Testimony of
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Mr. Chairman, Senator Dodd, and Members of the Committee,

I appreciate the opportunity to testify before the Committee today on the treatment of section 527 organizations as political committees within the meaning of the Federal Election Campaign Act ("FECA"). I wish to thank you for including testimony from a tax lawyer because the subject of the hearings involves the issue of reconciling tax law and election law. In this process, understanding the tax predicate of the issue and the legislative solution is particularly important. I am a Professor of Law at the University of Miami School of Law and the Director of the Law School's Graduate Program in Taxation. I teach courses in tax law and in election law. I am also the Tax Program Director of the Campaign Legal Center, a nonpartisan organization dedicated to campaign finance reform. I write primarily in the area of tax exempt organizations, including their political activities.

My testimony today focuses on the tax elements and tax planning strategies that have made this legislation necessary. Section 527 organizations exist at the point where the Internal Revenue Code (the "Code") intersects FECA. Such statutory intersections involving tax law are routine. What is not routine is the use of one statute to avoid or evade another. When that occurs, explicit rules for coordinating the intersection of the two statutes are required. That is the situation relating to section 527 organizations. My testimony will describe the intersection of the two statutes, analyze the nature of the intersection, and explain why S.271, the 527 Reform Act of 2005, is a reasoned and principled approach to statutory coordination. The purpose of S. 271 is to ensure that tax law is not misused as the foundation for avoidance or evasion of FECA.

I. Exemption under Section 527

Section 527 defines a "political organization" as "a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function." Section 527(e)(1).

Section 527 organizations are exempt from federal income tax on exempt function income. The issue is what income qualifies as exempt function income. Exempt function income is defined by the source of the income, the use of the income, and the requirement that the income be held in a segregated fund. A section 527 organization qualifies for exemption only if it satisfies all three requirements.
An exempt function is "the function of influencing or attempting to influence the selection,

nomination, election, or appointment of any individual to a Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected or appointed." Section 527(e)(2). The applicable regulations provide a range of examples of exempt function activities. Treas. Reg. § 1.527-2(c).

A section 527 organization is not taxable on expenditures made for such exempt functions if the exempt function income is derived from the sources enumerated in section 527(c)(3)(A)-(D). These sources are contributions, membership dues, proceeds from a political fundraising event, or proceeds from any bingo games. Amounts derived from other sources will not be treated as exempt function income even if such amounts are used for exempt function expenditures or segregated for such use in the future.

A section 527 organization is also subject to the requirement that funds from enumerated sources be "segregated for use only for the exempt function of the political organization." Section 527(c)(3). For this purpose a "segregated fund" is defined as "a fund which is established and maintained by a political organization or an individual separate from the assets of the organization or the personal assets of the individual." Treas. Reg. § 1.527-2(b)(1). A fund will not be properly segregated if "more than insubstantial amounts" are derived from sources other than the enumerated sources or used for purposes that are not exempt functions. Treas. Reg. § 1.527-2(b)(1). While the precise standard of what is "more than insubstantial" has not been defined in precedential guidance, the segregation of funds requirement makes it clear that section 527 organizations are exempt only if operate for an exempt function.

II. Tax Planning for a New Generation of Section 527 Organizations

Section 527 became controversial only when political operatives saw an opportunity to use section 527 to design entities that would be exempt from federal income tax and would not expose contributors to the gift tax while at the same time avoiding treatment as political committees under FECA. In the 1990s the major planning challenge was to secure exemption under section 527. At this time, the Federal Election Commission ("FEC") was interpreting FECA and its regulations to limit political committee characterization only to entities that expressly advocated the election or defeat of a particular candidate for public office and interpreted express advocacy as requiring the use of the magic words in footnote 52 of *Buckley v. Valeo,* 424 U.S. 1 (1976). The challenge was the tax planning that would qualify the entities as exempt under section 527.

Planning into section 527 was no easy task. In a series of private letter rulings, the Internal Revenue Service ("IRS") accepted a variety of arguments as to why activities that appeared to be lobbying or issue advocacy should be treated as activities that satisfied the requirements of section 527(e)(2). PLR 9652026 (Oct. 1, 1996), PLR 9725036 (Mar. 24, 1997), PLR 9808037 (Nov. 21, 1997), PLR 199925051 (Mar. 29, 1999). All of these arguments rested on the assertion that the ballot measure or legislative lobbying or issue advocacy or voter registration or voter mobilization at issue was not nonpartisan but in fact was undertaken for the purpose of

influencing the outcome of elections or that such activities would have the result of influencing election outcomes. The organizations went to extraordinary lengths to support their innovative arguments. The board of one organization passed a resolution affirming that the organization intended to influence the outcome of an election. Another organizations secured an opinion letter from a political scientist stating that the activities would have the result of influencing the outcome of the election.

Once the tax issue had been addressed, there was no need to be concerned that the FEC would interpret FECA to require that the entity now treated as exempt under section 527 would be treated as a political committee for election law purposes. The absence of magic words was sufficient to allay concerns about election law.

III. Phase Two Planning: New Issues under FECA

Planning for the new section 527 organizations entered a new phase when the Supreme Court found in *McConnell v. FEC,* 540 U.S. 93 (2003) that the magic words test was not a constitutional requirement but simply an aid to statutory interpretation. Section 527 organizations could no longer rely on the magic words barrier to political committee treatment.

The political operatives who design, operate, and represent section 527 organizations devised an innovative response to what they could only have regarded as an adverse development. Having argued that a broad range of activities satisfied the section 527(e)(2) definition of exempt function activity, they then argued to the FEC that section 527 organizations engaged in a broad range of activities that did not constitute the kind of activities required for characterization as political committees under FECA.

This clever strategy involved turning the arguments made to the IRS on their head and then presenting the result to the FEC, while maintaining the original arguments for federal tax purposes. The section 527 organizations now argued to the FEC that lobbying or issue advocacy was not related to influencing the outcome of election campaigns. This strategy depended on abandoning the arguments about the intent of engaging in the activities or the inevitable consequences of engaging in the activities. The organizations argued instead that the activities in question are what they appear to be, or that "lobbying is lobbying" or "issue advocacy is issue advocacy." This is the very proposition the organizations went to such lengths to negate in their arguments to the IRS. In short, these groups argued to the IRS that their activities were primarily political in order to get favored tax status, but then argued to the FEC that these same activities were not political in order to avoid treatment as political committees.

The first phase of section 527 planning, the tax law phase, involved planning into section 527 to secure exemption. The second phase of section 527 planning involved planning out of FECA to avoid characterization as a political committee. Engaging in both simultaneously presents a classic case of statutory arbitrage. It involves the use of a tax law predicate to avoid or evade the requirements of federal election law.

This classic statutory arbitrage could never have occurred if the FEC had properly interpreted FECA. The FEC's failure to treat section 527 organizations as political committees, even in the face of the organizations' own insistence that they were operating primarily for the purpose of influencing federal elections, means that Congress must provide guidance on the interpretation of the meaning of a political committee under FECA. In the face of statutory arbitrage that undermines the integrity of FECA, it is left to Congress to provide principles for coordinating the two statutes in a principled manner that avoids the current abuse of FECA.

IV. The 527 Reform Act Is a Coherent and Principled Approach to Section 527 Organizations

The 527 Reform Act of 2005 provides a structure for coordinating the Code and FECA with respect to the treatment of those section 527 organizations that still maintain that FECA does not apply to them. The approach is based on taking such organizations at their word and respecting their decision to identify themselves as political organizations within the meaning of section 527 for purposes of gaining the advantages of exemption from federal income tax and protecting contributors from the gift tax. The bill thus leaves the initiative with the organization itself. Organizations may choose to plan their way into section 527. Alternatively, an organization may seek exemption under section 501(a) as an organization described in one of the subsections of section 501(c). The 527 Reform Act of 2005 begins with a recognition that section 527 exemption is a conscious choice, the result of a deliberate planning strategy. Making such choices is at the core of all tax planning. To say that an organization engages in tax planning relating to the choice of entity tax status is simply to say that an organization engages in normal tax planning, the same kind of planning that all taxable or tax entities undertake during their formation. Tax planning is routine. What is unusual is to deny that tax planning occurs or to suggest that entities have no choice regarding their tax status. Once a tax status has been chosen, it is not unusual to suggest that the organization must operate in a manner consistent with the form it has chosen. Having planned their way into section 527, such organizations must operate in a manner consistent with the requirements of section 527.

Tax planning routinely reflects judgments about the non-tax consequences of tax choices. Whether an entity is a partnership or a Subchapter C corporation or a Subchapter S corporation may reflect judgments about such matters as protection of various entities or their equity owners from tort claims or about the status of equity owners in bankruptcy. Similarly, the choice of section 527 as the form of exemption carries with it a choice relating to election law. It is this choice that the bill clarifies with respect to those section 527 entities properly subject to FECA.

The 527 Reform Act of 2005 begins with the organization's choice of section 527 and then defines clear exceptions for those entities not subject to FECA and thus not properly treated as political committees for FECA purposes. In so doing, the bill properly limits the reach of federal election law and properly coordinates the choice made with respect to tax status with the implications of that choice for federal election law.

The 527 Reform Act of 2005 interdicts the kind of statutory arbitrage at the heart of

contemporary efforts to use tax law to avoid or evade federal election law. In so doing the bill properly coordinates the Code and FECA with respect to the choice of exempt status and treatment of an organization as a political committee.

V. Excluding Section 501(c) Organizations Is a Coherent and Principled Approach

The 527 Reform Act of 2005 does not apply to section 501(c) organizations, as it states explicitly in Section 4(3). This approach reflects the very different tax predicate of section 527 and section 501(c). Section 501(c) organizations may not be organized for the primary purpose of influencing the outcome of elections. Section 501(c)(3) organizations may "not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." A section 501(c)(4) organization may not be organized for the primary purpose of influencing the outcome of elections. A section 501(c)(4) organization that falls within the FECA definition of a political committee simply cannot exist. Any organization that identifies itself as a section 501(c)(4) will focus on arguing that its activities constitute either issue advocacy or legislative lobbying and that neither activity is intended to influence the outcome of elections or will have the result of influencing the outcome of elections. Cases that raise characterization issues within the meaning of the various subsections of section 501(c) are routinely handled by the IRS. Any organization organized or operated for the primary purpose of influencing the outcome of elections is not properly treated as exempt under section 501(c)(3) or section 501(c)(4) or section 501(c)(5) or section 501(c)(6).

What is the result if a section 501(c) organization pushes the outer limits of tax planning and violates the requirements of its exempt status? Even here an organization will not be required to operate going forward as a section 527 organization that is also a political committee under FECA. Permanent loss of exempt status is one option for the IRS, but not the only one. Another option is to revoke exemption for some period retroactively but to permit the organization to operate as an exempt entity under section 501(c) going forward. In the case of an organization that is applying for recognition of exemption but does not qualify under section 501(c), the organization has the option of withdrawing its application and restructuring its operations to conform to the statutory requirements applicable to a section 501(c) organization. In such cases, the IRS will not simply treat the organization as an involuntary section 527 organization.

Thank you Mr Chairman, Senator Dodd, and Members of the Committee for the opportunity to present this testimony.

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