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Making Sense of Taxation of Political Expenditures of Nonprofit Organizations

This is obscure as blog topics go, but worth your time if you advise on candidate-related activities of 501(c) orgs. By "501(c) orgs," we mean organizations exempt under section 501(c) of the Internal Revenue Code that aren't 501(c)(3) public charities and private foundations: most commonly, unions, trade associations, and social welfare organizations. Taxation of these activities has been tricky for ages, but got more complicated in January 2010, when the Supreme Court declared in *Citizens United v. Federal Election Commission* that corporations and labor unions were no longer prohibited from making independent expenditures to support or oppose candidates in federal elections. More on that below.

First, some background: 501(c) orgs are generally tax-exempt on all of their income (other than unrelated business taxable income). In 1976, section 527 of the IRC created a new tax status for political organizations to exempt them from federal income tax to the extent they raised and spent funds for candidate-related political purposes. The new Code provision taxed 527s on their net investment income, however, and to foreclose candidates using 501(c) orgs to generate investment income without taxation, section 527**(f)** imposed a tax on 501(c) orgs, on the **lower of** their political activity expenditures or their net investment income.

Applying section 527(f) hinges on the meaning of "political activity." Treasury Department regulations from 1980 say that expenditures **"allowed"** under federal or similar state laws are **not** subject to the 527(f) tax, except as otherwise provided, but left the "otherwise provided" part blank, sticking in two placeholders, labeled "Reserved," instead. These regs, known as the "reserved regulations," remain non-existent to this day.

The lack of reserved regulations didn't matter much for the first thirty years, because 501(c) orgs, which are usually corporations (or unincorporated labor unions), were generally constrained by election laws prohibiting them from making independent expenditures. When the Supreme Court struck down that prohibition, it opened the door for unprecedented levels of independent direct political activity by 501(c) orgs – free from income taxation, and potentially from burdensome donor disclosure obligations. In theory, section 527(f) could discourage this free-for-all by taxing the political expenditures of such entities – but until the reserved regulations are promulgated, any political expenditures "allowed" by federal election law arguably escape the tax. Since what's "allowable" has mushroomed under *Citizens United*, a literal reading of the existing regulations renders all of those independent expenditures untouchable by section 527(f).

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Nonprofit Law Matters looks at legal issues in the nonprofit and tax-exempt organizations world. Written by the attorneys and paralegals of Adler & Colvin, it provides updates and analysis regarding philanthropy, charity, and other exempt organization issues.

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We're uncomfortable with this unreasonable outcome. In an upcoming article in the *Election Law Journal*, we propose a new framework for interpreting the existing regulations in the absence of the reserved regs. Under our proposal, an expenditure of a 501(c) org would be deemed "allowable" under election law, and therefore nontaxable under section 527(f), if the expenditure is both permitted **and** not subject to campaign finance disclosure. This definition of "allowable" is more restrictive than "allowable = permitted = nontaxable," but more in line with our understanding of Congress' purpose in enacting 527(f) and Treasury's rationale in promulgating the 527(f) regs. Instead of creating their own definition of "political," Congress and Treasury intended to rely on federal and state campaign finance law to define the scope of election-related activities that should be monitored and/or prohibited. We think **those** are the activities that 527s should expect to conduct tax-free, and that 501(c) orgs should be discouraged from conducting. Relying on the dictionary meaning of "allowable" after *Citizens United* shields too much patently political activity that should either be subject to public disclosure, or taxed under section 527(f).

We hope our framework will help practitioners wrestling with similar matters, and Treasury, whenever it decides to draft the reserved regulations. A link to the article entitled, "Taxation with Reservations: Nonprofit Political Expenditures After *Citizens United*," is here. In the meantime, we would love to hear your thoughts about our proposal.

– Rosemary Fei and Nancy McGlamery

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