WASHINGTON WATCH

A Rant About the Implications of an IRS Scandal

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"When I use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean-neither more nor less."

"The question is," said Alice, "whether you can make words mean so many different things."

"The question is," said Humpty Dumpty, "which is to be master-that's all." (Lewis Carroll, *Through the Looking Glass*.)

This summer and fall the newspapers have been full of reports about IRS scandals. More column-inch space has been devoted to the IRS's handling of applications from social welfare organizations, referred to by their Code Section as 501(c)(4) organizations, than any other tax scandal in recent memory. As estate planners, we should care about this scandal for two reasons: First, the treatment of **Section 501(c)(4)** organizations has some relevance to our practice, and second, the fallout from this scandal is going to affect tax administration across the board.

The substantive issue

To understand any tax scandal, one first needs to know the law. **Section 501(c)(4)** organizations are defined in the Code as "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 in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes."

The quintessential 501(c)(4) organization is Rotary International. Other well-known 501(c)(4) organizations are the Sierra Club (as distinct from the Sierra Club Foundation, which is a 501(c)(3) organization), the AARP (as distinct from the AARP Foundation, which is a 501(c)(3) organization), and the NRA (which has several 501(c)(3) subsidiaries).

In recent years, many organizations that are commonly thought of as "political" have also qualified under **Section 501(c)(4)** , such as Organizing for Action and Crossroads GPS. The attraction of **Section 501(c)(4)** status for these political organizations is that they do not need to make public their list of donors.

The relevant definition of a social welfare organization in the Code states that such organization must be operated "exclusively" for the promotion of social welfare. The meaning of that word "exclusively" is at the heart of this controversy. One might think that "exclusively" has a common meaning; Google's on-line dictionary defines exclusive as "to the exclusion of others; only; solely."

In this context, however, exclusively does not mean "solely." In 1950, Congress enacted the tax on unrelated business income of exempt organizations described in **Section 501(c)** , including **Section 501(c)(4)** organizations. Those provisions pertain to activities of organizations that are not "substantially related" to the organization's "function constituting the basis for its exemption under section 501." **1** Thus the UBIT rules made it clear that **Section 501(c)(4)** organizations could engage in activities that were not related to their exempt purposes.

In an attempt to rationalize this law and some prior court cases, the Treasury promulgated regulations under **Section 501(c)(4)** . With a stroke of the pen worthy of Lewis Carroll, the regulations state that "[a]n organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general

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welfare of the people of the community." **2** The regulations also provide that "[t]he 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." **3** With that, "exclusively" became "primarily," and the IRS was left in the position of determining whether and to what degree applicants for **Section 501(c)(4)** status were engaging in political activity. **4**

Gift tax treatment

Section 501(c)(4) organizations are themselves exempt from income taxes. However, contributions to such organizations are not deductible for income tax purposes. The question of whether contributions to (c)(4) organizations are subject to gift tax has a less clear answer.

The charitable deduction in the gift tax provisions is not as broad as the definition of exempt organizations in **Section 501(c)** . Rather, like **Section 170** (i.e., the income tax deduction statute), it picks and chooses from among the types of organizations described in **Section 501(c)** . **Section 501(c)(4)** is not one of the provisions picked up for a gift tax exemption or deduction. **Section 2522** provides a deduction for "charitable and similar" gifts, specifically describing:

- **Section 501(c)(3)** organizations.
- U.S. federal, state, and local governmental units.
- Certain fraternal societies.
- Certain organizations of war veterans.

Section 2501(a)(4) gives special treatment to gifts to certain political organizations (so-called 527 organizations), providing not a deduction but an exclusion from the definition of a taxable transfer. No similar provision applies to gifts to **Section 501(c)(4)** organizations.

Early case law on political contributions, prior to the enactment of **Section 2501(a)(4)** , held that contributions made to promote a specific policy objective were not gifts. On the facts of these cases, the courts found that the political expenditures were "free from donative intent" and therefore not taxable as gifts. **5** A decade later, the Tax Court found in *Carson,* **6** that neither in-kind electioneering expenses nor direct cash contributions to a political campaign over which the taxpayer exercised no control were gifts subject to gift tax. The Tax Court distinguished political contributions from taxable gifts on the ground that, absent familial or social ties, they are not gratuitous transfers to the candidate but rather represent the use of the donor's "resources to promote the social framework [he] considers most auspicious to the attainment of his objectives in life."

Although the Service acquiesced in the result in *Carson*, it held its ground on **Section 501(c)(4)** organizations. In a 1982 Revenue Ruling, the IRS stated that it "continues to maintain that gratuitous transfers to persons other than [527 organizations or charitable organizations] are subject to the gift tax absent any specific statute to the contrary, even though the transfer may be motivated by a desire to advance the donor's own social, political, or charitable goals." **7**

Discussing the applicability of the gift tax to contributions to 501(c)(4) organizations in a 2000 pamphlet, the Joint Committee on Taxation drew the analogy to political contributions: "The rationale reflected in the *Carson* and *Stern* decisions-that is, that the recipient organization or candidate may be viewed for gift tax purposes as means to the end of the contributor-arguably could be applied to contributions made to fund advocacy activities of section 501(c)(4) organizations." **8** Commentators have also raised constitutional issues with the IRS's position, arguing that imposing a gift tax on contributions to a section 501(c)(4) organization would burden

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the donor's exercise of his rights to freedom of speech and association under the First Amendment. Taxing contributions to section 501(c)(4) organizations may also implicate the Equal Protection Clause. **9**

On this backdrop, it became public information in May 2011 that the IRS had opened five gift tax audits with respect to contributions to 501(c)(4) organizations. After expressions of outrage from Congress, the IRS swiftly withdrew its inquiries. In a July 2011 memo to the Commissioners of the Small Business/Self-Employed and Tax-Exempt and Government Entities Divisions, then Deputy Commissioner Steven Miller announced that "[u]ntil further notice, examination resources should not be expended on this issue. It is anticipated that any future examination activity would be after the coordination described above and would be prospective only after notice to the public.... Accordingly, all current examinations relating to the application of gift tax to contributions to **I.R.C. §501(c)(4)** organizations should be closed." **10** To date, gift tax examinations of gifts to **Section 501(c)(4)** organizations remain suspended.

Allegations of political motivation

Unbeknownst to the public, this gift tax retreat occurred at the same time that the IRS was struggling internally with its criteria for considering requests for exemption under **Section 501(c)(4)** . Between 2010 and 2012 the annual number of applications for exemption under **Section 501(c)(4)** doubled. **11** Over that same period, the IRS budget and staff were cut. **12** There was an increasing backlog of applications for exemption that had not been evaluated, as well as organizations that received allegedly intrusive and extensive requests for additional information.

Responding to complaints from constituents and press reports, Congressmen called for investigation. Some expressed concern that **Section 501(c)(4)** groups inappropriately were being allowed to spend unfettered amounts of money on political campaigns, while others alleged that the IRS was using political criteria to determine which applications for exemption were scrutinized. IRS officials testified at congressional hearings denying the allegations.

News that the National Office had in fact been involved with these issues broke at the May 2013 meeting of the American Bar Association Tax Section in Washington, D.C., when Lois Lerner, then Director of the IRS Exempt Organizations Division, answered a question from the audience about the handling of these applications. That question, it turned out, had been planted by Lerner herself, at the

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urging of her superiors at the IRS. This revelation opened the door to more allegations. We heard reports that it was the overwhelmed staff in Cincinnati who developed the "BOLO" (be on the look out) list that included the words "tea party," "patriot," and "progressive." Other reports placed responsibility for the screening terms on IRS officials in Washington, or even the White House, alleging that Washington was directing the inquiries, or at least encouraging them, or permitting them to occur.

Substantive fallout

At present, we are no closer to resolving these issues. Congress has not passed any new laws about **Section 501(c)(4)** organizations. The IRS has promulgated no new regulations. The gift tax issue remains in suspense.

The fact remains that **Section 501(c)(4)** was not intended to house political organizations. Even when "exclusively" is construed to mean "primarily," someone has to draw the line. How is the IRS to determine whether an organization is primarily devoted to social welfare without a holistic understanding of its activities? And if Congress does not want the IRS looking into these activities, it should clarify or change the laws. Some commentators have suggested that the evaluation of an organization's activities is inherently political and that some agency other than the IRS should consider them. Others blame Congress for creating a legal framework that led to "exclusively" taking on a twisted meaning.

The gift tax issue remains on hold, overshadowed by the scandal. Declaratory judgment actions have been filed to try to force the IRS to give a yes or no answer on pending exemption applications. Meanwhile practitioners worry out loud about whether the other functions of the IRS are being dragged down in this process, increasing inefficiency and paralysis. The focus on **Section 501(c)(4)** applications has slowed the approval process for charitable organizations. Furthermore, audit activity in the exempt organizations area seems to be on the decline.

Administration of our tax system

The scandal in Washington does not affect only exempt organizations. In our Washington, D.C. law firm, we have a tradition of what we call "government service," the idea that there is much to be gained by both the government and the private sector when attorneys move from private practice to the government. In many substantive areas, the government depends on attorneys coming from private practice, bringing their practical experience with them, and serving the public good. Lawyers generally take pay cuts-sometimes substantial pay cuts-to do government service, but they do so out of love for the law and a desire to improve government.

One of the greatest tragedies of this scandal is the deterrent effect it has on the willingness of attorneys to commit to government service. The media reports that IRS attorneys whose names were associated with this scandal have been harassed and threatened, their children followed home from school. They have been made to feel unsafe in their own homes. Several of these attorneys-who are not political appointees but regular government employees-have been named in lawsuits in their personal capacity. Even though guilt or innocence has yet to be determined, these attorneys have had to hire counsel out of their personal funds.

We do not yet know which, if any, of these individuals are guilty of wrongdoing, and which might have

been involved in the issue because they were trying to fix a problem that had been drawn to their attention. If it was the job of some in Washington to manage the exemption application process, then they rightfully inquired about the selections processes in use and how cases were handled. Surely some of these people were part of the solution, not part of the problem.

Yet they have been tried and convicted on the pages of the daily papers, left to suffer indignities and damage to their reputations. In my own firm, I hear younger attorneys express an unwillingness to work for the government now. Why would people take a pay cut to work for the IRS at such great risk to their future and the well-being of their families?

While a generation of IRS attorneys prepares to retire, we need bright young people to step into their shoes, to try to do what is right, and to administer the tax laws. Any errors made with respect to **Section 501(c)(4)** organizations cannot be allowed to taint government service for all. That result would be a harsh penalty for taxpayers, who deserve thoughtful and idealistic young lawyers on the side of the government. We may never know what really happened with respect to the **Section 501(c)(4)** organizations, but we will suffer from this scandal's repercussions for decades.

1
Section 513(a) .

2
Reg. 1.501(c)(4)-1(a)(2)(i) .

3
Id.

4
See also **Rev. Rul. 81-95, 1981-1 CB 332** .

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Stern, **27 AFTR 2d 71-1647** , 436 F2d 1327, 71-1 USTC ¶12737 (CA-5, 1971), *aff'g* **24 AFTR 2d 69-6101** , 304 F Supp 376, 70-1 USTC ¶12640 (DC La., 1969).

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71 TC 252 (1978), *aff'd* **47 AFTR 2d 81-1619** , 641 F2d 864, 81-1 USTC ¶13396 (CA-10, 1981).

7
Rev. Rul. 82-216, 1982-2 CB 220 .

8
Joint Comm. on Taxation, *Overview of Present-Law Rules and Description of Certain Proposals Relating to Disclosure of Information by Tax-Exempt Organizations with Respect to Political Activities*, JCX-59-00, at 45 note 129 (6/19/2000).

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Rhomberg, *Constitutional Issues Cloud the Gift Taxation of* ***Section 501(c)(4)*** *Contributions, Taxation of Exempts*, Vol. 15, No. 4 (Jan./Feb. 2004).

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Memorandum from Steven T. Miller, Deputy Commissioner for Services and Enforcement, to Commissioner, Small Business/Self-Employed Division and Commissioner, Tax-Exempt and Government Entities Division (7/7/2011), http://www.irs.gov/pub/newsroom/guidance_for_irs_sbse_estate_and_gift_tax_and_tege_exempt_organizations.pdf.

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http://www.reuters.com/article/2013/05/13/us-usa-tax-irs-criteria-idUSBRE94C03N20130513.

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http://www.nytimes.com/2012/01/12/business/budget-cuts-hamper-irs-from-performing-its-duties-report-says.html?_r=0.