LR #5 SECTION 501(c)4) POLITICAL CAMPAIGN ACTIVITY: Enact an Optional "Safe Harbor" Election That Would Allow IRC § 501(c)(4) Organizations to Ensure They Do Not Engage in Excessive Political Campaign Activity

PROBLEM

Organizations exempt from tax as Internal Revenue Code (IRC) § 501(c)(3) organizations, contributions to which may be tax deductible, are prohibited from *any* participation or intervention in political campaigns on behalf of (or in opposition to) candidates for public office.[1] However, these organizations are permitted to engage in lobbying activity, so long as the activity is "insubstantial."[2] Subsection (h) of IRC § 501, added by Congress in 1976, is an elective "safe harbor" that allows for a determination, based solely on the electing IRC § 501(c)(3) organization's expenditures, of whether its lobbying activities are within permissible limits.[3] An IRC § 501(c)(3) organization that does not make an election under IRC § 501(h) is subject to a "facts and circumstances" test to determine whether it has engaged in excessive lobbying activity.[4]

Unlike IRC § 501(c)(3) organizations, IRC § 501(c)(4) organizations, contributions to which are generally not deductible, may engage in substantial lobbying.[5] IRC § 501(c)(4) organizations may also engage in political campaign activity, but only if they are "*primarily* engaged in promoting in some way the common good and general welfare of the people of the community."[6] There is no statutory or regulatory quantification of the term "primarily" for this purpose, nor is there a statutory or regulatory "safe harbor" for determining whether an IRC § 501(c)(4) organization's political campaign activities are within permissible limits. Section 501(c)(4) organizations engaging in political campaign activity are subject to a "facts and circumstances" test to determine whether they have engaged in impermissible political activity.

According to the Taxpayer Bill of Rights the IRS adopted on June 10, 2014, taxpayers have the *right to be informed*, *i.e.*, "the right to know what they need to do to comply with the tax laws."[7] An elective safe harbor for IRC § 501(c)(4) organizations, by establishing acceptable limits of political campaign activity and providing a method for measuring those activities, would support this right.

EXAMPLE

XYZ, Inc., which engages in political campaign activity through its volunteers, applies to the IRS for recognition of its exempt status under IRC § 501(c)(4) as a social welfare organization. Neither XYZ nor the IRS can determine from statutory, regulatory, or judicial authorities:

- How to measure XYZ's social welfare activity;

1 IRC §§ 170(c) and 501(c)(3).

2 IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(b)(3)(i).

3 Tax Reform Act of 1976, Pub. L. No. 94-455, § 1307, 90 Stat. 1520, 1720 (1976).

4 Treas. Reg. § 1.501(h)-1(a)(4).

5 See, e.g., Treas. Reg. § 1.504(c)(4)-1(a)(2)(ii), referencing "action" organizations.

6 IRC § 501(c)(4)(A); Treas. Reg. § 1.501(c)(4)-1(a)(2)(i) (emphasis added). Treas. Reg. § 501(c)(4)-1(a)(2)(ii) provides that promoting social welfare does not include participation or intervention in political campaigns.

7 Taxpayer Bill of Rights, *available at* http://www.taxpayeradvocate.irs.gov/About-TAS/Taxpayer-Rights.

- Whether there is a required minimum percentage of such activity, or whether multiple factors should be considered; and if so;
- The weight to be given to these factors.[8]

The IRS's "expedited" procedures would allow it to approve XYZ's application based on XYZ's attestations about how it allocates its time and resources. However, XYZ does not meet the requirements for "expedited" approval because it relies on volunteers whose time is "counted" in determining the portion of its resources allocated to political campaign activity. Confronted with this uncertainty, XYZ may decide to simply refrain from *any* political campaign activity, even though some level of such activity would be permissible. Alternatively, XYZ may gauge for itself the level of permissible political campaign activity and take the risk that the IRS will agree, based on all the facts and circumstances, that it guessed correctly.

RECOMMENDATION

To provide greater certainty to IRC § 501(c)(4) organizations, the National Taxpayer Advocate recommends that Congress enact an optional safe harbor election similar to IRC § 501(h) that would allow IRC § 501(c)(4) organizations to elect the use of a numerical test, based solely on their expenditures (*i.e.*, without counting volunteer activities), to determine the amount of political campaign activity they may engage in without jeopardizing their exempt status.

PRESENT LAW

Congress Provided a Safe Harbor for IRC § 501(c)(3) Organizations with Respect to Their Lobbying Activities.

Organizations exempt under IRC § 501(c)(3) are prohibited from *any* participation or intervention in political campaigns on behalf of (or in opposition to) candidates for public office.[9] However, they may engage in lobbying activities (*i.e.*, activities to influence legislation) as long as those activities are "insubstantial."[10] One practitioner described this statutory framework (as it existed prior to enactment of IRC § 501(h)) as follows:

> Probably the major objection to present law is related to its uncertainty. Although the present law has been in effect for approximately 40 years, neither the courts nor the Internal Revenue Service has been able to derive a universally acceptable definition of "substantial." The Service has refused to take a position on the meaning of substantial in quantitative terms, such as what percentage of expenditures or time devoted to lobbying activities would be deemed insubstantial. Moreover, the Service has at times attempted to view the term "substantial," not only in undefined quantitative terms, but in undefined qualitative terms as well. A "facts and circumstances" test, apparently called for by the Regulations, takes the bewildered charities

8 Moreover, if the IRS denies XYZ's application, or approves the application but later revokes XYZ's exempt status due to excessive political activity, XYZ may not seek a declaratory judgment IRC § 7428. *See* Legislative Recommendation: *Amend IRC § 7428 to Allow IRC § 501(c)(4), (c)(5), or (c)(6) Organizations to Seek a Declaratory Judgment to Resolve Disputes About Exempt Status and Require the IRS to Provide Administrative Review of Automatic Revocations of Exempt Status*, *infra*.

9 IRC § 501(c)(3) provides that a charity may "not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

10 IRC § 501(c)(3) recognizes exempt status for an organization "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes" only if "[n]o substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation." Treas. Reg. § 1.501(c)(3)-1(b)(3) provides that an organization "is not organized exclusively for one or more exempt purposes if its articles expressly empower it: (i) To devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise."

> out of definable areas, such as specific financial expenditures and allocations of staff time, and into completely uncharted areas, including not only time of volunteers, but importance of the effort, and very possibly other factors. This appeared to be the case in the Service's attempt to revoke the section 501(c)(3) status of the Maryland Association for Mental Health, Inc., largely on the grounds that the association had engaged in substantial lobbying activity through the use of unpaid volunteers. While such uncertainty gives the Service flexibility, this is exactly what is objectionable to the charities. As Mortimer Caplin pointed out in his testimony before the House Committee on Ways and Means, revenue agents are normally accounting majors, not philosophy majors, and it is almost impossible to tell what one of them would decide on a given set of facts. Inconsistent enforcement of the law by the Internal Revenue Service would naturally follow.[11]

In 1976, "to set relatively specific expenditure limits to replace the uncertain standards of present law" Congress enacted IRC § 501(h).[12] The provision allows eligible organizations to elect the use of a numerical test based solely on their expenditures to determine whether they have engaged in excessive lobbying activities, thereby causing them to be subject to an excise tax or to lose tax-exempt status under IRC § 501(c)(3). This numerical test is purely elective and thus operates as a "safe harbor." Eligible organizations that do not elect the expenditure test remain subject to the "insubstantial" test, a facts and circumstances inquiry.[13]

Under the election, the amount of time an organization spends on an activity is not relevant except to the extent an expenditure (*e.g.*, compensation) thereby arises. Volunteer activity is relevant to the determination only to the extent it triggers an expenditure. Section 501(h) limits are determined by reference to IRC § 4911, which imposes an excise tax on "excess lobbying expenditures."[14] If the § 501(c)(3) organization's lobbying expenditures do not exceed the IRC § 4911(c) limits, the organization will not be taxed under § 4911 or lose its § 501(c) exemption.[15]

For electing organizations, permissible lobbying expenditures are calculated on a sliding scale that is a function of the organization's "exempt purpose expenditures."[16] For example, under IRC § 4911, an organization with exempt purpose expenditures of $500,000 or less could spend 20 percent of its exempt

11 John B. Hufaker, Esq., Pepper, Hamilton & Sheetz (Philadelphia), *Legislative Activities of Charitable Organizations Other Than Private Foundations, with Addendum on Legislative Activities of Private Foundations*, Research Papers sponsored by the Commission on Private Philanthropy and Public Needs (also known as the Filer Commission) 2917, 2920 (1977) (fn. refs. omitted).

12 H.R. Rep. No. 94-1210, pt. 1, at 8 (1976) and S. Rep. No. 94-938, pt. 2, at 80 (1976), noting the provision "is designed to set relatively specific expenditure limits to replace the uncertain standards of present law, to provide a more rational relationship between the sanctions and the violations of standards, and to make it more practical to properly enforce the law. However, these new rules replace present law only as to charitable organizations which elect to come under the standards of the bill;" Tax Reform Act of 1976, Pub. L. No. 94-455, § 1307, 90 Stat. 1520, 1720 (1976). For a discussion of the lengthy legislative history of the provision, described as representing "a compromise on a compromise on a compromise on a compromise" see Jill S. Manny, *Nonprofit Legislative Speech: Aligning Policy, Law, and Reality*, 62 Case W. Res. L. Rev. 757 (2012).

13 Treas. Reg. § 1.501(h)-1(a)(4). When final regulations under § 501(h) were issued in 1990, former IRS Commissioner Mortimer Caplin took the opportunity to advise tax practitioners: "[u]nderstanding that the decision whether to elect [the section 501(h) safe harbor] should only be made after a careful review of its implications, we are convinced that making the election will serve the interest of the great majority of eligible 501(c)(3) organizations that engage even remotely in efforts to influence legislation or public opinion or in other activities touching on public policy." ABA Sec. on Tax'n, *Open Letter*, 10 Sec. Tax'n Newsl. 73 (1990-91).

14 IRC § 501(h)(2).

15 Treas. Reg. § 1.501(h)-1(a)(3).

16 IRC § 4911(c)(2). IRC § 4911(e)(1)(A) provides that "the term 'exempt purpose expenditures' means, with respect to any organization for any taxable year, the total of the amounts paid or incurred by such organization to accomplish purposes described in section 170(c)(2)(B) (relating to religious, charitable, educational, etc., purposes)."

purpose expenditures on lobbying activities. An organization with exempt purpose expenditures of more than $500,000 but not over $1 million could spend $100,000 plus 15 percent of its exempt purpose expenditures over $500,000 on lobbying activities.[17] An organization with exempt purpose expenditures of more than $1 million but not over $1.5 million could spend $175,000 plus ten percent of its exempt purpose expenditures over $1 million on lobbying activities.[18] An organization with exempt purpose expenditures of more than $1.5 million could spend $225,000 plus five percent of the excess of the exempt purpose expenditures over $1.5 million.[19] The lobbying expenditures cannot exceed $1 million for any organization (a limit that is reached when exempt purpose expenditures equal $17 million), and "grass roots" expenditures must always be less than or equal to 25 percent of the permissible lobbying expenditure as calculated with the sliding scale.[20]

Congress Has Not Provided a Safe Harbor for IRC § 501(c)(4) Organizations with Respect to Political Campaign Activities.

As discussed above, organizations exempt under IRC § 501(c)(4) are not subject to the same restrictions on their lobbying activities as IRC § 501(c)(3) organizations.[21] The statutory prohibition on *any* participation or intervention in political campaigns on behalf of candidates for public office, applicable to IRC § 501(c)(3) organizations, also does not apply to organizations exempt under IRC § 501(c)(4). Thus, IRC § 501(c)(4) organizations can engage in some amount of political campaign activity, so long as they are "*primarily* engaged in promoting in some way the common good and general welfare of the people of the community."[22]

"Primarily," like "insubstantial" (in the context of evaluating lobbying activities of IRC § 501(c)(3) organizations), is undefined in the statute and regulations.[23] The IRS uses a facts-and-circumstances test to determine if an organization has engaged in impermissible political campaign activity.[24] Unlike IRC § 501(c)(3) organizations, which can make a IRC § 501(h) safe harbor expenditure election with respect to their lobbying activities, IRC § 501(c)(4) organizations do not have the benefit of an elective statutory "safe harbor."

17 IRC § 4911(c)(2).

18 *Id*.

19 *Id.*

20 *Id*. Under IRC § 4911(c) and (d) "grass root expenditure" means expenditures for the purpose of influencing legislation "through an attempt to affect the opinions of the general public or any segment thereof" (as opposed to "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").

21 A section 501(c)(4) organization may qualify for exemption even if, because of its lobbying activities, it is an "action" organization (*e.g.*, its main objective can only be attained by legislation and its main activity is advocating for that legislation). *See* Treas. Reg. § 1.504(c)(4)-1(a)(2)(ii), citing the action organization regulations of Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii) and (iv).

22 IRC § 501(c)(4)(A) exempts organizations operated "exclusively" for the promotion of social welfare, but Treas. Reg. § 1.501(c)(4)-1(a)(2)(i) allows exempt status to organizations "*primarily* engaged in promoting in some way the common good and general welfare of the people of the community" (emphasis added). In any event, Treas. Reg. § 501(c)(4)-1(a)(2)(ii) provides that promoting social welfare does *not* include participation or intervention in political campaigns.

23 On Nov. 29, 2013, the Treasury Department and the IRS requested public comment on a proposed regulation that would provide guidance to tax-exempt social welfare organizations on political activities related to candidates that will not be considered to promote social welfare. Prop. Treas. Reg. § 1.501(c)(4)-1, 78 Fed. Reg. 71535 (Nov. 29, 2013), *available at* http://www.regulations.gov/#!documentDetail;D=IRS-2013-0038-0001. However, on May 22, 2014, the IRS announced that "[g]iven the diversity of views expressed and the volume of substantive input," it would revise the proposed regulation before proceeding with a public hearing. Revised proposed regulations have not been published to date.

24 Rev. Rul. 2007-41, 2007-25 I.R.B. 1421; IRS Publication 4221-NC, *Compliance Guide for Tax-Exempt Organizations (Other than 501(c)(3) Public Charities and Private Foundations)*, 5-6 (Sept. 2014), *available at* http://core.publish.no.irs.gov/pubs/pdf/p4221-nc–2014-09-00.pdf. The IRS may in some cases rely instead on an applicant's attestations pursuant to procedures adopted in 2013, discussed below.

At the administrative level, in 2013, after the Treasury Inspector General for Tax Administration (TIGTA) reported the IRS had adopted inappropriate procedures for evaluating IRC § 501(c)(4) applications, the IRS began issuing Letter 5228, *Application Notification of Expedited 501(c)(4) Option*, to certain organizations whose applications for exempt status under IRC § 501(c)(4) indicated the organizations could potentially be engaged in political campaign intervention or be providing private benefit to a political party.[25] The letter offers a "safe harbor" to these organizations if they can certify, among other things, that:

- They devote 60 percent or more of both their spending and time (including volunteer time) to activities that promote social welfare as defined by section 501(c)(4); and
- Campaign intervention amounts to less than 40 percent of both their spending and time (including volunteer time).[26]

According to the IRS's interim guidance to employees, organizations providing the required attestations within 45 days of the date of the letter will receive recognition of exempt status within one month.[27] There is no explanation in the letter to taxpayers, in the interim guidance to employees, or elsewhere, of why the IRS decided upon the 60/40 ratio or why volunteer time is considered relevant. The procedures have not been incorporated in the Internal Revenue Manual (IRM), but even if they were, the IRS could change or remove them at any time.[28] The IRS has not issued any guidance such as a revenue procedure that would require it to continue to follow these procedures.

The IRS reviews the applications of organizations that are not eligible to receive Letter 5228, or that do not respond with the required attestations within 45 days, using "regular" procedures, *i.e.*, "review[ing] the facts and circumstances in the pending application and any other materials to determine if the organization is operated primary for social welfare purposes, including by evaluating the possible political issues."[29]

REASONS FOR CHANGE

The extent to which an IRC § 501(c)(4) organization may engage in political campaign activity generally requires an evaluation of the relevant facts and circumstances, yet there is little statutory, regulatory, or judicial guidance as to what facts and circumstances are relevant and how they should be evaluated in relation to each other. This creates uncertainty for taxpayers, in the same way that "inconsistent enforcement of the law by the Internal Revenue Service would naturally follow" from the absence of a safe harbor for evaluating IRC § 501(c)(3) organizations' lobbying activities, which was the case prior to the 1976 enactment of IRC § 501(h).

25 Tax Analyst, *IRS Provides Instructions for Optional Expedited Process for Some Tax-Exempt Applications*, 2013 TNT 129-15 (July 5, 2013); Interim Guidance, TEGE-07-1213-24, *Request for EO Technical Assistance* (Dec. 23, 2013) *available at* http://www.irs.gov/pub/foia/ig/spder/TEGE-07-1213-24%5b1%5d.pdf (removing the requirement that the application have been outstanding for a specified number of days); Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2013-10-053, *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review* (May 14, 2013) *available at* http://www.treasury.gov/tigta/auditreports/2013reports/201310053fr.pdf.

26 IRS Letter 5228, *Application Notification of Expedited 501(c)(4) Option* (Sept. 2013), *available at* http://www.irs.gov/pub/irs-tege/letter5228.pdf. The letter contains specific instructions explaining what types of expenditures do not promote social welfare (*e.g.*, "direct or indirect participation or intervention in any political campaign on behalf of (or in opposition to) any candidate for public office").

27 Interim Guidance, TEGE-07-1213-24, *Request for EO Technical Assistance* (Dec. 23, 2013) *available at* http://www.irs.gov/pub/foia/ig/spder/TEGE-07-1213-24%5b1%5d.pdf.

28 *See Barnes v. Comm'r*, 130 T.C. 248, 255 (2008) and cases cited therein (stating that the IRM "does not have the force of law, is not binding on the Commissioner, and does not confer any rights on the taxpayer.").

29 Interim Guidance, TEGE-07-1213-24, *Request for EO Technical Assistance* (Dec. 23, 2013) *available at* http://www.irs.gov/pub/foia/ig/spder/TEGE-07-1213-24%5b1%5d.pdf.

Moreover, even if the IRS can decide, in an objective and consistent manner, whether organizations have engaged in too much political campaign activity to be exempt under IRC § 501(c)(4), it may not be *perceived* as doing so. Its failure to provide any rationale for establishing the 60/40 allocation in the context of its Letter 5228 procedures exacerbates the perception of arbitrariness. Further, these attestation procedures the IRS has adopted for some IRC § 501(c)(4) applicants include volunteer time in the calculus of permissible levels of political campaign activity. This disproportionately excludes organizations from exempt status when they actually spend a *smaller* portion of their expenditures on political campaign activity. Enacting an elective safe harbor for IRC § 501(c)(4) organizations would support taxpayers' *right to be informed* by setting out parameters they can reference and rely on in determining what they must do to comply with the law. By excluding volunteer time from the equation, the safe harbor provision would allow for a determination of whether amounts that were not subject to tax when contributed to an organization were *expended* in a manner consistent with exempt status under IRC § 501(c)(4).

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that Congress enact a provision analogous to the current elective safe harbor under IRC § 501(h), which is available to IRC § 501(c)(3) organizations. This new safe harbor would be available to IRC § 501(c)(4) organizations that engage in political campaign activity.

The provision would not only establish an acceptable level of political campaign activity that does not promote social welfare and do so with reference to an organization's exempt social welfare activity, but would also take into account the size and budget of the organization. Such a provision would quantify the amount of permissible political campaign activity by relating it to the organization's expenditures in furtherance of its exempt (social welfare) purpose. Thus, organizations holding themselves out as meeting the requirements for receiving contributions that are exempt from tax under IRC § 501(c)(4) could be evaluated on how they actually expend those contributions.

Under this analysis, as with the IRC § 501(h) election, volunteer time and activity, which do not generate taxable income for which tax exemption would be available in the first instance, would be irrelevant (except to the extent an expenditure arises as a consequence of volunteer activity, *e.g.*, amounts spent to solicit and train volunteers or transport them to rallies or shopping malls where they campaign).