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CFPB Issues Affinity Credit Card Report to Congress: How Nonprofits Can Minimize Their Legal and Tax Risk

Nonprofit Alert

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Affinity credit cards continue to be significant revenue generators for colleges and universities (and their affiliated organizations), associations and many other types of nonprofit organizations. The federal Consumer Financial Protection Bureau ("CFPB") recently released its 2012 Annual Report to Congress on College Credit Card Agreements (the "Report"), as well as a database where individual agreements are stored. The Report is a good reminder of how important affinity programs can be for some nonprofits, and also provides a good opportunity to revisit the relevant legal and tax issues. Below, we outline the highlights of the Report, and then discuss some important considerations and practices that can help nonprofits minimize their legal and tax risk from affinity programs of all types.

Affinity Credit Cards Are Big Business

In 2011, the CFPB received 798 college credit card agreements from 21 credit card issuers; information and analysis regarding these agreements is set forth in the Report. The Report demonstrates that the majority of college credit card agreements are between issuers and affiliated organizations, such as fraternities, sororities, alumni associations, or foundations affiliated with or related to an institution of higher education ("affiliated organizations"). The database contains credit card agreements from more than 700 card issuers.

The top ten college credit card agreements with the largest payments made by credit card issuers in 2011 totaled more than $14 million. These ten agreements represent approximately 24 percent of all payments made by issuers pursuant to college card agreements in 2011. The amount of credit card issuers increased between 2009 to 2011; in contrast, the number of agreements, total number of accounts open at year-end, amounts of payments by credit card issuers, and the number of new accounts opened all declined.

Background on the Report

Section 305 of the federal Credit Card Act requires that the CFPB collect information on agreements between universities or affiliated organizations and credit card issuers that provide for the issuance of credit cards to college students, as well as alumni and other affiliated persons. Under the law, the CFPB must submit to Congress, and make available to the public, an annual report that lists information submitted to the CFPB concerning such agreements. Issuers must submit the terms of any agreements they have with colleges and affiliated organizations. In addition, credit card issuers must submit the following information:

- Data on the number of accounts covered by the agreement that were open at year-end;
- The amount of payments made by the credit card issuer to the college or affiliated organization;
- The number of new accounts opened in the calendar year; and
- Any additional agreement or memorandum of understanding between the credit card issuer and the college or affiliated organization that relates to the agreement.

The Federal Reserve had previously collected this information, however, the CFPB assumed this responsibility in 2011.

Legal and Tax Issues Associated with Affinity Programs

Certain legal and tax issues arise in affinity credit card programs, such as those addressed in the

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CFPB 2012 Annual Report. Nonprofit organizations seeking to engage in an affinity arrangement of any kind – credit card or otherwise – can structure their relationships and operate their programs in a manner that helps to minimize potential tax and legal liability. Below, we outline these considerations and offer suggestions for mitigating risk.

Tax

Affinity arrangements are relationships whereby a tax-exempt nonprofit organization allows a company to use the organization's name, logo, and mailing list in connection with that company's marketing of a particular product or service – in this instance, credit cards. Generally, those who apply for a credit card under such arrangements are issued a credit card that bears the name and logo of the nonprofit; in turn, the nonprofit receives a fixed amount of revenue in connection with the arrangement (such as receiving a small percentage of purchases made using the credit cards). Such relationships may provide nonprofit organizations and affiliated entities with a significant source of revenue that may qualify for treatment as tax-free royalty income. However, an improperly structured arrangement may result in a nonprofit being required to treat payments received as subject to the federal tax on unrelated business income ("UBI"). In addition, affinity arrangements often carry with them certain other legal risks, as discussed below.

As tax-exempt organizations, nonprofits are subject to tax on income received from activities that constitute a trade or business, that are regularly carried on, and that are not substantially related to its tax-exempt purposes. This tax is commonly referred to as the unrelated business income tax ("UBIT"). The determination of whether a particular revenue stream is subject to UBIT is a very fact-intensive one. In general, the Internal Revenue Service ("IRS") has taken the position that income generated through active involvement in a program that sells products or services, such as credit cards, often will present UBIT exposure to the nonprofit. However, there are a number of exceptions to UBIT in the Internal Revenue Code (the "Code"); of particular relevance to affinity arrangements is the Code's exception for royalties in Section 512(b)(2).

Payments received in exchange for a nonprofit's mere licensing of its intangible property to another party – for whatever reason and use – generally qualify as tax-exempt royalties under this Code Section. A nonprofit that licenses its name, logo, and mailing list may receive tax-free royalty revenue in exchange for such licensure to the extent that there is no more than a *de minimis* level of services (such as marketing or administrative services) conducted by the nonprofit in connection with the relationship. Courts have ruled that payments received by nonprofit organizations through affinity card relationships are payments for intangible property – *i.e.*, the organization's name, logo and mailing list. However, whether revenue received by the organization is characterized as a payment for the goodwill associated with the organization's intangible property or as a payment for marketing and/or administrative services – or a combination of both – turns on the amount and nature of the services performed by the organization.

In practice, many credit card issuers that seek to market their cards through affinity relationships desire more than merely gaining the right to use the nonprofit's name, logo, and mailing list. Rather, they often expect to receive some type of active marketing and/or administrative support. Many tax-exempt organizations have accommodated those requests for active support in affinity relationships by entering into two separate agreements (or two separate sections of the same agreement) with affinity program providers, thereby splitting the fees received by the organization into taxable services revenue and non-taxable royalties. This "split" must be set in such a manner that the taxable and non-taxable amounts fairly represent the value of the taxable services and the value of the organization's intangible property license.

Endorsement/Tort Liability

While many nonprofits avoid the use of the term "endorsement" to describe the relationship with a credit card issuer under an affinity program, the fact of the matter is that many consumers will view the permitted use of a nonprofit's name and logo as an endorsement or recommendation that the credit card has met certain standards of quality. In the event that the credit card and related services provided cause harm to an individual, it is possible that such individual may look to the nonprofit for relief (under a "negligent endorsement" theory of liability).

In order to help guard against this potential liability, nonprofits should conduct due diligence in selecting credit card issuers, review the issuer's performance on an ongoing basis, use adequate disclaimers to clearly and accurately explain the nonprofit's limited role with respect to the credit card issuer's provision of products/services, maintain sufficient liability insurance, avoid trying to directly control or dictate the manner in which the credit card issuer provides products/services, and use indemnification and limitation of liability provisions in contracts with credit card issuers in order to lessen tort liability

exposure.

Marketing Restrictions

There is a growing body of restrictions on the type of solicitations for credit cards that issuers may make, both at the federal and state levels. Under the Credit CARD Act there are restrictions on marketing credit cards to those under 21 unless they can prove sufficient income or have a co-signer, sending pre-approved offers by mail to those under 21, and providing incentives to students to apply for a credit card on campus, near campus, and at events sponsored or related to a college. In addition, affinity credit card agreements must now be filed with the CFPB and are made public. On top of this, the CFPB is increasing scrutiny of credit card issuers. Nonprofit organizations should take care to obtain sufficient warranties and assurances from credit card issuers that they will act consistently with all applicable laws governing their marketing activities. Also, nonprofits may seek to enforce their own set of restrictions to protect their relationship with their members, constituents, students and alumni, and the like, as well as their overall brand.

Click here for the CFPB Annual Report to Congress on College Credit Card Agreements. **Click here** for the College Credit Card database.

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