Testimony to Senate Judiciary Subcommittee on Crime and Terrorism

April 9, 2013

Gregory L. Colvin, Adler & Colvin, San Francisco

Current Issues in Campaign Finance Law Enforcement

"Problems in IRS Enforcement of Political Rules for 501(c)4) Organizations; Reforms Needed"

Good morning, Senators. I appreciate the chance to come before you and address the question why we have seen so little enforcement--civil or criminal--of the federal tax laws that are supposed to regulate the political activities of 501(c)(4)[1] organizations.

My law firm represents a broad range of nonprofits and their donors. For 35 years, I have formed tax-exempt organizations, including (c)(4)s, and advised them on their political activities under Internal Revenue Service rules.

Why is the IRS in the business of enforcing political rules? Every person, every entity, in the country has a federal tax life. It must pay tax on its income unless it is exempt by statute.[2] The only entity allowed to have a primary political purpose is a 527 organization; it has a partial tax exemption and must disclose its donors over $200.[3] All other tax-exempts must have a primary purpose that does NOT include politics. Therefore, the IRS cannot avoid the law enforcement duty to (1) qualitatively, define political activity and (2) quantitatively, determine what is too much.

IRS Form 990 requires an answer under penalty of perjury: "Did the organization engage in direct or indirect political campaign activities on behalf of or in opposition to candidates for

public office?"[4] Those who answer "yes" must report the amount spent, the number of volunteer hours, and describe what they did.[5]

There is a fundamental problem affecting enforcement of the political tax rules on 501(c)(4) nonprofits. The tax rules are vague, unpredictable, and unevenly applied. Only the most flagrant violations could be knowing, willful, or deliberate and subject to criminal prosecution.

What is political intervention? The IRS interpretation must be gleaned from a few old cases and rulings,[6] internal training materials,[7] and a few bursts of guidance[8] from the last decade. The IRS insists on an open-ended "facts and circumstances" approach rather than drawing bright lines between partisan politics and truly nonpartisan voter education. Political intervention under tax law is more than express advocacy under election law, we are told, but what is it? Reasonable minds could differ on that judgment, dramatically so.

How much political intervention is too much for a tax-exempt 501(c)(4)? Its primary operations must promote social welfare—"the common good" of the community with no element of political intervention or private benefit. The IRS therefore deduces that non-qualifying activities must be "less than primary."[9]

While the Service has never pinned this down to an annual level of expenditures, it has tacitly accepted 49% as a defensible figure. Yet because of the IRS "facts and circumstances" approach, we can never be sure. So, the speech of some (c)(4) groups is chilled. They avoid the risk and stay far below the 49% level, while their adversaries may go right up to the edge.

Two things about the focus of this hearing on (c)(4)s:

First, there are well over 100,000 registered with the IRS. Most are highly reputable and do very little or no political activity. They do not present a law enforcement problem.

Second, enforcing these tax laws is not limited to the 501(c)(4) class. The vagueness of the IRS rules affects (c)(3) charities, banned from political intervention entirely. And (c)(5) unions and (c)(6) trade associations must obey the same primary purpose rule as (c)(4)s do.[10]

Here's the most difficult political tax law enforcement problem: what is 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 Bipartisan Campaign Reform Act (McCain-Feingold) in 2002 required disclosure to the FEC of spending on "electioneering communications," defined basically as paid advertising that names a candidate and is broadcast within 30 or 60 days before an election.[11] The IRS went in a different direction. It issued Revenue Ruling 2004-6, listing a series of six bad factors and five good factors by which to judge "advocacy communications."[12] Three years later, it issued Ruling 2007-41, with a seven-factor test on "issue advocacy."[13]

The two multi-factor tests are not the same. Neither of them directly applies to the key question in this hearing: what political speech by a (c)(4) counts against its tax-exemption?

So, how can a lawyer advise his or her client, how can a prosecutor evaluate a case, in which a (c)(4) denies it will engage in candidate politics on its federal tax form, and on that same day in March it broadcasts a TV ad praising a Senator who is up for re-election in November?

Under the seven-factor IRS test, three factors look bad: it names a candidate, expresses approval of him, 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 one IRS ruling but not the other.

With this kind of vague, uncertain, multi-factor approach, the (c)(4) can find a reputable lawyer to advise that the ad is NOT political intervention under the IRS tests. Therefore, an officer of the (c)(4) entity can sign a tax return believing that its denial is true and correct.

Let's turn to the quantitative side of the puzzle. Is the IRS properly interpreting its own precedents if it allows 49%? In recent litigation regarding *Vision Service Plan*,[14] which did not involve political activity, the IRS and the Department of Justice took the stance that ANY non-exempt activity, if substantial (that is, more than 5-15%), violates 501(c)(4). I have come to believe that the critics of 49% are right. The permitted level for political spending ought to be "insubstantial" as it is for private benefit.

A year ago, I proposed that Congress amend the Internal Revenue Code to set a 10% upper limit on political spending for all 501(c) groups, while keeping the 0% limit in place for 501(c)(3) charities.[15] This "silver bullet" would drive most of the undisclosed (c)(4) and (c)(6) money into 527 political committees, into the sunlight where it would be disclosed.

I want to conclude by suggesting that the Internal Revenue Service itself can solve both the qualitative and quantitative problems.

First, the IRS and Treasury can 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. I chair the drafting committee of the Bright Lines Project, sponsored by Public Citizen, which is developing just such a proposed regulation for IRS consideration.

Second, the Service can reconsider its position on the "less than primary" ceiling for (c)(4), (5) and (6) political spending. It can establish a percentage, at 10% (more or less), and/or a dollar level, as safely insubstantial.

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.

Questions

1. *Has anyone ever been convicted of a crime for failing to report political activity on a nonprofit tax return?*

I am aware of only one instance. During the Iran-Contra scandal in the 1980s, a man named Carl (Spitz) Channell, president of the National Endowment for the Preservation of Liberty, pled guilty to a felony conviction for conspiracy to defraud the government based on a number of violations of his organization's 501(c)(3) status, including political intervention.[16] He used tax-exempt funds to place TV ads aimed at defeating certain Congressmen who opposed aid to the contras in Nicaragua, and bragged about it to his co-conspirator Oliver North. Other than that, criminal prosecutions for conducting political activities in a tax-exempt organization, and failing to report that on an IRS tax filing, are truly rare.

2. *How does the filing of an exempt organization tax return relate to the criminal tax laws?*

The Internal Revenue Code does contain criminal laws to punish dishonest reporting. Section 7206 states: "Any person who willfully makes and subscribes any return, statement, or other document, which contains … a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter … shall be guilty of a felony…."

The annual Form 990 tax return filed by almost all tax-exempt organizations (except those with less than $50,000 of income and churches), must be signed by a corporate officer under penalty of perjury, declaring that "I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete."

3. *Do 501(c)(4) organizations have additional reporting requirements on Form 990, Schedule C?*

They do. They must also report:

* expenditures for activities defined (somewhat differently) as political under Section 527,
* filing of Form 1120-POL reporting tax paid on the lesser of investment income or political spending during the year,
* a list of ALL payments made to 527 political organizations, and
* a proxy tax report under Section 6033(e) to the extent that the organization gave insufficient notice of non-deductible political and lobbying expenses to its dues-paying members.

If your eyes are glazing over at this point, you can begin to see the problem. In my experience, many 501(c) organizations and their accountants get lost in the minute technicalities and fail to file complete information on the return.

4. *Is "political intervention" defined in the Treasury Regulations?*

The Internal Revenue Regulation (only 113 words) is of little help defining political "intervention," which is the term that appears throughout the Code.[17] The Regs tell us very little beyond what is in the statute, only that (a) 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.

5. *Can you give some examples of organizations in the 501(c)(4) category?*

You may hear about those very controversial (c)(4)s, connected to 527 SuperPACs and deeply involved in federal elections, such as Crossroads GPS and Priorities USA. There are also long-standing (c)(4)s with well-known policy agendas that do varying degrees of political activity, such as the National Rifle Association, the Christian Coalition, and the Sierra Club. But there are also brand-name (c)(4) organizations that stay completely away from political intervention, such as the AARP, Common Cause, the Disabled American Veterans, service clubs such as Rotary and Kiwanis, many health care service organizations, and committees such as in my state, California, that raise and spend fully-disclosed donations on ballot measures but stay out of candidate races.

6. *What has changed about the political spending of 501(c)(5) and (c)(6) organizations?*

After the *Citizens United* Supreme Court decision in 2010,[18] they are no longer required to limit their political spending to segregated PACs. Labor unions and chambers of commerce may spend unlimited amounts of general treasury funds on independent expenditures in politics under the election laws now, which makes it more likely that they will come closer to the edge and risk their tax-exempt status due to excessive political intervention in an election year.

7. *Is this a partisan issue?*

It is not. 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.

8. *Has anyone questioned the disparity between the two IRS Rulings on issue advertisements?*

In May 2012, I wrote 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.[19] In other words, they just don't know.

9. *Can you give an example of the quantitative problem--how to determine whether a 501 (c)(4) should no longer be tax-exempt due to excessive political intervention?*

Assume that a (c)(4) spending $100 million on its programs during an election year spends $40 million on independent expenditures expressly advocating the election or defeat of candidates, admitted and described on Form 990 as political intervention. It spends another $40 million on broadcast "issue advocacy" ads that it believes pass the IRS multi-factor test and $20 million on grants to other (c)(4) organizations.

Is the organization safely qualified to be a (c)(4) organization based on spending 60%, a primary proportion, of its resources on social welfare? It depends partly on how the outgoing grants are treated. The IRS could treat the grants as a passive use of funds that is not the organization's own program activity, and shouldn't count as social welfare in the balance. If the grants do count, what does the organization need to do to make sure the money is not simply being passed off to other groups that will spend it on political intervention? It could stipulate that the grants are restricted solely to social welfare activity, but that could mean (money being fungible) that the grantee's other unrestricted funds may now be freed up to pay for more political advertising, while the grant itself could be used for more so-called "issue" ads. (Any (c)(4) grants made to 527 organizations, such as SuperPACs, are certain to be treated as political intervention.)

In this scenario, the $100 million (c)(4) organization is admitting that 40% of its spending was political. That's under 49% so it is "less than primary" and if the IRS doesn't challenge the social welfare character of its issue ads or its grants, it would remain tax-exempt.

10. *Has there been any attempt to quantify the "less than primary" test? What was the result?*

In 2004, I co-chaired a Task Force within the Exempt Organizations Committee of the ABA Tax Section that recommended to the IRS a safe harbor or a presumption of compliance at the level of 40% of annual program expenditures for 501(c)(4) organizations.[20] The Service

declined to do so. It seemed a modest proposal at the time, given the complete ban on corporate political spending that existed federally and in half of the states. Then, the Supreme Court decided in 2010 that the (c)(4) organization named Citizens United, and all other corporations and labor unions, could no longer be prohibited from making independent expenditures in elections, and (c)(4)s became the vehicle of choice for large, undisclosed donations to be spent on a combination of explicit political ads, issue ads, and other borderline election-year activities.

11. *Why do you say it is necessary to lower the amount that 501(c) organizations can spend on political intervention?*

So long as huge amounts and proportions of political campaign funds can flow through multi-purpose 501(c) entities, the task of achieving public disclosure will be almost impossible. It is very difficult to create rules that accurately trace political spending back to original sources in an organization with multiple programs. How far back do you go? Do you count the dollars first-in first-out or last-in first-out? Do you allocate the spending proportionately over all the donors? Do you let the organization say that the money came from investments, T-shirt sales, and small donors, and not from any big donors? Do you require donors to specify whether their money may or may not be used for politics?

Some of my colleagues worry that the "dark" money would go deeper underground to taxable vehicles with even less IRS regulation, but at least it would not have the halo and blessing of the federal tax-exempt system as it does now. I agree with my colleague Miriam Galston that 501(c) organizations should be whole-heartedly, not half-heartedly, devoted to their tax-exempt purposes.[21]

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[1] Internal Revenue Code (IRC) Section 501(c)(4) provides for the exemption from federal income tax of social welfare organizations. All references are to the Internal Revenue Code of 1986 as amended.

[2] IRC Section 162(e) prevents taxpayers from taking ordinary and necessary business tax deductions for political campaign expenditures.

[3] IRC Section 527 sets forth the tax-exemption and disclosure rules for political committees, parties, PACs, and other political organizations.

[4] IRS Form 990 (2012), Part IV, Line 3.

[5] Form 990, Schedule C, Part I.

[6] 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).

[7] 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.

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

[9] Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii); Revenue Ruling 81-95, 1981-1 Cum.Bull. 332.

[10] IRS Gen.Couns.Mem. 34233 (December 3, 1969).

[11] 2 U.S.C. 434(f)(3).

[12] 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).

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

[14] Vision Service Plan v. U.S., 96 A.F.T.R.2d 2005-7440, 2005-7443 (E.D. Cal. 2005), *affirmed* 2008 WL 268075, 1 (9th Cir. 2008).

[15] http://blog.ourfuture.org/20120411/A_Silver_Bullet_That_Would_End_Secret_Tax-Exempt_Money_in_Elections.

[16] 87 *Tax Notes Today* 83-3 (April 30, 1987).

[17] Treas. Reg. § 1.501(c)(3)-1(c)(3)(iii).

[18] Citizens United v. Federal Election Commission, 558 U.S. 310 (2010).

[19] IRS Correspondence to Gregory L. Colvin, January 14, 2013, attached.

[20] Comments of the Individual Members of the ABA Exempt Organizations Committee's Task Force on Section 501(c)(4) and Politics (May 25, 2004), www.abanet.org/tax/pubpolicy/2004/040525exo.pdf.

[21] Miriam Galston, *Vision Service Plan v. U.S.: Implications for Campaign Activities of 501(c)(4)'s*, 53 EXEMPT ORG. TAX REV. 165 (2006).

April 7, 2013 6 pm

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

JAN 14 2013

UIL: 501.38-00; 527.03-00

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Dear Mr. Colvin:

This responds to your August 24, 2012, request for an information letter concerning Revenue Rulings 2004-6 and 2007-41. Your request is a follow-up to your letter dated May 7, 2012, in which you suggested that the IRS issue a single Revenue Ruling on issue advocacy communications that would apply to all tax-exempt organizations.

You request that the information letter answer the following questions:

1) "Would the application of [Rev. Rul. 2004-6] or [Rev. Rul. 2007-41] ever result in different judgments for the same communication, as to whether it was issue advocacy or political campaign intervention?"

2) "[Rev. Rul. 2004-6] includes, as a negative factor "target[ing] voters in a particular election." While not specifically mentioned in [Rev. Rul. 2007-41], is the presence of geographical targeting still a relevant factor?"

3) "Which [revenue] ruling applies to the primary purpose test for qualification as a tax-exempt non-charitable section 501(c) organization, such as a social welfare 501(c)(4) organization?"

4) "Why are [Rev. Rul. 2004-6] and [Rev. Rul. 2007-41] worded differently?"

Section 3.06 of Revenue Procedure 2013-4, 2013-1 IRB 126, provides that an "information letter" is a statement issued by the Director, Exempt Organizations Rulings and Agreements that "calls attention to a well established interpretation or principle of tax law ... without applying it to a specific set of facts." It also provides: "An information letter is advisory only and has no binding effect on the Service."

Rev. Rul. 2004-6, 2004-4 IRB 328 determines, in six situations, whether an organization described in section 501(c)(4), (5), or (6) that engages in public policy advocacy has expended funds for an "exempt function" as described in section 527(e)(2) and would

be subject to tax under section 527(f). Rev. Rul. 2007-41, 2007-25 IRB 1421, determines, in 21 examples, whether an organization described in section 501(c)(3) participated or intervened in any political campaign on behalf of or in opposition to any candidate for public office.

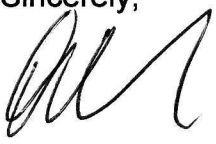
Rev. Rul. 2004-6 and Rev. Rul. 2007-41 make determinations under different sections of the Internal Revenue Code. There is not "a well established interpretation or principle of tax law" that responds to your specific questions. Therefore, pursuant to Rev. Proc. 2012-4, we decline to issue an information letter.

Notice 2012-25, 2012-15 I.R.B. 789, published on April 9, 2012, invites all taxpayers to submit recommendations for guidance for inclusion on the Guidance Priority List, which Treasury and the IRS use each year to identify and prioritize tax issues to be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The due date for recommendations was May 1, 2012, but the Treasury Department and the Service may consider recommendations subsequently submitted.

This letter will be made available for public inspection. The Internal Revenue Service will delete any name, address and other identifying information as appropriate under the Freedom of Information Act. See Announcement 2000-2, 2000-2 I.R.B. 295.

If you have questions, please contact Andrew Megosh at (202) 283-8942.

Sincerely,



David L. Fish
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Supplemental Statement

12. *Isn't the IRS, as a tax collection agency, ill-suited to regulate political activities?*

I am more optimistic than others on this question. In my 35 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.[i]

The current director of the IRS Exempt Organizations Division had experience with the Federal Election Commission before she came to the Service. Senior IRS officials have deep experience evaluating political tax cases and have written long treatises on the subject. I believe that they are scrupulously fair and nonpartisan in these cases. Where they have made mistakes at lower levels, such as the sudden enforcement of gift tax on a few donors to (c)(4)s in 2011 or the recent improper release of confidential donor information, they have quickly corrected their procedures. The IRS is able to recognize political intervention in clear cases, such as express advocacy for or against candidates, outright political contributions, endorsements, and partisan candidate training programs, although the Service does not have a broad-scale program to detect and prosecute violations.

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. Working outside of government, groups like the Alliance for Justice have trained thousands of nonprofit executives on how to apply these rules,

and for the last 23 years there have been virtually no law enforcement problems in the lobbying area due to lack of clarity, no complaints of oppressive IRS prosecution.

The Service and Treasury could draw bright lines defining political intervention as well. They just need the institutional imperative to do so. In July, 2012, the director of the Exempt Organizations Division wrote to Democracy 21 and Campaign Legal Center, saying that the Service "will consider proposed changes" to regulations and other guidance in the area of 501(c)(4) political activity.[ii] But a few months later, the topic was completely absent from the IRS 2012-2013 Priority Guidance Plan. Recently, the IRS took the step of issuing a questionnaire to 1300 organizations that had declared themselves tax-exempt under 501(c)(4), (5), or (6), asking in detail about their activities, including media buys and political intervention during 2012.[iii] That's a start. The IRS should be mandated to launch a regulations project on tax-exempt political intervention, with public input, to be finished by January, 2016, before the next presidential election cycle.

To those who say the IRS should not be involved in political activity law enforcement I would reply: Congress set things up this way. The Internal Revenue Code denies a business tax deduction for political spending, charities are banned from political intervention, Sections 501(c) and 527 apply limits and taxes on political activity so that private political campaigning is not subsidized through the federal tax system. The only way to remove what Yale Professor John Simon calls political "border patrol" from IRS responsibility would be for Congress to repeal all those parts of the Code.

The IRS' jurisdiction over political activity reaches beyond federal elections to the state, county, and city levels. It is the only law enforcement system in a position to apply consistent rules on political spending by Americans and their organizations at every level of government. I believe that's actually a good thing.

13. *What's the difference between a 501(c)(4) organization and a 501(c)(3)?*

A 501(c)(4) social welfare organization is one step below a 501(c)(3) charity. They both must serve the public interest, and both are exempt from federal income tax on their annual net earnings. But the (c)(4) cannot receive tax-deductible charitable contributions and therefore the tax rules it must obey are more lenient. It is not subject to any public support testing, it can conduct unlimited lobbying on legislation, and it can engage in some degree of political campaign activity--what kind and how much is the critical question in this hearing.

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

[ii] http://electionlawblog.org/?p=37338.

[iii] http://www.irs.gov/Charities-&-Non-Profits/Other-Non-Profits/Self-declarers-questionnaire-for-section-501-c-4-5-and-6-organizations.