes and pro-am playing spots is a qualified sponsorship payment.

Example 4. P conducts an annual college football bowl game. P sells to commercial broadcasters the right to broadcast the bowl game on television and radio. A major corporation agrees to be the exclusive sponsor of the bowl game. The detailed contract between P and the corporation provides that in exchange for a $1,000,000 payment, the name of the bowl game will include the name of the corporation. In addition, the contract provides that the corporation's name and established logo will appear on player's helmets and uniforms, on the scoreboard and stadium signs, on the playing field, on cups used to serve drinks at the game, and on all related printed material distributed in connection with the game. P also agrees to give the corporation a block of game passes for its employees and to provide advertising in the bowl game program book. The fair market value of the passes is $6,000, and the fair market value of the program advertising is $10,000. The agreement is contingent upon the game being broadcast on television and radio, but the amount of the payment is not contingent upon the number of people attending the game or the television ratings. The contract provides that television cameras will focus on the corporation's name and logo on the field at certain intervals during the game. P's use of the corporation's name and logo in connection with the bowl game constitutes acknowledgment of the sponsorship. The exclusive sponsorship arrangement is not a substantial return benefit. Because the fair market value of the game passes and program advertising ($16,000) does not exceed 2% of the total payment (2% of $1,000,000 is $20,000), these benefits are disregarded and the entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 5. Q organizes an amateur sports team. A major pizza chain gives uniforms to players on Q's team, and also pays some of the team's operational expenses. The uniforms bear the name and established logo of the pizza chain. During the final tournament series, Q distributes free of charge souvenir flags bearing Q's name to employees of the pizza chain who come out to support the team. The flags are valued at less than 2% of the combined fair market value of the uniforms and operational expenses paid. Q's use of the name and logo of the pizza chain in connection with the tournament constitutes acknowledgment of the sponsorship. Because the fair market value of the flags does not exceed 2% of the total payment, the entire amount of the funding and supplied uniforms are a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 6. R is a liberal arts college. A soft drink manufacturer enters into a binding, written contract with R that provides for a large payment to be made to the college's English department in exchange for R agreeing to name a writing competition after the soft drink manufacturer. The contract also provides that R will allow the soft drink manufacturer to be the exclusive provider of all soft drink sales on campus. The fair market value of the exclusive provider component of the contract exceeds 2% of the total payment. R's use of the manufacturer's name in the writing competition constitutes acknowledgment of the sponsorship. However, the exclusive provider arrangement is a substantial return benefit. Only that portion of the payment, if any, that R can demonstrate exceeds the fair market value of the exclusive provider arrangement is a qualified sponsorship payment.

Example 7. S is a noncommercial broadcast station that airs a program funded by a local music store. In exchange for the funding, S broadcasts the following message: "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call today at 555–1234. This station is proud to have the Music Shop as a sponsor." Because this single broadcast message contains both advertising and an acknowledgment, the entire message is advertising. The fair market value of the advertising exceeds 2% of the total payment. Thus, the advertising is a substantial return benefit. Unless S establishes that the amount of the payment exceeds the fair market value of the advertising, none of the payment is a qualified sponsorship payment.

Example 8. T, a symphony orchestra, performs a series of concerts. A program guide that contains notes on guest conductors and other information concerning the evening's program is distributed by T at each concert. The Music Shop makes a $1,000 payment to T in support of the concert series. As a supporter of the event, the Music Shop receives complimentary concert tickets with a fair market value of $85, and is recognized in the program guide and on a poster in the lobby of the concert hall. The lobby poster states that, "The T concert is sponsored by the Music Shop, located at 123 Main Street, telephone number 555–1234." The program guide contains the same information and also states, "Visit the Music Shop today for the finest selection of music CDs and cassette tapes." The fair market value of the advertisement in the program guide is $15. T's use of the Music Shop's name, address, and telephone number in the lobby poster constitutes acknowledgment of the sponsorship. However, the combined fair market value of the advertisement in the program guide and complimentary tickets is $100 ($15 + $85), which exceeds 2% of the total payment (2% of $1,000 is $20). The fair market value of the advertising and complimentary tickets, therefore, constitutes a substantial return benefit and only that portion of the payment, or $900, that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment.

Example 9. U, a national charity dedicated to promoting health, organizes a campaign to inform the public about potential cures to fight a serious disease. As part of the campaign, U sends representatives to community health fairs around the country to answer questions about the disease and inform the public about recent developments in the search for a cure. A pharmaceutical company makes a payment to U to fund U's booth at a health fair. U places a sign in the booth displaying the pharmaceutical company's name and slogan, "Better Research, Better Health," which is an established part of the company's identity. In addition, U grants the pharmaceutical company a license to use U's logo in marketing its products to health care providers around the country. The fair market value of the license exceeds 2% of the total payment received from the company. U's display of the pharmaceutical company's name and slogan constitutes acknowledgment of the sponsorship. However, the license granted to the pharmaceutical company to use U's logo is a substantial return benefit. Only that portion of the payment, if any, that U can demonstrate exceeds the fair market value of the license granted to the pharmaceutical company is a qualified sponsorship payment.

Example 10. V, a trade association, publishes a monthly scientific magazine for its members containing information about current issues and developments in the field. A textbook publisher makes a large payment to V to have its name displayed on the inside cover of the magazine each month. Because the monthly magazine is a periodical within the meaning of paragraph (b) of this section, the section 513(i) safe harbor does not apply. See § 1.512(a)–1(f).

Example 11. W, a symphony orchestra, maintains a website containing pertinent information and its performance schedule. The Music Shop makes a payment to W to fund a concert series, and W posts a list of its sponsors on its website, including the Music Shop's name and Internet address. W's website does not promote the Music Shop or advertise its merchandise. The Music Shop's Internet address appears as a hyperlink from W's website to the Music Shop's website. W's posting of the Music Shop's name and Internet address on its website constitutes acknowledgment of the sponsorship. The entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 12. X, a health-based charity, sponsors a year-long initiative to educate the public about a particular medical condition. A large pharmaceutical company manufactures a drug that is used in treating the medical condition, and provides funding for the initiative that helps X produce educational materials for distribution and post information on X's website. X's website contains a hyperlink to the pharmaceutical company's website. On the pharmaceutical company's website, the statement appears, "X endorses the use of our drug, and suggests that you ask your doctor for a prescription if you have this medical condition." X reviewed the endorsement before it was posted on the pharmaceutical company's website and gave permission for the endorsement to appear. The endorsement is advertising. The fair market value of the advertising exceeds 2% of the total payment received from the pharmaceutical company. Therefore, only the portion of the payment, if any, that X can demonstrate exceeds the fair market value of the advertising on the pharmaceutical company's website is a qualified sponsorship payment.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved April 12, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 24, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 25, 2002, 67 F.R. 20433)