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Political Advocacy and Taxable Entities: Are They the Next "Loophole"?

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POLITICAL ADVOCACY AND TAXABLE ENTITIES: ARE THEY THE NEXT "LOOPHOLE"?

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INTRODUCTION

Over the last twenty years, independent political groups have increased their attempts to sway national opinion and influence elections.[1] These independent groups (IGs) are not directly associated with a candidate or a political party, but generally either seek to promote issues associated with candidates running for office, or seek to influence an election in favor of or in opposition to a specific candidate. During the 2004 election cycle, many of these groups became household names. Moveon.org, Swift Boat Veterans for Truth and countless other IGs were extremely active in trying to sway the electorate during the 2004 election. Section 527 political organizations, which are IGs that have as

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1. The history of our nation is full of independent groups seeking to influence society and its laws. The National American Woman Suffrage Association fought for women's voting rights, the National Women's Party fought for the Nineteenth Amendment, and the NAACP has been active in promoting civil rights. What is different now is the magnitude and the scope of independent political groups. The Independent Groups (IGs) that are the subject of this article are not just interested in promoting issues and causes, but also seek to influence directly the election of candidates. *See* Edward B. Foley, *The 'Major Purpose' Test: Distinguishing Between Election-Focused and Issue-Focused Groups*, 31 N. KY. L. REV. 341, 342 (2004) (contending that independent political committees by definition seek to directly influence elections and other independent groups that do not have influencing elections as their major purpose nonetheless may seek to influence a federal election to achieve their primary ideological purpose).

their primary purpose influencing elections, spent over $600 million during the 2004 election cycle.[2] This Article examines whether certain taxable entities will become the new "loophole" used by IGs to avoid campaign finance regulations. The Article concludes that in most cases taxable entities will not be an attractive campaign vehicle because there will be significant tax implications if an entity forgoes tax-exempt status.

IGs are currently exploring alternative entity structures because Congress has indicated that it may further regulate these organizations based on their entity status. These attempts to regulate the activities and spending of IGs are often in tension with First Amendment principles and jurisprudence. As Congress attempts to further regulate the campaign activities of IGs, many of these groups seek to organize their affairs in a way that allows them to escape this regulation.[3] Their methods of doing so and the consequences of their actions have been written about for some time.[4] As part of the Bipartisan Campaign Reform Act (BCRA), Congress recently stepped up its efforts to tighten campaign finance laws and attempted to place restrictions on groups engaged in independent political advocacy.[5] However, the Supreme Court, in *Federal Election Commission v. Wisconsin Right to Life* (*WRTL*),[6] significantly rolled back some of the restrictions placed on corporations and labor unions (two types of IGs) that were enacted as

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2. OpenSecrets.org provides receipts and expenditures of 527 organizations by election cycle. *See* OpenSecrets.org, *Advocacy Group Spending*, www.opensecrets.org/527s/; *see also* Jeffrey M. Berry & Clyde Wilcox, THE INTEREST GROUP SOCIETY (4th ed. 2007).

3. The Federal Election Commission is charged with regulating entities subject to the nation's election laws. The Service is charged with enforcing election related provisions contained in the Internal Revenue Code.

4. *See, e.g.*, Samuel Issacharoff & Pamela S. Karlan, *The Hydraulics of Campaign Finance Reform*, 77 TEX. L. REV. 1705, 1705, 1715-16 (1999) (discussing campaign finance regulation and arguing that reforms may be counter-productive because money will trickle down a less desirable path); Gerard J. Clark & Steven B. Lichtman, *The Finger in the Dike: Campaign Finance Regulation After* McConnell, 39 SUFFOLK U. L. REV. 629, 662-67 (2006) (noting that political actors adjusted to campaign finance reforms through the use of certain independent political groups); David S. Broder, Op-Ed., *What McCain-Feingold Didn't Fix*, WASH. POST, May 20, 2004, at A29 (arguing that the current campaign finance regulatory scheme is being circumvented by independent groups).

5. Bipartisan Campaign Reform Act of 2002, 2 U.S.C. § 431 (2002).

6. 127 S.Ct. 2652 (2007).

part of the BCRA. The Court upheld an as-applied challenge brought by Wisconsin Right to Life and found that some of the restrictions in BCRA violated the First Amendment when applied to certain communications by corporations and labor unions. The decision basically rendered the challenged provisions useless with regard to much of the election-related communication by corporations and unions.

Even prior to this decision, Congress was considering additional and different ways of regulating the campaign activities of IGs, and the *WRTL* decision may encourage Congress to seek alternative means of regulating the campaign activities of corporations and unions. For example, Congress amended § 527 of the Code to require political organizations to disclose contributions and expenditures as a condition of the organization receiving tax-exempt status. One of the reasons that Congress chose this regulatory approach, as opposed to simply requiring political organizations to disclose, is that Congress believed that the statute had a better chance of withstanding constitutional challenge if it were designed as a condition on receiving the benefit of tax-exempt status.[7] Similarly, Congress could seek to regulate the communication of corporations and labor unions by requiring shareholders or union members to approve election-related communication. The *WRTL* decision only increases the chances that Congress will seek new and innovative ways to regulate the communication of IGs. As Congress seeks out new ways to regulate IGs, IGs will seek out new and innovative ways to engage in political advocacy with as little government regulation as possible. To the extent that Congress bases its new regulations on the entity structure of an organization, IGs will increasingly look for entity structures that are not subject to regulation.

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7. *See*, 146 CONG. REC. S5994-03, 2000 WL 859709 (June 28, 2000) ("The constitutionality of this bill would be clear for an entirely different reason. And that is that this bill does not prohibit anyone from speaking, nor does it force any group that does not currently have to comply with FECA or disclose information about itself to do either of those things. Instead, the bill speaks only to what a group must do if it wants the public subsidy of tax exemption—something the Supreme Court has made clear no one has a constitutional right to have."); Gregg Polsky & Guy-Uriel E. Charles, *Regulating Section 527 Organizations*, 73 GEO. WASH. L. REV. 1000, 1004 (2005) (discussing constitutional question and examining the legislative history surrounding § 527's disclosure provisions).

IGs, like other organizations, need some type of organizational structure to carry on their activities. In general, IGs organize as corporations or unincorporated associations and then obtain tax-exempt status for the organization. Businesses have long considered organizational form when choosing how to conduct business; therefore, it is no surprise that IGs will seek to do so as well. The major difference is that businesses generally seek organizational forms that will help them maximize profits, while IGs seek forms that allow them to maximize their political advocacy. In determining how to organize the entity, IGs are faced with two different organizational form choices. The first is how to organize the entity under state law. They must determine whether they want to organize as a corporation, partnership, limited liability company, or unincorporated association. The second is whether they want to claim tax-exempt status, and if they do, under what provision of the Internal Revenue Code.

Each of the above decisions has potentially serious implications for the operation of the IG. Because corporations are subject to significant restrictions under campaign-finance laws, the decision to organize as a corporation may significantly restrict an organization's ability to engage in political advocacy.[8] Furthermore, since the Internal

8. Corporations are prohibited from making contributions in connection with an election for any Federal office, 2 U.S.C. § 441b (2002); 11 C.F.R. § 114.2(b)(1) (2005), from making any expenditures with respect to a federal election, 2 U.S.C. § 441b (2002); 11 C.F.R. § 114.2(b)(2)(ii) (2005), from making payments for electioneering communications, 2 U.S.C. § 441b (2002); 11 C.F.R. § 114.2(b)(2)(iii) (2005), and from facilitating the making of contributions, unless they are to a segregated account of the corporation, 2 U.S.C. § 441b (2002); 11 C.F.R. § 114.2(f)(1) (2005). The recent Supreme Court decision in Federal Election Commission v. Wisconsin Right to Life (*WRTL*) limits the breadth of the corporate prohibition on electioneering communication. 127 S.Ct. 2652, 2652 (2007). Under *WRTL*, corporations may engage in electioneering communication as long as it is not the "functional equivalent" of express advocacy. *Id.* at 2673. Express advocacy is an election law term that is derived from the Supreme Court's decision in Buckley v. Valeo (per curiam), 424 U.S. 1 (1976). In *Buckley*, the Court held that "influencing an election" was vague and the Court would read the provisions as to only apply to communication that expressly advocated the election or defeat of a candidate. *Id.* at 80. Some believe that "express advocacy" was limited to certain magic words like "vote for" or "vote against." See *WRTL*, 127 S.Ct. at 2677 (Scalia, J., concurring); McConnell v. Federal Election Comm'n, 540 U.S. 93, 126-28 (2003). After *WRTL* a

Revenue Code regulates the political activity of tax-exempt organizations, the choice whether to apply for tax-exempt status and under what specific provisions of the Code also has serious consequences for the type of communication an IG may engage in.[9]

In 1975, Congress passed § 527 of the Internal Revenue Code that created a new type of tax-exempt organization, a political organization. Entities organized under § 527 were organizations that had as their primary purpose the election or defeat of a candidate for public office.[10] After the creation of political organizations in 1975, IGs generally sought to structure themselves to take advantage of the tax-exemption provided to political organizations under § 527.[11] If an IG is a political organization under § 527, it is not required to pay tax on the contributions it receives, and donors contributing to the organization are not subject to gift tax.[12] Furthermore, if a 527 organizes as an unincorporated association, it is not subject to the restrictions placed on corporations under federal election laws.[13]

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corporation may not engage in express advocacy or its functional equivalent. *WRTL*, 127 S.Ct. at 2667.

The Supreme Court has also created some exceptions to this rule for certain tax-exempt organizations. *See* Fed. Election Comm'n v. Mass. Citizens for Life (*MCFL*), 479 U.S. 238, 263-64 (1986) (finding that the corporate ban would not apply to 501(c)(4) organizations that (1) were formed for the "express purpose of promoting political ideas and cannot engage in business activities," (2) have no shareholders or others with interests in its assets or earnings, (3) were not "established by a business corporation or a labor union, and (4) it is their policy not to accept contributions from such entities").

9. *See infra*, Part II.

10. I.R.C. § 527(e)(1) (West 2006). A 527 organization may also be formed to influence the nomination or appointment of a governmental official. I.R.C. § 527(e)(2) (2002).

11. I.R.C. § 527(a), (c) (West 2006); *see also* S. REP. NO. 93-1357, at 4, 25-37 (1974), *reprinted in* 1974 U.S.C.C.A.N. 7478, 7481, 7501-13 (discussing modified tax treatment of political organizations).

12. I.R.C. § 2501(a)(5) (West 2006). The Internal Revenue Code provides that donors who make gifts over $12,000 are subject to gift tax on the donation. The gift tax is generally thought to prevent donors from giving away assets prior to death to avoid the estate tax. Moreover, even if the estate tax did not exist, donors might try to shift their income to family members who were in lower tax brackets for income tax purposes. Gifts to charitable organizations and to 527 political organizations are statutorily exempt from this tax.

13. *See supra*, note 8 (noting restrictions on corporations).

In 2000, however, Congress amended § 527 and added significant disclosure requirements mandating that 527 organizations disclose contributions in excess of $200 and expenditures in excess of $500.[14] Thus, many organizations attempted to avoid § 527 status and instead organized under § 501(c)(4) as social welfare organizations, which were not subject to the disclosure requirements contained in § 527.[15] Thus, the status quo at the moment is that independent groups interested in engaging in political advocacy usually organize as either 527 Political Organizations or as 501(c)(4) Social Welfare Organizations.[16]

The current regulatory climate, however, is putting pressure on the status quo. Many in Congress believe that the current restrictions on 527s are insufficient and that 527s should be regulated as political committees, which would mean that 527 organizations would be subject to significant campaign-finance regulations including contribution limits and disclosure requirements.[17] Although there has been debate whether political organizations can be treated as political committees,[18] the threat

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14. I.R.C. § 527(j)(1) (West 2006). A 527 organization must disclose the name and address of the person receiving expenditures if those expenditures exceed $500. I.R.C. § 527(j)(3)(A). It must also disclose the name and address of each individual who contributed an aggregate amount of $200 or more to the organization during the calendar year. I.R.C. § 527(j)(3)(B).

15. Section 501(c)(4) organizations must be organized primarily for a social welfare purpose, and political advocacy is not a social welfare purpose. Thus many IGs cannot organize as 501(c)(4) organizations. *See infra*, Part I(B).

16. Independent groups may also be labor unions under § 501(c)(5) and business leagues under § 501(c)(6).

17. 527 Fairness Act of 2005, H.R. 1316, 109th Cong. (2005); 527 Reform Act of 2005, H.R. 513, 109th Cong. (2005); 527 Reform Act of 2005, S. 271, 109th Cong. (2005); Letter from John McCain, U.S. Senator, Russell D. Feingold, U.S. Senator, Christopher Shays, U.S. Representative, & Marty Meehan, U.S. Representative, to Mai T. Dihn, Acting Assistant General Counsel, Federal Election Commission (Apr. 9, 2004) (on file with Campaign Legal Center), *available at* http://www.campaignlegalcenter.org/attachments/1113.pdf; *see* Miriam Galston, *Emerging Constitutional Paradigms and Justifications for Campaign Finance Regulation: The Case of 527 Groups*, 95 GEO. L.J. 1181, 1182-1184 (2007).

18. Edward B. Foley & Donald Tobin, *Tax Code 527 Groups Not an End-Run Around McCain-Feingold*, 72 U.S.L.W. 2403, 2404 (2004) (contending that 527 organizations should be classified as political committees under FECA if their major purpose is the election or defeat of a federal candidate). *But see* Allison R. Hayward & Bradley A. Smith, *Don't Shoot the Messenger: The FEC, 527 Groups, and the*

of increased regulation has encouraged IGs to consider other entities for delivering their message.[19]

This Article examines whether certain taxable entities will become the new "loophole" used by IGs to avoid campaign finance regulations. In examining this issue, the Article will first discuss the current regulatory structure of tax-exempt organizations and the basic rules regarding political participation by those organizations. Part II looks at the characteristics that independent organizations seek when choosing an organizational form. Part III discusses various tax theories that provide the basis for examining the tax implications of an organization's forgoing tax-exempt status. This section analyzes whether tax-exempt status actually matters for tax purposes. If there are no tax benefits to organizing as a tax-exempt organization, then IGs can avoid tax-exempt status and the regulatory burdens that come with that status. Part IV applies the principles set out in parts II and III to determine whether taxable entities are an efficient means of meeting an IG's organizational goals. I then make some suggestions for the future in light of the discussion in Parts II-IV. I also conclude that in most cases, there will be significant tax implications if an entity forgoes tax-exempt status. I further conclude that to the extent that taxing IGs that choose to forgo tax-exempt status is counterintuitive and seems inconsistent with

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Scope of Administrative Authority, 4 ELECTION L.J. 82, 94-97 (2005) (arguing that 527 status alone is insufficient to regulate a 527 as a political committee); Richard Briffault, *The 527 Problem . . . and the* Buckley *Problem*, 73 GEO. WASH. L. REV. 949, 950 (2005) (discussing the constitutionality of regulating 527s as political committees); Gregg Polsky & Guy-Uriel E. Charles, *Regulating Section 527 Organizations*, 73 GEO. WASH. L. REV. 1000, 1004 (2005) (arguing that further regulation of 527s is unconstitutional); Galston, *supra* note 17 (exploring the constitutionality of various attempts to regulate 527 organizations); Gregg D. Polsky, *A Tax Lawyer's Perspective on Section 527 Organizations*, 28 CARDOZO L. REV. 1773 (Feb. 2007) (arguing that the statutory language involving the primary purpose of an organization to influence an election should be interpreted differently for tax and election law purposes).

19. In fact, in the recent symposium on this topic by the First Amendment Law Review at the University of North Carolina, James Bopp, one of the leading lawyers in the country advising independent political groups, indicated that he already knows what he will turn to next if Congress further regulates tax-exempt organizations. In fact, it was Mr. Bopp's comments that inspired this article. Mr. Bopp, however, did not disclose his next entity of choice. Symposium, *No Strings Attached? The First Amendment and Tax Exempt Organizations*, 6 FIRST AMEND. L. REV. 1 (2007).

normative tax principles, Congress has also recognized this fact and has created a tax-exempt vehicle from which an IG can engage in political advocacy. If IGs choose to avoid such status, they cannot then complain that the tax rules, as applied to them, are unreasonable.

I. CURRENT REGULATORY FRAMEWORK

Under the current regulatory structure, almost all IGs operate as tax-exempt organizations.[20] Depending on the type of activity, they may choose to be organized as corporations or some other type of non-corporate entities, but almost all IGs obtain tax-exempt status under the Internal Revenue Code. The tax code provides some type of tax-exempt status for over twenty-seven different types of entities.[21] These organizations are generally exempt from tax on income generated by activities related to the organizations' exempt purpose.[22] Thus, contributions to organizations are generally not considered taxable income to the organizations. Income that is not related to the exempt purpose of the organization (usually referred to as unrelated business income) and investment income is often subject to tax.[23]

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20. *See* Lloyd Hitoshi Mayer, *The Much Maligned 527 and Institutional Choice*, 87 B.U. L. REV. 625, 681-82 (2007) (noting the possibility that further regulation of 527s might encourage entities to organize as taxable entities); Stephen R. Weissman & Kara D. Ryan, *Soft Money in the 2006 Election and the Outlook for 2007*, at 1, 12 (Campaign Finance Institute, Washington D.C. 2007), *available at* http://www.cfinst.org/books_reports/pdf/NP_Softmoney_06-08.pdf (noting the use of two taxable entities to engage in some type of political advocacy).

21. *See* I.R.C. § 501(c) (West 2006).

22. I.R.C. § 501(a) (West 2006) (providing that an organization identified in subsection (c) is exempt from tax). *But see* I.R.C. § 511 (West 2006) (providing for the imposition of tax on the unrelated business income of an otherwise exempt organization).

23. Investment income is also taxed up to the amount the organization spends on political advocacy. I.R.C. § 527(f)(1) (West 2006) (stating that if an organization described in section 501(c) *that is exempt from tax under section 501(a)* expends any amount during the taxable year to influence a political campaign, there shall be an amount subject to tax equal to the lesser of the net investment income or the aggregate amount so expended during the taxable year for such an exempt function). Section 501(c)(3) organizations are not subject to tax on investment income under the current statutory scheme because these organizations cannot participate in any political campaign without foregoing their tax-exempt status. Section 501(c)(4)

In general, IGs seeking to engage in political activity will use one or more tax-exempt entity. Each of these entities has advantages and disadvantages, and in many cases an IG will use multiple tax-exempt entities to achieve its goals. Section 501(c)(3) organizations are not permitted to participate directly or indirectly in any political campaign on behalf of a candidate, but they may engage in nonpartisan voter-education activities and attempt to influence legislation as long as that is not a substantial part of their activities.[24] Section 501(c)(4) organizations, social welfare organizations,[25] are allowed to engage in political activity, but the political activity must not be their primary

organizations have no such absolute restriction regarding their participation in political campaigns, and thus to treat 501(c)(4) and 527 organizations in a similar manner, investment income of a 501(c)(4) must be taxed to the extent of its political activities.

24. Treas. Reg. § 1.501(c)(3)-1(c)(3)(iii) (as amended in 1990) (An organization is an action organization and does not qualify for § 501(c)(3) status if it "participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office."). Section 501(c)(3) organizations are: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . or for the prevention of cruelty to children or animals." I.R.C. § 501(c)(3) (West 2006). *See also* Treas. Reg. § 1.501(c)(3)-1(d)(1)(i) (describing generally which activities a 501(c)(3) organization may be organized and operated for in order to receive exempt status (religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals)); Treas. Reg. § 1.501(c)(3)-1(d)(2)-(5) (specifically defining "charitable," "educational," "testing for public safety," and "scientific" as exempt purposes listed in § 1.501(c)(3)-1(d)(1)(i)). For an in-depth analysis of the rules related to 501(c)(3) organizations and political campaigns, see Steven H. Sholk, *A Guide to Election Year Activities of Section 501(c)(3) Organizations*, *in* 6 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 837 (2006).

25. I.R.C. § 501(c)(4) organizations are:

> Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons . . . and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

I.R.C. 501(c)(4) (West 2006).

purpose.[26] Section 501(c)(5) organizations, labor unions,[27] and § 501(c)(6), business leagues [28] are allowed to engage in political activity and are subject to similar restrictions to those of 501(c)(4)s.[29] Section 527 organizations, however, are allowed to engage in unlimited political activity. In fact, an entity cannot organize as a 527 political organization unless influencing the election of a candidate for public office is the primary function of the organization.[30]

A. 501(c)(3) Organizations

Section 501(c)(3) charitable organizations are treated differently than other tax-exempt organizations. These are the organizations that most people identify as tax-exempt organizations. They are private schools and universities, religious institutions, and charitable organizations. They educate our children, provide spiritual fulfillment and help the needy. Because of this "charitable" purpose, 501(c)(3) organizations are generally exempt from tax. In addition, the Internal Revenue Code provides that donations to 501(c)(3) organizations are tax deductible by the donor.[31] Thus, 501(c)(3) organizations receive a dual

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26. Treas. Reg. 1.501(c)(4)-1(a)(2)(i) (as amended in 1990) provides that an organization qualifies as a section 501(c)(4) organization if "it is primarily engaged in promoting in some way the common good and general welfare of the people of the community." Treas. Reg. 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990) provides that "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." *See also*, Rev. Rul. 81-95, 1981-1 C.B. 332 (A § 501(c)(4) organization may participate in a political campaign as long as its primary function (its other activities) is a social welfare function.).

27. I.R.C. § 501(c)(5) organizations are "Labor, agricultural, or horticultural organizations."

28. I.R.C. § 501(c)(6) organizations are "Business leagues, chambers of commerce, real-estate boards . . . not organized for profit and no part of net earnings of which inures to the benefit of any private shareholder or individual."

29. I.R.C. §§ 501(c)(5), (6) (West 2006); I.R.S. Gen. Couns. Mem. 34, 233 (Dec. 3, 1969) (political intervention cannot be the primary activity of a 501(c)(6) organization.)

30. I.R.C. § 527(e)(1) (West 2006).

31. I.R.C. § 170 (West 2006). Charitable contributions are generally defined by section 170(c) of the Code as, among other things, a donation to a "corporation, trust, or community chest, fund, or foundation . . . organized and operated

tax benefit. Their income is not taxed, and donations to the organizations are deductible by the donor. These tax benefits are considered a subsidy by society to 501(c)(3) organizations.[32]

In order to ensure that tax-exempt status is not used as a means of subsidizing political campaign activity, the tax code prohibits 501(c)(3) organizations from participating or intervening in "any political campaign on behalf of (or in opposition to) any candidate for public office."[33] There is no de minimus exception to this rule, and even a small amount of campaign activity is prohibited.[34]

But this prohibition does not eliminate 501(c)(3) organizations as a vehicle of choice for some IGs. Despite the campaign ban, 501(c)(3) organizations may engage in voter-education drives, discuss issues, participate in educational activities, lobby, and invite candidates to speak as long as the invitations are non-partisan.[35]

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exclusively for religious, charitable, scientific, literary, or educational purposes . . . or for the prevention of cruelty to children or animals." I.R.C. § 170(c)(2)(B) (West 2006). This definition closely parallels the definition for an exempt organization under section 501(c)(3) of the Code. Donations to § 501(c)(3) organizations are deductible by operation of § 170 of the Internal Revenue Code. I.R.C. § 170(c)(2)(D) (West 2006) (extending charitable contribution deductions for contributions to qualified § 501(c)(3) organizations which have not participated or intervened in any political campaign or attempted to influence legislation).

32. Regan v. Taxation with Representation, 461 U.S. 540, 544 (1997).

33. I.R.C. § 501(c)(3) (West 2006).

34. *See* Branch Ministries v. Rossott, 40 F. Supp. 2d 15, 17, 21 (D.D.C. 1999), *aff'd* 211 F.3d 137 (D.C. Cir. 2000) (revoking Church's exemption for newspaper advertisements urging the defeat of candidate William Jefferson Clinton). The Service, however, rarely revokes a 501(c)(3)'s exempt status and only does so when the organization refuses to refrain from such activities in the future or when the violation is blatant. *See* INTERNAL REVENUE SERVICE, FINAL REPORT, PROJECT 302: POLITICAL ACTIVITIEES COMPLIANCE INITIATIVE: EXECUTIVE SUMMARY 3 (2006), *available at* http://www.irs.gov/pub/irs-tege/final_paci_report.pdf (describing alleged acts of political campaign intervention in the 2004 election cycle and noting that revocation was recommended in only three out of eighty-two cases).

35. For a general discussion of the rules related to 501(c)(3) organizations and political campaigns, *see* Sholk, *supra* note 24; Ann M. Murphy, *Campaign Signs and the Collection Plate—Never the Twain Shall Meet?*, 1 PITT. TAX REV. 35, 40-65 (2003); I.R.S. Fact Sheet FS-2006-17 (setting out various scenarios indicating impermissible political intervention); Rev. Rul. 78-248, 1978-1 C.B. 154 (non-biased voting records allowed); Rev. Rul. 86-95, 1986-2 C.B. 73-74 (forum for educating voters that does not promote one candidate over another is allowed).

IGs that are willing to forgo intervention in political campaigns for or against candidates, and are solely interested in educating the public about issues, will clearly prefer 501(c)(3) status. These organization will not only be tax exempt, but they will receive the added benefit that contributions to the organizations will be tax deductible by the donors. In addition, contributions to 501(c)(3) organizations are not subject to gift tax.[36]

B. 501(c)(4) Organizations

Section 501(c)(4) organizations are social welfare organizations or civic leagues.[37] In order to qualify as a 501(c)(4) organization, the organization must be primarily engaged in promoting the "common good and general welfare" of the community.[38] Intervention in a political campaign is not considered promotion of social welfare.[39] Thus, a 501(c)(4) organization may intervene in a political campaign on behalf of a candidate, but that activity may not be its primary function.[40] IGs that wish to discuss issues, educate the public, or engage in other social welfare functions may organize as 501(c)(4) organizations and may then intervene in an election for or against a candidate as long as social welfare continues to be the organizations' primary function.[41]

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36. The Code provides for an exemption from gift tax for gifts, other than gifts of future interests, up to $12,000 per year. Thus, in general, gifts over $12,000 are subject to gift tax, which is paid by the donor. I.R.C. § 2501 (West 2006). Donees are secondarily liable. Gifts to 501(c)(3) and 527 organizations are not subject to gift tax. I.R.C. § 2522(a)(2) (West 2006).

37. I.R.C. § 501(c)(4) (West 2006).

38. Treas. Reg. § 1.501(c)(4)-1(a)(2)(i) (as amended in 1990).

39. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990).

40. There is some debate regarding how substantial a non-exempt function may be. For an excellent discussion of this issue see Miriam Galston, *Vision Service Plan v. U.S.: Implications for Campaign Activities of 501(c)(4)s*, EXEMPT. ORG. TAX REV. 165 (2006) (non-exempt activities should not be more than an insubstantial part of an organization's overall activities). *See also* Greg Colvin et al., *Comments of the Individual Members of the Exempt Organizations Committee's Task Force on Section 501(c)(4) and Politics, May 25, 2004, reprinted in* TAX NOTES TODAY, 102-16 (2004) (arguing for a safe harbor provision providing that 40 percent of an organization's activities may be for a non-exempt purpose).

41. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990).

Although the income of § 501(c)(4) organizations is tax-exempt, donations to 501(c)(4) organizations are not deductible by the donor. In addition, if a 501(c)(4) has investment income, that investment income is taxable dollar for dollar to the extent the organization has spent funds to intervene in a political campaign.[42] For example, a 501(c)(4) with $3,000 in investment income and $2,000 in political expenditures will find $2,000 of its investment income subject to tax.

Finally, while the law is a little unsettled in this area, contributions to 501(c)(4) organizations may be subject to gift tax.[43] The Service's position has been that contributions to tax-exempt entities over $12,000 are subject to gift tax unless there is a specific statutory exception that applies.[44] Section 501(c)(3) and 527 organizations are statutorily exempt from gift tax, but 501(c)(4) organizations are not.[45]

C. 501(c)(5) and (c)(6) Organizations

Section 501(c)(5) organizations, labor unions, and 501(c)(6) organizations, business leagues, are regulated in the same way as 501(c)(4) organizations. These organizations are allowed to intervene in political campaigns, but intervening in a political campaign must not be their primary function. Just as with 501(c)(4) organizations, the Code does not require 501(c)(5) and 501(c)(6) organizations to disclose their contributions or expenditures except in very limited circumstances. These organizations, however, are also not exempt from the gift tax, so donors who contribute more than $12,000 may be subject to gift tax on their contributions.

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42. I.R.C. § 527(f) (West 2006).

43. *See infra* note 181.

44. The Code provides that the first $12,000 given to a person or entity is not subject to gift tax. I.R.C. § 2503(b) (West 2006) (setting the exempt amount at $10,000 and noting that it is adjusted for inflation). Others have argued that 501(c)(4) organizations are not subject to gift tax. *See infra,* note 72.

45. I.R.C. § 2522(a)(2) (West 2006) (gifts to 501(c)(3) are not subject to gift tax); I.R.C. § 2501(a)(4) (West 2006) (exempting gifts to § 527 political organizations from the gift tax).

D. 527 Organizations

Prior to passage of § 527, many political organizations did not qualify as tax-exempt under any of the above sections because their primary activity involved intervention in a political campaign. No other tax-exempt organization is allowed to have intervention in a political campaign as its primary purpose. Congress's solution was to create a tax-exempt entity under section 527 for organizations whose primary purpose was to influence elections.[46] Section 527 organizations are exempt from tax on their "exempt function income," which is defined as contributions, membership dues, and proceeds from political fundraisers.[47] They are, however, subject to tax on investment income or on other income that is not exempt function income.[48] Contributions to 527 organizations are also statutorily exempt from the gift tax.[49] Unlike other tax-exempt organizations, however, § 527 organizations are subject to a significant disclosure regime. This regime requires most 527 organizations to disclose contributions in excess of $200 and expenditures in excess of $500.[50]

Finally § 527 appears to have been written in a way that makes inclusion into its regulatory regime mandatory.[51] Generally, an organization wishing to be exempt from tax applies for exempt status with the Service, and the Service either accepts or rejects that application. Political organizations do not need to apply for section 527 status, and are considered 527 organizations as long as they meet the definition of a political organization that is contained in section 527. Section 527 provides that a political organization is an organization "operated primarily for the purpose of directly or indirectly accepting

46. I.R.C. § 527(e)(1) (West 2006).
47. I.R.C. § 527(c)(3) (West 2006).
48. I.R.C. §§ 527(c)(3), (f) (West 2006).
49. I.R.C. §2501(a)(4) (West 2006).
50. I.R.C. §§ 527(j)(1), (j)(3)(A), (j)(3)(B) (West 2006).
51. *See* Nat'l Fed'n of Republican Assemblies v. United States, 148 F. Supp. 2d 1273, 1282 (S.D. Ala. 2001); Nat'l Fed'n of Republican Assemblies v. United States, 218 F. Supp. 2d 1300, 1308 n.7 (S.D. Ala. 2002); I.R.S. Field Serv. Adv. 200037040 (Sept. 15, 2000) (indicating that § 527 is not an elective provision); Rev. Rul. 2003-49, 2003-20 I.R.B. 903 (indicating in answer 20 that an organization is subject to 527 if it meets the definition of political organization in §527(e)).

contributions or making expenditures" to influence the "selection, nomination, election, or appointment of any individual to any Federal, State or local public office."[52] Under 527(i) an organization must give notice to the Secretary that it wishes to be treated as a 527 organization. A 527 organization that does not give notice is subject to tax under 527(i)(4). Thus, according to the Service, an organization is a political organization if it meets the definition in 527(e) even if the organization does not notify the Secretary under 527(i).[53] Under the Service's interpretation, the organization is a political organization that has failed to make disclosures under 527(i). Because § 527 status may not be elective, organizations seeking to avoid 527's regulatory regime by forgoing tax-exempt status may find that all their contributions *and* expenditures are subject to tax under § 527(i)(4).[54]

The question whether 527 is elective or compulsory is extremely important for an IG trying to organize as a taxable organization. If the Service is right and any organization meeting the definition of a political organization in 527 is treated as a tax-exempt political organization, then most IGs will not benefit from organizing as a taxable entity. Even if the IG organizes as a taxable entity the Service would argue that 527(i)(4) applies and that it should be taxed on all of its nondisclosed contributions and expenditures. If that position prevails, choosing a taxable entity will only be attractive to organizations that do not have as their primary purpose the influencing of elections.

Making § 527 non-elective is rational if § 527 is designed as a campaign-finance regulation. Congress wanted to mandate disclosure of all organizations with certain characteristics, and used the tax code as a means of obtaining that disclosure. The idea is that tax-exempt status is a benefit and disclosure is merely a requirement of obtaining that benefit. This rationale may not survive First Amendment challenge, however, if the entity itself is organized as a taxable entity. If the organization is set up as a taxable organization and pays tax based on those principles, then the organization is not receiving a subsidy as a condition of tax-exempt

52. I.R.C. §527(e)(1), (2) (West 2006).
53. I.R.S. Field Serv. Adv. 200037040 (Sept. 15, 2000).
54. I.R.C. § 527(i)(4) (West 2006).

status, and it would be harder for Congress to justify the statute based on a subsidy rationale.[55]

II. CHOICE OF ENTITY

Statutes regulating entities in the tax and campaign-finance arena usually have addressed two different concerns. One set of rules is designed to ensure that the benefits of tax-exempt status or of corporate form are not abused. For example, § 501(c)(3) organizations are not only exempt from taxation but also receive contributions that are deductible to the donor. This means that the public indirectly subsidizes these organizations. Because of this subsidy, Congress has prevented 501(c)(3)s from intervening in an election on behalf of a candidate for public office.[56] This regulation can be seen as an attempt to protect the integrity of 501(c)(3) organizations and the public fisc. This type of regulation impacts political advocacy, but does not have as its primary purpose the regulation of political campaigns.

The second set of rules places restrictions on entities for the purpose of regulating campaign activities. Here, Congress is trying to achieve a campaign regulatory end, and it is using the entity status as a means of implementing those regulations. Section 527's disclosure provisions are a clear example of this type of regulation.[57] The recent decision in *WRTL* makes it even more likely that Congress will attempt to achieve campaign regulatory ends through other means. For example, instead of regulating the campaign activities of corporations and unions through election laws, Congress could regulate those organizations by requiring corporations and unions to obtain shareholder or member approval before engaging in electioneering communication. Because

55. *See* Donald. B. Tobin, *Anonymous Speech and Section 527 of the Internal Revenue Code*, 37 G.L. REV. 611, 636-682 (2003) (discussing constitutional questions spawning litigation on whether the statute is mandatory).

56. *See* I.R.C. § 501(c)(3) (West 2006).

57. *See* Mayer, *supra* note 20 (creating an institutional choice model and arguing that the IRS is not the institution of choice for campaign regulation of 527 political organizations).

such efforts would be time consuming and expensive, corporations and labor unions might forgo engaging in electioneering communication.[58]

When Congress is regulating in this manner—using an organization's entity status as a means of regulating political activity—there is a serious concern that the regulations may violate the First Amendment. As I have previously argued, in order to survive First Amendment scrutiny, the regulation either must be constitutional according to traditional campaign-finance jurisprudence or must be a permissible condition that is placed on an organization in order to receive some government subsidy or benefit.[59] If the provision meets the first requirement there is really no need to consider the second part of the equation. But if the basis for finding a restriction constitutional is the fact that a benefit is received as a condition of the regulation, an essential component of such a finding is that a benefit is actually received. If the tax code is used as the justification for regulating an entity, in order to assess the constitutionality of the restriction, we need to know the tax consequences to an organization if it was not considered tax-exempt.[60] In other words, we need to know whether the organization is actually receiving a tax benefit in order to know whether the condition placed on it is actually a restriction based on a benefit received by the organization. A discussion of this issue is contained is Parts III and IV.

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58. In fact, I can see a very strong argument that corporations and unions have First Amendment rights but that for corporate governance reasons we do not want corporations or unions using shareholder or member funds for political advocacy unless a majority of the shareholders or members approve of such action. Moreover, such a regulation would be more rationally related to the purpose of the regulation. Nonprofit organizations, like Massachusetts Citizens for Life, were not the type of organizations that Congress was originally trying to regulate with the corporate ban, and the Court later found an exception to the corporate ban for MCFL-type organizations. A MCFL-type organization would not be subject to the regulation I discuss because it would not be a for-profit corporation with shareholders.

59. *See* Tobin, *supra* note 55, at 636-82.

60. I have examined this issue at length in the context of § 527 organizations and argue that § 527 organizations do receive a tax benefit. *See* Tobin, *supra* note 55, at 638-651, 653-655. *But see* Roger Colinvaux, *Regulation of Political Organizations and the Red Herring of Tax Exempt Status*, 59 NAT'L TAX J. 531 (2006); Polsky & Charles, *supra* note 7 (concluding that 527 organizations to not receive a tax benefit).

What is particularly important in examining the regulation of IGs is the understanding that the form of the entity (under tax and business law) impacts the regulation of the political speech. Entity choice here matters. If the regulation of the entity is based on protecting the fisc and/or limiting abuse of a tax benefit, then entity regulation makes sense. But if the purpose of the restrictions is to engage in campaign-finance regulation, then entity-based restrictions are extremely hard to justify. Proponents of this entity-based regulation need to be able to justify why a particular entity is somehow more corruptive or dangerous than another.[61]

Since entity-based regulation is not primarily concerned with the content of the speech but instead is more concerned with the organization structure, entity-based regulation provides an incentive for IGs to seek out the entity status that places the fewest restrictions on their advocacy.[62] These entity-based restrictions impose a cost on IGs

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61. For example, the Supreme Court in *Buckley v. Valeo* upheld the regulation of Political Action Committees because of the concern that these entities had influencing elections as their primary purpose. 424 U.S. 1, 35-36, (1976) (per curiam). Thus, the Supreme Court determined that corruption concerns allowed for regulation of these entities even for speech that was not express advocacy. Some have sought the regulation of 527s on similar grounds. Professor Foley and I argued that section 527s whose primary purpose is influencing federal elections can be regulated as PACs. *See* Edward B. Foley and Donald Tobin, *Tax Code Section 527 Not an End-Run Around McCain-Feingold*, 72 U.S.L.W. 2403 (2004). Others have argued that 527s can be regulated simply based on their status as a 527 organization. *See Disclosure of Political Activities of Tax-Exempt Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 106th Cong. 73-80 (2000) (testimony of Frances R. Hill, Professor, University of Miami School of Law). Similarly in *Austin v. Michigan Chamber of Commerce*, the Supreme Court recognized that the unique legal and economic characteristics of the corporate entity coupled with a state's desire to avoid corruption or the appearance of corruption constituted a sufficiently compelling rationale for a state to place certain regulations on political expenditures by corporations. 494 U.S. 652, 658-660 (1990). The Court recognized that state law grants the corporate entity "special advantages—limited liability, . . . perpetual life, and favorable treatment of the accumulation and distribution of assets . . . [that can be used] . . . to obtain an unfair advantage in the political marketplace" over other entities. *Id.* at 658-59 (quoting *MCFL*, 479 U.S. 238, 257 (1986)) (alteration added).

62. In addition to this entity-based regulation, § 527 organizations are also subject to federal election law if they engage in activities that are covered by the Federal Election Campaign Act. For the most part, these regulations are content-

engaged in political advocacy. The cost may be financial or it may be speech related. Thus many IGs face the same type of organizational questions that businesses face in choosing the entity through which they want to conduct business.

In choosing the entity through which IGs conduct political advocacy, the IGs have four major concerns. First, they would prefer to maximize their resources and thus prefer a vehicle that would subject them to the least amount of tax. Second, IGs seek limited liability due to the increased litigiousness of political campaigns, the increased harshness of the content of many political ads, and the very real concern that IGs will be sued for defamation. Third, many independent groups prefer that their donors remain anonymous. This may be because they do not want the public to know the real supporters of a particular message, they fear retribution for the message, the message is unpopular, or the donors prefer to remain out of the public eye. Finally, IGs want as much flexibility as possible to engage in the widest range of political advocacy. For example, under federal election law, corporations and labor unions, with some small exceptions, are not allowed to engage in certain types of political communication and are also limited in how they can make political contributions.[63] IGs, therefore, often do not want the constraints that are placed on them by organizing as corporations.[64]

Finally, it is important to recognize that if an organization is determined to be a political action committee (PAC), then entity choice is no longer extremely important.[65] PACs are already subject to

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based and apply regardless of whether the entity engages in the communication. This is not true, however, if the organization is a political committee under FECA. If an organization is a political committee, it is subject to the contribution limitations and disclosure provisions in FECA. 2 U.S.C. § 441a(a), 433, 434 (2007). In addition, corporations and labor unions are statutorily prohibited from engaging in express advocacy or electioneering communication. 2 U.S.C. § 441b (2007).

63. *See supra* note 8.

64. *See MCFL*, 479 U.S. 238 (The nonprofit corporation argued successfully that the corporate restrictions should not apply to it. Had the restrictions applied, MCFL would have either had to organize as a political committee and thus be subject to those stringent regulatory requirements or been prohibited from publishing its newsletter urging readers to vote "pro-life.").

65. The term "political committee" is defined, in relevant part, as: "(A) any committee, club, association, or other group of persons which receives contributions aggregating in excess of $1,000 during a calendar year or which makes expenditures

contribution limitations and to disclosure obligations, and properly organized PACs are not subject to the corporate ban on making political contributions.[66] PACs routinely organize as corporations and file for status as tax-exempt organizations under § 527. In fact, the legislative history surrounding 527 suggests that Congress contemplated that all 527s would be PACs.[67]

A. Tax Liability

Independent Groups seek to maximize their influence in the political process, and many raise large sums of money to do so. It is inefficient for those organizations to pay as much as 35 percent of the amount of money they raise to the government in the form of taxes. As discussed in the next part, the choice of entity by the IGs may have a significant impact on their tax liability and thus on the amount of money that organizations will have to spend on advocacy.

For example, 501(c)(3), (c)(4) and 527 organizations generally do not have to pay tax on contributions they receive.[68] In some circumstances, 501(c)(4)s and 527 organizations have to pay tax on investment income, and 527s that choose not to meet the disclosure obligations in § 527(i) must pay tax on non-disclosed contributions and expenditures.[69]

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aggregating in excess of $1,000 during a calendar year; or (B) any separate segregated fund established under the provisions of section 441b(b) of this title." 2 U.S.C. § 431(4) (2007). The FEC has also promulgated regulations defining the term "political committee." 11 C.F.R. § 100.5 (2007).

66. 2 U.S.C. § 441b(a) (2007) (contribution and expenditure limitations); 2 U.S.C. § 441b(c) (electioneering communication limitation). PACs cannot receive corporate contributions although corporations may pay the administrative and fundraising costs of PACs connected to the corporation.

67. *See* Tobin, *supra* note 55, at 625 ("At the time Congress passed § 527 an organization whose primary purpose was to influence the election of a candidate for public office was subject to FECA and would have been regulated as a PAC. *Buckley v. Valeo*, which limited the reach of FECA, was not decided until 1976. Thus it is fair to conclude that when § 527 was passed, Congress expected that political organizations would be regulated as political committees.").

68. I.R.C. §§ 501(a), 527(c)(3)(A) (West 2006).

69. I.R.C. § 527(f) (West 2006). Section 501(c)(4) organizations are subject to tax on investment income to the extent that the organization makes expenditures for an "exempt function" under § 527. This generally means that when a 501(c)(4)

An IG must also be concerned with whether contributions to it will be considered a gift subject to federal gift tax. The gift tax is levied on the donor, so there would be no direct tax to the IG, but if donors were required to pay gift tax on amounts they contributed to IGs then donors would either be less likely to give or would give smaller amounts, adjusting their contributions for the cost of the tax.[70] Section 527 organizations are statutorily exempt from the gift tax rules,[71] but there is serious disagreement whether contributions to 501(c)(4) organizations are subject to gift tax.[72] In most cases, however, IGs that choose to organize as tax-exempt organizations end up with little or no tax liability.

B. Limited Liability

IGs are often formed and operated by influential people with significant personal wealth.[73] IGs are also often engaged in activities that might subject the organizations to suit.[74] Organizers of IGs are

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engages in political advocacy, it will have to pay tax on the amount it spends on political advocacy to the extent of its investment income. If the 501(c)(4) has more in investment income than it spends on political advocacy, the remaining investment income is not subject to tax; I.R.C. § 527(c) (2007) (exempting exempt function income from tax but not including investment income in the definition of exempt function income).

70. Although donors are responsible for the gift tax, donees are secondarily liable. I.R.C. § 6324(b) (West 2006).

71. The gift tax does not apply to donations to political organizations organized under § 527. I.R.C. § 2501(a)(4) (West 2006).

72. *See* Barbara K. Rhomberg, *The Law Remains Unsettled on Gift Taxation of Section 501(c)(4) Contributions*, 15 TAX'N OF EXEMPTS 62, 65 (Sept.-Oct. 2003) (recognizing the Service's position that donations to 501(c)(4)s are subject to the gift tax but arguing that the Service position may not survive court challenges); *see also* Carson v. Comm'r, 641 F.2d 864, 865-66 (10th Cir. 1981) (finding payment was for donor's own economic advantage and campaign contributions are not gifts within meaning of gift tax law); Stern v. United States, 436 F.2d 1327, 1329-30 (5th Cir. 1971) (finding donations to political organizations were not subject to the gift tax).

73. Even individuals without significant wealth are interested in protecting the wealth that they have.

74. *See* Posting of Ned Barnett to Barnett and Toor on PR, *High-Risk (to the PR Person/Agency) PR* (May 15, 2006), http://barnettmarcom.blogspot.com/2006/05/high-risk-to-pr-personagency-pr.html (Kerry threat to sue Swift Boat Veterans for Truth). Henry Mark Holzer & Erika Holzer, *Legal Terrorism* (Aug. 10, 2004), http://www.swiftvets.com/article.php?story=20040810190737687. *See also* Edward

therefore increasingly seeking an organizational form that helps protect the organizers, contributors, and employees from liability.

The organizational decision regarding limited liability is a business organization question not a tax question. The form of the organization for tax purposes is not controlling. Instead, what is important is the treatment of the organizations under state law. IGs seeking liability protection thus need an organizational form that provides for limited liability under state law. The problem for IGs is that the corporate form provides the best means of limiting liability but campaign finance laws limit a corporation's activities.[75] For example, corporations are prohibited from using corporate funds to make contributions to candidates, from engaging in electioneering communication that is the "functional equivalent" of express advocacy,[76] and from expressly advocating[77] for or against a candidate for public

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B. Foley & David Goldberger, *The Swift Boat Ad: A Legal Analysis* (Aug. 13, 2004), http://moritzlaw.osu.edu/electionlaw/ebook/part3/campaign_false02.html; Lassa v. Rongstad, 718 N.W.2d 673, 679 (Wis. 2006) (Candidate brought defamation action against organization that sent out a mailer stating that Lass "hooked up" with the then-State Senate Majority Leader and asserting "'[n]obody knows for sure what she had to promise to gain his approval.'" (alteration added). The defamation suit was ultimately engulfed in a larger dispute regarding Rongstad's refusal during discovery to provide the names of people who contributed to his organization.).

75. *See* 2 U.S.C. § 441a(a) (2000); 11 C.F.R. § 110.1 (amended 2005). *See also* 11 C.F.R. § 114.2(b)(1) (amended 2005) (corporations are prohibited from making contributions in connection with an election for any Federal office); 11 C.F.R. § 114.2(b)(2)(ii)-(iii) (corporations are also prohibited from making any expenditures with respect to a federal election and making payments for electioneering communications); 11 C.F.R. § 114.2(f)(1) (corporations are also prohibited from facilitating the making of contributions, unless they are to a segregated account of the corporation). As discussed *supra* the Court limited the restrictions on electioneering communication by corporations to electioneering communication that was the "functional equivalent" of express advocacy. *WRTL*, 127 S.Ct. 2652, 2655 (2007).

76. Electioneering communication is defined as "broadcast, cable, or satellite communication which . . . refers to a clearly identified candidate for Federal office . . . ." and is made within sixty days of a general election or thirty days before a primary. 2 U.S.C. § 434(f)(3)(A) (2007).

77. Express advocacy is an election law term that is derived from the Supreme Court's decision in *Buckley v. Valeo*. Buckley v. Valeo, 424 U.S. 1 (1976). In *Buckley*, the Court held that the "influencing an election" was vague and the Court would read the provisions as to only apply to communication that expressly

office.[78] Some IGs organize as corporations and comply with the restrictions on corporations.[79] They simply refrain from making contributions to candidates, and avoid engaging in express advocacy or its equivalent.[80] This is a strategic decision by the IG, and IGs can engage in political advocacy even if they are corporations. The decision to incorporate, however, does restrict the breadth of an IG's communication. An IG can attempt to work around this problem by creating two organizations, one a PAC that takes only hard money and can engage in these restricted activities, and the second a non-PAC corporate 527 that cannot engage in the restricted activities.[81] This strategy, however, may not work if Congress increases the regulation on 527 organizations, or if Congress seeks other means of regulating corporations in light of the Court's decision in *WRTL*.

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advocated the election or defeat of a candidate. Some believe that "express advocacy" was limited to certain magic words like "vote for" or "vote against." If one engages in express advocacy, then that communication is regulated by the Federal Election Campaign Act, and the contribution limitations and disclosure provisions of the Act apply. *See supra* note 8.

78. See discussion of *WRTL*, *supra* note 8.

79. Some IGs have received the benefit of corporate status without being subject to many of the restrictions placed on corporations. These organizations take advantage of an exception for organizations that meet specific requirements set out by the Supreme Court in *MCFL*. *See supra* note 8 (discussing corporate restrictions and *MCFL* exception.).

80. In fact, many IGs are willing to organize as corporations and live with the restrictions on corporate activity. These organizations generally engage in lobbying and issue discussion. They avoid using express advocacy and electioneering communication. Moreover, since electioneering communication does not include communication over the Internet, many IGs have determined that they can still get their message out without having to engage in electioneering communication. The point here is not that corporate IGs cannot engage in any activity, but that organizing as a corporation limits the activities an organization can engage in.

81. The term "electioneering communication" means any broadcast, cable, or satellite communication which: (1) refers to a clearly identified candidate for federal office; (2) is made within sixty days before a general, special, or runoff election for the office sought by the candidate or thirty days before a primary or preference election, or a convention or caucus of a political party that has authority to nominate a candidate, for the office sought by the candidate; and (3) in the case of a communication which refers to a candidate for an office other than President or Vice President, is targeted to the relevant electorate. Bipartisan Campaign Reform Act of 2002 § 201(a)(3), 116 Stat. at 89.

At the moment, it is unclear how important limited liability is to IGs. To date, there has not been a groundswell of suits against IGs for defamation.[82] As the political environment heats up, however, large contributors may be fearful that they will be held personally liable if the IG does not have limited liability and is sued. It is too early to tell if this is a real concern, but IGs must keep that concern in mind when they make entity decisions.[83]

C. Anonymity

Some contributors to IGs wish to remain anonymous so IGs may try to choose an organizational form that will not require the disclosure of contributions. Under current election law, entities that engage in express advocacy or electioneering communication must disclose the contributions and expenditures connected to that communication.[84] As discussed earlier, the choice of the entity under either state law or tax law would have no bearing on whether the entity was required to disclose amounts spent on express advocacy or electioneering communication. These are speech-related disclosures and are not entity based. IGs engage in a broad range of communication that is neither express advocacy nor electioneering communication, and the choice of entity decision will have significant ramifications on the extent to which disclosure regulations will apply to those communications.

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82. Defamation suits against candidates, however, exist, and there is no reason to believe that IGs would never be the target of such a claim. *See, e.g.*, William P. Marshall, *False Campaign Speech and the First Amendment*, 153 U. Pa. L. Rev. 285 (2004) (analyzing constitutional issues raised by regulations concerning false campaign speech).

83. James Bopp raised the liability concern at the symposium sponsored by FALR. Symposium, *No Strings Attached? The First Amendment and Tax-Exempt Organizations*, 6 FIRST AMEND. L. REV. 1 (2007).

84. 11 C.F.R. § 104.5(j) (as amended in 2005) (requiring every person who has made a disbursement for the direct costs of producing or airing electioneering communications as defined in 11 C.F.R. § 100.29 (amended 2005) aggregating in excess of $10,000 during any calendar year to file a statement with the FEC within twenty-four hours). *See also* 11 C.F.R. § 104.20 (2003) (detailing how to report electioneering communications as set forth in 2 U.S.C. § 434(f) (2000) and 11 C.F.R. § 104.5(j)).

Entities that choose to organize as § 527 political organizations are subject to a significant disclosure regime. Section 527 requires the IG to disclose all contributions over $200 and all expenditures over $500.[85] Because of these disclosure obligations, IGs appear to be shifting their entity choice to 501(c)(4) organizations.[86] Section 501(c)(4) organizations are required to disclose their large donors to the IRS on an annual basis, but this information is not available to the public.[87]

Thus, to the extent the disclosure obligations are entity based and not communication based, IGs will strongly consider the disclosure obligations when making choice-of-entity decisions.

D. Free Speech

Election and tax law place some restriction on the freedom IGs have to engage in political speech. For example, a 501(c)(3) organization is allowed to speak about important national issues and is allowed to engage in a limited amount of lobbying, but is statutorily prohibited from intervening in a "political campaign on behalf of (or in opposition to) any candidate for public office."[88] Similarly, a section 501(c)(4) organization must be organized primarily to engage in social welfare activities, and political advocacy is not considered a social

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85. I.R.C. § 527(j)(3)(B) (West 2006) (contribution non-disclosure limit of $200); I.R.C. § 527(j)(3)(A) (expenditure non-disclosure limit of $500).

86. *See* Stephen R. Weissman and Kara D. Ryan, *Soft Money in the 2006 Election and the Outlook for 2008: The Changing Nonprofits Landscape*, Campaign Finance Institute Report (2007), *available at* http://www.cfinst.org/books_reports/pdf/NP_Softmoney_06-08.pdf; *See also The New Stealth PACs: Tracking 501(c) Non-Profit Groups Active in Elections*, Public Citizen Report (2004), *available at* http://www.stealthpacs.org/ documents/StealthPACs.pdf. In addition, some Federal Communications Commission (FCC) regulations require organizations to disclose the purchaser of communication that appears on the airwaves. In certain circumstances, entity status may control what information needs to be disclosed to the FCC. *See* 47 U.S.C. § 317(a)(1); 47 C.F.R. § 73.1212 (radio); 47 C.F.R. § 76.1715 (TV).

87. Treas. Reg. § 301.6104(b)-1(b)(2). *See also* I.R.C. § 6104(b) (West 2006) (requiring Service to make Form 990s, filed by 501(c) organization public but authorizing Service to withhold names and addresses of contributors).

88. I.R.C. § 501(c)(3) (West 2006).

welfare activity.[89] Finally, as previously noted, most corporations are not entitled to contribute to candidates, engage in electioneering communication, or engage in express advocacy.[90] Therefore, in choosing entity status, IGs want the entity that will provide them with the most flexibility regarding the type of communication in which they want to engage. Since most corporations are prohibited from engaging in express advocacy or electioneering communication that is the functional equivalent of express advocacy and from making contributions to candidates, corporate status may be a poor choice for most organizations that want to engage in a wide variety of communication designed to influence an election.

There is, however, a limited exception to the restriction on corporations for corporations that meet the criteria set out in *Massachusetts Citizens for Life*.[91] The *MCFL* exception allows non-profit social-welfare organizations to engage in express advocacy if the organizations are not engaged in business, have no shareholders or others with interests in their assets, and do not receive funds from for-profit corporations or unions.[92]

At the moment, it appears that for organizations that qualify for the exception in *MCFL*, organizing as corporations and seeking tax-exempt status under § 501(c)(4) provides the most flexibility with regard to the types of speech they may engage in.[93] For those organizations that do not qualify for the *MCFL* exception, organizing as unincorporated associations and seeking tax-exempt status under section 527 provides the most flexibility. As Congress considers further regulation of 527

89. Some commentators argue that 501(c)(4) organizations should only be allowed to engage in an insubstantial amount of non-social welfare activity. *See* Galston, *supra* note 40. Professor Galston's position is certainly more consistent with the statutory language in § 501(c)(4) providing that a (c)(4) organization must be "operated exclusively for the promotion of social welfare." I.R.C. § 501(c)(4) (West 2006).

90. 11 CFR § 110.1(g) (2007).

91. *See supra* note 8.

92. *MFCL*, 479 U.S. 238, 263-64 (1986).

93. There appears to be nothing that would prevent a § 527 organization from organizing as a limited liability corporation. This would provide the IG with limited liability, and it could still apply for tax-exempt status under § 527. For a discussion of the use of LLCs see *infra* Part IV.

organizations and as concerns about liability increase, groups may be seeking alternative entity structures to engage in political advocacy.

III. TAXATION OF POLITICAL ACTIVITY

The central question in determining whether IGs can use taxable entities to engage in political activity is whether those organizations have taxable income and what the tax liability would be if the IG were not a tax-exempt entity. If an IG has no taxable income then there is no need for an IG to organize as a tax-exempt organization. This part looks at the history surrounding the taxation of political organizations and examines whether there would be tax consequences to an IG if it organized as a for-profit entity. This history is important because some have argued that the history indicates that political organizations have not traditionally been subject to tax and that § 527 status does not, therefore, confer a tax benefit on those organizations.[94] The fact that political organizations were not historically taxed does not, however, answer the question of how a taxable IG would be taxed unless we know the basis for that exemption. Moreover, the history surrounding the taxation of political organizations indicates that the justification for exempting them from tax has been complicated and controversial.

A. History of the Tax Treatment of Political Organizations

Prior to the passage of § 527 of the Code, the tax treatment of political organizations was ad hoc and potentially inconsistent with normative tax principles. At first, the Service basically ignored political organizations, and generally took the position that political organizations did not need to file tax returns.[95] The rationale for this non-statutory

94. *See generally* Colinvaux , *supra* note 60.

95. Prior to 1974 there was no specific definition of a political organization. Section 527 of the Code defines a political organization as an organization operated for the purpose of directly or indirectly influencing the selection, nomination, election, or appointment of any individual to any federal, state, or local public office. I.R.C. §§ 527(e)(1), (2); S. REP. NO. 93-1357, at 25 (1974), *as reprinted in* 1975 U.S.C.C.A.N. 7478, 7502. *See* Tax Treatment of Contributions of Appreciated Property, to Committees of Political Parties, 37 Fed. Reg. 22427 (Oct. 19, 1972) (Notice of Opportunity to Submit Written Comments to Request for Public Hearing)

exemption is unclear. At that time, political organizations were either political parties or candidate committees. The exemption was either founded on the principle that political contributions were "political gifts" and that political organizations therefore had no taxable income,[96] or it was based on the notion that the payments to candidates were held in quasi-trust by the party or political organization.[97]

In 1939, the Service ruled on whether (1) "contributions to political organizations are allowable deductions in the donor's Federal income tax return and (2) political gifts or donations to individuals or to political organizations are subject to Federal income tax."[98] The formation of the question indicates that these types of payments were viewed as some type of gift.[99] Absent a gift rationale it would be obvious that contributions to political organizations were not deductible. The Service ultimately concluded that contributions were not deductible but that "a political gift . . . received by an individual or [by] a political organization . . . is not taxable income to the recipient."[100]

In 1954, the Service confirmed that a "political gift" is not taxable income to the recipient.[101] Revenue Ruling 54-80 dealt with whether funds contributed to a political candidate were taxable if the funds were diverted for the candidate's personal use. The Service recognized that political gifts to candidates were not taxable, but concluded that once the funds were diverted for personal use, the funds

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(indicating that it is a matter of history that the Service has never required political committees to file income tax returns because it believed that virtually all of the receipts were from gifts).

96. *See* S. REP. NO. 93-1357, at 25 (1974) (indicating the payments were excluded as gifts); Tax Treatment of Contributions of Appreciated Property, to Committees of Political Parties, *supra* note 95.

97. *See* I.R.S. Gen. Couns. Mem. 35,499 (Feb. 8, 1974) (claiming the precise justification for excluding political campaign contributions from gross income has never been clearly articulated, but that it is clear that the justification is not that the contributions are gifts); I.R.S. Gen. Couns. Mem. 39,813, 41, n.32 (Mar. 20, 1990) (claiming conduit or quasi-trust rationale was the reason for the exclusion), *reprinted in* [1986-1990 Transfer Binder] IRS Pos. (CCH) & 2208, at 7540.

98. I.T. 3276, 1939-1 C.B. 108.

99. If the contributions were not a gift then it is clear that it would not be deductible from income.

100. I.T. 3276, 1939-1 C.B. 108 (alteration added).

101. Rev. Rul. 54-80, 1954-1 C.B. 11.

were taxable to the recipient. The Service, however, provided no real discussion of how it reached its conclusion.

The conclusion in Revenue Ruling 54-80, however, may shed light on why the Service later moved away from the gift rationale as the basis for excluding political donations. If the contribution is considered a gift to the candidate, then the candidate might have a right to the money tax free even if the candidate used the money in his personal capacity. It would simply be a gift to the candidate, and gifts are not taxable under § 102 of the Code. If, however, the exclusion is not based on the gift rationale, then the tax treatment when funds are diverted to candidates becomes clearer. Under that logic, there is some special exception for political campaigns, and when the money is diverted that special treatment is not applicable.

In 1968, the Service once again indicated that contributions to organizations should be treated as gifts.[102] In a Technical Advice Memorandum, the Service considered the tax consequences to an organization that had its tax-exempt status revoked because it intervened in an election on behalf of a candidate. Because the organization was not tax-exempt for the years in question, the Service had to determine the taxable income of the organization during that period. The Service concluded that contributions to the taxable organization were not included in the gross income of the organization because they were gifts under § 102.[103] The Service explicitly rejected the notion that the contributor's intention to further the organization's general objectives defeated gift treatment.[104] The Service recognized that if "the presence of a motive to accomplish certain general objectives would rule out a finding of gift, then taxpayers could never claim a deduction" for contributions to tax-exempt organizations because "taxpayers when making contributions, invariably seek to accomplish some objective, although such objective may be very broad."[105]

Thus, by 1968 the Service had worked out a way to deal with the taxation of contributions to political organizations. Contributions to

102. I.R.S. Priv. Ltr. Rul. 6812121000A (Dec. 12, 1968) (finding contributions to § 501(c)(3)s made during period that exempt status was revoked were not income to the (c)(3) because such a contribution was a gift).

103. *Id.*

104. *Id.*

105. *Id.*

political parties, candidates, or organizations were gifts. In the case of the candidate, the contributions were not gifts to the candidate in his personal capacity, but were gifts to his political campaign. If the funds were diverted for the candidate's personal use then they would be treated as income to the candidate, unless that candidate could prove that the funds were gifts to him in his personal capacity.

By 1972, political campaigns and organizations were becoming more sophisticated and there were complicated tax issues surrounding the donation of appreciable property and the taxation of investment income. Political parties were encouraging people to give appreciable property to the party. The taxpayer would not have to pay tax on the built-up gain in the property, and the political party could sell the property tax free (because the Service was not requiring political parties to file returns). The Service then released a notice regarding a public hearing on the tax treatment of political parties.[106] In that notice the Service stated "[i]t has been the position of the Internal Revenue Service that campaign contributions are gifts for gift tax purposes."[107] The notice further recognized that the Service has not required political parties to file tax returns and stated "[i]t appears that this practice had its inception and was continued in the belief that virtually all of the receipts of the parties were from gifts and that the parties would not have taxable income."[108] Although the notice is qualified with "it appears," clearly as late as 1972 the gift rationale was the best justification the Service could articulate for not subjecting contributions to political parties to income tax. It is therefore not surprising that a 1974 Senate Report on political organizations indicated that political contributions were not taxed because they were considered gifts.[109] Moreover, at the time, the Service's position was clear that such payments were subject to the gift tax.[110]

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106. *See* Tax Treatment of Contributions of Appreciated Property, to Committees of Political Parties, *supra* note 95 (Notice of Opportunity to Submit Written Comments to Request for Public Hearing).

107. *Id.* (alteration added).

108. *Id.* (alteration added).

109. S. REP. NO. 93-1357, at 25, 32 (1974).

110. *See* Rev. Rul. 72-355, 1972-2 C.B. 532 (finding political contributions subject to the gift tax); Announcement 73-84, 1973-2 C.B. 461-462 (announcing new policy with regard to the taxation of political organizations and re-affirming the

Interestingly, at about the same time that Congress was considering codifying tax-exempt status for political organizations, the Service began articulating a different reason for not treating contributions to political organizations as income. In 1973, the Service considered whether political contributions donated to a charity upon the death of the candidate were included in the candidate's estate. In reaching its conclusion, the General Counsel Memorandum indicated that the Service's position regarding the taxation of campaign contributions was that they were not taxable if used for campaign purposes but would be taxable if they were for personal use.[111] The Service also indicated that it had concluded that it would assume that contributions were not intended as gifts to the candidate for his personal use absent evidence to the contrary.[112] The basis for this assumption was that contributions were given with the intent that they be used for campaign purposes, and that assumption gave rise to a quasi-trust relationship.[113] In other words, the Service argued that the candidate holds the contribution in trust for the contributor and must use the funds in the manner the contributor wanted (i.e. to promote the candidate's campaign). From this theory, the General Counsel Memorandum concludes that the "quasi-trust relationship forms the basis for the income tax treatment of political funds."[114]

In 1974, the Service considered whether contributions to an officeholder to pay office expenses were excludable from gross income.[115] The Service indicated that "[p]olitical campaign expense contributions have received unique treatment by the Service and the

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Service's position that contributions are subject to gift tax.). As previously discussed, the test for a gift for income tax purposes is different than the test for whether there is a gift for estate tax purposes. *See supra* note 96. However, the Service's position that nothing is received in exchange for the contribution for estate tax purposes also implies that the payment was a gift for income tax purposes.

111. I.R.S. Gen. Couns. Mem. 35,462 (Aug. 31, 1973).

112. *Id.*

113. *Id.* This makes sense with regard to why diverted funds are taxable. They were not intended as gifts to the candidate in his personal capacity. It does not, however, indicate that the trust theory was the basis of the exclusion. As discussed *infra*, the trust theory does not work. *See also* I.R.S. Gen. Couns. Mem. 39,813 (Mar. 19, 1990).

114. *Id.* at 5.

115. I.R.S. Gen. Couns. Mem. 35,664. (Feb. 8, 1974).

courts" and that office expenses were not entitled to the same treatment.[116] The Service further stated that the precise justification for excluding political campaign contributions from gross income was never clearly articulated but that it is clear that the justification "is not that the contributions are gifts within the context of Code § 102."[117]

In 1974, the Service issued a revenue ruling designed to explain the tax treatment of political organizations. Revenue Ruling 74-21 involved an organization formed to engage in activities to influence the nomination and election of individuals to public office.[118] The organization sought advice from the Service regarding its tax status, and the Service determined that the organization "more nearly resemble[d] a corporation than a trust or partnership and that the tax rules for corporations appl[ied]."[119] The Service then set out the relevant tax principles that would apply to the organization.[120] It required the organization to submit a corporate tax return and pay tax at the corporate tax rate. The Service concluded, however, that campaign contributions were not includible in gross income and that campaign expenditures were not deductible.[121]

Later, in 1990, the Service was once again faced with the question of how to tax an exempt organization that lost its tax status. The General Counsel Memorandum recognized that there had been confusion regarding the tax treatment but implied that confusion was only outside the Service. Specifically, the memorandum indicated "[t]here may have been some confusion outside the Service as to the basis for not taxing campaign contributions [citing Senate Report indicating that the basis was gift treatment] . . . . The underlying rationale was a conduit or 'quasi-trust concept', however, not section

116. *Id.* at 2 (alteration added).

117. *Id.* at 3. This statement is incredible in light of the prior history regarding gift treatment and the fact that the Service's announcement in 1973 indicated that gift treatment was likely the reason for the exclusion. The statement was necessary, however, for the Service to be able to distinguish contributions to a candidate from contributions to a Member of Congress's office.

118. Rev. Rul. 74-21, 1974-1 C.B. 14, 15.

119. *Id.* at 6 (alterations added).

120. *Id.*

121. *Id.*

102"[122] The Service may have been right that a possible alternative rationale is a quasi-trust concept, but the idea that the Service was consistent in promoting this rationale is absurd.

There is some support for the Service's quasi-trust view in its treatment of social clubs.[123] Social clubs are exempt from tax. This exemption appears to have been granted based on administrative convenience. It was very difficult to obtain tax forms from these organizations, and the revenue collected from them was insignificant.[124] More than thirty years after the exemption was granted, a congressional report discussing whether investment income of social clubs should be subject to tax indicated that the decision to exempt social clubs was justified when the income to the organizations was limited to the receipts of the membership.[125] The idea was that since the social organization collected money from members and then spent it on members, the individual was in "substantially the same position as if he had spent his income on pleasure or recreation."[126] The quasi-trust rationale may be logical in the social club context when the payment is being spent for the benefit of the contributor. It is far more problematic when an independent organization can spend the funds as it sees fit.[127]

Although the precise justification for excluding political contributions is unclear, what is clear is that the Service was struggling with how to treat political organizations for tax purposes. Normative tax principles were providing neither a simple nor an administrable standard for how to tax political organizations. In 1975, Congress resolved the confusion regarding the tax treatment of political organizations and

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122. I.R.S. Gen. Couns. Mem. 39,813, 41 n.32 (Mar. 19, 1990) (alterations added).

123. *See* Colinvaux, *supra* note 60 (making the social club argument).

124. H.R. REP. 922, at 4 (noting the reason for the exemption was administrative ease). *But see* Colinvaux, *supra* note 60, at 532 (indicating that under general income tax principles contributions to a social club would not be income).

125. S. REP. NO. 91-522, at 71 (1969); *see also* Colinvaux, *supra* note 60, at 532.

126. *Id.*

127. Interestingly, the Service rejected this type of quasi-trust rationale in *Communist Party of U.S.A. v. Commissioner*, where the Government argued that a "membership fee" to a political party was taxable, and asserted that all political parties are taxable associations under the Code. 373 F.2d 682, 683 (1967).

enacted § 527 of the Code.[128] As enacted in 1975, § 527 provided for a new type of exempt organization, a political organization, and clarified that contributions to a political organization were not subject to tax and that its expenditures were not deductible from income.[129]

After the passage of § 527, the Service was still occasionally called upon to determine the tax liability of political organizations when those organizations did not qualify for tax-exempt status. This mainly occurred when the Service sought to revoke an organization's tax-exempt status. If the Service revoked an organization's exemption, then it needed to determine the tax consequences of that revocation. In those instances, it appears that the Service has taxed the investment income of the organization, but has not treated the contributions to the organization as income.[130]

B. Tax Theory—Is there any taxable income anyway?

IGs concerned about increased regulation of tax-exempt entities may seek an alternative organizational form to avoid these restrictions. In order to determine the benefits or consequences of forgoing tax-exempt status, one needs to examine what the tax consequences to an organization would be if it forewent tax-exempt status. In my view, if the current provisions in the Code were applied correctly, in most cases there would be significant financial ramifications to an IG that chooses to

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128. Upholstery Regulators Act, Pub. L. No. 93-625, § 10(a), 88 Stat. 2108, 2116 (codified as amended at I.R.C. § 527 (2002)).

129. I.R.C. §§ 527(a), (c) (1975); *see also* S. REP. NO. 93-1357 (1974).

130. *See* I.R.S. Gen. Couns. Mem. 39,813 at 2208 (finding the contributions were gifts); Christian Coalition Intern. v. United States, 133 F. Supp. 2d 437, 439 (E.D. Va. 2001) (involving tax dispute of $198; the amount clearly would be more if contributions were considered income); Democratic Leadership Council v. United States, No: 1:05-cv-1067 (JGP) (suing for refund of tax paid on investment income by the DLC in a suit contesting the Service's decision to revoke its tax-exempt status); Democratic Leadership Council, Inc. v. United States, No: 1:05-cv-01067 (JGP), Plaintiff's Statement of Material Facts ¶¶ 68-70 (indicating deficiencies in the amount of $3,839, $5,264, $5,510.24, and $6,985.82). The notice of deficiency in the *DLC* case also indicates that the Service did not include in taxable income contributions to the DLC, Notice of Deficiency, *on file with the author*. *See also supra* note 102.

organize as a taxable entity. There may, however, be creative ways that an IG can ameliorate some of these consequences.

In determining whether an IG organized as a taxable entity would incur significant tax liability there are two possible incidences of taxation. First, the IG receives contributions or payments from third parties. If these payments constitute income, the IG will have significant tax liability, and it will pay a hefty price for forgoing tax-exempt status.[131] Second, if the contributions to IGs are not considered income because they are gifts, then there is the possibility that those contributions will be subject to gift tax. If donors to a taxable IG are subject to gift tax of up to 45 percent on their contributions, IGs will have a difficult time raising funds from large donors.

1. Payments received by a taxable IG may be income for tax purposes

Gross income under § 61 of the Code is defined broadly as "income from whatever source derived."[132] Under this expansive definition, absent another provision of the Code, payments to a taxable IG would be income. There are several tax theories, however, including a conduit theory (which incorporates the pooling and quasi-trust rationale), a capital contribution theory, and a gift theory, that could potentially be used to argue that payments received by taxable IGs should not constitute income to the organizations.

a. Conduit theory

One of the theories that the Service presumably relied upon to exclude contributions from income prior to the passage of § 527 was a conduit theory. Under the conduit theory approach, the payments to IGs are not considered income because the organizations are merely acting as

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131. One argument is that the contributions to the IG would be income but that the expenses of the IG would be deductible business expenses of the organization. Section 162(e) of the Code prohibits entities from deducting from income amounts spent on political advocacy. Thus, if the contributions were considered income to the IG, the IG would have to pay tax on the contributions without a commensurate deduction for the IG's expenses (at least those expenses related to political advocacy).

132. I.R.C. § 61 (West 2006).

conduits for spending that a taxpayer could have made by herself. Although the Service never explained what the theory is, it is likely based on either a pooling or a trust rationale. These two rationales are often conflated by the courts, and in some instances both theories may apply. People may pool resources and the organization holding the money may have a trust obligation to the contributors. But it also appears that each theory may stand on its own. I consider them separately because they are supported by slightly different rationales.

Under the pooling theory, when individuals make post-tax payments to a political organization, the political organization is viewed merely as the collector of the individual payments.[133] As such, the payment would be no different than if the individuals themselves each made part of the payment for the specific political activity at issue. Clearly ten people could each pay for 1/10th the cost of a political advertisement without any entity (besides the television station) being involved or taxed. If an IG acted merely as the means of pooling money, then there would be no basis for taxing the entity.

Professor Gregg Polsky and Guy-Uriel E. Charles argue that the pooling theory should apply to contributions to political organizations.[134] They use the example of neighbors pooling money to build a fence in the neighborhood. They correctly conclude that the neighbors would not have to pay tax on the pooled funds.[135] They then argue that contributions to political organizations are similar to the fence building example and therefore should not be taxed.[136]

Proponents of the pooling theory also point to the Service's treatment of social clubs as a justification for not taxing political organizations.[137] Prior to the statutory exemption for social clubs, the

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133. Daniel L. Simmons, *An Essay on Federal Income Taxation and Campaign Finance Reform*, 54 FLA. L. REV. 1, 98 (2002) (arguing that these payments may not be gifts, but instead are purchases of services with value equal to contributions).

134. Polsky & Charles, *supra* note 7, at 1015-1016.

135. *Id.*

136. *Id.* My disagreement with Polsky and Charles is more in degree than theory. I agree that the the entity used to pool funds to build a fence would not be taxable. But IGs are very sophisticated organizations with significant entity-level activity. They are simply involved in too much independent activity to be seen as organizations that merely pool funds.

137. Colinvaux, *supra* note 60, at 532.

Service determined that it would not require social clubs to file returns.[138] The original basis for that determination appears to be administrative ease.[139] Later explanations justify the exemption based on a conduit theory.[140] The Joint Committee justified the exemption on the grounds that "the organization merely facilitates a joint activity of its members."[141] Congress, in considering further changes to the taxation of social clubs in 1969, indicated that "the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent this income in pleasure or recreation (or other benefits) without the intervening separate organization."[142]

Moreover, in a series of cases involving the pooling of funds for advertising expenses, the courts have held that pooled funds are not necessarily income to the entity that aggregates those funds. The specific rationale for not taxing those contributions was the trust theory discussed *infra*, but in those cases the courts recognized that the distributors were merely pooling funds to engage in advertising.[143] Central to the holdings in those cases was the fact that the contributors exercised significant involvement in the activities of the entity that received the pooled

138. H.R. REP. NO. 922, at 4 (1916).

139. *Id.*

140. Colinvaux, *supra* note 60, at 532; S. REP. NO. 91-552, at 71 (1969).

141. Historical Organization Development and Present Law of the Federal Tax Exemption for Charities and Other Tax Exempt Organizations, J. Comm. on Taxation, 109th Cong., JCX-29-05, 28 (2005).

142. S. REP. NO. 91-522, at 71 (1969).

143. *See e.g.*, Affiliated Foods, Inc. v. Comm'r of Internal Revenue, 154 F.3d 527, 532-33 (5th Cir. 1998); Florists' Transworld Delivery Ass'n v. Comm'r of Internal Revenue, 67 T.C. 333, 345-55 (1976); Ford Dealers Adver. Fund, Inc., Jacksonville Div. v. Comm'r of Internal Revenue, 55 T.C. 761, 771-72 (1971); Dri-Powr Distrib. Ass'n Trust v. Comm'r of Internal Revenue, 54 T.C. 460, 479 (1970); Angelus Funeral Home v. Comm'r of Internal Revenue, 47 T.C. 391, 396-97 (1967), *reh'g denied* 407 F.2d 210 (9th Cir. 1969); Broad. Measurement Bureau v. Comm'r of Internal Revenue, 16 T.C. 988, 1001 (1951); The Seven-Up Co. v. Comm'r of Internal Revenue, 14 T.C. 965, 978 (1950).

funds.[144] The Service, however, has not acquiesced in this treatment and rejects the pooling theory even in these cases.[145]

Thus we can see a model for the type of activity that might qualify as merely a pooling of money. These are activities taking the place of what individuals could do on their own if they joined together as a group. In the fence example used by Professors Polsky and Charles, the entity itself is just created to pool the money. The neighbors have decided upon the project, and the person or people who control the entity serve only an administrative function. In the joint advertising example above, the various distributors could have joined together and each written a check to the advertising company for a portion of the advertisement. The creation of an association to do so made it easier for the parties to pool their money. The organization itself had no real function but to act as a conduit for the contributors.

In the context of taxable IGs, however, the pooling theory does not work. Unlike neighbors joining together to build a fence, IGs are not merely pooling funds to complete a specific project in an agreed upon way. Similarly, IGs are not like social clubs. Social clubs are run for the benefit of the members, and the contribution is much more like an individual consumption decision. Presumably, the member gets the benefit of his dues in the form of benefits offered by the club. IGs do not have members and are not run for the benefit of their members. Nor are IGs similar to advertising associations where the contributors exercise significant control over how the money is spent.

Instead, IGs are independent groups that seek to influence elections through a wide range of activities. Donors do not have a voice in the organization. There is no board charged with making sure that activities are undertaken for the benefit of those who have contributed money. Donors lose control over their money as soon as they contribute it to the organization. In fact, political organizations often promote more than one issue or candidate. An individual may contribute money even though she only supports some of the organization's activities.

144. *Dri Power Distrib.*, 54 T.C. at 476-77.

145. Rev. Rul. 74-318, 1974-2 CB 13 (rejecting pooling theory and finding the contributions to the organization to be income and allowing for a deduction of the expenditures).

It may be that an IG could organize in a way that satisfies the pooling theory. A group of neighbors with a common goal could join together to run political commercials. But in the large majority of cases, IGs are not designed to be conduits for the pooling of resources, and instead are individual organizations with individual plans and goals. They seek contributors who agree with those goals, but they are not designed to be responsible to the contributors.[146]

The pooling theory may have been one of the factors that the Service originally considered in not subjecting political parties and candidates to tax. The weakness of that theory may also have been the reason Congress chose to codify the tax treatment of exempt political organizations under § 527.

Implicit in the pooling theory is the idea that the organization receiving the funds is not the true owner of the funds. They are pooled funds and each contributor is the true owner. It is unclear if this trust requirement is a component of the pooling theory or stands on its own as an independent justification. I have, however, analyzed it here as another theory supporting a conduit approach. The trust theory is similar to the pooling theory in that it claims the organization is not the true owner of the funds and is merely acting in the contributor's stead. It relies on the view that payments to an IG can be seen as contributions that the payor expects will be used in a certain manner on her behalf.[147] The payments would then be held in "trust" in a way that limits the organization's use of the funds.[148] In that context, the organization would be expending funds for the payor at her discretion so the payment would remain hers and would not constitute income to the political organization. Presumably, this is different from the pooling justification because the trust theory does not require a pooling of funds or any type of equal contribution. This is based less on the idea of a joint enterprise and more

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146. As the district court noted in *National Federation of Republican Assemblies (NFRA)*, political organizations are not required to give the money back to contributors upon dissolution. Nat'l Fed'n of Republican Assemblies v. United States, 148 F. Supp. 2d 1273, 1282 (S.D. Ala. 2001). *See also* Nat'l Fed'n of Republican Assemblies v. United States, 218 F. Supp. 2d 1300, 1308 n.7. (S.D. Ala. 2002).

147. *NFRA*, 148 F. Supp. At 1282.

148. *Id.*

on the idea that the person receiving the contribution has an obligation to spend the money in a specific way.

The trust justification has been applied in the for-profit context with regard to telethons and in the advertising context discussed *supra*. Thus, when a television studio receives contributions as part of a telethon and aggregates those contributions and passes them on to the charity, the contributions are not considered income to the television station because the station is acting in trust on behalf of the contributors.[149] Similarly, when a group of distributors joined together to create a joint advertising program, and money contributed but not spent in the joint program was returned to the participants, the courts have held that the entity is not taxable on the funds but instead holds them in trust for the contributor.[150] Interestingly, the mere determination that something is a trust does not really answer the question. Trusts may be taxed on income that is not distributed, and it is possible that expenditures on political advertising will not be considered a distribution by the trust.[151]

Just as with the pooling theory, the trust rationale fails as a justification for excluding contributions to an IG from the gross income. IGs are under no obligation to spend contributors' money in any specific fashion. They are not merely holding the money and passing it along to another party, and the money is not designated for a specific purpose. They are not acting as agents for contributors but instead are seeking contributions to support the missions of the organizations. Once given, it is the IG that has dominion and control over the funds, and it may spend them in any manner it sees fit, consistent with its organizational purpose.[152] The Service has concluded that conduit treatment is appropriate only when the organization is clearly functioning as an agent

149. I.R.S. Gen. Couns. Mem. 39,813 at 209 n.34 (Mar. 20, 1990).

150. *See supra* note 143.

151. I.R.C. §§ 665, 666 (West 2006).

152. Simmons, *supra* note 1333, at 98-99; Rev. Rul. 75-146, 1975-1 C.B. 23 (rejecting conduit treatment when contributions made to Congressman to fund intern program stating that "[t]o claim that one is merely a conduit while at the same time enjoying all of the fruits of the involved transaction is anomalous" (quoting Riverfront Groves, Inc. v. Comm'r of Internal Revenue, 60 T.C. 435, 445 (1973) (alteration added)).

for the donor and is not the true owner of the funds.[153] In most cases, however, IGs are engaged in too much activity to be seen as mere conduits for taxpayers' contributions.

b. Capital contribution theory

Another possible tax theory that would provide that contributions to an IG were not taxable income to the IG is that the payments are actually contributions of capital to the organization. Under existing law, contributions of capital are not usually included in the gross income of a taxable entity.[154] Thus if the payment to the IG is considered a capital contribution, the IG would not have taxable income on the payment when it is received.

There are three problems with the capital contribution theory. First, except in extraordinary circumstances that do not apply here, payments will not be considered contributions to capital unless the contributor receives some type of capital interest in the entity in return for the payment. Second, if the contributor does receive some type of interest, then that interest must be real, which may have tax implications for the contributor and may impact the way in which the IG is required to operate. Third, even if the theory works, the result is that the contributions are not considered income to the IG, but the contributions may still be considered gifts for gift tax purposes.

Determining whether the payment is a contribution to capital is difficult in the IG context because the law anticipates a payment to a for-profit corporation. We can, however, extrapolate from decisions dealing with for-profit businesses, and apply the for-profit model in this

153. The Service has examined the conduit theory in the context of a charitable organization that lost its exempt status and concluded that the conduit theory does not justify excluding contributions from gross income. The Service said that since public charities exercise considerable discretion and control of the contributed funds, they are not merely conduits for the payments. The Service concluded that charities exercise more than ministerial power over donated funds and that the donations, once made, are controlled by the charities, not the donor. The Service has concluded that the conduit theory is reserved for situations in which the organization is clearly an agent, and not the "true owner" of the funds. *See* I.R.S. Gen. Couns. Mem. 39,813 (Mar. 19, 1990).

154. I.R.C. § 118(a) (West 2006) (corporations); I.R.C. § 721(a) (2000) (partnerships).

context.[155] Generally, a payment will not be considered a contribution to capital unless the person making the payment receives some capital interest in the entity. There are some very exceptional instances, however, when something can be considered a capital contribution even if the contributor has not received an interest in the entity.

The Court has set out a five-part test for determining whether a payment by a nonshareholder is a contribution to capital.[156] In order for a payment by a nonshareholder to be considered a contribution to capital it must: (1) become a permanent part of the transferee's working capital structure; (2) not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee; (3) be bargained for; (4) result in benefit to the transferee in an amount commensurate with its value; and (5) the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.[157]

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155. *See* Brown Shoe Co. v. Comm'r of Internal Revenue, 339 U.S. 583, 588-89 (1950) (holding that payment by community groups to corporation as an inducement to locate or expand in their communities was a capital contribution); Edwards v. Cuba R.R. Co., 268 U.S. 628, 632 (1925) (holding that payment by the Cuban Government to a railroad to promote construction in Cuba was a contribution to capital). *But see* United States v. Chicago, Burlington & Quincy R.R. Co., 412 U.S. 401, 413 (1973) (holding that facilities constructed for public safety at government expense and giving to private company was a subsidy and not a contribution to capital); Detroit Edison Co. v. Comm'r of Internal Revenue, 319 U.S. 98, 102-03 (1943) (holding that payments by customers to a utility for the cost of building power lines was not a contribution to capital).

156. *Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. at 413. The Court first held that payments by nonshareholders could be contributions to capital in *Cuba R.R. Co.*, 268 U.S. 628 (1925). The test in *Chicago, Burlington & Quincy R.R. Co.* clarified the Court's holding in *Cuba R.R.* and applied a five-part test. It is questionable whether the Court was correct in *Cuba R.R.* in treating payments by communities to a corporation as contributions to capital. *See* Thomas L. Evans, *The Taxation of Nonshareholder Contributions to Capital: An Economic Analysis*, 45 VAND. L. REV. 1457, 1459 n.5 (1992). The Service's position is that in light of intervening case law, payments by communities to corporations are generally not contributions to capital. I.R.S. Gen. Couns. Mem. 37,354 (Dec. 21, 1977) (tracing history of nonshareholder contributions to capital.); *see also* I.R.S. Gen. Couns. Mem. 39,813 at 210-11 (Mar. 20 1990) (applying a five-part test and determining contributions were not contributions to capital).

157. *Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. at 413; *See also* 10 JACOB MERTENS, Jr., THE LAW OF FEDERAL INCOME TAXATION § 3829 (2007).

Under this test, payments made to IGs do not qualify as contributions to capital. The payments are not a permanent part of the organization's working capital structure. They are received by the organization and expended on political advocacy. They are not retained by the organization to enhance its capital structure. Moreover, the payments are, in some sense, compensation for services. As previously discussed, the IG performs a service for the person who makes the payment.[158] The IG engages in political advocacy. It is not much different than if the person had hired a political consultant to produce a political advertisement. The payment to the consultant would clearly be income to the consultant. In addition, the payments are not bargained for, and they do not contribute to the production of income for the organization.

The five-part test discussed above applies when a nonshareholder makes a contribution to capital. An IG, however, might be set up to allow contributors to pay money and receive some type of capital interest in exchange for their payment. If these capital interests had substance, then they would likely be recognized for tax purposes. If the contributions were recognized for tax purposes then the capital contributions would likely not be income to the IG.

Although it would be difficult for a contribution to an IG to be characterized as a contribution to capital of the IG, it is not impossible. The IG could provide shares, partnership interests, or membership interests to the contributors in exchange for the contributions. The contributor's interest could include an interest in the assets of the entity upon dissolution, a voting interest, or even an interest in the profits of the organization.[159]

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158. Simmons, *supra* note 133, at 98.

159. There are potential securities law implications depending on how the IG sets up its affairs. If contributors are passive and there is some type of profit interest in the membership interest, federal and state laws may deem the interests to be securities. If they are deemed to be securities, the interest will be subject to significant regulation. *See* Nutek Info. Sys. v. Arizona Corp. Comm'n, 977 P.2d 826 (Ariz. 1999) (finding an LLC membership interest to be a security); S.E.C. v. Parkersburg Wireless Ltd. Liab. Corp., 991 F.Supp. 6 (D.D.C. 1997) (finding an LLC membership interest to be a security); SEC v. Vision Commc'n Inc., No. 94-065, 1994 SEC LEXIS 1409, at *4-5 (D.D.C. May 11, 1994) (issuing a permanent injunction barring promoters from selling membership interests because those interests were subject to securities laws). *See also* THOMAS A. HUMPHREYS,

If the contributions to the IG were treated as contributions to capital, then the contributions would not be treated as taxable income to the IG. There are, however, serious drawbacks in providing a capital interest in exchange for the contribution. First, the IG must give up something of value. This might be some control of the organization by, for example, providing large contributors with voting rights, or it might be that contributors had some right to the assets of the entity upon dissolution. The creators of the IG might therefore have to relinquish some of their power and control of the IG.

Treating contributions to the IG as contributions to the IG's capital also might have serious implications for contributors. If the IG is organized as a partnership or an LLC, a contributor would be subject to tax on her share of the income generated by the IG. Moreover, the conclusion that a payment is contribution to capital only answers the question whether the contribution to the IG is income to the IG. The contributor may still be subject to gift tax on the contribution since the contributor may not have received money or money's worth for the contribution.[160]

LIMITED LIABILITY COMPANIES & LIMITED LIABILITY PARTNERSHIPS § 9.02 (Law Journal Press 2007) (1998) (thoroughly discussing various issues surrounding the treatment of membership interests as securities). This issue has been debated in academic circles and is outside the scope of this project, *see* Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage this Result,* 45 HASTING L.J. 1223, 1278-91 (1994) (arguing LLC membership interests should not be treated as securities); Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069, 1095-1102 (1992) (holding LLC membership interests should not be treated as securities); Marc I. Steinberg and Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105, 1119-22 (1992) (arguing that in many cases, LLC interests should be treated as securities). The decision whether to treat an LLC interest as a security usually turns on the passive nature of the member's investment and the potential profit from the investment. In this case, the IG could design the membership interest so it clearly was not an investment. Moreover, it could provide significant voting rights to the members and provide members with hiring and/or oversight authority to increase the likelihood that members would be considered active participants.

160. *See* I.R.C. § 2512(b) (West 2006) (valuation of gifts); Treas. Reg. § 25.2512-8 (2006) (the value of property transferred by donor which exceeds the value of money or money's worth given for the transfer is reached by the gift tax). Several courts and commentators, however, have argued that payments to political

c. Gift theory

While the conduit and contribution-to-capital theories do not, in most instances, provide sufficient reasons for excluding payments to a taxable IG, as discussed previously, neither theory appears to be the original basis for the Service's determination that payments to a political organization are not income. It appears from the history behind the Service's issuance of Revenue Rule 74-21 (indicating that contributions to a political organization would not be considered income) that the Service believed that contributions to political organizations were gifts and therefore were not considered income.[161]

There are two substantive tax issues here. The first is whether the contributions may be excluded from the IG's income as gifts, and the second is whether the contributors are subject to gift tax on the contributions. The standards used to determine a gift for income tax and gift tax purposes are not the same. A gift for income tax purposes is one that is given with detached and disinterested generosity, while the test for a gift for gift tax purposes is whether the payment was given for money or money's worth.[162] Thus, it is possible that a payment may be a gift for income tax purposes and not for gift tax purposes. However, a determination that a payment was made with detached and disinterested generosity makes it likely that a court will conclude that a payment was

organizations are not subject to gift tax because they are bona fide, arms-length transactions and free from donative intent. *See supra* note 72.

161. *See* Tax Treatment of Contributions of Appreciated Property to Committees of Political Parties, *supra* note 95 (indicating that it is a matter of history that the Service has never required political committees to file income tax returns because it believed that virtually all of the receipts were from gifts); Announcement 73-84, 1973-2 C.B. 461 (reversing previous position and requiring political parties to file returns and indicating that gross income will include interest and dividends but not contributions). *But see* Regan v. Taxation with Representation, 461 U.S. 540, 544 (1997) (indicating the Service based its decision on the conduit theory and not the gift theory).

162. Comm'r of Internal Revenue v. Duberstein, 363 U.S. 278, 285 (1960) (holding that gift for income tax purposes is a payment made with "detached and disinterested generosity"); I.R.C. § 2512(b) (2006) (gift when property transferred for less than adequate consideration in money or money's worth); Treas. Reg. § 25.2512-8 (2006) (gift when "value of property transferred by the donor exceeds the value in money or money's worth of the consideration given").

not made for money or money's worth. Thus while the determination that a payment is a gift would benefit the IG by excluding it from income, it also may make it more difficult for the IG to obtain contributions because contributors might fear the gift tax consequences of making large contributions.[163]

Section 102 of the Code provides that gifts are not included in the income of the recipient. Thus if contributions are gifts within the meaning of § 102, then contributions to an IG would not be included in income. In determining whether a payment should be included in income or whether it is a gift for income tax purposes the test is whether the payment was given with detached and disinterested generosity.[164] Moreover, in reaching this conclusion, courts will primarily look to the donor's intent in making the payment. The problem for the IG in making the argument that contributions are not included in income because they are gifts is that it increases the chances that the contributor would be subject to gift tax on the contribution.

Contributions to IGs appear to meet the classic definition of gift. They are given to the IG without the expectation of something in return and to further the general ideals and principles of the IG. Contributors do get some type of intangible benefit from their contributions or they would not make them, but in other circumstances the Service has consistently not considered these types of intangible benefits in determining whether a contribution was a gift and therefore deductible under § 170 of the Code. In the charitable context, a person makes a contribution to a charity because she believes in the mission of the charity and wants to support that mission. A cancer survivor can give to the American Cancer Society even though the contribution may not be completely detached, and a parishioner can make a contribution to a church even if she receives some religious enlightenment from the religious institution.[165]

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163. The Code provides that the first $12,000 given to a person or entity is not subject to gift tax. I.R.C. § 2503(b) (West 2006).

164. *Duberstein*, 363 U.S. at 285 (1960).

165. The Service has reached the same conclusion in a similar hypothetical situation. *See* I.R.S. Priv. Ltr. Rul. 6812121000A (Dec. 12, 1968) ("To illustrate, when an exempt organization like the Cancer Fund receives a voluntary contribution . . . the Service would not argue that this contribution was anything but a voluntary payment of something for nothing . . . .").

Moreover, charities routinely honor donors by naming institutions, buildings, or programs after the donors. The intangible benefits to donors and their families have not been sufficient to defeat gift treatment.[166] Thus, the mere fact that one makes a contribution to an IG does not necessarily mean that he did so without detached and disinterested generosity. The contributor hopes to promote the organization's goals, but that is really no different than the motivation for most gifts to charities. In fact, the Service recognized that general support for the goals of an organization will not exclude gift treatment.[167]

There is, however, support for the contrary notion that contributions to political organizations are not gifts because the payor to a political organization receives a benefit in exchange for the payment. This conclusion is supported by cases rejecting the Service's position that payments to political organizations are gifts subject to the gift tax.[168] In *Stern v. United States*,[169] Mrs. Stern, a wealthy investor, believed that

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166. Generally the "detached and disinterested test used to determine whether something is a gift under § 102 is the same standard used for determining whether something is a deductible gift under § 170. To be deductible under § 170, a gift must also be to a qualifying organization." De Jong v. Comm'r of Internal Revenue, 309 F.2d 373, 377 (9th Cir. 1962) (using § 102 standard to determine whether a deduction was proper under § 170). *See also* I.R.S. Priv. Ltr. Rul. 6812121000A (Dec. 12, 1968) (finding contributions to § 501(c)(3)s made during period that exempt status was revoked were not income to the (c)(3) because such a contribution was a gift).

167. *See* I.R.S. Priv. Ltr. Rul. 6812121000A (Dec. 12, 1968). Charities routinely provide naming right in exchange for contributions and these naming rights have not been held to defeat gift treatment. *See* Rev. Rul. 68-432, 1968-2 C.B. 104, 107 (1968) ("Such privileges as being associated with or being known as a benefactor of the organization are not significant return benefits that have a monetary value."); Treas. Reg. 53.4941(d)-2(f)(2) (naming rights only an incidental or tenuous benefit for purposes of determining self-dealing in the private foundation context).

168. Stern v. United States, 436 F.2d 1327, 1330 (5th Cir. 1971); *see also* Carson v. Comm'r of Internal Revenue, 641 F.2d 864, 866 (10th Cir. 1981) (payment was for donor's own economic advantage and campaign contributions are not gifts within the meaning of the gift tax law); Jeffrey Schoenblum, *The Changing Meaning of "Gift": An Analysis of the Tax Court's Decision in Carson v. Commissioner*, 32 VAND. L. REV. 641, 653-54 (1979) (political contributions should not be treated as gifts arguing that taxation of political contribution is unrelated to the purpose of the gift tax).

169. 436 F.2d 1327 (5th Cir. 1971).

political corruption in Louisiana was hurting Louisiana's business reputation. She made large political expenditures and pooled her money with that of other like-minded individuals. The Service argued that the contributions were gifts subject to gift tax. The court found that the political expenditures were made in the ordinary course of business, were designed to protect her business interests, and were free of donative intent.[170] Specifically, the court found

> [t]he contributions were motivated by [Stern's] desire to promote a slate of candidates that would protect and advance her personal and property interests . . . . In a very real sense, then, Mrs. Stern was making an economic investment that she believed would have a direct and favorable effect upon her property holdings and business interests . . . .[171]

While this holding relieved Mrs. Stern of gift tax liability, it may have subjected the receiving organization to income tax. If the payment was made in the ordinary course of business without donative intent then the payment should be considered income to the association since it was not made with detached and disinterested generosity.

Under *Stern* those payments to IGs that were made in the ordinary course of business or for financial reasons would not be considered gifts and would be income to the IGs. The problem with applying the *Stern* logic broadly to payments to political organizations is that Stern's success turned on the specific facts of her case. It is not clear that most contributors to IGs are doing so in the ordinary course of business with the hope of receiving a financial benefit.

Moreover, outside the political candidate context, the Service has generally opposed gift treatment for contributions in analogous situations, and the Service has, at times, taken a very strict reading of the detached and disinterested generosity test. For example, in a case involving contributions to defray officeholders' costs in conducting official activities, the Service ruled that contributions were not made with detached and disinterested generosity.[172] The Service concluded

170. *Id.* at 1329.
171. *Id.* at 1330 (alterations added).
172. I.R.S. Gen. Couns. Mem. 35664 (Feb. 8, 1974).

that because the contributions made the officeholder more effective and better able to serve his constituents, contributions from constituents were not made with detached and disinterested generosity.[173] The Service reached a similar conclusion with regard to contributions made to support a Congressional intern program[174] and office travel of a member of Congress and his staff.[175]

Although the Service initially took a hard line in this area, its positions regarding the intern program and member travel were not litigated. It is doubtful, based on the Service's position with regard to intangible benefits not defeating gift treatment under § 170 that the Service's prior positions would hold up in court. In fact, there is evidence that the Service would not treat such tenuous connections as defeating the detached and disinterested generosity standard.[176]

Therefore it is very possible that contributions to a taxable IG would be gifts and not income to the IG. This would resolve most of the IG's tax problems and would be far simpler than trying to cast the contributions as contributions to capital. A determination that the

173. *Id.*

174. Rev. Rul. 75-146, 1975-1 C.B. 23 ("[D]onors contribute to the intern fund with the intention of obtaining a more efficient public servant by supporting the intern program. Therefore, the contributions are not made with an incentive of detached and disinterested generosity and do not qualify as gifts . . . ." (alteration added)).

175. Rev. Rul. 76-276, 1976-2 C.B. 14 ("In this case, the contributions enable the Member of Congress to become more accessible to constituents which, in turn, provides constituents with the opportunity of obtaining more effective representation in Congress.").

176. I.R.S. Gen. Couns. Mem. 39,813 (March 20, 1990); I.R.S. Priv. Ltr. Rul. 6812121000A (Dec. 12, 1968) (A transferor's general intent that the organization's objectives be furthered is not inconsistent with "the spirit of 'detached and disinterested generosity. . . .' If it were true that the presence of a motive to accomplish certain general objectives would rule out a finding of gift, then taxpayers could never claim a deduction under section 170 . . ., since taxpayers when making contributions, invariably seek to accomplish some objective . . . ."). In addition, when the Service revokes an organization's tax-exempt status, the Service does not appear to treat contributions to the taxable entity as income to the organization. *See supra* note 130 discussing *DLC* and *Christian Coalition.*

contributions are gifts for income tax purposes, however, increases the likelihood that they will be taxed as gifts under the gift tax.[177]

2. Gift tax

Gift tax is owed on gift transfers that are in excess of $12,000 annually.[178] The standard for determining whether a contribution is a gift for gift tax purposes is whether the transfer was made for "money or money's worth."[179] The main justification for treating payments to IGs as gifts for income tax purposes is that they are made with detached and disinterested generosity, and the payor receives no tangible benefit in return for the payment. If the payments are treated as gifts for income tax purposes based on that reasoning, it would also appear that the payor did not receive money or money's worth for the contribution.[180]

The Service has consistently taken the position that payments to IGs are subject to gift tax unless there is a specific statutory provision to the contrary.[181] The government's theory presumably is that the

177. Because there are different standards for gifts under each provision, however, there is a slight chance that the contributions could be considered gifts for income tax purposes and not gifts for gift tax purposes.

178. *See* I.R.C. § 2503(b) (West 2006) (statute exempts $10,000 for gift tax and then adjusts that amount for inflation); Treas. Reg. § 25.2512-8 (as amended in 1992) (gift when "value of property transferred [by the donor] exceeds the value in money or money's worth of the consideration given" (alteration added)). Under current law, taxpayers are entitled to a $1,000,000 gift tax credit. Thus a person can give up to $1,000,000 during his lifetime without having to pay gift tax. I.R.C. § 2505 (West 2006). A taxpayer, however, must file a tax return with the Service indicating that the gift should not be taxed. The gift amount is then subtracted from the amount of credit available for a taxpayer's estate. The law in this area, however, is in flux as the estate tax is repealed in 2010 and reinstated in 2011. *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901(b) 115 Stat. 38, 150 (2001) (codified as amended in scattered sections of 26 U.S.C.).

179. *See* I.R.C. § 2512(b) (West 2006); Treas. Reg. 25.2512-8 (as amended in 1992).

180. I.R.C. § 2512(b) (West 2006).

181. *See* Rev. Rul. 59-57, 1959-1 C.B. 626 (contribution made to a political party or candidate is subject to gift tax); I.R.S. Tech. Info. Rel. 1125 (Dec. 17, 1971) (noting that the Service would only follow *Stern* in the Fifth Circuit and that "[i]t is the view of the Service that political campaign contributions are taxable gifts irrespective of the subjective intent of the taxpayer." (alteration added)); Rev. Rul. 72-355, 1972-2 C.B. 532 ("Since the enactment of the present gift tax in 1932, it has

contributions were made without the donors' receiving anything of value in return for the contribution.[182] This conclusion makes sense if the payment is treated as a gift for income tax purposes. It is, however, hard to reconcile the Service's position in the gift tax context with its position in the income tax context. In the gift tax context the Service argues that the payment is a gift because it is not made for "money or money's worth." It argues that the "donor's own social, political or charitable goals" are insufficient to provide the necessary "money's worth" for the exchange.[183] In the income tax context, however, the Service argues that these "goals" are sufficient to defeat gift treatment and even tenuous benefits like the fact that a member of Congress may be more efficient and better able to serve his constituents will prevent gift treatment. In my view, in these instances the tests in both the income and gift tax context turn on the same basic facts, and a payment should either be a gift for both income and estate tax purposes or for neither.

Some practitioners have successfully argued that contributions to political and social welfare organizations are not gifts, and Barbara Rhomberg has written a thorough analysis of potential gift tax consequences for contributions to social welfare organizations.[184] These arguments, however, are generally premised on the fact that the contributions are arms-length transactions without donative intent. Clearly a donor that lacked donative intent for gift tax purposes would

been the position of the Internal Revenue Service that contributions to a political campaign are taxable transfers for purposes of the gift tax . . . ."); Announcement 73-84, 1973-2 C.B. 461; Rev. Rul. 82-216, 1982-2 C.B. 220 ("The Service continues to maintain 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.").

182. *See e.g.*, Faulkner v. Comm'r, 41 B.T.A. 875 (1940) (contribution to women's health organization subject to gift tax), *rev'd on other grounds*, 112 F.2d 987 (1st Cir. 1940) (finding organization a charitable organization so payments to it were not subject to gift tax); DuPont v. U.S., 97 F. Supp. 944 (D. Del 1951) (finding contribution to the "national economic council" subject to gift tax even though plaintiff believed that he would benefit from the improved economic policies promoted by the council); Blaine v. Comm'r, 22 T.C. 1195 (1954) (contributions to social welfare organization were subject to gift tax).

183. Rev. Rul. 82-216, 1982-2 C.B. 220.

184. *See supra* note 72.

also lack donative intent for income tax purposes. In other words, the main argument necessary to avoid gift tax treatment also prevents the donation from being a gift for income tax purposes.

The basic argument is that for determining whether something was given for "money or money's worth" the Treasury Regulations provide that a transfer of property "made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."[185] The purpose of this regulation appears to be that the Service will not look behind regular business-type transactions to determine whether there was a fair deal. Practitioners have argued, however, that "a transaction which is bona fide, at arm's length, and free from any donative intent" in the Treasury Regulation applies even outside of the business context and defines what will be considered ordinary course of business.[186] They claim that the parenthetical "(a transaction that is bona fide, at arm's length, and free from any donative intent)" after the words "course of business" in the regulation defines what course of business must mean.[187] Thus, they argue that if they can show that a transaction is bona fide, at arm's length, and free from any donative intent they do not need to show that it was in the ordinary course of business.[188]

This argument stretches the basic purposes of the ordinary course of business exception to the gift tax rules pretty far. The point of the regulations is that if something is given without receiving fair value in exchange it should be a gift for gift tax purposes. In most cases, a bona fide, arm's length transaction, free of donative intent will solve that problem.[189] But inherent in the test are two important assumptions: (1) that there is a transaction and that something is being exchanged for

185. Treas. Reg. § 25.2512-8 (as amended in 1992).

186. *See supra* note 72.

187. Rhomberg, *supra* note 72.

188. *Id.*

189. Rhomberg points out that the Service has applied the standard outside the business context to property transferred in a divorce. *Id.* at 70. The divorce situation is still similar to a business transaction. The parties are bargaining, and we have some confidence that the bargain will produce an even exchange. There is no similar type of bargaining when someone makes a contribution to a political organization.

something else based on some market valuation, and (2) that the transaction is *free* of donative intent. Here, contributions to IGs are not bargained-for exchanges where arm's-length bargaining provides a basis for respecting the transaction. Thus, even if the commentators are correct, and the test does apply outside the business context when there is no market-type exchange, it is still hard to argue that contributions to IGs are *free* of donative intent.[190] Instead, they are contributions to an organization because someone supports the goals of the organization. Moreover, if in fact the commentators are correct and these *are* transactions then there is no basis to exclude those transactions from a taxable IG's income.[191]

The better rule is to treat these contributions as what they are—gifts. They are given to an organization to support its mission and not for pecuniary benefit. The intangible benefits that someone receives in exchange for his contribution are simply too tenuous to defeat gift treatment for either income tax or gift tax purposes. Moreover, a determination that these intangible benefits might be sufficient would be administratively untenable as each case would have to be considered on its own facts.

This view of normative tax rules, however, provides some possibilities for IGs organizing as taxable organizations. An IG that relies on contributions under $12,000 could successfully argue that the contributions it received were gifts, without contributors to the organization having to pay gift tax since gifts of $12,000 and below are not subject to gift tax. Thus, for a small group of IGs the gift strategy may work. Interestingly, the $12,000 gift tax limit would act as a type of contribution limitation since contributors would not likely be interested in paying gift tax on the amount over $12,000.

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190. *Carson* was grounded on different reasoning. *Carson* merely stated that campaign contributions, when considered in light of the purposes behind the gift tax, are simply not gifts. 641 F.2d 864, 866 (5th Cir. 1981). This argument would not be applicable in the context of taxable organizations.

191. This is not a problem when the organization is tax-exempt because it would not be taxed on the contribution in any event. It does, however, pose serious problems if the organization is not tax-exempt.

IV. TAXABLE INTEREST GROUPS

If Congress further regulates tax-exempt organizations, IGs will increasingly examine whether the benefits of tax-exempt status are worth the costs. As these groups explore the use of taxable entities, my view is that these groups will ultimately turn to taxable limited-liability companies (LLCs) or to taxable corporations. The attractiveness of taxable corporations will depend upon whether the Congress reacts to the recent decision by the Court in *WRTL* and places further regulations on corporations, and to what degree IGs are trying to avoid the corporate restrictions that currently exist. LLCs, however, have the potential to allow an organization to meet all four criteria (limited tax liability, limited liability, anonymity, limited regulation of speech) set out in Part II. This part examines how the normative tax rules discussed in Parts II and III would play out in the context of a taxable LLC and concludes that in most cases there will be significant financial consequences if an IG organizes as a taxable organization.

Limited liability companies can elect to be taxed as partnerships.[192] If they chose to do so, FEC regulations provide that the organizations' choice for tax purposes will also control their treatment under federal election laws.[193] Thus, if an LLC chooses to be taxed as a partnership, the election law regulations restricting the political activities of corporations will not apply.

This section takes a brief look at how one could form a taxable LLC that would engage in political advocacy.[194] First, as discussed earlier, taxable IGs would still be subject to general campaign-finance regulation. Thus, if a taxable IG engaged in express advocacy or electioneering communication, the IG would be subject to regulation. Moreover, since the Service asserts that 527 status is not elective, but applies to any organization that has as its primary purpose influencing the election of a candidate for public office, even a taxable IG must be

192. Treas. Reg. § 301.7701-3(a) (as amended in 2006).

193. 1 C.F.R. § 110.1(g) (2007).

194. The normative tax rules would be applied in a similar way if the IG decided to organize as a corporation. In that case, the corporation, not the shareholders, would be responsible for any tax liability generated by the organization.

careful to ensure that it is not primarily engaged in activities designed to influence the election of one or more candidates.[195]

The first question an entity needs to address is whether an entity can organize as an LLC even if it lacks a profit motive. Generally, partnerships, LLCs, and corporations are thought of as profit-making entities, and partnerships are usually thought of as joint enterprises entered into to make a profit.[196] These entities can be formed, however, without a profit motive.[197] A taxable LLC would, therefore, be a potential vehicle for IGs seeking to create an entity that would not be subject to either the tax regulations surrounding tax-exempt organizations or the FEC regulations limiting the activities of corporations.

The next question a taxable LLC must confront is the potential income tax implications to the LLC. Assuming that two basic principles of tax theory were applied—that payments in exchange for membership interests are treated as contributions to capital and that contributions to the LLC would be treated as gifts for income tax purposes—the following scenario might work for an IG organized as a LLC.

A taxable LLC would be most advantageous when an IG was being formed with several large donors and then expected to raise funds from the populace at amounts mainly under the gift tax limit of $12,000 or when the IG anticipated that most of its contributions would be under the gift tax limit. The large contributors could receive membership interests in the LLC in return for their contributions. This would likely mean that the contributions would be treated as contributions to the capital of the LLC. These large contributors could receive voting interests in the affairs of the LLC and could also receive capital interests in the LLC upon liquidation.[198] Thus, major contributions to the LLC

195. Since the disclosure provisions in § 527 are premised on the fact that the tax-exempt organization is receiving a benefit from tax-exempt status, it is unclear whether § 527's disclosure provisions would be constitutional as applied to a taxable entity.

196. *See* I.R.C. §§ 761, 7701 (West 2006).

197. For example, California law provides for the creation of non-profit LLCs. Cal. Corp. Code § 17002 (West 2004).

198. The LLC would need to make sure that its memberships were not considered securities under securities law. If the capital interest in the LLC made the membership interest subject to security laws, then the LLC would likely not want

would not be taxable to the IG because they could be treated as contributions to capital.

There might, however, be consequences to the members of the LLC. Since LLCs are treated as partnerships for tax purposes, the members would have tax liability if the LLC had any income in a particular year. They also could find themselves liable for debts of the LLC if someone successfully pierced the corporate veil. Moreover, even if a contribution is deemed a contribution to capital for income tax purposes, the contribution may still be considered a gift for gift tax purposes. The argument would be that although the contribution was a contribution to capital and thus not income to the IG, the contributor still did not receive money or money's worth for the payment. The IG would have to successfully argue under Treasury Regulation 25.2512-8 that the payment should be considered as for money's worth because it was a bona fide transaction, made at arm's length, and free of donative intent.[199] Although, as I discuss in Part III(B)(2), it may be difficult for the IG to argue that the donor received money or money's worth for a payment, the argument is strengthened when the donor receives a membership interest in or from the LLC. Under those circumstances, it is easier for the donor to claim that he received money's worth for the payment. In this context, the donor at least received something of value and there may be an element of bargained-for exchange. Moreover, since the IG is relying on the capital contribution theory and not the gift theory as a means of excluding the contributions from income, the parties may be able to meet the requirement in the Treasury Regulation that the payment be at arm's length and free of donative intent. Assuming the contributions to capital to the IG were not gifts subject to gift tax, the IG could then receive large contributions with few tax ramifications. The large contributions would not be income as contributions to capital, and they would not be gifts because they would be deemed for money or money's worth.

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to provide for a capital interest. Moreover, it is possible that the major contributors would be active participants and then their membership interests would not be considered securities.

199. *See infra* Part III(B)(2) (discussing the argument that contributions to an IG may not be subject to gift tax).

The IG could then seek smaller contributions from individuals under a gift theory. The IG would make it clear that it was only taking those contributions if the donor believed that they were gifts to the organization. The organization could make it clear that donations needed to be made with detached and disinterested generosity and that the contributor expected nothing in return from the donation. Although that fact would not be definitive, it would indicate that the donor's intent under *Duberstein* was for the contribution to be treated as a gift.

The only problem for the LLC would be for payments above $12,000 that were not substantial enough for the LLC to issue membership shares in exchange for the payments. In order for the structure here to work the IG would have three choices: (1) the contribution would have to be a gift and the donor would have to be willing to pay gift tax or deduct the amount from his lifetime gift credit; (2) they could issue membership interests at amounts just over $12,000 (assuming capital contributions were not subject to gift tax); or (3) they could refuse donations over $12,000 but below some amount that entitled someone to a membership interest.

The above structure would allow an IG to operate as a taxable organization and still have very little, if any, tax liability. This structure would only work if the contributions to capital were not treated as gifts for gift tax purposes.

The second concern for IGs is that they have limited liability. Although the law in the LLC context is not as settled as the law in the corporate contexts, LLCs provide for limited liability.[200] The members of an LLC are not personally liable for the debts of the LLC. Thus if the IG were sued for defamation, the individual members would not be liable for any damages. They would, however, be subject to suit in their personal capacity if they personally committed a tort.

The third concern facing many IGs is that they would prefer that their contributors remain anonymous. Assuming the LLC operates its affairs in a way that avoids regulation under the securities laws and

200. HUMPHREYS, *supra* note 1599, at § 2.02[2]d.

avoids status as a political organization under § 527, a taxable LLC would have no disclosure obligations.[201]

Finally, the LLC would allow the IG to engage in communication to the fullest extent. The LLC could be organized in such a way as to avoid being treated as a corporation for purposes of federal election law. An LLC has a choice of being treated as a partnership or a corporation for tax purposes.[202] FEC regulations provide that it will treat an LLC in the manner consistent with its tax status.[203] So if an LLC chooses to be taxed as a partnership, then the restrictions placed on corporate communication will not apply to the LLC. Thus, an LLC has the benefit of providing the IG with limited liability without the consequences of the communication restrictions that are placed on corporations.

CONCLUSION

As IGs seek out alternative organizational arrangements to engage in political advocacy, the costs and benefits of forgoing tax-exempt status and organizing as a taxable entity become paramount. Some argue that tax-exempt status does not provide significant benefits to IGs and that IGs would have little or no tax liability if they were organized as taxable entities.[204] My analysis here, however, produces a different result. If normative tax principles are applied in a neutral fashion, contributions to IGs will be treated as gifts. Thus the IG will have no taxable income as a result of the contribution. Contributions to the IG, however, will also be treated as gifts for purposes of the gift tax. Thus, contributors to IGs who contribute more than $12,000 will bear a significant additional financial obligation due to the donation. These

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201. As previously discussed, if the LLC engaged in electioneering communication or express advocacy, it would be subject to regulation under FECA and would be subject to some disclosure obligations.

202. Since LLCs can choose to be taxed as partnerships, the LLC can avoid being regulated as a corporation under election law by choosing to be taxed as a partnership under the tax laws. Treas. Reg. § 301.7701-3(a) (as amended in 2006).

203. FEC regulations provide that the organization's tax status will control its status for election law purposes. 11 C.F.R. § 110.1(g) (2007).

204. *See supra* note 60.

additional costs will be passed on to the IGs and the IGs will bear the financial ramification from the applicability of the gift tax.

There is the possibility as I discuss in Part IV that an LLC can organize its affairs in a manner as to avoid significant tax liability. This would require courts to accept a very favorable view of what constitutes a gift for gift tax purposes, and, in the short term, would be very risky. IGs can avoid this problem by accepting gifts only under the gift tax limit (now $12,000), but this will hamper the IG's ability to raise funds. Thus, the costs of forgoing tax-exempt status and choosing to organize as a taxable LLC are high and are likely greater than the benefits.

Some may argue that this result makes no sense. IGs are not generating a profit, and they have no income in the traditional sense. I agree that the application of normative tax principles is not producing a result that is consistent with good tax policy. Congress, however, recognized this fact and created tax-exempt organizations from which IGs can engage in political advocacy. In exchange for this preferential treatment (or, one might say, correct treatment), Congress has put certain regulatory requirements on tax-exempt organizations. If those organizations seek out other organizational forms to achieve their ends, then they should not complain when those forms create tax consequences.

This article also highlights the problem with entity-based campaign finance regulation. As Congress tries to regulate groups based on the status of the entity, instead of the speech it engages in, IGs will have greater incentives to seek out alternative entity structures. When Congress is trying to protect the fisc and taxpayer subsidies, it makes sense to engage in entity-based regulation, but when Congress is trying to regulate speech, entity-based regulation merely encourages organizations to seek out an alternative entity for their speech.

This article suggests that there would be significant consequences to an IG that decided to forgo tax-exempt status, but it also indicates that creative IGs can seek out different ways of organizing their affairs to avoid entity based congressional regulation. Congress would do better to regulate political advocacy by addressing the activities of the IGs and not their entity status.