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TESTIMONY OF
THE STAFF OF THE JOINT COMMITTEE ON TAXATION
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
OF THE HOUSE COMMITTEE ON WAYS AND MEANS
JUNE 20, 2000

Introduction

My name is Lindy Paull. As Chief of Staff of the Joint Committee on Taxation ("Joint Committee"), it is my pleasure to present the written testimony of the Joint Committee staff at this hearing before the Subcommittee on Oversight of the House Committee on Ways and Means.[1] Recent press reports have focused on the use of political organizations described in section 527 of the Internal Revenue Code of 1986 ("section 527 organizations") to fund political activities that are not disclosed to the public under either the general Federal tax rules governing disclosure of information by tax-exempt organizations or under the Federal election laws.

At the outset, let me note that the Joint Committee staff in general believes that the public interest would be served by greater disclosure of information relating to tax-exempt organizations. Our recommendations relating to disclosure of information by tax-exempt organizations are contained in our study of disclosure provisions relating to tax-exempt organizations, which was mandated by the Internal Revenue Service Restructuring and Reform Act of 1998.[2]

Our testimony today provides an overview of the present-law rules governing the tax treatment of section 527 political organizations and political activities by tax-exempt

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[1] This testimony may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the Subcommittee on Oversight of the House Committee on Ways and Means, June 20, 2000* (JCX-60-00), June 20, 2000.

[2] *See,* Joint Committee on Taxation, *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions As Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998, Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations* (JCS-1-00), January 28, 2000.

organizations in general.[3] In addition, our testimony will describe recent Internal Revenue Service ("IRS") rulings that have led to the development of a new type of section 527 organization and will discuss how these section 527 organizations are being used.

Background and Overview of Present Law

Federal election law

The Federal Election Campaign Act of 1971 ("FECA") was enacted to regulate communications made in connection with Federal elections. The FECA, as amended in 1974, 1976, and 1979, imposed restrictions on eligible contributors, imposed dollar limits on contributions, required disclosure of campaign receipts and expenditures, and set up the Federal Election Commission ("FEC") to administer and enforce the law.

The FECA applies broadly to cover all money spent in connection with or for the purpose of influencing Federal elections. Under the FECA, individuals are permitted to contribute up to $1,000 to a candidate per election and up to $20,000 per year in contributions to the federal accounts of a national party committee. In addition to these specific limits, individuals have an aggregate annual Federal contribution limit of $25,000. Separate contribution limits also apply to multi-candidate political action committees ("PACs"), other political committees, and party committees.

The FECA requires the filing of reports, which are made publicly available. These reports may be required monthly, quarterly, or semi-annually depending upon whether it is an election year and the nature of the reporting organization. Pre- and post-election reports are also generally required. These reports require itemized disclosure of receipts and expenditures in excess of certain dollar thresholds.

Political committees are required to register with the FEC and are subject to the Federal limitations on the amounts and sources of contributions.

In 1976, the Supreme Court ruled, in the landmark case of *Buckley v. Valeo*,[4] that the FECA limitations on contributions were appropriate to guard against the reality or appearance of improper influence stemming from candidates' dependence on large campaign contributions. However, the Supreme Court overturned the FECA limitations on independent expenditures, on candidate expenditures from personal funds, and on overall campaign expenditures. Thus, the decision in *Buckley v. Valeo* permits unlimited spending by individuals or groups on communications with voters to expressly support or

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[3] The Joint Committee on Taxation staff has also prepared a detailed description of present law for this hearing. *See,* Joint Committee 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), June 19, 2000.

[4] 424 U.S. 1 (1976).

oppose clearly identified Federal candidates, as long as such expenditures are made without coordination or consultation with any candidate.

The *Buckley v. Valeo* court also limited the scope of the FECA to communications that contain express words advocating the election or defeat of a political candidate – so-called "express advocacy." Thus, express advocacy is subject to the FECA reporting requirements and contribution limits. Communications that fall outside of the FECA definition of "express advocacy" are commonly referred to as "issue advocacy."

Issue advocacy is a form of "soft money." Soft money generally refers to money that may indirectly influence Federal elections, but is raised and spent outside of the purview of the FECA. For example, soft money may be spent by state and local political parties on grassroots organizing and voter drives that may benefit all party candidates, not just state or local candidates.

All entities are required under the FECA to disclose allocations of expenditures between Federal accounts (i.e., express advocacy for Federal elections) and non-Federal accounts (including issue advocacy). National parties are required to disclose their sources of contributions and expenditures for both Federal and non-Federal accounts. State and local parties are required to disclose their sources of contributions and expenditures with respect to Federal accounts only under the FECA. Expenditures for issue advocacy by organizations other than national parties are not subject to disclosure under the FECA.

Section 527 organizations

The Internal Revenue Code provides a limited tax-exempt status to "section 527 political organizations." Section 527 was enacted in 1975 to clarify the tax treatment of political organizations, such as campaign committees and political party organizations. Prior to 1975, such organizations generally did not pay any Federal income tax. The theory for this treatment was that the contributions made to such organizations were gifts that would not be taxable to the recipient.

In the late 1960's, the IRS became aware that some political organizations were accumulating significant funds and were not filing tax returns to report their investment income and that funds were being diverted from these organizations for the personal benefit of candidates. In 1968, the IRS ruled that contributions to candidates and political organizations that were diverted from campaign activity were income to the candidate; the IRS required political organizations to keep extensive records to substantiate that there was no diversion of funds. In 1973, the IRS announced that political parties and committees were required to file tax returns unless the Internal Revenue Code was amended. In its announcement, the IRS stated that the gross income of political parties and committees included interest and dividend income, income from commercial activities, and gains from the sale of appreciated property. This announcement formed the basis for section 527.

Under section 527, political organizations are generally exempt from Federal income tax on contributions, but are subject to tax on their net investment income and certain other income. In addition, contributions to section 527 organizations are exempt from Federal gift taxes. A section 527 political organization means a party, committee, association, fund, account, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions and making expenditures for what is called an "exempt function." An exempt function of a section 527 organization 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.

Other tax-exempt organizations

It is important to note that other types of tax-exempt organizations may engage in political activities and lobbying activities under present law. Tax-exempt organizations that engage in political activities generally are subject to tax under section 527 on the lesser of their net investment income or their expenditures for political activities. However, such organizations are permitted to establish a separate segregated fund that is treated as a separate organization for purposes of computing the applicable tax under section 527.

Tax-exempt organizations (other than charities described in section 501(c)(3)) generally are permitted to engage in political activities. For most tax-exempt organizations, political activities are inconsistent with the purposes for which the organizations were formed, so the organizations do not engage in any significant amount of such activities. However, certain types of tax-exempt organizations (such as social welfare organizations described in section 501(c)(4), labor organizations described in section 501(c)(5), and business leagues and trade associations described in section 501(c)(6)), do engage in more extensive political and lobbying activities. For these organizations, the only restriction is that the political activities cannot be the primary activities of such organizations. Furthermore, these organizations are not subject to any specific limit on their lobbying activities, as long as the lobbying is germane to the accomplishment of the organization's tax-exempt purposes. It is not uncommon for social welfare organizations, labor organizations, and business leagues to engage in substantial lobbying activities. According to media and other reports, some of these organizations are also engaged in substantial political activities.

Charitable organizations described in section 501(c)(3) (for example, schools and churches) are not permitted to engage in any political activity under present law. However, such organizations may engage in unlimited educational activities and in limited lobbying activities.

Educational vs. political or lobbying activities of tax-exempt organizations

There is no bright-line test under present law for determining when the activities of a tax-exempt organization are political activities, lobbying activities, or educational activities. The IRS has stated that whether an organization is participating or intervening, directly or indirectly, in a political campaign depends upon all of the facts and circumstances of each case. Nonpartisan issue advocacy generally is considered an educational activity under present law. Partisan issue advocacy might be considered a lobbying activity or a political activity under present law. Issues often arise as to the character of activities relating to voter education, such as the dissemination of voter education guides and scorecards. Indeed, the IRS has ruled that not only the format and content of materials, but also the timing and nature of the distribution of materials are relevant in determining whether the materials constitute political activity. Thus, materials that might be considered political activity if disseminated in one manner may be educational in another context.

Disclosure of information by tax-exempt organizations

Tax-exempt organizations are required to file an annual information return with the IRS (Form 990). The Form 990 contains information relating to the activities of the organization for a year. The return includes information on the income and expenses of the organization, although these items are generally reported in broad categories. While tax-exempt organizations are currently required to report their expenditures for political activities and lobbying activities on their Form 990s, detailed information about such activities need not be reported.

Under present law, certain public disclosure requirements apply broadly to all tax-exempt organizations. Thus, section 501(c) organizations are required to make a copy of their annual Form 990 available for public inspection. In addition, such returns can be requested from the IRS. However, under present law, section 501(c) organizations are not required to disclose the names of their donors.

Section 527 organizations file an annual income tax return, Form 1120-POL. The return requires such organizations to report certain items of income and expense so that the applicable tax under section 527 may be calculated. The Form 1120-POL does not require any information relating to contributions to and expenditures by the section 527 organization. In addition, the Form 1120-POL is not publicly disclosed under present law.

Section 527 organizations are subject to the FECA rules requiring reporting and disclosure of contributions and expenditures in excess of $200 if they engage in express advocacy for FECA purposes. However, certain section 527 organizations (such as those organizations that only engage in issue advocacy or that are created solely to influence or attempt to influence state or local elections) may not be subject to the FECA rules.

If a non-section 501(c)(3) organization establishes and maintains a separate segregated fund under section 527, the fund is required to file Form 1120-POL. Form 1120-POL filed for a separate segregated fund (or a separate section 527 organization) is not subject to public disclosure by the organization or the IRS.

Recent Trends in Section 527 Organizations

Historically, section 527 organizations (other than organizations created to influence state or local elections) were subject to the FECA contribution limits and reporting and disclosure requirements because these organizations were generally created to engage in the type of express advocacy that the FECA regulates.

In addition, many tax-exempt organizations historically argued that the activities in which they engaged were educational activities and not political activities. The recent trend, however, has been to try to characterize certain activities as political, rather than educational. The apparent reason for this shift is the gift tax exemption for contributions to section 527 organizations. Individuals who are willing to make large contributions to fund political activities want the benefit of the gift tax exemption accorded under section 527. Furthermore, as long as the organization has no net taxable income, there will be no tax paid under section 527.

As a result, in recent years, a new breed of section 527 organization has been created for the purpose of engaging in political activity which is apparently not subject to the FECA. These organizations are created to engage in issue advocacy. Many of them are specifically prohibited in their charter from engaging in express advocacy. The genesis of these new section 527 organizations can be traced to a series of IRS private letter rulings beginning in 1996. The rulings highlight the fine line that the IRS has drawn between permitted educational activities (nonpartisan issue advocacy) and political activities for section 527 purposes.

In these rulings, the first of which was issued in 1996, the IRS ruled that voter education and grass roots lobbying that tax-exempt organizations had contended for many years were educational activities could be characterized as political activities for section 527 purposes. In the first ruling, in 1996, the IRS stated that the purpose of a fund (section 527 segregated fund) maintained by a section 501(c)(4) organization was "equivalent to accepting and expending funds *not* (emphasis added) to expressly advocate for or against candidates, but to promote a program of issue advocacy designed to influence the public to give more importance to * * * [certain] issues when they decide among the candidates."[5] The apparent reason for requesting the IRS ruling was to ensure that a large individual contributor would be accorded the exemption from gift tax for contributions to section 527 organizations.

In the 1996 ruling, the section 527 fund was used to finance issue advertisements and the distribution of voter guides on candidate records. The fund's activities were

[5] PLR 9652026.

limited to the preparation, publicizing, and distribution of Congressional voting records and voter guides on Federal elected officials and candidates. According to the ruling, the voter education materials paid for by the fund would include some or all of the following: (1) comparative information about the identities and amounts of campaign contributions received by the candidates; (2) comparisons of incumbents' voting records with their challengers' views on the same subjects; (3) information about the past and current affiliations of the candidates with certain issues or groups; (4) quotations from statements by opposing candidates on the same issues; (5) voter guides listing all Federal candidates throughout the country; (6) voter guides listing only the major party candidates for Federal office; (7) voter guides limited to the Federal candidates in a single state or district; (8) voter guides comparing the candidates on only one issue, or on many issues; (9) voter guides formatted to fit the special characteristics of television, radio, newspaper, on-line, or other media; (10) voting records on certain issues; (11) materials containing messages suggesting that voters should study the candidates' records on certain issues carefully, or that one should remember to vote on Election Day; and (12) dissemination of voting records and voter guides using television, radio, newspaper, newsletter, magazines, and other print media, on-line electronic transmission, mail, telephone banks, facsimile transmission, posting of signs, public meetings, rallies, media events, door to door canvassing, and other forms of direct contact with the public.

In 1997, the IRS issued another private letter ruling on similar facts. In this case, a social welfare organization described in section 501(c)(4) was developing an election-year voter education program to raise public consciousness about the importance of certain issues and about the positions of incumbent public officials and candidates on those issues, "without engaging in express advocacy for or against any identified candidates."[6] The organization intended to engage in the dissemination of voter education materials (similar to the facts in the 1996 ruling) and grass roots lobbying. With respect to grass roots lobbying, three potential types of activities would be conducted: (1) a grass roots lobbying handout would be used in door to door canvassing, targeted to congressional districts and locations within states selected with the political interests of the organization in mind; (2) mass media advertisements would be prepared, timed to be disseminated during a major political party convention, listing the legislative proposals introduced in the current Congress and urging the public to call and ask Congress to act without mentioning a specific bill; and (3) mass media advertisements would be targeted to certain congressional districts or states where the organization has a political interest and would refer to one or two incumbent legislators from that district or state, by name, indicated one or more votes they cast or positions they took in Congress on issues of importance to the organization.

The IRS ruling noted that the grass roots lobbying in this case reflected a dual character by calling for legislative action, and also raising public awareness about how the identified legislators stand on issues that the organization believes voters, based on opinion polling, would take into account in making judgments about the positions of the candidates. The IRS also stated that all of the grass roots lobbying activities described by

[6] PLR 9725036.

the organization would have a political purpose even though they would not expressly advocate the election or defeat of any particular candidate.

In 1999, the IRS addressed the issue of an organization that was organized to engage both in express advocacy and in partisan issue advocacy.[7] Specifically, the organization intended to make contributions to the campaigns of certain candidates, pay for political advertising expressly advocating the election or defeat of named candidates, mass media campaigns, ballot initiative campaigns, and litigation strategically aimed at altering the political process. The organization represented that the main part of its activities would involve issue advocacy. According to the ruling, the organization would develop and distribute voter guides and voting records, mass media advertisements, grass roots lobbying, direct mail campaigns, and the active use of ballot measures, referenda, initiatives, and other public opinion campaigns, all linked to the primary purpose of influencing the political process. These activities would occur over several election cycles.

In the 1999 ruling, the organization indicated to the IRS that issues would be selected based on a combination of legislative priorities of the organization, the organization's general public policy agenda, and public opinion research. The issues selected would encourage differentiation between candidates whose views on selected issues agree with the organization and those opposed to such views. Distribution of materials and the scheduling of events would be targeted toward areas of the states in which the organization had a political interest and in which it believed it could have a political impact.

With respect to the voter registration and get-out-the-vote activities of the organization, the IRS ruled that such activities were partisan. The IRS noted that, while the activities were not specifically identified with one candidate or party in every case, they were partisan in the sense that the organization intended these measures to increase the election prospects for candidates with stands favorable to the organization. Thus, the IRS concluded that expenditures for these activities qualified under section 527.

The IRS ruling stated that generally, expenditures made in connection with ballot measures, referenda, or initiatives are not section 527 activities. However, the IRS stated that expenditures for such activities could qualify under section 527 if it can be demonstrated that such expenditures were part of a deliberate and integrated political campaign strategy to influence the election of certain candidates. The IRS further noted that the organization had indicated that its participation in such campaigns was for the purpose of linking candidates, in the minds of voters, to positions on certain issues within the organization's area of interest and encouraging voters to give greater weight to these issues when making judgments about candidates.

[7] PLR 199925051.

Measuring the Amount of Issue Advocacy by Tax-Exempt Organizations

These rulings highlight some of the ways in which section 527 organizations are being used to engage in activities that may not be subject to the FECA. However, it is difficult to measure the extent to which these organizations are being used for this purpose and the growth in the number and size of such organizations.

Information available from the IRS Statistics of Income indicates that the number of Form 1120-POLs filed grew from 1996 to 1998. In 1996, 4,363 returns were filed for the period from December 1994 through November 1995; in 1997, 6,006 returns were filed for the period from December 1995 through November 1996, and in 1998, 5,649 returns were filed for the period from December 1996 through November 1997. The number of Form 1120-POLs filed during the period were the highest during the 1996 election cycle. Data for the 1999 filing year are not yet available.

Total political expenditures reported for non-section 501(c)(3) organizations on either the Form 990 or Form 1120-POL for 1994 were approximately $38 million and for 1995 were approximately $29 million. Aggregate data for more recent years are not available.

Based on an informal survey of Form 990 information filed by tax-exempt organizations, political expenditures appear to increase significantly during election years relative to other years for organizations that engage in this type of activity. Thus, while it is not possible to assess fully the extent to which tax-exempt organizations are attempting to influence the political process, it is clear that such organizations are engaged in activities intended to influence, directly and indirectly, campaigns at the Federal, state, and local level.

We should also note that the extent of tax-exempt organization activity intended to influence the political process cannot be measured accurately merely by looking at the political expenditures reported by such organizations on their Form 990s. Tax-exempt organizations may also engage in lobbying activities that are intended to influence elections. In addition, many tax-exempt organizations will take the position on their Form 990s that the activities in which they are engaged are educational, rather than political. As a practical matter, the IRS and the general public will not be able to discern from the Form 990 the exact nature of activities that are characterized as educational because such activities are reported in broad and general terms. Thus, the only way in which such activities may be challenged under present law is through an IRS audit of the return of a tax-exempt organization.

Some organizations have attempted to quantify the extent to which section 527 organizations are engaged in partisan issue advocacy. One group estimated that

approximately $100 million has already been spent or committed for issues advertisements on a variety of issues during the 1999-2000 election cycle.[8]

The Annenberg Public Policy Center of the University of Pennsylvania has identified 37 organizations that funded, or committed to fund, broadcast media issue advertisements between January 1999 and early March 2000 costing in excess of $114 million.[9] The Annenberg Center estimated that this amount was nearly as much as was spent on issue advertising in the entire 1995-1996 election cycle.

The Annenberg Center also provided information on the types of issues advertisements that had been run by various organizations.

One example cited in the Annenberg Center materials was a series of television advertisements run in May 1997 as the Senate was preparing to vote on the late term abortion ban. The ads urged citizens to call their Senators and aired in the states of undecided senators. A repackaged version of the ads were run in 1998 against a candidate in a Congressional special election. The Annenberg Center noted that the ads, which were aired as nonpartisan issue advocacy ads in 1997, were aired as direct advocacy independent expenditures in 1998.

In another example cited by the Annenberg Center, an organization aired television advertisements on taxes and health care in two states with important Senate and House races in 1998. The ads advocated against the policy positions of incumbent Senators running for reelection and also targeted an incumbent House member in one race. In one television ad that described the positions of a challenger to one of the incumbent Senators, the announcer stated:

> "Candidate X knows that nothing is more important than our health. That's why Candidate X voted to guarantee health insurance for people who change or lose their job. And Candidate X voted to require insurance companies to cover people with pre-existing medical conditions. To help women fight breast cancer, Candidate X voted to expand insurance coverage for mammography testing for women over fort. Good healthcare is important. Call. Tell Candidate X you support his efforts to improve health care."

Although the Annenberg Center materials do not identify whether section 527 organizations or other organizations are creating the types of issue advertisements cited in the materials, there is a clear trend toward greater use of section 527 and tax-exempt organizations in general to engage in partisan issue advocacy. The present-law disclosure rules for tax-exempt organizations do not require organizations to disclose the same type of information that is required under the Federal election laws. Unless present law is

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[8] Common Cause, *Under the Radar: The Attack of the "Stealth PACs" on Our Nation's Elections, A Report From Common Cause.*

[9] Issue Ads @APPC. http://appcpenn.org/issueads/2000issuead.html.

changed, it will be difficult for the public to assess the extent to which tax-exempt organizations are engaged in political activities.