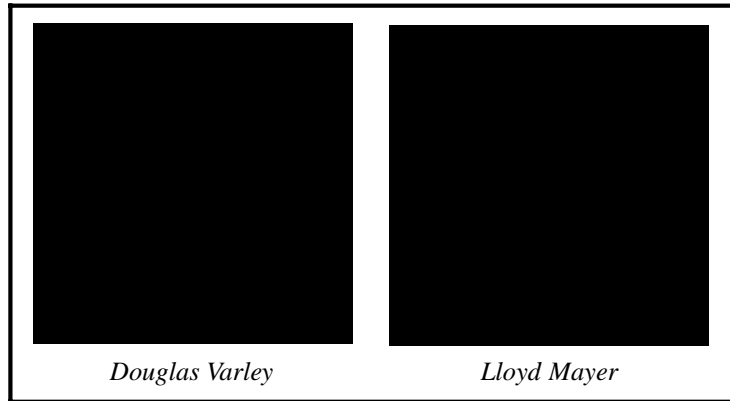


# Teaching Taxation: Following the Money in the 2000 Election

*Douglas Varley and Lloyd Mayer\**  
*Caplin & Drysdale*



## Speech Outline Prepared for the ABA Tax Section Exempt Organizations Committee Meeting

October 13, 2000

**I. Introduction:** Congress has passed the first campaign finance legislation in more than 20 years. The legislation requires section 527 political organizations to disclose detailed information about their activities, sources of support, and expenditures to the Internal Revenue Service and the public.

## II. Context: Categories of Tax-Exempt Organizations

### A. 501(c)(3) Organizations

1. Must operate exclusively for Religious, Charitable, Scientific, Literary, Educational, or other listed tax-exempt purposes.
2. Contributions are deductible and exempt from gift tax.
3. Cannot participate or intervene in (including publishing or distributing statements) any political campaign on behalf of (or in opposition to) any candidate for public office.
4. Section 501(c)(3) organizations that are “public charities” under section 509(a) can attempt to influence legislation, provided this is not a substantial part of their activities. Section 501(h) provides precise expenditure limits for lobbying.

### B. 501(c)(4) Organizations

1. Must operate exclusively for the promotion of social welfare — essentially the same purposes as section 501(c)(3).

2. Contributions are not deductible. The IRS position is that contributions are subject to gift tax. See Rev. Rul. 82-216, 1982-2 C.B. 220
3. Can attempt to influence political elections so long as this is not the organization’s primary activity. May be subject to income tax on investment income up to the amount of their spending on electioneering. IRC section 527(f).
4. No limits on the organization’s ability to influence legislation.

### C. 501(c)(5) Organizations

1. Labor unions.
2. Dues may be deducted as an ordinary and necessary business expense if the requirements of sections 67 and 162 are met. However, sections 162(e) and 6033(e) provide that the portion of dues allocable to an organization’s lobbying and electioneering activities is not deductible. Organizations may either inform their members of the portion of their dues that is not deductible or pay a proxy tax. As a practical matter, 6033(e) does not affect labor unions, because they qualify for an exception to the general rule for organizations that can show that 90 percent or more of dues and similar amounts are not deductible by the members. See Rev. Proc. 98-19, 1998-1 C.B. 547. Most labor union members cannot deduct their dues by reason of section 67, which imposes a 2 percent floor for miscellaneous deductions.
3. Can attempt to influence political elections.
4. Can attempt to influence legislation germane to the organization’s exempt purpose.

### D. 501(c)(6) Trade Associations

1. Must operate exclusively to improve the business conditions of a line of business.

\*Douglas Varley is a partner and Lloyd Mayer an associate at Caplin and Drysdale, Washington.

2. Dues may be deducted as ordinary and necessary business expense if the requirements of section 162 are met. However, section 6033(e) provides that the portion of dues allocable to the organization's lobbying and electioneering activities is not deductible.
4. Can attempt to influence political elections.
5. Can attempt to influence legislation.

### III. Section 527 Organizations

- A.** Section 527 provides that political organizations are tax-exempt organizations. This exemption applies to all contributions, membership dues, and other political fundraising income segregated for use for the organization's "exempt function," but does not apply to other income, including investment income. A section 527 organization's exempt function is "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." IRC section 527(e)(2). To qualify as a section 527 organization, an organization must be "organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function." IRC section 527(e)(1). Section 2501(a)(5) provides that transfers to section 527 organizations are exempt from the gift tax.
- B.** Traditionally, most if not all 527 organizations were political parties, political committees, or campaign committees that *expressly advocated* the election or defeat of particular candidates. These organizations were subject to an array of disclosure and contribution limits under the Federal Election Campaign Act of 1971 (FECA), 2 U.S.C. sections 431-441h, 451-455, and, if they were involved in state or local elections, under state election laws. Recently, however, donors and their tax advisors discovered that an organization could qualify as a section 527 organization by engaging in grassroots lobbying, issue advocacy, voter registration, publishing incumbent or candidate scorecards, and similar activities, as long as such activities were targeted or otherwise designed to influence the outcome of elections. See PLR 9652026 (Oct. 1, 1996); PLR 9725036 (Mar. 24, 1997); PLR 9808037 (Nov. 21, 1997); PLR 199925051 (Mar. 29, 1999). Because these activities did not involve "express advocacy," as defined by the Supreme Court, they do not require reporting to the Federal Election Commission.
- C.** Such "stealth PACs" were attractive for several reasons, when compared to other types of tax-exempt organizations. Section 501(c)(3) charitable organizations are eligible to receive tax-deductible contributions, but are absolutely barred from supporting or

opposing any candidate for public office. Other section 501(c) organizations, including organizations described in section 501(c)(4) (social welfare leagues), (c)(5) (labor unions) and (c)(6) (business associations), must operate primarily for a purpose that meets the requirements of the applicable subsection; activities designed to influence elections do not meet this primary purpose requirement. The IRS has also taken the position that contributions to such organizations are subject to the gift tax. All of these organizations are not required to disclose to the public the identities of their donors, but they are required to provide information about major donors to the IRS and to provide to the IRS and the public certain financial and other information on IRS Forms 990/990-EZ.

- D.** In contrast, the new section 527 organizations did not have any reporting or disclosure requirements under the Internal Revenue Code except for reporting net non-exempt function income — usually investment income — annually on Form 1120-POL if such income exceeded \$100. Contributions to such organizations are also not subject to the gift tax. And since FEC rules did not reach them, they could operate to influence elections without having to report their activities, or sources of financial support, to anyone.
- E. It was too good to last.** Responding to ever-mounting pressure to "do something" about campaign finance reform, on June 8th the Senate passed an amendment to a defense budget bill that required section 527 organizations to disclose certain information to the IRS and the public. After several weeks of debate, the introduction of alternative bills, and hearings in the House, a reform bill passed the House and Senate. President Clinton promptly signed the bill on July 1, 2000.
- F.** The legislation required existing section 527 organizations to register with the IRS by July 31, 2000 and new organizations to register within 24 hours of their creation. Hence the IRS had to provide guidance almost immediately. It did so, issuing Form 8871, Political Organization Notice of Section 527 Status, (*The Exempt Organization Tax Review*, August 2000, p. 320) on July 12, 2000, and Form 8872, Political Organization Report of Contributions and Expenditures, (*The Exempt Organization Tax Review*, August 2000, p. 324) less than a week later. Both forms are available at [www.irs.gov/bus\\_info/eo/pol-file.html](http://www.irs.gov/bus_info/eo/pol-file.html). The IRS also has issued a revenue ruling answering some of the initial questions about the new legislation. Rev. Rul. 2000-49, 2000-44 IRB 1 (*The Exempt Organization Tax Review*, November 2000, p. 176; *Doc 2000-26441 (9 original pages)*; or *2000 TNT 199-6*).
- G.** Details of the reporting regime
1. **Organizations Affected.** The final legislation applies only to organizations described in section 527 of the code. Organizations described in section 501(c) are not affected, even if they are taxed

under section 527(f), unless they maintain a separate segregated fund for engaging in section 527 activity. IRC sections 527(i)(5)(A), (j)(5)(D). Such a fund is treated as a separate organization under section 527(f)(3) and therefore is subject to the new legislation, although the rest of the section 501(c) organization is not.

2. **Filing Requirements.** Section 527 organizations are subject to three new filing requirements: (1) an initial notice of existence (Form 8871); (2) periodic reports on contributions and expenditures (Form 8872); and (3) expanded annual return requirements (Forms 990/990-EZ and Form 1120-POL).

3. **Exemptions to Filing Requirements.** Three categories of section 527 organizations are completely or partially exempt from these new filing requirements:

- a. Organizations that reasonably expect to have annual gross receipts of less than \$25,000 in all taxable years are exempt from the notice and periodic report requirements. IRC sections 527(i)(5)(B), (j)(5)(C). Organizations that actually have gross receipts of less than \$25,000 in a given year are exempted from the new annual return requirements for that year, unless they have investment income of \$100, in which case they must file an 1120-POL. Rev. Rul. 2000-49, Q&A 43.
- b. Organizations that are required to report under the FECA as political committees are exempt from the notice and periodic report requirements, but not the annual return requirement. IRC sections 527(i)(6), (j)(5)(A).
- c. A state or local party committee or a state or local candidate committee is exempt from the periodic report requirement but not the notice or annual return requirement. IRC section 527(j)(5)(B).

4. **Notice Requirement (Form 8871).** A section 527 organization must file a notice of its existence with the IRS within 24 hours of being formed, with the first notices being due on July 31, 2000 for organizations in existence before that date. The notice must be filed both in writing and electronically.

- a. The written filing is accomplished by filing a completed Form 8871 with the IRS Service Center in Ogden, Utah. This form lists the organization's name, federal Employer Identification Number, mailing address, business address (if different), e-mail address (if any), purpose, related entities and the nature of the relationship, and the names and addresses of officers, board members, highly compensated

employees, custodian of records, and a contact person.

- b. Each section 527 organization must also complete a shorter electronic form, listing its name, address, e-mail address (if any), custodian of records, and contact person, at the IRS Web site ([www.irs.gov/polorgs](http://www.irs.gov/polorgs)). See IRC section 527(i)(1)(A); Rev. Rul. 2000-49, Q&A 9.

5. **Periodic Report Requirement (Form 8872).** A section 527 organization that receives any contribution or makes any expenditures for section 527 exempt functions during a calendar year must file periodic reports on Form 8872 during that year, beginning with the first month or quarter in which it accepts a contribution or makes an expenditure. These reports must list the names, addresses, amounts received from, and, for individuals, the occupation and name of employer, of persons who have *given* more than \$200 in the aggregate in a calendar year to the organization, and the names, addresses, amounts received by, and, for individuals, occupation and name of employer, of persons who have *received* more than \$500 in expenditures in the aggregate in a calendar year from the organization. IRC section 527(j)(3). Contributions and expenditures are considered made when the person has contracted or is otherwise obligated to make the contribution or expenditure. IRC section 527(j)(4).

- a. **Exception.** The only exception is for "independent expenditures" under FECA. IRC section 527(j)(5)(E). An independent expenditure is one made by a person expressly advocating the election or defeat of a candidate for federal office that is made *without* cooperation or consultation with, or in concert with, or at the request or suggestion of, any candidate for federal office, or any authorized committee or agent of such candidate. 2 U.S.C. section 431(17); Rev. Rul. 2000-49, Q&A 38. Such expenditures and the sources of the funds used must be reported to the FEC.

- b. **Timing.** In non-election years, an organization may submit Form 8872 either on a monthly (due on the 20th day after the last day of each calendar month, except the report for December is due on January 31 of the following year) or semi-annual (due on the last day of the month following each half-year) basis. IRC section 527(j)(2)(A)(ii), (B); Rev. Rul. 2000-49, Q&A 30, 32. In election years, an organization can choose to submit these reports either monthly or quarterly (due on the fifteenth day after the last day of each calendar quarter, except the fourth quarter report is due on January 31 of the following year) basis. IRC section 527(j)(2)(A)(i), (B); Rev. Rul. 2000-49, Q&A 31, 32. An organization that

chooses the quarterly option is also required to file a pre-election report no later than 12 days before any election with respect to which the organization makes a contribution or expenditure listing all reportable contributions and expenditures up to 20 days before the election, and a post-general election report no more than 30 days after a federal general election, listing all reportable contributions and expenditures up to 20 days after the election. IRC section 527(j)(2)(A)(i)(II), (III).

- c. **Contributions received before 7/1/2000.** Contributions received or expenditures made on or before July 1, 2000, are not required to be disclosed on Form 8872; contributions or expenditures made after July 1, 2000, but pursuant to a contract entered into on or before that date also do not need to be disclosed on Form 8872. Pub. Law No. 106-230, section 2(d), 114 Stat. 477, 482.
6. **Annual Return Requirement (Forms 990/990-EZ and Form 1120-POL).** The organization must file Forms 990/990-EZ and Form 1120-POL as long as it has at least \$25,000 in gross receipts for the year. Section 6012(a)(6). These requirements apply for taxable years beginning after June 30, 2000, and are in addition to the existing requirement that a section 527 organization with more than \$100 of net investment or other taxable income in a given fiscal year file Form 1120-POL for that year, regardless of its amount of total gross receipts for the year. IRC section 6012(a)(6); Rev. Rul. 2000-49, Q&A 43, 45.
7. **Public Disclosure.** All of the information, *including information about donors*, filed by a section 527 organization is subject to public disclosure. The notice must be made available indefinitely; under section 6104(d) the periodic and annual reports must be made available for three years.
- a. **By the IRS on the Internet.** The IRS is required to post on the Internet the name, address, e-mail address, and the name and address of the custodian of records and a contact person of each organization within five business days of receiving that organization's notice. IRC section 6104(a)(3). The IRS is in fact posting both this information and a complete copy of the written Form 8871 submitted by each organization at [www.irs.gov/polorgs](http://www.irs.gov/polorgs). Although the IRS is *not* required to post periodic reports (Form 8872) or annual reports (Forms 990/990-EZ) for section 527 organizations on the Internet, it is permitted to do so and it has indicated it will.
  - b. **By the IRS in Writing.** The IRS is required to make the notice (Form 8871) and periodic reports (Form 8872) and annual reports (Forms 990/990-EZ and Form 1120-POL) available to the public, but, with the exception of requiring the posting of some of the information from the notice on the Internet, the exact means of doing so is left to the discretion of the Secretary of the Treasury. IRC section 6104(a)(1)(A). The IRS has posted entire notices on the Internet and has indicated it will post periodic reports on the Internet as well. The current IRS practice with respect to annual reports filed by section 501(c) organizations is to make them available through the EO Photocopy Unit in the IRS Ogden, Utah, Service Center. For section 501(c)(3) organizations, the IRS has also made the returns available on CD-ROM, and the information from those CD-ROMs is in turn being posted on the Internet by Philanthropic Research Inc. at [www.guidestar.org](http://www.guidestar.org), in cooperation with the Urban Institute's National Center for Charitable Statistics. Consequently, political organizations should anticipate that their filings will be available in a number of ways.
  - c. **By the Organization in Writing.** Each section 527 organization is required to allow public inspection and to provide copies of its notice, its periodic reports, and its annual returns to the public upon request. IRC section 6104(d). The organization will satisfy the requirement to provide copies of its notice or any periodic report if the IRS has posted the notice or the report on its Web site and the organization provides the person asking for a copy of the notice or report with the IRS Web site address. Rev. Rul. 2000-49, Q&A 19, 41. The notice (Form 8871) disclosure requirements are the same as the disclosure requirements that apply to applications for recognition of exemption (Form 1023 or Form 1024) filed by section 501(c) organizations. The periodic report (Form 8872) and annual return (Forms 990/990-EZ and Form 1120-POL) disclosure requirements are the same as the disclosure requirements that apply to annual information returns (Forms 990/990-EZ) filed by section 501(c) organizations.
8. **Penalties**
- a. **Failure to File Notice.** A section 527 organization that fails to file the required notice will be subject to the highest corporate tax rate on all of its exempt function income, less expenses necessary to generate that income. IRC section 527(i)(4), (b)(1). The organization is not allowed to deduct its exempt function expenditures because political campaign expen-

ditures are not deductible under section 162(e). Rev. Rul. 2000-49, Q&A 15. Consequently, all contributions to the organization, less fundraising costs, will be subject to tax.

- b. **Failure to File Periodic Report.** A section 527 organization that fails to file a complete periodic report will be taxed on each expenditure and each contribution that is not properly reported at the highest corporate tax rate. IRC section 527(j)(1), (b)(1). This can result in double taxation; if an organization fails to report a contribution and then fails to report the expenditure funded by that contribution, it will owe tax both on the amount of the contribution and on the amount of the expenditure.
- c. **Failure to File Annual Report.** The penalty for failing to file a required annual return, either Forms 990/990-EZ or Form 1120-POL is \$20 per day, with a maximum penalty of the lesser of \$10,000 or 5 percent of the organization's gross receipts for the year, for organizations with gross receipts of \$1 million or less for the year. For organizations with gross receipts of more than \$1 million for the year, the penalty is \$100 per day up to a maximum of \$50,000 for organizations. IRC section 6652(c)(1).
- d. **Failure to Provide Copies to the Public.** Failure to allow public inspection or to provide a copy of the notice (Form 8871) to the public can result in a penalty of \$20 each day the failure continues, with no maximum. IRC section 6652(c)(1)(D). Failure to provide a copy of a periodic report (Form 8872) or an annual return to the public can result in a penalty of \$20 per day, up to a maximum of \$10,000 per report. IRC section 6652(c)(1)(C).

#### 9. Early Results

- a. On August 11, 2000, the IRS announced that it had received more than 8,500 initial notice forms (Form 8871). More than 6,600 of those forms had already been scanned and placed on the Internet as of that date. The IRS also announced that it had received several periodic reports (Form 8872), probably representing pre-election reports relating to the national party conventions or primary elections.
- b. The filing results to date show a wide variety of organizations. Numerous candidate committees for state and local candidates have filed reports, as well as many section 527

organizations associated with unions, other types of tax-exempt organizations, and for-profit companies, as well as organizations supporting a broad range of causes. Not everyone, however, is taking the registration process completely seriously. For example, someone has submitted an electronic filing (with no corresponding written Form 8871 posted by the IRS on the Internet as yet) for ABC Incorporated, with Mickey Mouse listed as its custodian of records and Minnie Mouse as its contact person and the IRS New Carrollton, Maryland office as the listed address.

#### 10. Where do we go from here?

- a. **Constitutional Issues.** One of the first objections raised to the legislation was that it is unconstitutional, particularly with respect to requiring the disclosure of information about donors. The National Federation of Republican Assemblies, joined by a state and local unit of the federation, has already challenged the new law based on the First and Tenth Amendments.
- b. **IRS field service advice.** Now that stealth 527 funds are no longer a means of avoiding disclosure of political activities, observers expect that donors desiring anonymity will attempt to use other categories of organizations, for example section 501(c)(4) organizations — which can engage in some partisan political activity — or taxable entities — claiming that contributions are not taxable under section 102. A Field Service Advice Memorandum recently issued by the IRS National Office may be highly relevant in assessing the risks of these strategies. FSA 200037040 (Sept. 15, 2000).

The IRS memorandum holds that a section 501(c)(4) organization that engages in too much campaign intervention — partisan electioneering cannot be the organization's primary activity — is a section 527 organization. The memorandum states explicitly that section 527 is not an elective status; if an organization satisfies the statutory requirements it will be treated as exempt under section 527, apparently with all that this now entails. The memorandum further states that an organization can be a section 527 organization even if its organizing documents do not provide that influencing elections is its primary purpose. Hence, the organizational test under section 527 is apparently looser than under section 501(c)(3).