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Social Welfare and Political Organizations: Ending the Plague of Inconsistency

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SOCIAL WELFARE AND POLITICAL ORGANIZATIONS: ENDING THE PLAGUE OF INCONSISTENCY

*Roger Colinvaux**

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INTRODUCTION

The Supreme Court’s decision in *Citizens United v. Federal Election Commission*¹ opened the door to more political speech by

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1. 558 U.S. 310 (2010).

nonprofit organizations. By removing the longstanding limit on the ability to make independent expenditures for or against candidates, the Supreme Court in effect invited nonprofits to participate more, and in new ways, in partisan politics.

The political organization and the social welfare organization are the most obliging forms for nonprofit political speech. The political organization, as its name suggests, is the natural place for partisan muckraking. As such, it has long attracted the attention of federal regulators and is subject to campaign finance-related disclosure rules. The social welfare organization, on the other hand, may not be mostly political, and so has avoided campaign finance-related regulation at the federal level.² Yet the open-ended nature of a social welfare purpose can be used to accommodate a great deal of political activity. Thus, after *Citizens United*, the social welfare organization became attractive as an essentially unregulated vehicle for partisan speech.

The results have been catastrophic. As new groups form, some with political ends, the Internal Revenue Service (“IRS”) must decide a basic question: whether an organization’s main purpose is political. Rules written for a different era have failed miserably in the post-*Citizens United* regulatory environment. Attempting to apply the rules, the IRS dithered in granting exemptions, and opened itself up to charges that it unfairly targeted nonprofit groups based on their political views.³ The sensational claims have proved impossible to set aside. As a result, the IRS budget has been slashed,⁴ the IRS Commis-

2. This Article does not discuss state law solutions to regulating the political campaign activity of social welfare organizations. For that discussion, see Linda Sugin, *Politics, Disclosure, and State Law Solutions for 501(c)(4) Organizations*, 91 CHI-KENT L. REV. 895 (2016).

3. See, e.g., Zachary A. Goldfarb & Karen Tumulty, *IRS Admits Targeting Conservatives for Tax Scrutiny in 2012 Election*, WASH. POST (May 10, 2013), https://www.washingtonpost.com/business/economy/irs-admits-targeting-conservatives-for-tax-scrutiny-in-2012-election/2013/05/10/3b6a0ada-b987-11e2-92f3-f291801936b8_story.html?utm_term=.e52c09b07eae; see also Peter Overby, *IRS Apologizes For Aggressive Scrutiny Of Conservative Groups*, NAT’L PUB. RADIO (Oct. 27, 2017, 3:08 PM), <https://www.npr.org/2017/10/27/560308997/irs-apologizes-for-aggressive-scrutiny-of-conservative-groups>; Alan Rappeport, *In Vetting Political Groups, I.R.S. Crossed Party Lines*, N.Y. TIMES (Oct. 6, 2017), at A23, <https://www.nytimes.com/2017/10/05/us/politics/irs-targeting-tea-party-liberals-democrats.html>.

4. Joe Davidson, *IRS Chief Departs, Blasting Congress for Budget Cuts Threatening Tax Agency*, WASH. POST (Nov. 7, 2017), https://www.washingtonpost.com/news/powerpost/wp/2017/11/07/irs-chief-departs-blasting-congress-for-budget-cuts-threatening-tax-agency/?utm_term=.9c8b39c4c4bd (“[Commissioner] Koskinen had repeatedly warned Congress about the dangers of shortchanging the agency But Republicans were intent on penalizing the IRS because they said it had improperly scrutinized right-leaning organizations.”); see, e.g., BRANDON DEBOT, EMILY HORTON & CHUCK MARR, *CTR. ON BUDGET & POL’Y PRIORITIES, TRUMP BUDGET CONTINUES*

sioner has faced down impeachment charges,⁵ and the tax exemption system and the rule of law are showing signs of strain.⁶ Making a bad situation worse, Congress has ordered the IRS not to act,⁷ leaving a festering situation to fester.

This Article considers the use of social welfare organizations for political purposes, assesses the damage, and offers solutions.⁸ Part I of the Article provides an overview of present law and compares social welfare and political organizations in the context of political campaign intervention. Part II considers the many serious ongoing harms that

MULTI-YEAR ASSAULT ON IRS FUNDING DESPITE MNUCHIN'S CALL FOR MORE RESOURCES 2 (last updated Mar. 17, 2017), <https://www.cbpp.org/sites/default/files/atoms/files/3-14-17bud.pdf>.

5. Andy Kroll, *How the IRS Chief Went from Respectful Public Servant to Political Punching Bag*, WASH. POST (Mar. 2, 2017), https://www.washingtonpost.com/life-style/magazine/how-the-irs-chief-went-from-respected-public-servant-to-political-punching-bag/2017/02/28/d8b4673e-d1f4-11e6-945a-76f69a399dd5_story.html?utm_term=.dc27ffcd610b; see also Susan Davis, *House Republicans Divided over Impeachment of IRS Commissioner*, NAT'L PUB. RADIO (Sept. 8, 2016, 4:37 PM), <https://www.npr.org/2016/09/08/493157987/house-republicans-divided-over-impeachment-of-irs-commissioner>; Deirdre Walsh, Ted Barrett & Manu Raju, *Move to Impeach IRS Boss Fails, Spotlights GOP Split*, CNN: POLITICS (Dec. 6, 2016, 7:44 PM), <https://www.cnn.com/2016/12/06/politics/house-freedom-caucus-irs-commissioner-john-koskinen-impeach/index.html>.

6. See Sugin, *supra* note 3, at 900 (explaining that “[t]he Tea Party scandal illuminated the problem that had been long ignored in the § 501(c)(4) regulations. The standard was too vague”); see also ERIKA K. LUNDER & L. PAIGE WHITAKER, CONG. RESEARCH SERV., R40183, 501(c)(4)S AND CAMPAIGN ACTIVITY: ANALYSIS UNDER TAX AND CAMPAIGN FINANCE LAWS 5-6 (2013), <https://fas.org/sgp/crs/misc/R40183.pdf> (outlining three difficulties in defining how much campaign activity a social welfare group may engage in); Robert O'Harrow, Jr., *Fallout from Allegations of Tea Party Targeting Hamper IRS Oversight of Nonprofits*, WASH. POST (Dec. 17, 2017), https://www.washingtonpost.com/investigations/fallout-from-allegations-of-tea-party-targeting-hamper-irs-oversight-of-nonprofits/2017/12/17/6403c1c0-c59e-11e7-a4413a768c8586f1_story.html?utm_term=.e3e192ed82f6 (“Tim Delaney, president and chief executive of the National Council of Nonprofits, said his 25,000 members rely on federal regulators to look out for abusive practices and maintain the public's trust in nonprofits. Many of them worry about the weakening of the [IRS Exempt Organizations] division.”).

7. Press Release, House Appropriations Comm., Appropriations Committee Releases Fiscal Year 2018 Financial Services Bill (Jun. 28, 2017), <https://appropriations.house.gov/news/documentsingle.aspx?DocumentID=394953> (explaining that the bill provides for “[a] prohibition on a proposed regulation related to political activities and the tax-exempt status of 501(c)(4) organizations”); see also Michael Wyland, *Whatever Happened to the IRS Tax Exemption Scandal?*, NONPROFIT Q. (Aug. 22, 2017), <https://nonprofitquarterly.org/2017/08/22/whatever-happened-irs-tax-exemption-scandal/> (providing a brief synopsis of some legislative proposals to prohibit the IRS from regulating § 501(c)(4) organizations).

8. This Article focuses on social welfare (or “§ 501(c)(4)”) organizations. The issues discussed, however, are similar for many other § 501(c) organizations, especially labor unions and trade associations (organized under §§ 501(c)(5) and 501(c)(6) of the Internal Revenue Code, respectively).

have resulted from the current legal framework. Part III assesses different solutions. The Article concludes that in general, the disclosure and financing rules concerning the political activity of social welfare and political organizations should be consistent. Consistent rules would reduce incentives to deceive regulators and the public and help restore some integrity to the tax exemption system. Consistent rules would also pave the way to eliminate existing limits on political activity by social welfare organizations and reduce the role of the IRS in regulating speech.

I.

CHOOSING BETWEEN §§ 501(C)(4) AND 527 FOR POLITICAL PURPOSES

Social welfare organizations, described under § 501(c)(4) of the U.S. Internal Revenue Code (the “Code”), are now established vehicles for political campaign intervention. According to the Center for Responsive Politics, in the 2016 election cycle, § 501(c)(4) organizations spent more than \$145 million on campaigns.⁹ For perspective, this is about 60% of the amount spent by the political parties.¹⁰ The electoral relevance of § 501(c)(4) organizations is likely to continue. Bernie Sanders, Hillary Clinton, and Donald Trump have at least one thing in common—each is associated with a § 501(c)(4) organization to advance particular political causes.¹¹ Other notable politically active § 501(c)(4) organizations include NRA Institution for Legislative

9. Ctr. for Responsive Politics, *Outside Spending: 2016*, OPENSECRETS.ORG, https://www.opensecrets.org/outsidespending/fes_summ.php?cycle=2016 (last visited Jan. 29, 2019). This compares to over \$118 million in 2014, Ctr. for Responsive Politics, *Outside Spending: 2014*, OPENSECRETS.ORG, https://www.opensecrets.org/outside-spending/fes_summ.php?cycle=2014 (last visited Jan. 29, 2019), and \$257 million in 2012, Ctr. for Responsive Politics, *Outside Spending: 2012*, OPENSECRETS.ORG, https://www.opensecrets.org/outsidespending/fes_summ.php?cycle=2012 (last visited Jan. 29, 2019).

10. Ctr. For Responsive Politics, *Outside Spending: 2016*, OPENSECRETS.ORG, https://www.opensecrets.org/outsidespending/fes_summ.php?cycle=2016 (last visited Jan. 29, 2019). The percentage for 2014 is 49%, Ctr. for Responsive Politics, *Outside Spending: 2014*, OPENSECRETS.ORG, https://www.opensecrets.org/outsidespending/fes_summ.php?cycle=2014 (last visited Jan. 29, 2019), and in 2012, § 501(c)(4) spending exceeded party spending, Ctr. for Responsive Politics, *Outside Spending: 2012*, OPENSECRETS.ORG, https://www.opensecrets.org/outsidespending/fes_summ.php?cycle=2012 (last visited Jan. 29, 2019).

11. See Jonathan Karl & Benjamin Siegel, *Bernie Sanders' New Political Group Raises Campaign Finance Questions*, ABC NEWS (Aug 19, 2016, 12:00 AM), <http://abcnews.go.com/Politics/bernie-sanders-political-group-raises-campaign-finance-questions/story?id=41520854>; see Niraj Chokshimay, *Clinton Starts Anti-Trump Organization*, N.Y. TIMES, May 15, 2017, at A14, <https://www.nytimes.com/2017/05/15/us/politics/hillary-clinton-onward-together.html>; see TRUMP FOR AMERICA, <http://www>

Action, 45 Cmte, America Future Fund, Americans for Prosperity, the League of Conservation Voters, Majority Forward, the Environmental Action Defense Fund, VoteVets, and other lesser spenders such as the Planned Parenthood Action Fund.¹²

The rise of the political § 501(c)(4) organization is directly attributable to the 2010 Supreme Court decision in *Citizens United v. Federal Election Commission*.¹³ Before *Citizens United*, § 501(c)(4) organizations were used for political purposes, but their use was relatively limited. A main barrier was the campaign finance law rule that barred corporations from making independent expenditures from general corporate treasury funds to expressly advocate for or against candidates.¹⁴ Social welfare organizations could and did run hard-hitting issue ads that had the effect of taking sides in a campaign, but with express advocacy curtailed, the attractiveness of § 501(c)(4) organizations was limited to a select type of speech that required legal nuance for every communication.¹⁵ When the Supreme Court struck down the limit on corporate independent expenditures, it opened the door for social welfare organizations to be used more extensively and overtly in political campaigns.

Nonetheless, the appeal of § 501(c)(4) for campaign intervention remained tenuous still because of the uncertain application of the gift tax to donors for their § 501(c)(4) contributions. The Code explicitly provides a gift tax exemption for contributions to political organizations (organized under § 527 of the Code), and for charitable organizations (under § 501(c)(3)), but provided no exemption for § 501(c)(4) contributions.¹⁶ Without a specific gift tax exemption, the

.trumptransitioncommittee.com/ (stating that it is an “organization established and maintained under Section 501(c)(4) of the Internal Revenue Code”).

12. For a complete list of the top nonprofit political spenders, see Ctr. For Responsive Politics, *Political Nonprofits: Top Election Spenders*, OPENSECRETS.ORG, https://www.opensecrets.org/outsidespending/nonprof_elec.php?cycle=2016 (last visited Jan. 29, 2019); see generally FED. ELECTION COMM’N., INDEPENDENT EXPENDITURE TOTALS BY COMMITTEE AND FILER TYPE: JANUARY 1, 2015 THROUGH DECEMBER 31, 2016 (Apr. 7, 2017) (reporting total 2016 campaign expenditures reported by group types to the FEC).

13. 558 U.S. 310 (2010).

14. Section 203 of the Bipartisan Campaign Reform Act of 2002 amended § 441b of the Federal Election Campaign Act to prohibit the use of corporate or union general treasury funds for express advocacy. 2 U.S.C. § 441b (2012) (transferred to 52 U.S.C. § 30118).

15. The Supreme Court carved out a limited exception for § 501(c)(4) campaign activity in *FEC v. Massachusetts Citizens for Life*, 479 U.S. 238, 259 (1986), by holding that election law limits did not apply to a § 501(c)(4) organization “formed to disseminate political ideas not to amass capital” and which did not accept corporate or labor union contributions.

16. I.R.C. § 2501(a)(6) (enacted by Pub. L. No. 114-113 (2015)).

presumption was that the gift tax applied.¹⁷ Thus, before *Citizens United*, the possibility of a substantial tax on § 501(c)(4) contributions was a significant additional deterrent to using § 501(c)(4) for political purposes, even though the IRS historically had not enforced the gift tax in the § 501(c)(4) context (whether for political or nonpolitical contributions).¹⁸

After *Citizens United* relaxed the speech limits and made § 501(c)(4) more attractive in the political context, the IRS changed course and began to enforce the gift tax.¹⁹ Congressional leaders strongly disapproved,²⁰ the IRS retreated,²¹ and eventually Congress passed an explicit gift tax exemption for § 501(c)(4) gifts.²² Thus, by 2015, the two main barriers to using § 501(c)(4) organizations for the serious conduct of political campaign activity had been removed.

One barrier nonetheless remained and remains: knowing the amount of campaign activity that is consistent with status as a social welfare organization. The law on this question is uncertain, and, since *Citizens United*, controversial. The relevant provisions date to 1959 when the Treasury Department promulgated regulations for § 501(c)(4) organizations.

With respect to political activity, there are two key parts to the regulation. First, the regulation flatly provides that campaign intervention does not promote social welfare, making it by definition an unre-

17. See Rev. Rul. 82-216, 1982-2 C.B. 220 (ruling 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”).

18. For discussion of the many issues concerning the gift tax and political activity, see generally 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 (2012).

19. Stephanie Strom, *I.R.S. Sets Sights on Donors’ Gifts That Push Policy*, N.Y. TIMES, May 13, 2011, at A1. Enforcement of the gift tax was one of the few bright line regulatory levers the IRS had to deter the use of § 501(c)(4) for political purposes.

20. Letter from Senator Orrin Hatch, to Douglas Shulman, Comm’r, Internal Revenue Serv. (May 18, 2011), 2011 TAX NOTES TODAY 97-31. (May 19, 2011).

21. Memorandum from Steven T. Miller, Deputy Comm’r for Servs. & Enf’t, Internal Revenue Serv. to Comm’r, Small Bus./Self-Employed Div. & Comm’r, Tax-Exempt and Gov’t Entities Div. (July 8, 2011), https://www.irs.gov/pub/newsroom/guidance_for_irs_sbse_estate_and_gift_tax_and_tege_exempt_organizations.pdf.

22. Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, 129 Stat. 3120 (codified as amended at 26 U.S.C. § 2501(a)(6)). The gift tax exclusion also applies to § 501(c)(5) and § 501(c)(6) organizations.

lated activity.²³ Second, the regulations interpret the statute's requirement that a social welfare organization be organized and operated "*exclusively* for the promotion of social welfare" to mean that the organization be "*primarily* engaged in promoting in some way the common good and general welfare of the people of the community."²⁴ The IRS has construed this to mean that "the organization's primary activities [must] promote social welfare."²⁵ Taking both parts of the regulation together, the result is that social welfare organizations may engage in campaign activity, notwithstanding that it is singled out as an unrelated activity, but only if the campaign activity (combined with any other non-social welfare activities) does not constitute the primary activity of the organization.

The difficulty then is determining when an unrelated activity becomes a primary one, i.e., in deciding how much of an activity is too much. One informal standard is that a § 501(c)(4) organization will not lose its exempt status so long as at least fifty-one percent of its activities are in pursuit of social welfare.²⁶ Some courts take a more restrictive approach, concluding that unrelated activities must not be "substantial."²⁷ Regardless of which standard is used, however, there is no firm guidance as to whether the permitted amount of unrelated activities should be assessed based on expenditures alone, or also on qualitative factors such as the effort or the time spent by volunteers.²⁸

23. The regulation provides: "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" Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990).

24. *Id.* § 1.501(c)(4)-1(a)(2)(i) (emphases added).

25. Rev. Rul. 81-95, 1981-1 C.B. 332.

26. This has been referred to as a rule of thumb used by IRS agents in the field. 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).

27. See *Vision Service Plan v. United States*, No. CIVS041993LKKJFM, 2005 WL 3406321, at *5, *6-7 (E.D. Cal. Dec. 12, 2005). For additional discussion, 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). The substantiality threshold likely stems from the Supreme Court's decision in *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945).

28. The IRS 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, at 192 (1995). As Professor Aprill notes, "[a]dvisors differ widely in how much politicking they believe § 501(c) organizations . . . can undertake without endangering

Consequently, social welfare organizations that engage in political campaign activity operate in a cloud.

That said, the legal uncertainty about how much campaign activity is allowed for social welfare organizations is longstanding, and until recently, was not very important. For decades, the IRS, policymakers, and the public lived with the uncertainty as one of many imperfect areas in tax law and administration. The uncertainty did not matter much because, for the most part, social welfare organizations stayed out of politics and could be safely ignored.²⁹ However, once the campaign finance and gift tax barriers to using § 501(c)(4) organizations for political purposes were removed, the “primarily” test of tax law rose in prominence as the controlling limit on § 501(c)(4) campaign activity. The result has been a fiasco.

Before considering the fiasco though, it must first be noted as to why, even after *Citizens United*, anyone would seriously want to use the § 501(c)(4) category for political reasons. In general, politically motivated groups have a natural home in the tax code—i.e., § 527, which governs political organizations. A political organization is defined as an organization “organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function.”³⁰ An exempt function is, generally, political campaign activity.³¹ Thus, when the main purpose of an organization is political, the tax classification follows that purpose.

After *Citizens United*, a new organization contemplating political campaign activity would weigh the pros and cons of the different tax classifications: § 527 versus § 501(c)(4). In the key categories of income tax exemption and the treatment of donors to the organization, there is either no material difference, or the edge goes to the social welfare organization.

First, the income tax treatment of the two organizations is broadly similar. Political organizations are exempt on their (political)

their exempt status.” Ellen P. Aprill, *Regulating the Political Speech of Noncharitable Exempt Organizations After Citizens United*, 10 *ELECTION L.J.* 363, 382 (2011).

29. See Frank Bass, *After Citizens United, a Surge in “Dark Money” Groups*, MAPLIGHT (May 12, 2016), <https://maplight.org/story/after-citizens-united-a-surge-in-dark-money-groups/>.

30. I.R.C. § 527(e)(1) (2012).

31. “The term ‘exempt function’ means the function of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors” I.R.C. § 527(e)(2).

contribution income but pay tax on their investment income.³² At first blush then, social welfare organizations appear to have a significant advantage because their generic tax exemption covers not only contributions but extends to investment income. However, if a social welfare organization engages in political campaign activity, a tax is imposed on the lesser of the organization's net investment income or political expenditures.³³ In other words, politically active social welfare organizations lose their exemption on investment income (up to the amount of political expenditures).

Nonetheless, despite this broad parity in tax treatment, social welfare organizations maintain an advantage over political organizations because the § 501(c)(4) exemption covers a wide range of activities, including lobbying.³⁴ A political organization by contrast is expected mostly to engage in politics and does not have an exemption with respect to any nonpolitical activity.³⁵ For example, if a political organization wanted to engage in a charitable activity, nonpartisan electoral activity, or even lobbying, the amounts spent on these activities would be subject to tax. Thus, for all practical purposes, § 527 works for and is intended for purely political organizations.³⁶ A mixed

32. This tax treatment generally follows normative tax principles. The exemption on contribution income is not intended as a subsidy but reflects the idea that political organizations are a pooling of already taxed resources. See 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”); Gregg D. Polsky & Guy-Uriel E. Charles, *Regulating Section 527 Organizations*, 73 GEO. WASH. L. REV. 1000, 1015 (2005) (noting that the nontaxation of contributions made to fund political activity reflects application of “general tax principles”); I.R.S. Gen. Couns. Mem. 39,813 (Mar. 19, 1990) (noting that Congress had “essentially codified the conduit concept”). Congress also provided in the legislative history to § 527 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). Investment income, however, is income appropriately subject to tax (i.e., taxation of investment income is in line with the neutrality, no-subsidy rationale, namely that political organizations do not provide a public benefit that should be subsidized).

33. Congress imposed this tax to achieve parity in the tax treatment of political campaign activity, meaning that organizations would not have an incentive to conduct campaign activity outside of the political organization form in order to escape the tax on investment income. 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).

34. Social welfare organizations lose exemption with respect to political activity and unrelated trade or business activity.

35. I.R.C. § 527(c)(3). Congress codified the tax treatment of political organizations in 1975 to clarify the tax treatment of a known entity type—political parties and political committees whose sole purpose was to elect or nominate candidates.

36. The exemption for political organizations extends beyond contribution income to include income from bingo games and sale of campaign materials. *Id.*

purpose organization or one contemplating a range of activities (whether or not in furtherance of social welfare) is far better off under § 501(c)(4).

Section 501(c)(4) has other advantages over § 527, the most notorious of which relates to the disclosure of donors. In the year 2000, Congress imposed a disclosure regime on political organizations, requiring the public disclosure of donors who make more than \$200 in contributions.³⁷ The rules mimic the disclosure rules that apply to political committees required to register with the Federal Election Commission (“FEC”).³⁸ Congress took this action in response to groups that managed to escape FEC regulation (and so disclosure obligations) but nonetheless were engaged in political activity and organized under § 527.³⁹ Controversially, Congress used the tax law instead of the campaign finance law as the basis for disclosure.⁴⁰ Accordingly, since the year 2000 political activity conducted through a § 501(c)(4) organization but not a § 527 organization may be done anonymously, making § 501(c)(4) clearly preferable to § 527 for donors who want to avoid disclosure.

Section 501(c)(4) organizations have yet another advantage over § 527 organizations, namely a significant tax benefit for donors who finance their contributions with appreciated property. The Code provides that contributions of appreciated property to a § 527 organization are a realization event for the donor, meaning that the donor must pay tax on the capital gain.⁴¹ By contrast, the same property donated to a § 501(c)(4) organization has no tax consequence for the donor. Thus, a donor with highly appreciated property to donate for political purposes would strongly prefer to transfer the asset to a § 501(c)(4)

37. *Id.* § 527(j)(3)(B).

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

39. Frances R. Hill, *Probing the Limits of Section 527 To Design a New Campaign Finance Vehicle*, 26 TAX NOTES 387 (2000); see also Aprill, *supra* note 28, at 371. At the time, the groups were referred to as “stealth PACs.”

40. As Professor Aprill has said, “the amendments to § 527 are campaign finance laws in tax clothing.” Aprill, *supra* note 28, at 391. Professor 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.” *Id.* at 400. She notes, however, that after *Citizens United* upheld disclosure provisions under campaign finance law, reliance on the taxing power may no longer be required. *Id.*; see also Polsky & Charles, *supra* note 32, at 1022–24. The result has been to charge the IRS with the responsibility for enforcing what is really campaign finance not tax law.

41. I.R.C. § 84.

organization—not a § 527 organization—in order to avoid a tax on the gain (especially since the gift tax no longer applies).⁴²

To sum up, in comparing the § 501(c)(4) and § 527 tax classifications with respect to political activity, the income tax treatment for each is broadly similar: exemption for contributions and taxation of investment income. The main differences then lie elsewhere, with § 501(c)(4) offering clear advantages. Social welfare organizations may engage in nonpolitical activities without tax penalty,⁴³ and donors to social welfare organizations may remain anonymous and avoid capital gains taxes on contributions of appreciated property.

All these advantages for social welfare groups must then be weighed against the one advantage of the political organization: unlimited political activity. Social welfare groups remain subject to the political activity limit of the Treasury regulations, i.e., campaign intervention may not be their primary activity. The question for putative political groups (as well as existing social welfare organizations) then becomes the true meaning of primary activity. The willingness to plan around this test and push its boundaries and the enforcement capabilities of the IRS becomes the locus for the choice between § 501(c)(4) and § 527 status and resulted in the aforementioned fiasco.

It is far beyond the scope of this Article to assess the calamity that resulted from the IRS's efforts to administer the "primarily" standard (for which Congress bears significant blame),⁴⁴ but some description of the affair is necessary. The broad outlines are well known. In a clumsy admission to tax lawyers, the head of exempt organizations at the IRS apologized for using inappropriate audit selection criteria and for delaying the applications for § 501(c)(4) status,

42. If the gift tax applied, however, the nontaxation of appreciated property gifts to § 501(c)(4) organizations likely would not be a reason to give to a § 501(c)(4) organization instead of a § 527 organization. Faced with a choice between paying gift tax on the entire amount of the contribution (if made to a § 501(c)(4) entity) or capital gains tax on the amount of appreciation (if made to a political organization), a donor would opt for capital gains tax and donate to the § 527 entity.

43. There are two limitations here: unrelated trade or business activities are subject to tax, and as noted above, the total amount of unrelated activities must become primary.

44. Congress's decision to make the IRS responsible for administering campaign finance disclosure rules and its push-back against IRS efforts to enforce the gift tax on § 501(c)(4) organizations are two of the main culprits.

especially of “Tea Party” groups.⁴⁵ This led to hysterical reactions and accusations of political targeting by the IRS.⁴⁶

Suffice it to say that although the IRS made poor decisions, because of the subject matter, the affair was blown out of all proportion as a proxy for other political fights. Rather than fomenting outrage, serious policymakers in Congress would have reprimanded the IRS and then moved on to address the underlying problem, which, as outlined above, lies in the advantages to conducting political activity in the § 501(c)(4) form relative to the political organization after *Citizens United*.

Instead, Congress made a difficult situation worse. Through two actions, Congress has effectively entrenched the uncertainty of the status quo. First, by enacting a gift tax exclusion for contributions to § 501(c)(4) groups, and not at the same time extending disclosure rules to § 501(c)(4) organizations, Congress in effect endorsed continued exploitation of § 501(c)(4) for political purposes.⁴⁷ In other words, a stand-alone gift tax exclusion sends the message that Congress expects donors to fund political activity by § 501(c)(4) groups, knowing full well the advantages § 501(c)(4) status brings over § 527 status. Second, Congress directed the IRS not to take any action to clarify standards for campaign intervention under § 501(c)(4).⁴⁸ This has had the effect of freezing the cloud of uncertainty about how much political activity is too much, all but telling the IRS not to attempt to enforce the law in any meaningful way and encouraging groups to take advantage of legal ambiguity and a cowed overseer.

45. See generally TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2013-10-053, INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW (2013), <https://www.treasury.gov/tigta/auditreports/2013reports/201310053fr.pdf>.

46. See e.g., *The IRS: Targeting Americans for Their Political Beliefs: Hearing Before the Comm. on Oversight and Gov't Reform*, 113th Cong. 2 (2013) (statement of Rep. Darrell Issa, Chairman, Comm. on Oversight and Gov't Reform). The saga continues in a wide range of lawsuits. For additional discussion, see generally Evelyn Brody & Marcus Owens, *Exile to Main Street: The I.R.S.'s Diminished Role in Overseeing Tax-Exempt Organizations*, 91 CHI.-KENT L. REV. 859 (2016).

47. This is not to suggest that the gift tax should apply to § 501(c)(4) organizations; rather, through happenstance, the applicability of the gift tax was the only real barrier (rightly or wrongly) to keeping political money from moving into § 501(c)(4).

48. Under the Consolidated Appropriations Act of 2016, the IRS may not use funds to “issue, revise, or finalize any regulation, revenue ruling, or other guidance not limited to a particular taxpayer relating to the standard which is used to determine whether an organization is operated exclusively for the promotion of social welfare for purposes of section 501(c)(4) of the Internal Revenue Code of 1986.” Pub. L. No. 114-113, Div. E, tit. I, § 127(1), 129 Stat. 2242, 2433.

With paralysis as the new normal, the question is whether it matters. Given the advantages of § 501(c)(4) over § 527, it is reasonable to expect that § 501(c)(4) organizations will continue to be used in political campaigns. Even so, social welfare organizations are still a clear second choice for political spending by independent groups. For example, in the 2016 election cycle, § 501(c)(4) spending was dwarfed by the spending of superPACs.⁴⁹ SuperPACs spent \$1.06 billion while § 501(c)(4) organizations spent just 13.7% of that, at \$145.5 million.⁵⁰ At a minimum, this suggests that the nondisclosure of donors and beneficial financing offered by § 501(c)(4) are not enough to outweigh the limit on their political activities, even with limited IRS enforcement.

Further, in the wake of *Citizens United*, the fact that § 501(c)(4) organizations increasingly are engaging in politics is consistent with the free speech policy behind that decision. Under *Citizens United*, free speech is furthered when corporations of all stripes exercise their now protected constitutional rights to engage in independent expenditures. Thus, to the extent that social welfare organizations were restrained before the decision, that restraint has now been lifted and social welfare groups are, to some degree, just exercising their newly found constitutional rights.

Nevertheless, for a variety of reasons, the uncertainty of the status quo is neither desirable nor sustainable, as the next part of the article explores.

II.

SYSTEMIC PROBLEMS FROM INCONSISTENT RULES

It has been said that inconsistency is the hobgoblin of little minds. Perhaps this is true when the pursuit of consistency undoes rational but inconsistent rules. In the context of political activity, however, the inconsistent treatment of political speech across tax exemption categories does not make sense and indeed is itself the problem. The preferences given to political speech by social welfare organizations—nondisclosure and (to a lesser extent) preferred financing—are causing significant harms to the tax system and the rule of law that are bound to get worse with each election cycle. In a nutshell, the incon-

49. SuperPACs are § 527 organizations also unleashed by *Citizens United*.

50. See Ctr. For Responsive Politics, *Outside Spending: Totals by Type of Spender*, OPENSECRETS.ORG, https://www.opensecrets.org/outsidespending/fes_summ.php?cycle=2016 (last visited Jan. 29, 2019). That said, the percentage of § 501(c)(4) spending as a percentage of super PAC spending for the past two election cycles was considerably higher, at 34.5% in 2014, and 42.2% in 2012.

sistency drives opportunistic behavior, creates political tension between the IRS and Congress, and leads to many negative ripple effects throughout the regulatory system. The harms take multiple forms and are surveyed below.

A main harm results from the fact that § 501(c)(4) has become a home for anonymous speech. Ever since the Federal Election Campaign Act Amendments of 1974,⁵¹ a norm of campaign finance law, albeit a debated one, has been to require disclosure of the sources of political contributions.⁵² The desire of some to avoid disclosure has led to the sourcing of political speech through alternative vehicles, first stealth PACs and now social welfare groups. When political speech occurs outside of the reach of disclosure rules, it is termed (by disclosure advocates) as “dark money.”

The initial harm that comes from using social welfare organizations for dark money relates to the dark money problem more generally.⁵³ Dark money in political campaigns has become a polarizing issue.⁵⁴ Its use is viewed by many as a blatant abuse of the campaign finance system, as dishonest, and sometimes illegal. In a word, dark money smacks of corruption. It evokes shadowy figures, backroom deals, and smoke-filled rooms.⁵⁵ Importantly, whether dark money actually corrupts is not the main issue. Rather it is the perception of corruption that matters.

Thus, a significant (if hard to quantify) harm that comes from using social welfare organizations for dark money is the corrosive effect on the tax exemption system that comes from being associated with corruption. When “dark money” and “501(c)(4)” become synonymous in the eyes of the public, one result is to tarnish the entire social welfare population. Yet of the roughly 80,000 social welfare organizations, most do not engage in political activity.⁵⁶ Nevertheless,

51. Pub. L. 93-443, 88 Stat. 1263 (1974).

52. The Supreme Court has upheld disclosure rules on several occasions as advancing the public interest in preventing corruption or the appearance of corruption, including in *Citizens United*. *E.g.*, 558 U.S. at 371.

53. See generally JANE MEYER, *DARK MONEY: THE HIDDEN HISTORY OF THE BILLIONAIRES BEHIND THE RISE OF THE RADICAL RIGHT* (2016).

54. Importantly, the term itself is polarizing. What is darkness to some is privacy to others.

55. See Meyer, *supra* note 53, at 226-28.

56. The National Center for Charitable Statistics reports that in 2013 there were 82,197 social welfare organizations: *Number of Nonprofit Organizations in the United States, 2003-2013*, NCCS, <http://nccs.urban.org/sites/all/nccs-archive/html/PubApps/profile1.php?state=US> (last visited Jan. 30, 2019); see also JEREMY KOULISH, *FROM CAMPS TO CAMPAIGN FUNDS: THE HISTORY, ANATOMY, AND ACTIVITIES OF SECTION 501(C)(4) ORGANIZATIONS 6-7* (2016) (finding that advocacy occurs in less than one-third of social welfare organizations, with advocacy defined to include lobbying and

the negative impact affects the entire brand and has even led to calls to abolish the category.⁵⁷

Further, the taint is not limited to § 501(c)(4) organizations but extends to charitable, or § 501(c)(3), organizations. For good reason, public understanding of tax classifications is minimal at best. The important differences between a § 501(c)(3) charity and a § 501(c)(4) social welfare group are known to a subset of tax lawyers and policy experts, but for most people, it is easy to conflate the two types of organization. This is especially true because “social welfare” is considered a charitable purpose and sounds charitable in nature. In addition, the common use of networked exempt organizations means that affiliated § 501(c)(3), § 501(c)(4), and § 527 organizations often have similar sounding names. Dark money in one is easy to attribute (rightly or wrongly) to all. As a result, dark money becomes to some degree attached to perceptions of all exempt organizations, undermining public trust.

Loss of trust in the nonprofit sector is an existential risk. The halo effect—the notion that nonprofit institutions confer public benefits, seek truth, are independent, and are even noble—is central to the overall success of the sector. The stronger the association of nonprofits and dark money, and the related ugliness of partisanship and propaganda, the weaker the entire sector becomes.

This weakness is amplified by a related erosion to the rule of law in the tax exemption system. The lure of dark money (and preferred financing) causes political actors to exploit vulnerabilities in the law to the greatest degree. Legal standards in the exempt organization field are notoriously vague, based on words like “primary” and “substantial,” not to mention “charitable,” “social welfare,” “educational,” “community,” and of course what it means to “participate” or “intervene” in a political campaign. The system of tax classifications was not drawn up to be a precise scientific taxonomy but has always re-

other activity that is not campaign activity). As discussed in Professor Aprill’s article in this issue, there are different estimates of the number of § 501(c)(4) organizations, but certainly they number in the tens of thousands. Ellen P. Aprill, *Examining the Landscape of § 501(c)(4) Social Welfare Organizations*, 21 N.Y.U. J. LEGIS. & PUB. POL’Y 345, 360-63 (2018); see also Drew Dimmery & Andrew Peterson, *Shining the Light on Dark Money: Political Spending by Nonprofits*, 2 RUSSELL SAGE FOUND. J. SOC. SCI. 51 (2016) (detailing “politically adjusted revenue (PAR)—the part of nonprofits’ revenue that is devoted to political activity” and the growing importance of nonprofits in political spending and campaign finance).

57. John D. Colombo, *The IRS Should Eliminate 501(c)(4) Organizations*, N.Y. TIMES: ROOM FOR DEBATE (May 15, 2013), <https://www.nytimes.com/roomfordebate/2013/05/15/does-the-irs-scandal-prove-that-501c4s-should-be-eliminated/the-irs-should-eliminate-501c4-organizations>.

quired judgment by regulators, the good faith of private actors, and the political support of Congress to work well. Dark money has put all three to the test.

For instance, when a group begins with political aims, but wants to keep donors anonymous, it is easy to form as a § 501(c)(4) social welfare organization. A group need not be much more than a name (e.g., “Citizens for Good”), a bank account, and officers to manage and spend money. No physical office or activities, apart from the raising and spending of money, is necessary. For new groups, the IRS has to make a judgment,⁵⁸ based on statements of intent by the group’s founders and an often-limited track record, as to whether the group properly is a § 501(c)(4) organization or is in reality a political organization. Without strong support for this regulatory function from both political parties in Congress, any categorical judgment by the IRS exposes the agency to scrutiny and voluble criticism.

Further, the law the IRS uses to make judgments in this area is weak. Unless the legal standards are changed,⁵⁹ the IRS must make a series of very difficult assessments, even when a group has an extensive track record. Is a group’s activity political campaign activity, and therefore limited? Or is the activity lobbying, issue advocacy, nonpartisan activity, educational activity, or something else, and therefore not limited (unless “unrelated”)? Groups intent on evading the political activity characterization can plan the activity to be close to but not clearly political activity, opening the door to ambiguity. In addition, because political activity is based on the facts and circumstances, in theory the IRS must make a separate assessment with respect to each act or expenditure, which allows any determined group to exploit uncertainties in the law and question the IRS’s decision repeatedly.⁶⁰

58. The judgment would occur either when the group files an annual information return (Form 990) or when the group applies for § 501(c)(4) status, if it does so.

59. As noted above, the IRS issued Proposed Regulations to change some of the standards in this area, imposing bright lines that would deem certain activity (e.g., voter registration drives, advertisements made within a certain proximity to an election) as political campaign activity. The regulations were widely criticized. Congress subsequently intervened by forbidding the IRS from taking further steps to develop the law in the area. See Katy O’Donnell, *White House Surrenders on ‘Dark Money’ Regulation* (Dec. 18, 2015, 5:41 PM), <http://www.politico.com/story/2015/12/white-house-dark-money-216956>. Subsequently, in appropriations bills, Congress has forbidden the IRS from using funds for regulatory scrutiny of groups based on their ideological beliefs, including as recently as a House-passed bill on September 14, 2017. Department of the Treasury Appropriations Act of 2018, H.R. 3354, 115th Cong. Division D § 108 (as passed by House, Sept. 14, 2017).

60. Robert Maguire, *How Crossroads GPS Beat the IRS and Became a Social Welfare Group*, OPENSECRETS BLOG (Feb. 12, 2016), <https://www.opensecrets.org/news/2016/02/how-crossroads-gps-beat-the-irs-and-became-a-social-welfare-group/>.

Moreover, even if there is agreement that an activity is political, political activity is a permitted activity. The issue then becomes whether the political activity in the aggregate has crowded out social welfare activity as the primary activity of the organization. As noted, though, the legal standard for what constitutes a “primary” activity is another grey area, requiring more judgment by the agency and application of unclear standards.

A further complicating factor is that, purely as a matter of collecting the right amount of federal income tax from the organization, it is of slight consequence whether an organization is classified as a § 501(c)(4) or a § 527.⁶¹ As a result, there is little revenue at stake in properly assigning an exemption category to a group.⁶² Normally, the absence of revenue concerns would allow the IRS to take a somewhat lax enforcement approach. With respect to political activity, however, because there is a disclosure consequence to tax classification, the IRS cannot (or should not) ignore classification issues, and the flaws to the system are magnified.

This leads to an erosion of the rule of law. Groups are emboldened to challenge the IRS. Some groups plainly are not concerned about IRS enforcement, spending well over 50% of all expenses (in some cases, near 100%) on what would appear to be political activity.⁶³ Other groups might just game the system. For example, the League of Women Voters reports that “creative political operatives can leverage campaign expenditures by donating 50.1 percent of a 501(c)(4) organization’s receipts to an affiliated 501(c)(4) organization in order to establish a social welfare primary purpose. The second social welfare organization then has a larger contribution base on which to determine its 49.9 percent maximum permitted campaign expenditures.”⁶⁴ Further, some groups could effectively rent out their exemptions. For example, a large existing § 501(c)(4) organization with an annual operating budget of, say, \$5 million all in social wel-

61. Admittedly, this depends upon whether social welfare organizations have investment income and the IRS enforces the tax under § 527(f).

62. As noted, this does not apply to donors. *See supra* Part I.

63. Robert Maguire, *Political Nonprofit Spent Nearly 100 Percent of Funds to Elect Tillis in '14*, OPENSECRETS BLOG (Oct. 20, 2015), <https://www.opensecrets.org/news/2015/10/political-nonprofit-spent-nearly-100-percent-of-funds-to-elect-tillis-in-14/>; Will Tucker, *Two Dozen Dark Money Groups Have Busted 50 Percent Cap on Politics at Least Once* (Dec. 9, 2015), <https://www.opensecrets.org/news/2015/12/two-dozen-dark-money-groups-have-busted-50-percent-cap-on-politics-at-least-once/>.

64. LEAGUE OF WOMEN VOTERS, MONEY IN POLITICS: INDEPENDENT EXPENDITURES, LWV: MONEY IN POLITICS REVIEW 4 (July 20, 2015), http://forum.lwv.org/sites/default/files/mip_independent_expenditures_final_.pdf (providing an overview of “independent expenditures” and § 501(c)(4)’s deficient disclosure requirements).

fare activity could absorb up to \$4,999,999 of contributions for political ads arguably without risking exemption. Still other groups might risk perjury through incorrect or false statements on the annual information return, leading to erosion of the integrity of the reporting regime.

Relatedly, social welfare organizations can be used to get around other campaign finance related laws. Private foundations, for instance, risk loss of tax exemption and an excise tax if they fund campaign intervention.⁶⁵ Private foundations nonetheless can provide the base funding for the social welfare arm of a § 501(c)(4) organization. With a (presumably) bona fide social welfare core activity thus established, the § 501(c)(4) organization can then raise and spend almost as much on political activity.⁶⁶ In a similar vein, concern is mounting that funneling money through § 501(c)(4) organizations provides a way for foreign nationals to influence elections.⁶⁷ The ability to move money from organization to organization makes it more difficult to track by requiring that the IRS follow the (fungible) money.

Not only does the current legal framework foster disregard for the law, the rule of law also is damaged by the IRS's apparent inability to take effective enforcement action. As dark money washes through the nonprofit world, voices opposed to undisclosed political spending blame the IRS for not enforcing the tax-exemption laws. This criticism, however, feeds a misperception that political activity is tax-favored by exemption and that the IRS's administrative impotence enables tax cheats. But any IRS failure properly to characterize nonprofit groups supports a disclosure shelter, not a tax shelter. The root of the problem is not vague exemption standards and uncertain political activity definitions but inconsistent disclosure rules and Con-

65. I.R.C. § 4955 (2012).

66. As Professor Aprill explains: “[D]onors can set up a private foundation, getting the charitable contribution deduction or donations to it, then donate funds earmarked for charitable activities from the private foundation to a § 501(c)(4) organization. The private foundation undertakes oversight known as expenditure responsibility for those donated funds . . . The contributions from the private foundation permit the § 501(c)(4) to use other contributions for lobbying and campaign intervention.” Aprill, *supra* note 56, at 377 n.187. This same tactic could also be used by public charities.

67. See Uri Friedman, *Beyond Russia: 5 Ways to Interfere in U.S. Elections – Without Breaking the Law*, ATLANTIC (July 24, 2017), <https://www.theatlantic.com/international/archive/2017/07/legal-ways-interfere-election/534057/>; see also Jon Schwarz & Lee Fang, *Cracks in the Dam: Three Paths Citizens United Created for Foreign Money to Pour into U.S. Elections*, INTERCEPT (Aug. 3, 2016, 1:12 PM), <https://theintercept.com/2016/08/03/citizens-united-foreign-money-us-elections/> (noting that in theory, § 501(c)(4) organizations have to keep any foreign money segregated and only spend funds from American donors on U.S. elections).

gress's charge to the IRS to enforce the inconsistency (and also to do nothing about it).

In short, the fact of inconsistent federal law on the treatment of political activity means that issues of anonymous political speech, weak and hard-to-enforce exemption standards, questions about defining political activity, disrespect for the rule of law, and damage to the reputation of the IRS will be a core part of the legal landscape in which all nonprofits operate. The unfortunate state of the status quo should prompt change. The next Part of the Article examines possible solutions.

III.

SOLUTIONS: CONSISTENT RULES AND FEWER LIMITS

There are several goals in crafting solutions. One goal is to provide for consistent treatment of political campaign activity, absent a compelling reason for inconsistent treatment. Consistent treatment will reduce incentives to plan and strategize around tax classifications, resulting in more honesty and easier administration.

Another goal is to choose solutions that reduce the role of the IRS in regulating political activity. It is in the public interest for the tax agency to be charged with the objective administration and enforcement of the revenue laws. It is not in the public interest for the IRS to be in a position of making nuanced and facts-and-circumstances determinations that open the agency to charges of partisanship, absent a significant revenue-related purpose.

A final goal is to advance the most appropriate tax treatment of social welfare and political organizations to account for the new types of speech allowed by *Citizens United*.⁶⁸

A. Consistent Disclosure and Tax Treatment

A critical part of any solution is for Congress⁶⁹ to make consistent⁷⁰ the disclosure and tax treatment of social welfare and political

68. As noted at the outset, this Article focuses on social welfare organizations. However, the general approaches discussed here also pertain to other noncharitable exempt organizations like labor unions and trade associations.

69. Although arguably some changes could be achieved through administrative action, see Donald B. Tobin, *Campaign Disclosure and Tax-Exempt Entities: A Quick Repair to the Regulatory Plumbing*, 10 ELECTION L.J. 427, 438 (2011) (advocating before the IRS controversy that the IRS make changes to the disclosure rules on social welfare organizations), legislation is preferable after the recent scandals, Donald B. Tobin, *The 2013 IRS Crisis: Where Do We Go from Here?*, 142 TAX NOTES 1120 (2014) [hereinafter *2013 IRS Crisis*].

70. The issue for tax law is consistent treatment across exemption categories—so that the same type of activity is disclosed (or not) regardless of tax classification.

organizations. The self-evident value of consistency is that, with consistent rules, there would be no reason to pick a tax classification to gain a disclosure or financing advantage, thereby greatly reducing the occasions and incentive for abuse and opportunism, with all their resulting harms. This is (or should be) common-sense policymaking.⁷¹ Further, consistent rules in this area fit with past congressional legislation, which has followed a pattern of loophole closure, both with respect to the taxation of investment income,⁷² and disclosure.⁷³

1. *Disclosure*

Political consensus aside, imposing disclosure rules on social welfare organizations is not without difficulties. In the political organization context, disclosure of contributors is a generally effective means to identify the source of financing because political activity is, for all intents and purposes, the sole activity of a political organization. Applying disclosure rules to an organization that primarily engages in nonpolitical activity is not as neat.

One problem is that disclosing all donor names does not directly reveal the source of political funds. Because money is fungible, there is no way of knowing which of the disclosed donors funded the political activity. Further, donors can frustrate the value of disclosure by first donating to a shell § 501(c)(4) (or other) organization that in turn donates to the § 501(c)(4) organization that spends the money for political purposes. Disclosure by the latter § 501(c)(4) organization of the grant from the shell organization would not be very informative.⁷⁴

Whether to require disclosure (or not) is more a question of campaign finance law and less important for tax purposes than that there be consistency.

71. That said, it would be naive not to recognize that common sense is often in short supply, and in this case may be resisted by those who want to preserve avenues for anonymous political speech, are not bothered by harms to the IRS or the tax system and have no objection to facilitating tax benefits to political donors.

72. The inclusion of a tax on the investment income of noncharitable exempt organizations when Congress codified the tax treatment of political organizations in 1975 was intended to preserve consistent tax treatment across the exemption categories. As explained by the legislative history, social welfare organizations should be treated "on an equal basis for tax purposes with political organizations." S. REP. NO. 93-1357, at 7505 (1974).

73. The addition of disclosure rules as a condition of political organization status in the year 2000 was intended to close the "stealth PAC" loophole and provide for consistent disclosure rules.

74. The § 527 disclosure regime can be circumvented in a similar way: a donor first transfers funds to a social welfare organization, which then transfers the money to the § 527 organization. Although the § 527 organization discloses the § 501(c)(4) source, absent disclosure by the § 501(c)(4) organization, there is no way to know the original source. Requiring disclosure by § 501(c)(4) organizations would help curb this abuse.

In addition, disclosing all donor names is to over-disclose and compromise the privacy of donors that make contributions to fund nonpolitical activities.⁷⁵

Some of these concerns might not materialize, however. For example, one approach would be to require disclosure of all donors to social welfare organizations that engage in political activity, as it is defined for political organizations under § 527.⁷⁶ Donations under \$200 would not have to be disclosed.⁷⁷ Under this rule, social welfare organizations could avoid disclosure in two ways: (1) by refraining from political activity, or (2) by conducting all political activity out of a separate segregated fund.⁷⁸ The result would be to encourage social welfare organizations to conduct any political activity from a separate segregated fund that was funded solely by outside contributions.⁷⁹ In other words, the organization would have a choice: protect against over-disclosure by segregating the funding and conduct of political activity or conduct the activity directly and face the wrath of donors of the social welfare activities.⁸⁰ Faced with such a choice, many social welfare organizations would segregate their activities.

Admittedly, this approach requires a fairly clear understanding of the type of conduct that must be disclosed. Further, it would be a trap for an unwary social welfare organization that inadvertently conducts political activity and as a result has to disclose all donors for the year. Accordingly, exceptions for *de minimis* political activities and for small social welfare organizations might be appropriate.

From a tax perspective, the ideal scenario would be to place the obligation to enforce disclosure in the hands of the FEC, for both so-

Suffice it to say, however, that a donor determined to remain anonymous can probably find a way.

75. See Terence Dougherty, *Section 501(c)(4) Organizations: Political Candidate-Related and Other Partisan Activities in Furtherance of the Social Welfare*, 36 SEATTLE U. L. REV. 1337, 1410-11 (2013) (expressing the concern that requiring disclosure of all donors might harm their ability to get new members).

76. This is the definition of “exempt function.”

77. The \$200 amount tracks the disclosure threshold for political organizations. The amount is measured by aggregating all contributions of a single donor.

78. Separate segregated funds are treated like political organizations and subject to disclosure rules. I.R.C. § 527(f)(3) (2012).

79. If the organization funds the segregated fund with general treasury monies of the § 501(c)(4), that would trigger disclosure of all § 501(c)(4) donors.

80. Another option would be disclosure of all donors to the social welfare organization making contributions (in the aggregate) above a certain threshold amount, e.g., \$25,000. This would help to minimize over-disclosure. Although some political activity would go undisclosed, the privacy of small donors (which may or may not make up the bulk of the social welfare activity) would be protected. See generally Tobin, *Quick Repair*, *supra* note 70 (suggesting a threshold of \$25,000).

cial welfare and political organizations.⁸¹ Monitoring campaign speech is a damaging distraction for the IRS as recent events have shown.⁸² Most importantly though, notwithstanding imperfections that a disclosure regime for social welfare organizations would entail, as discussed in Part II of this Article, the costs of not acting, and of preserving the status quo, are higher.

2. *Taxation of Donors*

Less significant than disclosure, but still important, is securing consistent tax treatment of donors. As noted, under current law, donors of appreciated property to a political organization must pay tax on the capital gain.⁸³ By contrast, donors of appreciated property to a social welfare organization do not pay such a tax. The result is that politically motivated donors with appreciated property to contribute have a reason to fund a social welfare organization instead of a political organization in order to avoid income tax.

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.”⁸⁴ Absent a tax on the donor, the political organization would bear the tax burden upon sale and realization of investment income. Thus, the concern at the time⁸⁵ 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. As discussed, the inconsistent treatment creates an incentive to use social welfare organizations for political purposes, which was not an issue in 1975 when the rule was enacted. Further, as a tax policy matter, because of the broader exemption for social welfare organizations, tax on appreciation may

81. See Mayer, *supra* note 38, at 682 (arguing that the FEC and not the IRS should be the institution of choice for monitoring disclosure); see also Tobin, *2013 IRS Crisis*, *supra* note 69, 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); S. 229, 114th Cong. (2015); H.R. 1134, 115th Cong. (2017). In general, it amends the Federal Election Campaign Act, not the Internal Revenue Code, to require disclosure of independent expenditures.

82. See *supra* text accompanying notes 4-8.

83. I.R.C. § 84.

84. S. REP. NO. 93-1357, at 7481 (1974).

85. Prior to Congress’s enactment of § 84, the IRS determined that the political organization should pay tax on the gain. Rev. Rul. 74-21, 1974-1 C.B. 14, and Rev. Rul. 74-23, 1974-1 C.B. 17.

be avoided entirely.⁸⁶ This runs contrary to the congressional policy of taxing investment income with respect to political activity and to the view that transfers of appreciated property for political purposes are not gifts⁸⁷ and therefore gain should be realized upon transfer.

The solution is to extend the income tax on unrealized appreciation to donors making contributions to social welfare organizations.⁸⁸ The tax could be limited only to social welfare organizations that engage in political activity (within several years of the contribution). Broader reform, though, would extend the tax to contributions of appreciated property to all noncharitable exempt organizations. 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.

3. *Remaining Issues*

Consistent disclosure and financing rules would, at a minimum, greatly reduce incentives to abuse the social welfare organization form for political purposes. Consistent rules would relieve some of the pressure on the “primarily” test and on the IRS. Groups with mainly political intentions, without disclosure or financing benefits to organizing as social welfare organizations, would in all likelihood prefer political organization status to avoid facing limits on political activity, however opaque those limits may be.

That said, however, a broader issue remains, namely whether and how to limit the political activity of social welfare organizations. As a practical matter, so long as the primary activities test is the basis for

86. The potential for tax avoidance is straightforward. A donor with highly appreciated stock donates to a social welfare organization in Year 1. Assuming the donation is a gift, no income tax applies on the unrealized appreciation at the time of the donation. I.R.C. § 102. Also in Year 1, the social welfare organization sells the stock, and does not pay income tax on the proceeds because of income tax exemption. The social welfare organization refrains from political activity in Year 1 in order to avoid imposition of the § 527(f) tax on investment income. (Thus, careful timing of political activity is involved, which makes the tax avoidance harder (assuming that the § 527(f) tax applies).) In Year 2, however, the social welfare organization 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 property may be contributed without triggering income tax on the appreciation either to the donor or to the organization.

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

88. See Polsky & Charles, *supra* note 32, at 1013 n.81 (encouraging realization for appreciated property gifts to noncharitable exempts in the absence of gift tax).

limiting political activity, there will be questions and concerns about crossing the line, especially by established social welfare groups that have a strong base of nonpolitical activity (e.g., AARP, NRA, Planned Parenthood, Sierra Club, etc.). In other words, consistent rules will not vanquish the question of how much is too much. Further, as a matter of tax policy, there is a valid question whether any limit on political activity makes sense or is constitutional, especially after the *Citizens United* decision. In addition, in the event that Congress (or the IRS) does not create consistent rules in this area, other ways to approach the problems of the status quo should be considered.

B. *Reforming Political Activity Limits*

The issue is how much political activity by social welfare organizations should be allowed consistent with the tax status. As discussed earlier, Treasury regulations and IRS guidance together require that “the organization’s primary activities [must] promote social welfare.”⁸⁹ A leading complaint is that the standard is uncertain in application both qualitatively and quantitatively. A related complaint is that the standard is too permissive a deviation from the statutory mandate of “exclusive” social welfare activity.⁹⁰ What should be done? Where

89. Rev. Rul. 81-95, 1981-1 C.B. 332.

90. The “primarily” test of the regulations has been criticized as agency overreach and an improper interpretation of congressional intent. See Press Release, Democracy 21, Rep. Van Hollen and Watchdog Groups File Lawsuit Challenging Flawed IRS Regulations (Aug. 21, 2013), <https://perma.cc/3Z4Z-YZCG>. “Exclusively” as “primarily,” however has a long history. In the § 501(c)(3) context, the Supreme Court found in 1945 that an insubstantial nonexempt purpose, and therefore some nonexempt activities, was consistent with tax exemption under an “exclusively” standard. *Better Bus. Bureau of Wash., D.C. v. United States*, 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”). The Treasury regulations for § 501(c)(3) subsequently adopted a nonliteral construction, providing that “exclusively” means primarily. Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 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”). This is the standard generally adopted in the § 501(c)(4) regulations in 1959. Congress also embraced a nonliteral understanding of the term “exclusively” when it passed the unrelated business income tax in 1950, Revenue Act of 1950, ch. 994, § 301, 64 Stat. 906, 947 (codified as amended in I.R.C. § 511), which became applicable to social welfare organizations in 1969, Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(a)(2), 83 Stat. 487, 536 (codified as amended in I.R.C. § 511). As to what “primarily” means, and whether it has the same meaning for § 501(c)(3) and § 501(c)(4), are legitimate questions. But agency overreach is not the issue. For an excellent discussion of the evolution and meaning of the standard, see Galston, *supra* note 27.

and how to draw the line?⁹¹

1. A Percentage-Based Test

One approach would be to define a “primarily” threshold for social welfare organizations using a mechanical bright-line. A model would be the regulations in the § 501(c)(3) area that articulate in great detail the permitted amount of lobbying.⁹² For example, regulations could specify the exact amount of expenditures allowed for political activity in relation to overall expenses,⁹³ 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 (i.e., “cheap speech”). Some working definition of political activity also would have to be adopted.

One threshold issue with such an approach is deciding where to draw the line. Should the line be at forty-nine percent, thirty-three percent, twenty-five percent, or ten percent or less? What level of political activity is consistent with social welfare organization status? A forty-nine percent line seems the least arbitrary, based as it is on majoritarian logic. That is, if more than half of an organization’s activities are not related to exempt purposes, then it makes sense to conclude that the organization is not mostly organized for exempt purposes. Perhaps second-best is a ten percent or less test, which some would argue comes closer to Congress’s original intent in using the term “exclusively” for social welfare in the statute and seems to advance a policy that political activity by social welfare organizations should be severely constrained.

If the line is drawn at less than forty-nine percent, however, an additional issue arises, namely, the creation of a gap between failed social welfare organizations and political organizations. For example, if the threshold were, say, that no more than twenty-five percent of activities could be political, what would happen to organizations that

91. The primary activities test of present law could be changed legislatively or administratively, in most cases, with similar results.

92. Treas. Reg. § 56.4911-1 to -10 (1990). 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).

93. There are multiple proposals. *See, e.g.*, Ellen P. Aprill, *The Section 527 Obstacle to Meaningful Section 501(c)(4) Regulation*, 13 *PITT. TAX REV.* 43, 75 (2015) (noting a preference for a limit “well below 40%”); *see* American Bar Association 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/dam/aba/administrative/taxation/policy/050714comments.authcheckdam.pdf> (suggesting an amount “somewhere between insubstantial (but not zero) and 40%”).

exceeded the threshold, but did not engage in enough political activity to qualify as a political organization? Presumably, such organizations would lose social welfare organization 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.⁹⁴ Furthermore, the administrative burden on the IRS would increase because of the addition of yet another line to police—that between the social welfare organization, the taxable nonprofit, and the political organization.

Another issue is that any percentage-based limit would have to account in some fashion for non-political, non-social welfare activity. Under current law, there is no separate sublimit on political activity as an unrelated activity, i.e., the forty-nine percent “rule of thumb” applies to all nonrelated activity. For example, if a forty-nine percent limit is chosen as the bright line, it could apply: (1) to all non-social welfare activity, with the organization free to choose the balance of political and non-political unrelated activity, or (2) with a separate sublimit on political activity, i.e., a forty-nine percent limit of which no more than X percent may be political activity. Yet, if a distinct sublimit just for political activity were imposed, doing so brings the issue back to the question of arbitrariness. Why single out one nonexempt activity for a separate cap and (presumably) a distinct mechanical test? Why should political activity be capped at, say, twenty-five percent but unrelated trade or business activity could go up to forty-nine percent of total activity?

In short, the promise of greater certainty and perhaps compliance under a percentage-based approach (even assuming workable rules could be devised) must be balanced by recognition that a detailed regulatory regime to assess the primarily threshold would require a number of arbitrary decisions, and perhaps more importantly, imply a much more robust enforcement presence by the IRS, including a need for additional resources. Thus, though superficially appealing, a percentage-based approach would increase administrative burdens on the

94. In this regard, note that for a taxable organization, no deduction is allowed for campaign activity, making the loss of exemption that much more punitive. I.R.C. § 162(e). For additional discussion of taxation of taxable nonprofit political organizations, see Roger Colinvaux, *Political Activity Limits and Tax Exemption: A Gordian's Knot*, 34 VA. TAX REV. 1, 54-58 (2014) (discussing whether § 527 treatment is voluntary or mandatory and the need for a new tax baseline); Donald B. Tobin, *Will Taxable Entities Be the New Stealth Dark Money Campaign Organizations?*, 49 VAL. U. L. REV. 583 (2015). For additional discussion of the “gap,” see Aprill, *supra* note 93, at 73-74.

IRS and have the perhaps perverse effect of involving the IRS more deeply—not less—in political activity questions.⁹⁵

2. *Allow Unlimited Political Campaign Activity*

Another option, which might seem radical at first, is to eliminate the definitional limit on political campaign activity, i.e., permit unlimited political activity that relates to the social welfare purpose of the organization. This would require revisiting the regulations, which have provided since 1959 that “[t]he 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.”⁹⁶ Relevant here, the regulation has been extended to apply to other noncharitable exempt organizations such as § 501(c)(5) labor unions and § 501(c)(6) trade associations.⁹⁷

Though longstanding, the rationale for the regulation is uncertain,⁹⁸ and on its face seems absurd. A social welfare lobby group, a labor union, and a trade association 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 consumer advocate 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

95. Notably, in its proposed regulations on § 501(c)(4) political activity, the IRS declined to provide guidance on the question of what constitutes “primarily.” Prop. Treas. Reg. § 1.501(c)(4)-1, 78 Fed. Reg. 71,535, 71,537-38 (Nov. 29, 2013). For a summary of the Proposed Regulations, see Aprill, *supra* note 93, at 49-54.

96. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990). The proposed regulations would have modified this part of the regulations, replacing the current use of the § 501(c)(3) standard for political activity with a new definition of political activity, distinct for § 501(c)(4). Prop. Treas. Reg. § 1.501(c)(4)-1, 78 Fed. Reg. 71,535, 71,537 (Nov. 29, 2013).

97. I.R.S. Gen. Couns. Mem. 34,233 (Dec. 3, 1969), 1969 WL 20405 (providing that § 501(c)(5) and § 501(c)(6) organizations face similar constraints as § 501(c)(4) organizations).

98. See 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, 73 n. 83 (2004); see also Aprill, *supra* note 93, at 71 (noting that the proposed regulations in 1956 made no mention of political activity).

of reality by defining political activity as incompatible with noncharitable exempt purposes. Is there a good reason?

One (after-the-fact) explanation is a private benefit rationale, i.e., that political campaign activity, unlike lobbying, ultimately serves the private ends of a candidate whose personal mission and benefit may be far removed from the purposes of a social welfare organization. Thus, the IRS 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.”⁹⁹ But this conclusion is debatable. Support for a political candidate need not mean reverence or identity. Further, it is not clear why the fact that a candidate has positions on multiple issues means that support for the candidate *by definition* cannot also advance the organization’s mission.

Another argument is that restrictions on campaign activity are necessary to protect against capture of the organization and consequent corruption of its purposes.¹⁰⁰ It has long been observed that nonprofit organizations are prone to capture because of weak oversight.¹⁰¹ 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, fear of capture 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.¹⁰² In addition, many ex-

99. I.R.S. Gen. Couns. Mem. 34,233, 1969 WL 20405 (Dec. 30, 1969); *see also* Am. Campaign Academy v. Comm’r, 92 T.C. 1053, 1055-57, 1070-73, 1079 (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). Others share this view. *See* Dougherty, *supra* note 75, at 1394 (arguing that supporting a candidate’s campaign “can be considered supportive of the private interests of that candidate” because it “directly benefits that candidate economically” and helps “a private constituency”). 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 27, at 170.

100. Brain Galle & Donald Tobin, Center for Interdisciplinary Law and Policy Studies, Comments on Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities 6–8 (Feb. 22, 2014); *see also* Aprill, *supra* note 93, at 70 (“Engaging in political campaign intervention will inevitably involve issues not related to such organizations’ exempt purposes.”).

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

102. *See e.g.*, FRANCES R. HILL AND DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶ 13.01, at 13-2–13-5 (2002) (noting that the “only reason for having

isting social welfare organizations already engage in considerable amounts of political activity, which is another way of saying that capture concerns already exist under present law. Although removing the definitional limits might make capture worse, it is questionable whether any increased risk of capture to a social welfare organization is sufficient to justify arbitrary limits on a core activity.¹⁰³

Most likely, the reason for the regulation is rooted in the parallel relationship between § 501(c)(3) and § 501(c)(4). Because the “promotion of social welfare” is a charitable purpose under the § 501(c)(3) regulations,¹⁰⁴ and § 501(c)(3) organizations are prohibited from engaging in political activity, it is an easy (if facile) conclusion that political activity by definition does not further social welfare for purposes of § 501(c)(4). If the Treasury Department made this conclusion, however, it was probably reluctant to prohibit campaign activity in the § 501(c)(4) regulations outright because of concern that doing so would be inconsistent with the statute.¹⁰⁵ On the other hand, for the Treasury Department to acknowledge that campaign activity could further social welfare would be to introduce a difficult inquiry into whether the political activity was “related” or “unrelated.”¹⁰⁶ Whether

two separate types of exempt organizations was that the Section 501(c)(4) self-help model appeared to present private benefit issues that might prove troublesome under Section 501(c)(3)”; John Francis Reilly, Carter C., Hull, and Barbara A. Braig Allen, *IRC 501(c)(4) Organizations*, in EXEMPT ORGANIZATIONS; TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2003 at I-1 (2004), <https://www.irs.gov/pub/irs-tege/eotopic03.pdf> (noting that § 501(c)(4) “comprehends a very broad category of organizations”); 1981 CPE Text, Chapter G, “Social Welfare: What Does It Mean? How Much Private Benefit Is Permissible?” available at <https://www.irs.gov/pub/irs-tege/eotopicg81.pdf> (noting that § 501(c)(4) is “a haven for organizations that lack the accepted essential characteristics of a taxable entity, but elude classification under other subparagraphs of § 501(c)”). The exemption for § 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).

103. 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) to revoke an organization’s exempt status.

104. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2017).

105. The presence of an express prohibition on campaign intervention in § 501(c)(3) and the absence of one in § 501(c)(4) raises a strong negative inference that no prohibition was intended for § 501(c)(4) organizations.

106. 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) (as amended in 2017); see Thomas A. Troyer, *Quantity of Unrelated Business Consistent with Charitable Exemption – Some Clarification*, 56 TAX NOTES 1075, 1076 (1992).

for those reasons or not, the regulations struck a compromise. By declaring that political activity does not further social welfare purposes, the regulations avoid a “related-unrelated” inquiry but achieve a limitation, set by the “primarily” test.

Yet a conclusion that political activity does not further exempt purposes under § 501(c)(3) reflects, or should reflect, different concerns than a conclusion that political activity does not further social welfare organization purposes, especially after the *Citizens United* decision. In the § 501(c)(3) context, the corrupting influence on the organization, fears of private benefit, and the risk of capture make campaign intervention uniquely ripe for a prohibition. Prohibition serves the no-subsidy norm, is tied inextricably to the charitable deduction,¹⁰⁷ and is critical to protect the integrity of the charitable exempt purpose.

In the context of social welfare organizations, however, these same arguments are unconvincing. Limiting the campaign intervention of social welfare organizations does not serve the no-subsidy norm. Not only are contributions to social welfare organizations not deductible as charitable contributions,¹⁰⁸ but to engage in campaign intervention is to trigger loss of exemption with respect to the political activity.¹⁰⁹ In addition, social welfare organizations plainly are not “public benefit” organizations in the same way as a charity.¹¹⁰ The § 501(c)(4) organization is allowed to engage in unlimited lobbying (as are the § 501(c)(5) and § 501(c)(6) organizations) and some political activity, and is considered a “catchall” exemption category for groups that fail to fit elsewhere.¹¹¹ Thus, § 501(c)(4) is a useful classification for nonprofit lobby groups and local civic organizations that

107. No charitable deduction is allowed to an organization that fails the political activities prohibition. I.R.C. § 170(c)(2)(D) (2012). Other tax benefits are also related to the § 501(c)(3) classification, such as tax-exempt financing. *Id.* § 145.

108. Veterans’ organizations, although technically a type of “social welfare organization,” are eligible to receive deductible contributions but are not subject to the political activities prohibition. *Id.* § 501(c)(19). Veterans’ organizations therefore are hard to categorize.

109. *Id.* § 527(f)(1).

110. The point is even stronger for labor unions and trade associations. Although these groups are undoubtedly a positive force in civil society, they 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.

111. See JAMES J. FISHMAN & STEPHEN SCHWARZ, *TAXATION OF NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 768 (2d ed. 2006) (referring to § 501(c)(4) as a “dumping ground”).

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.

Nonetheless, even if the standard explanations for the regulation do not appear justified, placing a limit on the political activity of social welfare organizations does allow for the distinction between the social welfare organization and the political organization. In this way, the limit can be said to protect the integrity of the social welfare organization purpose by making sure that the nonpolitical activity (or purpose) remains “primary.”¹¹² 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 social welfare organizations is to provide appropriate labels of organizational types.

The labeling function of the political activity limit probably was a sufficient reason before *Citizens United* removed the campaign finance law ban on corporate (and labor union) independent expenditures.¹¹³ As a practical matter, the ban indirectly served as a quantitative limit on political activity, simply because it limited the type of speech a social welfare organization could engage in. In a way, the tax law limits largely were superfluous.¹¹⁴ The pre-*Citizens United* world of campaign finance thus fits fairly neatly into the tax law paradigm of political activity limitations. The definitional 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. Social welfare organization 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 definitionally inconsistent with so-

112. 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).

113. 52 U.S.C. § 30116; *Citizens United v. FEC*, 558 U.S. 310, 320 (2010).

114. The issue advocacy loophole exploited by some political organizations to avoid the Federal Election Campaign Act never really spread to the social welfare organization, 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 § 527 over § 501(c)(4) to be certain of avoiding gift tax. See Gregg D. Polsky, *A Tax Lawyer’s Perspective on Section 527 Organizations*, 28 CARDOZO L. REV. 1773, 1782 (2007).

cial welfare organization 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.¹¹⁵ 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.¹¹⁶

All that said, from a purely 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.¹¹⁷ 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 § 527.¹¹⁸ 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.¹¹⁹

Under current law, however, there are potentially significant tax differences between a social welfare organization and a political organization. Broadly, if a social welfare organization exceeds the political activity limit and becomes a political organization, it would mean a loss of exemption on the income from the social welfare organization purpose.

The question then is what explains this result. Probably the best explanation is rooted again in a history of organizations being either

115. 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 social welfare organization purposes. For a discussion of the difficulty of maintaining a related-unrelated distinction in the context of political activity of charitable organizations, 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, 749-50 (2012).

116. 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.

117. 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.

118. This assumes that it is administratively feasible to switch tax classifications and that there is some process in place for doing so.

119. Note that a shift from social welfare organization status to political organization status should be less important to the organization than a shift from § 501(c)(3) status to another 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.

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.¹²⁰ 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 social welfare organizations seek to engage in significant political activity.

In short, the loss of exemption on social welfare organization purpose income for engaging in too much political activity has not been tested. A genuine mixed social welfare-political purpose organization was not enough of a reality, and thus, crossovers 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 social welfare organization 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 social welfare organization 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 social welfare organizations should be eliminated.¹²¹

Getting rid of the definitional political activity limitations has significant appeal. It would simplify tax administration, improve compliance, and embrace free speech. That said, removal of the limits should not be undertaken until the nontax advantages of social welfare organization status (especially the nondisclosure of donors) have been eliminated relative to the political organization. Put another way, after *Citizens United*, the ultimate usefulness of the political activity definitional limitations on social welfare organizations 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 social welfare organization purposes should be extinguished.

120. I.R.C. § 527(c) (2012).

121. Technically, a limit on “unrelated” political activity would remain and would help protect against capture concerns.

C. Additional Reform Possibilities

To this point, the argument is that there should be consistent disclosure and financing rules between social welfare and political organizations, and the political activity limits could then be eliminated as not serving any compelling tax interest. This would be a significant improvement over current law. Additional reforms, outlined below, could also be considered.

1. Tax the Investment Income of Social Welfare Organizations

One reform is overbroad to the question of political activity, and so technically outside the scope of this Article, but merits serious consideration: to tax the investment income of social welfare organizations. In addition to eliminating a subsidy of questionable merit,¹²² assuming that the disclosure advantages of social welfare organizations are erased, taxing the investment income of § 501(c)(4) organizations would virtually eliminate the significance of engaging in political activity as a social welfare organization. It simply would not matter from a tax perspective whether a social welfare organization intervened in campaigns.¹²³ The role of the IRS in regulating the political activity of social welfare organizations would be extremely limited.¹²⁴

2. Expand the Exempt Status of Political Organizations

Another approach would be to expand the tax exemption for political organizations to include social welfare income. This might be a good alternative to dispensing with the political activity limits on so-

122. For discussion, see Daniel Halperin, *The Tax Exemption Under I.R.C. § 501(c)(4)*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 519, 528 (2018) (arguing that consumer mutual nonprofits should be taxed on investment income and that "it is troublesome to allow full exemption to an organization that may spend just short of half its resources on social activities"); April, *supra* note 56. The investment income of social welfare organizations should be pursued on the merits, not as a response to the problem of political activity of social welfare organizations. As noted *supra*, Part II, of the roughly 80,000 social welfare organizations, most do not engage in political activity. That said, however, taxing the investment income of mutual nonprofits generally could yield a significant simplification of the taxation of noncharitable exempts. See also David S. Miller, *Reforming the Taxation of Exempt Organizations and Their Patrons*, 67 TAX LAW. 451, 452 (2014) (suggesting that a § 501(c)(4) organization that "engages in a significant amount of lobbying or campaigning would be taxable on all of its investment income").

123. The § 527(f) tax could be eliminated.

124. The IRS would still have to enforce the proxy tax, or the rule that social welfare organizations that engage in political or lobbying activity either inform members that a portion of their dues are not deductible or pay a tax.

cial welfare organizations, especially in the absence of uniform disclosure rules. The result would be to eliminate the tax penalty if a social welfare organization exceeded the “primarily” test (however the test is formulated). Instead of losing exemption, the organization could instead be reclassified as a political organization with no tax cost to the organization.

This should also make it much easier as a practical matter for the IRS to reclassify organizations as political. Because the only real consequence to reclassification would be disclosure (not loss of exemption), it should be harder to attack the IRS politically for having the temerity to suggest that an organization with a substantial level of political activity should be shifted to political organization status. Relatedly, such a regime would also make a political activity limit more coherent. For example, if Congress or the IRS took the position that social welfare organizations should engage in only *de minimis* political activity, any organization with substantial political activity would be reclassified as a political organization, forcing disclosure, but again, at no tax cost.

3. *Tax Social Welfare Organization Political Expenditures*

Another approach is worth mentioning, namely taxation of political campaign activity by social welfare organizations. The idea would be to treat social welfare organizations for tax purposes as the mirror of political organizations. All expenditures for campaign activity would be taxed at corporate rates, i.e., as “nonexempt function income.” The tax could be avoided by conducting the activity through a separate segregated fund, which would be treated as a political organization.¹²⁵ The benefit to this approach would be to create strong tax incentives to conduct campaign activity through a separate fund. It would therefore be an alternative to having to legislate disclosure rules for the campaign speech of social welfare organizations. This is because the tax detriment of conducting campaign activity directly would likely overwhelm the disclosure advantage to doing so.

The downsides to this approach are that the IRS would have to enforce the tax rigorously and without reservation.¹²⁶ This would in-

125. This would be largely equivalent to making the tax under § 527(f) a tax on political expenditures and eliminating the “lesser of” feature (and so the reference to investment income).

126. The IRS has reserved for the future how to tax large swathes of expenditures pursuant to § 527(f). Treas. Reg. § 1.527-6(b)(2), (3) (1980) (reserving treatment of political expenditures allowed under FECA or similar state statute and indirect political expenditures). For extensive discussion and recommendations on this issue, see Nancy E. McGlamery & Rosemary E. Fei, *Taxation with Reservations: Taxing Non-*

volve the IRS more deeply in regulating political activity and open the door to constant pressure on the agency as being in the business of taxing the exercise of First Amendment rights. Further, clear lines about the type of activity that would trigger the tax would have to be drawn. Otherwise, the tax could be open to challenge on vagueness grounds. Relatedly, as a tax on speech, there inevitably would be other constitutional challenges. Although the tax could easily be avoided through an alternate channel, the Supreme Court in *Citizens United* placed emphasis on the (perceived) burden of setting up a separate segregated fund as a constitutional remedy.¹²⁷

4. *Enforce the No-Subsidy Norm*

A final issue relates to maintaining the no-subsidy norm with respect to § 501(c)(3) organizations. Transfers from § 501(c)(3) organizations to social welfare organizations are allowed so long as the funds are used for social welfare purposes. Already under present law there are reasons to be concerned that, money being fungible, tax deductible dollars are flowing through § 501(c)(3) organizations to § 501(c)(4) organizations for political purposes or to § 527 organizations. This threatens the integrity of the charitable deduction and charitable exempt purposes. The temptation to launder money through a § 501(c)(3) would be even greater if political activity limits are lifted for social welfare groups.

One way to protect the no-subsidy norm would be to impose a proxy tax on § 501(c)(3) organizations that would apply to the extent of grants to a social welfare organization that engages in political activity. A proxy tax would not prevent the establishment of exempt organization networks but would help to ensure that funding for social welfare organizations that engage in campaign activity and that are affiliated with a § 501(c)(3) organization occurs with nondeductible dollars. As an alternative, Congress could extend the taxable expenditure concept that applies to private foundations to include grants by public charities to social welfare organizations that engage in political activity.

profit 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”).

127. 558 U.S. 310, 337 (2010). (“PACs are burdensome alternatives; they are expensive to administer and subject to extensive regulations.”).

CONCLUSION

The inconsistency of treatment between social welfare and political organizations is like a cancer slowly metastasizing through the exempt organization system. It undermines the rule of law, the effectiveness of the IRS, and public faith in a system of rational rules, objectively applied. The remedy requires only the political will to make the rules consistent. Consistent rules would reduce, if not eliminate, incentives to lie about the nature of an organization's purpose or communications with the public. Consistent rules also could lead to a change in the law that eliminates restrictions on the free speech of social welfare organizations. Congress should act.