

**Proposals for Federal Tax Law Simplification
Relating to the Political and Lobbying Activities of
Tax Exempt Organizations:
Explanation and Analysis**

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These proposals were originally developed during the first half of 2011, with valuable assistance from many colleagues, by the authors, who are (and were at the time) the co-chairs of the Political and Lobbying Activities Subcommittee of the Exempt Organizations Committee of the Tax Section of the American Bar Association, in anticipation of an Administration request to the Tax Section of the American Bar Association for tax simplification proposals. However, these proposals have not been reviewed by, or incorporated into any document sanctioned by the ABA, and represent only our views as individual practitioners. We gratefully acknowledge those practitioners who provided input (including Ellen Aprill, Greg Colvin, Betsy Grossman, James Joseph, Ofer Lion, John Pomeranz, Ezra Reese, Emily Robertson, Kevin Shortill, Donald Tobin, and Jean Tom), but none of them has had an opportunity to review this work product, and all responsibility for these proposals rests with the authors.

Due to the circumstances under which these proposals were developed, they are limited to those that either simplify the Internal Revenue Code, or simplify federal tax law compliance for exempt organizations engaged in political or lobbying activities. Both authors support additional proposals that go beyond simplification that are not included here.

The complexity of the Code dictates that even simplifying it is a technical and complicated exercise, as will be evident to anyone reading this. However, we note that if all the changes proposed below were made, the Code would be as much as 2,500 words shorter than current law; the regulations would be shortened by several times that amount.

The following proposals (including some alternatives) are intended to be considered together. While the authors would support adoption of some of these proposals alone, others would have serious unintended effects on some exempt organizations, and we could not support their adoption in isolation without modification. We have noted these interactions below.

Our purpose in releasing these proposals now is to spark discussion, and to make them available in the context of much-needed legislative changes being considered that would affect the political and lobbying activities of exempt organizations.

501(h) – Expand Application of Expenditure Test

Present Law:

In order to qualify for and maintain tax-exempt status under section 501(c)(3), “no substantial part” of an organization’s activities may be spent “carrying on propaganda, or otherwise attempting, to influence legislation,” i.e., lobbying. Section 501(c)(3) establishes the “no substantial part” test as the default rule for measuring permissible amounts of lobbying activity for section 501(c)(3) organizations. Whether an organization’s lobbying constitutes a “substantial part” of its overall activities is determined by an examination of all of the facts and circumstances, including the organization’s expenditures and time devoted, both by compensated and volunteer workers, to lobbying activities. Under the “no substantial part” test, an organization that conducts excessive lobbying in any year may have its tax-exempt status revoked, and may also be subject to penalty taxes on its lobbying expenditures.

Section 501(c)(3) organizations other than churches, private foundations, governmental units, and certain 509(a)(3) supporting organizations (that support a non-501(c)(3) organization) have the option of electing to have their lobbying activity measured under the “expenditure test” under section 501(h), rather than the “no substantial part” test. It is widely understood that the reason churches are not allowed to elect the expenditure test is that at the time their representatives felt that even having the option of measuring lobbying under this test would undermine their ability to argue that the Constitution prohibits imposing any limits on their lobbying as a condition of tax exemption. (*See also* discussion of section 501(h)(7) below.)

A public charity that has made the section 501(h) election must categorize its lobbying expenditures as either direct or grassroots lobbying. Direct lobbying is defined as “any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation.” Grassroots lobbying is defined as “any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof.” The primary difference between direct and grassroots lobbying is that grassroots lobbying is directed in the first instance at the public rather than at the legislature, and must include a “call to action.” More specifically, a grassroots lobbying communication has the principal purpose of encouraging the recipient to contact a government official or employee for the purpose of influencing legislation and gives the contact information of the government official or employee, provides a petition, postcard, or other medium through which to communicate with a government official or employee for the principal purpose of influencing that government official or employee with respect to legislation, or specifically identifies one or more legislators that the individual should target regarding their vote on legislation.

Under the expenditure test, an electing public charity is permitted to make expenditures for lobbying up to certain monetary limits specified in Code section 4911. These limits reflect a sliding scale percentage of the organization’s exempt purpose expenditures and may not exceed a total of \$1,000,000. Additionally, an organization may not spend more than 25% of its permitted lobbying amounts on grassroots lobbying. Under the expenditure test, if an organization exceeds the lobbying expenditures limits, an excise tax of 25% of the excess lobbying expenditures for

the tax year will be imposed on the organization. Only if an organization's lobbying expenditures exceed the section 4911 limits by 50% over a four-year period will its tax-exempt status be subject to revocation.

In addition to imposition-of-tax and revocation-of-exemption consequences of the distinction between direct and grassroots lobbying, section 501(h) applies reporting requirements for electing charities. They are required to report on their annual information return on Form 990 the total amount of their lobbying and grassroots lobbying expenditures, as well as the maximum amount that the charity could have expended on each without triggering an excise tax.¹ Accordingly, these reporting requirements require separate detailed recordkeeping of both direct and grassroots lobbying expenditures.

Section 4911(f), entitled "Affiliated Organizations," is a long Code section that causes two or more section 501(c)(3) organizations that meet a complex definition of an "affiliated group" to be treated as a single organization for purposes of applying the expenditure limits of section 501(h), if just one member of the group files a 501(h) election. Treas. Reg. 56.4911-7, -8, -9, and -10 contain eight pages of complicated rules interpreting section 4911(f). It appears that section 4911(f) was intended to discourage charities from establishing multiple affiliates, each with its own 501(h) lobbying allowance, in order to circumvent the \$1 million cap on lobbying and take advantage of the higher spending percentages available to smaller charities.

Reasons for Change:

Option A: Making the Expenditure Test the Default. For a vast majority of section 501(c)(3) public charities, the expenditure test under section 501(h) is highly advantageous, providing a bright-line test with which to plan, measure and limit an organization's permissible lobbying activities. Charitable organizations that engage in legislative activities in furtherance of their exempt purposes know that so long as they make the 501(h) election and keep their lobbying expenditures within the proscribed limits, they can participate in these activities without fear that they are exemption-threatening or will subject them to penalty taxes. They also benefit from a safe harbor, whereby if they inadvertently exceed the lobbying limits in one year, their exempt status will not be in jeopardy.

This stands in contrast to the vague and ill-defined "no substantial part" test applicable to non-electing charities, which does not offer any concrete metrics for an organization to determine when its lobbying activities are insubstantial or excessive. It is also unclear whether the detailed definitions of what does and does not constitute lobbying articulated in section 501(h) apply to organizations under the "no substantial part" test; for example, advocacy without a specific legislative reference would not constitute lobbying under 501(h), but certain courts have taken the position that it could count under the "no substantial part" test. The vagueness and uncertainty of the "no substantial part" test is compounded by the severity of the penalty for violations—revocation of tax-exempt status. Moreover, the subjective nature of the "no substantial part" test leads to concerns about selective enforcement by the IRS, and may also

¹ This applies only to 990 and 990-EZ filers. Those who file the 990-N are not required to make any additional reports on lobbying whether or not they elect under 501(h).

chill permissible lobbying activity by non-electing charities, who may avoid engaging in lobbying activities altogether for fear of failing the test.

Given the likelihood that most charities would benefit from the application of the expenditure test rather than the “no substantial part” test, automatic application of section 501(h) as a default or mandatory rule rather than one requiring affirmative election would be beneficial for the sector, particularly for small charities that may not have the resources to familiarize themselves with the benefits of 501(h) or who may not realize that they must make an election to qualify for the expenditure test. Indeed, given that violating the “no substantial part” test may result in loss of exemption, the most dire fate for an exempt organization, it makes more sense to have the default or mandatory rule applicable to charities be the expenditure test, which provides a safe harbor for permissible legislative activity, offers clear-cut definitions to aid in compliance, and imposes financial penalties, rather than the potential loss of exemption, as the first-line deterrent against excessive lobbying.

It is important to note, however, that there are certain charities that currently find it beneficial to remain under the “no substantial part” test and that intentionally do not make the 501(h) election. The authors know of four such types of charities: 1) charities that engage in more grassroots lobbying than the section 501(h) limits permit; 2) large charities whose lobbying expenditures may exceed the \$1 million cap while still constituting an insubstantial part of their activities; 3) land conservation charities whose land purchases for charitable purposes are not counted towards their exempt purpose expenditures, and 4) groups seeking to avoid the complexities of the affiliated group rules. If 501(h) is made mandatory, these types of charities could be disadvantaged—for example, large charities that currently spend over \$1 million on lobbying activities under the “no substantial part” test could have their lobbying sharply curtailed. Below, we suggest additional tax simplification reforms to go hand in hand with the 501(h) reform to address these specific concerns so that no charities will be disadvantaged by making application of section 501(h) automatic.

Option B: Leave 501(h) as opt-in, but expand groups eligible to make the election. As a matter of consistency and simplicity, it makes sense to have all charities governed by the same rules, or at least enjoy the same options for rules – choosing to elect the expenditure test or remaining under the “no substantial part” test. Political circumstances in 1976 unrelated to clarity or simplicity dictated the carve-out for churches for eligibility to elect the expenditure test. Consultations with leading church tax counsel² suggest that many churches would prefer to have this option, and that while their sector is vast and diverse they do not anticipate strong opposition to amending the Code to allow churches to opt into the expenditure test. They would, however, resist an attempt to make it the default for a group of organizations that have historically always been irrevocably defaulted to the “no substantial part” test. Therefore, an alternative to making 501(h) the default would be to leave it as opt-in but delete the language making churches ineligible to make the election.

In addition, some of the other carve-outs from 501(h) eligibility make little sense. Because we are proposing (below) that private foundations be able to lobby in support of their

² Including the co-chairs of the Religious Organizations Subcommittee.

charitable purposes to the same extent as other 501(c)(3)s, they should also be allowed to elect under 501(h) and follow those rules should they so choose. Similarly, there seems to be little basis in public policy for preventing a small subset of 509(a)(3) supporting organizations from electing the expenditure test while still (under current law) allowing them to lobby under the “no substantial part” limits.

Eliminating the Separate Limit on Grassroots Lobbying. This has been proposed before. In the 109th and 108th Congresses, bills introduced in the Senate and the House included language to do so. In 1999, such language was included in the Taxpayer Refund and Relief Act (H.R. 2488, 106th Congress), which was passed by both houses, but vetoed for unrelated issues. The provision has been endorsed by organizations spanning the spectrum in terms of size, scope, and ideology, for a variety of reasons, three of which are discussed below.

The distinction between direct and grassroots lobbying is complicating and burdensome without serving any public policy. The strongest arguments for eliminating the distinction between direct and grassroots lobbying are based in good public policy, and have been made by Congressional staff. In 2001, the Staff of the Joint Committee on Taxation described the distinction between direct and grassroots lobbying as a source of complexity in the Code that should be simplified.³

One source of complexity is the significant record-keeping and allocation formulas and rules that a charity must follow in order to comply with reporting requirements. Its staff must keep detailed timesheets that track what portion of their time is reasonably allocated to each type of lobbying. Out-of-pocket and overhead expenses must be examined to determine what portion should be allocated to each type of lobbying, and the proper allocation is not always clear or straightforward. A charity whose lobbying activities approach its lobbying limits may spend significant time and resources to ensure it is allocating correctly, and in planning directed at avoiding characterization of expenditures as direct or grassroots lobbying expenditures.⁴ For any charity, but particularly charities with lower budgets, the time and expense required to keep up with the recordkeeping and reporting, and within the rules of section 501(h), can divert significant resources that otherwise would be devoted to charitable purposes. The burden is doubled when this record-keeping must be done for both direct and grassroots lobbying separately. Such a substantial increase in burden on charities ought only to be required where the public policy ends to be achieved outweigh it.

To the contrary, however, the Joint Committee Staff found no significant public policy reasons for maintaining the distinction. First, the existence of a separate grassroots limit neither increases nor decreases the overall amount of lobbying expenditures permitted to electing charities. The Staff argued that there is no significant policy rationale for a separate limitation on grassroots lobbying. The overall purpose of either type of lobbying is to encourage the adoption or change of legislation and it is only the method by which they are undertaken that is

³ STAFF OF THE JOINT COMMITTEE ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION 451 (Joint Comm. Print 2001).

⁴ *Id.* at 454.

different. Both grassroots and direct lobbying therefore, as long as they are not substantial, appear equally consistent with exempt purposes.⁵

The original argument for parity of treatment of grassroots lobbying by businesses and charities is no longer applicable. One of the primary rationales that could be inferred from the congressional record and the history behind restricting the lobbying activities of charities was the maintenance of fairness regarding the treatment of grassroots lobbying between charities and other entities. When section 501(h) was adopted in 1976, businesses were permitted to deduct their direct but not their grassroots lobbying expenses. It seems from the record that fairness and balance were considerations underlying the choice to limit grassroots lobbying by charities more severely than direct lobbying, because of the disparate treatment of these two types of lobbying expenses for businesses. However, since the loss of the business deduction for lobbying in 1993, that argument has lost any weight that it once had.

Grassroots lobbying arises out of charities' connection with their constituencies and reflects their public benefit purposes, and should not be discouraged. A public policy argument can be made that grassroots lobbying is particularly aligned with the charitable purposes that form the basis for charities' tax exemption under section 501(c)(3). Grassroots lobbying is arguably the form of lobbying that society should encourage, not discourage, the charitable sector to participate in. Charities exist to serve their charitable constituency, and through that service, gain expertise and knowledge about issues that they can then communicate to the general public. The public is inundated with information from so many different sources that it may not only be difficult to sort through the information available, but even more difficult to analyze that information to reach an informed decision. Charities can assist the public by keeping them abreast of legislation that is relevant to them. They can help the public navigate the legislative process by informing them whom they need to contact to express their opinions, and how that contact should be made. These educational activities are inherent in any grassroots lobbying campaign. If anything, the Code should evidence a preference towards charities spending their money to encourage citizens to influence their legislators (should the issue be important enough to them to do so), over spending money on a lobbyist to communicate that information to the legislator.

Successful grassroots lobbying by charities cannot occur unless charities secure public support for their positions, ensuring that such lobbying activities are consistent with their charitable purposes. By engaging the public through grassroots lobbying, the charity demonstrates more and deeper public support than just giving money. It is easier for many people to write a check to a charity than to take the time to make a phone call, write a letter or email, attend a rally, or undertake some other significant action that requires more thought and effort. In the hearings leading up to the passage of section 501(h), one of the concerns that was expressed with regards to lobbying was that an organization's lobbyist might not be expressing the views of its members and donors, but the organization's own views.⁶ Grassroots lobbying

⁵ *Id.* at 455.

⁶ *Legislative Activity by Certain Types of Exempt Organizations: Hearing on H.R. 13720 Before the H. Comm. on Ways and Means, 92nd Cong. (1972)* (for examples of these concerns, see statements by Congressman Joe D. Waggoner, pp. 81, 227).

eliminates this concern, since it is exactly the charity's supporters who are expressing their views by contacting their elected representatives.

One Million Dollar Cap. As many have noted, the absolute \$1 million spending limit on “lobbying non-taxable amounts” under section 501(h) is outdated, as it has not been adjusted for inflation since it was established in 1976. Moreover, the \$1 million cap is unduly limiting, particularly for large charities with annual exempt purpose expenditures over \$100 million, for whom \$1 million in lobbying expenses can constitute less than 1% of their budget, a far cry from “substantial.” As a result, recent years have seen an increasing number of very large charities revoke their 501(h) election, while as a matter of public policy we believe that electing the certainty and clarity of the expenditure test should be encouraged. The \$1 million cap is also unnecessary, since large charities would otherwise be subject to a 5% limit on their lobbying expenses under the existing sliding scale percentage limits under sections 501(h) and 4911, a percentage limit that some commentators and courts have found to be insubstantial.

Eliminating the Affiliated Organization Rules. Section 4911(f) was aimed at solving a merely hypothetical problem; there is no experiential information base to indicate it was needed. Charities wanting to spend more than \$1 million to lobby can simply choose the insubstantial standard instead of the 501(h) election. The opportunity to have a 20% lobbying limit is not a sufficient incentive to establish multiple charities with budgets under \$500,000; each charity would need to spend the other 80% on non-lobbying activities. Also, the time, effort, and cost of setting up a series of new 501(c)(3) entities would make this an unattractive way to game the graduated lobbying limits.

Rather, this section has become a trap for the unwary; it is the most confusing, lengthy element of the 501(h) election and the applicable regulations. It requires Type I section 509(a)(3) supporting organizations to be consolidated with their parent public charity and its other (a)(3) subsidiaries under a single lobbying limit if only one supporting organization elects 501(h). Likewise, many affiliated groups of state and local charitable organizations, functioning under a group exemption, may be forced to share a single 501(h) lobbying limit and establish delicate protocols for determining how much lobbying each affiliate can conduct. These chapters, clubs, and other local units exist on a geographical basis to serve grassroots communities, not to abuse the lobbying rules.

For instance, thousands of local parent-teacher associations have been required to come under one lobbying limit administered by their statewide central organization because of section 4911(f), preventing them from using the 20% lobbying allowance each one may desire to advocate passage of school bonds, tax measures, and educational reforms at the local level. This chills the exercise of their First Amendment speech rights without a rational basis.

If, as we suggest below, the \$1 million cap is removed or indexed for inflation, there is even less reason to retain section 4911(f) in the Code. We have not proposed here that the graduated lobbying percentages be indexed as well. While we would wholeheartedly support such a change as good tax policy, we have concluded it does not qualify as simplification of the Code, nor is it essential to the fairness and viability of simplifying the Code by making section 501(h) the default standard for limiting charities' lobbying.

Recommendations/Options:

OPTION A:

The authors' recommendation is to eliminate the elective nature of section 501(h) and instead, to have 501(h) rules automatically govern lobbying expenditures by all 501(c)(3) organizations (including private foundations – see pages 15-16 below), except for churches, their conventions or associations, and their integrated auxiliaries, and governmental units. This change would be accomplished by the following simplifications of the Code:

- revise and consolidate sections 501(h)(3), (4), and (5) to read:
 - Organizations to which this subsection applies – This subsection shall apply to any organization which is described in subsection (c)(3) except an organization that is described in section 170 (b)(1)(A)(i) or section 170(b)(1)(A)(v).⁷
 - In addition to being much less wordy, this change removes the redundancy of subsection (5) which makes churches “disqualified” to elect; excluding them from coverage of the provision is enough.
- revising section 4911(a)(2), which describes organizations to which 4911 applies, to track 501(h)(3) and to eliminate the reference to the election;
- deleting section 501(h)(6) – which describes the years for which the election is effective;
- making corresponding formatting, numbering, and cross-referencing changes as needed.

This recommendation also removes the unneeded reference in current section (5)(C) to members of affiliated groups, and eliminates the awkward carve-out and cross-reference in current section (4)(F) to the “last sentence of section 509(a),” which affects only a very few 509(a)(3) supporting organizations and has been notoriously cited as one of the most confusing sentences in the Internal Revenue Code.

If the recommendation to make the expenditure test the default rather than an opt-in status is adopted, the following four proposals -- three of which are simplifications themselves -- would also be necessary to avoid an unfair impact on charities that are disadvantaged by the expenditure test as currently formulated. We support each of these in their own right as well as considering them essential to the viability of the proposed change to make the 501(h) expenditure test the default for most charities:

- 1) Grassroots Lobbying: For charities whose lobbying activities consist primarily of grassroots lobbying and who may engage in more grassroots lobbying than the existing 501(h) limits permit (without such activities becoming a substantial part of their activities), this situation could be addressed by eliminating the separate limit on grassroots lobbying entirely, leaving only the total lobbying limit imposed by section 501(h). This would be achieved by the following: (1) deleting 501(h)(1)(B), which imposes a limit on grassroots lobbying; (2) deleting 501(h)(2)(C), which defines

⁷ Please note that this change also effects our proposal, discussed below at pages 15-16 , to make section 501(h) applicable to private foundations.

grassroots expenditures; (3) deleting 501(h)(2)(D), which defines the grassroots ceiling amount; (4) deleting the words “the greater of” in 4911(b), and deleting 4911(b)(2), which refers to excess grassroots lobbying; (5) deleting 4911(c)(3), which defines grassroots expenditures; (6) deleting 4911(c)(4), which defines grassroots non-taxable amount; and (7) making corresponding formatting, numbering, and cross-referencing changes as needed.

2) Lift the \$1 Million Cap: To avoid disadvantaging those large organizations that find the \$1 million spending limit on “lobbying non-taxable amounts” to be unduly limiting and a very tiny fraction of their annual budgets, the authors believe the \$1 million cap should be eliminated. This can be accomplished by deleting the words “the lesser of (A) \$1,000,000 or (B)” from section 4911(c)(2). In the alternative, the \$1 million should at the very least be indexed to reflect inflation since 1976.

3) Land Conservation Charities: Due to certain provisions of the regulations implementing section 4911, charities that buy land for charitable purposes such as land trusts and land conservation organizations are not permitted to count such expenditures, which are substantial, as exempt purpose expenditures for the purpose of calculating 501(h) limits. This substantially lowers their corresponding permissible lobbying non-taxable amount limits. This problem could be fixed by changes to the applicable regulations under section 4911, permitting the value of the land purchase to be treated as an exempt purpose expenditure for these organizations. While the change is regulatory, we recommend that direction along these lines be included in any legislative amendments, or at least incorporated into the legislative history to provide guidance to the Service.

4) Charities with Affiliated Groups: Certain charities that would be swept into the extremely complex affiliated group rules under section 4911 by electing 501(h) currently find it easier to operate under the “no substantial part” test. This situation could be addressed by repeal of section of 4911(f) and deletion of the cross-reference to it in subsection 501(h)(8). Not only would this remove pages of unnecessary text from the Code and Regulations, it would eliminate the need for complex group lobbying calculations on Schedule C to Form 990.

These changes each have substantial merit in and of themselves and we strongly support their adoption under either Option A (discussed above) or Option B (below). However, they are an absolutely integral part of our recommendation that the expenditure test should be the default for all charities other than churches and governmental units.

In addition, under Option A we believe it would be wise to create a new election under section 501(h) for those organizations that wish affirmatively to opt into the “no substantial part” test.⁸ That is, while it is less simple than making it mandatory, we recommend that section

⁸ This change could be effectuated by adding the words, “such organization has made an election (in such manner and at such time as the Secretary may prescribe) not to have the provisions of this subsection apply to such

501(h) should only be the default rule. If section 501(h) were made the default without the additional provisions described above that address existing situations in which the “no substantial part” test is preferable, then an opt-back into “no substantial part” is critical.

The authors believe that these tax simplification proposals would address the most significant problems with the current regime: a vague default standard that impedes compliance and chills permissible lobbying activity, the need for charities to affirmatively elect into the more advantageous 501(h) expenditure test, an outdated \$1 million overall cap, and an overly harsh anti-abuse regime for non-existent abuses.

OPTION B:

Section 501(h) would remain an opt-in provision, but the pool of eligible organizations should be expanded to include all 501(c)(3)s except governmental units. The Code could be simplified as follows:

- revise and consolidate sections 501(h)(3), (4), and (5) to read:
 - Organizations to which this subsection applies – This subsection shall apply to any organization which is described in subsection (c)(3) except an organization that is described in section 170(b)(1)(A)(v).
- make corresponding formatting, numbering, and cross-referencing changes as needed.

Under this option we would still support removing the separate grassroots lobbying limit, lifting the \$1 million cap, addressing the regulatory limit on treating land purchases as exempt purpose expenditures for land conservation organizations, and eliminating the rules for affiliated groups, all as discussed in items 1-4 under Option A above.

Repeal 501(h)(7)

Present Law:

Code subsection 501(h)(7) currently provides that for 501(c)(3) organizations that have not elected to measure their lobbying under the expenditure test set forth in Code sections 501(h) and 4911 (“non-electing charities”), none of the provisions of section 501(h) or section 4911 may be used to construe the phrase “no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation” under subsection 501(c)(3).

Reasons for Change:

Section 501(h)(7) has been interpreted to forbid non-electing charities from using sections 501(h) and 4911 as guidance as to what activities constitute “lobbying” and how much

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organization and which, for the taxable year which includes the date the election is made, is described in subsection (c)(3)” to section 501(h)(7)(B).

of such activities are “substantial” for purposes of the requirement under Code section 501(c)(3) that “no substantial part” of a non-electing charity’s activities constitute “lobbying.” In the absence of any regulations or other precedential guidance on lobbying for non-electing charities, repealing section 501(h)(7) would offer these organizations needed clarity that would significantly simplify their compliance with the “no substantial part” lobbying limit.

It appears that section 501(h)(7) was enacted for wholly unrelated reasons in 1976 – reasons that have proven to be largely irrelevant. The legislative history suggests that Code section 501(h)(7) was enacted more to avoid any congressional impact on litigation to challenge the 501(c)(3) lobbying limits than to prohibit non-electing charities from looking to sections 501(h) and 4911 for guidance in measuring their organizations’ lobbying. The Joint Committee on Taxation’s *General Explanation of the Tax Reform Act of 1976* discusses section 501(h)(7) in the context of the concerns expressed by a number of churches and church-related groups that application of the new provisions of sections 501(h) and 4911 might lead the Service to reject arguments that the First Amendment prohibited restrictions on lobbying by churches. The Joint Committee explained that churches and integrated auxiliaries of churches (and certain other 501(c)(3) entities) were, for this reason, excluded from those charities eligible to make the election under 501(h). The explanation then states that section 501(h)(7) was enacted to prevent the new lobbying provisions from having “any effect on the way the lobbying language of section 501(c)(3)” should be interpreted for non-electing charities.⁹ In essence, it appears that Code section 501(h)(7) was intended to protect non-electing charities from possible negative impacts of the new lobbying provisions, not to constrain the non-electing charities reference to it.

Meanwhile, since the enactment of section 501(h)(7), the Service has failed to undertake a rulemaking or offer any guidance on the questions of what constitutes “lobbying” for non-electing charities and how much lobbying is “substantial” under section 501(c)(3)’s “no substantial part” limit on lobbying under which non-electing charities operate.¹⁰ Instead, the Service takes the position that what constitutes “substantial” with respect to “attempts to influence legislation” by non-electing charities must be evaluated based on a review of all the relevant “facts and circumstances.”¹¹ Lacking clear guidance, non-electing charities are tempted to draw analogies from the clear definitions of “lobbying” under section 4911 (and its accompanying regulations) and the clear lobbying limits of section 501(h)). However, the common interpretation of section 501(h)(7) is that it prohibits non-electing charities from relying

⁹ Joint Committee on Taxation, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 (December 29, 1976) at 415. The Joint Committee went on to note the recently concluded litigation in *Christian Echoes National Ministry, Inc., v. U.S.*, 470 F.2d 849 (10th Cir. 1972), *cert. den.*, 414 U.S. 864 (1973), stating that the lobbying provisions in the 1976 Act were “not to be regarded in any way as an approval or disapproval of the decision” (*Id.* at 415 – 416) echoing section 501(h)(7)’s disclaiming any efforts to construe the statute against non-electing charities. *See also*, Judith E. Kindell & John F. Reilly, *Lobbying Issues* in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1997, 286 (1996) (citing the Joint Committee explanation in support of the statement that “[b]y disqualifying churches and church-related organizations from making the election, Congress sought to remain neutral on the constitutional issue”).

¹⁰ Indeed, the CPE text cited above explicitly rejects any search for clarity as to how much lobbying is “substantial,” contrasting it with the 501(h) limits. *See* Kindell & Reilly, *supra*, at 279 – 280.

¹¹ *Id.* at 273 and 279-280.

on 501(h) and 4911 to determine what lobbying is or how much of it non-electing charities can engage in.¹²

Repealing section 501(h)(7) would significantly simplify compliance with the lobbying limits by non-electing charities by permitting them to draw analogies to the clear limits and definitions available to charities that can and have made the 501(h) election.¹³

Proposal:

Repeal section 501(h)(7).

Equalizing Local Lobbying Rules

Present Law:

Section 4911(e)(2) defines “legislation” for charities electing 501(h) to include “action with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure.” That definition is imported into the tax regime governing business expense deductions by the cross-reference in section 162(e)(4)(B).

However, section 162(e)(2) carves out an exception for local legislation for business taxpayers and their associations, allowing a business expense deduction, without limitation, for all ordinary and necessary expenses involved in appearances before or communications to “any local council or similar governing body.”

The result is that charities and business lobbying on the same piece of local legislation, such as a minimum wage ordinance or an environmental impact statement for a land use development, are treated unequally by the Code. The business or the association to which it belongs can use deductible funds without limit to advance its position, while the charity’s use of deductible funds is limited by section 501(h) or the insubstantial test. When the charity has exhausted its lobbying allowance, it cannot advocate further that year without risk of excise tax and/or loss of exemption.

¹² See, e.g., REPORT OF JAMES M. COLE, SPECIAL COUNSEL, SELECT COMMITTEE ON ETHICS, IN THE MATTER OF REPRESENTATIVE NEWT GINGRICH (dated January 17, 1997), *Appendix: Summary of Law Pertaining to Organizations Exempt from Federal Income Tax under Section 501(c)(3) of the Internal Revenue Code*, reprinted at 143 CONG. REC. H.224 (Jan. 21, 1997) at H.231: “The substantial-part test [sic] is applied without regard to the provisions of section 501(h). The law, regulations and rulings regarding the expenditure test may not be used to interpret the law, regulations and rulings of the substantial-part test.” [citing section 501(h)(7)].

¹³ Further clarity might be offered by an IRS rulemaking that provided clear guidance for non-electing charities, but that proposal is beyond the scope of this legislative simplification project.

Reasons for Change:

The charity lobbying rules should be aligned with the business rules. There is no public policy justification for giving businesses a tax advantage over charities in city and county affairs. In fact, it is highly burdensome for small community public interest groups to track and report to the IRS on expenditures for local lobbying. Often, local governing bodies have mixed legislative, administrative, or even judicial roles, voting on narrow issues such as building permits, zoning variances, appeals, and commission appointments. The IRS charity lobbying rules were designed with Federal and State legislatures in mind, and do not translate well into classification of expenses related to influencing quasi-administrative decisions that may involve only a few acres of land but are intensely important to community groups and to a commercial developer. See Colvin, “Give Charities Same Local Lobbying Exception Businesses Enjoy,” letter to General Accounting Office published in Tax Notes, (August 11, 1997).

Further, this disparate tax treatment may violate the Equal Protection Clause of the Fourteenth Amendment, in the absence of any rational basis.

Recommendations/Options:

Delete the words “any local council, or similar governing body” from section 4911(e)(2). With the cross-reference in section 162(e)(4)(B) in place, this will automatically put businesses and charities electing 501(h) on the same footing. It will make the 501(h) election more attractive to eligible charities as well, simplify reporting on Schedule C to Form 990, and relieve the IRS of an audit burden.

This step would also allow complete elimination of section 162(e)(2) that provides detail on the local business lobbying exception. To the extent that the language of sub-sections 162(e)(2)(B)(i) and (ii) may constrain the local business lobbying deduction, businesses would benefit from the simplification as well.

Private Foundations – Lobbying as a Taxable Expenditure

Present Law:

Section 4945(d) lists five different activities that constitute “taxable expenditures” for private foundations. Under section 4945(a), the initial tax imposed on the foundation is 20% of the expenditure and 5% on any foundation manager who agreed to the expenditure. If the expenditure is not corrected within the taxable period, the tax on the foundation rises to 100% and to 50% on a foundation manager who refused to agree to the correction. Given the heavy tax consequences, taxable expenditures are essentially prohibited activities for private foundations.

Section 4945(d)(1) defines the first type of taxable expenditure as made “to carry on propaganda, or otherwise to attempt, to influence legislation, within the meaning of subsection (e).” Section 4945(e) further defines attempts to influence legislation to include both grassroots and direct lobbying, but not to include nonpartisan analysis, study, or research and not to include contacts made with a legislative body in the foundation’s self-defense. (Foundation lobbying

definitions and exceptions are further elaborated in Treas. Reg. 53.4945-2, which is nine pages long and largely restates rules set out in regulations at 56.4911-0 *et seq.*)

Reasons for Change:

The absolute prohibition against lobbying activity in section 4945(d)(1) does not serve an articulated policy goal and adds burdensome complexity to grantmaking compliance. All section 501(c)(3) organizations are already limited by statute to an insubstantial level of lobbying and most non-private foundations have the option of electing precise dollar limits under section 501(h). Other tax rules provide that donors to foundations receive reduced charitable deductions and are publicly disclosed on Schedule B to Form 990PF, so as a matter of policy, foundation lobbying would be accompanied by less of a tax subsidy and more donor disclosure than is the case for public charities. Indeed, the lobbying prohibition on private foundations may not withstand First Amendment constitutional scrutiny as a restriction on freedom of speech and association if, after 40 years, there appears to be no rational basis to deny foundations the limited lobbying voice that other charities have.

Recommendations/Options:

Delete section 4945(d)(1) and also delete section 4945(e) as a definition of lobbying for private foundations that would no longer be necessary. This recommendation is coupled with the suggestion (see pages [3-10] above) that the lobbying expenditure-based regime of sections 501(h) and 4911 be applied automatically to all charities. Private foundations currently enjoy the same clear lobbying definitions and exceptions that public charities do under section 501(h), by regulation, and that clarity should not be lost in the transition to equal treatment.

As suggested in page [10] for all section 501(c)(3) organizations, a private foundation under a uniform lobbying regime should be able to opt out of the expenditure ceilings and follow the insubstantial rule instead, while preserving its access to the same lobbying definitions and exceptions applicable to all charities.

Eliminating the separate lobbying prohibition for private foundations would mean that most of the nine pages of regulations pertaining to foundations could be deleted.

Also in the interests of simplification, we recommend deleting section 4912(c)(2)(C) so that a private foundation choosing the insubstantial part test would have the same 5% tax consequence as a public charity if its lobbying activity caused loss of its 501(c)(3) exemption.

Private Foundations -- Election-Related Activities as a Taxable Expenditure

Present Law:

For private foundations, section 4945(d)(2) defines the second type of taxable expenditure as made “to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive.” This subsection is qualified by the phrase “except as provided in subsection (f)” and section 4945(f) narrowly constrains the voter

registration drives that a private foundation can support to those conducted by an organization that (1) is a 501(c)(3) entity, (2) operates in five or more states and in more than one election period, (3) must spend substantially all of its income on active programs, (4) meets a public support test that is stricter than the tests in sections 509(a)(1) and (2), and (5) may not receive contributions earmarked for specific locations or elections. Most of Treas. Reg. 53.4945-3 is devoted to details on how a public charity can qualify to conduct voter registration drives as a private foundation grantee under section 4945(f) and obtain an advance ruling from the IRS approving its qualifications.

Reasons for Change:

All section 501(c)(3) organizations are barred from engaging in any partisan political activity, and having different rules for private foundations than for other section 501(c)(3) organizations on voter registration drives creates burdensome complexity with no compelling public policy justification.

The rest of section 4945(d)(2) should also be eliminated because it prohibits a private foundation from influencing the outcome of any public election, which it is already prohibited from doing as a section 501(c)(3) organization. Section 4945(d)(2) served the purpose of being the only excise tax on political activity when it was enacted in 1969, but now that charities generally are subject to an excise tax on political activity under section 4955, there is no need for a separate penalty regime under section 4945(d)(2) for private foundations.

The principal difference between the two penalty taxes is the initial rate (20% for private foundations and 10% for other charities) on violations; similarly the penalty tax structure for foundation managers is double that for managers of other charities. However, the first-tier taxes serve mainly as a mild deterrent to correctable violations. For the more serious offenses—those that are not corrected—the 100% tax on the charity is identical and therefore eliminating the separate foundation tax regime would reduce excess wording without changing the tax result.

Aside from the extraordinary constraints on foundation-funded voter registration, the language imposing a tax on expenditures “influencing the outcome of any specific public election” creates a risk of interpretation different from the 501(c)(3) prohibition on political intervention related to candidates. There is a chance that ballot measure elections or even nonpartisan voter education could fall within the terms of section 4945(d)(2). By regulation, Treas. Reg. 53.4945-3 seems to align section 4945(d)(2) with the 501(c)(3) political prohibition, but the danger of divergent statutory meanings persists, and for no good reason.

Eliminating these sections would also relieve both public charities and the IRS of the burden of the advance ruling process for a public charity seeking assurance that it qualifies under section 4945(f) to conduct foundation-funded voter registration.

Recommendations/Options:

Delete section 4945(d)(2) on election-related activities of private foundations and also delete section 4945(f) since the special exception for private foundation-funded voter registration drives would no longer be necessary.

Delete the cross-referencing phrase in section 4955(e), “a taxable expenditure for purposes of section 4945,” since the elimination of section 4945(d)(2) would cause all political expenditures of section 501(c)(3) organizations to be subject to a uniform excise tax structure.

Eliminate Duplicative Definitions of “Political Expenditure” in Section 4955*Present Law:*

Section 4955 imposes an excise tax on any section 501(c)(3) that makes a “political expenditure.” The tax is equal to 10% of the expenditure, and, if the political expenditure is not corrected within a specified period, an additional excise tax equal to 100% of the expenditure is imposed on the organization. The term “political expenditure” is defined in section 4955(d)(1) as any amount paid or incurred in participating or intervening in any political campaign on behalf of, or in opposition to, any candidate for public office. Section 4955(d)(2) provides a breakdown of certain expenditures¹⁴ that are included in the definition of “political expenditure” for “an organization which is formed primarily for purposes of promoting the candidacy (or prospective candidacy) of an individual for public office (or which is effectively controlled by a candidate or prospective candidate...).”

Reasons for Change:

Section 4955(d)(2) is unnecessary, given the breadth of section 4955(d)(1), and may create confusion about what is included in the general definition of “political expenditure.” The Service has explained that the activities described in section 4955(d)(2) are a subset of the activities covered by section 4955(d)(1). 60 F.R. 62209-01, 1995-2 C.B. 253 (“[t]he plain language of the statute makes it clear that the expenditures described in section 4955(d)(2) are included within the general category of political expenditures that is described in section 4955(d)(1).”) By highlighting certain activities in section 4955(d)(2), a section that applies only to organizations that are formed primarily to promote a particular candidate or potential candidate or that is controlled by such candidate or potential candidate, Congress has created some doubt about whether these particular activities are considered “political expenditures” for other section 501(c)(3) organizations that are formed for non-political purposes or are independent from a candidate. If there is concern that these activities might escape the generally applicable definition of political campaign intervention, Congress could direct Treasury to issue

¹⁴ The specific expenditures noted in section 4955(d)(2) are the amounts paid or incurred by the organization (i) to the candidate or potential candidate for speeches or other services, (ii) for travel expenses of such individual, (iii) for polls, surveys or studies for use by such individual, (iv) for advertising, publicity or fundraising for such individual, or (v) for other activities that accrue to the benefit of such individual.

regulations to clearly define that term, and such guidance could include the activities noted in section 4955(d)(2) as a form of political campaign intervention for all purposes.

Recommendations/Options:

Delete section 4955(d)(2); re-write 4955(d) to read as follows: (d) Political expenditure. For purposes of this section, the term “political expenditure” means any amount paid or incurred by a section 501(c)(3) organization in any participation in, or intervention in (including the publication or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Align Section 527(c)(3) with Section 527(e)(1)

Present Law:

Under section 527(b)(1), a political organization is generally taxed on its “political organization taxable income.”¹⁵ “Political organization taxable income,” as defined in section 527(c)(1), does not include “exempt function income.”¹⁶ Section 527(c)(3) defines “exempt function income” to include certain types of income received by the organization “to the extent such amount is segregated for use *only* for the exempt function of the political organization.”¹⁷ The Regulations interpret this to mean that if more than an insubstantial amount of expenditures from a segregated fund are not for an exempt function, all receipts flowing into the fund are no longer considered “exempt function income” and may be subject to tax.¹⁸

In comparison, a “political organization” is defined as an organization “organized and operated *primarily* for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function.”¹⁹

A political organization’s “exempt function” is defined as including certain types of political activity, such as influencing or attempting to influence the selection, nomination, election, or appointment of individuals to certain offices.²⁰

Reasons for Change:

Present law leaves open the question of the status of organizations (or funds) that are primarily but not exclusively political. For example, an organization that primarily conducts political activities (i.e., at least 51% of its activities are political) will not qualify as a section

¹⁵ I.R.C. section 527(b)(1).

¹⁶ I.R.C. section 527(c)(1)(A).

¹⁷ I.R.C. section 527(c)(3) (emphasis added).

¹⁸ See Reg. section 1.527-2(b)(1).

¹⁹ I.R.C. section 527(e)(1) (emphasis added).

²⁰ I.R.C. section 527(e)(2).

501(c)(4) organization because it is not primarily operated for social welfare purposes. Under section 527(e)(1), such an organization could qualify as a political organization, but if more than an insubstantial amount of its activities are not conducted for an “exempt function,” it could not pay for those activities using tax-exempt receipts if it maintains only one bank account to fund its operations. Funds to pay for such non-political activities must be kept separate from the tax-exempt exempt function income, and that income would not qualify for the clear exclusion from taxable income under section 527(c)(1). This creates a trap for the unwary and needless complexity in maintaining multiple accounts to fund different types of perfectly permissible activities.

Accordingly, under current law, an organization or fund conducting primarily political activities, but also conducting more than insubstantial non-political activities, may fall into a “no-man’s land,” where it cannot take advantage of either the section 501(c)(4) or the section 527 tax exemptions. This is an awkward and potentially unfair result for primarily political organizations with substantial lobbying activities, given that an organization or fund conducting any other mixture of lobbying and political activities is eligible for tax exemption.

Furthermore, the requirement that amounts in a segregated fund be used “only” for political purposes diverges from the definition of “political organization” in section 527(e)(1), which requires that the organization be “primarily” engaged in exempt political purposes. It makes little sense to have a mismatch between the scope of political organization status and the scope of the exemption from income tax. This is especially true as a 527 political organization is in any case subject to tax on all of its investment income. Harmonizing the two provisions would allow section 527 to more closely parallel section 501(c)(4) and certain other categories of exempt organizations, which provide a tax exemption (with some exceptions) so long as the organization is primarily engaged in promoting its exempt purposes.²¹

Recommendation :

The word “only” in the last phrase of section 527(c)(3) should be replaced by the word “primarily” to make the definition of “exempt function income” in section 527(c)(3) consistent with the definition of “political organization” in section 527(e)(1). The language reading “to the extent such amount is segregated for use *only* for the exempt function of the political organization” would become “to the extent such amount is segregated for use *primarily* for the exempt function of the political organization.”

501(c)(3)/527(e) Definition

Current Law:

Section 501(c)(3) requires that an organization exempt under that section “not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.” Section 527(e) also describes

²¹ See, e.g., Reg. section 1.501(c)(4)-1(a)(2)(i).

political activity, which it calls “exempt function” and defines in the first sentence of section 527(e)(2) as “influencing, or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed. . . .” Section 527(f) specifies that, if an organization exempt under section 501(c) expends any amount for an exempt function, it will be taxed on the lesser of its net investment income or the aggregate amount spent for exempt functions.

Reasons for Change:

The difference in the language for these definitions of electioneering poses compliance difficulties for 501(c) organizations, such as section 501(c)(4), section 501(c)(5) and section 501(c)(6) organizations, all of which are permitted to engage in electioneering so long as such is not their primary activity, but which are also subject to section 527(f). The IRS relies on the “facts and circumstances” standard that it applies under section 501(c)(3) to define electioneering for purpose of determining the eligibility of such organizations for exemption. Revenue Ruling 81-95, 1981-1 C.B. 33, for example, concluded that a section 501(c)(4) organization may also carry on lawful electioneering so long as it is primarily engaged in activities that promote social welfare. For examples of what constitutes politicking, Revenue Ruling 81-95, however, looked to a number of revenue rulings involving prohibited electioneering for section 501(c)(3) organizations. Despite the difference language, the IRS has used the section 501(c)(3) “facts and circumstances” analysis to define exempt function for purposes of section 527 as well. *See, e.g.,* PLR 9808037, PLR 9652026, and PLR 9725036. Section 527 exempt function, however, covers a broader number of offices. Thus, section 501(c) organizations permitted to engage in electioneering and subject to the section 527 tax must measure their “political” activities under two different definitions.

We gave serious consideration to a proposal that would have made these two definitions completely harmonious. Purely from a simplification perspective, this would be the best result. However, we have concluded that there are sound public policy reasons not to narrow the areas of operation of 527 organizations. Indeed, without the broader reach of its statutory definition, an entity organized to advocate for a candidate for office in a political committee would be of uncertain tax status, possibly not even exempt. When such organizations are covered by 527(e), they are subject to public disclosure of receipts and expenditures, and enjoy only limited tax exemption (as they pay tax on investment income). Due to the heightened public disclosure and limited exemption, we conclude it would be unwise to discourage use of 527 organizations as the primary vehicle for (broadly speaking) political advocacy.

Further, because of the difference in language, it is not clear from the statute that the analysis to determine whether an activity constitutes “campaign intervention” should be the same as to determine if it is an “exempt function” (presuming the activity occurs with respect to an elected office covered by both provisions). It is necessary to be familiar with voluminous precedent and, indeed, non-precedential rulings, to understand this result. Describing the type of activity covered with the same language would eliminate unnecessary inconsistency that is the source of potential confusion.

Recommendation:

To eliminate the need for 501(c) organizations to track two types of “political” activities, one for purposes of measuring their primary purpose and one for tracking 527(f) tax liability, amend 527(f)(1) to read:

(f) Exempt organization, which is not political organization, must include certain amounts in gross income

(1) In general -- If an organization described in section 501(c) which is exempt from tax under section 501(a) expends any amount during the taxable year directly (or through another organization) for campaign intervention (within the meaning of section 501(c)(3)), then, notwithstanding any other provision of law, there shall be included in the gross income of such organization for the taxable year, and shall be subject to tax under subsection (b) as if it constituted political organization taxable income, an amount equal to the lesser of –

- (A) the net investment income of such organization for the taxable year, or
- (B) the aggregate amount so expended during the taxable year for such campaign intervention.

Additionally, the first sentence of section 527(e)(2) should be revised to parallel section 501(c)(3). Thus, the first sentence of section 527(e)(2) would define exempt function as “the function of participating, or intervening in (including the publishing or distribution of statements), on behalf of (or in opposition to) the selection, nomination, election, or appointment of any individual to any Federal, State or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed.”

Adjust 527(j) Reporting Thresholds

Current Law:

Section 527(j) provides for disclosure of contributions and expenditures of political organizations. Subsection (j)(5) excludes from the disclosure provisions political committees that are required to report to the FEC, State and local political party committees, political committees of State and local candidates, State and local political committees, and political organizations that anticipate gross receipts of less than \$25,000 for any taxable year. Organizations that are not exempt from the disclosure provisions are required under section 527(j)(3) to disclose the name and address, and in the case of an individual, the occupation and employer, of any person who receives an expenditure from the organization or who makes a contribution to the organization when the contributions or expenditures exceed the statutory threshold. Under section 527(j)(3)(A) the organization must disclose expenditures over \$500, and under section 527(j)(3)(B) the organization must disclose contributions over \$200.

Under the Federal Election Campaign Act, political committees are required to disclose contributions and expenditures over \$200. 2 U.S.C. section 434. Organizations that are not

political committees but engage in political activities that are not coordinated with candidates and do not make contributions to candidates are generally not considered political committees. These organizations are not subject to the disclosure requirements in section 434. They are potentially subject to disclosure provisions when they engage in communication that is “electioneering communication” as defined by 2 U.S.C. section 434(f)(3). Organizations engaging in electioneering communication must disclose expenditures for electioneering communication over \$10,000 and contributions for electioneering communication over \$1,000 (sections 434(f)(1) and (2)(a)).

Reason for Change:

The disclosure limits in section 527(j) are very broad and set at very low levels. The disclosure limits require recordkeeping and administrative costs that are unnecessary to achieve Congress’s goals of providing information to the electorate and limiting corruption in campaigns. Congress’s goals can be met with higher reporting levels, as indicated by Congress setting disclosure for electioneering communication at higher levels. In addition, many small organizations have gross receipts over \$25,000, and the low gross receipts threshold creates unnecessary burdens for these small organizations.

The higher reporting levels and an increase in the gross receipts threshold that subjects organizations to the disclosure provisions will decrease the administrative costs to political organizations and simplify their reporting requirements. Moreover, there has been a shift from entities organizing as section 527 political organizations to entities organizing as section 501(c)(4) social welfare organizations when section 527 political organization status may be more appropriate. Raising the disclosure and threshold amounts may reduce the incentives for these organizations to organize as social welfare organizations, thus increasing the overall level of public disclosure regarding political spending. Finally, the reporting levels in section 527 are not indexed for inflation.

Recommendation:

Raise the limits in section 527(j) to be consistent with the limits set for electioneering communications. Political organizations would be required to disclose contributions in excess of \$1,000 and expenditures in excess of \$10,000. The gross receipts threshold amount under 527(j)(4) that exempts organizations from the reporting requirements should be raised from \$25,000 to \$100,000.

Section 527(g)

Current Law:

Section 527(g) provides a special set of rules for newsletter funds established and maintained by candidates and officeholders, defining them as political organizations, but also limiting the definition of exempt function applicable to them, eliminating the specific deduction of \$100 provided in determining the taxable income of section 527 organizations, and defining candidates who can establish and maintain such funds. Section 527(e) generally defines a

political organization as an entity operated primarily for the purpose of accepting contributions or making expenditures for an “exempt function.” The second sentence of section 527(e)(2) defines “exempt function” to include “the making of expenditures” relating to a public or political office “which, if incurred by the individual, would be allowable as a deduction under section 162(a).”

Reason for Change:

Prior to the enactment of section 527, Rev. Rul. 73-356, 1973-2 C.B. 31 concluded that both subscription fees and solicited contributions received by a congressman solely to defray the costs of newsletters reports and questionnaires sent to constituents were includable in the congressman’s gross income. The ruling also concluded, however, that the amounts expended for these purposes were deductible under section 162(a) as ordinary and necessary business expenses.

Section 527(g), with its special rules for newsletter funds, was part of section 527 as originally enacted in 1975. It has continued unamended since then. The purpose of section 527(g) was to address the result of Rev. Rul. 73-356, which “improperly affects the taxable income that must be reported by elected officials.” S. Rep. No. 1357, 93d Cong., 2d Sess. 32 (1974), 1975-1 C.B. 517. The result of the new law was to treat newsletter funds “in a manner similar to an exempt political organization.” *Id.* at 33. The special mention of newsletter funds was required because the original definition of “exempt function” activity included political campaign activities but not activities that were in connection with an elected official’s duties while in office.

In 1988, section 527(e)(2) was amended to add to the definition of “exempt function” the “making of expenditures relating to [a public or political office] which, if incurred by the individual, would be allowable as a deduction under section 162(a).” This was a “conforming change” that was made alongside a change related to the reimbursement of employee business expenses. Rep. No. 445, 100th Cong., 2nd Sess. 6 (1988), 1988 U.S.C.C.A.N. 4515.

By its reference to section 162(a), this amendment to section 527(e)(2) now separately includes funds used for officeholder expenses including newsletter funds, as those expenses would otherwise be includable in section 162(e) under Rev. Rul. 73-356. While section 527(g) also includes the newsletter funds of candidates, those would also be covered by section 527(e)(2) as political campaign expenses. As a result, the special rule in section 527(g) – and its differential tax treatment of newsletter fund income deductions compared to other political organizations – is no longer needed, and adds needless complexity to section 527, the regulations, and Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*.

Recommendation:

Repeal section 527(g).

Section 527(h)

Present Law:

Political organization taxable income of a principal campaign committee, which is defined in section 527(h)(2) as the political committee designated by a candidate for Congress as his [sic] principal campaign committee, is taxed at the generally applicable corporate income tax rates. Political organization taxable income of all other political organizations is taxed at the highest corporate rate.

Reasons for Change:

Section 527(h) was enacted by the Economic Recovery Act of 1981 (P.L. 97-34). Prior to its enactment, all political organization taxable income was taxed at the highest corporate rate. The legislative history is silent as to the reasons for the change in 1981.

The effect of section 527(h) is to give principal campaign committees an economic advantage that is not supported by policy considerations. Removing section 527(h) would level the playing field for all political organizations. The effect of the proposed amendment is that all political organization taxable income will be taxed at the highest corporate rate.

Recommendations:

Delete section 527(h) in its entirety.

Exempt Contributions to Section 501(c)(4) Organizations from Gift Tax

Present Law:

Gift tax generally is imposed annually on the transfer of property by gift by any individual.²² Where property is transferred for less than an adequate and full consideration, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift for gift tax purposes.²³

The Code clearly provides that the gift tax applies to gratuitous transfers from one individual to another, such as lifetime transfers between family members. The application of the gift tax to contributions to nonprofit organizations is uncertain, however, with differing Code provisions and varying administrative treatment by the Service over the years.

²² See I.R.C. section 2501(a). Currently, the annual exclusion from gift tax generally applies to gifts of \$13,000 or less to each recipient, or \$26,000 per recipient for married couples. See I.R.C. section 2503(b). The lifetime exemption amount beyond that is \$5,000,000 for 2011 (indexed for inflation in 2012). See I.R.C. section 2505. However, the lifetime exemption is set to decrease to \$1,000,000 beginning in 2013. For 2011 and 2012, the gift tax rate is 35%, but is scheduled to increase to 55% beginning in 2013.

²³ See I.R.C. section 2512(b).

For example, contributions to section 501(c)(3) organizations are eligible for a deduction for gift tax purposes, effectively excluding such contributions from the gift tax.²⁴ Qualifying contributions to fraternal societies and veterans' organizations carry similar gift tax deductions.²⁵ Transfers to section 527 "political organizations" are excluded from the gift tax.²⁶

This specific exclusion for transfers to section 527 organizations was added to the Code following losses by the Service in two cases in which it sought to impose the gift tax on contributions that were used for what would generally be considered political purposes. As discussed below, however, the courts in the *Stern* and *Carson* cases determined that the transfers were not subject to gift tax on broader grounds.²⁷ Congress appears to have enacted this narrow exclusion to deal with the specific fact situation in the *Stern* and *Carson* cases, without intending for the gift tax to be broadly applied to contributions to other nonprofit organizations. In any event, the Code does not currently have any explicit gift tax deduction or exclusion for contributions to section 501(c)(4) organizations.

In a 1982 Revenue Ruling, the Service indicated that "gratuitous transfers to persons other than organizations described in section 527(e) of the Code are subject to the gift tax absent any specific statute to the contrary, even though the transfers may be motivated by a desire to advance the donor's own social, political or charitable goals."²⁸ This position is directly contrary to the reasoning in the *Stern* and *Carson* cases; in the ruling, the Service explicitly acquiesced in the result but not the reasoning of the latter.

Notwithstanding the lack of "any specific statute to the contrary," from 1982 until 2011, the Service did not appear to be administratively applying the gift tax to contributions to section 501(c)(4) organizations and there are no indications that there have been any significant enforcement efforts during this period. Such enforcement efforts as may have been undertaken were evidently intermittent, were certainly not widely known, and word of them shared in light of recent publicity came as a surprise to many practitioners in this area. Neither had the Service informed the public in announcements, gift tax return instructions or otherwise, of the applicability of the gift tax to 501(c)(4) contributions. Although the Service's website contains extensive information and instructions for nonprofit organizations and their donors, there is no mention of the possible application of the gift tax in these circumstances.

As a result, the 2011 public release by a contributor to a 501(c)(4) organization of a gift tax examination notice caused great confusion and alarm among section 501(c)(4) organizations, their contributors, and their tax advisors. Public statements by the Service that only five donors were being audited and that the review was being conducted as part of a gift tax compliance

²⁴ See I.R.C. section 2522(a)(2). Contributions to section 501(c)(3) organizations are also eligible for a deduction from income tax as charitable contributions. See I.R.C. section 170.

²⁵ See I.R.C. sections 2522(a)(3), 2522(a)(4).

²⁶ See I.R.C. section 2501(a)(4).

²⁷ *Stern v. United States*, 436 F. 2d 1327 (5th Cir. 1971); *Carson v. Comm'r of IRS*, 71 T.C. 252 (1978).

²⁸ Rev. Rul. 82-216, 1982-2 C.B. 220.

effort, rather than as part of a more general compliance review of contributions to 501(c)(4) organizations, raised questions about how these contributors and the 501(c)(4) recipient organizations were selected for audit, and whether more audits would be forthcoming. The problem was temporarily addressed when the IRS announced a moratorium on enforcement of gift taxes on gifts to section 501(c)(4) organizations, and termination of the audits it had opened.²⁹ The announcement promised any future enforcement would be prospective only. That remains the status quo today.

Tax-exempt organizations are permitted varying levels of educational, lobbying and political campaign activity. Section 501(c)(3) organizations may engage in unlimited educational activities and some lobbying activities, but may not participate or intervene in any political campaign on behalf of, or in opposition to, any candidate for public office. At the other end of the spectrum, section 527 “political organizations” generally are required to be organized and operated primarily for the purpose of accepting contributions and/or making expenditures to try to influence political elections, but may also engage in nonpartisan educational and purely issue-based lobbying activities as long as they are not the primary purpose.³⁰ 501(c)(4) organizations fall somewhere in the middle. They may engage in unlimited educational activities, like 501(c)(3) organizations, and unlimited lobbying activities, unlike either 501(c)(3) or 527 organizations. 501(c)(4) organizations may participate or intervene in political campaigns on behalf of, or in opposition to, any candidate for public office, so long as they are not “primarily engaged” in such political activities.³¹

In 1983, in *Regan v. Taxation With Representation*, three members of the Supreme Court indicated that the ruling upholding the limitation on lobbying activities by section 501(c)(3) organizations was constitutional, because the creation of an affiliate section 501(c)(4) organization provided a statutory alternative through which to pursue its goals through lobbying.³² In 1984, the Supreme Court confirmed this as an accurate description of its holding.³³

In 2000, in *Branch Ministries v. Rosotti*, the D.C. Circuit Court of Appeals upheld the bar on political campaign activities by section 501(c)(3) organizations.³⁴ Applying the constitutional reasoning used in *Regan*, the court indicated that the church could form a related organization

²⁹ See “Guidance for SB/SE Estate and Gift Tax and TE/GE Exempt Organizations,” (July 7, 2011) obtainable online at <http://www.irs.gov/newsroom/article/0,,id=241592,00.html>.

³⁰ An activity may be fairly characterized as educational or lobbying and still be treated as “exempt function” activity of a 527 organization so long as there are facts and circumstances to demonstrate a nexus between the activity and an ultimate electoral goal of the organization. See *Association of the Bar of the City of New York v. Commissioner*, 858 F. 2d 876 (2d Cir. 1988) (discussed in Judith E. Kindell & John Francis Reilly, *Election Year Issues*, Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal Year 2002 at 349-350). The IRS analysis of lobbying as a 527 exempt function activity is reflected in PLR 97-25-035 and PLR 98-08-037.

³¹ Reg. section 1.501(c)(4)-1(a)(2)(i).

³² *Regan v. Taxation With Representation*, 461 U.S. 540, 552-53 (1983) (Blackmun, J., concurring).

³³ See *FCC v. League of Women Voters*, 468 U.S. 364, 399-400 (1984).

³⁴ *Branch Ministries v. Rosotti*, 211 F.3d 137 (D.C. Cir. 2000).

under section 501(c)(4) which in turn may form a segregated political fund that could be utilized for political campaign activities.³⁵

In 2010, the Supreme Court in *Citizens United* found unconstitutional, on First Amendment grounds, a law which barred corporations from using general treasury funds either to expressly advocate the election or defeat of candidates or to broadcast electioneering communications within 30 days of a primary election and 60 days of a general election.³⁶ The bar was held unconstitutional notwithstanding the fact that a political action committee (“PAC”) could be created by the corporation and utilized for such speech, reasoning that a PAC is a separate association from the corporation, and is expensive and administratively onerous.³⁷ The Court did not address the section 501(c)(4) tax-exempt status of *Citizens United*, nor the applicable political campaign speech limitations under the Code and applicable Regulations.

Reasons for Change:

Many contributions to section 501(c)(4) “social welfare organizations” do not appear to constitute a “gift” within the meaning of the gift tax law. Careful advisors and wary donors can structure transactions to avoid characterization as a gift by incorporating an element of consideration. In addition, under the rationale of applicable case law, a donor who contributes to a 501(c)(4) in order to further the donor’s private financial or business interests is more likely to successfully argue that the contribution is not a taxable gift than one who gives out of a disinterested intent to further social welfare, an anomalous result from a policy perspective. The changes we propose would not necessarily simplify the Code itself, but would reduce the complexity of its application and the need to spend time and resources structuring transactions to maximize the donor’s ability to avoid the tax, which the IRS may or may not agree are sufficient to avoid the gift tax if enforcement activities are re-initiated. It would also help make sure that large donors are not deterred from making contributions to support lawful and constitutionally protected activities.

Long-standing judicial decisions determined that political contributions are exempt from the gift tax because political contributions are not “gifts” in the traditional sense.³⁸ In the *Stern* and *Carson* cases, the courts reasoned that payments to the nonprofit organizations to support their political activities were not intended as gifts, but rather were made for full and adequate consideration, either because the donor expected to benefit from the outcome of the organization’s activities, or because such activities were treated as a service performed for the donor.³⁹ Alternatively, payments in the nature of campaign contributions, when considered in the light of the history and purpose of the gift tax, were simply not gifts within the meaning of

³⁵ *Id.* at 143.

³⁶ *Citizens United v. FEC*, 130 S. Ct. 876, 897 (U.S. 2010)

³⁷ *Id.* at 898.

³⁸ *See Stern v. United States*, 436 F. 2d 1327,1330 (5th Cir. 1971); *see also Carson v. Comm’r of IRS*, 71 T.C. 252, 263 (1978).

³⁹ *Id.*

the gift tax law.⁴⁰ This same reasoning applies to contributions that individuals make to support the varied educational, lobbying, and political campaign activities of 501(c)(4) organizations that they wish to further.

Historically, “gifts” have been considered donations made out of a donor’s love, respect, admiration, or similar affections, to benefit family, friends or others, without any expected return benefit. Contributions to 501(c)(4)s, on the other hand, are often made with the goal of supporting these varied activities and achieving a particular impact on society in the donor’s lifetime. In addition, the gift tax was intended to serve as a backstop to the estate tax by imposing a tax on lifetime transfers to beneficiaries who would otherwise receive the money or property at the death of the transferor. Given the expectation of a return benefit to the contributor, and that 501(c)(4) contributions are simply not akin to transfers made to avoid the estate tax, contributions to section 501(c)(4) organizations do not appear to be gifts for gift tax purposes.

Contributions used for educational, lobbying and general social welfare purposes are similar to charitable contributions to section 501(c)(3) organizations, which are not subject to the gift tax. Likewise, contributions used for political campaign activities are akin to spending by section 527 organizations, which likewise are not subject to the gift tax. Given these similarities, and the common continuum of activities among these types of organizations, there is no logical reason to subject contributions to 501(c)(4) organizations to the gift tax.

Application of the gift tax to contributors to section 501(c)(4) organizations also raises serious First Amendment concerns. The limitation on the lobbying activities of section 501(c)(3) organizations was upheld in *Regan* in reliance on the availability of the use of affiliated section 501(c)(4) organizations to engage in such speech. Contributions to section 501(c)(4) organizations are not eligible for an income tax deduction. The *Regan* court found that barring a federal subsidy inherent in tax-deductible contributions to 501(c)(3) organizations to fund political speech was not a constitutionally significant restriction. Declining to subsidize First Amendment activities by denying a deduction for contributions may be permissible, but it is another thing entirely to restrict such activities by applying a very heavy tax on contributions made to support such activities.

Further, the bar on political campaign activities by section 501(c)(3) organizations similarly was upheld in *Branch Ministries* in reliance on the availability of the use of affiliated section 501(c)(4) organizations to engage in political campaign activities through the formation of a segregated political fund under section 527. More recently, however, the Supreme Court in *Citizens United* rejected the idea that the ability to form a separate political action committee served as a proper constitutional outlet for certain political speech otherwise barred by the statute in question. Clearly, the imposition of a gift tax creates restrictions on free speech and freedom of association for both section 501(c)(4) organizations and their contributors – restrictions that appear unconstitutional under the First Amendment. Application of the gift tax on 501(c)(4)

⁴⁰ See *Carson v. Comm’r of IRS*, 71 T.C. 252, 263-264 (1978) (“...we prefer to rest our holding on the broader grounds that campaign contributions... when considered in light of the history and purpose of the gift tax, are simply not ‘gifts’ within the meaning of the gift tax law”).

contributors also calls into question the constitutionality of the prohibitions on certain political speech by section 501(c)(3) organizations. The constitutional outlet for such political speech restrictions relied on by the Supreme Court in *Regan* and *Branch Ministries*, formation of a 501(c)(4) organization and a 527 political fund, may no longer be viable after the *Citizens United* ruling.

Finally, largely due to a lack of visible enforcement and education by the Service, significant confusion exists amongst donors, 501(c)(4) organizations, and their respective advisors regarding application of the gift tax to contributions to 501(c)(4) organizations -- or would, had the IRS not declared a moratorium on enforcement. From 1982 until 2011, the IRS did not consistently or rigorously enforce the gift tax on contributions to 501(c)(4)s and had been publicly silent on this issue, leading donors and advisors alike to believe that, while contributions to 501(c)(4)s were theoretically subject to the gift tax, the Service had little interest in taking on the thorny constitutional issues and fact-intensive analysis necessary to enforce gift tax on such contributions under existing case law. The Service's decision to impose a moratorium on enforcement after its unsuccessful 2011 foray into enforcement confirms these difficulties. Amending the Code to explicitly exempt such transfers from gift tax would eliminate the uncertainty inherent in relying on the reasoning of old case law, ensure uniformity of application, and reduce the resources (in the form of estate planners and legal advisors) donors concerned about the potential application of gift tax would have to employ to evaluate and structure contributions to 501(c)(4)s should the moratorium ever be lifted. It would also end two uncertainties: what efforts are sufficient to avoid application of the gift tax, and whether and when the IRS's self-imposed moratorium might end.

Recommendations:

We recommend that either of the following two legislative proposals be enacted to effectively eliminate the application of the gift tax to contributions to section 501(c)(4) organizations:

1. Amend section 2501(a) to add the following subsection (5) (and renumber subsequent subsections):
 - (5) Transfers to social welfare organizations: Paragraph (1) shall not apply to the transfer of money or other property to a social welfare organization (within the meaning of Section 501(c)(4)) for the use of such organization.

or

2. Amend section 2522(a) to provide that, in computing taxable gifts for the calendar year, there shall be a deduction, in the case of a citizen or resident, in the amount of all gifts made during such year to or for the use of a section 501(c)(4) organization, by adding the following subsection (3) and renumbering subsequent subsections:
 - (3) a social welfare organization described in section 501(c)(4)