INSURANCE SALE INCOME

UBIT ROYALTY TREATMENT EXTENDED TO INCOME FROM INSURANCE SALES

Bellco Credit Union confirms that the UBIT 'royalty' precedents are not limited to any particular type of business arrangement or product.

Author: RICHARD F. RILEY, JR. AND JASON J. KOHOUT

RICHARD F. RILEY, JR. is a partner in the Washington, DC office of Foley & Lardner LLP. JASON J. KOHOUT is an associate in the Milwaukee office of Foley & Lardner LLP. Foley & Lardner served as counsel to Bellco Credit Union in the case discussed in this article.

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Nearly all organizations that qualify for exemption from federal income tax are nevertheless liable for income tax on their unrelated business taxable income (UBTI). This tax is called the unrelated business income tax, or UBIT. UBIT is generally imposed on net income from any trade or business activity that is regularly carried on by the organization but is not substantially related to the substantive purposes or functions giving rise to the organization's tax-exempt status.[1]

Section 512(b) allows certain “modifications” to income that could otherwise be subject to UBIT. Among them is the following: “There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.”[2]

The Code and regulations are otherwise silent on the meaning of “royalties” that are excluded from UBTI under Section 512(b)(2). The only help provided by the regulations is a statement that: “whether a particular item of income falls within any of the modifications provided in Section 512(b) shall be determined by all the facts and circumstances of each case.”[3]

The dearth of statutory and regulatory guidance has given rise to repeated litigation over the meaning of the royalty exclusion, most prominently in the area of "branding"—that is, income from an exempt organization's license of its name, logo, other trademarks, and other intangible assets reflecting its identify. Closely related to this issue (and often arising in the same cases) has been litigation over the rental of mailing lists and other member contact data maintained by exempt organizations. The goodwill represented by mailing lists and contact data can also be viewed as an element of an organization's “brand.”

The results of this litigation provide a good sense of the bounds of the royalty exclusion. To claim the royalty exclusion, as explained in more detail below, an exempt organization generally must be able to show that the payments were for the use of intellectual or intangible property licensed or otherwise made available for use by another party, and not for services provided to the putative licensee. The courts decisively rejected the Service's early "all or nothing" argument that the royalty exclusion will not apply if the organization provides any services at all. Instead, the courts look to the

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underlying purpose of any payment, and certain services will not vitiate the “royalty” character of payments if the payments are clearly and primarily compensation for the organization's intangible intellectual property. In addition, quality control procedures and activities undertaken by the organization to protect the value of its intellectual property are not considered services that negate the “royalty” exclusion. Generally, in order to confirm “royalty” treatment for UBIT purposes, the courts seek to confirm that a revenue stream is essentially *passive* income derived from the exploitation of an intangible intellectual property asset, rather than income from the active performance of services or business activities.

The key recent case of *Bellco Credit Union,* 105 AFTR 2d 2010-1778, 2010-1 USTC ¶50343, 735 F Supp 2d 1286 (DC Col., 2010) is the first significant UBIT “royalty” case in a decade. Though clearly based on existing case law, the *Bellco* decision extended the royalty precedents to new areas and new activities. As the *Bellco* decision demonstrates, the UBIT royalty exclusion, because it is so fact-intensive, remains an unsettled area.

Pre-*Bellco* cases and rulings

The UBIT royalty cases decided before *Bellco* clarified several aspects of the royalty exclusion, but there were still some areas of uncertainty. The key court decisions and IRS rulings that remain the primary guidance in this area are described below.

Broad quality control consistent with royalty treatment.

An important tax precedent in this area involved a for-profit company. In *William J. Lemp Brewing Co.,* 18 TC 586 (1952), the Tax Court held that a contract that kept significant, broad-ranging quality control rights with a licensor company was a true license and the payments under the contract qualified as royalties (the context was whether the licensor was a personal holding company). The licensing contract called for the licensor to “supervise the methods of brewing, advertising, and marketing of beer.” Another clause was even broader, stating “it is understood and agreed that it is the mutual desire of all the parties hereto to produce and sell a high quality beer under the 'Lemp' name.” The Tax Court ruled that activities designed to protect the value of intellectual property are part of providing the intellectual property for a third-party use.

In Rev. Rul. 81-178, 1981-2 CB 135, the IRS applied *Lemp* in the UBIT context and ruled that an organization retaining approval rights and conducting activities to protect its intellectual property could maintain royalty treatment for the payments it received, although personally conducted, active “endorsement” activities were not consistent with royalty treatment. *Lemp* is also cited and followed in the more recent mailing list rental cases discussed further below, in which the mailing list revenue of exempt organizations was held to qualify for tax-exempt royalty treatment.[4]

Third-party publication and directory cases—services and advertising income.

A series of cases determined that the royalty exclusion did not apply to the sale of space in directories, newsletters, and programs. In *Fraternal Order of Police, Illinois State Troopers Lodge No. 41,* 87 TC 747 (1986), *aff'd,* 60 AFTR 2d 87-6050, 833 F2d 717, 87-2 USTC ¶9624 (CA-7, 1987),[5] a tax-exempt police union contracted with a third-party publisher to publish its annual directory. The third-party publisher was allowed, under the contract, to solicit the business listings and the organization received a certain percentage of the resulting revenues. While the organization itself was not actively engaged in selling the listings, it was very involved in approving editorial content. The organization argued that it had sold the third-party publisher the right to exploit the petitioner's name. But the court found instead that the publisher was selling advertising, a non-excluded UBTI source. Thus, the receipts were subject to UBIT.

The Court of Appeals for the First Circuit found in *State Police Ass'n of Massachusetts,* 80 AFTR 2d 97-6074, 125 F3d 1, 97-2 USTC ¶50627 (CA-1, 1997), on facts similar to the *Illinois State Troopers* case, that the third-party publisher was essentially an

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agent for the exempt organization in conducting the organization's publication. The publication bore the organization's marks and the organization had tight control over all aspects of the publication and the third-party publisher's activities. Because the organization was actively engaged in the editorial portions of the publication, the court found that the revenues were taxable advertising income and not tax-exempt royalties. The First Circuit rejected the argument that the organization's activities were limited to *Lemp*-like quality review procedures. A similar result was reached regarding basketball tournament programs in *National Collegiate Athletic Ass'n,* 92 TC 456 (1989), *rev'd on other grounds,* 66 AFTR 2d 90-5602, 914 F2d 1417, 90-2 USTC ¶50513 (CA-10, 1991).

Pre-*Bellco*insurance cases discussing royalty treatment

On more than one occasion, an exempt organization contracted with an insurance company and allowed the company to sell insurance under the exempt organization's brand. Some of these contracts may have been drafted inartfully, with the result that some of the exempt organizations provided a high level of services to the insurance company. These pre-*Bellco* insurance sale cases therefore generally did not allow tax-exempt royalty treatment for the income.

In contrast to the publication cases discussed above, the insurer or insurance marketing company in these cases was not the agent of the exempt organization. However, the contracts often did obligate the exempt organization to provide a substantial level of services to the insurance company in promoting the insurance. In *Texas Farm Bureau,* 75 AFTR 2d 95-2323, 53 F3d 120, 95-1 USTC ¶50297 (CA-5, 1995), *rev'g* 71 AFTR 2d 93-1681, 822 F Supp 371, 93-1 USTC ¶50257 (DC Tex., 1993),[6] the Texas Farm Bureau agreed to promote the life insurance, to furnish facilities for state and district sales directors, and to service policyholders, in addition to clerical, telephone, and administrative services. In addition, the Texas Farm Bureau pledged, in a broad contract clause, “to use its good offices, influence, and prestige in promoting the general welfare” of the insurance company. In *National Water Well Ass'n, Inc.,* 92 TC 75 (1989), the court found that the petitioner performed administrative and advertising services, wrote articles on safety, provided exhibit space at conventions, and provided an employee responsible for distributing information concerning the insurance. In both of these cases, the royalty exclusion was held inapplicable because of the level of activity.

The decisions in *Texas Farm Bureau* and *National Water Well Ass'n* did not engage in a detailed analysis of whether the payments were for the active selling of the insurance or instead were primarily for the licensing of the intellectual property for royalties. In *Texas Farm Bureau*, the district court found that there was a factual issue as to whether a two-part agreement existed whereby the Bureau would be compensated for its expenses and also for licensing its intellectual property. On appeal, the Fifth Circuit reversed and, seeing no mention of royalty or intellectual property in the agreements, dismissed the argument that part of the payment should be allocated to the use of intellectual property.

Because of their underlying facts, these cases do not necessarily stand for the proposition that the presence of services automatically “taints” all revenue as service income not eligible for the royalty exclusion—especially in the light of the later affinity card and mailing list cases discussed below. These earlier insurance cases are best read as situations in which the organizations seemed essentially to be engaged in direct sales of insurance—that is, an active trade or business. That the organization also provided the brand to sell the insurance was insufficient to characterize the payment or even part of the payment as a royalty, especially in the absence of any allocation to licensing intellectual property as opposed to providing services. In this context, the organizations' intellectual property may not have struck the courts as particularly valuable in comparison to the value of the organizations' serving as the equivalent of an insurance agency.

The key decisions—affinity credit cards and mailing lists.

The most widely cited cases in the UBIT royalty area—and the cases that reflect current doctrines on the issue—involved “affinity” credit cards. In affinity card arrangements, an organization's brand is licensed to a financial institution to issue credit cards to members or other people associated with the organization. Also involved is the related issue of organizations making their mailing lists and other member contact data available to outside parties to allow the marketing of the affinity cards and other contacts with the members. The fact that the organizations in these cases may have provided some services to the licensees did not prevent the application of the

royalty exclusion. The key was that the organizations' contracts and actions clearly showed that payments received were for the license of the organization's intangible property, and not for any significant services.

The basic facts in the affinity card and mailing list cases are fairly similar. The exempt organization contracts with a bank or other financial institution to license the organization's logo for use on an affinity credit card. The organization may also allow the institution to use its mailing list to send solicitations for the cards.[7] In other cases, the organization simply rents its mailing list to a third party.[8] In all these cases, the exempt organization typically provides some sort of minor level of service to the bank that is offering the credit card. The exempt organization may also contract with third-party list managers and vendors to facilitate the rental of the mailing list by other organizations.[9]

In litigation, the government asserted that a small level of activity “tainted” the entire license arrangement and denied the royalty exclusion on the entire payment. The government position was not accepted by the courts, and it eventually announced it would no longer assert UBIT in affinity card and mailing list “royalty” cases on similar fact patterns.[10] Two central cases were *Sierra Club, Inc.,* 78 AFTR 2d 96-5005, 86 F3d 1526, 96-2 USTC ¶50326 (CA-9, 1996), and *Oregon State University Alumni Ass'n, Inc.,* 84 AFTR 2d 99-6515, 193 F3d 1098, 99-2 USTC ¶50879 (CA-9, 1999), both decided by the Ninth Circuit.

In *Sierra Club*, the Ninth Circuit adopted a plain meaning definition of royalties. It held that royalties are “by definition 'passive' and thus cannot include compensation for services rendered by the owner of the property.” It should be noted that the decision rejected the Sierra Club's argument that a royalty encompassed any payment for use of a property right regardless of the presence of other additional services, stating that “'royalties' in Section 512(b) are defined as payments received for the right to use intangible property rights and that such definition does not include payments for services.” But, the Ninth Circuit likewise rejected the Service's all-or-nothing approach, saying “to the extent the Commissioner claims that a tax-exempt organization can do nothing to acquire such fees ... the Commissioner is incorrect.” Instead, the decision determined that the underlying reason for the payments was for the use of the intellectual property and therefore the payments qualified as royalties.

Tasks such as maintaining the lists on a computerized data base (when list management was consistent with the Sierra Club's exempt purpose), hiring a third party to sell the list, and setting the rates for list rentals were dismissed as ancillary to licensing the intellectual property and did not represent the Club's entrance into the list business. However, the decision first examined the Sierra Club's arrangement with the list administrator and the list renter and determined that their activities were not attributable to Sierra Club. With these activities not attributable to the Sierra Club, the organization really had very little “activity” for the court to consider.

In *Oregon State University Alumni Ass'n,* an alumni organization engaged in somewhat more activities than the Sierra Club had when licensing its logos and mailing list to a bank for an affinity credit card program. The organization managed the mailing lists itself, spent 12 hours of clerical staff time annually on services for the bank, and did a very limited amount of promotion of the credit card (mainly responding to calls from alumni asking about the card). The Ninth Circuit again rejected the government's “all-or-nothing” approach, whereby a small amount of activity could taint the entire royalty payment. Instead, the Ninth Circuit opted to instead ascertain the main purpose for the payments.

The Ninth Circuit looked at the amount of payment, compared it to the amount of

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“services” provided by the alumni association, and concluded that the payments were obviously for the use of intellectual property. “Were the banks purchasing the secretarial and clerical services rather than use of the schools' names," it said, "they would be paying about $22,000 per hour.” The court also cited the de minimis nature of the services.

Other case law before *Bellco* followed these results. In *Mississippi State University Alumni, Inc.,* TC Memo 1997-397, RIA TC Memo ¶97397, 74 CCH TCM 458 (1997), the alumni association put applications for the affinity credit card in the lobby of the alumni center and on general information tables when visiting local alumni chapter meetings, provided messages to the bank to add to monthly credit card statements, and published one informative article about the affinity credit card in the alumni magazine. The bank purchased advertising in the alumni magazine, but the court found that to be an independent transaction for which the bank paid separately. These activities were found to be insignificant compared to the value of the intellectual property, and the alumni association retained its royalty exclusion.

In *Planned Parenthood Federation of America, Inc.,* TC Memo 1999-206, RIA TC Memo ¶99206, 77 CCH TCM 2227 , and *Common Cause,* 112 TC 332 (1999), the Tax Court delved into the details of mailing list rentals. The Tax Court held that "list management" activities (such as promoting list rental transactions involving the rental list via distribution of rate cards, sorting and providing specially culled mailing lists, custom printing of labels, making personal sales calls to potential renters, approving or disapproving all list rental orders from mailers, making arrangements to fill the order, and arranging billing) were royalty-related activities. By contrast, "list brokering" activities, such as searching for and coordinating list rentals for a list renter, were not ancillary services to a rental transaction, and therefore were not royalty-related. However, the Tax Court found that the list brokers had acted on behalf of those using the mailing lists, so those services did not negatively impact "royalty" treatment for the exempt organizations renting the lists.

Finally, it is important to remember that the 1981 holding of the original decision in *Disabled American Veterans,* 48 AFTR 2d 81-5047, 227 Ct Cl 474, 650 F2d 1178, 81-1 USTC ¶9443 (Ct. Cl. 1981),[11] may still be applicable. The Court of Claims, and later the Sixth Circuit, ruled that the Disabled Americans Veterans was engaged in the active business of making money from its mailing list, and not eligible for the royalty exclusion because it had provided substantial services to customers and had aggressively solicited list rentals. While royalty case law has evolved substantially since the Court of Claims' 1981 decision, there nonetheless remains the real possibility that aggressive list brokerage activity on behalf of a mailing list provider could result in the loss of the royalty exclusion. The basic UBIT question remains deciding what represents "passive" licensing of intellectual and intangible property generating tax-exempt royalties as opposed to "active" business services potentially generating UBTI.

Bellco—Royalty treatment in the insurance sales context

Bellco represents an application of the basic royalty principles outlined above, but in a distinctly new context. The royalty issue in *Bellco* involved, not the marketing of affinity credit cards or the general licensing or renting of an organization's mailing list, but the marketing of insurance products to an exempt organization's members. Before *Bellco,* no court had considered insurance programs from a royalty perspective, and the IRS had often been successful in treating such income as subject to UBIT.[12] A district court in Colorado ruled that the credit union's income from this insurance marketing program qualified as true “royalties” exempt from UBIT.[13]

Background.

Bellco Credit Union is a large state-chartered credit union operating in the Denver, Colorado area. State-chartered credit unions such as Bellco are exempt from tax as organizations described in Section 501(c)(14)(A). Like most types of tax-exempt organizations, state-chartered credit unions are subject to UBIT to the extent they have unrelated business taxable income.[14]

Bellco received three types of income that were at issue in the litigation:

- Income from the sale of credit life and credit disability insurance made available to Bellco's member-borrowers in connection with their credit union loans.
- Income from the sale of financial products (mutual funds, annuities, etc.).
- Income from the direct-mail sale of accidental death and dismemberment (AD&D) insurance to Bellco's members by an unrelated insurance marketing company.

Only the income from the direct-mail AD&D insurance sales was considered from a

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“royalty” perspective. The court resolved questions about the other two types of income based on whether the activities were “substantially related” to Bellco's tax-exempt purposes as a state-chartered credit union. The court held that most sales of credit insurance to member-borrowers, and sales of financial products to members, were “substantially related” to the credit union's exempt purposes, while sales of financial products to *non*-members were held not substantially related to exempt purposes and thus subject to UBIT.

Royalties on insurance sales.

The AD&D sales program in *Bellco* was based on a "Joint Marketing Agreement" entered into by Bellco and an insurance marketing company called Affinion. Under that agreement, Bellco provided its member mailing list to Affinion and reviewed and approved the AD&D marketing letters that were sent to the members over the Bellco CEO's signature. Affinion made all the arrangements for the actual insurance coverage and was responsible for the communications with members that involved substantive descriptions of the insurance and the terms of coverage. Bellco received payments under the contract equal to 30% of the premiums paid by members for the AD&D coverage. It also received a "marketing bonus" representing an incentive payment to Bellco for renewing its exclusive AD&D insurance arrangement with Affinion.[15]

In a helpful passage, the court succinctly framed the royalty issue in *Bellco.* It relied on several of the key royalty court decisions discussed above and—as expected, based on such case law—describes the question as whether Bellco is, at bottom, receiving income for a passive license of its intangible property (its name, marks, and other brand attributes, plus its member mailing list) or instead is providing too many active business services to the licensee for the payments to qualify as passive royalties. As the court notes, this is a very factual inquiry, and not cut-and-dried:

> The issue, then, is whether the income is a payment for passively permitting the use of some intangible property (such as Bellco's goodwill or its customer list), in which case the resultant income is a royalty, or, instead, payment for services rendered by the owner of such property, in which case it is not.
>
> This is not, however, an "all-or-nothing proposition." *Oregon State Univ. Alumni Assoc., Inc. v. Comm'*r, 193 F.3d 1098, 1101 (9th Cir.1999). That is, merely because income derives from some intangible product does not make it royalties if the provider of that product actively promoted or marketed the intangible. *Sierra Club*, 86 F.3d at 1534 (rejecting the argument that "Congress intended to exclude *all* royalty income from [UBIT], not simply royalty income passively derived") (emphasis in original). On the other hand, provision of some minimal service does not necessarily negate the exemption. *Oregon State Univ. Alumni Ass'n*, 193 F.3d at 1101. Importantly, "the owner of an intangible may engage in certain activities to exploit and protect the intangible which do not change the nature of the payment

> received." *Common Cause v. Comm'r*, 112 T.C. 332, 342 (Tax Ct.1999). "The question is whether [the tax-exempt entity] did little enough work for the money they received to be royalties, ... or whether they did too much, so that the money was taxable as unrelated business income." *Oregon State Univ. Alumni Ass'n*, 193 F.3d at 1099.[16]

Based on this framework, the court resolved the key factual disputes.

Title of agreement. The agreement between Bellco and Affinion was styled a "Joint Marketing Agreement." On its face, this could be a negative factor, as "joint marketing" by the parties could be a sign of active business operations rather than a passive license. However, the court acknowledged that "[t]his agreement was a deemed a 'joint marketing agreement' in order to comply with federal privacy laws"[17] and treated the agreement as consistent with royalties. Some of the prior affinity card and mailing list rental cases also found royalty treatment despite the absence of specific "royalty" or "license" language in the documentation.

Nevertheless, it certainly would still be advisable, to the extent possible under privacy laws or other constraints, for parties creating a royalty arrangement based on the license of intangible property to style their agreements consistent with that understanding. Contrary wording in the documents is not fatal to royalty treatment, as shown in *Bellco*, but it may be a negative factor unless a persuasive explanation for the contrary wording is available.

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Characterization of income streams. Under the AD&D insurance agreement Bellco received what the agreement called an "administrative allowance" equal to approximately 30% of the premiums paid by the credit union members who purchased AD&D insurance in response to Affinion's direct-mail solicitations[18] Bellco also received a one-time "marketing bonus" during the years in issue, which the court described as "nothing more than an incentive payment made to Bellco for renewing the exclusive contract with Affinion."[19] In the end, the court treated this income as tax-exempt royalties to Bellco based on the *substance* of the arrangement, despite the fact that the payments were not denominated "royalties."

As with the title of the agreement, prior cases involving affinity cards and mailing list rentals have not required payments to be called “royalties” in order to recognize valid royalty treatment, but this is another area where parties entering into royalty arrangements will want to style the payment stream accurately and specifically.

Focus on the limited scope of organization's *actual* activities. The "Joint Marketing Agreement," by its terms, obliged Bellco “to '[p]rovide all relevant marketing information necessary for the development of an effective direct marketing strategy, and '[a]uthorize and coordinate' the mailings 'as mutually agreed upon by the parties.' ”[20] In fact, however, Bellco's actual activities under the arrangement were “much more limited” than implied by this language. The first requirement simply obliged Bellco to provide its member mailing list to Affinion, and the second requirement meant that Bellco had to review and sign off on the marketing letters and agree on the mailing date. Those are activities that courts in earlier cases recognized as consistent with passive, royalty treatment, and the *Bellco* court took the same approach.

Once again, however, parties entering into a royalty arrangement in the first instance should take care to describe in their contractual documents the actual scope of the parties' respective responsibilities, and in particular to note any restrictions on the activities of the tax-exempt licensor.

Automated bill payment service by the credit union. One of Bellco's functions in the AD&D insurance program was allowing members to sign up for automatic debiting of their monthly AD&D premium payments from their checking accounts, using the same automated clearing house (ACH) electronic payment system used for utility payments and many other personal bills. The court said that, compared to some other activities of Bellco, “this does come a bit closer to being a 'service' provided [to Affinion] to support the AD&D program,”[21] which could be inconsistent with royalty treatment. But in the end, the court said that the ACH payment system was essentially automatic and minimal in scope, and so did not taint the royalty stream.

The more that any services provided by a tax-exempt licensor can be seen as “automatic” and requiring little discretionary decision-making, the stronger the case for valid royalty treatment will be.

Credit union call center activities. Bellco calculated that 683 total employee hours were devoted to the AD&D insurance program during the year in issue, 2003.[22] The majority of that allocated staff time represented employees answering calls about the AD&D program at Bellco's member call center. The call center employees generally would simply acknowledge, in response to member questions, that this was a valid Bellco-approved program and provide some basic information about the program's structure. They would otherwise direct the members to call Affinion for any details, however. The court viewed this activity as a “close call,” but in the end found the call center function to be consistent with passive royalty treatment because it primarily represented Bellco protecting its own intangible assets (its goodwill with its members, which made its “brand” valuable in the first place), rather than any true services for Affinion:

> The Court acknowledges that expending 683 hours of labor does seem, at first blush, to be substantial. Resolution of this issue is a close call, and Bellco's participation in the AD&D program *nears crossing the line from passive sale of intangible information to active service and support.* But, given careful scrutiny, it is clear that much of Bellco's time was spent on activities intended to protect Bellco's goodwill with its members and its member privacy rather than to actively promote the AD&D program or otherwise perform administrative services for that program. Thus, evaluating all of the evidence and considering all of the facts and circumstances, the Court finds that, although Bellco did perform some work in connection with the program, that work was focused on *protecting its intangible assets* and was sufficiently insubstantial, so as to result in the income appropriately being considered royalties.[23]

The court also observed that, if Bellco's call center services were valued on an hourly basis, it would mean that Affinion was paying some $300 per hour for relatively routine administrative services. “It is unreasonable to assume that any business would pay such a rate, no matter the quality of the call center staff.”[24] This was another factor supporting the characterization of the payments from Affinion to Bellco as royalties rather than compensation for services.

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So in the end, and acknowledging the presence of some “close calls” on the facts as to the scope of some of services provided by Bellco, the district court found that the AD&D direct mail insurance sales program fit into the same category as affinity card programs and mailing list rentals considered in earlier cases. It was essentially a license of the tax-exempt organization's intangible brand assets for the purpose of generating a passive revenue stream that qualified as “royalties” exempt from UBIT.

Conclusion

Perhaps the most important aspect of the *Bellco Credit Union* is the court's application of the affinity card and mailing list royalty precedents in a brand new area—the direct-mail sales of insurance. Insurance sales are a business context in which the IRS and the courts, over the past 30-plus years, had often found taxable UBTI in a variety of different fact patterns and for a variety of different types of exempt organizations. The *Bellco* case confirms that the “royalty” precedents are not limited to any particular type of business arrangement or product, but instead are conceptually applicable to wide areas—including but not limited to insurance—in which exempt organizations might be able to license their intangible brand assets and member contact data on a tax-favored basis.

Tax-exempt royalties, which can represent very substantial revenue streams for exempt organizations, remain in some ways a controversial aspect of the UBIT and tax exemption regime.[25] Royalties based on the licensing of brand attributes will continue to be an enticing revenue source for exempt organizations in a difficult fundraising era. Because of the extension of the royalty concept beyond affinity cards and mailing lists, as illustrated in the *Bellco,* the IRS “forbearance” policy against further enforcement action in this area may no longer apply,[26] and further litigation seems likely.

[1] See generally Sections 511-514.

[2] Section 512(b)(2).

[3] Reg. 1.512(b)-1.

[4]

See, e.g., Planned Parenthood Federation of America, Inc., TC Memo 1999-206, RIA TC Memo ¶99206, 77 CCH TCM 2227 ; Common Cause, 112 TC 332 (1999).

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See also Ark. State Police Ass'n Inc., TC Memo 2001-38, RIA TC Memo ¶2001-038, 81 CCH TCM 1172 , *aff'd*, 89 AFTR 2d 2002-1274, 282 F3d 556, 2002-1 USTC ¶50269 (CA-8, 2002).

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There have also been a number of UBIT cases on insurance income, not involving a royalty issue, that turned on whether insurance activities by an exempt organization represented “trade or business” activity, or were “substantially related” to an organization's tax-exempt purposes. See, e.g., American Bar Endowment, 58 AFTR 2d 86-5190, 477 US 105, 91 L Ed 2d 89, 86-1 USTC ¶9482 (1986); Nat'l League of Postmasters, 77 AFTR 2d 96-2558, 86 F3d 59, 96-1 USTC ¶50317 (CA-4, 1996); Louisiana Credit Union League, 51 AFTR 2d 83-451, 693 F2d 525, 82-2 USTC ¶9717 (CA-5, 1982); Professional Ins. Agents of Mich., 78 TC 246 (1982). These issues of insurance income received by exempt organizations, outside the royalty context, are beyond the scope of this article.

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See, e.g., Oregon State Univ. Alumni Ass'n, Inc., 84 AFTR 2d 99-6515, 193 F3d 1098, 99-2 USTC ¶50879 (CA-9, 1999).

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See, e.g., Common Cause, *supra* note 4.

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See, e.g., Sierra Club, Inc., 78 AFTR 2d 96-5005, 86 F3d 1526, 96-2 USTC ¶50326 (CA-9, 1996).

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In a 12/16/99 memorandum from the Director, Exempt Organizations Division at the IRS National Office distributed to Area Managers in the Exempt Organizations Division, the IRS suggested it would no longer challenge royalty treatment in affinity card and mailing list rental cases “unless the factual record clearly reflects more than unsubstantial services being provided [by the organization].” This memorandum is available at www.irs.gov/pub/irs-tege/121699a.pdf.

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See also Disabled American Veterans, 68 AFTR 2d 91-5109, 942 F2d 309 (CA-6, 1991).

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See, for example, the insurance income UBIT cases cited in note 6, *supra.*

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The United States initially filed a protective notice of appeal of the *Bellco* decision, but ultimately chose to dismiss its appeal. The district court opinion therefore stands as the final decision in the case.

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Federally chartered credit unions are not subject to UBIT, however, because federal credit unions are exempt from income tax as federal government instrumentalities described in Section 501(c)(1). Entities described in Section 501(c)(1) are specifically exempt from UBIT by statute. See Section 511(a)(2)(A).

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The facts of the Bellco/Affinion AD&D arrangement are recited at 735 F. Supp. 2d 1294-98.

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735 F. Supp. 2d at 1304.

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Id. at 1295. The laws in question were enacted as part of the Financial Services Modernization Act of 1999, a/k/a, the Gramm-Leach-Bliley Act, P. L. 106-102, 11/12/99.

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Bellco received “approximately” 30% of premiums because, under the program, Bellco paid the premiums for the first $1,000 of AD&D coverage elected by a member—essentially a “free bonus”—and the member paid for all insurance coverage above $1,000. Affinion subtracted Bellco's premium liability for the first $1,000 of coverage for electing members from the 30% administrative allowance, and remitted the balance to Bellco.

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735 F. Supp. 2d at 1298.

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Id.

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Id at 1306.

22

This total was reached through the allocation methodology Bellco used to compute the expenses for all of its activities that the IRS asserted were “unrelated” to its exempt purposes (including, for this purpose, the AD&D insurance program).

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735 F. Supp. 2d at 1305 (emphasis added).

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Id. at1306.

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For example, the royalties received by AARP from underwriters of its branded insurance products have drawn scrutiny from some members of Congress. See Reps. Wally Herger (R-CA) and Dave Reichert (R-WA), "Behind the Veil: The AARP America Doesn't Know:" (March 2011), available at waysandmeans.house.gov/UploadedFiles/AARP_REPORT_FINAL_PDF_3_29_11.pdf.

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See the IRS memorandum discussed in note 10, *supra.*