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United States Senate

COMMITTEE ON FINANCE
WASHINGTON, DC 20510-6200

September 28, 2010

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

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Via Electronic Transmission

Dear Commissioner Shulman:

The Senate Finance Committee has jurisdiction over revenue matters, and the Committee is responsible for conducting oversight of the administration of the federal tax system, including matters involving tax-exempt organizations. The Committee has focused extensively over the past decade on whether tax-exempt groups have been used for lobbying or other financial or political gain.

The central question examined by the Committee has been whether certain charitable or social welfare organizations qualify for the tax-exempt status provided under the Internal Revenue Code.

Recent media reports on various 501(c)(4) organizations engaged in political activity have raised serious questions about whether such organizations are operating in compliance with the Internal Revenue Code.

The law requires that political campaign activity by a 501(c)(4), (c)(5) or (c)(6) entity must not be the primary purpose of the organization.

If it is determined the primary purpose of the 501(c)(4), (c)(5) and (c)(6) organization is political campaign activity the tax exemption for that nonprofit can be terminated.

Even if political campaign activity is not the primary purpose of a 501(c)(4), (c)(5), and (c)(6) organization, it must notify its members of the portion of dues paid due to political activity or pay a proxy tax under Section 6033(e).

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Also, tax-exempt organizations and their donors must not engage in private inurement or excess benefit transactions. These rules prevent private individuals or groups from using tax-exempt organizations to benefit their private interests or to profit from the tax-exempt organization's activities.

A September 23 *New York Times* article entitled "Hidden Under a Tax-Exempt Cloak, Private Dollars Flow" described the activities of the organization Americans for Job Security. An Alaska Public Office Commission investigation revealed that AJS, organized as an entity to promote social welfare under 501(c)(6), fought development in Alaska at the behest of a "local financier who paid for most of the referendum campaign." The Commission report said that "Americans for Job Security has no other purpose other than to cover money trails all over the country." The article also noted that "membership dues and assessments ... plunged to zero before rising to $12.2 million for the presidential race."

A September 16 *Time Magazine* article examined the activities of Washington D.C. based 501(c)(4) groups planning a "$300 million ... spending blitz" in the 2010 elections. The article describes a group transforming itself into a nonprofit under 501(c)(4) of the tax code, ensuring that they would not have to "publically disclose any information about its donors."

These media reports raise a basic question: Is the tax code being used to eliminate transparency in the funding of our elections – elections that are the constitutional bedrock of our democracy? They also raise concerns about whether the tax benefits of nonprofits are being used to advance private interests.

With hundreds of millions of dollars being spent in election contests by tax-exempt entities, it is time to take a fresh look at current practices and how they comport with the Internal Revenue Code's rules for nonprofits.

I request that you and your agency survey major 501(c)(4), (c)(5) and (c)(6) organizations involved in political campaign activity to examine whether they are operated for the organization's intended tax exempt purpose and to ensure that political campaign activity is not the organization's primary activity. Specifically you should examine if these political activities reach a primary purpose level – the standard imposed by the federal tax code – and if they do not, whether the organization is complying with the notice or proxy tax requirements of Section 6033(e). I also request that you or your agency survey major 501(c)(4), (c)(5), and (c)(6) organizations to determine whether they are acting as conduits for major donors advancing their own private interests regarding legislation or political campaigns, or are providing major donors with excess benefits.

Possible violation of tax laws should be identified as you conduct this study.

Please report back to the Finance Committee as soon as possible with your findings and recommended actions regarding this matter.

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Based on your report I plan to ask the Committee to open its own investigation and/or to take appropriate legislative action.

Sincerely,

Max Baucus
Chairman

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

COMMISSIONER

February 17, 2011

The Honorable Max Baucus
Chairman, Committee on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

I am responding to your letter about political campaign activities of organizations claiming to be tax exempt under sections 501(c)(4), (5) and (6) of the Internal Revenue Code (the Code). You wrote that such activities may be inconsistent with the tax-exempt status of these organizations. You asked us to survey major 501(c)(4), (5) and (6) organizations involved in political campaign activity to examine whether they are operated for the organization's intended tax exempt purpose and to ensure that political campaign activity is not the organization's primary activity.

To meet the requirements for tax exemption, a section 501(c)(4), (5) or (6) organization must engage primarily in activities that further its exempt purpose. As you acknowledge in your letter, under the law, section 501(c)(4), (5) and (6) organizations may engage in political campaign intervention, so long as the intervention, along with any other non-exempt activity, is not their primary activity. They also may conduct unlimited issue advocacy and lobbying, as long as those activities are germane to their exempt purposes. To determine the primary activities of an organization, including determining whether political campaign activity is a primary activity of an organization, we must wait until the organization files its annual information return to review the organization's activities for the entire year, as well as the facts and circumstances surrounding those activities. Only after a review of all the relevant information, including all expenditures and volunteer time, can we determine whether the organization is meeting the requirements for exemption, and whether any tax is due. This makes it difficult for us to assess during the tax year whether an organization claiming to be exempt under 501(c)(4), (5) or (6) is complying with the applicable limits on political campaign activity. Also, many organizations permissibly extend their due date for filing their annual information returns, which increases the delay between any improper activity that an organization conducted and our receipt of the information needed to assess the organization's compliance with the legal requirements.

We face an additional challenge in the initial formation of these organizations. The fact that these types of organizations have no legal requirement to file an application with us to seek a determination that they are exempt within section 501(a) results in many such organizations essentially "self declaring" exemption without our determination as to

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exempt status. This means we do not have an opportunity to review the stated purposes and activities of such an organization before it files one or more Forms 990.

We share your concern that tax-exempt organizations of all types comply with the applicable laws governing political campaign activities and not use them for improper purposes. We took a major step in 2008 to enhance the reporting of tax-exempt organizations other than charities (including those described in section 501(c)(4), (5), or (6)), by requiring them to provide specific information on the annual Form 990 about their political campaign activities. Requiring this information makes the organization's political campaign activities more transparent to us and to the general public. We use this information in determining if political campaign activity is an organization's primary purpose and whether any tax may be due.

In the work plan of the Exempt Organizations Division, we announced that beginning in FY2011, we are increasing our focus on section 501(c)(4), (5) and (6) organizations. With the additional information available on the new Form 990, we will look at issues relating to political activity, inurement, and the extent of compliance with the requirements for tax exemption by organizations that self-identify themselves under these sections. We appreciate your request to conduct a survey of these types of organizations, but given the timing of information challenges discussed above, we feel that this is not likely to provide us with the necessary compliance information. In our view, focusing our efforts on the annual information returns that we receive from these organizations is most appropriate.

To ensure that tax-exempt organizations follow the tax laws, we are committed to a balanced program overseeing a wide range of tax-exempt organizations, including those exempt under the sub-sections cited in your letter. Additional information on the relevant law is in the enclosure.

Thank you for your attention to this area of the law. We appreciate your continuing support of our efforts to administer the tax laws that apply to tax-exempt organizations, and we welcome the opportunity to meet with you and your staff to discuss these matters.

Please call me at (202) 622-9511, or Floyd Williams, Director of Legislative Affairs, at (202) 622-4725, if you need additional information or would like to schedule a meeting.

Sincerely,

Douglas H. Shulman

Enclosure

IRS-JW-220-005474

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Enclosure

Types of Tax-Exempt Organizations

Charitable organizations described in section 501(c)(3) must be organized and operated to further charitable, religious, educational, etc. purposes. As such, they must be operated for the public rather than private benefit and their net earnings may not inure to the benefit of any private shareholder or individual. Section 501(c)(3) organizations are eligible to receive tax-deductible charitable contributions under section 170. To be treated as a tax-exempt section 501(c)(3) organization, most charitable organizations (other than churches) must notify the IRS by filing Form 1023, Application for Recognition of Tax-Exempt Status.

The exempt purpose of section 501(c)(4) social welfare organizations is to promote social welfare by promoting the common good and general welfare of people in the community. For section 501(c)(5) labor, agricultural, and horticultural organizations, the exempt purpose is the betterment of conditions of those engaged in their pursuits, the improvement of the grade of their products, or the development of a higher degree of efficiency in their respective occupations. The section 501(c)(6) business league exempt purpose is to promote the common business interest of its members and not to conduct a regular trade or business for profit. The net earnings of these organizations may not inure to the benefit of any private shareholder or individual (for section 501(c)(4) and (6) organizations) or member (for section 501(c)(5) organizations).

The exempt purpose of section 527 political organizations is attempting to influence the election, selection, nomination, or appointment of any individual to federal, state, or local public office, office in a political party or the Presidential and Vice-Presidential electors. These include candidate committees, party committees, and political action committees (PACs). Certain section 527 political organizations are automatically tax exempt: FEC political committees, state and local candidate committees, state and local party committees, and small organizations that never receive more than $25,000 in gross receipts during any taxable year. All other section 527 political organizations must electronically file Form 8871 to be tax-exempt, including state PACs that receive more than $25,000 in any taxable year. If they do not file Form 8871, they are taxable section 527 organizations and subject to tax on all of their income (including contributions) at the highest corporate rate. They are not eligible to receive tax-deductible charitable contributions under section 170.

Types of Advocacy

The Internal Revenue Code distinguishes between different types of advocacy that tax-exempt organizations may engage in, particularly lobbying activity and political campaign activity.

Lobbying activity is the attempt to influence legislation. For these purposes, legislation includes action on acts, bills, resolutions, or similar items by the Congress, any state

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legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure.

Political campaign activity is the attempt to influence the election of candidates to public office. This includes any activities that favor or oppose one or more candidates for public office, such as candidate endorsements, contributions to political campaign funds, or public statements of position (verbal or written) made by or on behalf of an organization in favor of, or in opposition to, any candidate for public office.

General advocacy includes activity attempting to influence the public on issues of concern to the organization, attempting to influence actions by the executive branch of government such as issuance of regulations, and activities intended to encourage people to participate in the electoral process in a manner that does not favor or oppose any particular candidates.

The IRS bases its determination of whether an activity constitutes lobbying or political campaign activity on all of the relevant facts and circumstances. Consequently, a communication made shortly before an election that identifies a candidate and takes a position may not constitute political campaign activity in certain circumstances. See Rev. Rul. 2004-6 for examples of the facts and circumstances considered in making such a determination.

Advocacy by Tax-Exempt Organizations

As the chart below illustrates, the different types of tax-exempt organizations discussed above have different rules as to the types of advocacy they may conduct consistent with their tax-exempt status. Engaging in each type of advocacy through some form of tax-exempt organization is possible, but not all types of tax-exempt organizations can engage in each type of advocacy.

	501(c)(3)	501(c)(4)	501(c)(5)	501(c)(6)	527
Receive Tax-Deductible Charitable Contributions	YES	NO	NO	NO	NO
Engage in Legislative Advocacy	LTD	YES	YES	YES	LTD
Engage in Candidate Election Advocacy	NO	LTD	LTD	LTD	YES
Engage in Public Advocacy Not Related to Legislation or Election of Candidates	YES	YES	YES	YES	LTD

By statute, section 501(c)(3) charitable organizations may not engage in lobbying activity as a substantial activity and are absolutely prohibited from engaging in political campaign activity. They may engage in other advocacy activities, including encouraging people to participate in the electoral process in a manner that does not

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support or oppose any candidates for public office, without jeopardizing their tax-exempt status. In addition to the possibility of loss of tax-exempt status if they engage in political campaign activity or too much lobbying activity, the expenditures for such activities may be subject to an excise tax under section 4955 for political campaign activity or section 4911 or section 4912 for lobbying activity. A section 501(c)(3) organization that loses its tax-exempt status due to too much lobbying or political campaign activity may not be treated as a section 501(c)(4) organization.

At the opposite end of the spectrum are section 527 political organizations. As their exempt purpose is to engage in political campaign activity, they are unlimited in the amount they may do. However, they are limited in the amount of lobbying and other advocacy they may conduct. Section 527 political organizations that expend more than an insubstantial amount from any fund for non-political campaign activity will be subject to tax on all the income (including contributions) to that fund.

The organizations described in sections 501(c)(4), 501(c)(5), and 501(c)(6) are treated similarly as to the treatment of their advocacy activities. Activities that further the respective exempt purposes of these three types of tax-exempt organizations not only include general advocacy activities related to their exempt purpose, but can also include lobbying activity related to their exempt purpose. Thus, for example, a ballot measure committee may qualify as a section 501(c)(4), (5), or (6) organization. Political campaign activity does not further their respective exempt purposes so they are limited in the amount of political campaign activity they may engage in without jeopardizing their tax-exempt status as that activity, along with all other non-exempt purpose activity, must be less than primary.

While section 501(c)(4), (5), and (6) organizations may engage in a limited amount of political campaign activity without jeopardizing their tax-exempt status, they are subject to tax under section 527(f) on the lesser of their net investment income or the amount expended for their political campaign activity. In determining whether an activity is subject to tax under section 527(f), all the relevant facts and circumstances are considered.

Additionally, section 501(c)(4), (5), and (6) organizations may be subject to the notice and proxy tax requirements of section 6033(e). Under section 162(e), the organization cannot generally take a deduction of expenses for lobbying and political campaign activity as an ordinary and necessary business expense. Although in some instances, dues or similar amounts paid to section 501(c)(4), (5), and (6) organizations may be deductible as an ordinary and necessary business expense, they are not deductible to the extent the organization uses dues or similar amounts for attempting to influence legislation or candidate elections. Unless substantially all of the organization's members do not deduct their dues or similar amounts as a business expense, the section 501(c)(4), (5), and (6) organization must either (1) notify its members of the portion of the dues used for lobbying or political campaign activity or (2) pay a proxy tax on that amount. Rev. Proc. 98-19 provides tests for determining whether substantially all of an organization's members do not deduct dues as business expenses. In making

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the calculation, the organization does not include any expenses that were subject to tax under section 527(f), so it includes only those expenditures for political campaign activity that exceed the organization's net investment income.

The IRS has recognized the need for guidance in this area and issued Rev. Rul. 2004-6, which provides examples illustrating facts and circumstances to be considered in determining whether section 501(c)(4), (5), and (6) organizations are subject to tax under section 527(f).

Tax-Exempt Organization Reporting and Disclosure Requirements

Most tax-exempt organizations must file an annual information return with the IRS. Section 501(c)(3) charitable organizations that are churches or government instrumentalities have no requirement to file the annual information return. Also, section 527 political organizations that are automatically tax-exempt and were not required to file Form 8871 have no requirement to file the annual information return.

Depending on the amount of the organization's annual gross receipts and net assets, the annual information return is the Form 990, the Form 990-EZ, or the Form 990-N. Section 527 political organizations are not required to file Form 990-N. These forms are publicly available. However, other than for section 527 political organizations, the IRS is not permitted by statute, and the organizations have no requirement, to disclose the names and addresses of contributors. Therefore, the publicly available information generally does not include Schedule B. Over the last several years, the IRS has imaged Form 990 series returns on DVD and made them available to the public. Recipients of this information then make these returns available on the internet to anyone. The forms are due on the 15th day of the fifth month following the end of the organization's taxable year (May 15 for calendar year organizations), but organizations may request extensions of up to six months (so many calendar year organizations do not file until November 15 of the year after the taxable year being reported).

Organizations filing Form 990 or Form 990-EZ must report whether they had any expenditures for political campaign activity and, if so, how much they expended. Section 501(c)(3) charitable organizations must also report their lobbying activities, if any. Section 501(c)(4), (5), and (6) organizations that have not established that their members cannot deduct substantially all of their dues as a business expense must report on their lobbying and political campaign activity, unless it consists solely of in-house lobbying that was less than $2,000. This information is now collected on Schedule C of Form 990 or Form 990-EZ.

As discussed above, section 527 political organizations must file Form 8871 to be tax-exempt, unless they are automatically tax-exempt because they are an FEC political committee, state or local candidate committee, state or local party committee, or a small organization that never receives more than $25,000 in gross receipts for any taxable year. Organizations file these forms electronically, and they are publicly available on the IRS web site. Section 527 political organizations that have filed Form 8871 must also

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periodically report information on their contributions and expenditures using Form 8872 unless they meet the requirements of a qualified state or local political organization. These forms are also publicly available on the IRS web site. As only those section 527 political organizations that filed Form 8871 must file Form 8872, a section 527 political organization that is not exempt because it has not filed Form 8871 is not required to file Form 8872. Thus, an organization that did not qualify as a section 501(c)(4) organization because its primary activity was political campaign activity and therefore was an organization described in section 527 would have no requirement to disclose contributor information unless and until it filed Form 8871.

Section 527 political organizations report their taxable income on Form 1120-POL. Under section 6103, this form is not publicly disclosable. While the taxable income of tax-exempt section 527 political organizations consists primarily of investment income, the taxable income of those section 527 organizations that are not exempt because they have not filed Form 8871 includes all income, including contributions. However, those organizations have no requirement to disclose any information other than the aggregate amount of those contributions on Form 1120-POL.

Section 501(c)(4), (5), and (6) organizations use Form 1120-POL to report any tax due under section 527(f). If those organizations pay the proxy tax under section 6033(e), they report it on Form 990-T. While the Forms 990-T that section 501(c)(3) charitable organizations file are required to be publicly disclosed, those that section 501(c)(4), (5), and (6) organizations file are not.