
Association Affinity Programs: An Overview

Many associations derive significant non-dues revenue from sponsored affinity programs.¹ These programs arise when tax-exempt organizations are compensated for licensing their intellectual property (e.g., their names, logos, copyrighted content, and mailing lists) to commercial providers of goods or services for marketing purposes as a benefit to the organizations' members, who usually receive discounts on the providers' products or services.

Affinity programs exist across a wide range of service and product industries, including, but not limited to, credit cards, insurance products, retirement plans, travel and tour packages, communication packages, discount programs, professional services in areas such as law and accounting, retail consumer items, and equipment. Essentially, associations are compensated for licensing their intellectual, or intangible, property to vendors because the associations' "affinity" with the vendors' products or services is thought to boost sales to the organizations' members.² Tax-exempt organizations can receive tax-free royalty payments in exchange for the licensing and use of their intellectual property.

Cause-Related Marketing Distinguished

Although similar in many ways, affinity programs are distinguishable in a certain respect from what is called cause-related marketing, where commercial firms pay exempt organizations royalties for the use of the organizations' intellectual property in the vendors' marketing to the public as a whole, rather than solely to the organizations' members. Cause-related marketing is found on radio, television, or print media. A classic example of this type of advertising is when a company states that it is a "proud sponsor of the American Charitable Organization" or that "a portion of each sale will be contributed to the Good Deed Foundation."

Again, affinity programs are somewhat narrower than cause-related marketing in that generally, only the organizations' members are targeted for marketing purposes. Affinity programs have been in existence for years and are vital to numerous associations' financial success. The income derived from such programs supplements members' dues and greatly assists in furthering the organizations' various tax-exempt missions.³

Royalties Generally

If affinity programs are structured properly, the payments that the organizations receive are considered tax-exempt royalties. A royalty is a payment for the right to use intellectual property. The exempt organizations receive royalty income either in fixed amounts or, more frequently, in amounts based on the gross sales revenue from the goods or services sold. Royalty income is one of the exceptions to the law on unrelated business income taxation ("UBIT"). The main goal of UBIT law is to prevent tax-exempt organizations from gaining an unfair competitive advantage over taxpaying organizations. Section 511 of the Internal Revenue Code imposes UBIT on the "unrelated business income" of otherwise tax-exempt organizations, which is income that is derived from any unrelated trade or business regularly carried on by the organization, minus any allowable deductions directly connected to carrying on the trade or business. The royalty exclusion from UBIT for exempt-organization-sponsored affinity programs has been litigated aggressively over the years. This, in turn, has clarified the law on affinity programs to a large extent.⁴

Case Law on Royalties

While the Internal Revenue Code does not clearly define "royalty" to assist in deciding what kinds of payments are taxable, the Internal Revenue Service (IRS) initially viewed royalties as limited to where the association remained completely "passive"; any active involvement at all by the organization, such as administration or marketing, tainted the royalty's exclusion from UBIT.⁵ For example, in the early 1980s in *Disabled American Veterans v. Commissioner*,⁶ the court said that to be tax exempt, royalties must be the "conventional type of passive investment income traditionally earned by exempt organizations."

Fortunately for associations, more recent court decisions have defined "royalty" more broadly to exclude from UBIT royalty payments for the right to use an association's name, logo, and mailing lists, even where the association has some incidental active involvement in the program. In two cases, both entitled *Sierra Club, Inc. v. Commissioner*,⁷ the courts found that sponsored affinity programs can involve more than just "bare" licensing of intellectual property rights; exempt organizations may participate in the programs in other modest ways, including review of marketing materials or management of a mailing list, without risking exposure to UBIT.

It is now acceptable for organizations to receive exempt royalty payments for not only licensing their intellectual property to vendors, but also for insignificant, incidental, or minor assistance with the programs that the organizations must provide. Licensors of intellectual property may participate in the following activities, among others, while still maintaining the passive nature of their royalty payments:

- Retain the right to review promotional materials and mandate that vendors "tone down" their sales tactics or correct the spelling of names to ensure that the use of the intellectual property will not damage the organization's reputation.⁸
- Give signatures of its president to the vendor to duplicate on promotional materials, such as in a mailing using the association's letterhead (i.e., name, logo, and contact information).⁹
- Occasionally assist members who contact them directly regarding the affinity program by sending brochures to those making the request, referring complaints to the vendor, and asking the vendor to provide certain members with special treatment, such as expedited or preapproved applications or credit limits above the average.¹⁰
- Occasionally meet with the vendor to review the performance of the affinity program.¹¹

- Agree to inform its members of the existence of the affinity program, so long as the exempt organization is not required to mail any solicitation materials to its members.¹²
- Take affinity program application forms to chapter meetings along with other exempt organization membership information.¹³
- Give messages to the vendor to print in its statements to members who enrolled in the affinity program, announcing events put on by the exempt organization.¹⁴
- Write an article about the affinity program to be included in one of the exempt organization's publications.¹⁵
- Inform others that its mailing list is available, protect its mailing list's value by renting only to appropriate mailers, and make the list available to mailers in a tangible form.¹⁶

However, engaging in more than incidental activities invites the possibility of the revenue being subject to UBIT.¹⁷ For example, any agreements requiring the personal services of the organization's members, such as mandating that members make personal appearances at events, would be considered "active" involvement, thus converting the payments into taxable unrelated business income.¹⁸ In addition, advertising or marketing provided by the association will give rise to UBIT by tainting the passive nature of the activity. If such advertising or marketing support is intended, it should be conducted pursuant to bifurcated agreements, as discussed below.

Due to the developments discussed above, the Director of the Exempt Organizations Division at the IRS issued a field memorandum in 1999 regarding royalties from mailing lists and affinity credit cards, recognizing that "courts will continue to find the income to be excluded royalty income unless the factual record clearly reflects more than unsubstantial services being provided. Thus, further litigation in cases with facts similar to those decided in favor of the taxpayer should not be pursued."¹⁹ After decades of litigation, the law on affinity programs of nonprofit organizations and associations is fairly predictable and settled.

Bifurcated Agreements Strongly Suggested

While not legally required, often the best way to structure affinity programs is by entering into "bifurcated" contracts with the commercial vendors, especially if the exempt organization's activities are predicted to be anything more than minimal and passive.²⁰ In the royalty license contract, the organization licenses its intellectual property in return for royalty payments. The other contract for services, either with a taxable subsidiary of the organization or with the organization itself, lists all of the ancillary activities, such as administrative and marketing activities. While bifurcation does not guarantee that the IRS will not assert that all the income is taxable, it certainly helps to safeguard the tax status of the program.

The royalty license contract might contain the following features:²¹

- Identification of the parties, the program, and the clear specification that the organization, in this agreement, is only providing intellectual property in exchange for royalties.
- License of the intellectual property to the commercial firm, including identification of the intellectual property and detailed specifications for its use.

- Confidentiality provision to safeguard membership and other confidential information of the organization.
- Description of the royalty payments, like a percentage of gross revenue, and provisions for royalty payments.
- Description of the goods or services offered by the commercial firm, possibly including attachments with detailed service standards and timetables.
- Clear statement that the organization will not provide any marketing or administration services associated with the program via the licensing agreement.
- Indemnification of the organization by the commercial firm against claims related to the firm's goods or services, and possibly mandating that the firm list the organization as an additional insured on its insurance policy.
- Identification of termination features, including some payment to the organization from the commercial firm for some amount of time after termination, if, as is frequent, the vendor has established a lucrative market for its products by exploiting the organization's sponsorship and name. This might include transfer of the book of business by the original sponsored vendor to the organization's successor sponsored vendor, payout of royalties for a certain number of years after termination, and a penalty payment, among others.
- The organization's right to audit the commercial firm's books and records in connection with the program's revenues and royalties.

The services contract might address the following topics:²²

- Identification of the parties, the program, and the clear specification that the subsidiary or the organization itself, in this agreement, is providing administration, marketing, or similar services in return for fee compensation.
- Descriptions of the services to be rendered by the subsidiary or organization, possibly including attachments with detailed service standards and timetables.
- Any services that the commercial firm will provide.
- Fee compensation to the subsidiary or organization.
- Mutual indemnifications.
- Termination provisions, probably connected to those contained in the separate royalty agreement described above.

Conclusion

Sponsored affinity programs offer nonprofit organizations and associations numerous benefits. These programs may be an attractive option for organizations seeking additional revenue to improve advocacy, education, communications, research, and other tax-exempt goals.²³ What is more, the tax risks associated

with these programs are relatively minor and can feasibly be managed if the organization is willing to engage in some advanced planning, which often involves the use of bifurcated agreements. With proper structuring, the payments earned from these affinity programs are categorized as royalties and thus generally are not taxable as unrelated business income.

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- ¹ Jerald A. Jacobs, *Association Law Handbook* 393 (American Society of Association Executives) (4th ed. 2007).
- ² *Id.*
- ³ *Id.*
- ⁴ *Id.* at 394.
- ⁵ *Id.*
- ⁶ 650 F.2d 1178 (Ct. Cl. 1981).
- ⁷ 94 T.C. 60 (1990); 103 T.C. 107 (1994)
- ⁸ *Oregon State University Alumni Ass'n, Inc. v. Comm.*, 71 T.C.M. 1935 (1996).
- ⁹ *Id.*
- ¹⁰ *Id.*
- ¹¹ *Id.*
- ¹² *Alumni Ass'n of the University of Oregon, Inc. v. Comm.*, 71 T.C.M. 2093 (1996).
- ¹³ *Miss. State University Alumni, Inc. v. Comm.*, 74 T.C.M. 458 (1997).
- ¹⁴ *Id.*
- ¹⁵ *Id.*
- ¹⁶ *Common Cause v. Comm.*, 112 T.C. 332 (1999).
- ¹⁷ Jacobs, *supra* note 1, at 398.
- ¹⁸ Rev. Rul. 81-178, 1981-2 C.B. 135.
- ¹⁹ IRS Field Memorandum, December 16, 1999.
- ²⁰ Jacobs, *supra* note 1, at 400.
- ²¹ *Id.* at 399-400.
- ²² *Id.* at 400.
- ²³ *Id.* at 393.

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