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A Tax Lawyer's Perspective on Section 527 Organizations

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Never before has a section of the Internal Revenue Code (Code) featured so prominently in the discussion of campaign finance regulation. And for the first twenty years after it was enacted in 1975, section 527 was considered obscure and uncontroversial. But now this tax provision is front and center in the debate on how, if at all, independent political organizations ought to be regulated.

The goal of this essay is to describe what section 527 does and does not do by placing the provision in its tax context. This essay does not take a position on whether independent political organizations can be regulated as political committees by the Federal Election Commission under the Constitution and, if so, whether such regulation would be normatively wise. Instead, it makes the more modest claim that such regulation should not be based on the tax law's definition of political organization found in section 527.

Section 527 controls the tax treatment of "political organizations." Reformers take the position that once an organization notifies the IRS that it is a political organization subject to section 527, the organization admits that partisan electioneering is its primary purpose.[1] Because of this self-identified primary purpose, the argument goes, these organizations are constitutionally susceptible to strict campaign finance regulation, such as contribution limitations. Furthermore, reformers submit, organizations choose to notify the IRS that they are political organizations in order to receive substantial tax benefits. As Senator Levin has put it, why should an organization be able to "say one thing to the IRS to get the tax exemption and say the opposite to the Federal

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* Associate Professor of Law, University of Minnesota Law School. I thank Ellen Aprill, Guy-Uriel Charles, Brian Galle, Brant Hellwig, Lloyd Mayer, and Donald Tobin for helpful comments and suggestions on an earlier draft.

[1] *See, e.g.*, *527 Reform Act of 2005: Hearing to Examine and Discuss S. 271, a Bill Which Reforms the Regulatory and Reporting Structure of Organizations Registered Under Section 527 of the Internal Revenue Code Before the Sen. Comm. on Rules & Admin.*, 109th Cong. (2005) [hereinafter *527 Hearing*] (statement of Sen. John McCain), *available at* http://rules.senate.gov/hearings/2005/McCainTestimony.pdf. Technically, organizations described in section 527 include non-independent organizations, such as the Democratic and Republican parties. In this paper, when I refer to section 527 organizations, I am referring only to *independent* 527 organizations.

Election Commission to avoid having to register as a political committee?"[2] For these reasons, reformers believe that current legislative proposals that would require self-identified 527 organizations to register as political committees with the Federal Election Commission would survive constitutional scrutiny.

These arguments have superficial appeal. After all, section 527 by its explicit terms governs only organizations whose primary purpose is to influence elections.[3] The tax law's identification of these groups appears to provide an efficient and fair mechanism to distinguish between election-oriented groups and issue-focused (ideological) ones.[4] However, the reformers' arguments are premised on fundamental misunderstandings about the scope and purpose of this provision of the tax code. The arguments assume that political organization status under the tax law code is elective and that such status results in substantial tax benefits for the organization. More importantly, the arguments presuppose that the IRS's line-drawing between ideological and campaign-focused activity is appropriate for use in regulating campaign finance, even though the purpose of the tax law is far removed from the purpose of campaign finance law and even though campaign finance law is generally subject to more stringent constitutional scrutiny than the tax law.

Once section 527 is placed in proper context, it becomes clear that the tax law is not a very good mechanism for differentiating between election-focused and ideological groups. Because of its unique policies and idiosyncrasies, the tax law has an exceptionally broad definition of "political organization," one that has the potential to capture ideological as well as partisan organizations. Furthermore, section 527 should not be understood to convey any real tax benefits to organizations that self-identify. Accordingly, the reformers' mission to use section 527 as a campaign finance instrument is misguided.

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[2] 146 CONG. REC. S6041, 6044 (daily ed. June 29, 2000) (statement of Sen. Levin).

[3] *See* I.R.C. § 527(a) (subjecting each "political organization" to its scheme of taxation); § 527(e)(1) (defining "political organization" as one "organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function"); § 527(e)(2) (defining exempt function as "the function of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed."). The proposed 527 legislation would carve out from its scope current 527 organizations that were organized exclusively to influence the election of state or local public office, the selection of office in a political organization, or the nomination and appointment of federal judges. *See* S. 2511, 109th Cong. § 2 (2006).

[4] Using section 527 for election law purposes appears to be efficient because it would not require a separate test for teasing out political organizations and appears to be fair because groups that self-identify under section 527 allegedly receive substantial tax benefits for doing so.

I. TAX TREATMENT OF ELECTIONEERING EXPENDITURES

A. *After-Tax Money Principle*

Before addressing the particularities of section 527, it is necessary to understand first how the tax law treats electioneering expenditures. In a variety of ways, the federal income tax laws ensure that funds used for electioneering consist exclusively of dollars that have already been taxed (after-tax money).[5] In this regard, electioneering expenditures are taxed in the same way as funds spent on ordinary consumption items, such as food, drink, and entertainment. The tax laws contain interconnected rules to ensure this result. First and foremost, the code denies individuals and businesses any deduction for campaign contributions and similar expenditures.[6] Denying this deduction ensures that campaign contributions are comprised of after-tax money.[7]

Second, the code contains a special rule applicable to charities to prevent circumvention of this non-deductible treatment. Charities, such as the United Way, are absolutely barred from engaging in any level of electioneering.[8] Because charities are uniquely able to receive tax-deductible contributions,[9] without the prohibition on electioneering donors could effectively deduct their campaign contributions by giving tax-deductible contributions to charities, which could then use the donations to support their donors' favored candidates.

Third, the code includes a different anti-circumvention rule applicable to tax-exempt organizations (other than charities). Tax-exempt organizations, like 501(c)(4) social welfare groups such as the AARP, cannot receive tax-deductible contributions but are able to generate tax-exempt investment income.[10] Unlike charities, these

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[5] *See Disclosure of Political Activities of Tax-Exempt Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 106th Cong. (2000) [hereinafter *2000 Campaign Finance Hearings*] (statement of Joseph M. Mikrut, Tax Legislative Counsel, U.S. Dep't of the Treasury ("The current-law tax rules provide appropriate and consistent treatment of political organizations and other organizations that engage in electioneering activities by generally ensuring that only after-tax dollars are used to fund such collective activities.")).

[6] *See* I.R.C. § 162(e)(1)(B)-(C).

[7] For example, assume that an individual is subject to a 50% marginal tax rate. In order to contribute $100 to a campaign, she would have to earn $200, leaving her with $100 of dollars after tax to make the contribution. The other $100 of the $200 pre-tax earnings would go to the IRS. If campaign contributions were deductible, she could contribute all $200 of her pre-tax earnings to the IRS because the $200 campaign contribution deduction would offset the $200 of pre-tax earnings, resulting in no tax liability with respect to the earnings.

[8] *See* I.R.C. § 501(c)(3) (barring charities from "participat[ing] in, or interven[ing] in . . . any political campaign on behalf of (or in opposition to) any candidate for public office").

[9] *See* I.R.C. § 170(a) (allowing a deduction for contributions to charitable organizations described in I.R.C. § 501(c)(3)).

[10] *See* I.R.C. § 501(a) (exempting organizations described in I.R.C. § 501(c) from income tax). While contributions to 501(c)(3) organizations are deductible under I.R.C. § 170(a), no

organizations are not barred from electioneering. Accordingly, without a special rule, 501(c)(4) organizations could use their untaxed investment yield to support a candidate, thus circumventing the principle that only after-tax dollars be used for this purpose. Section 527(f) closes this loophole by imposing a special tax on tax-exempt organizations that engage in electioneering.[11]

Finally, the tax code includes section 527, which covers organizations whose primary purpose is to electioneer. Donors to a 527 organization cannot deduct their contributions and all of the 527 organization's investment income is subject to tax at the highest marginal rate applicable to corporations.[12] As a result, all of a 527 organization's electioneering expenditures are funded with after-tax dollars. Together, these rules operate to ensure that electioneering expenditures are made only with after-tax dollars, regardless of whether they are made by individuals, businesses, charities, tax-exempt organizations, or 527 organizations.[13]

B. *Policy Justification for the After-Tax Money Principle*

If electioneering could be funded with pre-tax dollars, it would raise serious concerns. To understand why, consider the results if Congress were to decide to subsidize campaign contributions by making them tax-deductible. If a taxpayer subject to a 35% marginal tax rate makes a $1,000 deductible campaign contribution, the after-tax cost to her is only $650.[14] The government pays the other $350 in the form of

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deduction is allowed for contributions to other 501(c) organizations.

11 The base of the special tax is the lesser of the organization's investment income and its electioneering expenditures, while the rate of tax is the highest marginal rate applicable to corporations. *See* I.R.C. § 527(f)(1). Effectively, these rules assume that the organization's investment income is traced first to fund electioneering as opposed to some other activity that would not trigger the special tax. This unfavorable assumption creates an incentive for tax-exempt organizations who wish to engage in electioneering to form segregated 527 funds to do so. Even though the segregated fund will be required to pay tax on all of its investment income, these funds will not generate a lot of investment income if they do not hold contributed money for very long (i.e., if they spend their contributions quickly). This strategy would allow tax-exempt organizations to continue to generate tax-exempt investment income.

12 *See* I.R.C. § 527(c)(1).

13 *See also 2000 Campaign Finance Hearings*, *supra* note 5, at 27-42 (statement of Joseph M. Mikrut). As Lloyd Mayer notes, in some situations pre-tax dollars may be used to finance electioneering. *See* Lloyd Hitoshi Mayer, *The Much Maligned 527 and Institutional Choice*, 87 B.U. L. REV. (forthcoming 2007), *available at* http://ssrn.com/abstract=925529, at 14 n.68. For example, veterans organizations are eligible to receive tax-deductible contributions but are not subject to the political activity bar. *See* I.R.C. § 170(a), (c)(3). However, these gaps are likely not significant. *See* Mayer, *supra*.

14 The donor's after-tax cost is only $650 because the $1,000 contribution deduction would absorb $1,000 of her income that would otherwise be taxed at a rate of 35%. Therefore, the net cost to her is the excess of the $1,000 donation over the $350 tax benefit resulting from the

forgone tax revenue. The end result is that the government has essentially matched 53.8% ($350/$650) of this taxpayer's net after-tax contribution of $650. But if a taxpayer subject to a 10% marginal tax rate gives the same $1,000 to his favored candidate, the after-tax cost to him is $900, with the government kicking in the remaining $100. The government has effectively matched this taxpayer's contribution at a rate of only 11.1% ($100/$900). The following table compares these results with those obtained if the donor is in the other currently existing marginal tax rate brackets:

A. Contribution Amount	B. Marginal Tax Bracket	C. Value of Deduction (A x C)	D. After-Tax Cost of the Contribution (A-C)	E. Rate of Government Match (C/D)
$1,000	0%[15]	$0	$1,000	0%
$1,000	10%	$100	$900	11.1%
$1,000	15%	$150	$850	17.6%
$1,000	25%	$250	$750	33.3%
$1,000	28%	$280	$720	38.9%
$1,000	33%	$333	$667	50%
$1,000	35%	$350	$650	53.8%

As this table shows, the rate of government match rises dramatically as the donor's marginal tax rate increases.[16] The result would be government subsidization that favors candidates of the wealthy over candidates of the less wealthy, an obviously troubling form of government spending.[17]

$1,000 deduction.

[15] While there is no explicit 0% bracket in the Code, because of the personal exemption and dependency deductions and certain credits, there is effectively a 0% bracket.

[16] As Ellen Aprill has discussed, this inverse relationship is even more pronounced if one considers the fact that low-income taxpayers are much less likely to itemize their deductions than higher-income taxpayers. *See* Ellen P. Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843, 845-46 (2001). Non-itemizers (i.e., taxpayers who take the standard deduction) receive no tax benefit from their charitable contributions regardless of their marginal tax rates. As a result, their donees receive no matching contribution from the government. This is because the hypothetical subsidy comes in the form of a deduction rather than a credit, the value of which is generally constant among donors. For example, if the hypothesized campaign contribution deduction were turned into a credit equal to 25% of the contribution, then the rate of government match would always equal 33.3%, regardless of the taxpayer's marginal tax rate provided that the credit was refundable. If the credit was nonrefundable, then the rate of match would be 33.3% with respect to donations by taxpayers who have a pre-credit tax liability at least equal to the amount of the credit, but would be lower for all other taxpayers. Refundable credits are those which result in a negative tax liability (i.e., a payment from the government to the taxpayer) in cases where the credit amount exceeds the taxpayer's pre-credit liability.

[17] The principle that only after-tax dollars be used to finance electioneering has sometimes been justified by commentators as one that prevents the use of public funds for political purposes.

In addition, a deduction for campaign contributions would provide government subsidization of campaigns limited only by the donor's income in a given year.[18] Wealthy taxpayers could donate huge amounts of money per year, leveraging their donations with the government's 54% match. Meanwhile, candidates supported by less wealthy taxpayers would be limited both by their supporters' lower amount of disposable income as well as the greatly reduced rate of government matching.[19]

The policy rationale behind the principle that electioneering be funded with after-tax dollars—to prevent disproportionate and unlimited government subsidization of campaigns—is an important one. Without this principle, government funds would be used disproportionately to assist candidates preferred by wealthy donors.[20] As a result of this serious policy concern, the IRS has interpreted the bounds of electioneering activity extremely broadly so as to deter attempts to circumvent the rule by disguising partisan activity as non-partisan. In other words, in determining what sorts of activity constitute electioneering, the IRS has chosen to err on the side of over- rather than under-inclusiveness.

However, the mere fact that public funds would be used for political purposes does not appear to be a critical concern. Since 1976 a number of presidential candidates have received federal funds generated by voluntary taxpayer contributions through the so-called "check-off" system. In the check-off system, taxpayers may choose to check a box on their individual income tax form indicating their desire to earmark $3 ($6 with joint returns) of their total tax liability towards the Presidential Election Campaign Fund. This money is then distributed to presidential candidates that meet certain qualifications. This system uses public money because the taxpayer's tax liability remains the same regardless of whether or not they check the box. As a result, the system operates as a tax credit of $3 ($6 for joint returns) for amounts contributed to the fund. The check-off system has not generated any criticism regarding the propriety of using public funds for political purposes, suggesting that the concern about using public money for electioneering purposes does not justify the after-tax money principle. *See also* John M. de Figueiredo & Elizabeth Garrett, *Paying for Politics*, 78 S. CAL. L. REV. 591 (2004) (proposing a refundable federal income tax credit of up to $100 for political contributions made by low- and middle-income taxpayers).

[18] While the charitable deduction is limited to a percentage of the donor's adjusted gross income (generally 50% or 30% depending on the type of charitable organization) in the year of donation, any excess amount may carried over to subsequent years (subject to the same percentage limitation). *See* I.R.C. § 170(b), (d).

[19] By contrast, the Presidential Election Campaign Fund operates as a tax credit limited to $3 for single taxpayers and $6 for married couples. Other reform proposals have argued in favor of limited tax credits. *See, e.g.*, de Figueiredo & Garret, *supra* note 17, at 645 (proposing maximum tax credit of $100); Spencer A. Overton, *The Donor Class: Campaign Finance, Democracy, & Participation*, 153 U. PA. L. REV. 73 (2004) (same).

[20] *See* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 364 (1972) (noting that, if political contributions were deductible, it would exacerbate the ability of "wealthy people . . . to dominate the political process").

C. *IRS' View of Electioneering*

The IRS has broadly construed electioneering to prevent circumvention of the after-tax money principle. As noted above, charities (which are able to receive tax-deductible contributions) are absolutely barred from engaging in electioneering, and tax-exempt organizations (other than charities) are required to pay a special tax on their electioneering expenditures. It is in these contexts that the IRS has historically defined the bounds of electioneering quite broadly, apparently to prevent circumvention of the important tax rule that electioneering expenditures be funded with after-tax dollars.[21] For example, in Revenue Ruling 76-456, the IRS determined that a charity "formed to elevate the standards of ethics and morality in the conduct of political campaigns" would engage in prohibited electioneering if it were to solicit the signing or endorsement of its code of fair campaign practices by candidates for political office.[22] Even though the campaign code was entirely nonpartisan, the IRS concluded that such solicitation "constitutes participation or intervention in a political campaign and may result, through the publication or release or the names of candidates who sign or endorse or who refuse to sign or endorse the code, in influencing voter opinion."

Similarly, in Revenue Ruling 78-248, the IRS found that the mere distribution of a factual voter guide on selected issues important to the distributing organization constituted electioneering.[23] The IRS described the voter guide as follows:

> The organization publishes a voter's guide for its members and others concerned with land conservation issues. The guide is intended as a compilation of incumbents' voting records on selected land conservation issues of importance to the organization and is factual in nature. It contains no express statements in support of or in opposition to any candidate. The guide is widely distributed among the electorate during an election campaign.

Even though the guide was entirely factual and without editorial

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21 Even though the precise language relating to electioneering varies throughout the Code, the IRS has been consistent in defining the scope of that activity. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 96-52-026 (Dec. 27, 1996) (activity that qualifies an organization as a 527 is the same activity that cannot be performed by a 501(c)(3) charity); *see also* Mayer, *supra* note 13, at 15 ("The various tax provisions discussing political activity use varying language. In practice, however, the IRS has repeatedly indicated that the same range of activities is implicated by these various references."); Frances R. Hill, *Probing the Limits of Section 527 to Design a New Campaign Finance Vehicle*, 86 TAX NOTES 387, 391 (2000).

22 Rev. Rul. 76-456, 1976-2 C.B. 151.

23 Rev. Rul. 78-248, 1978-1 C.B. 154. *But cf.* Rev. Rul. 80-282, 1980-2 C.B. 178 (ruling that a distribution of a voter guide was permissible where the guide was to be distributed only to the organization's relatively small normal readership and where the distribution date did not coincide with an election campaign).

comment, because it was focused on a narrow range of issues and was distributed during an election campaign, publishing it constituted electioneering for tax purposes.

These rulings are indicative of the position of the IRS to broadly construe the bounds of electioneering.[24] As a tax policy matter, this makes sense, as it ensures that electioneering be funded only with after-tax dollars. By erring on the side of possibly finding too much (as opposed to too little) electioneering, the IRS deters taxpayers from disguising electioneering activity as non-partisan. Meanwhile, the cost to taxpayers of any error in this direction is quite low. Activity that constitutes electioneering for tax purposes is not barred or substantially impeded; rather, it simply must be funded in such a way as to ensure that only after-tax dollars are used.[25]

II. THE GIFT TAX PROBLEM: EXPANDING THE SCOPE OF SECTION 527

Because of the IRS' broad definition of electioneering, the 527 category is very large. Furthermore, it appears that the 527 category is actually expanding because of a bizarre incentive in the tax code for ideological organizations (i.e., issue-focused as opposed to election-focused) to emphasize the electioneering aspect of their activities in order to obtain 527 status and thereby avoid anomalous and onerous gift tax consequences for large donors. To date, the IRS seems to freely allow this tax planning technique. As a result, the scope of Section 527, which was already expansive as a result of the broad definition of electioneering, is becoming even more expansive.[26]

An advocacy organization that wishes to engage in electioneering can organize as a 501(c)(4) social welfare organization[27] or a 527

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[24] For further discussion of the broad construction used by the IRS, see Elizabeth Kingsley & John Pomeranz, *A Crash at the Crossroads: Tax and Campaign Finance Laws Collide in Regulation of Political Activities of Tax-Exempt Organizations*, 31 WM. MITCHELL L. REV. 55, 63-71 (2004).

[25] For example, a charity that wishes to engage in electioneering (as broadly defined) may set up a segregated fund under section 501(c)(4). Because the segregated fund would not receive deductible contributions and because the fund would be subject to the special tax under section 527(h), electioneering expenses would be funded only with after-tax dollars. A tax exempt organization other than a charity could engage in electioneering (as broadly defined), but would be subject to the section 527(h) special tax.

[26] *See* Kingsley & Pomeranz, *supra* note 24, at 100-01.

[27] A 501(c)(4) social welfare organization is a non-profit organization that 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)(i) (1990). Unlike 501(c)(3) charities, these organizations may engage in electioneering (though it cannot rise to the level of the organization's primary purpose) and may engage in substantial lobbying. For an extensive analysis of the scope of section 501(c)(4), see ABA SECTION OF TAXATION, COMMENTS OF THE INDIVIDUAL MEMBERS OF THE EXEMPT ORGANIZATIONS COMMITTEE'S TASK FORCE ON

organization.[28] As a practical matter, determining which category—501(c)(4) or 527—applies often depends on the organization's amount of electioneering relative to its other activities. In general, if an advocacy organization's electioneering activity predominates over its other activities, then the organization fits within the 527 category.[29] If not, then it would fit within the 501(c)(4) category. For instance, consider an organization that works to eradicate gender discrimination through both non-electioneering activity (e.g., lobbying) and electioneering activity. If the non-electioneering activity predominated, the organization would qualify as a 501(c)(4), but would qualify as a 527 if its electioneering activity predominated.[30]

The distinction between 501(c)(4) and 527 status would not matter if the two organizations were treated the same for tax purposes. In fact, there is considerable consistency in tax treatment. For both types of organizations, contributions are non-deductible by the donor and the organization's investment income used to finance electioneering is taxed. These two rules operate to ensure that electioneering expenditures are funded only with after-tax dollars. However, there is one significant difference in tax treatment. Large contributions to 501(c)(4)s may be subject to federal gift tax, whereas contributions to 527s are statutorily exempt from that tax. This creates an incentive for advocacy organizations that expect to receive large donations to emphasize the electioneering aspect of their ideological activities in order to obtain 527 instead of 501(c)(4) status.

The gift tax, which is payable by donors, generally applies to all gifts in excess of the inflation-adjusted exemption amount, which is currently set at $12,000.[31] The gift tax rate schedule is progressive and currently reaches a maximum rate of 46%. Donations to 527s and 501(c)(3)s are statutorily exempt from the gift tax; however, no statutory exemption applies for donations to 501(c)(4)s. Thus, while it is clear that donations to 527s and 501(c)(3)s would not trigger gift tax, the IRS takes the view that 501(c)(4) donations are subject to the tax.[32]

SECTION 501(C)(4) AND POLITICS (2004), *available at* http://www.abanet.org/tax/pubpolicy/2004/040525exo.pdf.

[28] An advocacy organization could also organize itself as a 501(c)(5) labor organization or 501(c)(6) business league. With respect to the issues raised in this Article, these organizations are indistinguishable from the more common 501(c)(4) organizations. As a result, I will refer only to 501(c)(4)s but the analysis is equally applicable to 501(c)(5)s and (c)(6)s.

[29] For a more complete discussion, see ABA SECTION OF TAXATION, *supra* note 27, at 4-7.

[30] *See* Kingsley & Pomeranz, *supra* note 24, at 72-73.

[31] The exemption amount applies on a per donor, per donee, per year basis. Therefore, a donor could give $12,000 gifts to an unlimited number of donees each year with all gifts qualifying for the exemption. Likewise, a donee could receive an unlimited number of $12,000 from different donors and all of the gifts would be exempt. Furthermore, gifts in excess of the exemption amount will first be absorbed by the donor's unified estate tax credit before they result in gift tax liability.

[32] Rev. Rul. 82-16, 1982-2 C.B. 220.

However, it is questionable whether the position of the IRS would survive judicial scrutiny if challenged.[33] Nevertheless, well-advised donors would certainly consider the possibility of gift tax liability in deciding whether to make a large donation.[34]

As a result, wealthy donors who are well-advised often prefer to make large contributions (i.e., those in excess of $12,000) to 527s rather than 501(c)(4)s. This preference has motivated some organizations that could plausibly fit within either the more election-driven 527 category or the more issue-focused 501(c)(4) category to emphasize their electioneering motives to the IRS to obtain 527 status. In 1999, for example, an organization requested and obtained an IRS ruling that its issue advocacy (e.g., ballot measure advocacy and lobbying) would constitute electioneering; this allowed the organization to obtain 527 status and avoid the gift tax problem for its donors.[35] The IRS found that the organization's issue advocacy, which would ordinarily not constitute electioneering, nevertheless qualified as such because of the organization's "mission statement, the timing and targeting of messages, and the variety of ways in which [it] plan[ned] to use ballot measures and other public opinion campaigns to affect the candidate selection process."[36] The ruling also noted that, to substantiate its electoral goals, the organization would use a variety of methods including the solicitation of written opinions by political experts concluding that the organization's issue advocacy would likely impact the outcome of one or more elections. Based on this record, the IRS concluded that the organization's issue advocacy had the requisite electoral motives.

It appears that the taxpayer in the 1999 ruling desired 527 status simply to avoid a potential gift tax problem for its donors. This ruling and others like it[37] suggest that the IRS freely allows organizations that might more logically fit in the 501(c)(4) category to emphasize its electoral motives so as to squeeze into the 527 category. It is safe to assume that the IRS presumably allows this sort of tax planning because

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33 *See* Barbara K. Rhomberg, *Constitutional Issues Cloud the Gift Taxation of Section 501(c)(4) Contributions*, 15 TAX'N EXEMPTS 164, 170-71 (2004) (arguing that application of the gift tax might be unconstitutional); Barbara K. Rhomberg, *The Law Remains Unsettled on Gift Taxation of Section 501(c)(4) Contributions*, 15 TAX'N EXEMPTS 62, 65-66 (2003) (arguing that IRS' position may be inconsistent with Treasury regulations and judicial decisions); ABA SECTION OF TAXATION, *supra* note 27, at 13 (concluding "that the authorities can be construed to both support and oppose imposition of the gift tax").

34 *See* Rosemary E. Fei, *The Uses of Section 527 Political Organizations*, *in* 1 NONPROFIT ADVOCACY & THE POLICY PROCESS: STRUCTURING THE INQUIRY INTO ADVOCACY 23, 26 (Elizabeth J. Reid ed., 2000), *available at* http://www.urban.org/UploadedPDF/structuring.pdf.

35 I.R.S. Priv. Ltr. Rul. 99-25-051 (March 29, 1999).

36 *Id.*

37 *See* I.R.S. Priv. Ltr. Rul. 96-52-026 (Oct. 1, 1996); I.R.S. Priv. Ltr. Rul. 97-25-036 (March 24, 1997); I.R.S. Priv. Ltr. Rul. 98-08-037 (Feb. 20, 1998).

it recognizes that the application of the gift tax in the 501(c)(4) context is entirely unjustified as a policy matter. The gift tax was originally designed to backstop the estate tax,[38] a progressive tax imposed on large estates. Without a gift tax, the estate tax could be easily avoided through inter vivos transfers. The gift tax was designed to negate this planning opportunity and make donors more or less neutral as between the choice of giving during life or giving after death. The estate tax itself was created to break up large concentrations of wealth. In addition, because heirs received a stepped-up basis in the decedent's assets, the estate tax also serves to ensure that unrealized appreciation gets taxed.

More recently, the gift tax has been noted to serve other important goals, independent and separate from the goals of the estate tax. Even though the estate tax is scheduled to expire temporarily in 2010 (in addition to the stepped-up basis at death rule) the gift tax will remain intact. Congress retained the gift tax to prevent related parties from shifting income between themselves. Without a gift tax, high-bracket taxpayers could, by using back-and-forth gifts between family members, easily shift income to related low-bracket taxpayers or could move income into low income-tax states. Congress retained the gift tax to inhibit this sort of income tax planning.

None of these concerns are implicated when money is contributed to a 501(c)(4). Contributions to these organizations reduce the donor's wealth, just like ordinary consumption purchases, which are not subject to gift tax. No wealth is passed along to heirs and no income tax games are being played. Contributions to 501(c)(4)s ought to be gift-tax free, just as contributions to 501(c)(3)s and 527s are. Considering the objectives of the gift tax, these latter organizations are indistinguishable from 501(c)(4)s.

Accordingly, the application of the gift tax in the 501(c)(4) context is unwarranted, a product apparently of mere Congressional oversight. Recognizing this but feeling constrained by a statutory scheme that appears to require this result, the IRS freely allows taxpayers to engage in self-help. Any organization that could even remotely fit within the 527 category can claim that status with impunity from the IRS and thus avoid the gift tax problem. This relaxed posture of the IRS is also fully consistent with the tax law's broad definition of electioneering.

There is another normative reason why the IRS would prefer a broader, rather than narrower, scope of the 527 category. 527s must make disclosures regarding contributions and expenditures to avoid a

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[38] *See* Carson v. Comm'r, 71 T.C. 252, 261 (1978) ("[A] review of the legislative history of the gift tax clearly demonstrates that it was intended to backstop the estate tax—to impose on inter vivos dispositions to beneficiaries under circumstances that (aside from the time of making the arrangements) are akin to dispositions generally made at death.").

substantial financial penalty; however, no such disclosure requirements apply to 501(c)(4)s. If the IRS prefers greater rather than lesser disclosure, expanding the 527 category (by broadly construing the definition of electioneering) furthers this goal because, at the margin, it will result in the formation of transparent 527 organizations instead of opaque 501(c)(4) organizations.

III. ADDRESSING THE REFORMERS' MISCONCEPTIONS

A. *Misconception #1: 527 Status is Elective*

Reformers sometimes imply that political organization status under section 527 is elective.[39] As a result, they believe that 527s have no cause to complain when their decision to be treated as a political organization for tax purposes results in more stringent campaign finance regulation. In fact, however, tax status as a political organization is not, as a technical matter, elective. An organization either is or is not a political organization for tax purposes based strictly on its activities. If these activities indicate that the primary purpose of organization is to electioneer (as that term is defined for tax purposes), then the organization is a political organization under section 527. Otherwise, it is not.[40]

Nevertheless, as explained above, it is true that some ideological groups have planned their way into the 527 category so as to avoid the gift tax problem that applies to 501(c)(4)s. Therefore, at the margins, 527 status is elective as a practical matter. Some have argued that those ideological organizations that have planned their way into the 527 category must live with the non-tax consequences of their tax planning

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39 *See, e.g.*, *Hearing to Examine the Scope and Operation of Organizations Registered under Section 527 of the Internal Revenue Code Before the Sen. Comm. on Rules & Admin.*, 108th Cong. (2004) (statement of Sen. John McCain) ("[A]ny 527 group is by definition in the business of political campaigns, and its has *voluntarily* sought the tax advantages conferred on political groups.") (emphasis added), *available at* http://rules.senate.gov/hearings/2004/031004_mccain.htm.

40 *See* Nat'l Fed'n of Republican Assemblies v. United States, 218 F. Supp. 2d 1300, 1308 n.7 (S.D. Ala. 2002) ("An organization cannot elect whether to *be* a political organization, because status as a political organization depends on satisfaction of the definition of a political organization provided in Section 527(e)."); I.R.S. Field Serv. Adv. Mem. 00-37-040 (September 15, 2000) ("Section 527 is not an elective provision."). The *National Federation of Republican Assemblies* decision was reversed by the Eleventh Circuit in *Mobile Republican Assembly v. United States*, 353 F.3d 1357 (11th Cir. 2003), and some have interpreted the reversal as supporting the proposition that political organization status is elective. However, the better reading of *Mobile Republican Assembly* is that, while filing the notice of 527 status is elective, status as a political organization subject to section 527 is not. *See Edited Transcript of the January 30, 2004 ABA Tax Section EO Committee Meeting*, 44 EXEMPT ORG. TAX REV. 23, 29 (2004).

(i.e., regulation by the FEC as a political committee).[41] But it is important to remember the impetus for this planning—the potential for the imposition of unwarranted and harsh gift tax consequences on the organization's donors. This is tax planning to achieve the appropriate policy result in the face of a flawed statutory regime. Congress ought to fix the gift tax problem by amending the Code to clarify that contributions to 501(c)(4)s are exempt from the gift tax.[42] At that point, there would no longer be any reason for groups to plan their way into the 527 category.

B. *Misconception #2: Self-Identifying Results in Tax Benefits*

Subsection 527(i) was added to the tax code in 2000 to increase the transparency of 527 organizations. This provision requires 527s to notify the IRS of their existence in order to avoid a 35% tax on the contributions that they receive.[43] Together with simultaneously enacted section 527(j), which requires disclosures about the organization's contributions and expenditures, this new provision vastly improved the transparency of 527s. The bills which seek to regulate 527s as political committees typically limit their application to those organizations that notify the IRS of their 527 status (and thus avoid the 35% tax on contributions). The rationale appears to be based on an estoppel-type argument: why should organizations be able to make a public proclamation that they are "political organizations" in order to receive a tax benefit (i.e., the avoidance of the 35% tax) and then turn around and deny that they are political committees for campaign finance regulation purposes?[44]

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[41] *See 527 Reform Act of 2005: Hearing to Examine and Discuss S. 271, a Bill Which Reforms the Regulatory and Reporting Structure of Organizations Registered Under Section 527 of the Internal Revenue Code Before the Sen. Comm. on Rules & Admin.*, 109th Cong. (2005) (statement of Frances R. Hill, Professor, Univ. of Miami Law Sch.), *available at* http://rules.senate.gov/hearings/2005/HillTestimony.pdf ("Organizations may choose to plan their way into section 527 . . . Once a tax status has been chosen, it is not unusual to suggest that the organization must operate in a manner consistent with the form it has chosen.").

[42] At the same time, Congress should amend the Code to provide that the contribution of appreciated property to a 501(c)(4) triggers the recognition of gain by the donor. *See* Gregg D. Polsky & Guy-Uriel E. Charles, *Regulating Section 527 Organizations*, 73 GEO. WASH. L. REV. 1000, 1013-14 n.81 (2005).

[43] With respect to the statutory exemption from gifts that applies to contributions to 527 organizations, the IRS has determined that the exemption applies regardless of whether the organization self-identifies. *See* Rev. Rul. 00-49, 2000-2 C.B. 430. Accordingly, self-identification does not result in any gift tax benefit for donors to the organization.

[44] *See, e.g.*, 146 CONG. REC. S6041, 6044 (daily ed. June 29, 2000) (statement of Sen. Levin) (lamenting that 527s are "having it both ways" by "say[ing] one thing to the IRS to get the tax exemption and say[ing] the opposite to the Federal Election Commission to avoid having to register as a political committee.").

This argument is based on the notion that avoiding the 35% tax on contributions received by the organization constitutes a tax subsidy for transparent 527s as opposed to a penalty on opaque 527s. If the tax on contributions is really a penalty, then the 527s that disclose are not receiving a substantial tax benefit (as some reformers suggest); rather, disclosing 527s are merely avoiding an onerous penalty. Accordingly, if the tax on contributions is in the nature of a penalty, the bills that tie political committee status to section 527(i) notification force 527 organizations to choose between (i) full-fledged regulation as a political committee under FECA, or (ii) an onerous 35% penalty on the contributions that they receive.

Properly understood, section 527(i) is a penalty on nondisclosure. Under general tax principles, contributions to 527 organizations ought to be exempt from tax. Money contributed to 527 organizations has already been taxed; taxing this money again when it is contributed would impose an extra layer of tax merely because the money has been pooled with other money.[45] For instance, assuming a 50% marginal tax rate, if an individual spends $1,000,000 on a political advertisement, that would consume $2,000,000 of her pre-tax earnings. However, if 527s are required to pay tax on their contributions, in order to give the organization $1,000,000 of purchasing power, she would have to give $4,000,000 of pre-tax earnings. This is because she would owe $2,000,000 in tax upon her earning of $4,000,000 ($4,000,000 x 50%), and the organization would owe $1,000,000 ($2,000,000 x 50%) of tax upon her contribution of the remaining $2,000,000.[46] This would be an anomalous result under the federal income tax, which treats pooled and non-pooled consumption expenses neutrally.[47] Thus, section 527 does not provide any tax subsidy for organizations that comply with the 527(i) notification requirement; instead, section 527(i) imposes a penalty through the tax code on non-compliant organizations.[48]

The historical tax treatment of contributions to political organizations supports the view that section 527(i) imposes a penalty.

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[45] *See 2000 Campaign Finance Hearings*, *supra* note 5 (statement of Joseph Mikrut, Tax Legislative Counsel, U.S. Dep't of Treasury).

[46] I have assumed simply for computational ease that both the individual and the 527 organization would pay tax at the 50% rate, instead of the current 35% marginal rate that would currently apply to high-income individuals and to 527 organizations. If a 35% rate were used, a non-pooled expenditure (i.e., direct) would require $1,538,462 of pre-tax earnings and a pooled expenditure (i.e., through a 527 organization) would require $2,366,865 of pre-tax earnings.

[47] *See 2000 Campaign Finance Hearings*, *supra* note 5, at 40 (statement of Joseph Mikrut, Tax Legislative Counsel, U.S. Dep't of Treasury).

[48] *See id.*; Fei, *supra* note 34, at 30. *But see* Donald B. Tobin, *Anonymous Speech and Section 527 of the Internal Revenue Code*, 37 GA. L. REV. 611, 614-16 (2003) (arguing that exemption of contributions could be considered a subsidy); Daniel L. Simmons, *An Essay on Federal Income Taxation and Campaign Finance Reform*, 54 FLA. L. REV. 1, 96-101 (2002) (same).

Prior to 1975, the tax code did not specifically address how these contributions were to be taxed. Nevertheless, the IRS during that period consistently took the position that contributions to these organizations were exempt from taxation.[49] This position was codified by the enactment of section 527 in 1975 and continues to apply to all contributions made to all 527s, except for those which fail to comply with the disclosure requirements recently added in 2000.

C. *Misconception #3: The Tax Law's Line-Drawing Is Appropriate For Use in Regulating Campaign Finance*

Reformers believe that section 527 by definition applies to only partisan, election-focused organizations.[50] For the reasons previously detailed, the IRS takes an exceptionally broad view of what sorts of activity constitute electioneering. In drawing the line between ideological (i.e., issue-focused) activity, which may be funded with pre-tax dollars in certain circumstances, and electioneering activity, which cannot, the IRS has decided to err on the side of an overbroad definition of the latter. Erring on this side does not implicate constitutional concerns because it merely pushes electioneering into tax vehicles (e.g., 527s or 501(c)(4)s) that ensure that the activity is appropriately taxed.

In the campaign finance regulation context, the stakes are obviously much higher. The Court has consistently required that campaign finance regulation must be narrowly tailored to address a significant government interest, such as the prevention of corruption or the appearance thereof.[51] It is unlikely that the tax law's line-drawing in this context—the result of its own unique policies and idiosyncrasies—would be able to satisfy this strict scrutiny.

IV. IMPACT ON TAX LAW OF 527 REFORM

If the reformers are successful in pushing through legislation that would regulate 527s as political committees, besides the inevitable constitutional challenge there would be other consequences. Because the current proposals do not regulate 501(c)(4) groups, they would create incentives to form these organizations. These groups are permitted to engage in electioneering, but that activity cannot

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49 *See* S. REP. NO. 93-1357, at 25 (1974), *as reprinted in* 1975 U.S.C.C.A.N. 7478, 7501-02.

50 *See supra* note 39.

51 *See, e.g.*, Buckley v. Valeo, 424 U.S. 1, 26-27 (1976); Fed. Election Comm'n v. Mass. Citizens for Life, Inc., 479 U.S. 238, 256 (1986); McIntyre v. Ohio Elections Comm'n, 514 U.S. 334, 347 (1995).

predominate over its non-electioneering activity. The only significant friction to this planning would be the potential for triggering gift tax on large contributions. Because the IRS's position on that issue is arguably questionable, one would expect to see that position challenged in court.[52] In addition, some 501(c)(4)s might push the electioneering limits of that category, requiring the IRS to use some of its scarce resources to police this issue.[53] It seems clear that the current 527 proposals would result in ripple effects with respect to the tax law and the IRS.[54]

CONCLUSION

Reformers assume that, by definition, all 527 organizations are partisan, election-driven organizations. They also believe that by self-identifying to the IRS these organizations receive substantial tax benefits. Based on these presuppositions, reformers argue that strict regulation of 527 organizations is both constitutional and normatively beneficial. However, when section 527 is carefully analyzed from a tax perspective, it becomes evident that these assumptions are flawed. Because of the after-tax money principle and the gift tax problem described above, Section 527 potentially covers organizations that are ideological, rather than election-driven. In addition, the "tax benefits" that accrue to self-identifying 527s are more appropriately considered penalties on opaque organizations. As a result, the tax law's definition of "political organization" is not appropriate for use in teasing out those organizations that are subject to strict campaign finance regulation.

52 Alternatively, 527 reform might trigger legislative efforts to fix the gift tax problem.

53 The current 527 proposals would require FEC registration by self-identified 527 groups. A 527 organization that disguises itself as a 501(c)(4) would not be required to register, but would, if discovered by the IRS, be required to pay the 35% penalty under section 527(i).

54 *See* Mayer, *supra* note 13, at 49-52 (describing some of the unintended federal income tax consequences of the legislative proposals to treat 527 organizations as political committees under FECA).