Tax Court Rules (Again) on *Sierra Club* Affinity Card Income

by Albert Lauber and Lloyd Mayer

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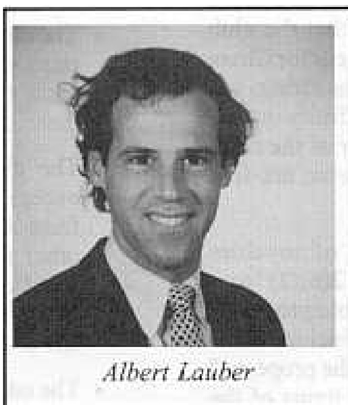

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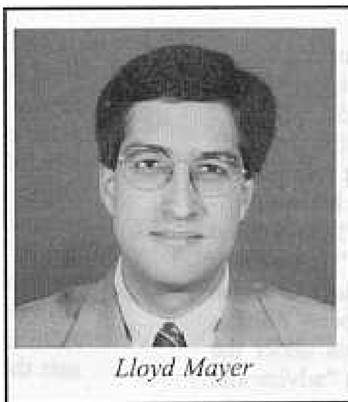

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The Tax Court, per Judge Halpern, recently issued its opinion in the latest chapter of the *Sierra Club* litigation, deciding on remand an issue of continuing importance to nonprofit organizations: whether receipts from affinity credit card programs are tax-exempt "royalties" under section 512(b)(2) of the Internal Revenue Code. *Sierra Club v. Commissioner*, T.C. Memo 1999-86 (March 23, 1999). Previously the Tax Court had granted summary judgment to the Sierra Club on this issue (103 T.C. 307 (1994)), as well as on the related issue of whether income from renting mailing lists constitutes a "royalty" (65 T.C.M. (CCH) 2582 (1993)).

On appeal, the Ninth Circuit affirmed as to the "royalty" status of list-rental income, but reversed and remanded as to the affinity card program, concluding that the Tax Court had erroneously granted summary judgment on this issue by resolving disputed factual issues in favor of the Sierra Club. 86 F.3d 1526 (1996). After holding a trial on these issues, the Tax Court has now ruled in the Sierra Club's favor once again, concluding that 100 percent of its receipts from the affinity card program during the years at issue constituted "royalties" within the meaning of section 512(b)(2).

The Affinity Card Program

In 1986, the Sierra Club signed an affinity credit card contract with American Bankcard Services (ABS), whereby ABS agreed to offer club members a Visa or MasterCard bearing the Sierra Club's name and logo. The club agreed to "cooperate with" ABS in soliciting club members and encouraging them to acquire the cards. ABS assumed responsibility for all marketing and promotional activities, subject only to the Sierra Club's "advice and consent." ABS agreed to pay the club a fee computed as a percentage of members' cardholder sales volume. Although the contract described this payment as a "royalty fee," the agreement was not styled a "license agreement," and it did not explicitly license ABS to use the club's name, logo, member list, or other intangible property.

ABS prepared a marketing plan, schedule, and sample solicitation materials and sent them to the Sierra Club for its review and approval. After making some modifications in response to the club's objections — these modifications were chiefly designed to "tone down" the sales pitch — ABS began soliciting club members. The initial solicitation letters were written on the Sierra Club's letterhead, contained the club's return address, and were signed using a facsimile signature of the club's president. These letters described the affinity card program as a "new member service" and explained the financial and other benefits that the club and its members could derive from the program. ABS paid all the costs of preparing and distributing these letters; to facilitate the solicitation, the club furnished ABS with a magnetic tape containing its members' names and addresses. The letters were mailed using the club's nonprofit postage permit (a fact later conceded to be a mistake).

ABS placed advertisements for the credit card in the Sierra Club's magazine and in publications of the club's local chapters. The club billed ABS for these advertisements at the same rates it charged other advertisers, and it treated the resulting income as gross advertising income for UBIT purposes. ABS ultimately failed to pay some of the club's invoices for these advertisements, and the club's effort to collect those bills was unsuccessful.

Members who applied for the credit card received a thank-you letter. This letter was signed jointly by officials of the Sierra Club and the card issuer (Chase Lincoln), and it bore the logo of both organizations. ABS paid 100 percent of the costs of preparing and distributing this letter. ABS and Chase Lincoln thereafter administered the program and maintained its records, with little involvement by the club's own staff. The club did not accept applications for the credit card or handle members' inquiries about the program, but rather directed all complaints and inquiries to ABS and Chase Lincoln. The club's own commitment of personnel to the program was limited to "a bit" of its finance director's time.

In 1987, ABS defaulted on its obligations to the Sierra Club. The club terminated its agreement with ABS in December 1987 and entered into a direct relationship with Chase Lincoln, the card issuer. The character of the club's income under this new arrangement was not considered by the Tax Court, since the income was received after the 1986-1987

tax years at issue. However, the new arrangement differed from the previous one in several respects, chiefly because the new credit card did not display the Sierra Club's logo and the club agreed to bear certain advertising expenses.

The Tax Court's Latest Opinion

The IRS sought to tax the Sierra Club's income from the affinity card program, contending that no portion of its income constituted a "royalty" within the meaning of section 512(b)(2). Rather, the commissioner asserted that the club derived its income from the performance of services for Chase Lincoln and ABS, variously described as "sponsoring, endorsing, promoting, and marketing" the affinity credit cards. On remand, the Tax Court ruled in favor of the club, concluding that its receipts in their entirety were tax-free "royalties."

Judge Halpern began with the definition of royalties adopted by the Ninth Circuit: "under section 512(b)(2) 'royalties' are payments for the right to use intangible property" that necessarily are "passive" and thus "cannot include compensation for services rendered by the owner of the property." 86 F.3d at 1532. The court then examined the terms of the agreement between the club and ABS and the parties' actual practice under that agreement.

The court first reaffirmed its conclusion, reached earlier in its summary judgment opinion, that the agreement was for use of valuable intangible property, namely, the Sierra Club's name, marks, logo, and mailing list, as well as the facsimile signatures of its officers. Although the contract was not explicitly labeled "License Agreement," the court had no difficulty concluding that the contracting parties "had in mind the use by ABS of [the club's] name and marks." In reaching this conclusion, the court pointed out that the agreement allowed ABS to use the club's intangible property only as long as ABS did not default on its obligations under the agreement. The court also found that the club's "advice and consent" rights with respect to marketing material were designed to safeguard the Sierra Club's name, logo, and marks. The court accordingly held that the club's receipts under the affinity program constituted — at least in part — royalties for the use of intangible property.

The court then considered whether any part of the club's receipts represented compensation for providing marketing or other services. The court found that the agreement as drafted and implemented required ABS to bear 100 percent of the marketing costs, unless the club elected (which it did not do) to pay some marketing costs in consideration of a larger royalty from ABS. The Sierra Club's right of prior review over promotional materials, the court found, was not intended to give the club responsibility for marketing the program, but was designed only to protect the goodwill inherent in its intangible property rights. The court therefore concluded that the club derived no income from the performance of marketing services.

The commissioner argued that the club provided a number of other "personal services" to Chase Lincoln and ABS, including publication of advertisements, sponsorship of the program, endorsement of the credit card, use of the club's nonprofit mail permit, and a variety of "member services" (e.g., asking Chase Lincoln to relax its credit standards for some applicants, and later holding members harmless after ABS' default). The court considered and rejected each of these IRS arguments, concluding in essence that the Sierra Club (1) had not performed these services; (2) had not performed these services for ABS; or (3) had not been compensated for these services by ABS under the royalty agreement. In so holding, the Court relied chiefly on the following facts:

- The club billed ABS separately, at its usual commercial rates, for all advertisements appearing in the Sierra Club's magazine, and ABS' failure to pay some of these invoices was unforeseeable.
- The club did not endorse or promote the program, except for the endorsement that necessarily resulted from ABS' use of the Sierra Club's name, logo, and other intangibles. Sierra Club officials made no personal appearances, and they otherwise furnished no individualized endorsement other than that implied by use of their facsimile signatures.
- The one-time use of the club's nonprofit mailing permit was an inadvertent mistake and was not something ABS had bargained for in the royalty agreement.
- The Sierra Club provided no "services" to its members on behalf of ABS, apart from giving them an opportunity to apply for the credit card. All inquiries about the program were directed to ABS and Chase Lincoln. All administrative services were provided by ABS and Chase Lincoln. And the club had not agreed in advance to assist less-creditworthy applicants or pick up the pieces after ABS' default. These latter actions were motivated by the club's desire to preserve goodwill with its members, and they were not services for which ABS in executing the agreement intended to compensate the club.

In sum, the Tax Court held that all of the income the club received under its agreement with ABS constituted "royalty" income within the meaning of section 512(b)(2), and that no portion of the club's receipts represented compensation for services rendered. The court thus found it unnecessary to decide the other questions raised by the Commissioner — namely, whether the club was engaged in a "trade or business" and (if so) whether such trade or business was "regularly carried on" and "unrelated" to the Sierra Club's exempt purposes.

What Does It Mean?

The Tax Court's opinion on remand, in combination with the Ninth Circuit's earlier opinion in *Sierra Club* and other Tax Court opinions on the subject,[1] firmly establishes that affinity card receipts, like list-rental income, can qualify as

[1]*See Mississippi State Univ. Alumni Inc. v. Commissioner*, 74 T.C.M. (CCH) 458 (1997); *Alumni Ass'n of the Univ. of Oregon*, 71 T.C.M. (CCH) 2093 (1996); *Oregon State Univ. Alumni Ass'n Inc. v. Commissioner*, 71 T.C.M. (CCH) 1935 (1996).

tax-free royalties — so long as the arrangements are structured properly. This last point is critical, as a closing note in Judge Halpern's opinion emphasizes. While the Sierra Club's post-1987 agreements with Chase Lincoln were not before the court, Judge Halpern noted that these new agreements provided for issuance of a different credit card not displaying the club's logo, and also provided that the club would bear certain advertising expenses. The court suggested in *dicta* that this new arrangement was sufficiently different from the club's 1986-1987 arrangements that the same conclusion might not necessarily be reached concerning the taxability of its post-1987 income.

In the course of its opinion, the Tax Court clarifies or reaffirms several points of interest to nonprofit organizations seeking to resist the Commissioner's increasingly quixotic campaign to tax this type of income. First, the court makes clear that the substance of the parties' agreement, not its form, will control. In the past, the IRS has often sought to buttress its denial of "royalty" treatment by seizing on the absence of a written contract, or the fact that the contract was not captioned a "License Agreement." In *Sierra Club*, the agreement was not styled a "License Agreement" and it did not, in so many words, license the use of the club's intangible property. The Tax Court placed little weight on these facts, relying on inferences from the contract terms and its understanding of the parties' intent in reaching its decision about what ABS was actually paying for. Of course, careful drafting of such agreements with an eye to tax consequences can enhance the taxpayer's case for royalty treatment. But many agreements (especially older ones) were not drafted with that degree of care, and the Tax Court's opinion squarely holds that such formal details are not dispositive.

Second, the court's opinion clearly indicates that a nonprofit's income from licensing intangible property will be considered separately from income (if any) received for performing services. In prior audits and private rulings, the IRS has employed a sort of "tainting theory" in attacking affinity contracts, which typically provide for a single, undifferentiated stream of income. The commissioner has contended that the nonprofit's performance of services as part of the contract package in effect "taints" the royalty, rendering the entire consideration subject to UBIT.

Judge Halpern's opinion rejects any sort of "tainting" argument. He first addresses whether the club licensed intangible property: Finding that it did so, the court held that the resulting consideration was thus a tax-free royalty "at least in part." He then addresses, as a separate question, whether "any part of the receipts was received by [the club] in consideration of its services." The inescapable conclusion is that, if the club had been compensated for performing more than *de minimis* services,[2] it would have been taxable only on the fair market value of those services, with the royalty component remaining tax-free.

Conceivably, some taxpayers might have difficulty carrying their burden of proof as to the fair market value of any services provided, especially if the contract does not specify the extent of the expected services or how they shall be compensated. Judge Halpern had no occasion to address this factual issue, having found that the club provided no services whatsoever. However, his opinion makes clear — as a conceptual matter — that any services will be treated as distinct for tax purposes and taxed separately from the royalty. If a taxpayer can prove (by time records or testimony) the amount of time its staff devoted to taxable services, it should be able to quantify the value of those services by reference to staff salaries, an overhead allowance, and a market-based profit margin.

Third, the court's opinion reaffirms the principle that services in the nature of "quality control" — e.g., review of solicitation letters and marketing materials to ensure factual accuracy and good taste — are consistent with "royalty" treatment and do not give rise to taxable services income. The court correctly reasons that "quality control" services are not performed for the affinity partner; indeed, such efforts by the nonprofit are (if anything) adverse to the affinity partner, which typically favors extremely aggressive marketing. Rather, the court holds that a nonprofit exercising its "quality control" rights is in effect working for itself, safeguarding its intangibles against diminution in value caused by inappropriate use.

What's Next?

If the past is any guide, it seems likely that the IRS will seek to appeal. That decision, however, lies not with the Commissioner, but with the Solicitor General, who must authorize any appeal by the Justice Department. Unfortunately for the government, Judge Halpern's opinion poses a serious obstacle to appellate success, and it is an obstacle that the Tax Division and the Solicitor General's Office normally regard as weighing heavily against appeal.

The Tax Court's opinion on remand does not decide any legal issues, other than those previously considered or implicitly decided by the Ninth Circuit. Rather, the opinion on remand rests on numerous findings of fact, including the resolution of ambiguities in the club's written contract with ABS which the Ninth Circuit believed to necessitate a trial. Judge Halpern bases many of his factual findings on the testimony of witnesses, which he repeatedly finds "credible." Because the Tax Court's findings of fact are subject to appellate review under a "clearly erroneous" standard, and because appellate courts almost invariably defer to trial judges' credibility determinations, the Solicitor General is likely to see the handwriting on the wall. This may be the reason why the government ultimately did not appeal an earlier Tax Court decision in another affinity-card case, *Mississippi State Univ. Alumni, Inc. v. Commissioner*, 74 T.C.M. (CCH) 458 (1997), despite assertions by senior IRS officials that this earlier case would be appealed.

[2]The Tax Court has previously held that a nonprofit organization may perform *de minimis* services for an affinity partner without giving rise to taxable services income. *See Mississippi State Univ. Alumni Inc.*, 74 T.C.M. at 466; *Alumni Ass'n of the Univ. of Oregon*, 71 T.C.M. at 2098; *Oregon State Univ. Alumni Ass'n Inc.*, 71 T.C.M. at 1939-40; *Disabled American Veterans v. Commissioner*, 94 T.C. 60, 78 (1990), *rev'd on other grounds*, 942 F.2d 309 (6th Cir. 1991).

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Moreover, an appeal in *Sierra Club* seems unnecessary from the standpoint of creating precedent. Appeal would lie to the Ninth Circuit, which is already considering affinity-card issues raised by the government's appeal of two other Tax Court decisions: *Oregon State Univ. Alumni Ass'n Inc. v. Commissioner*, 71 T.C.M. (CCH) 1935 (1996), and *Alumni Ass'n of the Univ. of Oregon v. Commissioner*, 71 T.C.M. (CCH) 2093 (1996).

The Tax Court's opinion in *Sierra Club* provides a useful roadmap for how nonprofit organizations should structure affinity programs in order to create the best possible case for tax-exempt royalty treatment. Specifically:

- The arrangement should be memorialized in a contemporaneous written contract, styled a "License Agreement." This agreement should unambiguously provide for a license by the affinity partner of certain identified intangibles owned by the nonprofit organization, such as its name, logo, marks, and facsimile signatures of its officers. The consideration paid to the nonprofit should explicitly be denominated a "royalty."

- If the arrangement entails (as it normally will) use of the nonprofit's membership or donor list, that fact should be stated in the agreement. The terms governing the affinity partner's use of the list — e.g., each use should be for one time only — ought to be explicit. Ideally, the fee paid for using the list should be separate from the royalty paid for using the intangibles, and that fee should be the same as would be paid by any other prospective user of the list on comparable terms.

- The nonprofit's involvement in promotional activities should be limited to "quality control," i.e., reviewing marketing plans, brochures, and advertisements to ensure factual accuracy and good taste and thus protect the value of the licensed intangibles.

- To ensure complete non-taxability of its receipts from the affinity program, the nonprofit should avoid performing any other services for the affinity partner. Thus, the nonprofit should not send out solicitations or application forms, provide a telephone hotline to answer members' questions or handle complaints, or provide marketing advice to the affinity partner about the best way to "reach" its members. While the nonprofit may license use of its logo and its officers' facsimile signatures in solicitation letters, there should be no personal appearances or other individualized endorsements by officers, directors, or staff.

- If the affinity partner wishes to place advertisements in the nonprofit's newsletters or magazine, it should pay separately for those ads at the same rates charged other advertisers for comparably-sized advertisements. The nonprofit should include these receipts in gross advertising income for UBIT purposes.

- If the nonprofit agrees to perform commercial services for the affinity partner — such as fielding members' inquiries or complaints — such services should be specified in a different contract, separate and distinct from the license agreement. This contract should identify the individuals expected to perform these services and should specify a compensation formula that covers the nonprofit's direct and indirect costs, as well as affording a reasonable profit. The individuals performing such services should keep contemporaneous time records documenting the extent of their activity.

Apart from this most recent loss on the affinity-card issue, the IRS is also fighting against the tide of court decisions on the related issue of whether receipts from mailing-list transactions are "royalties" under section 512(b)(2). Two cases raising this issue outside the affinity-card context are now pending before Judge Wells in the Tax Court. *Common Cause v. Commissioner*, Docket No. 13921-97; *Planned Parenthood Federation of America, Inc. v. Commissioner*, Docket No. 13922-97. (The authors are counsel to the taxpayers in both cases.) Senior IRS officials have stated that, if the government loses one or both of these cases, it plans to seek the Justice Department's authorization for an appeal, in the hope of creating a circuit conflict and thus setting the stage for Supreme Court review. (Whether the commissioner can convince the Solicitor General to expend additional resources on an issue with comparatively little revenue significance is another question.) Thus, for the time being at least, nonprofit organizations should expect continued IRS opposition on audit to treating affinity-program and list-rental receipts as non-taxable royalties, even if their arrangements conform to the *Sierra Club* pattern. Under existing case law, however, such receipts will be exempt from tax if the arrangement is structured properly.

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