
POLITICAL ACTIVITY LIMITS AND TAX EXEMPTION: A GORDIAN'S KNOT

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The article considers the correct tax treatment of organized political activity by the tax system and discusses the problems that have arisen from political activity depending on whether the organization is a charity, a noncharitable exempt, or a political organization. The article then examines administrative and legislative options to the problems raised by political activity. Quantum-based solutions to the problem of political activity by noncharitable exempts do not provide a clear advantage over present law. Formally quantifying the “primarily” test would result in more certainty, but would also require that the Service be more, not less, involved in the regulation of political activity. If the policy goal is to curb political activity by noncharitable exempts, changing the test from “primarily” to something more restrictive like “substantially” or “exclusively” would be effective, but would create new categories of taxable nonprofits that are treated worse than political organizations for engaging in less political activity, which is irrational. Further, it is not clear, especially after the *Citizens United* decision, why as a matter of tax exemption the regulations decree that political activity may not further noncharitable exempt purposes. Before *Citizens United*, the political activity limits were not especially relevant, but at least helped to differentiate organization types. However, *Citizens United* largely rendered existing tax law limitations obsolete by making a new kind of multi-purpose organization possible. As a result, definitional political activity limits are no longer justified and should be eliminated, but only if the 527(f) tax on investment income remains vital and the differences in the disclosure regimes between political organizations and noncharitable

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exempts are erased. In addition, Congress should affirm that the gift tax does not apply with respect to political contributions, but also extend the income tax to transfers of appreciated property to noncharitable exempts. Further, Congress should acknowledge that the increase in political speech by noncharitable exempts will lead to abuse of charitable organizations, and take steps to prevent the laundering of independent expenditures through the charitable form. Congress also should recognize that *Citizens United* has led to a need to develop a new tax baseline for political activity conducted “for profit” or outside of section 527.

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I. INTRODUCTION

Human beings are political animals. In a democracy like the United States, this means that the impulse to intervene in a political campaign by advocating expressly for or against a candidate is innate. Our freedom to indulge this impulse is protected by the First Amendment to the U.S. Constitution, as “the most fundamental [of] First Amendment activities.”¹

Taxation is also fundamental to a free society. Payment of taxes is a charge on citizenship — “what we pay for [a] civilized society.”² Taxes allow for the common defense and general welfare and fund a government that provides the basis for electoral activity.

But apart from the obvious fact that tax policy is a major political issue, the puzzle is what these two features of civil life — political activity and the payment of taxes — have to do with one another. For those not versed in the federal income tax law, the answer might be appealingly obvious: nothing. Political activity is about speech, and taxation is about raising revenue. They do not seem directly connected.

Merely a cursory glance at recent news, however, shows that taxation and political activity have an ominous link. In May 2013, the Internal

¹ See *Buckley v. Valeo*, 424 U.S. 1, 14 (1976).

² *Compania Gen. de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

Revenue Service (Service) was accused of political bias in determining the tax-exempt status of applicants.³ If true, this would have been a scandal of similar proportion to when President Nixon ordered the Service to investigate his political enemies.⁴ It would also have been an abuse of power, and perhaps worthy of the indignant exclamations and hostile finger pointing prevalent in the hearing rooms of Congress over the summer of 2013.⁵

But if false — if rather than political targeting, the Service had been attempting, clumsily, to administer the tax law — then the accusations highlight important questions about the relevance of political activity to the tax system. Why would the taxing authority ask questions about an organization’s prospective political activity if not for nefarious reasons? Why else would the Service willingly wander into a thicket of controversy, especially when little revenue is likely at stake? To those familiar with tax law, the answer is easy. The Internal Revenue Code (Code) dictates that political activity is relevant to an organization’s tax status. Accordingly, the Service should, indeed must, ask about political activity — the topic is a legitimate target of inquiry.

Thus, political activity plainly matters for tax purposes. What is less clear, however, is why it matters. The relationship between political activity and taxation is neither obvious nor widely understood. Why does the tax classification of an organization depend on whether the organization engages in political activity, and if it does, on the amount of activity? Should the fact of political activity convert a tax-exempt entity into a taxable one? Should too much political activity result in reclassification of a tax-exempt entity from one type to another type? What is at stake that forces the Service to become involved in such questions, and as a result, jeopardizes the integrity, not to mention the funding and mission, of a vital administrative agency?

³ TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2013-10-053, INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW (2013).

⁴ David Dykes, *Former IRS Chief Recalls Defying Nixon*, USA TODAY (May 26, 2013), <http://www.usatoday.com/story/news/nation/2013/05/26/irs-chief-defied-nixon/2360951/> (describing former Internal Revenue Service (Service) Commissioner Johnnie Mac Walters’ efforts to prevent Service involvement in Nixon’s investigation requests and noting comparisons between contemporary accusations of Service bias).

⁵ *The IRS: Targeting Americans for Their Political Beliefs: Hearing Before the Comm. on Oversight and Gov’t Reform*, 113th Cong. (2013). As of this writing, the controversy continues. *Hearing with IRS Commissioner John Koskinen: Hearing Before the Comm. on Ways and Means*, 113th Cong. (2014), opening statement of Chairman Camp (stating that “[t]he time for denials, delays, obstruction and attempts to blow this off as a “phony scandal” are over. This Committee is fed up and we expect some answers, from not only the IRS, but the whole Administration.”).

The answers to these questions — always of interest — have become urgent after the Supreme Court’s decision in *Citizens United v. Federal Election Commission*.⁶ *Citizens United* allowed corporations and labor unions to engage in unlimited independent political activity — in effect establishing a major new legal category of speech. This represents a fundamental change to the legal landscape, the effects of which are still being felt.

One of the main immediate results is that the funding and conduct of political activity has expanded to new organization types. Before *Citizens United*, the bulk of political activity was conducted by the “political organization,” a type of tax-exempt entity whose donors must be publicly disclosed.⁷ After *Citizens United* it is natural to expect that political activity will be conducted much more by “social welfare” and other noncharitable exempt organizations like labor unions and trade associations, groups that are not required to disclose their donors.⁸ Political activity also might migrate to the for-profit or taxable nonprofit form.⁹

Even apart from such effects, the full legal significance of *Citizens United*’s expansion of speech has yet to be understood. This article argues that a main effect of *Citizens United* is to render the existing tax-exemption architecture outmoded, if not obsolete. The Service’s targeting scandal was but a mere symptom of this obsolescence. Accordingly, as part of tax reform, lawmakers should undertake a comprehensive review of political activity within the tax-exemption system. This article provides a guide for such a review and an analysis of various administrative and legislative solutions.

Part II considers the relationship between political activity and the tax system from a theoretical and practical perspective. This includes a discussion of the normative and historical baseline for taxing political

⁶ 558 U.S. 310 (2010).

⁷ I.R.C. § 527(j); Miriam Galston, *Emerging Constitutional Paradigms and Justification for Campaign Finance Regulation: The Case of 527 Groups*, 95 GEO. L.J. 1181, 1181 (2007) (noting how 527 groups were the center of most concerns about campaign finance following the 2004 election).

⁸ Thomas B. Edsall, *Dark Money Politics*, N.Y. TIMES OPINIONATOR BLOG (June 12, 2013, 9:39 PM), http://opinionator.blogs.nytimes.com/2013/06/12/dark-money-politics/?_r=0. Ellen P. Aprill, *Regulating the Political Speech of Noncharitable Exempt Organizations After Citizens United*, 10 ELECTION L.J. 363, 363 (2011) (stating that: “[t]he role of noncharitable exempt organizations . . . was perhaps the key feature of [the 2010] election”).

⁹ Randy Krehbiel, *T.W. Shannon Supporters Set Up For-Profit Corporation to Pay for Ads*, TULSA WORLD (Mar. 24, 2014).

activity by individuals, both acting alone and through the pooling of efforts, and the relevance of the nonprofit form to the conduct of political activity.

Part III briefly outlines the problems that political activity presents for the income tax system. One problem is definitional. The absence of a clear or uniform definition of political activity makes it hard to regulate. More importantly though, political activity must be assessed contextually. Political activity raises rather different challenges depending on whether the organization is a charity, a social welfare or other noncharitable exempt organization, or a political organization. The article discusses the nature of the problem in each case.

Part IV considers possible administrative solutions to problems raised by political activity, largely with respect to noncharitable exempt organizations. Broadly speaking, these include solutions based on how to define political activity, or whether to clarify or change the levels of permitted political activity. Rejecting many of the more conventional solutions, the article argues that, in the wake of *Citizens United*, the rule that political activity by definition is not consistent with noncharitable exempt purposes no longer makes sense from a tax perspective and, in theory, should be eliminated. In other words, political activity by noncharitable exempts should be allowed as consistent with exempt purposes. In practice, however, Part IV explains, elimination of current political activity limits by the Service would likely eviscerate donor disclosure rules; therefore, the only real solution to the principal problem lies with congressional action. Nevertheless, Part IV outlines some other modest steps the Treasury Department could take to improve administration of the rules.

Part V turns to legislative solutions. Arguing that the principal problem of present law is the different disclosure rules that apply across tax exemption categories, the first and best solution is for a uniform set of donor disclosure rules. From a tax perspective, Congress should simply remove the campaign finance-based disclosure rules from the tax code and leave the administration of disclosure to the Federal Election Commission. If political activity disclosure rules must remain in the tax code, Congress should at least provide for uniformity (whether it be for more or less or no disclosure). Otherwise, groups will continue to have incentives to exploit legal ambiguity and force the Service to deepen its involvement in regulating political activity.

Next, Part V argues that Congress should recognize that the definitional political activity limits for noncharitable exempts cannot be justified from a tax perspective after *Citizens United*. Congress should eliminate the rule that political activity categorically does not further exempt purposes, or, if the rule is retained, equalize the tax treatment

between noncharitable exempts and political organizations. This could be done by expanding the tax-exemption for political organizations to include noncharitable exempt function income. Relatedly, Congress should apply the income tax to donors of property on the appreciation when property is transferred to noncharitable exempt organizations. In addition, because it is increasingly less plausible after *Citizens United* to force political activity to be conducted from existing forms, it is time for Congress to develop a new baseline for treatment of a political organization outside of section 527.

Finally, Part V explains that *Citizens United* increases the likelihood that charitable organizations will be used as conduits for political activity. This could result in donors taking charitable deductions for funds that are transferred to related noncharitable exempt entities. To protect the integrity of charitable organizations, and prevent against illicit charitable deductions for political activity, Congress should take steps to prevent abuse. Legislation could include either a “proxy tax” regime on charitable organizations making grants to politically active organizations, or an excise tax on grants to such organizations if the funds are not used for the intended charitable purposes.

Political activity is fundamental to a free society, but it is not immune from the tax system. When political activity becomes a tax issue, the Service often finds itself at the center of controversy. Service action aside, however, responsibility for the underlying policy regarding the regulation of political activity is and should be with Congress. *Citizens United* is a major shock to the tax-exemption system, and deserves a considered response. In crafting solutions, Congress (and the Service) should be mindful that, as recent events have shown, it is not in the public interest to involve the Service any more than necessary in the regulation of political activity. Some Service involvement is important, and required, to enforce tax policy goals. Where tax policy is not at stake, though, appropriate solutions should focus on minimizing the Service’s role, a goal this article regards as fundamental.

II. THE POLITICAL ACTIVITY TAX BASELINE

This part describes why political activity is relevant to the income tax system. The issues are how the system should treat political activity by individuals, acting both alone and through collective efforts, and the relevance of the nonprofit form to the conduct of political activity. Use of the term “should” here invokes a normative question of the “correct” tax treatment, or, the way for the tax system to treat political activity without providing a subsidy. The discussion is critical to establishing a normative

baseline for the tax treatment of political activity, which in turn helps to delineate the appropriate regulatory role for the Service.

A. Political Activity by Individuals Acting Alone and Together

Consider first political activity by an individual: Fred. Fred buys card stock and paint and paints a handful of yard signs that say “Vote Smith for President.” Fred also makes a contribution to Smith’s campaign. A necessary tax question arises: should Fred be able to claim a tax deduction for the cost of the card stock, paint, and the amount of the contribution? No, clearly not. This is personal consumption by Fred. Under the prevailing norms of the income tax no deduction or credit should be allowed. Fred’s political activity should be funded with after-tax dollars as with other forms of consumption. Spending on political campaigns, though clearly political expression, is like buying theater tickets: it is a personal choice of how to consume funds and should be made with after-tax income.

What if Fred were allowed a deduction or credit for his political activity? A deduction or credit would take the political activity expense out of the tax base, meaning that individuals would enjoy the benefit of income tax exemption to the extent income is used for political activity. The result would be a subsidy for the activity,¹⁰ as defined against the norm that includes personal consumption as within the income tax base.

Now, assume that Alice, also a supporter of Smith for President, sees Fred’s signs and suggests that Alice and Fred combine efforts in support of Smith. To make accounting more efficient, Alice and Fred open a joint bank account, incorporate the account, and finance their political activity from the contributions each makes to the account. Should the formation of the bank account result in a tax on the contributions?¹¹ No, Alice and Fred have both already paid tax with respect to the amounts deposited in the account and used to fund political activity. The bank account is just a device Alice and Fred use to pool their individual efforts.

Does it follow, however, that if the bank account is not taxed on the contributions of Alice and Fred, the nontaxation is a tax benefit? No. Here, nontaxation, in the form of a tax exemption to the bank account, functions

¹⁰ A subsidy in the form of a deduction would be unlimited and would raise serious distributional concerns. See Gregg D. Polsky, *A Tax Lawyer’s Perspective on Section 527 Organizations*, 28 CARDOZO L. REV. 1773, 1776-78 (explaining that “[i]f electioneering could be funded with pre-tax dollars, it would raise serious concerns,” namely “the disproportionate and unlimited government subsidization of campaigns”). A subsidy in the form of a credit, capped as to amount, would be less problematic.

¹¹ Alice and Fred might also establish a partnership. Either form would be a “political organization.” I.R.C. § 527(e)(1).

not as a tax benefit or subsidy but as a measuring device. In other words, the “exemption” label in this context does not indicate special tax treatment but performs the critical function within an income tax of ensuring that income is taxed once — when earned by Alice and Fred, and not when pooled together for their joint personal consumption.

Similarly, when the bank account spends the money for political activity, no deduction should be available. If the bank account is treated as a surrogate for Alice and Fred, then a no-deduction rule makes sense because neither Alice nor Fred would have been allowed a deduction when spending sums for political activity from their own accounts. Pooling their spending should not and does not change the tax treatment.¹²

What if Alice and Fred, after making contributions to the bank account, become disillusioned with Smith and cease their political activity? The money remains in the bank account and bears interest. Should the interest be subject to income tax? Yes. Just as if Fred alone saves money instead of spending it, the savings increment is income and subject to tax. The result should be no different when Fred and Alice jointly generate investment income.

This simple model establishes the baseline income tax treatment for political activity (political activity baseline) — no subsidy. Political activity by an individual is a form of consumption, paid with after-tax dollars. As an initial matter, this essential treatment should not change when the political activity takes on an organizational form.

Current law is broadly in accord with the political activity baseline. For individuals acting alone, political activity is funded with after-tax dollars. No deductions or credits are allowed for political expenditures.¹³ Although Congress in the past has allowed a deduction for political contributions, the subsidy was abandoned.¹⁴ For individuals pooling their political activities, the Code likewise traces the political activity baseline. Broadly, under section 527,¹⁵ which applies to “political organizations,”¹⁶ the income of a political organization used for political purposes is not taxed (so called

¹² As Professor Dan Halperin has said, “the goal should be to impose the same tax burden on group activities that would apply if similar activities were conducted individually.” Daniel Halperin, *Income Taxation of Mutual Nonprofits*, 59 TAX L. REV. 133, 134–35 (2006) (noting that the exemption for political parties “may reflect the notion that . . . pooling resources does not in itself result in income”).

¹³ This appropriate normative treatment is reflected in the rule denying a deduction for personal expenses. I.R.C. § 262.

¹⁴ See The Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497, 560–62.

¹⁵ Unless otherwise stated, all section references are to the Internal Revenue Code (“Code”) of 1986.

¹⁶ I.R.C. § 527(a).

“exempt function income”).¹⁷ Investment (and other) income is subject to tax.¹⁸ Alice and Fred’s joint bank account would fall under the Code’s treatment of a political organization.

B. Challenges to the Political Activity Baseline

Broadly speaking, there is considerable support for the political activity baseline in history and commentary. Initially the Service declined to apply the income tax to contribution income of political organizations.¹⁹ Although the reasoning is not clear, the Service ultimately relied upon the theory that political organizations were like conduits (a pooling of income theory).²⁰ Later, Congress also embraced an exemption for contribution income but appeared to believe that the basis for the Service’s position was that political contributions were gifts.²¹ Regardless of the precise rationale, Congress asserted unequivocally at the time that “political activity (including the financing of political activity) as such is not a trade or business which is appropriately subject to tax,”²² suggesting that contribution income of political organizations is outside the tax base and that exemption is not a subsidy.²³ In addition, commentators affirm that the

¹⁷ I.R.C. § 527(c)(1)(A). More precisely, the Code defines exempt function income to include contributions of money or other property, membership dues, political fundraising proceeds, and certain bingo game proceeds. I.R.C. § 527(c)(3).

¹⁸ *Id.*

¹⁹ As the IRS acknowledged, the rationale for excluding the income was not clear. Gen. Couns. Mem. 35, 664 (noting that “the precise justification for excluding political campaign expense contributions from gross income has never been clearly articulated. It is clear however, that the justification for excluding political campaign expense contributions from income is not that the contributions are gifts . . .”). For a discussion of the history of the tax treatment of political organizations, see William P. Streng, *The Federal Tax Treatment of Political Contributions and Political Organizations*, 29 TAX LAW. 139 (1976); see also *infra* discussion accompanying notes 63 to 71. For additional discussion, see Roger Colinvaux, *Regulation of Political Organizations and the Red Herring of Tax Exempt Status*, 59 NAT’L TAX J. 531, 535-36 (2006).

²⁰ I.R.S. Gen. Couns. Mem. 39,813 (Mar. 20, 1990) (noting that Congress had “essentially codified the conduit concept”).

²¹ S. REP. NO. 93-1357, at 7508 (1974). As the author has noted previously, the Service historically described political contributions alternatively as excluded either from gross income or from taxable income. Exclusion from gross income suggests a pooling of income theory; exclusion from taxable income suggests a gift theory. See Colinvaux *supra* note 19, at n. 12.

²² S. REP. NO. 93-1357, at 7502 (1974).

²³ As noted *infra* notes 191 and 222, Congress in 2000 appears to have viewed section 527 as providing a subsidy and so used the subsidy as the hook to impose disclosure conditions, but this view of section 527 is mistaken.

nontaxation of contributions made to fund political activity reflects application of “general tax principles.”²⁴

Notwithstanding the authority, perhaps the most compelling point in support of the exemption provided by the political activity baseline is a simple one. The political contribution income of organizations categorically has never been subject to income tax. The explanations for this result have differed and thus there is confusion about the rationale.²⁵ Sometimes, though, the best evidence is fact: for over 100 years, an organization’s income, broadly defined, simply has not included political contribution income.

Nevertheless, the political activity baseline as the non-subsidy norm is subject to challenge. A principal challenge arises from the term “exemption,” which carries with it an implicit idea of a government tax subsidy. In *Regan v. Taxation With Representation*, the Supreme Court asserted that “tax exemptions . . . are a form of subsidy that is administered through the tax system.”²⁶ The simple conclusion is that if the Code provides for an exemption, then there is a subsidy. The resulting challenge to the political activity baseline is that taxation of political contribution income should be the norm, and exemption is the deviation from the norm, and a subsidy. This matters because if exemption provides a subsidy, then the government has a stronger interest in regulating the activity.

The idea that exemption equals subsidy, though sometimes accurate, is incomplete. There are examples in the Code, apart from political organizations, where exemption is not a form of subsidy.²⁷ Social clubs and homeowners associations are two illustrations.²⁸ In other words, the mere

²⁴ Gregg D. Polsky & Guy-Uriel E. Charles, *Regulating Section 527 Organizations*, 73 GEO. WASH. L. REV. 1000, 1013 (2005); *Disclosure of Political Activities of Tax-Exempt Organizations: Hearing Before the Subcomm. On Oversight of the H. Comm. on Ways & Means*, 106th Cong. 60 (2000) (statement of Joseph Mikrut, Tax Legislative Counsel, U.S. Department of Treasury); Halperin, *supra* note 12, at 134; Colinvaux, *supra* note 19, at 532-540; *see also* Boris L. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Tax*, 85 YALE L.J. 299, 306 (1976).

²⁵ For example, Congress has relied on a gift theory of exemption. S. REP. NO. 93-1357, at 7508 (1974). The Service has relied on a conduit theory. I.R.S. Gen. Couns. Memo. 35,664 (Feb. 8, 1974) (noting that “the precise justification for excluding political campaign expense contributions from gross income has never been clearly articulated.”) For additional discussion, *see* Colinvaux, *supra* note 19, at 535-36.

²⁶ *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 544 (1983).

²⁷ *See, e.g.*, I.R.C. § 501(c)(7) (the exemption for social clubs); I.R.C. § 528 (and homeowners associations).

²⁸ *See e.g.*, the exemption for social clubs, I.R.C. § 501(c)(7) and homeowners associations, I.R.C. § 528. For discussion of the nature of exemption for many nonprofit organizations, *see* Halperin, *supra* note 12.

use of an “exemption” label in the Code does not answer the subsidy question.

The Supreme Court indirectly acknowledged as much by elaborating in *Taxation With Representation* that the “subsidy” provided by exemption generally is like “a cash grant to the organization of the amount of tax it would have to pay on its income.”²⁹ This formulation works assuming that exemption *is* a subsidy, because then the exemption functions to protect otherwise taxable income.³⁰ But when exemption is not a subsidy, but instead is just a statement of the correct tax treatment, then there is not a normative alternative, i.e., no “amount of tax to pay on its income.”³¹ Whether exemption is or is not a subsidy applies across many exemption categories.³²

Nevertheless, the exemption-as-subsidy reflex ushered in by *Taxation With Representation* has crept into judicial assessments of exempt status of political organizations. Without analysis of whether the exemption provided for political organizations is a subsidy, the 11th Circuit upheld disclosure rules imposed on political organizations as a constitutional condition of a subsidy provided by Congress.³³ Some commentators reasonably conclude from this that what might matter most to a determination of subsidy by courts is the fact of a statutory exemption rather than resort to principles of taxation.³⁴ In other words, a “subsidy” for purposes of constitutional law may be different than a subsidy viewed through the lens of a normative

²⁹ *Taxation with Representation*, 461 U.S. at 544.

³⁰ In the context of *Taxation With Representation* and section 501(c)(3) organizations, exemption does provide a subsidy. See Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283 (2011).

³¹ One rejoinder to the “exemption is not a subsidy” argument is to posit taxation in the absence of the statutory-based exemption of section 527, i.e., to ask whether absent a statutory exemption income would be recognized and tax otherwise would be paid. As discussed, *supra* and *infra*, the statutory-based exemption merely codified the existing administrative-based exemption. Although typically, exclusions (or exemptions) from taxation are derived from a clear statutory provision, significant exclusions from “income” without a statutory directive also are fundamental to the system. For example, imputed income and child support payments are excluded from gross income despite the absence of a specific exclusion or exemption. The exemption for political activity income is another example.

³² The gatekeeper of the tax subsidy label (i.e., “tax expenditures”) is the Congressional Joint Committee on Taxation, which does not consider tax exemption as a subsidy except in limited cases. STAFF OF J. COMM. ON TAXATION, 113TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2013-2018, at 39 (Comm. Print 2014). The author was formerly a Legislation Counsel with the Joint Committee.

³³ *Mobile Republican Assembly v. United States*, 353 F.3d.1357, 1359 (11th Cir. 2003).

³⁴ April, *supra* note 8, at 363, 400.

income tax. Even so, the Court's formulation of what constitutes a tax subsidy in *Taxation With Representation* and the fact that there is no evidence that Congress viewed the exemption for political contribution income as a subsidy when enacting section 527, point toward affirmation of the political activity baseline as the appropriate tax treatment.

Apart from the exemption label, the political activity baseline also faces more direct attacks. It is one thing to accept a pooling of income rationale for local or neighborly activity, and another when pooling occurs on a large scale as happens with today's political organizations. As Professor Donald Tobin has argued, well-funded independent political organizations now bear little resemblance to the types of organizations that the Service (and indirectly Congress) likely had in mind when embracing a pooling or conduit theory of exemption.³⁵ Furthermore, there are inherent limitations to the pooling theory. It seems to apply most aptly in cases where the organization merely is doing the bidding of its contributors, and not when organization managers have substantial control and discretion over the expenditure of funds, as do those of independent political organizations.³⁶

These points, though well taken, do not undermine the case that exemption for political contribution income of organizations does not provide a subsidy. It is true that political activity funded by a million Alices or Freds might result in targeted political advertising, campaign rallies, and other campaign efforts far more potent than Alice and Fred's yard sign.³⁷ Nevertheless, the quality or scale of the political activity, standing alone, is not a sufficient variable to alter the political activity baseline. The essential principle remains the same. The income has already been taxed. It does not matter whether the pooled income magnifies the impact of the spending. No new wealth has been created just because the quality of the spending changes through a pooling of efforts under independent control.³⁸

³⁵ Donald B. Tobin, *Political Advocacy and Taxable Entities: Are They the Next "Loophole"?*, 6 FIRST AMEND. L. REV. 41, 76–78 (2007).

³⁶ *Id.*

³⁷ Whether the political activity of an organization differs meaningfully from political activity conducted by individuals likely depends on the wealth of the contributors and the size of the contributions. Some wealthy individuals may establish, fund, and control a political organization that serves mainly to facilitate the activity of the individual, albeit with an organizational name. In such a case, the tax question is qualitatively no different than if Fred acting alone and with small sums decided to conduct activity using an organization instead of individually.

³⁸ Assume for example that instead of political activity, Alice and Fred and ten others pool efforts to buy a mansion with a swimming pool, well-equipped theater, and other luxuries. The dozen contributors become joint owners of the mansion. Does the fact that the pooling of resources results in a purchase of a markedly different quality than was possible

Another challenge to the political activity baseline for organizations would arise if a political organization were to have a profit motive.³⁹ A blanket exemption for political contribution income and denial of deductions for political activity expenses⁴⁰ make sense under a pooling of income theory, but not for a for-profit activity, which requires a more nuanced view both of contributions and expenses.

On the one hand, a political contribution to a for-profit political organization could be a contribution to the capital of the organization, analogous to the payments Alice and Fred made to establish a joint bank account. Capital contributions are intended to provide a foundation for the creation of wealth and should not be subject to tax.⁴¹ Thus, with respect to capital contributions, the (political) contribution income should not be taxed to the corporation.

On the other hand, political contributions also might be a purchase of services and not a capital contribution, in which case tax exemption at the corporate level for the contributions would not be appropriate. The for-profit political organization is not a mere pooling of resources, but the coming together by persons to conduct a productive activity and generate wealth. This is the reason for the corporate income tax, and thus income in effect to purchase the corporate activity should not be exempt at the organizational level.

In addition, with respect to the expenses of a for-profit political organization, the organization should be taxed based on its net income. The broad goal of an income tax is to measure and tax accessions to wealth. Deductions are the principal measuring tool used to distinguish net from gross income, and arrive at the proper taxable amount. Accordingly, the for-profit political organization should be allowed to deduct expenses⁴²

without pooling necessarily have an income tax consequence? In other words, should the act of pooling itself be taxed? In general, the answer is no. The joint-owners got what they paid for, nothing more, nothing less — there is no income to them. And the association, if any, formed to purchase the mansion likewise does not have income. *Compare* I.R.C. § 528.

³⁹ At present, in general, political activity is not conducted in the “for-profit” form. *See* Tobin, *supra* note 5, at 48 (noting that “almost all [independent political organizations] operate as tax-exempt organizations”). However, after *Citizens United*, the for-profit, or alternatively, the nonprofit taxable form, is of increasing likelihood. *See* Donald B. Tobin, *The 2013 IRS Crisis: Where Do We Go from Here?*, 142 TAX NOTES 1120 (2014). For a more detailed discussion of a taxable political organization (i.e., one organized outside of section 527), see Tobin, *supra* note 35.

⁴⁰ Under section 527, no deduction is allowed for political activity expenses but deductions in production of other income are allowed.

⁴¹ *See* I.R.C. § 118(a). For an assessment of the capital contribution theory of exemption for contribution income, see Tobin, *supra* note 35, at 81-84.

⁴² As a practical matter, the disallowance of a deduction for political activity expenses

incurred to earn fees, including political activity-related expenses. To the extent payments exceed expenses, the organization would have a profit and would pay tax on the profit. In short, the political activity baseline does not provide the right treatment for a for-profit political organization with respect to either contributions or expenses.

The two main challenges to the political activity baseline then are the belief that section 527 is not the correct normative treatment but rather provides a subsidy, and the prospect of the for-profit political organization. The implication of both challenges is that there is, or should be, an alternative tax treatment to that provided by section 527 (or the political activity baseline). In other words, if section 527 provides a subsidy, there should be a reasonable nonsubsidy tax alternative. If a political entity is for-profit, then the profit motive should be taken into account by the Code.

Section 527, however, purports to apply the exclusive tax treatment for political organizations, irrespective of subsidy treatment or profit motive.⁴³ Under a mandatory view of section 527, there is no alternative tax treatment. Further, even if section 527 is elective, the tax treatment of a political organization outside of section 527 is uncertain. Without a clear statutory exemption for contribution income, the income to finance political activity arguably would be subject to tax.⁴⁴ Yet political activity expenses generally are *not* allowed a deduction.⁴⁵ It is possible that a for-profit

is of no moment for a political for-profit because the disallowance is offset by the blanket exemption for contribution income. Indeed, section 527 *does* provide a subsidy to a political for-profit to the extent that political fee for service income exceeds expenses. For tax purposes, a political for-profit would have little reason to reject tax treatment as a political organization under section 527.

⁴³ In general, not-for-profit status is a matter of state law and is not a condition of tax exemption in the Code's various exemption provisions. But many exemption categories contain a proscription on private inurement (often called the nondistribution constraint). The ban on private inurement is a bar on the distribution of corporate earnings, which has the effect of disqualifying for-profit corporations from exempt status.

⁴⁴ As the author has argued elsewhere, given that political activity income has never categorically been included in income, it may be difficult to assert inclusion absent an express provision in the Code. *See, e.g.,* Colinvaux, *supra* note 19, at 544. Some argue that political contributions might be excluded as gifts. Tobin, *supra* note 35. Others cast doubt on whether there is sufficient "detached and disinterested generosity" for political contributions to qualify as gifts. *See* Aprill, *supra* note 8, at 544.

⁴⁵ I.R.C. § 162(e). There is an exception to the general rule of disallowance of a deduction for political activity expenses. Taxpayers in the trade or business of political activity are allowed to deduct political activity expenses made "directly on behalf of another person." I.R.C. § 162(e)(5)(A). The scope of this exception is uncertain, though the legislative history to the provision indicates that it was not intended to apply to "taxable membership organizations which act to further the interests of all their members rather than the interests of any one particular member." H.R. Rep. 103-213, pt. 4, at 610 (1993).

political organization, or a political organization that rejects a “subsidy” and opts for taxation outside the section 527 regime, could be subject to tax on its gross income.⁴⁶

To conclude, the current law exemption for political organizations is not a subsidy but the representation of the principle that activity should be taxed once and that the tax system should endeavor to treat an activity the same whether carried out alone or through joint efforts. Nevertheless, the political activity baseline, largely codified in section 527, is subject to challenge. The thrust of challenges to the baseline is that alternatives to section 527 treatment are necessary.

III. SOURCES OF PROBLEMS RAISED BY POLITICAL ACTIVITY IN THE TAX SYSTEM

This part provides an overview of the reasons political activity raises problems for the tax system. Broadly speaking, problems arise from two sources. One stems from the definition of political activity, and the other stems from legal architecture. This article focuses more on issues of legal architecture than on issues of definition, though the two are related.

A. Problems Arising from Defining Political Activity

Political activity is the subject of regulation, so knowing what is, and what is not, political activity is important. In general, political activity may loosely be characterized as activity intended to directly affect the election of a candidate for public office.⁴⁷ A positive definition of political activity has been elusive, however. Express advocacy on behalf of, or in opposition to, a candidate is clearly political activity,⁴⁸ as are contributions to a candidate’s campaign or to a political party and the rating of candidates.⁴⁹ Nonpartisan educational efforts such as get-out-the-vote campaigns and voter guides historically have not been considered political activity, even though they

⁴⁶ As discussed *infra* Part V(B)(5), this result arguably exists within section 527 with respect to political organizations that fail to notify the Service of their existence.

⁴⁷ Political activity is distinct from lobbying, which generally refers to attempts to sway the votes of elected representatives with respect to legislation. Political activity and lobbying each raises its own set of issues and rules and the two should be kept separate.

⁴⁸ *Branch Ministries v. Rossotti*, 211 F.3d 137, 144 (D.C. Cir. 2000) (upholding revocation of a church’s 501(c)(3) status for advertisements urging Christians not to vote for candidates Bill Clinton and Al Gore in the 1992 presidential election).

⁴⁹ *Association of the Bar of New York v. Commissioner*, 858 F.2d 876, 881 (2d Cir. 1988) (denying 501(c)(3) status to bar association because the rating of judges was political activity); Rev. Rul. 67-368, 1967-2 C.B. 194.

affect campaign outcomes.⁵⁰ The hosting of forums for candidate debate also is not political activity, so long as the event is open to all candidates.⁵¹ Other activities are less definitive and ultimately depend on the facts and circumstances such as the timing, regularity, extent, and nature of the activity.⁵²

Issue advocacy is a type of activity that nicely illustrates the problems of defining political activity. Without question, taking a stand on issues, without more, is not a political activity.⁵³ If an environmental protection organization educates the public about the dangers of climate change in a well funded and prominent series of advertisements, the activity should merely be one of expressing a view on issues, and not political. If, however, the advertisements appear shortly before an election in the advertising market of the electorate and environmental protection is an issue in the campaign, then the activity might be political. It depends on the facts and circumstances.⁵⁴

An uncertain, facts and circumstances-based definition leads to compliance and enforcement challenges. Because of potentially severe sanctions,⁵⁵ some organizations are wary of engaging in conduct that may be close to the line. As definitional uncertainty increases, so too does the reluctance of organizations to participate in activity that would ultimately not be prohibited or limited and that may be consistent with the organization's mission. A facts and circumstances test also is difficult for the Service to enforce consistently, raising charges and perceptions of political bias or selective enforcement.⁵⁶

Further complicating matters, the definition is not consistent across sections of the Code. Political activity has subtly different meanings

⁵⁰ Rev. Rul. 80-282, 1980-2 C.B. 178; Rev. Rul. 78-248, 1978-1 C.B. 154.

⁵¹ Rev. Rul. 74-574, 1974-2 C.B. 1670.

⁵² See Rev. Rul. 2004-6, 2004-1 C.B. 328; see also Elizabeth Kingsley & John Pomeranz, *A Crash at the Crossroads: Tax and Campaign Finance Laws Collide in Regulation of Political Activities of Tax-Exempt Organizations*, 31 WM. MITCHELL L. REV. 55 (2004) (summarizing the tax law defining political activity).

⁵³ See I.R.S. TAX GUIDE FOR CHURCHES AND RELIGIOUS ORGANIZATIONS, Pub. No. 1828, at 7–8 (Nov. 2013).

⁵⁴ Rev. Rul. 2007-41, 2007-1 C.B. 1421.

⁵⁵ The sanction for a charitable organization for engaging in any political activity is loss of charitable status. I.R.C. §§ 501(c)(3), 504(a).

⁵⁶ See STAFF OF J. COMM. ON TAXATION, 106TH CONG., REP. OF INVESTIGATION OF ALLEGATIONS RELATING TO INTERNAL REVENUE SERVICE HANDLING OF TAX-EXEMPT ORGANIZATION MATTERS 19 (Comm. Print 2000); Lloyd Hitoshi Mayer, *Grasping Smoke: Enforcing the Ban on Political Activity by Charities*, 6 FIRST AMEND. L. REV. 1, 4–13 (2007).

depending on whether the context is denying a deduction⁵⁷ or evaluating the tax-exempt status of the organization.⁵⁸ Organizations cannot assume that the same activity, which is not political for one purpose, will be treated the same way for all purposes. Variation in the law can also be hard for the Service, which has to train agents to know and apply the law consistently across areas of the Code. Moreover, different definitions of political activity can lead to a form of statutory arbitrage in which activity is structured to fit within one definition but not another.

B. Problems Arising from the Legal Architecture

Regardless of how political activity is defined, the issues raised by political activity are very different depending on the type of organization involved. Broadly speaking, there are three categories of tax-exempt organizations that matter in this context: the charity (organized under section 501(c)(3)),⁵⁹ the political organization (organized under section 527), and the rest (typically organized under sections 501(c)(4), (c)(5), or (c)(6)), and referred to in this article as the “noncharitable exempt”.⁶⁰

1. The 501(c)(3) Organization

For the 501(c)(3) charity, the problem of political activity has a deep historical pedigree. The federal income tax exemption for charitable organizations borrowed extensively from English common law and the law of trusts. In England, a charitable (and exempt) trust generally could not be organized for political purposes.⁶¹ It was a point of debate whether political

⁵⁷ I.R.C. § 162(e).

⁵⁸ Although the definition of political activity is broadly similar across section 501(c) and under section 527, there are differences. Section 527 is broader because it includes political activity relating to appointed offices (not just elected), including relating to judges. Further, some activity that is considered political for purposes of section 527 of the Code is considering lobbying for other Code sections. *See* Aprill, *supra* note 8, at 375.

⁵⁹ Section 501(c)(3) covers more than charitable organizations, also including educational, religious, scientific, literary, and public safety organizations. In this article, use of the term “charity” or “charitable organization” includes all organizations described in section 501(c)(3) eligible to receive deductible charitable contributions under section 170.

⁶⁰ This noncharitable exempt category technically includes any 501(c) organization except for organizations eligible to receive deductible charitable contributions, i.e., 501(c)(3) (except for public safety organizations), fraternal organizations (501(c)(10)), cemetery companies (501(c)(13)), veterans organizations (501(c)(17)). As stated in text, however, for purposes of this Article, the term “noncharitable exempt” generally refers to 501(c)(4), 501(c)(5), and 501(c)(6) organizations.

⁶¹ Oliver A. Houck, *On the Limits of Charity: Lobbying, Litigation, and Electoral Politics by Charitable Organizations Under the Internal Revenue Code and Related Laws*,

activity was permitted to attain a charitable purpose.⁶² The 1913 U.S. income tax statute allowing exemption for charities did not address the question.⁶³ In 1954, though, Congress decided unequivocally that charity and political activity are mutually exclusive, and enacted a prohibition on political activity by charities (political activities prohibition).⁶⁴

The political activities prohibition is longstanding but controversial. As a matter of tax administration and compliance, definitional issues often frame the debate.⁶⁵ More broadly, the fact of a prohibition perennially raises concerns under the First Amendment, particularly in the context of political activity by churches.⁶⁶ Further, many challenge the underlying policy of a prohibition and argue that charitable organizations should be permitted into the public square.⁶⁷ Others strongly support the prohibition, arguing that without it, charitable organizations would be hijacked for partisan objectives at the expense of their charitable purposes.⁶⁸ The Supreme Court has indirectly weighed in on the constitutional question, upholding broadly analogous limits on the lobbying activity of charities.⁶⁹

69 BROOK. L. REV. 1, 5 (2003). Note that *purpose* here legally is distinct from *activity* — a regular source of confusion.

⁶² *Id.* at 7-8; see also Laura Brown Chisolm, *Politics and Charity: A Proposal for Peaceful Coexistence*, 58 GEO. WASH. L. REV. 308, 346 (1990).

⁶³ The Tariff Act of 1913, Pub. L. No. 63-16 § II(G), 38 Stat. 114, 172.

⁶⁴ I.R.C. § 501(c)(3).

⁶⁵ See e.g., Ellen P. Aprill, *Why the IRS Should Want to Develop Rules Regarding Charities and Politics*, 62 CASE W. RES. L. REV. 643, 647 (2012); Donald B. Tobin, *Political Campaigning by Churches and Charities: Hazardous for 501(c)(3)s, Dangerous for Democracy*, 95 GEO. L.J. 1313, 1350 (2007).

⁶⁶ See Lloyd Hitoshi Mayer, *Politics at the Pulpit: Tax Benefits, Substantial Burdens, and Institutional Free Exercise*, 89 B.U. L. REV. 1137, 1138 (2009).

⁶⁷ See Johnny Rex Buckles, *Not Even a Peep? The Regulation of Political Campaign Activities by Charities Through Federal Tax Law*, 75 U. CIN. L. REV. 1071, 1073 (2007). For additional discussion, see Roger Colinvaux, *The Political Speech of Charities in the Face of Citizens United: A Defense of Prohibition*, 62 CASE W. RES. L. REV. 685, 688 (2012).

⁶⁸ Brian Galle, *Charities in Politics: A Reappraisal*, 54 WM. & MARY L. REV. 1561 (2013); Tobin, *supra* note 65.

⁶⁹ *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540 (1983). In *Taxation with Representation*, the Court likened the charitable tax exemption to a subsidy and said that as a condition of a subsidy, the lobbying limitations were allowed. The concurring opinion emphasized the importance of alternative exempt structures to the constitutional analysis, noting that organizations seeking substantial lobbying activity could organize under section 501(c)(4). The Court subsequently has relied on the reasoning in the *TWR* concurrence. For discussion of the effects of *Citizens United* on the constitutionality of the political activities prohibition, see ABA Section of Taxation Comments on Proposed Regulations Regarding Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities (May 7, 2014), <http://www.americanbar.org/content>

Regardless of one's position in this debate, when discussing political activity and tax exemption it is important to differentiate between charities and other exempt organizations. Not only are the issues raised by a prohibition distinct, but more centrally, the political activities prohibition reflects a clear tax policy. Because contributions to section 501(c)(3) organizations are deductible as charitable contributions,⁷⁰ absent a prohibition, political contributions by individuals for charitable electioneering would become deductible.

Thus, Service enforcement of the political activities prohibition is important and required, both to protect the tax base and to preserve the integrity of charitable purposes. Put differently, the political activities prohibition is one of the main borders enacted by Congress to separate the charitable from the noncharitable sphere, and the Service quite appropriately bears responsibility for policing that border.

2. The 527 Political Organization

For the political organization, the problem is entirely different. A political organization, as the term suggests, is one set up specifically to engage in political activity.⁷¹ The political organization includes political parties, political committees established by candidates, and political groups that are independent from a party or candidate.⁷²

The 1913 income tax statute ignored the political organization. The question of how to tax a political organization fell to the Service, which determined that political organizations were pass-through entities — vehicles to collect and spend political contributions.⁷³ Under that conduit conception, as discussed in Part II, no economic income was generated at

/dam/aba/administrative/taxation/policy/050714comments.authcheckdam.pdf; Colinvaux *supra* note 67; Miriam Galston, *When Statutory Regimes Collide: Will Citizens United and Wisconsin Right to Life Make Federal Tax Regulation of Campaign Activity Unconstitutional?*, 13 U. PA. J. CONST. L. 867 (2011).

⁷⁰ I.R.C. § 170(c)(2).

⁷¹ The organization must be “organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function.” I.R.C. § 527(e)(1).

⁷² “The term “political organization” means a party, committee, association, fund, or other organization (whether or not incorporated) . . .” I.R.C. § 527(e)(1). All PACs (political action committees) are political organizations whether or not connected to a party or candidate.

⁷³ For discussions of the history of the tax treatment of political organization, see Colinvaux, *supra* note 24, at 534–36; Streng, *supra* note 19; Donald B. Tobin, *Anonymous Speech and Section 527 of the Internal Revenue Code*, 37 GA. L. REV. 611 (2003).

the organizational level so tax exemption was appropriate.⁷⁴ The Service also concluded, however, that the investment income was “new” income, and should therefore be subject to tax.⁷⁵

Eventually, uncertainty about the tax treatment of political organizations (in large part involving application of the gift tax to political organization donors) led Congress to enact section 527 in 1975.⁷⁶ This section of the Code provided for the exclusive tax treatment of the political organization,⁷⁷ and largely codified the Service’s administrative practice of exemption for contribution income and taxation for investment (and other) income.⁷⁸ Congress also clarified against Service trends that donors to political organizations were not subject to gift tax,⁷⁹ and that contributions of appreciated property to a political organization would result in income tax on the appreciation.⁸⁰

The problem caused by the political activity of a political organization does not, however, have much to do with this broadly correct tax treatment. Rather, the problem surfaced in the late 1990s because of differences in the way in which political activity was defined under federal election law and federal tax law. Campaign operatives discovered that the federal tax law definition under section 527 was broader than the one in federal election law.⁸¹ The significance was that if activity could be designed to avoid the “political” label under federal election law, but still have sufficient political impact to be considered political activity for tax law purposes, registration with the Federal Election Commission (FEC) could be avoided yet section

⁷⁴ See Rev. Rul. 54-80, 1954-1 C.B. 11 (explaining that if income was diverted for personal use of the candidate, then there was income).

⁷⁵ See Rev. Rul. 74-21, 1974-1 C.B. 14.

⁷⁶ The Service encouraged Congress to act. See Streng, *supra* note 19, at 143.

⁷⁷ See I.R.C. § 527(e)(1); FSA 200037040 (noting the mandatory status of section 527 with respect to the law before changes in the year 2000).

⁷⁸ I.R.C. § 527. In the legislative history, Congress noted that “political activity (including the financing of political activity) as such is not a trade or business which is appropriately subject to tax.” S. REP. NO. 93-1357, at 7502 (1974).

⁷⁹ I.R.C. § 2501(a)(4). The legislative history provides that it was “inappropriate to apply the gift tax to political contributions because the tax system should not be used to reduce or restrict political contributions.” S. Rep. No. 93-1357, at 7508 (1974). At the same time, Congress decided that contributions of appreciated property to a political organization should trigger tax on the appreciation. *Id.*

⁸⁰ See I.R.C. § 84.

⁸¹ Frances R. Hill, *Probing the Limits of Section 527 To Design a New Campaign Finance Vehicle*, 26 THE EXEMPT ORG. TAX REV. 205 (1999); see also Aprill, *supra* note 8, at 385.

527 treatment achieved. Crucially, this meant that the organization would not have to disclose the identities of its donors publically.⁸²

At the time, these types of political organizations were referred to as “stealth PACs.” They were political action committees (PACs) because they qualified as political organizations, and “stealth” because of no donor disclosure. The type of activity they engaged in became known as “issue advocacy.” Because the advocacy was not “express” it escaped FEC regulation. However, because the advocacy was sufficiently political, it retained the political label for tax law purposes.

Congress acted to address the stealth PAC issue advocacy disclosure loophole in the year 2000.⁸³ Instead of amending the campaign finance law to broaden its coverage, Congress instead changed section 527 to require donor disclosure for political organizations, along with other public notice requirements.⁸⁴ The duties imposed by the new tax rules were intended to mimic federal election law.⁸⁵ Nondisclosure, though, would result in increased tax liability (assessed and collected as a penalty).⁸⁶ In effect, the tax treatment of a noncompliant 527 organization became punitive.

Accordingly, for the Service, the central problem of the political organization dates to the year 2000, when Congress tasked the Service with what should be a function of the FEC.⁸⁷ From then on, the Service was responsible for managing 527 disclosure rules by ensuring the publicity of donor information and enforcing the consequences of noncompliance.

3. Noncharitable Exempt Organizations: the 501(c)(4), (5), and (6)

Apart from the charity and the political organization, the Code recognizes a slew of other exemption categories. For example, section 501(c) lists twenty-nine different types.⁸⁸ Other Code sections provide for

⁸² See Richard Briffault, *The 527 Problem . . . and the Buckley Problem*, 73 GEO. WASH. L. REV. 949, 959 (2005).

⁸³ Act to Amend the Internal Revenue Code of 1986 to Require 527 Organizations to Disclose Their Political Activities, Pub. L. No. 106-230, 114 Stat. 477 (2000). Congress amended this legislation in 2002. Pub. L. No. 107-276, 116 Stat. 1929 (2002). The author worked on the amendments to the legislation.

⁸⁴ I.R.C. § 527(i), (j). As discussed *infra*, Congress appears to have chosen to amend the tax law to shelter the amendments from constitutional challenge.

⁸⁵ See e.g., Lloyd Hitoshi Mayer, *The Much Maligned 527 and Institutional Choice*, 87 B.U. L. REV. 625, 646 n.103 (2007).

⁸⁶ I.R.C. § 527(j)(1).

⁸⁷ As Professor Aprill has said, “the amendments to section 527 are campaign finance laws in tax clothing.” Aprill, *supra* note 34, at 391.

⁸⁸ I.R.C. § 501(c).

tax exemption as well.⁸⁹ The main ones of interest are the social welfare organization (501(c)(4)), the labor union (501(c)(5)), and the trade association (501(c)(6)).

In general, noncharitable exempt organizations are exempt from paying federal income tax, but pay tax on unrelated business income.⁹⁰ Importantly, unlike contributions to a charity, contributions to noncharitable exempts are not deductible as charitable contributions. Contributions may, however, be deductible as business expenses. This could occur, for example, if the contribution takes the form of member dues.⁹¹

Also unlike a charity, noncharitable exempts are permitted to engage in political activity,⁹² but political activity is deemed not to further noncharitable exempt purposes. Because noncharitable exempts are organized for a specific purpose articulated by statute (e.g., social welfare, labor, promotion of trade), the extent of political activity is not allowed to engulf the organization's primary purpose. In other words, the definitional category of the noncharitable exempt provides a sort of built-in cap on the amount of political activity. Organizations that exceed the cap may become political organizations under section 527, assuming their primary purpose is political activity.⁹³

The rules for noncharitable exempts — some political activity is allowed, just not too much — largely worked (or simply escaped much notice) before the Supreme Court's decision in *Citizens United*.⁹⁴ Before *Citizens United*, the meaningful cap was not imposed by tax law but by campaign finance law, which directly restrained the ability of corporations and labor unions to engage in independent political activity. By allowing unlimited independent express advocacy by corporations (and labor unions), *Citizens United* expanded their legal power by permitting an activity previously banned.

⁸⁹ See, e.g., I.R.C. § 528 (exemption for homeowners associations).

⁹⁰ The tax rules are not uniform. Some noncharitable exempts pay tax on investment income, or have special rules for treating unrelated business taxable income. See, e.g., I.R.C. § 501(c)(7) (social clubs). Charitable organizations also pay tax on unrelated business income. I.R.C. § 511.

⁹¹ I.R.C. § 162.

⁹² Rev. Rul. 81-95, 1981-1 C.B. 332 (providing that an organization “may carry on lawful political activities and remain exempt under section 501(c)(4) as long as it is primarily engaged in activities that promote social welfare”); I.R.S. Gen. Couns. Mem. 34,233 (Dec. 30, 1969) (providing that 501(c)(5) and 501(c)(6) organizations face similar constraints as 501(c)(4) organizations). Other noncharitable exempts likely are the same though the authority is fleeting. See Aprill, *supra* note 34, at 381.

⁹³ I.R.C. § 527(e)(1).

⁹⁴ 558 U.S. 310 (2010).

The consequences are significant. Before *Citizens United*, tax classifications largely reflected reality.⁹⁵ Organizations that sought noncharitable exempt status would not be likely to engage in much political activity, relative to other activities. The issue was not that noncharitable exempt purposes and political activity were mutually exclusive, rather that the campaign finance limits on political activity meant that for an independent organization with nonpolitical activity as an objective, the nonpolitical activity would be the main one, almost by definition. The pre-*Citizens United* world largely was one of black and white, political or not. To the extent a noncharitable exempt engaged in political activity, the activity would be incidental to the main purpose.⁹⁶

After *Citizens United*, however, organizations have a choice that did not exist before. An organization may now pursue a noncharitable exempt purpose and engage in unlimited independent political activity. The choice is available to both newly forming organizations and existing noncharitable exempts. Further, formation as a for-profit political organization also becomes more viable in light of the ability to engage in unlimited independent expenditures. In effect, *Citizens United* has paved the way for a new type of entity not readily recognized by existing tax law classifications.⁹⁷

Nevertheless, when the new mix of activity allowed by *Citizens United* is layered on top of the current tax exemption system, the noncharitable exempt form becomes attractive relative to the political organization. Most importantly, the noncharitable exempt form allows organizations to expressly advocate without donor disclosure.⁹⁸ By contrast, a political organization must disclose donors.⁹⁹

⁹⁵ One pre-*Citizens United* issue was that organizations that might otherwise qualify as a noncharitable exempt could plan into section 527 by emphasizing political purposes in order to avoid possible imposition of the gift tax. For donors not concerned about anonymity, the 2000 legal changes did not alter this incentive. For additional discussion, see Polsky, *supra* note 10, at 1782.

⁹⁶ The inverse also is accurate. Political organizations generally do not engage in nonpolitical activity.

⁹⁷ To use a well-worn metaphor, before *Citizens United*, the horse (the exempt purpose) would pull the cart (political activity, if any). By unleashing a new form of political activity, *Citizens United* made it possible for the cart to come before the horse.

⁹⁸ The general rule of exempt organizations is not to disclose publicly donor information. The exception is for donors to private foundations and political organizations. I.R.C. § 6104(d).

⁹⁹ I.R.C. § 527(j).

In addition, after commencing gift tax audits on 501(c)(4) organizations, the Service responded to Congressional pressure¹⁰⁰ and announced that, after all, it would not assert gift tax against donors to 501(c)(4) (and presumably other noncharitable exempt) organizations.¹⁰¹ This made the noncharitable exempt category even more attractive by largely equating the tax treatment of noncharitable exempts with political organizations, leaving the disclosure rules as the salient difference between the two.¹⁰²

The obstacle to choosing (or working within) the noncharitable exempt form then becomes the requirement of tax law that the political activity of a noncharitable exempt not be the primary activity. As a result, after *Citizens United*, the “primarily” legal standard for noncharitable exemption has faced considerable pressure. Newly formed organizations can claim (genuinely or not) to have primarily a nonpolitical purpose, but still engage in a lot of political activity.¹⁰³ Thus, the Service must make a judgment about a nascent organization’s true purpose. In addition, existing organizations interested in exercising their newly found freedom need to know how much political activity is too much. Accordingly, the Service actually has to apply the “primarily” test.

¹⁰⁰ For years, the IRS did not enforce the gift tax for transfers to 501(c)(4) organizations. For discussion of the many issues concerning the gift tax and political activity, see Ellen P. Aprill, *Once and Future Gift Taxation of Transfers to Section 501(c)(4) Organizations: Current Law, Constitutional Issues, and Policy Considerations*, 15 N.Y.U. J. LEGIS. & PUB. POL’Y 289, 291 (2012).

¹⁰¹ *IRS Suspends Exams on Application of Gift Tax to Contributions Made to Some Exempt Orgs.* 2011 TNT 131-18 (July 8, 2011); compare Rev. Rul. 82-216, 1982-2 C.B. 220 (holding 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”).

¹⁰² This assumes levels of political activity below the “primarily” threshold. In addition, contributions of appreciated property are ignored for tax purposes if made to a noncharitable exempt, but trigger income tax to the donor on the appreciation if made to a political organization. I.R.C. § 84. Accordingly, absent enforcement of the gift tax, the noncharitable exempt form overall is more attractive for tax purposes than the political organization. See *infra* notes 199-206.

¹⁰³ Donald B. Tobin, *Campaign Disclosure and Tax-Exempt Entities: A Quick Repair to the Regulatory Plumbing*, 10 ELECTION L.J. 427, 438 (2011); *Democracy 21 and Campaign Legal Center Call on IRS to Investigate Crossroads GPS to Determine if Group is Improperly Claiming 501(c)(4) Tax Status to Avoid Disclosing Its Donors to the Public* (Oct. 5, 2010), <http://www.democracy21.org/archives/whats-new/democracy-21-and-campaign-legal-center-call-on-irs-to-investigate-crossroads-gps-to-determine-if-group-is-improperly-claiming-501c4-tax-status-to-avoid-disclosing-its-donors-to-the-public/#>.

Citizens United therefore forcefully magnified the problem of how to administer the quantum of political activity permitted to noncharitable exempt organizations. The notorious result was the Service targeting scandal. The Service was accused of selecting certain organizations for extra scrutiny based on the name and likely political orientation of the group.¹⁰⁴ Regardless of management failures or other errors, however, the basic issue facing the Service was (and is) legitimate. As the tax administrator, the Service must assign a label to an exempt organization based on the extent and nature of its political activity. Thus, the problem of the political activity of noncharitable exempts is inherent to the legal architecture after *Citizens United*, and not a conspiracy. The problem also is in need of a solution.

4. Networks of Exempt Organizations

Finally, the problems raised by the political activity of exempt organizations is enhanced by complex structures of exempts. A 501(c)(3) charity might establish a related 501(c)(4) social welfare group, which in turn might set up a separate segregated fund that is treated as a 527 political organization. Although such arrangements may be constitutionally requisite,¹⁰⁵ as a matter of tax administration, the Service must look at the entire organization. For instance, deductible donations to a charity must not flow through to a controlled 501(c)(4) organization to finance political activity. Networks of exempt organizations also highlight compliance problems raised by a nonuniform definition of political activity.

IV. ADMINISTRATIVE SOLUTIONS TO PROBLEMS OF POLITICAL ACTIVITY

The problems raised by the political activity of tax-exempt organizations give rise to a number of possible solutions. Administratively, the Service and the Treasury Department¹⁰⁶ have the authority to take a number of steps.¹⁰⁷ Some stakeholders have for years urged the government

¹⁰⁴ TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2013-10-053, INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW.

¹⁰⁵ *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540 (1983). *But see* Galle, *supra* note 68, at 1631–32 (arguing that the 501(c)(4) loophole may no longer be constitutionally required).

¹⁰⁶ The Treasury Department has the authority to issue regulations. The Service provides other forms of guidance such as Revenue Rulings. For convenience, “Service” when used here may also include the Treasury Department and vice versa.

¹⁰⁷ I.R.C. § 7805. For a discussion regarding the authority of the Treasury to issue regulations in the area, and consideration of constitutional concerns, see ABA Tax Section Comments *supra* note 69.

to issue more guidance in the area.¹⁰⁸ Congress too has placed unflinching pressure on the Service. Prior to the recent scandal, the Service also had made efforts to enforce the area in a more public and deliberate manner.¹⁰⁹ The question is what Treasury and the Service can do now to address the problems and provide greater certainty in the law and more consistent enforcement.

A. Quantum-Based Solutions

One approach would be to focus on the thresholds for permitted political activity, or more broadly, on nonexempt activity. Current law thresholds could be made more precise, changed, or both.

1. A Bright Line Approach

Current regulations in the 501(c)(4) area declare that “[t]he promotion of social welfare does not include [political activity]”¹¹⁰ making political activity by definition nonexempt. The limit on nonexempt activity of any type is set by a “primarily” test. The regulations provide that the social welfare purpose is met if the organization is “primarily engaged in promoting in some way the common good and general welfare of the people of the community.”¹¹¹ Put another way, “the organization’s primary activities [must] promote social welfare.”¹¹²

What the “primarily” test means in practice, however, has long been a source of contention. The conventional wisdom is that a 501(c)(4) will not lose exempt status as a (c)(4) so long as at least fifty-one percent of its activities are in pursuit of social welfare.¹¹³ Although there is no formal guidance to this effect, it is a rule of thumb used by Service agents.¹¹⁴ Some

¹⁰⁸ See, e.g., Gregory L. Colvin, *Political Tax Law After Citizens United: A Time for Reform*, 66 EXEMPT ORG. TAX REV. 71 (2010); Kingsley & Pomeranz, *supra* note 52.

¹⁰⁹ See *Political Activity Compliance Initiative (2008 Election)*, http://www.irs.gov/pub/irstege/FY2011_Workplan_Political_Activities_Project_Excerpt.pdf.

¹¹⁰ Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (1990).

¹¹¹ Treas. Reg. § 1.501(c)(4)-1(a)(2)(i) (1990).

¹¹² Rev. Rul. 81-95, 1981-1 C.B. 332.

¹¹³ Cautious practitioners would set the current law threshold lower, however. See Miriam Galston, *Vision Service Plan v. U.S.: Implications for Campaign Activities of 501(c)(4)s*, 53 EXEMPT ORG. TAX REV. 165, 168 (2006).

¹¹⁴ Lindsey McPherson, *EO Training Materials Suggest 51 Percent Threshold for Social Welfare Activity*, 2014 TAX NOTES TODAY 13–15 (Jan. 21, 2014) (suggesting that the Service staff calculate the meaning of primary as fifty-one percent of expenditures for exempt activities).

courts take a more restrictive approach, however, concluding that nonexempt activities must not be “substantial.”¹¹⁵

Yet, even if the Service’s informal rule of fifty-one percent exempt activities is accepted, it is unclear how to apply the test. Is it fifty-one percent of expenditures? Does or should effort or the time spent by volunteers count? Is there room for a qualitative assessment?¹¹⁶ Indeed, the presence of this informal and ambiguous test is one of the culprits in the targeting scandal, opening the door for organizations to exploit legal uncertainty and claim 501(c)(4) status.¹¹⁷

Accordingly, one approach would be to define a primary threshold for noncharitable exempts using a mechanical bright-line. A model would be the regulations in the section 501(c)(3) area that articulate in great detail the permitted amount of lobbying.¹¹⁸ For example, regulations could specify the exact amount of expenditures allowed for political activity in relation to expenses,¹¹⁹ place caps on the amount of time spent by the organization, and attempt also to measure the impact of endorsements and other activities that may have a high impact but low expense. Some working definition of political activity also would have to be adopted.

The promise of greater certainty and perhaps compliance under such an approach, however, must also be balanced by recognition that a detailed regulatory regime to assess the “primarily” threshold implies a much more

¹¹⁵ See *Vision Service Plan v. United States*, No. CIVS041993LKKJFM, 2005 WL 3406321 (E.D. Cal. Dec. 12, 2005).

¹¹⁶ The Service has described the test as a facts and circumstances determination. Factors include funds and time (including volunteer time) spent, other resources used, and the manner in which the activities are conducted. See Raymond Chick & Amy Henchey, *Political Organizations and IRC 501(c)(4)*, EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL PROGRAM FOR FISCAL YEAR 1995, 192 (1995). As Professor Aprill notes, “[a]dvisors differ widely in how much politicking they believe section 501(c) organizations . . . can undertake without endangering their exempt status.” Aprill, *supra* note 34, at 382.

¹¹⁷ Dylan Matthews, *Crossroads GPS and Priorities USA Were Created for the Purpose of Hiding Donors*, WASH. POST WONKBLOG (May 15, 2013, 9:00 AM), <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/05/15/crossroads-gps-and-priorities-usa-were-created-for-the-purpose-of-hiding-donors/> (discussing the various interpretations of the “primary activity test” and describing how Crossroads GPS and other groups whose principal purpose is to fund political campaigns were organized as 501(c)(4) organizations).

¹¹⁸ Treas. Reg. § 56.4911-1 to -10. The organization can elect into this regulatory regime or instead be subject to a “substantially all” facts and circumstances test. I.R.C. § 501(h).

¹¹⁹ There are multiple proposals. See e.g., Aprill, *supra* note 34, at 382 (advocating a ten–fifteen percent of activity limit); ABA Tax Section Comments, *supra* note 69 (suggesting an amount “somewhere between insubstantial (but not zero) and 40%”).

robust enforcement presence by the Service, including a need for additional resources. This would increase administrative burdens on the Service and have the perhaps perverse effect of involving the Service more deeply — not less — in political activity questions. Notably, the 501(c)(4) proposed regulations demur on this issue, and decline to provide guidance on the question of what constitutes “primarily.”¹²⁰

Moreover, it would be difficult legally in the noncharitable exempt context to segregate political activity from other nonexempt activity. The “primarily” test of current law is directed to all nonexempt activity, not just political activity. Although a threshold could be adopted (e.g., no more than ten percent, forty percent, etc.), it would have to account for political and other nonexempt activity, which would make for an even more complex test. Although a threshold specifically directed to political activity could in theory be imposed, doing so would be arbitrary. Why single out one nonexempt activity from another for a separate cap and a mechanical test?

One of the reasons the detailed regulatory regime for lobbying in the 501(c)(3) context is workable is because lobbying is subject to a distinct statutory limitation.¹²¹ There is no statutory language in 501(c)(4) on which to base specific political activity limits. Further, as discussed more below, thresholds below fifty-one percent generally would create an undesirable gap between noncharitable exempt and political organizations.

2. Change “Primarily” to “Substantially” or “Exclusively”

A related quantum-based solution would be to change the regulatory standard from “primarily” to something else. For example, to qualify as a noncharitable exempt organization, regulations could provide that the organization must be “exclusively” or “substantially” engaged in its exempt purpose.¹²² The basis for such a change would be a reinterpretation of the language of the tax statute, which provides, for example, that a 501(c)(4) organization must be organized and operated “exclusively” for social welfare.¹²³ The Code does not say “primarily.” Indeed, in the wake of the

¹²⁰ Prop. Treas. Reg. § 1.501(c)(4)-1, 78 Fed. Reg. 71,535 (Nov. 29, 2013).

¹²¹ Lobbying may not be a “substantial part” of activities. I.R.C. § 501(c)(3), (h).

¹²² An interpretation of “primarily” that required far more than a majority of activities to be in furtherance of exempt purposes could have the same effect without changing the terminology.

¹²³ Similar reinterpretations would be required for other noncharitable exemptions, which often explicitly or implicitly follow the lead of section 501(c)(4). See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 80 (9th ed. 2007) (noting that the terms “substantial” and “exclusive” have been subsumed into the term “primary” for purposes of imposing a primary purpose test that “[I]s generally applicable to all categories of exempt

targeting scandal, the “primarily” test of the regulations has been criticized as agency overreach and an improper interpretation of congressional intent.¹²⁴

Although it should be within Treasury Department authority to reconsider the “primarily” standard for exempt status,¹²⁵ there are additional complicating factors. As discussed, the “primarily” standard applies to more than political activity, so changing the exemption thresholds, if the intent is just to limit political activity, in fact has broader effects.

Further, “exclusively” in the statute is a term of art, with origins in section 501(c)(3). Under section 501(c)(3), a charitable organization must be organized and operated “exclusively” for charitable purposes. Yet in 1945, the Supreme Court found in *Better Business Bureau of Washington, D.C. v. United States*¹²⁶ that an insubstantial nonexempt purpose was consistent with tax exemption under an “exclusively” standard.¹²⁷ The Treasury regulations for section 501(c)(3) subsequently adopted a nonliteral construction, providing that “exclusively” means primarily.¹²⁸ This is the standard generally adopted in the 501(c)(4) regulations in 1959.¹²⁹ Although the Service could adopt a standard based more directly on *Better Business Bureau*, or even on the 501(c)(3) regulations,¹³⁰ anything more restrictive would be problematic.

organizations.”).

¹²⁴ See Press Release, Democracy 21, Rep. Van Hollen and Watchdog Groups File Lawsuit Challenging Flawed IRS Regulations (Aug. 21, 2013), available at <http://www.democracy21.org/money-in-politics/letters-to-the-irs/rep-van-hollen-and-watchdog-groups-file-lawsuit-challenging-flawed-irs-regulations/>.

¹²⁵ There could be objections that because the standard is over half a century old, Congress has acquiesced in the change. See Galston, *supra* note 113, at 171 (noting, however, that it is unlikely Congress acquiesced to the regulation or to any specific allowable percentage of activity); ABA Tax Section Comments, *supra* note 69 (arguing that Treasury has authority with respect to the Proposed Regulations).

¹²⁶ 326 U.S. 279, 283 (1945) (holding that “the presence of a single [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes”).

¹²⁷ *Better Business Bureau* was phrased in terms of purposes, not activities, leaving the question of both the extent of permissible purposes and activities open. For additional discussion of the purposes-activities distinction, see Galston *supra* note 113, at 169.

¹²⁸ Treas. Reg. § 1.501(c)(3)-1(c)(1) (2008) (providing that “[a]n organization will be regarded as ‘operated exclusively’ for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes”).

¹²⁹ For an excellent discussion of the evolution and meaning of the standard, see Galston, *supra* note 113.

¹³⁰ The 501(c)(3) regulations contain a regulatory gloss on “primarily” that was not adopted by the 501(c)(4) regulations, namely that “[a]n organization will not be so regarded

Even discounting the effect of *Better Business Bureau* and the 501(c)(3) regulations, Congress has also adopted a nonliteral understanding of the term “exclusively.” Although Congress used the word in 1913,¹³¹ when it passed the unrelated business income tax in 1950,¹³² it made a literal interpretation of “exclusively” by the Treasury Department impossible. The imposition of a tax on the business income of exempt organizations carries with it the implicit permission to engage in activity that is *not* related to exempt purposes.¹³³ In other words, pursuit of an unrelated trade or business activity is by definition not to engage “exclusively” in an exempt purpose. The quantum of unrelated business activities that is consistent with exempt status is determined under the “primarily” and “insubstantial” test of the 501(c)(3) regulations, and is very open-ended.¹³⁴

if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.” Treas. Reg. § 1.501(c)(3)-1(c)(1) (2008). In other words, for section 501(c)(3), “primarily” is defined in part based on a “substantially” test. These conflicting directives reflect the Treasury’s own uncertainty about the scope of permitted nonexempt activity. “Treasury determined that it could not legally support the position that an organization could lose its exempt status as a result of substantial unrelated business activity.” Thomas A. Troyer, *Quantity of Unrelated Business Consistent with Charitable Exemption – Some Clarification*, 56 TAX NOTES 1075, 1076 (August 24, 1992).

¹³¹ Tariff Act of 1913, Section II G(a), chapter 16, 63d Cong., 38 Stat. 114, 172.

¹³² The Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906. In 1950, the unrelated business income tax (UBIT) applied to 501(c)(3), 501(c)(5), and 501(c)(6) organizations. In 1969 the tax was extended to 501(c)(4) organizations and many other noncharitable exempts. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487. So although the 1959 social welfare regulations were not adopted with the UBIT as a direct concern, a literal interpretation of “exclusively” in light of the effect of UBIT on other exemption provisions would have been difficult.

¹³³ STAFF OF J. COMM. ON TAXATION, 109TH CONG., HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 49 n.70 (Joint Comm. Print 2005) (concluding that “[a]s a practical matter, if ‘exclusively were construed by regulations in its ordinary sense, an organization would not be permitted to engage in unrelated business income tax activities, rendering the unrelated business income tax rules moot”).

¹³⁴ There is *no quantitative limit* on the unrelated business activities of a 501(c)(3) organization. The standard (for a charitable organization) is whether the organization conducts a charitable program “commensurate in scope” with its financial resources. Rev. Rul. 64-182, 1964-1 C.B. 186. As explained by the Service, the primary purpose test is “essentially a test of proof . . . whether there is a real, bona fide, or genuine charitable purpose, as manifested by the charitable accomplishments of the organization, and *not a mathematical measuring* of business purposes as opposed to charitable purpose.” I.R.S. Gen. Couns. Mem. 32,689 (Oct. 6, 1963) (emphasis added). For additional discussion, see Troyer, *supra* note 130.

Nevertheless, the Treasury Department could attempt to develop thresholds for political activity that are different than the thresholds for other unrelated activity.¹³⁵ For example, the “primarily” interpretation of “exclusively” could be retained for all nonexempt activity, and a “substantially” interpretation of “exclusively” for political activity. “Substantially” could be defined according to the facts and circumstances, or pursuant to a detailed and mechanical regulatory regime (with the attendant pros and cons discussed above).

All of that said, the reason to adopt a “substantially” test would be to advance a policy to limit the political activity of noncharitable exempts relative to current law. This goal, however, may be misguided. The result would be to create a sort of “no man’s land” for certain mixes of activities, which may not be sustainable.

For example, what would happen to organizations that exceed the “substantial” threshold for political activity, but do not engage in enough political activity to qualify as a political organization? Presumably, such organizations would lose noncharitable exempt status and become fully taxable nonprofits. It would be an odd system though, not to mention irrational and perhaps unconstitutional, to treat those organizations worse than political organizations from a tax perspective because they engage in *less* political activity. Furthermore, the administrative burden on the Service would increase because of the addition of yet another line to police — that between the noncharitable exempt, the taxable nonprofit, and the political organization.

Another related alternative is that the term “exclusively,” as applied to the political activity of 501(c)(4) (and other noncharitable exempt) organizations, should mean exclusively. Given the rule that political activity does not further noncharitable exempt purposes, no political activity should be allowed. One benefit of a literal “exclusively” standard relative to a “substantially” standard is easier policing. There would be no need to decide how much is too much. However, the tax disparities created would be even larger than under a “substantially” standard: a peppercorn of political activity would result in fully taxable status, but a lot of political activity would receive more favorable treatment under section 527.

Furthermore, section 501(c)(4) must be read together with its close cousin, section 501(c)(3). In section 501(c)(3), Congress wrote an express prohibition on political activity into the Code. Thus, there is a strong

¹³⁵ As noted above, it is unclear whether the Treasury has the authority to bifurcate the statutory term “exclusively” in such a way, and a legislative change may be required. It is one thing to conclude that particular activities do or do not further social welfare within the meaning of the statute, and another to impose a limit on a particular activity.

negative implication from the presence of the express prohibition in section 501(c)(3) and the absence of one in section 501(c)(4).

In addition, the need for the express prohibition on political activity in section 501(c)(3) also demonstrates that prior 501(c)(3) law,¹³⁶ which used “exclusively” as the test for exemption, did not prohibit political activity through this word. Instead, an express prohibition was needed. In short, it would be an odd reading indeed of section 501(c)(4) to interpret “exclusively” to contain a prohibition on political activity, when section 501(c)(3) also uses the term “exclusively” for exemption purposes *and* contains an express prohibition.

3. Eliminate Definitional Limits on the Political Activity of Noncharitable Exempts

Another quantum-based approach would be to revisit whether there should be a definitional limitation on the political activity of noncharitable exempt organizations. The basis for the present law limitations is the regulatory declaration that political activity does not further exempt purposes.¹³⁷ On its face, the conclusion seems absurd. A social welfare lobby group (501(c)(4)), a labor union (501(c)(5)), and a trade association (501(c)(6)) all plainly have political aspects that are directly connected to their exempt purposes.

For a social welfare lobby organization that promotes gun rights to advocate for a candidate in favor of gun control makes sense. For a labor union to favor a pro-union political candidate over another undoubtedly would serve labor purposes. For a trade association that promotes a particular industry, preferring the business candidate over the populist would seem to be in direct furtherance of its exempt purpose. Further, each type of organization may and does establish separate political organizations — convincing evidence that pursuing political activity furthers underlying organizational purposes. The law makes nonsense of reality by defining political activity as incompatible with noncharitable exempt purposes. Is there a good reason?

¹³⁶ That is, the law prior to the enactment of the political activities prohibition in 1954.

¹³⁷ For example, the regulations for social welfare organizations explicitly provide that political activity does not further social welfare. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (1990) (“The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office.”). The proposed regulations modify this part of the regulations, replacing the current use of the section 501(c)(3) standard for political activity with a new definition of political activity, distinct for section 501(c)(4). Prop. Treas. Reg. § 1.501(c)(4)-1, 78 Fed. Reg. 71,535, 71,535 (Nov. 29, 2013).

Interestingly, the rationale behind the regulatory conclusion that political activity categorically does not further social welfare is unknown.¹³⁸ One explanation is that political activity, unlike lobbying, ultimately serves the private ends of a candidate, whose personal mission and benefit may be far removed from the noncharitable exempt purposes of an organization. Thus, the Service has reasoned in the context of 501(c)(5) and 501(c)(6) organizations that “support of a candidate for public office necessarily involves the organization in the total political attitudes and positions of the candidate.”¹³⁹ That conclusion seems debatable. Support for a political candidate need not mean reverence or identity. Further, it simply is not clear why the fact that a candidate has positions on multiple issues means that political support for the candidate by an exempt organization *by definition* cannot also advance the organization’s mission.

Most likely, the reasoning of the Service and the regulations is rooted in the parallel relationship between section 501(c)(3) and 501(c)(4). The “promotion of social welfare” is a charitable purpose under the section 501(c)(3) regulations.¹⁴⁰ Charities of course are prohibited from engaging in political activity. The 501(c)(3) rules make for an easy leap to conclude that political activity by definition is not charitable, and so also does not further social welfare for purposes of 501(c)(4).

However, the Treasury could not prohibit political activity in the 501(c)(4) regulations because doing so would be inconsistent with the statute.¹⁴¹ Further, for the Treasury to acknowledge that political activity could be in furtherance of social welfare, or other noncharitable exempt purpose, would be to introduce a difficult inquiry into whether the political activity was “related” or “unrelated.”¹⁴² Whether for those reasons or not, the regulations take a middle ground. By declaring that political activity

¹³⁸ See Kingsley & Pomeranz, *supra* note 52, at 73 n.83.

¹³⁹ I.R.S. Gen. Couns. Mem. 34,233 (Dec. 30, 1969). See also *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989) (ruling that an organization that ran an educational program that trained campaign workers did not qualify under 501(c)(3) because of impermissible private benefit to Republican candidates and entities). Professor Miriam Galston argues that the assumption of the regulations that political activity does not further social welfare is “debatable” in cases of a single issue candidate, but stronger when political candidates take positions on issues outside the scope of an organization’s mission. Galston, *supra* note 113, at 170.

¹⁴⁰ Treas. Reg. § 1.501(c)(3)-1(d)(2) (2008).

¹⁴¹ See discussion *supra* text accompanying note 136.

¹⁴² In 1959 the Treasury was dealing with just such a “related-unrelated” inquiry in the context of a trade or business. Trade or business activity is allowed without limit, so long as it is “related” to the exempt purpose. Treas. Reg. § 1.501(c)(3)-1(e) (2008); see also Troyer, *supra* note 130.

does not further exempt purposes, the regulations avoid a “related-unrelated” inquiry, but achieve a limitation, set by the “primarily” test.

Yet the conclusion that political activity does not further exempt purposes under section 501(c)(3)¹⁴³ reflects, or should reflect, much different concerns than a conclusion that political activity does not further noncharitable exempt purposes. Although it may seem an easy leap, the chasm between the two sections is wide. The political activities prohibition of section 501(c)(3) is critical to protect the integrity of the charitable exempt purpose and is tied inextricably to the charitable deduction.¹⁴⁴

Noncharitable exempts, however, do not receive charitable contributions,¹⁴⁵ and so the exempt purpose does not require nearly as much “protection” as a matter of tax policy. Quite simply, noncharitable exempts are not “public benefit” organizations in the same way as a charity. Labor unions and trade associations, for example, though undoubtedly a positive force in civil society, are not disinterested public benefit organizations in the same sense as a 501(c)(3) charity is intended to be. Their purposes have manifest private or even political overtones. Defining their purpose as exclusive of political activity for tax reasons seems churlish, especially after the Supreme Court has allowed unlimited independent expenditures.

On the surface, 501(c)(4) organizations present a stronger case as “public benefit” organizations. They must serve the social welfare by “promoting in some way the common good and general welfare of the people of the community.”¹⁴⁶ There is a sense that social welfare organizations really are engaged in the same type of public benefit activities as charitable organizations.

In fact, however, the social welfare and charitable organization types are quite different. The 501(c)(4) is allowed to engage in unlimited lobbying (as are the (c)(5) and the (c)(6)), some political activity, and has become a “catchall” exemption category for groups that fail to fit

¹⁴³ Interestingly, the section 501(c)(3) regulations do not say directly, as do the 501(c)(4) regulations, that political activity does not further social welfare. Rather, the 501(c)(3) regulations provide an indirect route, finding that an organization that engages in any political activity is an “action” organization, and therefore fails the operational test (is not operated “exclusively” for exempt purposes). Treas. Reg. § 1.501(c)(3)-1(c)(3)(iii) (2008).

¹⁴⁴ No charitable deduction is allowed to an organization that fails the political activities prohibition. I.R.C. § 170(c)(2)(D). Other tax benefits are also related to the 501(c)(3) classification, such as tax-exempt financing. I.R.C. § 145.

¹⁴⁵ Veterans organizations, although technically a “noncharitable exempt” are eligible to receive deductible contributions, but are not subject to the political activities prohibition. I.R.C. § 501(c)(19) Veterans organizations therefore are hard to categorize.

¹⁴⁶ Treas. Reg. § 1.501(c)(4)-1(a)(2) (1990).

elsewhere.¹⁴⁷ Thus, section 501(c)(4) is a useful classification for nonprofit lobby groups and local civic organizations that serve a narrow class of beneficiaries. But the benefit served is less noble and less directly in the public interest than that of a charity.

Nevertheless, some argue that restrictions on political activity are necessary to protect against capture of the organization and consequent corruption of its purposes.¹⁴⁸ It has long been observed that nonprofit organizations are prone to capture because of weak oversight.¹⁴⁹ Without shareholders, nonprofit organizations are more open to direction by managers who might abuse the organization by taking it in personal, private directions.

Although capture is a legitimate concern, it has more force when directed to charitable organizations, which are formed in the public interest, than to noncharitable nonprofits, which tolerate a great deal more “private” interest.¹⁵⁰ Further, the cost to the tax system may be marginal. Depending on whether the organization has a profit and accumulates funds tax exemption may not be a significant benefit to the organization or loss to the Treasury.¹⁵¹

In addition, many existing noncharitable exempt organizations already engage in considerable amounts of political activity, which is another way of saying that capture concerns already exist under present law. Although

¹⁴⁷ See James J. Fishman & Stephen Schwartz, *TAXATION OF NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 768 (2d ed. 2006) (referring to 501(c)(4) as a “dumping ground”).

¹⁴⁸ Brain Galle & Donald Tobin, *Comments on Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities*, 6–8 (Ctr. for Interdisciplinary Law & Pol’y Stud. at the Moritz Coll. of Law, Working Paper No. 239, 2014).

¹⁴⁹ Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 506–07 (1981).

¹⁵⁰ The entire basis of exemption under section 501(c)(6) is to serve the interest of a league of businesses, i.e., a trade association. The exemption for section 501(c)(4) has long been believed to have been secured by the U.S. Chamber of Commerce. See STAFF OF J. COMM. ON TAXATION, 109TH CONG., *HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS* 29 (Joint Comm. Print 2005).

¹⁵¹ It is worth noting that to the extent political activity expenses increase, the exposure to tax under section 527(f) also increases depending on the amount of the organization’s investment income. Professor Halperin concludes that the exemption on income for organizations that accumulate funds could be very significant.

Daniel Halperin, *The Tax Exemption under Section 501(c)(4)*, URBAN INST 3, 5 (2014) (working paper), available at <http://www.urban.org/UploadedPDF/413152-The-Tax-Exemption-Under-Section-501.pdf>.

removing the definitional limits might make capture worse, it is questionable whether any increased risk of capture to a noncharitable exempt is sufficient to justify arbitrary limits on a core activity. Besides, the risk of capture on a systemic scale seems overblown. Some organization managers might be swayed to endorse or promote a candidate against the organization's interests. To the extent this occurs repeatedly, other doctrines of tax law could be used (such as private benefit)¹⁵² to revoke an organization's exempt status.

Nonetheless, even if many of the standard explanations for the definitional political activity limits do not appear justified, placing a definitional limitation on the political activity of noncharitable exempts does serve to delineate between the noncharitable exempt and the political organization. In this way, the limitation can be said to protect the integrity of the noncharitable exempt purpose by making sure that the nonpolitical activity (or purpose) remains "primary."¹⁵³ In other words, for convenience and perhaps even transparency, an organization's stated purpose – social welfare, labor, pursuit of trade, politics – must remain the top purpose, otherwise the tax classification changes. In short, one tax policy reason to limit the political activity of noncharitable exempts is to provide appropriate labels of organizational types.

The labeling function of the definitional limit probably was a sufficient reason for the limit before *Citizens United*. Before *Citizens United*, campaign finance law banned corporate (and labor union) independent expenditures.¹⁵⁴ As discussed above, this meant that for a noncharitable exempt, political activity generally would always be incidental to its main purpose. In other words, by placing severe limitations on the amount of permitted political activity, campaign finance law, not tax law, was controlling. The tax law limits largely were superfluous.¹⁵⁵ The pre-*Citizens*

¹⁵² See, e.g., I.R.S., 1981 EO CPE TEXT, G. SOCIAL WELFARE: WHAT DOES IT MEAN? HOW MUCH PRIVATE BENEFIT IS PERMISSIBLE? WHAT IS A COMMUNITY? 1 (1981). If organization funds are used to provide an excess benefit to an insider of a social welfare organization, then an excise tax applies to the transaction. I.R.C. § 4958.

¹⁵³ Notably, political organization treatment is based on whether the organization's "primary" purpose is to engage in political activity. I.R.C. § 527(e)(1).

¹⁵⁴ 2 U.S.C. § 441b (2000 ed.); *Citizens United v. FEC*, 558 U.S. 310, 320 (2010).

¹⁵⁵ The issue advocacy loophole exploited by some political organizations to avoid the Federal Election Campaign Act never really spread to the noncharitable exempt, perhaps because of questions about application of the gift tax, the need to dilute the activity to fit into the "loophole," and general uncertainty about the contours of the tax law political activity limits. As explained by Professor Polsky, before *Citizens United* and after the 2000 changes, the main issue was with donors, unconcerned about anonymity, who therefore preferred section 527 over section 501(c)(4) to be certain of avoiding gift tax. See Polsky, *supra* note 10, at 1782.

United world of campaign finance thus fit fairly neatly into the tax law paradigm of political activity limitations. The definitional and quantum-based limits were helpful in a black and white world, where organizations either were political, or not.

Now that unlimited independent corporate political activity is allowed, the tax law definitional approach is outmoded. Noncharitable exempt groups naturally will and should expect to be able to engage in more political activity, much of which on any common understanding will be related to the organization's purposes. The tax law rules that deem political activity as not consistent with noncharitable exempt purposes and so subject to limitation thus seem patently unsound.

Further, once *some* political activity is allowed by tax law, maintaining a quantum-based limit in the wake of *Citizens United* seems arbitrary, counterproductive, complex, and distracting — especially because the activity in truth will often be a related one.¹⁵⁶ Indeed, definitional limits on the activity puts a strain on the rule of law. It is like allowing life but decreeing that breathing is not related to existing.¹⁵⁷ The current approach also forces the Service to have a greater role in regulating political activity, which as recent events have shown, is a role no one seems to relish.

All that said, from purely a tax perspective, whether or not there are definitional political activity limits would not even matter much if the labeling function of the exemption categories had no tax consequences.¹⁵⁸ Then, the political activity limits sensibly could be retained and defended on the ground that the only tax consequence of exceeding the limit was a change in tax classification, e.g., from 501(c)(4) to 527. The organization would have a new tax classification, perhaps one it does not prefer, but one that is intended to reflect the reality of the organization's operations.¹⁵⁹

¹⁵⁶ See Halperin, *supra* note 151, at 7 (noting that for some organizations “it is unclear why participation in a political campaign, to help elect sympathetic candidates, is not a legitimate means to promote its charitable purpose”). If the stipulation that political activity does not further social welfare was removed from the regulations, a distinction between “related” and “unrelated” political activity would be introduced. This distinction exists for lobbying, or indeed any activity. The presumption however would be that political activity would further noncharitable exempt purposes. For a discussion of the difficulty of maintaining a related-unrelated distinction in the context of political activity of charitable organizations, see Colinvaux, *supra* note 67, at 749–50.

¹⁵⁷ This strain also exists in the context of a charity, but as noted, the other tax benefits associated with the charity make the charity distinguishable.

¹⁵⁸ As discussed below, there are significant consequences relating to disclosure that hinge on tax classifications. Disclosure rules are not however primarily driven by concerns of taxation, even though tax law is the vehicle.

¹⁵⁹ Note that a shift from noncharitable exempt status to political organization status should be less important to the organization than a shift from 501(c)(3) status to another

Under current law, however, there are potentially significant tax differences between a noncharitable exempt and a political organization. Broadly, if a noncharitable exempt exceeds the political activity limit and becomes a political organization, it means a loss of exemption on the income from the noncharitable exempt purpose (social welfare, labor, trade, etc.).

The question then is what explains this result. Probably the best explanation is rooted again in a history of organizations being either political or not, with campaign finance rules preventing too much of a gray area. The history of “political organizations” suggests that they were just that – serving politics and nothing else – i.e., parties and political committees. The tax treatment followed the facts, with a bright line exempting only political activity income.¹⁶⁰ The unstated assumption must have been either that political organizations would not engage as a general matter in nonpolitical activity, or, for simplicity, that they should not be encouraged to do so. That assumption for a political organization may still hold true. But now, the opposite problem exists, and bona fide noncharitable exempts seek to engage in significant political activity.

In short, the loss of exemption on noncharitable exempt purpose income for engaging in too much political activity was never tested sufficiently before *Citizens United*. A genuine mixed noncharitable-political purpose organization was not enough of a reality, and thus, cross-overs from social welfare to political status were not a concern for tax purposes. Now, the facts of organization types have changed, and the issue is raised as to whether the exempt status of the noncharitable exempt purpose income should depend on the quantum of political activity.

In the wake of *Citizens United*, the answer is no. Ideally, there should be no tax consequence to a noncharitable exempt for exceeding what amount to arbitrary limits on an important and generally related activity. In other words, so far as the tax law is concerned, the definitional limitations on the political activity of noncharitable exempts should be eliminated.¹⁶¹ As discussed in the next paragraph, however, this preferred outcome for tax

exemption category. This is not only because loss of 501(c)(3) status entails loss of tax benefits other than tax exemption, but also because the 501(c)(3) category brings with it a certain identity, both for the organization and in the public eye.

¹⁶⁰ I.R.C. § 527(c).

¹⁶¹ This result could be accomplished administratively by, for example, striking the regulatory declaration that political activity does not further social welfare purposes and issuing other forms of guidance with respect to other noncharitable exemption categories, such as 501(c)(5) and 501(c)(6). As discussed in Part V *infra*, the result also could be accomplished legislatively, which, all things equal, is preferable. Technically, a limit on “unrelated” political activity would remain, and would help protect against capture concerns.

purposes is subject to one important limitation, and, in any event, should not be undertaken until the nontax advantages of noncharitable exempt status (namely nondisclosure of donors) have been eliminated relative to the political organization.

The important limitation relates to the tax treatment of political activity. Under current law, if a noncharitable exempt slips into section 527 status, the tax treatment of political activity largely is unaffected. The reason is that when Congress codified section 527, it created a norm for the tax treatment of political activity, not just for political organizations, but also across the exemption categories. Recall that the essential tax treatment of a political organization is exemption for contribution income, but taxation for investment (and other) income. The question of what to do when a noncharitable exempt engages in political activity arose. There could be unequal treatment as compared to a political organization to the extent that (some of) the investment income of the noncharitable exempt is not subject to tax.

Congress had the foresight to close the potential loophole,¹⁶² and provided that if a noncharitable exempt engages in political activity, a tax is triggered on the lesser of the organization's investment income or the amount of its political expenditures.¹⁶³ The result was that political operatives would not have a tax incentive to conduct political activity out of a noncharitable exempt instead of a political organization.¹⁶⁴

Accordingly, from a tax perspective, it does not matter whether a noncharitable exempt engages in political activity (so long as the political activity is below the "primarily" threshold).¹⁶⁵ Political activity generally is taxed as it would be if it were conducted by a political organization.¹⁶⁶ Consistent treatment of political activity across the exemption categories is the right result and one that must survive any relaxation of the political

¹⁶² The legislative history explained that noncharitable exempts should be treated "on an equal basis for tax purposes with political organizations." S. REP. NO. 93-1357, at 7505 (1974), *reprinted in* 1974 U.S.C.C.A.N. 7478, 7505.

¹⁶³ I.R.C. § 527(f).

¹⁶⁴ In addition, Congress provided that the gift tax does not apply to contributions to political organizations. I.R.C. § 2501(a)(4).

¹⁶⁵ As noted, if the political activity exceeds the primarily threshold, there is a tax consequence with respect to the treatment of investment income, but not to the treatment of the political activity income, which remains constant. *See supra* Part III(B)(3); *infra* Part V(B)(3).

¹⁶⁶ The Code allows a noncharitable exempt to avoid the tax by conducting its political activity through a "separate segregated fund," which is treated as a 527 organization. I.R.C. § 527(f)(3).

activity limits on noncharitable exempts.¹⁶⁷ Thus, assuming the vitality of the tax on the political activity of noncharitable exempts, eliminating the definitional political activity limitations has significant appeal. It would simplify tax administration, improve compliance, and embrace free speech.

There remains, however, a critical nontax reason to retain political activity limitations. As noted, political organizations, but not noncharitable exempts, must disclose their donors to the public. If the blanket limitations on political activity of noncharitable exempts were removed, erstwhile political organizations likely would attempt to drop section 527 status in favor of noncharitable exempt status and avoid the section 527 disclosure regime.¹⁶⁸ From a tax perspective, choosing 501(c)(4) over 527 is not especially problematic.¹⁶⁹ From a campaign finance perspective, it would eviscerate donor disclosure rules.

In short, the ultimate usefulness of the political activity definitional limitations on noncharitable exempts is not related to tax policy, but rather is to distinguish between organizations that must disclose donors and organizations that avoid disclosure. Were it not for this function, and from a tax perspective, the rule that political activity does not further noncharitable exempt purposes should be eliminated.

4. Summary

Quantum-based solutions to the problem of political activity by noncharitable exempts do not provide a clear advantage over present law. Formally quantifying the “primarily” test would result in more certainty, but would also require that the Service be more, not less, involved in regulation of political activity. If the policy goal is to curb political activity, changing the test from “primarily” to something more restrictive like “substantially” or “exclusively” would be effective, but would create new categories of taxable nonprofits that are treated worse than political organizations for engaging in *less* political activity, creating an odd and perhaps unconstitutional result. The problem of whether to quantify the test or rely on facts and circumstances would remain.

¹⁶⁷ As discussed in the next section, the Treasury could take immediate steps to improve the vitality of this tax. *See infra* Part IV(B).

¹⁶⁸ Intriguingly, whether this is possible depends upon whether section 527 treatment is mandatory for organizations with a primary purpose of political activity, or optional. *See* discussion *infra* Part V(B)(5).

¹⁶⁹ The main tax issue would be that absent the gift tax on noncharitable exempts, contributions of appreciated property would be income tax-favored relative to the political organization. *See supra* Part III(B)(2). This preference should be eliminated. *See* discussion *infra* Part V(B)(3).

Further, it is not clear why it makes sense as a matter of tax exemption to decree that political activity may not further noncharitable exempt purposes. Political activity on its face often will be related to the primary purpose of noncharitable exempt organizations. Before *Citizens United*, the political activity limits were not especially relevant, but at least helped to differentiate organization types. However, *Citizens United* largely rendered existing tax law limitations obsolete by making a new kind of multi-purpose organization possible. As a result, definitional political activity limits are no longer justified and should be eliminated, but only if the 527(f) tax remains vital and the differences in the disclosure regimes between political organizations and noncharitable exempts are erased.

B. Other Administrative Approaches

Along with quantum-based solutions, other administrative approaches include modifying the definition of political activity, promulgating regulations under section 527, changing course on the gift tax, and a more aggressive enforcement posture.

1. Definitional Solutions

One of the principal solutions advanced by commentators and the Service is focus on the definition of political activity.¹⁷⁰ The lack of uniformity of a tax-law definition across the Code increases confusion for taxpayers, policymakers, and for the Service. Further, the use of a facts and circumstances test to define political activity also creates uncertainty, making it difficult to comply with and enforce the law. Accordingly, the Service and the Treasury Department could take steps to provide more definitional uniformity and a brighter-line definition.

Recent proposed regulations on the political activity of 501(c)(4) organizations move in the direction of bright lines. For example, the proposed regulations state that voter registration and get-out-the-vote efforts are political activity, as are certain advertisements that mention a candidate by name within sixty days of a general election campaign (or thirty days of a primary campaign).¹⁷¹ As the Treasury Department acknowledges in the preamble to the regulations, these bright-line rules lose the nuance of a facts and circumstances approach,¹⁷² which by its nature

¹⁷⁰ See, e.g., GREG COLVIN ET AL., PUBLIC CITIZEN, THE BRIGHT LINES PROJECT: CLARIFYING IRS RULES ON POLITICAL INTERVENTION (interim draft) (May 8, 2014), available at <http://www.citizen.org/documents/May%208%20Explanation%20with%20Exhibit.pdf>.

¹⁷¹ Prop. Treas. Reg. § 1.501(c)(4)-1, 78 Fed. Reg. 71,535, 71,539 (Nov. 29, 2013).

¹⁷² *Id.* at 71,537.

leaves open the question of whether activities are political. The gains of a bright-line approach in terms of greater taxpayer certainty and even enforcement may be offset by losses in accuracy and fairness, resulting in a more restrictive approach overall. In addition, the proposed regulations would frustrate a uniform definition by applying only to 501(c)(4) organizations,¹⁷³ leaving the law of political activity further fractured based on the section and paragraph of the Code.

The proposed regulations thus illustrate the difficult balancing act inherent in a bright-line solution. If the bright line positive definition is over-inclusive, stakeholders will complain, nonpolitical activity will be curtailed, and there will be additional opportunity for constitutional challenges under the First Amendment. If the bright line is under-inclusive, and a facts and circumstances test abandoned, then in some cases, the law will be largely eviscerated.

Further, a bright line, whether under or over-inclusive, may not be so bright, leading to ambiguity, loopholes, noncompliance, and uneven enforcement. One irony is that present law, for all its faults, is a mixture of both bright-line and facts and circumstances approaches. Over time, consensus has formed on certain bright lines (through court decisions and Service guidance), and facts and circumstances retained to account for lack of consensus, factual nuance, and the changing nature of political activity.¹⁷⁴

Some working definition of political activity is necessary for a variety of reasons. On balance, a facts and circumstances approach, though imprecise, best accounts for changes in behavior over time. That said, the definitional problem is a difficult one, and in general it is beyond the scope of this article to examine in depth the contours of the various definitions.¹⁷⁵

¹⁷³ *Id.*

¹⁷⁴ *See, e.g.*, Rev. Rul. 2007-41, 2007-1 C.B. 1421 (providing twenty-one examples of permitted and prohibited voter education activities, voter registration, candidate appearances, issue advocacy, rental of facilities, provision of mailing lists, use of websites, and other activities); Rev. Rul. 86-95, 1986-2 C.B. 73 (allowing a series of public forums if the forum and content are neutral); Rev. Rul. 80-282, 1980-2 C.B. 178 (addressing factors that show bias in the timing and distribution of voter guides); Rev. Rul. 78-248, 1978-1 C.B. 154 (providing guidance on the permitted content and structure of candidate questionnaires); Rev. Rul. 74-574, 1974-2 C.B. 160 (allowing sponsoring of candidate debates and forums that are educational and impartial); Rev. Rul. 67-71, 1967-1 C.B. 125 (providing that the evaluation of the qualifications of candidates or support for a slate of candidates violates section 501(c)(3)); Rev. Rul. 66-256, 1966-2 C.B. 210 (allowing sponsoring of candidate debates and forums that are educational and impartial).

¹⁷⁵ *See* discussion of guidelines for defining political activity *infra* Part V(B)(5). For an excellent overview and analysis of definitional issues, see ABA Tax Section Comments, *supra* note 69.

Nevertheless, in part because of the problems in defining political activity, one goal should be to minimize the need for a definition by making it less relevant for tax purposes. Reducing the relevance of political activity to the tax system would not only help to reduce uncertainty, but also would reduce the need for the Service to make difficult determinations that affect free speech.

2. Promulgate Regulations under 527(f)

One step the Treasury could take to maintain the integrity of existing categories is to promulgate long “reserved” regulations under section 527. The goal would be to eliminate any tax advantage to conducting political activity using a noncharitable exempt instead of a 527.

As discussed above, the Code provides that the political activity of a noncharitable exempt results in a tax on the organization’s investment income.¹⁷⁶ However, the regulations have long “reserved” how to tax certain political expenditures by noncharitable exempts, such as political expenditures that are allowed under the Federal Election Campaign Act or similar state statute,¹⁷⁷ and “indirect” political expenditures.¹⁷⁸

The importance of both reserved regulations increased after the *Citizens United* decision. *Citizens United* established a new category of permitted expense, namely independent expenditures by corporations and labor unions. The result is that as political activity migrates to noncharitable exempts, until regulations are written, this new speech category, which arguably is now allowed by the FECA,¹⁷⁹ may avoid triggering a tax on investment income. Accordingly, pending regulations, there may be a tax *advantage* to making independent expenditures and indirect political expenditures from a noncharitable exempt rather than a political

¹⁷⁶ If political expenditures are less than investment income, then the base for the tax is political expenditures. As noted above, the reason for the tax is to create equal treatment for political activity across code sections and incidentally to prevent political operatives from avoiding taxation on investment income by moving political activity to noncharitable exempts. In theory, the 527(f) tax should have a broader base — covering all nonexempt function income (as defined by section 527). The limitation of the base to investment income points to an acknowledgement that political organizations are not likely to have income other than exempt function income and investment income.

¹⁷⁷ Treas. Reg. § 1.527-6(b)(3) (1980).

¹⁷⁸ Treas. Reg. § 1.527-6(b)(2) (1980). Indirect political expenditures include overhead and other similar administrative type expenses.

¹⁷⁹ For extensive discussion and recommendations on this issue, see Nancy E. McGlamery & Rosemary E. Fei, *Taxation with Reservations: Taxing Nonprofit Political Expenditures After Citizens United*, 10 ELECTION L.J. 449, 449 (2011) (noting that “[a]fter *Citizens United*, what is ‘allowable’ [under the FECA] has mushroomed”).

organization.¹⁸⁰ Treasury could eliminate this advantage with regulations or other guidance.

Taking action on the reserved regulations would be an important and fair administrative step, and would help to level the playing field across exemption categories consistent with congressional intent.

3. Reconsider Application of Gift Tax to Noncharitable Exempts

The gift tax is a crucial element in the taxation of political activity. In general, gift tax applies to gifts by individuals above annual exemption amounts.¹⁸¹ The Code provides an exception from the gift tax for transfers to a political organization.¹⁸² Donors to political organizations have no concern about gift tax liability. However, there is no Code-based exception for gifts to noncharitable exempts. Accordingly, donors considering whether to fund political activity either by a political organization or by a noncharitable exempt have a distinct tax reason to choose the political organization to avoid gift tax liability.

After *Citizens United*, as more political activity shifted to the noncharitable exempt, the Service faced pressure from Congress to stop enforcing the gift tax. The Service ultimately yielded.¹⁸³ This abdication, however, removed a principal tax disadvantage to using the noncharitable exempt for political purposes. The result was to intensify the relevance of the different disclosure regimes. In other words, once the Service gave way on the gift tax issue, donors seeking anonymity would have every reason to prefer funding political activity through a noncharitable exempt rather than a political organization. Indeed, with the threat of the gift tax gone, contributions of property to noncharitable exempts actually receive more favorable tax treatment than property contributions to political organizations because the donor avoids tax on any appreciation in the property.¹⁸⁴

As a purely administrative matter, the Service could discourage political organizations from abusing the noncharitable exempt form by reconsidering its position on the gift tax. Enforcing the gift tax on donors to noncharitable exempts that engage in political activity would force large

¹⁸⁰ The tax advantage is potentially avoiding tax on investment income. Where an organization has no investment income, however, there is no tax advantage.

¹⁸¹ I.R.C. §§ 2501(a)(1), 2503(b). The gift tax does not apply to corporations.

¹⁸² I.R.C. § 2501(a)(4). The Code also provides an exception for transfers to a 501(c)(3) organization. See I.R.C. § 2522(a)(2) (allowing a deduction).

¹⁸³ See *supra* note 101.

¹⁸⁴ I.R.C. § 84.

donors to choose between gift tax liability and disclosure. Of course, Congress would remain free to amend the Code to change this result.

Having already retreated on the gift tax issue, however, the disadvantages of changing course are obvious. Arguably, Congress never intended for the gift tax to apply to noncharitable exempt organizations.¹⁸⁵ Enforcing the gift tax also would raise questions of selective enforcement if the Service ignored gifts to noncharitable exempts for nonpolitical purposes. Thus, although the Service relinquished leverage by not enforcing the gift tax,¹⁸⁶ it would further strain the credibility of the agency now to advance a position without political support based on a formal application of the law.

4. A More Aggressive Enforcement Posture

Another approach, though unlikely in the current political climate, is for the Service to take a more aggressive enforcement posture in the area. Arguably, one of the reasons the Service has been vulnerable to attack is because it has been too timid over time. Timidity on issuing guidance, in delaying resolution of cases, and on application of the gift tax all perhaps led to the management fiasco, remarkable public apology, and ensuing media circus.

The job of the Service is to administer the tax laws drafted by Congress. The law requires the Service to sort exempt organizations into categories based on political activity thresholds. Doing this job is difficult, and will often encounter stiff political resistance. Further, because there is little revenue to be gained by “targeting” an exempt organization, a tough enforcement stance will not be an institutional priority.

Nevertheless, if the Service had been assertive in the wake of *Citizens United* and reclassified some social welfare organizations as political organizations, it might have established useful precedent and discouraged others from attempting to exploit the ambiguity of the “primarily” test to avoid disclosure. A more assertive Service also might force Congress to

¹⁸⁵ See Polsky & Charles, *supra* note 24, at 1013 n.81 (noting that “[t]he application of the gift tax to 501(c)(4) organizations is inappropriate in light of the intended purposes of the gift tax . . . [which] is to backstop the estate tax”). Polsky and Charles suggest one rationale for imposing gift tax on 501(c)(4) organizations, namely to prevent contributions of appreciated property, which if made to a political organization, would be subject to tax on the appreciation. *Id.*

¹⁸⁶ David van den Berg, *Disappearing Social Welfare Groups Could Hinder IRS Examinations*, 2012 TNT 216-7 (November 7, 2012).

legislate in the area,¹⁸⁷ which is where the solution to the problems of political activity and exempt organizations can best be resolved.

V. LEGISLATIVE SOLUTIONS TO PROBLEMS OF POLITICAL ACTIVITY

The key question in fashioning legislation is discerning the “mischief” in need of a remedy or, put another way, agreeing on what needs fixing. With so much sound and fury on the issue of political activity and tax-exempt status, agreement on the mischief is elusive. The truth, though, is simple. There is an underlying legal deficit that only Congress can fix.¹⁸⁸

A. *Provide for Uniform Donor Disclosure Rules*

An effective solution to the core problem raised by the political activity of exempt organizations involves a legislative change¹⁸⁹ to the disclosure rules. As outlined above, in the year 2000, Congress amended the tax code to require political organizations publicly to disclose donor information in order to close a campaign finance loophole. The Service was charged with administering the disclosure regime and imposing tax penalties on failures to disclose. This put the Service in the awkward position of a tax agency playing at campaign law enforcement.

Perhaps more importantly, the 2000 changes also created a discrepancy in the tax law. Donors must be disclosed if political activity is conducted by a section 527 organization, but not if it is conducted by a noncharitable exempt. The discrepancy created the incentive for political operatives to engage in statutory arbitrage and is a direct cause of the problems the Service faced after *Citizens United*.

The obvious solution is to provide for uniform rules on disclosure of donors. If the disclosure rules were the same across the exemption categories, there would be no reason to choose a tax category based on disclosure. Uniform donor disclosure rules would immediately relieve pressure on the “primarily” test (or other political activity limitations). Political groups, without any disclosure benefits to organizing as a noncharitable exempt, generally would prefer political organization status. There would be no need to conjure or pay lip service to a social welfare or

¹⁸⁷ The fact of proposed regulations on the political activity of social welfare organizations are a welcome sign that the Service is taking action and involving the public (and incidentally, the Congress) in the process of how to regulate in the area.

¹⁸⁸ The Supreme Court also could reconsider *Citizens United*.

¹⁸⁹ Although arguably disclosure could be achieved through administrative action, *see* Tobin, *supra* note 103, at 440, legislation is preferable after the recent scandals. *See* Tobin, *Where Do We Go From Here*, *supra* note 39.

other noncharitable exempt purpose. The noncharitable exempt category would recede out of the limelight once again to occupy its historical place as relatively inconsequential. Indeed, whether or not disclosure is required is less important for tax purposes than that there be uniformity — so the same type of activity is disclosed (or not) regardless of tax classification.

From a tax perspective, the ideal would be to eliminate disclosure rules from section 527 and leave disclosure to be addressed by the campaign finance law and the FEC.¹⁹⁰ As recent events have shown, monitoring campaign speech is a damaging distraction for an agency that should have tax collection (not campaign finance) as its priority.¹⁹¹ New disclosure obligations by noncharitable exempts imposed via the tax law would more deeply involve the Service in enforcing campaign finance law¹⁹² and should be avoided.¹⁹³

Regardless of whether the instrument of disclosure is tax or campaign finance law, a difficult issue in establishing a disclosure regime for noncharitable exempts is deciding how much to preserve the privacy of donors that make contributions to fund nonpolitical activities.¹⁹⁴ A simple approach would be to require the disclosure of all donors if a noncharitable

¹⁹⁰ *Accord* Tobin, *supra* note 103, at 1129 (concluding that Congress should “pass broad-based legislation requiring disclosure of campaign-related activity and remove the Service as a campaign finance regulatory agency”). The DISCLOSE Act, introduced in Congress after *Citizens United*, is an example of such an approach. H.R. 148, 113th Cong. (2013). It amends the Federal Election Campaign Act, not the Internal Revenue Code, to require disclosure of independent expenditures. The DISCLOSE Act, however, shows a limited vision in limiting the disclosure requirement generally to nonprofit organizations and political committees. Disclosure should be based on the type of activity, not the type of entity, and in that way would also cover activity by for-profit or taxable nonprofit organizations.

¹⁹¹ As discussed above, the Treasury indirectly could reach this result by eliminating political activity limits on noncharitable exempt organizations, assuming that political activity status is voluntary. A legislative change clearly would be preferable. Professor Ellen Aprill has argued that one reason Congress used the tax code for campaign finance disclosure was to protect the disclosure requirements from constitutional challenge, i.e., by making disclosure a constitutional condition of a tax “subsidy.” She notes, however, that after *Citizens United* upheld disclosure provisions under campaign finance law, reliance on the taxing power may no longer be required. Aprill, *supra* note 34, at 400; *see also* Polsky & Charles, *supra* note 24, at 1022–24.

¹⁹² Any new disclosure rules likely would require complex anti-abuse rules, only further involving the Service in nontax matters.

¹⁹³ *See* Mayer, *supra* note 85, at 682 (arguing that the FEC and not the Service should be the institution of choice for monitoring disclosure).

¹⁹⁴ This issue is not present when requiring disclosure of contributors to political organizations, which generally do not engage in nonpolitical activity.

exempt engages in any (or a set amount of)¹⁹⁵ political activity. This, however, would result in over-disclosure and compromise the privacy of donors that fund nonpolitical activity. On the other hand, such a bright line would be easy to administer and understand. It would also likely have the result of encouraging noncharitable exempts to conduct any political activity from a separate segregated fund that was funded solely by outside contributions. By segregating the funding of political activity, the organization could protect against over-disclosure. Noncharitable exempts that did not so conduct their political activity would likely face the wrath of donors. Another option would be disclosure of all donors making contributions above a certain threshold amount, e.g., \$25,000.

Apart from the merits of any particular disclosure regime, the critical point is uniformity. Without uniform donor disclosure rules, there will remain reasons apart from taxation to choose one tax classification over another. It is this disparity more than any other that is the cause of current problems.

B. Legislative Solutions Grounded in Tax Policy

Although uniform donor disclosure rules are essential, ideally there are steps Congress should take from a tax perspective to improve the rules that govern political activity and tax exemption. The key is to recognize that *Citizens United* changed the legal landscape and that current tax law rules are outmoded.

1. Eliminate Limits on the Political Activity of Noncharitable Exempts

As discussed in depth in Part IV(A)(3) above, prior to *Citizens United*, the political activity limitations were a helpful device to sort exempt organizations. Now that campaign finance law allows unlimited independent expenditures, there is no continuing tax law justification to the artificial and unrealistic definitional political activity limits on noncharitable exempts or, relatedly, to the loss of exemption of nonpolitical activity income for exceeding political activity limits. Accordingly,

¹⁹⁵ Requiring disclosure only by organizations that engage in political activity above some threshold amount would help to minimize overdisclosure. Although insubstantial amounts of political activity would go undisclosed, the privacy of donors to noncharitable exempts with minimal political activity would be protected. Although requiring a dollar or other threshold entails legal and administrative costs, if the job of enforcement is left to the FEC and not the Service, the concerns are diminished. See generally Tobin, *supra* note 103 (suggesting a threshold of \$25,000).

Congress should affirmatively recognize that political activity is not by definition an unrelated activity for a noncharitable exempt organization.¹⁹⁶

2. Expand Exempt Status of Political Organizations

Another approach would be for Congress to expand the tax exemption for political organizations to include income from a noncharitable exempt purpose (in particular, for social welfare, labor, and trade association purposes). This would have the effect of eliminating the sanction for breach of the political activity limits by a noncharitable exempt.

Thus, assuming the political activity limits are retained, if a noncharitable exempt violated the limits and had a primary purpose of political activity, it would become a political organization as under current law. But unlike current law, the underlying tax treatment of the organization would not change significantly.¹⁹⁷ Noncharitable exempt purpose income would remain exempt. Political activity income would largely be unaffected. The 527(f) tax would be replaced in effect with a tax on investment income. The Service would still have to determine whether an organization's primary purpose was political or not, but different tax treatment would not be a principal consequence of reclassification. In other words, to the extent that the labeling function of the present law categories is useful, expansion of the 527 exemption would maintain present law labels, but just erase the significant tax law differences.¹⁹⁸

¹⁹⁶ To the extent applicable, other doctrines would help to protect against abuse of power by organization managers. The private benefit doctrine for example could be applied to organizations captured by political interests. *See, e.g.*, I.R.S., 1981 EO CPE TEXT, *supra* note 152.

¹⁹⁷ The different tax treatment of donors would remain.

¹⁹⁸ For reasons unrelated to political activity, Congress also should consider imposing tax on the investment income of noncharitable exempts. As others have shown, the exemption from tax on investment income for noncharitable exempts is a subsidy without significant justification. *See* Halperin, *supra* note 12. If the subsidy were eliminated, then the baseline tax treatment between the noncharitable exempt and the political organization would be broadly similar and normatively correct. A spillover benefit would be to reduce even further the significance of political activity to taxation, as the need for the Service to track the political activity of noncharitable exempts for purposes of protecting the tax base on investment income would disappear. In other words, the 527(f) tax would become redundant.

3. Extend Income Taxation to Transfers of Appreciated Property When Made to Noncharitable Exempts

As noted, under current law, donors of appreciated property to a political organization must pay income tax on the appreciation.¹⁹⁹ By contrast, donations of appreciated property to a noncharitable exempt do not result in income tax. Because the Service will not enforce the gift tax on donations to noncharitable exempts,²⁰⁰ the result is that political donors with appreciated property to contribute will prefer giving to a noncharitable exempt instead of a political organization in order to avoid income tax.²⁰¹

As with disclosure rules, this inconsistency was of little moment before *Citizens United*. Now that noncharitable exempts may engage in unlimited independent political activity, the income tax differential matters as it creates an additional reason to conduct political activity using the noncharitable exempt form.

The potential for tax avoidance is straightforward. A donor with highly appreciated stock donates to a noncharitable exempt in Year 1. Assuming the donation is a gift, no income tax applies on the unrealized appreciation at the time of the donation.²⁰² Also in Year 1, the noncharitable exempt sells the stock, and does not pay income tax on the proceeds because of income tax exemption. The noncharitable exempt refrains from political activity in Year 1 in order to avoid imposition of the 527(f) tax on investment income. In Year 2, however, the noncharitable exempt uses the proceeds from the stock sale to fund political activity. Because there is no investment income in Year 2, no 527(f) tax is owed. In this way, appreciated stock may be contributed without triggering income tax on the appreciation either to the donor or to the organization.

Congress imposed the tax on donations of appreciated property to political organizations in order to “prevent[] avoidance of tax by individuals by taxing them on any unrealized appreciation attributable to their contributions.”²⁰³ Absent a tax on the donor, the political organization would bear the tax burden upon sale and realization of investment income.

¹⁹⁹ I.R.C. § 84.

²⁰⁰ See *supra* note 101.

²⁰¹ If the Service had maintained the threat of enforcement of the gift tax on gifts to noncharitable exempts, the nontaxation of appreciated property gifts under the income tax generally would not have been a sufficient reason to contribute. That is, donors of property with a choice between paying gift tax on the entire amount of the contribution (if made to a noncharitable exempt) or income tax on the amount of appreciation (if made to a political organization) would opt for the income tax and donate to a political organization.

²⁰² I.R.C. § 102.

²⁰³ S. REP. NO. 93-1357, at 7481 (1975).

Thus, the concern at the time²⁰⁴ was over whether the donor or the political organization should bear the tax burden, and not that the unrealized appreciation would go untaxed. The issue today is of greater concern because tax on appreciation may be avoided entirely. This runs contrary to the congressional policy of taxing investment income with respect to political activity, and with the view that transfers of appreciated property for political purposes are not gifts²⁰⁵ and therefore gain should be realized upon transfer.

The solution is to extend the income tax on unrealized appreciation to donors making contributions to noncharitable exempts.²⁰⁶ The tax could be limited only to noncharitable exempts that engage in political activity (within several years of the gift). Broader reform, however, would extend the tax to all contributions of appreciated property to noncharitable exempts. The reasoning would be that such contributions are not gifts (for income or gift tax purposes) and thus the transfer should be a realization event.

4. Defining Political Activity

Another question is whether Congress should take action on the definition of political activity. A benefit of eliminating definitional political activity limits is that political activity becomes less important. Tax exemption for noncharitable exempts would no longer turn on political activity thresholds. However, political activity would remain significant for purposes of disclosure, imposition of the 527(f) tax, maintaining the line between the 501(c)(3) organization and other exempts, denial of business deductions, and depending upon the statutory architecture, sorting organizations into categorical distinctions.

It is beyond the scope of this article to examine in depth what should and should not be included in a political activity definition, but some broad objectives can be sketched. The definition of political activity for purposes of disclosure should generally follow campaign finance law. This is because the reasons to disclose information about political activity are rooted in

²⁰⁴ Prior to Congress's enactment of section 84, the IRS determined that the political organization should pay tax on the gain.

²⁰⁵ By making the "transfer" of appreciated property to a political organization a realization event, Congress stated its belief that transfers of property for political purposes were not gifts, and therefore that the transfer was a realization event. *Id.* (stating that "campaign contributions in reality are not a gift, but rather constitute contributions to further the general political or good-government objectives of the donor").

²⁰⁶ See Polsky & Charles, *supra* note 24, at n.81 (encouraging realization for appreciated property gifts to noncharitable exempts in the absence of gift tax).

campaign finance law, not tax law.²⁰⁷ Reliance on campaign finance definitions will help to ensure that, to the extent lawmakers continue to ask the Service to enforce campaign finance law, at least the Service will not be charged with defining the substance of what must be disclosed. In addition, the campaign finance definition of political activity also could be used to monitor the boundary between the noncharitable exempt and the political organization. Assuming that this boundary is retained and that the main tax differences between the two categories are eliminated, there would be little reason to utilize a tax law definition solely for the purpose of sorting organizations into categories.

Nevertheless, a distinct tax law definition of political activity remains useful to protect the tax base. The Code requires that political activity be funded with after-tax dollars, i.e., no deduction is allowed for political activity. This rule surfaces in two contexts: the political activities prohibition on charities,²⁰⁸ and the denial of a business deduction for political activity contributions,²⁰⁹ e.g., directly to a candidate or indirectly to a noncharitable exempt or political organization.

Accordingly, there is a tax law reason to define political activity independently from campaign finance law. A narrow tax law definition means more activity will be deductible (either as a business expense or as a charitable contribution). A broader definition (and so fewer deductions) protects the tax base, and insofar as political activity is a form of consumption, is consistent with general tax principles, at least in the individual context.²¹⁰

Present law boundaries, even though nonuniform and policed in large part by a facts and circumstances test, can be defended on the ground that the Treasury Department is better protected by a definition that may be overinclusive rather than underinclusive.²¹¹ Especially in the context of charitable contributions, a tax law definition that is distinct from (and broader than) a campaign finance definition is helpful to protect against dilution of charitable purposes.²¹² Although uniformity is a useful goal, uniformity nonetheless sometimes must yield to other tax policy objectives.

²⁰⁷ In general, the reasons are to prevent corruption and the appearance of corruption. See *Citizens United v. FEC*, 558 U.S. 310 at 314 (2010). The Supreme Court consistently has upheld the constitutionality of disclosure rules. *Id.*

²⁰⁸ I.R.C. § 170(c)(2)(D).

²⁰⁹ I.R.C. § 162(e).

²¹⁰ I.R.C. § 262.

²¹¹ See also Polsky, *supra* note 10 (discussing the reasons for a broad definition of political activity for tax purposes).

²¹² *Accord* Prop. Treas. Reg. § 1.501(c)(4)-1, 78 Fed. Reg. 71,535, 71,537 (Nov. 29, 2013) (noting that in the charitable context “a more nuanced consideration of the totality of

5. Clarify Whether Section 527 is Mandatory and Develop an Alternate Political Activity Baseline

Under current law, it is not clear whether section 527 treatment is mandatory or voluntary. The uncertainty results from the year 2000 amendments to section 527.

Before the amendments, political organization treatment was mandatory.²¹³ Mandatory treatment was generally appropriate because, as discussed in Part II, the political activity baseline established by section 527 generally makes sense as the normative (i.e., nonsubsidy) treatment. In other words, section 527 was mandatory in the same sense as “regular” tax treatment is mandatory for a corporation formed for profit—it is simply the default.

In the year 2000, Congress required political organizations to file a notice of existence with the Service.²¹⁴ Although Congress did not change the “mandatory” language of the Code,²¹⁵ Congress required that the notice must be filed in order to be “described in the section.”²¹⁶ The inference is that failure to file the notice means the organization is not “described in the section” and so is not a political organization. Congress also imposed significant disclosure burdens enforced by stiff penalties on section 527 organizations, thus mandating a cost to being described as a political organization.²¹⁷ The combination of unclear statutory language and the imposition of burdens on political organization status thus raised the question of whether political organizations could elect out of section 527 treatment.

The significance of whether section 527 is mandatory or voluntary is varied and important. For example, if the 2000 changes made 527 a voluntary section, political organizations may opt out of disclosure rules that are tied to the tax status. Further, if the definitional limits on political activity were to be eliminated, without uniform donor disclosure rules,

facts and circumstances may be appropriate”).

²¹³ “A political organization shall be subject to taxation under this subtitle only to the extent provided in this section.” I.R.C. § 527(a).

²¹⁴ I.R.C. § 527(i).

²¹⁵ Section 527(a) was not amended.

²¹⁶ “[A]n organization shall not be treated as an organization described in this section . . . unless it has given notice . . . that it is to be so treated.” I.R.C. § 527(i)(1).

²¹⁷ I.R.C. § 527(j). For a more complete discussion of the voluntary-mandatory question, see Aprill, *supra* note 34 (discussing the issues); Colinvaux *supra* note 19 (concluding that the section is voluntary); Gregg D. Polsky, *A Tax Lawyer’s Perspective on Section 527 Organizations*, 28 CARDOZO L. REV. 1773 (2007) (concluding that the section is not technically elective); Tobin, *supra* note 103 (concluding that the section is mandatory).

organizations could choose between political organization and noncharitable exempt status on the basis of disclosure rules, making nonsense of the political organization category.

If tax treatment as a political organization is mandatory, however, elimination of the definitional political activity limits, though seemingly a radical change, would not in effect be much different from current law. For example, under current law, if a noncharitable exempt engages in significant amounts of political activity, the “primary purpose” of the organization at some point becomes political. Political organization treatment follows a primary purpose test.²¹⁸ Thus, if political organization treatment is mandatory, eliminating definitional limits on the political activity of noncharitable exempts would do little to change the legal architecture. The Service still would have to enforce the line between noncharitable exempt and political organization status based on a “primarily” test, albeit a different one.²¹⁹

More fundamentally though, the mandatory-voluntary question implicates the right of an organization to be taxed on its net income and highlights the need for an alternative tax baseline for political organizations outside of section 527. Assuming section 527 remained mandatory, the year 2000 changes introduced alternate tax regimes for political organizations within section 527, which hinge on whether the notice of existence is filed. If the notice is filed, then the political activity baseline applies. If the notice is not filed, the result is to “tak[e] into account” political activity income and the “deductions directly connected with the production of such income.”²²⁰ The normal implication would be that political expenses would offset the presumably taxable political contributions, resulting in a tax on net income.

A separate provision of the Code, however, generally provides that no deduction is allowed for political activity expenses.²²¹ Thus, if section 527 is mandatory and political activity income is not exempt, then the penalty for failure to file a notice in effect is taxation on the organization’s gross income — a highly punitive result — just for forming as a political organization.

²¹⁸ I.R.C. § 527(e)(1) (defining a political organization as one “organized and operated primarily for the purpose of [political activity]”).

²¹⁹ As a practical matter, however, it might be even harder than presently to push an organization into section 527 status, giving rise (absent uniform donor disclosure rules) to increased nondisclosure relative to current law.

²²⁰ I.R.C. § 527(i)(4). One district court concluded that by this paragraph Congress “expressly” subjected political contributions to income tax. *National Federation of Republican Assemblies v. United States*, 218 F. Supp. 2d 1300, 1316 n.20 (S.D. Ala 2002).

²²¹ I.R.C. §§ 162(e), 262.

Punitive tax treatment of political organizations has been justified in large part from the belief discussed in Part II that the political activity baseline provides a subsidy. If so, then the argument is that the notice and disclosure conditions may constitutionally be imposed as a condition of the subsidy.²²² The absence of a subsidy, however, directly calls into question the rationale of a constitutional condition.²²³ Unless there is a viable alternative tax status available, i.e., unless section 527 is voluntary and there is a reasonable default tax treatment, the notice and disclosure provisions are a perhaps unconstitutional condition on formation as a political organization. Further, even if one accepts the subsidy conclusion, a “mandatory” subsidy under penalty of draconian tax treatment is exceptionally harsh, giving additional weight to an interpretation of section 527 as a voluntary section.²²⁴

A separate problem, however, is that even if section 527 is construed properly as voluntary,²²⁵ there is no clear nonpunitive tax status available for a political organization. One choice is for organizations opting out of the political organization regime to rely on pre-section 527 authority for exemption for political activity income. Although revival of the administrative exemption might seem a slender reed on which to base taxation,²²⁶ to the extent deductions for political activity expenses are not allowed, the alternative is to be taxed on gross income.

²²² As others have documented, Congress used the tax code and not campaign finance law to pass the notice and disclosure rules to protect the provisions from a constitutional attack. The theory was that these provisions were constitutional conditions of a subsidy, per *Regan v. Taxation with Representation of Wash.* See Aprill, *supra* note 34.

²²³ As Professor Aprill has said, however, if the exemption label is a subsidy for constitutional law purposes, then the absence of a subsidy for theoretical tax purposes is of no moment. See Aprill, *supra* note 34.

²²⁴ One way out is to conclude that Congress did not intend to tax political organizations that did not file a notice with the Service on their gross income, but rather assumed that organizations not filing the notice would continue to receive an administrative-based exemption on political activity income.

²²⁵ As discussed in Colinvaux, *supra* note 19, at 542: “[I]f in 2000 Congress had introduced a disclosure regime and retained the mandatory aspect of section 527, political organizations would, as a general matter, have been treated worse than other organizations with a Code-based exemption. In general, other exempt organizations elect into a Code section by holding themselves out as meeting the requirements of the Code, and then filing the applicable information return. But if an organization decides not to rely on an exemption provision, it can always file a tax return. Indeed, the notion that an exempt organization can have its exempt status revoked rests on the fundamental concept that exempt status is voluntary and elective.”

²²⁶ Political activity income also could be exempt as capital contributions, or perhaps as gifts. See Barbara K. Rhomberg, *Constitutional Issues Cloud the Gift Taxation of Section 501(c)(4) Contributions*, 15 TAXATION OF EXEMPTS 164 (2004); *supra* note 44; Barbara K.

The concern is all the more pressing in the wake of *Citizens United*. The effect of denying a deduction for political activity expenses before *Citizens United* (either within or without section 527) was tempered by campaign finance law prohibitions on corporate political activity. After *Citizens United*, corporations have more speech choices. Because there is ambiguity as to whether section 527 is mandatory, corporations will seek alternative tax statuses, either as noncharitable exempts, taxable nonprofits, or for-profit organizations. The new opportunities for corporate speech will place additional pressure both on an interpretation of section 527 that makes it a mandatory tax on gross income if no notice is filed, and on the appropriate taxation of political activity outside of the section 527 framework. Accordingly, it is time to consider an appropriate political activity baseline outside of 527 that would allow the deduction of political activity expenses.²²⁷

In this context, the parallels between section 527 and the exemption provided for homeowners associations under section 528 are illuminating. Section 528 was enacted the year after section 527.²²⁸ The issues presented were very similar. Homeowners associations pool the income of their members to maintain common property. Before section 528, there were questions about the extent to which income from members was taxed to the association, especially amounts collected but not spent in the year collected.²²⁹ Applying a pooling of income theory, Congress answered that such amounts were not income, providing in section 528 that the “exempt function income” of a homeowners association (dues and other payments for purposes of the association) was exempt.²³⁰ But all other income of a homeowners association was subject to tax.

Conceptually, political organizations and homeowners associations are similar, and so is the exemption Congress provided. One notable difference, however, is that homeowner association treatment is elective on a taxable year basis.²³¹ A homeowners association calculates whether it would be

Rhomberg, *The Law Remains Unsettled on Gift Taxation of Section 501(c)(4) Contributions*, 15 TAXATION OF EXEMPTS 62 (2003).

²²⁷ Highlighted again is the importance of removing campaign finance-based conditions from the Code. Without such conditions, political organization treatment sensibly could be mandatory. Then, to the extent for-profit political organizations form and a subsidy is provided, Congress could develop an appropriate alternative baseline for a for-profit political organization.

²²⁸ See Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

²²⁹ STAFF OF J. COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 598–99 (Comm. Print 1976).

²³⁰ *Id.* at 599–600.

²³¹ Treas. Reg. § 1.528-8 (1980).

better off being taxed as a C corporation (with a deduction for homeowner association expenses allowed) or as a section 528. Campaign finance limitations on corporate political activity made this type of an election for a political organization unnecessary in 1975. But something similar now is needed after *Citizens United*.

6. Protect the Charitable Deduction

There is a remaining critical issue that must be addressed post-*Citizens United*, even if nothing else is done. Because more noncharitable exempts now will engage in political activity, there is a serious risk that the charitable organization will be used as a flow through for political funds. The pathway is simple. A donor makes a contribution to a charity, takes a charitable contribution deduction, then the charity makes a grant to a politically active noncharitable exempt. Voilà, nondeductible political activity becomes deductible.²³² The laundering of political expenses through charitable organizations is of major concern to the integrity of the charitable deduction, charitable exempt purposes, and the tax base.

Before *Citizens United*, the problem existed but arguably was manageable without a legislative solution. Charities commonly create associated 501(c)(4) organizations to engage in lobbying activity (and perhaps occasional political activity). Thus, deductible 501(c)(3) dollars in theory could be used to fund nondeductible lobbying or political activity by grant from 501(c)(3) to 501(c)(4). To protect against this abuse, well-advised organizations develop clear firewalls and policies to ensure that the 501(c)(3) money is used appropriately.²³³ Further, the fact of campaign finance limits on the political activity by noncharitable exempts meant that the temptation to launder money through a charity (at great risk to the charity), though present, likely was modest.

After *Citizens United*, however, the opportunities to abuse the 501(c)(3) form have magnified. The increase of political activity by noncharitable exempts is inherent to the *Citizens United* decision, and will lead to a proliferation of exempt organization networks, often with a charity at the helm. Money will flow from 501(c)(3) to noncharitable exempts in increasing quantities. Inevitably, some charities will even be set up as shams to launder (i.e., to make deductible) independent expenditures.

²³² Admittedly, this problem could be worse if political activity limits are eliminated for noncharitable exempts. But it is a real concern under current law, which generally allows nearly half of a noncharitable exempt's activity to be political.

²³³ Private foundations are extra-cautious in this area. If a private foundation makes a grant for a noncharitable purpose it is subject to an excise tax. I.R.C. § 4945.

This type of problem is not new but has existed for some time in other, related areas. For example, in the context of the business deduction, the issue arises when a business pays dues to a noncharitable exempt that engages in nondeductible lobbying or political activity. Business member dues are deductible business expenses.²³⁴ The concern is that deductible member dues could be used for nondeductible political or lobbying activity. Congress sensibly responded to this concern by requiring the noncharitable exempt either to pay a tax on the political or lobbying activity or notify the payor that an allocable portion of the member dues were not deductible.²³⁵ This mechanism often is referred to as a “proxy tax,” i.e., the tax on the noncharitable exempt is a proxy for denying the deduction to the donor.

Congress also anticipated a similar money laundering problem in the private foundation context. A private foundation is a kind of 501(c)(3) organization²³⁶ that is typically funded by a wealthy patron. The continued influence of the patron over the private foundation led Congress to adopt a series of anti-abuse rules.²³⁷ One rule imposes an excise tax on private foundation grants that are not for a charitable (or other 501(c)(3)) purpose, technically called a “taxable expenditure.”²³⁸ The tax is payable by both the foundation and foundation managers.²³⁹

A taxable expenditure includes a private foundation grant that is used for political activity.²⁴⁰ In some cases, private foundations are able to protect themselves from imposition of the excise tax by exercising “expenditure responsibility,” i.e., extensive tracking and reporting, with respect to grants made to noncharitable exempts (or individuals).²⁴¹ Fear of the excise tax has led private foundations to exercise great caution with how charitable funds are spent.²⁴² Thus, foundations already are faced with tax

²³⁴ I.R.C. § 162.

²³⁵ I.R.C. § 6033(e). Pursuant to the legislative history, the Service has excepted certain organizations from the proxy tax regime, including all 501(c)(5) organizations. Rev. Proc. 98-19, 1998-1 C.B. 547.

²³⁶ I.R.C. § 509.

²³⁷ Thomas A. Troyer, *The 1969 Private Foundations Law: Historical Perspectives on Its Origins and Underpinnings*, 27 EXEMPT ORG. TAX REV. 52 (2000).

²³⁸ I.R.C. § 4945(d).

²³⁹ I.R.C. § 4945(a).

²⁴⁰ I.R.C. § 4945(d)(2).

²⁴¹ See I.R.C. § 4945(d)(4).

²⁴² See Letter from Gary D. Bass, Exec. Director, The Bauman Foundation to Amy F. Giuliano, Office of the Associate Chief Counsel, Internal Revenue Service (Dec. 19, 2013), available at <http://www.regulations.gov/#!documentDetail;D=IRS-2013-0038-0082> (explaining that a disparity in the definition of “political activities” for 501(c)(3) and 501(c)(4) organizations “will only increase anxiety among many charity executives and private foundations already nervous about nonpartisan civic engagement because of the

consequences if, for example, grants to a noncharitable exempt are used for political activity.

Similar legislative solutions now must be considered to protect against abuse of the charitable deduction in the advent of *Citizens United*. Congress could adopt a proxy tax on the 501(c)(3) organization that would apply to the extent of grants to a noncharitable exempt that engages in political activity. A proxy tax would not prevent or inhibit the establishment of exempt organization networks, but would help to ensure that funding for noncharitable exempts that are affiliated with a 501(c)(3) occurs with nondeductible dollars.

In the alternative, Congress could extend the taxable expenditure concept to cover 501(c)(3) grants to noncharitable exempts that engage in political activity. Thus, all 501(c)(3)s, and not just private foundations, would have to exercise expenditure responsibility, but only on grants where there is a prima facie risk of use for political activity.

7. Other Approaches

There are other possible legislative approaches.²⁴³ Legislation could abolish categories of exemption such as the social welfare category. Or legislation could alter the standard for exemption by articulating new thresholds for political activity by noncharitable exempts. For example, “no substantial part” of a noncharitable exempt’s activities could be political. Legislation could also then define “substantial” with percentages and definitions. The objections to such legislative approaches are similar to the objections raised if the Service were to attempt them. They ignore the core problem of statutory arbitrage, continue the present law fallacy of declaring political activity as inconsistent by definition with noncharitable exempt status, and more deeply involve the Service in regulating political activity.

VI. CONCLUSION

Contributions to fund political activity in an organizational form have from the inception of the income tax always been exempt. Exemption, though, was not to subsidize the activity but to avoid taxing the activity twice. Before *Citizens United*, the significance of political activity to the tax exemption system was mostly as a sorting device — a way to label

ambiguity of current IRS rules”).

²⁴³ For a discussion of approaches based on increasing the transparency of the Service’s administrative process, see George K. Yin, *Saving the IRS*, 100 VA. L. REV. ONLINE 22 (2014).

organizations as either primarily political, or not. As a matter of taxation, political activity was not especially important.²⁴⁴

By permitting a new category of speech, *Citizens United* made the tax-exemption system obsolete when it comes to political activity. After *Citizens United*, it no longer makes sense to view organizations in black and white terms. The fact is that noncharitable exempt organizations will engage in increasing quantities of political activity. There is no reason for the tax system to impose arbitrary limits. Further, what were marginal inconsistencies in legal treatment across exemption categories with respect to political activity are now magnified.

Accordingly, this article argues for a number of changes. Most important, Congress should enact uniform donor disclosure rules for political activity, and preferably leave enforcement to the FEC. Assuming as a result that no tax differences remain that hinge on donor disclosure, Congress then should eliminate the regulatory stipulation that political activity does not further noncharitable exempt purposes, making political activity largely irrelevant to tax classification (apart from 501(c)(3) organizations). In addition, Congress should affirm that the gift tax does not apply with respect to political contributions, but also extend the income tax to transfers of appreciated property to noncharitable exempts. Taken together, these changes do not eliminate the need to define political activity, but reduce its importance. Where the definition of political activity continues to matter for tax purposes (and so a campaign finance definition is less appropriate), a facts and circumstances-based definition generally is preferable to a bright line. Further, Congress should acknowledge that the increase in political speech by noncharitable exempts will lead to abuse of charitable organizations, and take steps to prevent the laundering of independent expenditures through the charitable form. Congress also should recognize that *Citizens United* has led to a need to develop a new baseline for political activity conducted “for profit” or outside of section 527.

The problem of political activity and tax exemption is like a Gordian’s knot, a seemingly unsolvable and intractable problem. Although the knot contains many strands, Congress can untie it with a simple legislative stroke to unify donor disclosure rules. Exempt organizations, apart from charities, then should be left free to engage in political activity in order to accomplish their exempt purposes.

²⁴⁴ The exception is for the charitable organization. Even here, in theory, tax exemption should not be affected by engaging in political activity. A charitable organization could simply reorganize under section 501(c)(4) — maintaining exempt status, but losing the other tax benefits associated with charitable status. Section 504 prevents this result, however. *See* I.R.C. § 504.