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SIERRA CLUB v. COMMISSIONER AND THE ROYALTY EXEMPTION TO THE UNRELATED BUSINESS INCOME TAX: HOW MUCH ACTIVITY IS TOO MUCH?

Katherine A. VanYe

Abstract: In Sierra Club v. Commissioner, the Ninth Circuit decided that royalties are payments for the right to use intangible property and are by definition “passive.” The court applied this definition and held that Sierra Club’s income from renting its mailing list was a royalty payment and thus exempt from taxation. This Note argues that while the court reached the correct conclusion, it did not propose a clear standard to guide future cases. Two alternative approaches could be adopted: (1) ancillary versus significant services; or (2) comparative value of property and services. These alternatives will provide clearer guidelines and enable courts to reach more consistent results.

The business income of tax-exempt organizations has been scrutinized by Congress since 1950. In an attempt to curb the ability of tax-exempt organizations to run tax-free businesses, Congress imposed a tax on the unrelated business income of certain tax-exempt organizations.1 At the same time, it also permitted certain income to be exempt from taxation.2 One such exemption was that royalty payments received by a tax-exempt organization would be excluded from unrelated business taxable income.3

For nearly a decade, this royalty exemption has been the subject of much debate. Tax-exempt organizations have attempted to structure agreements so that they receive royalty payments to avoid paying tax on that income. In light of this practice, the crux of the issue is how to define “royalty.” There is little dispute that, at a minimum, a royalty is a payment for the use of a property right.4 However, the question becomes more complicated when trying to determine whether the transfer of a property right in exchange for payment can ever be accompanied by services. The current approach is to determine whether a tax-exempt organization has been active or passive in conjunction with the transfer of property rights.5 If the organization has been too “active,” the income

2. I.R.C. § 512(b).
3. I.R.C. § 512(b)(2).
5. See infra notes 136–47 and accompanying text.
is taxed as unrelated business income. In June 1996, the Ninth Circuit applied this approach in *Sierra Club v. Commissioner* to determine whether over $1.2 million of income that Sierra Club earned from its mailing list rentals and affinity credit card program qualified for the royalty exemption. If the court had decided that the income was taxable, Sierra Club would have owed over $185,000 in taxes.

This Note argues that the active versus passive analysis is flawed because it neither provides tax-exempt organizations with clear guidelines nor is consistently applied. Part I details the development of the unrelated business income tax, and Part II explores the royalty exception to the tax. Part III reviews the facts, procedural history, and the Ninth Circuit’s decision in *Sierra Club*. Finally, Part IV critiques the court’s approach and suggests two alternative approaches: (1) ancillary versus significant services; or (2) comparative value of property and services.

I. EVOLUTION OF THE UNRELATED BUSINESS INCOME TAX

A. Legislative History

The unrelated business income tax was enacted by Congress in 1950. The purpose of the tax was to eliminate unfair competition between tax-exempt and for-profit organizations. Prior to 1950, the business income of tax-exempt organizations was not subject to taxation, regardless of whether the business operations were related or unrelated to the organization’s exempt purposes. As long as profits were used “in furtherance of tax-exempt purposes,” the income remained tax-free. The hearings regarding the enactment of the unrelated business income tax demonstrated Congress’s concern that tax-exempt organizations could use their tax-free profits to further business pursuits not related to...
their tax-exempt status.\textsuperscript{15} Meanwhile, for-profit competitors could expand only with profits remaining after taxes.\textsuperscript{16} By imposing a tax on the "unrelated business taxable income" of certain tax-exempt organizations, Congress sought to strike a balance between encouraging benevolent enterprise and restraining unfair competition.\textsuperscript{17}

By enacting the unrelated business income tax, Congress wanted to preserve tax-exempt organizations' abilities to earn tax-free income from certain types of investments such as dividends, interest payments, royalties, and most rents.\textsuperscript{18} Congress expressed the view that investment-producing incomes of this kind had long been recognized as proper sources of revenue for educational and charitable organizations and trusts.\textsuperscript{19} Congress also concluded that these exclusions should be exempt from taxation because they were "passive" in nature and were not likely to result in serious competition for taxable businesses with similar income.\textsuperscript{20}

Congress has since amended and added to the provisions of the unrelated business income tax since its enactment, but the basic structure of the tax has remained the same.\textsuperscript{21} Two amendments, however, are worth noting. First, in 1969, Congress extended the unrelated business income tax to virtually all tax-exempt organizations\textsuperscript{22} because many of the organizations that were not originally subject to the tax had begun to engage in substantial commercial activity.\textsuperscript{23} Just as Congress had

\begin{thebibliography}{99}
  \bibitem{15} H.R. Rep. No. 81-2319, at 37, \textit{reprinted in} 1950-2 C.B. at 409; see also \textit{infra} note 30 and accompanying text (defining unrelated trade or business).
  \bibitem{17} \textit{See American College of Physicians}, 475 U.S. at 838. Originally, the unrelated business income tax was not imposed on all tax-exempt organizations. The tax applied only to labor, agricultural, and horticultural organizations; literary, scientific, religious (other than churches), educational, and charitable organizations; and business and trade organizations. Organizations to which the tax did not apply included mutual-type organizations, fraternal beneficiary societies, civic leagues, social welfare organizations, and social clubs. H.R. Rep. No. 81-2319, at 36, \textit{reprinted in} 1950-2 C.B. at 408-09. This provision changed with the 1969 Tax Reform Act, which extended the unrelated business income tax to almost all tax-exempt organizations. Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(a)(1), 83 Stat. 487, 536 (codified as amended at 26 U.S.C. § 512 (1994)).
  \bibitem{20} \textit{Id.} at 31, \textit{reprinted in} 1950-2 C.B. at 506.
  \bibitem{21} Neeley, \textit{supra} note 12, at A-2.
  \bibitem{22} Tax Reform Act of 1969, § 121(a)(1).
  \bibitem{23} H.R. Rep. No. 91-413, pt. 1, at 47 (1969). For example, some churches were involved in operating chains of religious bookstores, hotels, factories, radio and TV stations, newspapers, parking lots, record companies, bakeries, cleaners, restaurants, and other businesses. \textit{Id.}
\end{thebibliography}

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originally sought to level the playing field between tax-exempt and for-profit organizations, it now wanted to treat all tax-exempt organizations equally by providing similar tax treatment for their business income.\textsuperscript{24} Second, in the Tax Reform Act of 1986, Congress added a provision to the Internal Revenue Code exempting the income from exchanges or rentals of donor or member lists among tax-exempt organizations.\textsuperscript{25} The Act's legislative history did not explain the rationale underlying the exception. However, when the conference report was discussed on the House floor, one of the sponsors stated that no inference was intended as to whether or not income from mailing list activities other than those between tax-exempt organizations constituted unrelated business income.\textsuperscript{26}

\textbf{B. Internal Revenue Code and Treasury Regulations}

Pursuant to Congress's intent to curb tax-exempt organizations' abilities to compete unfairly with for-profit organizations,\textsuperscript{27} the Internal Revenue Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c) (tax-exempt organizations).\textsuperscript{28} "Unrelated business taxable income" is a tax-exempt organization's gross income derived from any unrelated trade or business regularly carried on by it, less any allowable deductions.\textsuperscript{29} The Code further defines an "unrelated trade or business" as any trade or business, the conduct of which is not substantially related to the exercise or performance of a tax-exempt organization's exempt purposes.\textsuperscript{30} The Treasury regulations provide that the term "trade or business" generally includes any activity carried on for the production of income from the sale of goods or performance of services.\textsuperscript{31} The regulations further provide that a trade or business is substantially related to exempt purposes only when the conduct of the business activities has a substantial causal relationship to the achievement of the exempt purposes.\textsuperscript{32}

\begin{itemize}
  \item \textsuperscript{24} Neeley, supra note 12, at A-3.
  \item \textsuperscript{28} I.R.C. § 511 (1994).
  \item \textsuperscript{29} I.R.C. § 512(a)(1) (1994).
  \item \textsuperscript{30} I.R.C. § 513(a).
  \item \textsuperscript{31} Treas. Reg. § 1.513-1(b) (as amended in 1983).
  \item \textsuperscript{32} Treas. Reg. § 1.513-1(d)(2) (as amended in 1983).
\end{itemize}
business" does not include the exchange or rental of donor or member lists between certain tax-exempt organizations.\textsuperscript{33}

From these definitions of unrelated trade or business, the Code establishes a three-part test to determine whether a tax-exempt organization’s income is taxable. The income will be taxable as unrelated business income if the organization’s activity: (1) constitutes a trade or business; (2) is regularly carried on; and (3) is not substantially related to the organization’s tax-exempt purposes.\textsuperscript{34} However, the general scheme must also take into account several "modifications" provided for in the Code.\textsuperscript{35} One such "modification" is that all royalties remain exempt from taxation.\textsuperscript{36} The Treasury regulations further provide that whether a particular item of income is a royalty should be determined by all the facts and circumstances of each case.\textsuperscript{37}

II. ROYALTY EXCEPTION TO THE UNRELATED BUSINESS INCOME TAX

The royalty exception to the unrelated business income tax is one of several modifications provided for in the Code.\textsuperscript{38} Once a tax-exempt organization’s income is deemed to be unrelated business taxable income,\textsuperscript{39} the next step is to determine whether the income qualifies for treatment as a royalty payment or one of the other exemptions. Courts often have encountered difficulties applying the royalty provision because the Code and accompanying Treasury regulations do not articulate clearly what types of income should fall within this exemption.\textsuperscript{40}

\textsuperscript{33} I.R.C. § 513(h)(1). Tax-exempt organizations that qualify for this exception include only those charitable organizations and war veterans organizations authorized to receive tax-deductible charitable contributions. I.R.C. § 513(h)(1).


\textsuperscript{35} I.R.C. § 512(b) (1994). Some of the modifications that are excluded from income include dividends, interest, loan payments, annuities, royalties, certain rents, and certain research income. I.R.C. § 512(b).

\textsuperscript{36} I.R.C. § 512(b)(2).

\textsuperscript{37} Treas. Reg. § 1.512(b)-1 (as amended in 1992).

\textsuperscript{38} I.R.C. § 512(b).

\textsuperscript{39} See supra note 34 and accompanying text.

\textsuperscript{40} See, e.g., infra Part II.B.
A. Definition of Royalty

The term "royalty," as an exclusion from the unrelated business income tax, is not explicitly defined either by statute or by regulation. Revenue Ruling 81-178, relied on by the parties in Sierra Club v. Commissioner, is cited frequently in tax cases and tax literature as the source for the definition of royalties as applied to unrelated business income tax cases. The Revenue Ruling distinguishes between payments for the “use of a valuable right” and payments as compensation for services.

To be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes.... [R]oyalties do not include payments for personal services.

The Ruling discusses two different scenarios. In one, the income would be characterized as royalty payments; in the other, the income would be considered unrelated business taxable income. In the first scenario, a tax-exempt organization whose members are professional athletes solicits and negotiates licensing agreements with various businesses. The agreements authorize the businesses to use the organization's trademarks, trade names, service marks, copyrights, and members' names, photographs, likenesses, and facsimile signatures in connection with the distribution, sale, advertising, and promotion of merchandise or services offered by such businesses. The tax-exempt organization retains the right to approve the quality or style of the licensed products and services.

The Internal Revenue Service (Service) concludes that in this scenario, the organization’s income would be considered gross income from an unrelated trade or business, but because the payments are for the

41. See supra notes 36–37 and accompanying text.
43. 86 F.3d 1526, 1531 (9th Cir. 1996).
46. Id. at 136–37.
47. Id. at 135.
use of the organization’s trademarks, trade names, and similar items, the payments are royalties within the meaning of the statute and thus exempt from taxation. The Service further provides that even though the organization has the right to approve the quality or style of the licensed products and services, the result does not change. "The mere retention of quality control rights by a licensor in a licensing agreement situation does not cause payments to the licensor under the agreements to lose their characterization as royalties."\(^{48}\)

In the second scenario, the facts are the same as in the first, but the agreements require personal appearances by and interviews with organization members in connection with the endorsed products and services.\(^9\) In this instance, the income is also unrelated business taxable income but does not fall under the royalty exception because the agreements require the personal services of the members. The Service concludes that these payments are entirely compensation for personal services and therefore not royalties.\(^50\)

**B. How Different Circuits Have Dealt with the Royalty Issue**

Although the Service defined “royalty” in Revenue Ruling 81-178,\(^{51}\) courts have continued to struggle with what precisely constitutes a royalty payment. In the cases discussed below, the Fifth, Sixth, and Seventh Circuits found that the income of three different tax-exempt organizations did not constitute royalty payments and thus was taxable as unrelated business income. The Sixth and Seventh Circuits reasoned that the tax-exempt organizations were too active in earning the income in question, while the Fifth Circuit held that the payments were for personal services.

*Disabled American Veterans v. United States*\(^{52}\) was the first case in which a court considered whether the income derived from renting and exchanging mailing lists constituted royalty payments to be excluded.

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\(^{48}\) *Id.* at 136.

\(^{49}\) *Id.*

\(^{50}\) *Id.* at 137. For a discussion of allocation issues, see *infra* notes 170–75 and accompanying text. In the second scenario of Revenue Ruling 81-178, the Service does not discuss the possibility of distinguishing royalty payments from those payments that are compensation for personal services. Rev. Rul. 81-178, 1981-2 C.B. at 137.


\(^{52}\) 650 F.2d 1178 (Ct. Cl. 1981) [DAVI].
from the unrelated business income tax.\textsuperscript{53} The ten-year span of this litigation underscores the difficulty courts had in resolving the matter. After receiving an unfavorable decision from the Court of Claims,\textsuperscript{54} the Disabled American Veterans (DAV) relitigated the royalty issue in the Tax Court and won.\textsuperscript{55} However, the Sixth Circuit reversed the Tax Court and, in so doing, affirmed the Court of Claims analysis.\textsuperscript{56}

The Court of Claims concluded that the income DAV received from mailing list rentals constituted unrelated business taxable income because the income arose from a trade or business, the trade or business was regularly carried on, and DAV's rental of its mailing list was unrelated to its exempt purposes.\textsuperscript{57} DAV's rental was the product of extensive business activity, which included preparing rate cards, sending rate cards to list brokers, sorting the lists, and providing the information on magnetic tape or labels.\textsuperscript{58} Because DAV's income did not possess the characteristics of the conventional type of passive investment income traditionally earned by exempt organizations (dividends, interest, annuities, real property rents),\textsuperscript{59} the income did not qualify for the royalty exemption.\textsuperscript{60} As such, the court held that DAV's income should be taxed.\textsuperscript{61}

In \textit{Fraternal Order of Police v. Commissioner},\textsuperscript{62} the Seventh Circuit held that the Fraternal Order of Police's (FOP) income from the sale of space for business listings in \textit{The Trooper} magazine, published by the organization, was unrelated business taxable income and not exempt as royalties.\textsuperscript{63} The court concluded that the income should be taxed as unrelated business taxable income because the magazine's publication

\begin{itemize}
  \item \textsuperscript{54} \textit{DAV I}, 650 F.2d at 1190.
  \item \textsuperscript{55} Disabled Am. Veterans v. Commissioner, 94 T.C. 60 (1990) (holding that mailing list rental income constituted royalty payments, and rejecting notion that royalty must be derived from passive sources), rev'd, 942 F.2d 309 (6th Cir. 1991).
  \item \textsuperscript{56} Disabled Am. Veterans, 942 F.2d 309; see also Sierra Club v. Commissioner, 86 F.3d 1526, 1532 n.14 (9th Cir. 1996).
  \item \textsuperscript{57} \textit{DAV I}, 650 F.2d at 1185–89. For a discussion of when an organization's income will be deemed taxable, see supra notes 29–34 and accompanying text.
  \item \textsuperscript{58} \textit{DAV I}, 650 F.2d at 1184.
  \item \textsuperscript{59} Id. at 1189.
  \item \textsuperscript{60} Id. at 1190.
  \item \textsuperscript{61} Id.
  \item \textsuperscript{62} 833 F.2d 717 (7th Cir. 1987).
  \item \textsuperscript{63} Id. at 723–24.
\end{itemize}
constituted a trade or business, was regularly carried on, and was not substantially related to FOP's tax-exempt purposes.64

The court further noted that FOP's income was not passive in nature. FOP was an active participant in publishing the magazine. The organization retained numerous rights concerning the publication of the magazine including, but not limited to, having final authority over the editorial content of each issue, appointing the executive editor, and controlling the reprint of any material published in the magazine.65

Finally, in Texas Farm Bureau v. United States,66 the Fifth Circuit held that the income the Texas Farm Bureau (TFB) received from its agreement with two life insurance companies to promote their life insurance plans was unrelated business taxable income and was not exempt as royalty income.67 The life insurance companies paid TFB for administrative and clerical services, for office space and equipment, as well as for the exclusive right to use the TFB name and logo in Texas.68 Rendering services to the insurance companies and promoting the life insurance plans satisfied the three elements necessary to constitute unrelated business taxable income.69

The court further concluded that the income did not constitute royalty payments because the payments were for personal services.70 The court noted that TFB had two opportunities to designate part of the income as royalty payments: TFB could have either created a royalty agreement at the time of contracting or amended the original agreement to provide that the insurance companies would pay TFB royalties for allowing the insurance companies to use its name. However, TFB did not avail itself of either option.71 As such, the payments received were in consideration for the substantial services TFB provided to the two insurance companies.72

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64. Id. at 721; see also supra notes 29–34 and accompanying text.
65. Fraternal Order of Police, 833 F.2d at 723–24.
66. 53 F.3d 120 (5th Cir. 1995).
67. Id. at 124–26.
68. Id. at 122.
69. Id. at 124–26; see also supra notes 29–34 and accompanying text.
70. Texas Farm Bureau, 53 F.3d at 123 (citing Rev. Rul. 81-178, 1981-2 C.B. 135); see also supra Part II.A.
71. Texas Farm Bureau, 53 F.3d at 124.
72. Id.
C. The Internal Revenue Service's View of the Royalty Issue

While courts have grappled with these cases, the Service has consistently maintained that in order for unrelated business taxable income to be exempt as a royalty payment, the tax-exempt organization’s role with respect to the income-producing activity must be completely passive. If, in reviewing the activity, the Service finds that the organization’s role is passive, it declares the income a royalty. For example, the Service found that income from the sale of an organization’s rights to harvest pollock fish constituted royalty payments because the organization did not participate at all in the harvesting, processing, and marketing of the fish. Because the organization’s role was completely passive, the revenues were “true royalties.”

With respect to mailing list rentals, however, the Service has not settled on any one line of reasoning to deal with the royalty issue. In case law to date, the Service has applied the active versus passive analysis to the issue of whether income qualifies as a royalty payment; that is, if the organization is active in renting its mailing list, the income will be unrelated business taxable income and not exempt as a royalty. In addition, on at least two occasions, the Service has argued that any income, passive or not, derived from mailing list rentals or exchanges not solely between tax-exempt organizations, is unrelated business taxable income and does not qualify for the royalty exemption. The Tax Court rejected the argument.

Nevertheless, in Service memoranda issued both before and after the Tax Court’s rejection of this argument, the Service has maintained that the income from these mailing list exchanges and rentals, if not solely between tax-exempt organizations, should be taxable. According to the Service, “[t]he exception to unrelated trade or business for the exchange of mailing lists only applies where both organizations involved are tax

73. See, e.g., Sierra Club v. Commissioner, 86 F.3d 1526 (9th Cir. 1996); NCAA v. Commissioner, 92 T.C. 456 (1989), rev’d on other grounds, 914 F.2d 1417 (10th Cir. 1990); Fraternal Order of Police v. Commissioner, 833 F.2d 717 (7th Cir. 1987); DA V I, 650 F.2d 1178 (Ct. Cl. 1981).
75. See Sierra Club, 86 F.3d 1526; DA V I, 650 F.2d 1178.
77. See Alumni Ass’n of Univ. of Or., 71 T.C.M. (CCH) at 2099; Oregon State Univ. Alumni Ass’n, 71 T.C.M. (CCH) at 1941.
exempt.\textsuperscript{79} The Service supports this view by citing the legislative history that accompanied the 1986 amendment to section 513,\textsuperscript{80} and maintains that Congress acquiesced in taxing mailing list income that was not covered by the addition of Code section 513(h).\textsuperscript{81} Finally, aware that courts may continue to reject this argument, the Service also argues that the tax-exempt organization’s extensive business activity associated with the mailing list rental causes the income not to be classified as royalty payments.\textsuperscript{82}

III. SIERRA CLUB v. COMMISSIONER

In \textit{Sierra Club v. Commissioner},\textsuperscript{83} the Ninth Circuit considered whether Sierra Club’s income from its mailing list rentals and affinity credit card program constituted royalty payments and were thus exempt from the unrelated business income tax. In deciding this case, the court had to determine whether the income was still eligible for the royalty exemption when services were transferred with the property right.\textsuperscript{84} The court held that because Sierra Club was not particularly active in transferring its mailing list, the income constituted a royalty payment.\textsuperscript{85} The affinity credit card issue was remanded to the Tax Court.\textsuperscript{86}

A. Facts

Like many tax-exempt organizations, Sierra Club maintained a list of members, donors, supporters, and catalog purchasers.\textsuperscript{87} It also retained a service bureau to maintain and update the lists, and two list managers to administer and oversee the external uses of its lists.\textsuperscript{88} Sierra Club raised funds by permitting other organizations to “rent” the names from its mailing lists for a fee.\textsuperscript{89} Sierra Club set the rates for the list rentals and retained the right to review rental requests and to approve the proposed

\begin{itemize}
  \item \textsuperscript{79} Tech. Adv. Mem. 95-09-002.
  \item \textsuperscript{80} See supra notes 25–26 and accompanying text.
  \item \textsuperscript{81} Gen. Couns. Mem. 39,638 (May 28, 1987).
  \item \textsuperscript{82} Tech. Adv. Mem. 96-35-001.
  \item \textsuperscript{83} 86 F.3d 1526 (9th Cir. 1996) [Sierra Club III].
  \item \textsuperscript{84} Id. at 1536.
  \item \textsuperscript{85} Id.
  \item \textsuperscript{86} Id. at 1537.
  \item \textsuperscript{87} Id. at 1527.
  \item \textsuperscript{88} Id.
  \item \textsuperscript{89} Id.
\end{itemize}
mailing material and schedule for the requested mailing.\(^9\) The list managers promoted list rental through solicitations, personal sales calls, advertising, and seminars.\(^9\) Those seeking to rent Sierra Club’s lists placed an order with the list managers who forwarded the request to Sierra Club,\(^9\) which then filled the order through its service bureau.\(^9\) The bureau performed services requested by the list renter such as selecting names based on zip code, gender, or frequency of contribution.\(^4\) The service bureau billed the list managers for these services, who in turn billed the list renter for the costs.\(^5\) Sierra Club received a payment for the list rental, less the commissions for the list managers and list broker (who arranged for the rental on behalf of the list user) and the bureau’s service charges.\(^6\)

Sierra Club also entered into an agreement with American Bankcard Services, Inc. (ABS) whereby ABS would offer Sierra Club members a Visa or Mastercard with Sierra Club’s name and logo on the card.\(^7\) In return, ABS agreed to pay Sierra Club a monthly fee determined as a percentage of its sales volume.\(^8\) ABS was responsible for developing its own promotional and solicitation materials for the card program subject to Sierra Club’s approval.\(^9\) The agreement specifically stated that it did not establish a partnership or agent/principal relationship between ABS and Sierra Club.\(^10\)

ABS’s initial solicitations consisted of letters on Sierra Club letterhead and advertisements in Sierra magazine, for which ABS paid the standard commercial advertising rate.\(^1\) Sierra Club eventually terminated the agreement with ABS and entered into an agreement directly with the bank issuing the credit cards.\(^2\) Under this new agreement, Sierra Club agreed to endorse the program, encourage

\(^{90.}\) Id.
\(^{91.}\) Id.
\(^{92.}\) Id.
\(^{93.}\) Id.
\(^{94.}\) Id. at 1528.
\(^{95.}\) Id.
\(^{96.}\) Id.
\(^{97.}\) Id.
\(^{98.}\) Id.
\(^{99.}\) Id.
\(^{100.}\) Id.
\(^{101.}\) Id. at 1529.
\(^{102.}\) Id.
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participation by its members, include program information in its new member mailings, and advertise in *Sierra* magazine at its own expense.\(^3\)

**B. Procedural History**

In 1991, the Service issued a statutory notice of deficiency to Sierra Club, stating that the income from the Club’s mailing list rentals and affinity credit card program constituted unrelated business income and, as such, the organization had incurred a tax liability.\(^4\) Sierra Club contested the deficiency to the Tax Court.\(^5\) The Tax Court rendered two separate memorandum opinions holding that the income from both the mailing list rentals and the affinity credit card program were royalties and thus exempt from the unrelated business income tax.\(^6\) In reaching its decision on the mailing list issue, the Tax Court defined “royalties” as payments for the use of valuable intangible property rights regardless of the level of activity involved.\(^7\) As for the affinity credit card program, the Tax Court reasoned that Sierra Club’s agreement with ABS, and later the bank, was for the use of Sierra Club’s name, logo, and mailing list, and the financial consideration for the use of such items of intangible property constituted royalty payments.\(^8\)

**C. The Ninth Circuit Decision**

On appeal from the Tax Court, the Ninth Circuit asserted that “[t]he crux of the parties’ dispute is how to define ‘royalties’ for the purpose of I.R.C. § 512(b)(2).”\(^9\) After a lengthy discussion of the proper definition of “royalty,” the court applied that definition to Sierra Club’s mailing list rentals and affinity credit card program.\(^10\) Ultimately, the court upheld the Tax Court’s decision on the mailing list issue and remanded on the credit card program.\(^11\)

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103. Id.

104. Sierra Club v. Commissioner, 65 T.C.M. (CCH) 2582 (1993) [*Sierra Club I*].

105. Id.

106. See Sierra Club v. Commissioner, 103 T.C. 307 (1994) [*Sierra Club II*] (discussing income from affinity credit card program); *Sierra Club I*, 65 T.C.M. (CCH) 2582 (discussing income from mailing list rentals).

107. *Sierra Club I*, 65 T.C.M. (CCH) at 2584–85 (citing Disabled Am. Veterans v. Commissioner, 94 T.C. 60 (1990), rev’d, 942 F.2d 309 (6th Cir. 1991)).

108. *Sierra Club II*, 103 T.C. at 344.

109. *Sierra Club III*, 86 F.3d 1526, 1530 (9th Cir. 1996).

110. Id. at 1535–37.

111. Id. at 1536–37.
First, the Ninth Circuit reached a definition of royalty that was a compromise between the definitions proffered by the parties. On one hand, Sierra Club argued for a broad definition of royalty, which included any payment for the use of an intangible property right, regardless of any other activity involved with the payment. On the other hand, the Commissioner contended that a payment for the use of intangible property was a royalty only if "the subject of the payment [was] "passive in nature." The court interpreted the Commissioner's view to be "that a tax-exempt organization can do nothing to acquire such fees."

Because the term "royalty" is not defined either by statute or by regulation, the court began by looking to the "ordinary, everyday senses" of the word. The court turned to dictionaries to obtain a sense of the definition of royalty in everyday parlance. From these "ordinary" definitions, the court concluded that "'royalty' commonly refers to a payment made to the owner of property for permitting another to use the property." The court distinguished a royalty payment from a rent payment "by the nature of the property the owner is permitting another to use."

After exploring the ordinary meanings of royalty and the application of the term in Revenue Ruling 81-178, the court held that royalties are payments for the right to use intangible property and are by definition "passive." As such, they cannot include compensation for services rendered by the owner of the property. The distinction between payments for the right to use intangible property and payments for services also was supported by the Service in Revenue Ruling 81-178.

112. Id. at 1535.
113. Id. at 1532, 1534–35.
114. Id. at 1532.
115. Id. at 1535.
116. Id. at 1531 (quoting Commissioner v. Soliman, 506 U.S. 168, 174 (1993)).
117. Id.
118. Id.
119. Id. at 1531 n.12. "Rent" is defined as "compensation or fee paid, usually periodically, for the use of any rental property, land, buildings, equipment, etc." Black's Law Dictionary 1297 (6th ed. 1990).
120. Rev. Rul. 81-178, 1981-2 C.B. 135; see also supra Part II.A.
121. Sierra Club III, 86 F.3d at 1532.
122. Id.
and other circuit decisions that considered the royalty issue. The court also found that distinguishing between passive royalty income and income that is compensation for services is consistent with the purpose of the Internal Revenue Code.  

Second, in applying its definition of "royalty" to the mailing list issue, the Ninth Circuit held that Sierra Club's income from its mailing list rentals was royalty income and not compensation for services. The court supported this conclusion with the proposition that Sierra Club had collected only a fee and had not itself performed services related to the mailing list rentals. The court stated that this decision was consistent with that of other circuits because Sierra Club's activities "were far less substantial than the activities other courts have found to prevent a claim that income was royalty income."

The Ninth Circuit remanded to the Tax Court the issue of whether Sierra Club's income from its affinity credit card program constituted royalty income, postulating that the Tax Court would have to determine whether Sierra Club was performing endorsement services under the credit card agreement or whether it was merely licensing its name and logo. The court noted that if the Tax Court concluded the former, then under the Ninth Circuit's definition, Sierra Club's income would constitute unrelated business taxable income and would not qualify for the royalty exemption. But if the Tax Court decided that the agreement was a licensing agreement, then Sierra Club's income would constitute royalty income.

IV. ANALYSIS OF SIERRA CLUB v. COMMISSIONER

The difficulty with the Ninth Circuit's reasoning is that it fails to resolve adequately the issue of the quantity of services, if any, that can be transferred with "the right to use intangible property" before a tax-exempt organization will no longer qualify for favored tax treatment.

124. *Sierra Club III*, 86 F.3d at 1532–33; *see also supra* Part II.B.
125. *Sierra Club II*, 86 F.3d at 1533.
126. *Id. at* 1536.
127. *Id.*
128. *Id.; see also supra* Part II.B.
129. *Sierra Club III*, 86 F.3d at 1537.
130. *Id. at* 1536.
131. *Id.*
132. *Id. at* 1530.
133. *Id. at* 1532.
After *Sierra Club*, tax-exempt organizations are left only with the knowledge that acceptable levels of activity fall somewhere between that of the Disabled American Veterans\(^{134}\) and *Sierra Club*.\(^{135}\) Because a wide range of activities could fall between these two extremes, an approach is needed that will achieve consistent results when determining whether income related to a tax-exempt organization’s activities in conjunction with a transfer of a property right should be taxed.

### A. Current Approaches

Courts primarily have used two approaches to determine whether services transferred along with a property right disqualify the payment from being treated as a royalty. The first approach characterizes the tax-exempt organization’s activity accompanying the transfer of the property right. If the organization has not been “passive,” the income will be taxed.\(^{136}\) Under the second approach, any payment for the use of a valuable intangible property right constitutes a royalty payment, regardless of the organization’s activity.\(^{137}\)

The Ninth Circuit adopted the passive versus active approach in *Sierra Club*.\(^{138}\) The passive versus active distinction also has been used in decisions by other circuits.\(^{139}\) This approach incorporates an analysis of whether the tax-exempt organization was active or passive in relation to the property transfer and the payments received. As seen in *Disabled American Veterans*, if an organization is too active in receiving its payment, the income will no longer qualify as a royalty and will be taxed.\(^{140}\) However, as in *Sierra Club*, if a tax-exempt organization remains “passive,” the royalty exemption will apply.\(^{141}\)

One difficulty with this line of reasoning is that the term “passive” is a misnomer. *Sierra Club*, for example, actually was allowed to carry out some activities without being considered too “active.” It set the rates for

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134. See supra notes 52–61 and accompanying text (discussing Disabled American Veterans’ activities).

135. See supra notes 83–103 and accompanying text (discussing Sierra Club’s activities).

136. See *Sierra Club III*, 86 F.3d 1526; Texas Farm Bureau v. United States, 53 F.3d 120 (5th Cir. 1995); Fraternal Order of Police v. Commissioner, 833 F.2d 717 (7th Cir. 1997).

137. See *Sierra Club II*, 103 T.C. 307 (1994); *Sierra Club I*, 65 T.C.M. (CCH) 2582 (1993).

138. See supra Part III.C.

139. See, e.g., Texas Farm Bureau, 53 F.3d 120; Fraternal Order of Police, 833 F.2d 717; *DAV I*, 650 F.2d 1178 (Ct. Cl. 1981); see also supra Part II.B.

140. *DAV I*, 650 F.2d at 1189.

141. *Sierra Club III*, 86 F.3d at 1536.
list rentals, as well as retained the right to review list rental requests and approve the proposed mailing material and mailing schedule. Thus, Sierra Club was able to carry out a certain level of activity while still receiving income that qualified for favorable tax treatment. The inherent problem with the passive versus active approach, then, is determining what kinds of actions a tax-exempt organization can take before it will be considered too active. Courts have failed to clarify whether it is the nature or the quantity of the services rendered that will disqualify a tax-exempt organization’s income from being considered a royalty. Both Sierra Club and Revenue Ruling 81-178 seem to indicate that the primary factor is the nature of the services and have permitted organizations to retain quality-control rights. These decisions seem to indicate that while an organization may maintain quality-control rights over the property right transferred, if it does so while undertaking other extensive activities, its income will be deemed compensation for services.

The Tax Court applied the second line of reasoning in its Sierra Club decisions when it held that a royalty is any payment for the right to use intangible property regardless of the extent of activities accompanying the transfer. In so holding, the Tax Court adopted an overly broad standard that would have permitted tax-exempt organizations to earn a great deal of income without being taxed. Presumably, this approach would be limited by an inquiry into the substance of the property right being transferred; if there were a real royalty, all proceeds in the transaction would be exempt income. While this rule might be easier to apply consistently, it would be contrary to the original purpose of the unrelated business income tax, which limits tax-free income to passive-type investments.

142. Id. at 1527.
143. For example, neither DAV I nor Sierra Club III clarified whether the inquiry focused on the nature or the quantity of services rendered.
145. DAV I, 650 F.2d at 1184.
147. See supra notes 10–17 and accompanying text.
B. Recommended Approaches

Because neither of the lines of reasoning currently in use provides clear, consistent guidance for tax-exempt organizations to determine what kinds of activities are permissible, a new approach must be devised to resolve this issue. There are several analogous areas of taxation where issues involving transfers of both property rights and services are resolved by settled law with clear guidelines. In each instance, characterizing the level of activity is important in determining whether favored tax treatment will be attained. To the extent that these approaches can be adopted in the unrelated business income tax realm, they should be considered.

1. Ancillary Versus Significant Services

One area of taxation that provides a close analogy to the unrelated business income tax is the tax treatment of the sale or exchange of a patent. Payments a taxpayer receives for the use, productivity, or disposition of a patent are treated as long-term capital gain. This treatment is given to payments whether they are paid in a lump sum or are "contingent on the productivity, use, or disposition of the property transferred." If the transferor of a patent receives compensation for services in addition to payment for the patent, an allocation may have to be made depending on the significance of the services. Where the services are incidental or ancillary to the transfer of the patent rights, the complete payment for the patent and services is accorded long-term capital gain treatment. However, if the services are significant or unrelated to the property transferred, separate consideration must be stated and the consideration constitutes ordinary income. Determining whether the services are ancillary or significant is a question of fact for the court.

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148. See, e.g., I.R.C. § 351 (1994) (transfer to corporation controlled by transferor); I.R.C. § 1235 (1994) (sale or exchange of patents); see infra notes 149–50, 156 and accompanying text.
149. I.R.C. § 1235.
150. I.R.C. § 1235(a)(2).
152. Id.
153. Id.; see also Gable v. Commissioner, 33 T.C.M. (CCH) 1427, 1434 (1974).
154. Schulze, 40 T.C.M. (CCH) at 1238. For examples of incidental and ancillary services, see Gable, 33 T.C.M. (CCH) at 1432–34 (research program to carry out further work, development, and experiments to solve technical problems), United States Mineral Products v. Commissioner, 52 T.C. 177, 199 (1969) (unique technical information necessary for “effective utilization of the transferred
This same line of analysis has been applied to determine whether a transfer of know-how, in combination with services, should receive nonrecognition under section 351 of the Internal Revenue Code.\(^{155}\) Section 351 states that if property is transferred to a corporation solely in exchange for stock, and if, immediately after the exchange, the transferors are in control of the corporation, no gain or loss is recognized on the exchange.\(^{156}\) After determining that know-how constitutes property for the purposes of this section, Revenue Ruling 64-56 establishes that if a transferor performs services in connection with the transfer of property, then tax-free treatment is accorded to both the property and the services if the services are ancillary and subsidiary.\(^{157}\) However, if the services are independent of the property transfer, a reasonable allocation must be made, and part of the consideration is treated as compensation for services, thus falling outside section 351.\(^{158}\)

In both of the aforementioned examples, an approach has been developed in which a distinction can be made between ancillary and significant services. When the services are ancillary, the favored tax treatment is retained. This same approach could be applied to determine whether a tax-exempt organization's income should be treated as a royalty payment when the organization transfers services along with a right to use intangible property. If the services are merely ancillary, the income would remain exempt from taxation because it would still be considered a royalty payment. However, if the services rendered were significant, an allocation would have to be made for the income as compensation for services, and these payments would be subject to the unrelated business income tax.

This ancillary versus significant services approach should be favored over the passive versus active distinction because it more accurately describes the determination that courts are, in fact, making. Under the old approach, as in *Sierra Club*,\(^ {159}\) a court could determine that a tax-exempt

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formulas*), and *Ruge v. Commissioner*, 26 T.C. 138, 139, 143 (1956) (sixty days of consulting services per year to assist buyer in establishment and control of manufacturing operations). For examples of significant or unrelated services, see *Schulze*, 40 T.C.M. (CCH) at 1238 (suggestions concerning general operation of facility), *Spence v. United States*, 156 F. Supp. 556, 559 (Ct. Cl. 1957) (services provided while remaining as head of company after patent sale), and *Ruge*, 26 T.C. at 139, 143 (efforts and thoughts for promoting and developing business).

158. *Id.* at 134–35.
159. 86 F.3d 1526 (9th Cir. 1996).
organization, although it conducted some activities, had been "passive" in receiving income—even though the term "passive" implies that an organization should not have carried out any activities. By applying this new approach, the court will actually be characterizing the services as either ancillary or significant. Therefore, while distinguishing between ancillary and significant services is still a fact-intensive review, the parameters are much more clearly distinguishable than an inaccurate passive versus active distinction. To provide even greater clarity, the Service could also rule that certain services are always ancillary. The Service has essentially done so already in Revenue Ruling 81-178 by stating that retaining quality-control rights will not cause payments to lose their characterization as royalties.

Applying the ancillary versus significant services approach to Sierra Club would result in the same outcome reached by the Ninth Circuit; that is, Sierra Club’s income with respect to the mailing list would receive favored tax treatment. Sierra Club’s activities in conjunction with the mailing list—setting the list rental rates, and retaining the right to review requests to rent the list and to approve the proposed mailing material and schedule for mailing—would be considered ancillary services because the activities are merely incidental to the mailing list rental. As such, these services would not cause Sierra Club to be denied royalty exemption treatment.

2. **Comparative Value of Property and Services**

Another approach that could be adopted to determine whether the income from the transfer of both a property right and services should receive favored tax treatment is to consider the relative value of the services and property transferred. This approach has been used under section 351 when a person transfers property and services to a controlled corporation in exchange for stock. If the primary purpose of the section 351 transfer is to qualify the exchanges of property by other persons transferring property for the nonrecognition of gain or loss, the property transferred must meet a valuation test. If the property transferred is of

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160. See supra note 154 and accompanying text.
162. See text accompanying note 96.
163. I.R.C. § 351 (1994). In general, if a person transfers property to a corporation solely in exchange for stock, and that person is in control of the corporation after the exchange, no gain or loss is recognized on the exchange. I.R.C. § 351(a).
“relatively small value” in comparison to the stock already owned or to be received in exchange for services, the exchange does not receive the favored nonrecognition treatment. The Service has determined that a “relatively small value” is less than ten percent. The reasoning behind this regulation and Revenue Procedure is to ensure that transferors cannot obtain favored tax treatment for others by transferring de minimus amounts of property to a controlled corporation.

By analogy, the goal of the unrelated business income tax is to ensure that a tax-exempt organization cannot transfer valuable services along with a de minimus amount of royalty-producing property and still receive favored tax treatment. That being the case, the Service was able to establish a ceiling for the value of the services that could be transferred as compared to the value of the property right being transferred. By limiting the value of the services to ten percent of the value of the property, minimal services would be allowed along with a transfer of a property right. This approach is similar to the ancillary versus significant services approach in that it allows the tax-exempt organization to perform some services in conjunction with its transfer of a property right. Valuing the services and the property right may also be another way of defining “ancillary”; if the services are less than ten percent of the proceeds, they are presumed to be ancillary. Although applying this approach could present difficult valuation problems, these valuations would once again be questions of fact for the courts to decide. At a minimum, this approach improves upon the passive versus active analysis because it provides identifiable parameters.

Applying this approach to Sierra Club, the court would have had to assess the relative value of Sierra Club’s services in conjunction with the value of its mailing list. As long as the value of the services did not exceed ten percent of the mailing list value, then all of the income from the transaction would receive favored tax treatment. However, if the value of the services exceeded ten percent, Sierra Club would have to make an allocation between the compensation for services and the royalty payment, and the compensation would then be taxed.

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165. Treas. Reg. 1.351-1(a)(1)(ii) (as amended in 1996). Stock received for services, even if sufficient property is transferred, is always taxed as compensation for services. I.R.C. § 351(d).
168. See supra notes 151–58 and accompanying text.
169. See supra note 154 and accompanying text.
3. **General Allocation Issues**

When contemplating the issue of a tax-exempt organization's transfer of both property rights and services, it becomes apparent that the relative values of each portion of the transaction could fall anywhere along a wide spectrum. The two approaches outlined above resolve the problem of determining when the services are ancillary or have a relatively small value. However, the determination of the tax when a transaction falls outside this de minimus range of the spectrum remains unresolved.

In instances when the compensation for services is not de minimus, after establishing appropriate guidelines, the Service should require tax-exempt organizations to make the initial allocation decision between the amount of the payment that relates to the property right transferred and the amount that relates to the services rendered. Following an allocation approach taken elsewhere in the Code, the allocation would be binding on the tax-exempt organization. After the allocation has been made, a tax-exempt organization would be taxed on the compensation for services while the royalty payment would remain exempt. As such, in a transaction containing both a transfer of property rights and services, a tax-exempt organization should get the tax benefit up to the value of the property right, even if this value is small relative to the value of the services.

The question then arises whether it would ever be equitable for the Service to tax an entire payment because a tax-exempt organization failed to make an allocation. This was the result in *Texas Farm Bureau v. United States.* Because TFB did not create an agreement which allocated certain payments as royalties and other payments as compensation for services, all of the income was deemed taxable. Although the Service implied that it would have accepted a royalty allocation if TFB had created a royalty agreement at the time of contracting or had amended the original agreement, when TFB amended its tax return to reflect this allocation, the Service found this unacceptable. If a portion of the payment clearly appeared to be for the

172. 53 F.3d 120 (5th Cir. 1995); *see also supra* notes 66–72 and accompanying text.
174. *Id.* at 124.
175. *Id.* at 122.
use of TFB’s logo, it seems inequitable that the Service would not accept this allocation even in hindsight.

Nevertheless, it is understandable that if the Service determines that an allocation is inappropriate, it may challenge the validity of that allocation. This would be especially apropos if an organization attempted to disguise compensation as royalty payments in order to receive favored tax treatment. If a tax-exempt organization in fact attempts to disguise compensation, perhaps it would no longer be inequitable to allow the Service to designate the entire income amount as taxable. In that case, the tax would, in effect, become a penalty for the tax-exempt organization’s failure to allocate in good faith.

V. CONCLUSION

The problem with the courts’ current approach in determining what constitutes unrelated business taxable income is the lack of clarity in dealing with the issue of services that are transferred along with a valuable intangible property right. While payments that a tax-exempt organization receives for the transfer of property rights should fall within the royalty exemption, it is arguable whether or not a payment for accompanying services should be treated as compensation and therefore taxed. The active versus passive distinction does not provide an accurate description and has not been consistently applied. Instead, the proffered alternative approaches—focusing on the significance or value of the services and permitting allocations—provide clearer guidelines to tax-exempt organizations, achieve more consistent results, and do not undermine Congress’s original intent in enacting the unrelated business income tax.
