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Confused Yet? Why Not Understanding the IRS's "Facts and Circumstances" Test Might Mean You Really Understand It

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ABSTRACT

This article focuses on the Internal Revenue Service's regulation of social welfare organizations exempt under Section 501(c)(4) of the Internal Revenue Code, a type of nonprofit organization that has become increasingly controversial as a result of the U.S. Supreme Court's decision in *Citizens United* and the ensuing increase in political advocacy conducted by these organizations.

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I. INTRODUCTION

A century ago, with the introduction of the first federal income tax, Congress decided to exempt certain organizations from federal income tax to subsidize activities for which it determined to be beneficial to society. Today, Section 501(c) of the U.S. Internal Revenue Code ("Code") provides exemption for 29 different categories of organizations. This article focuses primarily on "social welfare" organizations, which are exempt under Section 501(c)(4) of the Code and operate primarily to further the common good and general welfare of the people of the community (such as by bringing about civic betterment and social improvements).

Social welfare organizations have become increasingly controversial as a result of the U.S. Supreme Court's decision in *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010), and the ensuing increase in political advocacy conducted by these organizations. In the oft-vilified *Citizens United* decision, the Court lifted the restrictions on expenditures by corporations and other entities that make independent expenditures to support or oppose candidates for public office. As a logical result, there has been an increase in the number of non-profit groups taking advantage of their constitutionally-protected First Amendment rights, and an even more dramatic increase in the amount of money being spent to influence elections. According to a report by Professor Daniel P. Tokaji entitled *The New Soft Money*, independent groups spent well under $100 million in express advocacy for most of the three decades since the data has been collected. Following *Citizens United*, that number jumped up to $200 million in 2010 and more than doubled again in 2012 when such spending reached $450 million in conjunction with the presidential election.

The dramatic increase in independent spending has caused concern and controversy, with many in the press and the general public focusing on the lack of disclosure and transparency under which most 501(c)(4) groups operate. A common concern is the proliferation of "dark money" in elections, a term which critics have used to describe money donated to 501(c) organizations that is subsequently used to support or oppose candidates for public office. Notably, Federal Election Commission ("FEC") regulations require 501(c) organizations to report election spending on express advocacy or electioneering (spending that occurs within 30 days of a primary or 60 days of a general election), but these organizations are generally not required to report their donors. While much of the opposition to these organizations' activities is likely politically motivated, many critical of this so-called "dark money" spending are legitimately concerned that it allows nonprofit organizations to influence a candidate without public knowledge of who is influencing that candidate.

On the other hand, there are those that laud such spending as a reaffirmation of their First Amendment rights, especially as disclosure is increasingly used as a thinly-veiled means of imposing intimidation and carrying out economic retribution against political dissidents. Such concerns are not a product of unsubstantiated hyperbole, as Brendan Eich was recently forced to resign as Mozilla CEO when it was disclosed that six years earlier he had given $1,000 to support a referendum banning gay marriage, and he was hardly the first. Activists compiled blacklists of donors to California's Proposition 8 and went after them. Shortly after the referendum passed, both the Artistic Director of the California Musical Theatre in Sacramento and the president of the Los Angeles Film Festival were hounded out of office.

As if the omnipresent political interests at play were not enough to drive this debate, many recognize that the principal source of controversy may be the fact that the Internal Revenue Service ("IRS") has failed to provide clear guidelines as to what activities constitute genuine issue advocacy versus political advocacy (hereafter, "political campaign intervention"). Despite the commonly-held view that recent U.S. Supreme Court decisions, such as *Federal Election Commission v. Wisconsin Right to Life, Inc.*, 551 U.S. 449 (2007)

("*Wisconsin Right to Life*"), have expanded the breadth of First Amendment freedoms guaranteed to nonprofit organizations, the lack of clarity is exacerbated by the fact that the current test employed by the IRS to analyze an organization's activities appears to blatantly ignore the Court's recent precedents interpreting the relevant constitutional issues.

If there were any doubt that this debate will remain highly charged and in flux well into the 2016 presidential election cycle, look no further than some of the contentious developments that recently transpired: (i) the IRS admitted to inappropriately targeting conservative-leaning groups for harsher evaluation and treatment; (ii) the IRS publicly acknowledged that its "facts and circumstances" test is ambiguous and confusing. *See* Notice of Proposed Rulemaking, REG-134417-13, 2013-52 I.R.B. 856; (iii) after introducing a Proposed Rulemaking aimed at regulating perceived "Candidate-Related Political Activities" in late 2013, the IRS was forced to scrap the proposal in its entirety after receiving unprecedented opposition from a broad coalition of nonprofits ranging from the National Rifle Association ("NRA") to the American Civil Liberties Union ("ACLU"); (iv) Lois Lerner, the former Director of the Exempt Organizations Unit of the IRS, was held in contempt of Congress for refusing to cooperate with the ongoing Congressional investigations; (v) the IRS remains embattled in the Congressional investigations, as well as multiple lawsuits centered on its unlawful targeting of conservative-leaning ideological organizations; and (vi) state legislatures across the country, including the Texas Legislature, continue to grapple with complicated statutory and rulemaking proposals largely aimed at reducing the influence of so-called "dark money" in state and local elections.

Given the historical lack of clarity coupled with the increased turmoil, it is apparent why any nonprofit organization seeking to engage in *any* political campaign intervention (or even issue-based advocacy that mentions a candidate or officeholder) must proceed with caution. The purpose of this article, therefore, is to shed some light on some of the issues surrounding advocacy by 501(c)(4) organizations and the rules regulating that advocacy. Part II provides a brief overview of the origins of tax exemption for social welfare organizations. Part III discusses the role and development of the IRS's amorphous "facts and circumstances" test. Finally, Part IV contains a detailed argument and case law analysis explaining why the "facts and circumstances" test is considered constitutionally suspect by many practitioners on both sides of the political spectrum.

In full disclosure, the author of this article represents Freedom Path, Inc. in the ongoing lawsuit, *Freedom Path, Inc. v. Lerner*, *et al.* Among other relief, Freedom Path, Inc. is seeking a declaratory ruling that the "facts and circumstances" test contained in Revenue Ruling 2007-41 and Revenue Ruling 2004-6, and any applicable rules and regulations implementing these Revenue Rulings, are unconstitutionally vague in violation of the Due Process Claus of the Fifth Amendment. Many of the arguments contained in that complaint are incorporated herein.

II. THE ORIGINS OF TAX EXEMPTION FOR SOCIAL WELFARE ORGANIZATIONS

Congress passed the first tax protections for civic leagues and organizations in the Tariff Act of 1913, the same year it exercised its new authority to pass a national income tax. The 1913 wording, which is nearly identical to today's statutory wording, exempted from taxation "any civic league or organization not organized for profit, but operated exclusively for the promotion of social welfare." In 1924, an amendment extended the protection to local associations of employees and it was later codified in 1959 as Section 501(c)(4). It remained largely unchanged until 1995, when the IRS barred 501(c)(4) organizations from allowing any part of their net earnings to inure to the benefit of any private shareholder or individual. Lobbying or seeking legislation germane to the organization's programs is a permissible means of attaining social welfare purposes; therefore, a section 501(c)(4) social welfare organization may be engaged in

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