Sierra Club, Inc. v. Commissioner, T. C. Memo. 1993-199

Income received by a nonprofit from an affinity card program can constitute royalty income if it is payment for the use of valuable intangible property rights.

Summary

The Sierra Club entered into an agreement with American Bankcard Services (ABS) for an affinity credit card program. Under the agreement, Sierra Club received a percentage of the total cardholder sales volume as a 'royalty fee' in exchange for allowing ABS to use its name, logo, and access its members. The Tax Court held that this income qualified as royalty income under IRC section 512(b)(2), exempt from unrelated business income tax. The decision hinged on the nature of the payments as being for the use of Sierra Club's intangible property rights, not as a share of profits or payment for services rendered by Sierra Club.

Facts

In 1980, the Sierra Club was approached by a predecessor of American Bankcard Services (ABS) to participate in an affinity credit card program. In 1986, Sierra Club and ABS formalized their agreement, where ABS agreed to offer credit card services to Sierra Club members. Sierra Club's role was to cooperate with ABS in soliciting its members to use the services, for which it would receive a 'royalty fee' based on the total cardholder sales volume. The agreement also involved Chase Lincoln First Bank as the issuing bank. Sierra Club did not share in Chase Lincoln's costs or risks associated with issuing the credit cards.

Procedural History

Sierra Club challenged the IRS's determination that the income from the affinity card program constituted unrelated business taxable income (UBTI). The Tax Court had previously issued a report on a related issue regarding Sierra Club's mailing lists (Sierra Club I). In the current case, both parties filed motions for partial summary judgment on the issue of whether the affinity card income constituted royalties exempt from UBTI under IRC section 512(b)(2). The Tax Court granted Sierra Club's motion and denied the Commissioner's motion.

Issue(s)

1. Whether the income received by Sierra Club from the affinity card program constituted royalties within the meaning of IRC section 512(b)(2)?
2. Whether Sierra Club participated in a joint venture with ABS or Chase Lincoln?
3. Whether Sierra Club was engaged in the business of selling financial services?

Holding

1. Yes, because the income was payment for the use of Sierra Club's valuable

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intangible property rights (name, logo, and access to members), qualifying as royalties under IRC section 512(b)(2).
2. No, because Sierra Club did not share in the net profits or losses of the affinity card program and did not have mutual control over its operation.
3. No, because Sierra Club did not control ABS's marketing efforts to the extent necessary to be considered in the business of selling financial services.

Court's Reasoning

The court analyzed the agreements between Sierra Club, ABS, and Chase Lincoln, focusing on the nature of Sierra Club's compensation. The court found that Sierra Club's income was based on a percentage of total cardholder sales volume, which the court deemed a 'royalty fee' for the use of Sierra Club's name, logo, and access to its members. This aligned with the definition of royalties as 'payments for the use of valuable intangible property rights' established in Disabled American Veterans v. Commissioner. The court rejected the Commissioner's arguments that Sierra Club was in a joint venture or in the business of selling financial services, citing the lack of shared profits, losses, or control over the program's operations. The court emphasized that Sierra Club's role was limited to cooperation and approval of marketing materials, not direct involvement in marketing or bearing financial risks associated with the program.

Practical Implications

This decision provides clarity for nonprofits considering affinity card programs. It establishes that income from such programs can be treated as royalty income, exempt from UBTI, if structured as payment for the use of the nonprofit's intangible assets. Nonprofits should structure their agreements to ensure payments are clearly tied to the use of their name, logo, or membership access, and avoid taking on roles or financial risks that could be construed as engaging in a trade or business. The decision has been cited in subsequent cases involving similar arrangements, reinforcing its significance in tax planning for nonprofits. Practitioners should advise clients to carefully document the nature of payments and the nonprofit's limited role in any marketing efforts to maintain the royalty characterization.

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