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Revisiting IRS Targeting: Progress of Agency Reforms and Congressional Options

"Treasury/IRS Regulations on Political Activity: A Much-Needed and Constructive Process"

Chairman Cruz, Ranking Member Coons, and distinguished Members of the Subcommittee, good afternoon. I appreciate the chance to come before you and address the question of how to improve the fair and thorough administration of federal tax laws that govern intervention by tax-exempt organizations in campaigns of candidates for public office.

My law firm in San Francisco represents a broad range of nonprofits and their donors. For almost 40 years, I have formed tax-exempt corporations and advised them on their political activities under Internal Revenue Service rules. At this hearing, I am appearing on behalf of the Bright Lines Project, sponsored by Public Citizen.

History of IRS and Political Tax Law

Why is the IRS in the business of enforcing political rules? Because Congress, for more than 60 years, has placed that duty upon the IRS through the Internal Revenue Code. Unless Congress were to remove that mandate from the IRS, it must continue to exercise its judgment as to what is partisan and what is nonpartisan election activity.

Why is this the case? Politics in America necessarily involves the raising and spending of money. Every person, every entity, in the country has a federal tax existence. It must pay tax on its income unless it is exempt by statute. The determination of taxable income, throughout the Code, depends on distinguishing deductible from non-deductible expenses. Donations to charities are tax-deductible only if the organization does not intervene in political campaigns. On the other hand, donations to political organizations are not tax-deductible. Likewise, for-profit corporations cannot take a business expense deduction for political payments.[1]

The federal tax policy on this score is remarkably consistent throughout the Internal Revenue Code: politics must be paid for with "after-tax" income. The descriptions of political intervention for taxable businesses and for tax-exempt organizations are virtually identical. No changes are needed to the Code sections on political activity except for Section 527, which defines political organizations but departs from the rest of the Code by covering appointive as well as elective offices.[2]

The IRS has been making judgments on the political expenses of taxpayers and tax-exempt organizations for longer than the Federal Election Commission has been in existence. The prohibition on political intervention by 501(c)(3) charities was enacted by Congress in 1954 and extra limits on voter registration funded by private foundations were enacted in 1969.[3]

The pressure on the IRS worsened after the *Citizens United* decision in 2010 because independent expenditures affecting all elections, federal, state, and local, by any corporation (for-profit or nonprofit) could no longer be prohibited by any campaign finance legislation. The volume of exemption applications from grassroots organizations seeking influence on public policy and elections mushroomed. However, the IRS still retained the Congressional mandate to determine which organizations are entitled to tax-exemption, depending on the nature and size of their political candidate activity.

Suggestions have been made that political tax law compliance judgments should be made by the FEC instead of the IRS. That would be unwise. The FEC has been constructed so that, much too often, it can be stymied by partisan gridlock. We expect the IRS to adhere to a high standard of political neutrality and I believe it has done so over most of its existence.[4] Furthermore, the IRS' jurisdiction over political tax law reaches beyond federal elections to state, county, and city levels. Surely we would not want to see the FEC making judgments affecting local groups involved in city mayoral contests and thousands of other races for non-federal offices. The IRS is the only law enforcement system in a position to apply consistent rules on the tax treatment of political spending by Americans and their organizations at every level of government. That authority is derived from its power -- not to tell Americans what they may or may not say politically -- but to determine whether such speech should be subsidized by a federal income tax deduction. As in many areas of public and private life, the IRS articulates definitions (what is a church, what is a home office, what is lobbying) and -- if the rulemaking is done well -- then taxpayers, with the help of their tax advisors, are able to comply voluntarily.

<u>Biggest Problem: Lack of Clear Standards</u>

The fundamental problem affecting enforcement of the political tax rules on 501(c) tax-exempts is this: they are vague, unpredictable, and difficult to interpret.

What is political intervention? Without comprehensive new regulations, the IRS interpretation must be gleaned from a few old cases and rulings,[5] internal training materials,[6] and a few bursts of guidance[7] from the last decade. The current Treasury regulation defining political intervention has only 113 words; it is totally inadequate.[8] The IRS has insisted on an open-ended "facts and circumstances" approach rather than drawing bright lines between partisan politics and truly nonpartisan forms of voter education and engagement. Political intervention under tax law is more than express advocacy under election law, the IRS has said, but it has never clearly drawn that line.

This is not a partisan issue. Our law office has represented both liberal and conservative 501(c) organizations and donors affected by this uncertain IRS enforcement, many referred by our Democratic and Republican colleagues in the California Political Attorneys Association.

Let's consider what is perhaps the toughest political tax law enforcement problem and the one that involves the largest monetary expense: the difference between political campaign advertising and so-called "issue ads" that name a candidate, say something good or bad about them, and tell the viewer to contact the candidate about the issue.

The IRS began with Revenue Ruling 2004-6, listing a series of six bad factors and five good factors by which to judge "advocacy communications."[9] Three years later, it issued Ruling 2007-41, with a seven-factor test on "issue advocacy."[10] The two multi-factor tests are not the same, unfortunately.

Let's suppose a tax-exempt organization broadcasts a TV ad in March praising a Senator who is up for re-election in November, for something he or she did or said on its favorite issue.

Under the seven-factor IRS test, three factors look bad: it names a candidate, expresses approval of him or her, and is not connected to an event such as a scheduled vote on legislation. But three factors look good: the election is still eight months away, the ad makes no reference to the election or voting, and it mentions no "wedge" issues separating the candidates. The group can satisfy the seventh factor with an ongoing series of ads on the same issues.

What if the ad is targeted to a battleground state? Targeting is a factor in the 2004 IRS ruling but not the one issued in 2007.

With this kind of vague, uncertain, multi-factor approach, neither the 501(c) organization's lawyers nor an IRS auditor can be sure whether the ad is -- or is not -- political intervention under the IRS tests.

In September, 2012, I confronted Lois Lerner, then head of the IRS Exempt Organizations Division, at a meeting in Boston of the American Bar Association, Tax Section, about the difficulty reconciling these two rulings. She declined to provide any further guidance.[11] In light of subsequent events, I wish I had asked her: "if you can't explain to us how you judge issue advocacy under these rulings, what do you say to your own employees in Cincinnati when they review applications for tax exemption?" I mention her name not as a personal criticism, but to illustrate that the reluctance to clear up the political tax law standards has been systemic and institutional over decades within the IRS -- until now.

This kind of ambiguity and uncertainty in political tax law has made advising clients and resolving cases difficult, time-consuming, and costly. Eventually, I have found, the IRS decides the vast majority of close cases in favor of the organization and its freedom to speak, but justice delayed often feels like justice denied.

In my 37 years in this field, I have not seen the IRS deny or revoke the tax-exempt status of an organization for political activities without good justification. Yes, some IRS political activity audits have been protracted, mainly because of its approach that it must investigate "all the facts and circumstances." It has methodically handled cases involving high-profile individuals, including former House Speaker Newt Gingrich, NAACP Chairman Julian Bond, Jimmy Swaggart, and even President Obama, who spoke as a candidate in his own United Church of Christ. After many years, working with the Department of Justice, it settled the question of the Christian Coalition's 501(c)(4) exemption, including carefully-drawn procedures to ensure that its voter guides comparing candidates would be prepared in a nonpartisan fashion.[12]

In testimony I gave to another Senate Judiciary subcommittee in April, 2013, I recommended that the IRS and Treasury undertake an intensive regulatory project to establish bright lines defining political intervention—that wouldn't tolerate the disguise of targeted "issue ads" that refer to and reflect a view on candidates, and that would provide safe harbors for genuine lobbying and genuine voter education. As we all know, the crisis within the IRS that came to a head the next month, May, 2013, revealed the collapse of its ability to efficiently and consistently rule on 501(c) exemption applications. This created the historic opportunity for Treasury and the IRS to commence exactly the kind of regulations project that we have needed for decades.

The Bright Lines Project

As a pro bono service, I am chair of the Drafting Committee of the Bright Lines Project, which began in 2008, five years before the eruption of the IRS crisis in political tax law enforcement. The Bright Lines Project was formed for the purpose of pressuring the IRS in

every possible way to develop clearer guidance on tax-exempt political activities, and is currently housed at Public Citizen. We seek to overcome the problems and uncertainties of past IRS enforcement so that in the future we will have more predictable standards, separating those organizations that promote nonpartisan voter engagement from those that allow themselves to become instruments of partisan political campaigns.

The Drafting Committee is a diverse group of nine attorneys who specialize in handling political issues that arise with nonprofit tax-exempt organizations. Together, we have hundreds of years of experience advising clients and dealing with the IRS on this topic. We have consulted widely with others across the political spectrum, in academia, in the religious community, and among election lawyers. Our recommendations go right down the middle, between those concerned about corruption who want tighter rules and those concerned about free speech who want more latitude.

Treasury/IRS Rulemaking: What We Need

In the effort to remedy the problems that were uncovered in the spring of 2013 regarding the IRS treatment of tax-exempt political issues, Treasury and the IRS began a rulemaking process to define candidate-related political activity for 501(c)(4) organizations, a corrective recommended by the Inspector General (TIGTA). The proposed regulations released in November, 2013, came sooner than many of us expected and were roundly criticized as a threat to Americans' free speech, drawing clumsy lines that went too far in many respects and not far enough in others.

My best guess is that the IRS' first draft went overboard in trying to define political activity because it was focused only on 501(c)(4) organizations, which the IRS had historically permitted to engage in politics so long as it was not their "primary purpose." (Some interpreted

this to allow up to 49% of their total activities to be political.) The first draft may have assumed that a harsh definition would still leave them plenty of room to influence elections as a "secondary purpose." What it failed to recognize is that a separate set of definitions only for (c)(4)s would be unworkable and disruptive. It ignored the largest category, over a million 501(c)(3) charitable organizations for whom political intervention is totally prohibited, and ignored the tax-exempt (c)(5) labor unions and (c)(6) trade associations who have the same need for guidance on political activity as do the (c)(4)s.[13]

Whether this was deliberate or not, the first draft of IRS political regulations provoked a huge outpouring of public commentary and many constructive suggestions from major nonprofit groups that would be affected. There was a record number of public comments – more than 146,000 – reflecting the intensity of frustration in the nonprofit sector with the ambiguity and administration of the political intervention rules. Conservative, moderate and progressive nonprofit organizations alike opposed various elements of the proposed rules, but at the same time expressed support for addressing the current lack of clear standards. According to an analysis by the Bright Lines Project, at least 594 organizations from across the political spectrum commented or signed on to comments from others. Even though nearly none of them liked the rules exactly as proposed, 67 percent of them had no objection to the continuation of the IRS rulemaking.[14]

The American public is anxious for clarity in the tax rules on political intervention, too. A September 2014 survey commissioned by two polling firms, one Democratic and the other Republican, showed widespread support for a bright lines standard.[15] The telephone survey of 800 likely voters showed that 86 percent think it's important to have clear rules in place concerning the political activities that non-profit organizations can and cannot do, and 57 percent

feel that way strongly. Establishing clear rules finds overwhelming bipartisan support: 87 percent of Democrats, 84 percent of Independents, and 88 percent of Republicans agree that clear rules are important. In addition, voters are very concerned about some of the consequences of unclear rules. 80 percent say political operatives, wealthy donors, and organizations abusing and taking advantage of such vague rules is a problem. 72 percent of Republicans surveyed agree. Among voters who had an opinion, a majority favored changing the way nonprofit activities are regulated to establish clearer and fairer rules for what counts as political.

I have confidence that the IRS and Treasury can guide this process to a successful conclusion. We have been waiting for 18 months since the public comment period closed in February of 2014 for the next draft of regulations to be released by Treasury and the IRS. It was scheduled for release in June and it is now July. I would have been delighted to hear the Commissioner announce their release this afternoon. The tax-exempt bar is eager to see them -- let's hope by the next ABA Exempt Organizations meeting in Chicago on September 18th.

I have seen first-hand the IRS and Treasury produce bright line regulations in the political realm that have been well-crafted to guide tax-exempt organizations and achieve self-enforcement in the vast majority of situations. Between 1986 and 1990, with heavy input from the nonprofit sector, the Service developed **lobbying regulations** for public charities and private foundations with clear definitions and clear safe harbor exceptions. Like the current political regulations, the first draft was a rocky start, but the final result turned out quite well. Working outside of government, groups like the Alliance for Justice and Independent Sector have trained thousands of nonprofit executives on how to apply these lobbying rules, and for the last 23 years there have been virtually no law enforcement problems due to lack of clarity, no complaints of oppressive IRS prosecution.

But the ambiguity of the current IRS rules on political intervention has created confusion both within the nonprofit community and the IRS itself. The result has been poor administration of the rules by the IRS – even to the point of causing an outcry of political bias. The IRS has admitted to poor judgment in using shortcuts to select which organizations should receive further scrutiny in their applications for tax-exempt status. Conservative groups especially have objected to the agency's use of such terms as "Tea Party" and "Patriot" to select cases; it has also used terms such as "Progressive" and "Occupy." While a number of conservative organizations have gotten extra scrutiny in the application process, so have many liberal organizations, such as "Clean Elections Texas" and "Emerge America."[16]

Bright Lines Project Drafting Committee Vice Chair Elizabeth Kingsley, a Partner at Harmon, Curran, Spielberg & Eisenberg, testified last week before the House Ways and Means Subcommittee on Oversight that she has seen at least nine recent IRS audits of liberal nonprofit organizations. Kingsley noted: "These have included both 501(c)(3) and 501(c)(4) groups. They have ranged from small to mid-sized, with budgets from less than $100,000 to approximately $3,000,000. The groups selected for audit have included those that lobby for or otherwise promote progressive policy changes, some that affirmatively advocate for progressive political candidates, some that support civic engagement at the grassroots level, and others that conduct data-intensive research on technical policy issues."[17]

We all will be better served by bright line regulations that reduce the degree of discretion that the IRS may exercise in making political tax judgments. Nonprofit organizations across the political spectrum are frustrated with the current ambiguity of the political intervention rules and are concerned about the level of discretion that ambiguity gives to the IRS in deciding what is, and what is not, political intervention. The rulemaking process must continue. It is time for the

public to see the best thinking of the lawyers at the IRS and Treasury. We look forward to IRS public hearings across the country where the nonprofit community and the public at large can participate in this conversation.

There are some in Congress who want to pull the plug on the IRS rulemaking. That would be a tragic loss of a golden opportunity. Not only would that leave us in the dark ages with the murky "facts and circumstances" approach to IRS enforcement, but it would stifle the voices of thousands who sincerely want to see the next version and comment upon it. There must be no turning back this time.

The Commissioner has said that no new IRS rules would be put in place for the 2016 elections. Fair enough; they could be effective on January 1, 2017. But there's no reason to halt the conversation on the development of new rules through a second, maybe even a third and a fourth version, this year and next year. The process should be completed before the next change in administration, while the public is engaged and the hope and momentum for clear political tax rules remains alive.

The Bright Lines Project Solution

The Bright Lines Project has submitted detailed suggestions for IRS and Treasury consideration. We have made four major submissions: a First Reaction (December 2013), a Full Comment (February 2014), a Detailed Explanation of the Bright Lines alternative proposal (May 2014), and our own complete draft of Regulations (November 2014). Our approach is straightforward. We define nine forms of *per se* political intervention and eleven safe harbors to protect grassroots lobbying, voter engagement, other types of nonpartisan speech, and the proper use and transfer of organizational resources to others. We include a glossary of 28 specific definitions for terms such as candidate, election, targeting, self-defense, and comparative voter

education. We would drastically reduce the discretion the IRS could exercise, so that it could only use the "facts and circumstances" approach in situations that don't fit into predictable patterns of partisan and nonpartisan involvement in elections.

So, for instance, on the subject of issue ads, we would replace the two confusing IRS rulings from 2004 and 2007 with a definition of "paid mass media advertising" and ask whether the advertisement reflected a view, that is, a discernible preference for or against a person's candidacy. If so, and the ad either (a) referred to the election or (b) was targeted to a close contest within the election year, it would be classified as political intervention. On the other hand, if the communication was not a paid mass media ad, and was limited to trying to influence an action that an incumbent could take while in office, it would be protected by a safe harbor for grass roots lobbying.

Conclusion

I want to conclude by identifying eight decisions that Treasury and the IRS must make to achieve public acceptance of the regulations and a workable political tax law system:

1. Draw the right line dividing partisan and nonpartisan speech -- we suggest it be "reflect a view" on a candidate, the standard successfully used in the IRS lobbying regulations.

2. Differentiate among forms of communication -- we suggest tougher rules for paid mass media ads.

3. Distinguish communications by their target audiences -- we suggest messages directed toward close contests be viewed as partisan and those directed toward under-represented voters or an organization's natural constituency be viewed as nonpartisan.

4. Identify time periods in which rules could be more relaxed -- we recommend that line be drawn at one year before the election.

5. Create and preserve safe harbors for nonpartisan speech -- we suggest that grassroots lobbying, even-handed voter education, registration and GOTV, self-defense, and personal remarks not made on behalf of an organization be protected.

6. Greatly reduce, but don't eliminate, the role of "facts and circumstances" -- we believe some flexibility is needed to judge new or complex situations, but the review should be structured in an orderly way.

7. Revisit the question of "how much" is too much political intervention to be exempt under Sections 501(c)(4), (5), or (6) -- we recommend that a clear annual expenditure percentage limit be drawn, mindful that this will impact donor disclosure and the choice of 501(c) or 527 vehicles for election spending.

8. Issue regulations defining political intervention that go beyond 501(c)(4) organizations -- we strongly feel they must apply universally and consistently across the Internal Revenue Code, for 501(c)(3) charities, all tax-exempts, tax-paying businesses, and political organizations.

These reforms would go a long way toward restoring public confidence in the tax-exempt universe, toward preventing the corruption of hidden financial leverage in our elections, and toward liberating the speech of citizen groups who have too long been intimidated by the fear of losing tax-exemption due to the unpredictable specter of IRS enforcement.

Thank you.

[1] Internal Revenue Code (IRC) Sections 501(c)(3) and 170(c)(2)(D) apply to charities and their donors. IRC Section 162(e) prevents taxpayers from taking ordinary and necessary business tax deductions for political campaign expenditures, and Section 6033(e) reinforces that rule with a proxy tax on dues revenue received by trade associations and certain other 501(c) organizations.

[2] The Bright Lines Project has proposed amendments to Section 527 to bring it into alignment with the other sections of the Code that define political activity and to position it better as an alternative vehicle for political spending by groups wishing to exceed the limits on Section 501(c) organizations. See http://www.brightlinesproject.org/wp-content/uploads/2015/06/IRC-527-amendments-FINAL.pdf.

[3] IRC Section 4945(f). As further examples, the IRS ruled in the early 1970's that universities could require students in political science classes to work in a candidate's campaign of their choice for course credit, and student newspapers could endorse candidates as an educational exercise, both without jeopardizing the 501(c)(3) status of the university. Revenue Rulings 72-512 and 72-513, 1972-2 Cum. Bull. 246. Although such rulings have been too few and far between, they have been issued impartially and have been appreciated by the nonprofit sector.

[4] For instance, after a lengthy study, the Joint Committee on Taxation of the U. S. Congress found "no credible evidence" of political bias in IRS enforcement. JCS-3-00, February 25, 2000.

[5] Revenue Ruling 78-248, 1978-1 Cum.Bull. 154; Revenue Ruling 80-282, 1980-2 Cum.Bull. 178; Revenue Ruling 86-95, 1986-2 Cum.Bull. 73; Association of the Bar of the City of New York v. Commissioner, 858 F.2d 876 (2d Cir. 1988), cert. denied, 490 U.S. 1030 (1989); Branch Ministries v. Rossotti, 211 F.3d 137 (D.C. Cir. 2000).

[6] Judith E. Kindell and John Francis Reilly, *Election Year Issues*, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, p. 335, www.irs.gov/pub/irs-tege/eotopici02.pdf.

[7] Revenue Ruling 2004-6, 2004-1 Cum.Bull. 328; Revenue Ruling 2007-41, 2007-1 Cum.Bull. 1421.

[8] Treas. Reg. Section 1.501(c)(3)-1(c)(3)(iii) contains very little beyond what is in the statute, only that (a) political intervention can be direct or indirect, (b) a candidate is an individual who offers himself or is proposed by others as a contestant for elective public office, (c) such office may be federal, state, or local, and (d) statements for or against a candidate may be oral or written.

[9] Rev.Rul. 2004-6, 2004-1 Cum.Bull. 328, is limited to determining the 501(c) organization's liability for investment income tax under IRC Section 527(f).

[10] Rev.Rul 2007-41, 2007-1 Cum.Bull. 1421, is limited to 501(c)(3) charitable organizations.

[11] For a verbatim description of this encounter, see http://www.prwatch.org/news/2012/10/11783/colvin-questions-issue-ads-irstreasury-answers-oral-exchange. In May 2012, I had written the IRS asking for a single, consolidated ruling. No substantive response. In August I wrote again, asking four simple questions on how to reconcile the two rulings. This January, after the election, the Service finally replied, admitting there was no "well established interpretation or principle of tax law" to answer my questions. IRS Correspondence to Gregory L. Colvin, January 14, 2013.

[12] Gregory L. Colvin, IRS Gives Christian Coalition Green Light for New Voter Guides, *Tax Notes* Vol.109/No. 8, Page 1093, November 21, 2005.

[13] 501(c)(5) unions and (c)(6) trade associations must obey the same primary purpose rule as (c)(4)s do. IRS Gen.Couns.Mem. 34233 (December 3, 1969).

[14] Bright Lines Project, Most Organizations Support Changes to Rules Governing Nonprofits (March 25, 2014).

[15] Lake Research Partners, Recent Research on IRS Political Rulemaking (September 30, 2014).

[16] Julie Bykowicz and Jonathan Salant, IRS Sent Same Letter to Democrats that fed Tea Party Row, Bloomberg News, May 14, 2013. (Use of the single word "Party" to select 501(c) applicants for scrutiny would have been unobjectionable, since political parties would be expected to qualify for exemption only under IRC Section 527 as political organizations.)

[17] Testimony of Elizabeth Kingsley before the Oversight Subcommittee, House Committee of Ways and Means, hearing on the Internal Revenue Service's Audit Selection Process (July 23, 2015).