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HOW TO SET UP AND MAINTAIN AN ACTION FUND AFFILIATED WITH A CHARITY

As charitable tax-exempt organizations work to deliver better results to their constituents, an increasing number of them look for appropriate ways to become active in the political life of their city, county, state, or nation. This is true not only for groups interested in controversial issues such as the environment, gun control, animal welfare, civil rights, and world peace, but also for traditional religious, health care, and educational institutions. Charities are getting involved in efforts to influence legislative and executive branch decisions, judicial appointments, voter registration and turnout, and litigation in the courts. Section 501(c)(3) does not restrict the amount of administrative lobbying, nonpartisan voter participation efforts, or litigation a charity may conduct in furtherance of its exempt purposes, but some types of advocacy are restricted or prohibited.[1]

Some groups want to do more legislative lobbying than the "insubstantial" degree permitted under Section 501(c)(3). Most public charities can make the election under Section 501(h) to report lobbying expenditures up to the statutory limit, which can be as high as 20% of annual expenditures for small nonprofit groups. Still, the organization may want to raise and spend a greater amount to lobby Congress, pay for mass media and other forms of grass roots lobbying, or campaign for or against an initiative or referendum coming before the voters on Election Day.

Despite the Section 501(c)(3) absolute prohibition on intervention in campaigns of candidates for political office, some charities wish they could endorse or speak freely about candidates, rate candidates on their issues, or gain influence with public officials by helping them get elected as other interest groups do.

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For charities wanting a more activist role in public policy, the best alternative may be to create a separate, affiliated entity under Section 501(c)(4), the tax status conferred on social welfare organizations.[2] The Service has ruled that lobbying on legislation for the public good is a perfectly appropriate social welfare activity for a Section 501(c)(4) entity.[3] While political intervention in candidate campaigns does not qualify as a social welfare activity, the Service has ruled that it is a permitted function for a Section 501(c)(4) organization so long as true social welfare activities remain primary. Political intervention, then, along with other non-social welfare activities, must be "less-than-primary" for the entity to retain its Section 501(c)(4) exemption.[4] It appears, therefore, that rating, endorsing, supporting, and opposing candidates—while they remain off limits for charities—are legitimate secondary activities for an affiliated social welfare organization under federal tax law.[5] A Section 501(c)(4) organization, unlike a charity, is therefore permitted to establish separate segregated funds under Section 527(f) to conduct its partisan candidate-related activities,[6] even if the (c)(4) is affiliated with a Section 501(c)(3) charity.[7]

Setting up a Section 501(c)(4) organization involves a tradeoff. Donations do not qualify as deductible charitable contributions to the donor. On the other hand, there is no limit on how much the organization may spend on lobbying, and most practitioners believe that it can spend somewhat less than half of its budget on partisan political activity. The discussion below will refer to the Section 501(c)(3) organization as "the Charity" and the Section 501(c)(4) affiliate as "the Action Fund."[8] (It should be noted that many of the principles discussed here are applicable to relationships between a charity and any non-501(c)(3) exempt entity—such as a Section 501(c)(6) trade association or a Section 501(c)(5) union—pursuing lobbying or political goals, or both, as part of their activities.)

There are three basic principles to be followed in structuring the relationship between the Charity and the Action Fund, especially where the Charity has been established and has

developed considerable goodwill for some time prior to the creation of the Action Fund. These are guiding principles (and in some cases aspirational ideals), not absolutes. The specific arrangements must, of course, be tailored to the realities of the situation as well as legal requirements. The three principles are:

1. Maximum feasible separation of the Charity and the Action Fund, both legally and operationally.
2. No subsidy of the Action Fund operations by the Charity, except for specific charitable projects, which may include lobbying within the Charity's limits.
3. Avoidance of day-to-day control of the Action Fund by the Charity (or vice versa) as an "alter ego," although one entity may, in effect, retain ultimate control over the other's strategic decisions through an interlocking corporate structure.

Separation of entities

The Action Fund must have a legal identity separate from the Charity. This is most clearly established through separate incorporation and separate operations.[9] All corporate formalities should be carefully observed by each organization—separate meetings of staff, board, and committees, as well as separate minutes of those meetings.[10]

Is an overlap between the boards of directors of a Section 501(c)(3) and a Section 501(c)(4) organization permitted under federal tax law? Briefly put, the answer is absolutely yes.

In this regard, the primary concern running throughout federal tax law is not governance structure, but proper use of tax-deductible funds. The tax treatment of a Charity/Action Fund nonprofit combination is a unique product of two strong public policies—one favoring expression of First Amendment political rights, and the other permitting Congress to place limits on the use of government subsidies.

Tax subsidy theory. Charities exempt from tax under Section 501(c)(3) enjoy the benefit of receiving gifts that donors may treat as deductible charitable contributions for income, estate, and gift tax purposes. This is an indirect government subsidy, in the form of lost tax revenue. Since Congress confers this tax ben-

[1] This article updates and extends a previous article by the same authors in this publication, Fei and Colvin, "How to Set Up a Lobbying Affiliate for an Existing Charity," 6 JTEO 178 (Jan/Feb 1995).

[2] For a one-page summary of the differences between exemption under Section 501(c)(3) versus Section 501(c)(4), see Reilly, Hull, and Braig Allen, "IRC 501(c)(4) Organizations," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2003* (2002) at I-25.

[3] Rev. Rul. 71-530, 1971-CB 237.

[4] Rev. Rul. 81-95, 1981-1 CB 332. For a list of other authorities concluding that Section 527-type candidate-related activities may not be the primary activities of a Section 501(c)(4) organization, and similar authorities for organizations exempt under Section 501(c)(5) and Section 501(c)(6), see Kindell and Reilly, "Election Year Issues," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2000* (1999) at 363-366.

[5] For a discussion of the permissiblity and implications of partisan candidate-related Section 527-type activities carried on within Section 501(c)(4) or other non-(c)(3) organizations, see Kindell and Reilly, *supra* note 4 at 433-438. Non-tax laws may curtail or shape a social welfare organization's political affairs. Incorporated Section 501(c)(4) entities generally fall under the prohibition on corporate political spending to influence federal elections under the Federal Election Campaign Act (FECA), with additional restrictions in the most recent amendments of FECA contained in the Bipartisan Campaign Reform Act of 2002 (BCRA). Similar laws regulate Section 501(c)(4) electoral activities at the state level.

[6] For a discussion of separate segregated funds under Section 527(f), and a diagram, see Kindell and Reilly, *supra* note 4 at 438-440, 475.

[7] For a discussion of the tax law issues raised by such arrangements, see Thomas and Kindell, "Affiliations Among Political, Lobbying and Educational Organizations," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2000* (1999) at pages 255-266; Reilly and Braig Allen, "Political Campaign and Lobbying Activities of IRC 501(c)(4), (c)(5), and (c)(6) Organizations," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2003* (2002) at 477-479.

[8] In some situations, rather than the Section 501(c)(3) charity establishing a Section 501(c)(4) affiliate, individuals associated with the charity—acting in their personal rather than organizational capacities—may want to establish a separate and independent Section 527 political organization. This alternative is diagrammed in Kindell and Reilly, *supra* note 4 at 474, and discussed in Thomas and Kindell, *supra* note 7 at 261-263, emphasizing the steps that must be taken to prevent the Section 527 organization's activities from being attributed to the (c)(3). Additional discussion of when individuals' activities may be attributed to a Section 501(c)(3) may be found in Kindell and Reilly, *supra* note 4 at 363-366.

[9] While this article refers to the corporate form of entity, it is conceivable that many if not all of the structural goals discussed herein could be achieved through an unincorporated association, trust, limited liability company, or other non-corporate legal forms. Since entities in corporate form are subject to certain regulations under FECA and BCRA that non-corporate entities escape, some organizations interested in influencing federal elections are exploring alternative formations, especially as various states adopt modern statutes based on the Uniform Unincorporated Nonprofit Association Act, which includes limited liability protections for members.

[10] The importance of forming and maintaining separate organizations, including specifically board meeting minutes, is discussed by the IRS in Thomas and Kindell, *supra* note 7 at 265.

efit as a matter of legislative grace, it may impose restrictions on the use of deductible funds. Congress has prohibited Section 501(c)(3) organizations from engaging in substantial lobbying, and from any participation in political candidate campaigns, to prevent deductible funds from being used to support those activities.

Like individual citizens, however, nonprofit organizations have certain First Amendment rights to engage in the political and legislative process, so federal tax law must allow organizations an alternative means to express those rights without relying on deductible funds. That vehicle is the Section 501(c)(4) affiliate, which cannot receive tax-deductible donations but which does (like the Section 501(c)(3) entity) enjoy exemption from tax on any annual excess of revenues over expenses, and can express the Charity's views on legislation without limits.

LOBBYING ON LEGISLATION FOR THE PUBLIC GOOD IS A PERFECTLY APPROPRIATE ACTIVITY FOR A SECTION 501(c)(4) ENTITY.

In *Regan v. Taxation With Representation of Washington,* 461 U.S. 540, 51 AFTR2d 83-1294 (1983), the Supreme Court upheld the congressional limitation on Section 501(c)(3) lobbying for exactly these reasons: the Charity's First Amendment rights are preserved through its ability to speak through its affiliated Action Fund. The ease of establishing a Section 501(c)(4) affiliate was a key factor in the decision. The Court addressed the requirements the IRS may properly impose on organizations with a dual Charity/Action Fund structure. In footnote 6, the Court stated: "The IRS apparently requires only that the two groups be separately incorporated and keep records adequate to show that tax deductible contributions are not used to pay for lobbying. This is not unduly burdensome."[11]

More recently, a federal circuit court has applied the *Regan* analysis to a situation involving political candidate intervention. In *Branch Ministries v. Rossotti,* 211 F.3d 137, 85 AFTR2d 2000-1767 (DC D.C., 2000), the court upheld the constitutionality of the Section 501(c)(3) prohibition on electioneering because, among other reasons, the charity (a church) could have formed a "related" organization under Section 501(c)(4), which in turn could form a political action committee that "would be free to participate in political campaigns."[12] The IRS continues to affirm this position.[13]

Although the Supreme Court and the IRS have not expressly so ruled in the case of Charity/Action Fund combinations, it is widely accepted by practitioners in the tax-exempt field (and, the authors believe, by the IRS officials who currently administer the area) that the Charity must be able to have a degree of control over the Action Fund sufficient to insure that the Action Fund does not pursue a public policy agenda incompatible with that of the Charity that created it. Otherwise, the Charity would lose the political voice that it is constitutionally entitled to exercise.

Overlapping boards of directors. An overlap between the two boards of directors appears to be a control arrangement that is satisfactory to the IRS. The IRS routinely accepts Section 501(c)(4) exemption applications, submitted simultaneously with Section 501(c)(3) applications, showing a complete or partial overlap between the two boards, and both organizations are recognized as tax-exempt.[14]

Milton Cerny of Caplin & Drysdale in Washington, D.C., formerly chief of the Rulings Branch in the Exempt Organizations office of the IRS, has written that the boards of a Charity and an Action Fund can overlap "in part or in whole." He states that "[w]hile the § 501(c)(3) cannot play any role in the day-to-day conduct of the § 501(c)(4)'s activities, it is not barred from exercising the ultimate policy control inherent in its ability to select the board of directors of the § 501(c)(4) and to determine their tenure."[15]

It is a basic principle of federal tax law that any corporation, for-profit or nonprofit, may create a subsidiary corporation that will be regarded as a separate entity for tax purposes. Applying that principle, a Section 501(c)(3) charity may act as the parent of a noncharitable Section 501(c) subsidiary, or even

[11] Regan v. Taxation With Representation of Washington, 461 U.S. 540, 51 AFTR2d 83-1294, 83-1296 (1983).

[12] The court stated, erroneously, that a Section 501(c)(4) organization is itself subject to the ban on intervening in political campaigns, apparently unaware of the holding in Rev. Rul. 81-95 allowing political intervention as a secondary, non-social welfare activity.

[13] See Kindell and Reilly, *supra* note 4 at 367-369. However, the IRS warns there that "the political campaign activities of the affiliated IRC 501(c)(4) organization, or of the [527(f) separate segregated fund] it establishes, should not be an attempt to accomplish indirectly what the IRC 501(c)(3) organization could not do directly. Facts and circumstances prevail here also."

[14] The IRS merely requires that overlapping personnel, whether directors, officers, or staff, properly allocate their time between the two organizations. Thomas and Kindell, *supra* note 7 at 260.

[15] Cerny, "Campaigns, Candidates and Charities: Guideposts for All Charitable Institutions," New York University's Nineteenth Conference on Tax Planning for 501(c)(3) Organizations (Matthew Bender, 1991) at 5-39.

a taxable subsidiary, without jeopardizing the parent's tax status.[16]

GCM 33912, 8/15/68, addressed this question in the situation of a Section 501(c)(3) organization holding a controlling interest in a commercial newspaper operation that engaged in legislative and political activity. The GCM concluded that the activities of a subsidiary should be attributed to the parent "only where the evidence clearly shows that the subsidiary is merely a guise enabling the parent to carry out its legislative activities or where it can be proven that the subsidiary is an arm, agent, or integral part of the parent."

If the subsidiary has been formed for a bona fide purpose and is not a mere instrumentality of the parent organization, and if the parent does not actively participate in the day-to-day management of the subsidiary, the controversial activities of the subsidiary—whether they are commercial, legislative, political, or even illegal—will *not* be attributed to the parent.[17]

Even though tax law allows the Charity to completely control the selection of the Action Fund's board of directors, it is best to establish only that degree of control necessary to ensure political compatibility and no more. This is important for several reasons:[18]

- If the IRS were to examine all the facts and circumstances to determine whether an Action Fund was a "mere instrumentality," a "guise," or an "arm" of a Charity, the extent of the Charity's involvement in the affairs of the Action Fund's board of directors probably would be a relevant factor.
- If an Action Fund, wholly controlled by a Charity, has little significant activity of its own but serves as a platform to create a political action committee, which the Charity may not do, there is a risk that the IRS may argue that the Charity has used an artifice to avoid the prohibition on political candidate activities.
- Because the two organizations undoubtedly will transact business with each other (grants, reimbursements, sharing tangible and intangible resources, etc.), some diversity in directors and officers allows each entity to establish a more arm's-length, disinterested approval process for inter-organizational transactions.
- The degree of control by one entity over the other is a factor, not only for the IRS in determining whether to attribute the activities of the Section 501(c)(4) organization to the Section 501(c)(3), but also for a court in deciding whether to pierce the corporate veil between the two, exposing the assets of one to contractual or tort liabilities generated by the activities of the other.

One common solution is a de facto overlap between the boards of the Charity and Action Fund corporations, but without corporate legal control—i.e., neither entity is given the legal power to select or remove any of the directors of the other. The members of the Action Fund's board of directors who also sit on the Charity's board must understand that, when acting in their capacity as Action Fund directors, they have a fiduciary duty under state corporate law to manage the affairs and assets of the Action Fund in accordance with the Action Fund's articles and bylaws. They are legally required to act in the best interests of the Action Fund, and their duty of loyalty to the Action Fund prohibits them from placing the interests of another organization, such as the Charity, above the interests of the Fund. Of course, the same is true in reverse when these overlapping directors act as members of the Charity's board. While this can work well in some situations, a mere *de facto* overlap runs the risk that, over time, the mutual understandings of the directors present at the beginning will dissipate and the overlap may decrease, eventually leading to serious "mission drift" problems, where the founding organization no longer feels it has a cooperative affiliate.

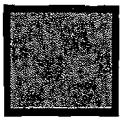
It is important to reiterate that it is thoroughly defensible for the Charity to have complete power to appoint and remove all members of the affiliate Action Fund's board of directors, or vice versa. This is frequently accomplished by setting up the Action Fund as a membership corporation, with the Charity as the sole voting member. Another often-used mechanism is for the Action Fund's bylaws to grant the Charity the power to designate, remove, and replace the Action Fund directors at will.

THE ACTION FUND MUST HAVE A LEGAL IDENTITY SEPARATE FROM THE CHARITY.

[16] The IRS addressed this in Thomas and Kindell, *supra* note 7 at 257-260.

[17] See also GCM 36203, 3/20/75; GCM 39326, 8/31/84.

[18] There are other rules that the two organizations may wish to avoid by creating a sufficient degree of separation between them, such as nondiscrimination regulations affecting employee benefits and accounting rules requiring consolidated final statements.



AN OVERLAP BETWEEN THE TWO BOARDS APPEARS SATISFACTORY TO THE IRS.

There are many other ways to exercise a more modest, yet effective, degree of control, though the effectiveness of any of the following arrangements in a particular setting may depend largely on the individual personalities involved and the level of mutual trust among the actors:

- The Charity could select the initial Action Fund board, leaving that board to elect its successors.
- It could be required that certain seats on the Action Fund board be filled by representatives of the Charity, or that the Charity have power to appoint a certain proportion of the Action Fund board.
- The Charity could approve a pool of people, in advance, from which the Action Fund board could select its directors, or selections made by the Action Fund board could be vetoed by the Charity until acceptable people are found.
- The overlap could be de facto only, with an informal understanding that the overlap is to continue. This can work well in closely held corporations where the directors understand the importance of maintaining continuity over the long term, and would bring in only new directors who agreed to serve on both boards.
- A non-corporate mechanism could be used to maintain political compatibility, such as a licensing or affiliation agreement under which the Action Fund agrees to use the name, logo, or other resources of the Charity (paying fair market value, as applicable), but subject to the Charity's power to terminate the agreement for cause, or even without cause. In the event of a schism, the Action Fund would be free to become independent, but it could not use the name, logo, or membership list of the Charity and would lose all the attributes of affiliation.

Over the years, the authors have found that the following legal form of interlock often is optimal for many (c)(3)-(c)(4) tandem arrangements: One entity—the Charity in this example—has no reference in its articles or bylaws to the other affiliated organization—the Action Fund here. The Action Fund's bylaws provide that the Charity has the power to appoint and remove, at will, all (or a majority, which is often sufficient) of the directors of the Action Fund; *provided, however*, that the Action Fund board has, at all times, a majority who are not also directors, officers, employees, or agents of the Charity. The Action Fund's articles and bylaws provide that no amendment can be made affecting the powers of the Charity without the Charity's written consent, preventing the Action Fund from unilaterally undoing the interlock. This structure ensures that the Action Fund will not be spirited away from the Charity by a board with divergent views, but allows each board to muster a disinterested majority of directors to approve transactions between them.

The discussion above focuses mainly on the dynamics of an existing charity setting up a new social welfare affiliate for public policy work. In today's activist environment, the Section 501(c)(4) entity is often created first, or at the same time as the Section 501(c)(3) charity.[19] The better arrangement, in those circumstances, is usually to place the 501(c)(4) organization "on top," so the non-charity (1) controls the selection of all or most of the charity's board and (2) develops (without the subsidy of tax-deductible charitable funds) the name, logo, mailing list, and other intangible assets that both the charity and the political program, or even a Section 527(f)(3) separate segregated fund of the Section 501(c)(4) organization, will eventually want to be able to use freely.[20]

Other legal steps to take. The new organization should apply to the IRS and state regulators as appropriate for recognition of its tax exemption. Group exemption is possible if there will be multiple organizations in the same tax-exempt category—for instance, where separate Section 501(c)(4) entities are set up to function in particular states or localities.[21]

Each organization must maintain its own full set of corporate records and its own Federal

[19] In some instances, no new Section 501(c)(3) organization is created. Rather, the Section 501(c)(4) organization obtains "fiscal sponsorship" for its charitable lobbying and non-lobbying programs from an existing, unrelated Section 501(c)(3) public charity. See Colvin, *Fiscal Sponsorship: 6 Ways to Do It Right* (San Francisco Study Center Press, 1993), pp. 27-41. This way, the (c)(4) can obtain access to tax-deductible funds raised to support discretionary grants from the (c)(3) fiscal sponsor, keeping the entire charitable/lobbying/political program under one corporate entity.

[20] Conditions under which control by a Section 501(c)(4) organization or other non-(c)(3) entity over a Section 501(c)(3) charity is permitted, are discussed by the IRS in Thomas and Kindell, *supra* note 7 at 255-256.

[21] As an example, the National Association for the Advancement of Colored People, a national Section 501(c)(3) organization, has set up its affiliated NAACP chapters as Section 501(c)(4) entities.

Employer Identification Number (FEIN). Each entity should have its own separate bank accounts, and funds should not be freely commingled or transferred without an appropriate (and documented) reason. To the extent possible and as soon as practical, the Action Fund should establish its own accounts with vendors and be separately billed for items such as printing and office supplies. The telephone number for the Action Fund should also be a separate line, separately invoiced.

Ideally, the Action Fund should have its own paid staff of employees, even on a part-time basis, rather than using the Charity's administrative staff. This degree of staff separation is often not feasible for small organizations, however, so sharing options like those discussed below may have to be considered.

If feasible, the mailing address of the Action Fund should be different from the Charity's, even if it is only a post office box that will be the only address shown on the Action Fund's letterhead. It is best for the Action Fund not to use the Charity's address as its own, especially on official documents, since the IRS has been known to use this fact to select Charity/Action Fund combinations for audit.

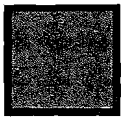
Joint fundraising. Fundraising efforts by an affiliated Charity and Action Fund ideally should be conducted separately to maintain a clear distinction between the two organizations in the minds of the donors. It is possible for a Charity and an Action Fund to engage in joint fundraising activities, but not without a certain degree of risk. Given the variety of forms that joint fundraising can take and the lack of legal precedent or guidance from the IRS in this area, great care should be taken.

Here are a few practical suggestions for Charity/Action Fund joint fundraising mailings, events, or other activities:

1. Before undertaking any joint activities, each entity should have held its own fundraising events and made separate solicitations. This is especially important in the early stages of the Action Fund's existence. This way, the Action Fund can establish that its overhead, and the cost of subsequent solicitations, are paid for with its own, nondeductible funds. It is best to avoid the implication that the Charity has subsidized, fronted, or provided the occasion for the Action Fund to raise funds. Start-up legal costs and filing fees should be paid by the Action Fund, not the Charity, from nondeductible donations or loans (which, if made by the Charity, must bear interest at the market rate).
2. If and when the Charity and Action Fund do conduct joint fundraising, it is better for the Action Fund to pay the up-front costs and incur the liabilities that may be needed to conduct the joint solicitation, with the Charity reimbursing its share later. This avoids giving the impression that the Charity has subsidized the Action Fund by extending it credit interest free.
3. When the expenses of joint fundraising are allocated, strict accounting standards should be followed, so the Action Fund pays no less than its fair share of costs. Generally, the Action Fund should pay the fair market value of any Charity asset that it uses, including the Charity's mailing list. In some cases, an allocation of costs paid to outside vendors based on the proportion of revenues received by each organization will be the most reasonable approach.
4. Careful attention should be given to the handling of donations. It is best if donors make out separate checks to each entity. If that is not practical, and checks will be made out to one entity that will share the proceeds with the other, the entity receiving the checks should enter into an agency agreement with the other.[22] The agreement should spell out appropriate procedures, safeguards, and obligations, especially regarding information provided to donors about their income tax deduction. The donor must be apprised of the amount or percentage of the gift that is for the Action Fund and therefore

THE CHARITY SHOULD NOT SUBSIDIZE GENERAL OPERATIONS OR ANY PART OF THE ACTION FUND'S BUDGET THAT IS NOT CHARITABLE.

[22] If the Action Fund has a separate segregated Section 527(f)(3) fund, and any jointly-raised funds will be earmarked for it, the Charity should not be the entity to receive the combined contribution checks from donors, since it would then be acting as the political fund's agent in accepting contributions, and disbursing funds to it, which is not consistent with the Section 501(c)(3) prohibition. The IRS has also told its auditors that joint fundraising situations involving Section 501(c)(3) and 527 organizations "should be carefully scrutinized from the aspect of whether the IRC 501(c)(3) organization is allowing its name or its goodwill to be used to further an activity forbidden to it. For example, if a well-known IRC 501(c)(3) organization 'jointly' sponsors a fundraising event with a lesser-known PAC, there is a strong suspicion that the IRC 501(c)(3) organization's drawing power is being used to aid the political intervention activities of the [Section 527 organization]."



NEITHER ENTITY SHOULD DIRECT OR CONTROL THE DAY-TO-DAY ACTIVITIES OF THE OTHER.

is not a tax-deductible charitable contribution.[23] Donors may be told that the amount or percentage of the funds to be given to the Charity is deductible, but extreme care must be taken in documenting this arrangement, because that disclosure is also potentially affected by the presence of return benefits to the donor (e.g., dinner tickets), as governed by Section 170(f)(8) and regulations thereunder. Each entity should report only its proper share of the joint revenues on its Form 990 tax return; the entity receiving the checks in the first instance should not treat the combined gross proceeds of the fundraising effort as its own revenue.

5. All written fundraising materials, as well as oral appeals for funds, must be scrupulously prepared so as to accurately present the distinct legal and tax status of the two entities.

Avoiding subsidies

The Charity should not subsidize the Action Fund's general operations or any portion of the Action Fund's budget that is not charitable.[24]

The Charity may legally fund specific charitable projects conducted by the Action Fund, under Rev. Rul. 68-489, 1968-2 CB 210, so long as the Charity retains discretion and control over the funds. The Charity should enter into an appropriate grant agreement specifying how the funds will be used by the Action Fund, what obligations the Action Fund will have to report on the use of the funds to the Charity, and what remedies the Charity will have if the Action Fund misuses the granted funds. The Charity even can provide that all or a portion of the funds granted will be used for direct or grass roots lobbying activity on issues of interest to the Charity, if it counts this amount as a lobbying expenditure, within the limits applicable to the Charity.[25]

The Charity should not provide goods or services to the Action Fund without receiving payment representing at least full fair market value (comparable commercial rates) in return or, in some cases, reimbursement of no less than a fair share of the Charity's costs for the goods or services (based on vendor invoices).

If the Charity is the established organization with assets, and complete operational separation is not feasible, the Charity may provide certain equipment or services to the Action Fund, including office space, computers, furniture, shared staff, payroll and benefits, lobbying and government relations, media and public relations, Internet services, and bookkeeping. In that situation, however, the following items should be covered in a written, arm's-length resource-sharing agreement:

1. All services provided by the Charity should be charged promptly and directly to the Action Fund. If the Action Fund's payments to the Charity can be fairly characterized as a reimbursement of shared expenses, they will not appear as income on the Charity's Form 990 tax return. If, however, the Action Fund is really purchasing technical support services from the Charity, the Charity may have to treat the payments as earned income, potentially subject to UBIT if taxable under Section 512.
2. The Charity staff working on Action Fund matters should keep time records, which can then be used to determine the percentage of each Charity employee's time, during each pay period, devoted to Action Fund work. That percentage of the employee's salary should be charged to the Action Fund, along with a factor covering employee benefits.
3. Using a reasonable allocation method (such as the employee time records mentioned above), a proportionate amount of the Charity's overhead—including rent, utilities, insurance, support staff, etc.—should be charged to the Action Fund.
4. Where use of resources can be metered (e.g., phone calls, photocopying, postage, fax), records should be made and charges

[23] Section 6113. For IRS guidance to its auditors on the application of Section 6113, see Kindell and Reilly, *supra* note 4 at 429-432.

[24] The reverse situation, in which the Action Fund subsidizes the Charity, is completely permissible. In fact, it may be advantageous for the Action Fund, if it has a surplus of cash and the Charity has a deficit, to loan a certain amount to the Charity. The Charity can repay the loan with deductible funds, with or without interest. The IRS has directed its field agents to four methods by which a (c)(3) could impermissibly subsidize a (c)(4)—direct fund transfers, paying expenses of the (c)(4), non-arm's-length dealings with respect to shared employees or facilities, and preferential or non-arm's-length use of the (c)(3)'s mailing list. Thomas and Kindell, *supra* note 7 at 265-266.

[25] Charities electing Section 501(h) must follow the "controlled grant" and transfer rules set forth in Reg. 56.4911-3(c) and Reg. 56.4911-4 when making payments to non-charities that lobby, to avoid having all the Action Fund's lobbying activities inadvertently counted against the Charity's grant

should be separately billed to the Action Fund.

5. To avoid the implication that Charity has advanced funds or credit on the Action Fund's behalf, the Charity might consider requiring a deposit in advance from the Action Fund for the estimated reimbursements over a set period, which could be a month, quarter, or year. This can be treated as an "imprest" fund, so that as the deposit is depleted, the Action Fund replenishes it before the next period begins.
6. If office space is shared, the Charity and the Action Fund ideally would each enter into a separate lease with the landlord. If that is not possible (as it may be, for example, if one of them owns the property or the landlord is unwilling to execute two leases), the Charity and the Action Fund should enter into a clearly documented, commercially reasonable lease or sublease that can be incorporated into the resource-sharing agreement, or executed separately. The rental may be below market only if it is the Action Fund leasing or subleasing to the Charity.
7. If the Charity wishes to extend coverage under its directors and officers liability insurance policy to the Action Fund, that should also be addressed in the resource-sharing agreement, requiring the Action Fund to pay for such coverage. Even if the insurer adds the Action Fund's directors and officers to the Charity's policy at no additional cost, the Action Fund should pay the Charity for a portion of the premiums, allocated on some reasonable basis, such as the relative size of the two organizations' annual budgets.
8. If the Action Fund will be permitted to make any use of any of the Charity's mailing or donor lists, the resource-sharing agreement should provide that the Action Fund will pay the Charity the full fair market value of its usage at the time of use. A list broker should be consulted to ensure proper independent valuation. If the Action Fund plans to use the lists for partisan candidate-related activities, however, additional precautions may be needed.[26]

[26] For an IRS training discussion of the mailing list issue, see Kindell and Reilly, *supra* note 4 at 383-384.

The preceding discussion of terms of a resource-sharing agreement assumes that the Charity is the established entity with the assets, and the Action Fund is a start-up, so the concern is to ensure that the Charity does not subsidize the Action Fund in any way. Where the Action Fund is the established entity and it plans to share its resources with the Charity, scrupulous adherence to the arrangements discussed above is less critical, since the Action Fund can freely subsidize the Charity. In that situation, the resource-sharing agreement's purpose is simply to document the arrangement, and the fact that the Charity will not pay more than its fair share of the costs of shared resources.

Alter ego problems

Neither entity should direct or control the day-to-day activities of the other.

To maintain the integrity of the separate incorporation of the Action Fund and minimize the Charity's liability exposure, the Charity should not become involved in the day-to-day management of the Action Fund's affairs. The Charity's board and officers should never direct the Action Fund's board or staff to take any action, or vice versa. Lines of authority, accountability, and responsibility should be separate, clearly understood, and well-documented.

The Charity and the Action Fund may communicate and coordinate at a strategic level, so long as it is clear that each is pursuing its own agenda and furthering its own corporate purposes in the course of such cooperation. In the authors' experience, one of the biggest "alter ego" problems for (c)(3)-(c)(4) tandem organizations, especially for small organizations managed by the same leadership team, is the tendency to make decisions affecting the Charity or the Action Fund or both "on the fly," and to communicate those decisions orally or by e-mail, without making a written record to be placed in the files of the proper entity. The best practice, to borrow a cliche from Hollywood, is to stop and "take a meeting" of the board, executive committee, or staff of the appropriate entity, and put the meeting minutes or at least a memorandum in the Charity's or Action Fund's records. In the event of a transaction between the two entities—such as a grant, joint program, or new shared expense—each organization should have a record that it

assented to the transaction, which sometimes involves an exchange of correspondence between the two. It helps to designate at least one person who will act as the guardian of the smaller entity's affairs, who will forcefully insist that his or her entity's agreement must be obtained and documented rather than assumed, and that joint plans should not proceed without his or her written approval.

Resource-sharing agreements between the Action Fund and the Charity should clearly state that they are *not* management contracts. The Action Fund board is not delegating management of its affairs to the Charity. Rather, the Action Fund board is contracting with the Charity to share the time of certain staff members who carry out assigned Action Fund administrative tasks under the direction and control of the Action Fund board.

The same person may, and frequently does, serve as executive director of both the Charity and the Action Fund. However, to prevent this fact from being used as evidence that the Charity controls the day-to-day activities of the Action Fund, it must be clear that the executive director is responsible directly and only to the Action Fund board for the performance of his or her Action Fund duties, and to the Charity board for Charity activities.

The Charity and the Action Fund should clarify, where appropriate for the news media and others, that the Charity and the Action Fund are separate organizations. This may require that the Charity monitor how the media describe the two, and send letters to news editors as needed to make the distinction clear. Also, staff and volunteers of both organizations should be educated about the distinction. It would be helpful to prepare a handout clarifying the distinction between the two organizations, and emphasizing that no one is acting as an agent of the Charity while working for the Action Fund. Ideally, a copy could be signed by each employee and volunteer of either organization who works on affairs of the other or who deals with the public, and kept on file by each organization.

Conclusion

Once a charity has made the decision to set up a separate Section 501(c)(4) organization to maximize its political power and influence, the legal challenges start and never end. In addition to the tax and corporate law issues presented here, the affiliated social welfare organization will have its own federal tax compliance issues, such as demonstrating every year that its nonpartisan public benefit activities predominate over its partisan political work, and coping with the special lobbying and political tax rules under Sections 162(e) and 527(f), which do not apply to charities. Whether or not the social welfare organization sets up political committees to raise and spend money to influence ballot measure and candidate elections, it will have to contend with a host of intricate federal, state, and even local campaign finance and ethics rules laden with disclosures, prohibitions, and frequent filings. In the new arena of Internet-based organizing and advocacy, planning for the construction, linkage, and cost allocations of interactive Web pages and e-mail messaging can involve legal issues of intellectual property, privacy, and defamation, as well as straining the application of tax-exempt and nonprofit corporate laws that have not kept pace with technological advances.

Political speech may be free in theory, but the risks and costs of legal compliance continue to rise. It must be worth the price, however, because more and more tax-exempt organizations seem compelled to find their full-throated voices through multiple affiliates devoted to public policy and political affairs. ■