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Structure and Activities of Section 501(c)(4) Organizations

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Thank you for the opportunity to present this testimony. The comments presented are my personal views and do not represent the views, if any, of the University of Miami or the University of Miami School of Law.

The exempt sector is a vibrant, diverse, dynamic and rapidly expanding part of our contemporary social, cultural, economic, and political life. It consists of multiple types of entities that differ markedly in the scope of their activities, the structures through which they operate, and the resources available to them. I have been asked to discuss the contemporary structure and activities of section 501(c)(4) organizations from the perspective of a student of tax exempt organizations.

I. Exempt Purposes and Activities of Section 501(c)(4) Organizations

Section 501(c)(4) provides that "[c]ivic leagues are organizations not organized for profit but operated exclusively for the promotion of social welfare."[1] Treas. Reg. 1.501(c)(4)-1(a)(2)(i) provides that "[a]n organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community." The same regulation describes qualifying section 501(c)(4) organizations as "operated primarily for the purpose of bringing about civic betterments and social improvements." Concepts like social welfare or promotion of the common good and general welfare are, of course, very expansive terms that do not readily suggest precise delineation.[2]

> Section 501(c)(4) organizations were historically differentiated from section 501(c)(3) public charities by how they promoted social welfare and civic betterment. Section 501(c)(4) organizations operated through self-help, which meant that the people who participated in the organization to improve their communities through collective action could not and did not want to exclude others in the community from enjoying the results of their work. In short, section 501(c)(4) organizations were defined by collective action with the potential for "free riding" by those in the community who had made no contribution to the civic betterment that everyone then enjoyed. Of course, section 501(c)(4) organization were not required to provide a benefit that

[1]Section 501(c)(4) also provides for the exempt of "local associations of employees."

[2]The Internal Revenue Service recognized the diffuse nature of the organizations that are found under section 501(c)(4), stating in a nonprecedential comment on these organizations that "section 501(c)(4) remains in some degree a catch-all for presumptively beneficial nonprofit organizations that resist classification under the other exempting provisions of the Code. Unfortunately, this condition exists because 'social welfare' is inherently an abstruse concept that continues to defy precise definition." Internal Revenue Service Exempt Organization Continuing Professional Education Technical Instruction Program for 1981, Chapter G, Social Welfare: What Does It Mean? How Much Private Benefit Is Permissible? (available online at 94 TNT 30-22).

entire communities would in fact share directly, but they could not expect to satisfy the requirements for exempt status if they deliberately excluded non-members or free riders.

These principles can be seen most clearly in the case of organizations that provide a tangible benefit so that access can be determined unambiguously. For example, an organization that provided free bus service to any member of the community during rush hour qualified for exemption as a section 501(c)(4) organization,[3] but an organization that provided bus service primarily to its own members did not qualify.[4] The same results applied to organizations that provided a television antenna, with the organization that made the antenna available to the entire community qualifying for exemption as a section 501(c)(4) organization,[5] while the organization that limited access to the antenna to its own members did not qualify.[6]

The Tax Court took a different approach in the case of an organization that provided a recreational facility for the women employees of one corporation.[7] The facility served thousands of women employees of the corporation, which the Tax Court held constituted a community benefit. The Service agreed that "there is no requirement that a section 501(c)(4) organization provide equal benefits to every member of the community," but it took the position that the facility in question served only a private group and not the general welfare of the community.[8]

Little contemporary attention has been devoted to this issue, in part because the activities of section 501(c)(4) organizations have become less focused on providing tangible benefits and more focused on advocacy activities addressed to large numbers of people.

II. Section 501(c)(4) Organizations as Complex Structures: Principles of Affiliation and Attribution

Section 501(c)(4) organizations come in a wide range of sizes. They engage in multiple activities. They now frequently consist of complex structures of section 501(c)(4) organizations, one or more section 501(c)(3) organizations, one or more section 527 organizations, and taxable entities. One or more components of a complex structure that includes a section 501(c)(4) organization may be part of a joint venture with one or more taxable entities. Such structures are now common among many forms of exempt entities, including notably section 501(c)(3) organizations and section 501(c)(6) business leagues. The pervasive presence of complex structures explains the inclusion of new Schedule R in the revised Form 990, the annual information return filed by exempt entities. Schedule R is designed to permit exempt entities of all types to report in detail the existence of related entities and the activities that they undertake.

Schedule R does not in any way suggest that complex structures are novel or that they raise new concerns. Complex structures have been used to shield components of an exempt

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[3] Rev. Rul. 78-69, 1978-1 C.B. 156.
[4] Rev. Rul. 55-311, 1955-1 C.B. 72.
[5] Rev. Rul. 62-167, 1962-2 C.B. 142.
[6] Rev. Rul. 54-394, 1954-2 C.B. 131.
[7] *Eden Farm v. United States*, 389 F. Supp. 858 (W.D. PA, 1975).
[8] Rev. Rul. 80-205, 1980-2 C.B. 184. *See also* Gen. Couns. Mem. 37675 (Sept. 15, 1978).

entity from liability that may arise in one component. A common example is the separate incorporation of medical schools in section 501(c)(3) universities. Complex structures have also been used to rationalize management of various types of activity and permit hiring of personnel with the skills necessary to operate each component of the complex structure efficiently and effectively.

Courts have considered a number of cases that have involved complex structures. Some of these cases involve issues arising from the complex structure and the terms of its operation. Others involve issues that do not implicate the complex structure. In both fact patterns, courts have not questioned the complex structures even though they may address elements of their operation. In *Regan v. Taxation with Representation*, 461 U.S. 540 (1983) the Court considered a structure of a section 501(c)(4) organization and a related section 501(c)(3) organization without in any way suggesting that such a structure in itself would be impermissible or unusual. In *Austen v. Michigan Chamber of Commerce*, 494 U.S. 652 (1990) the Court considered a section 501(c)(6) organization with a controlled section 527 political action committee and, again, did not suggest that this structure was novel or impermissible. When the Supreme Court struck down *Austen* in *Citizens United v. FEC*, 130 S. Ct. 876 (2010), it did so on grounds that did not indicate disapproval of the complex structure of the Michigan Chamber of Commerce.

The central operational issue in complex structures is to ensure that each entity conducts those activities consistent with its tax status and that the activities of one entity are not attributed to one or more other entities in the complex structure. Attribution can jeopardize the exempt status of the exempt entity to which the activity is attributed. Affiliation and even control will not trigger attribution if the separate identity of each entity is maintained.[9]

The separate identity principle is derived from *Moline Properties v. Commissioner,* 319 U.S. 436 (1943). The Court held that the separate identity of a corporation with a sole shareholder must be respected because it conducted activities consistent with the business purpose for which it had been organized and did not function as an agent of the sole shareholder or exist as a mere sham entity.

Both the courts and the Service have consistently applied the separate identity principle derived from *Moline Properties* to complex structures of exempt and taxable entities. In contrast to taxable entities where affiliation and control are determined by the ownership of stock or other equity interests, affiliation and control in the case of exempt entities is generally determined with reference to the authority to appoint directors.[10] The important point is, however, that affiliation or control does not determine attribution consistent with the separate identity principle.

Attribution is based on operational control. The reasoning is expressed in Gen. Couns. Mem. 39326, which states that

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[9]For a more complete discussion of these principles and their application to complex structures that include exempt entities, *see* Frances R. Hill and Douglas M. Mancino, Taxation of Exempt Organizations, Chapter 27 (Warren, Gorham & Lamont, 2002 with a cumulative supplement updated twice each year).

[10]*See*, e.g., Gen. Couns. Mem. 39326 (Jan. 17, 1985); Gen. Couns. Mem. 39598 (Dec. 8, 1986).

> To disregard the corporate entity requires a finding that the corporation or transaction involved was a sham or fraud without any valid business purpose or a finding of a true agency or trust relationship between the entities. Thus, the activities of a separately incorporated subsidiary cannot ordinarily be attributed to its parent organization unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent, or integral part of the parent. This is an evidentiary burden that is not easily overcome.

Factors that may support attribution include overlapping boards, shared officers, shared employees, and shared facilities and services. No one indicium is necessarily determinative. The Service has provided no generally applicable guidance on weighing these factors. Rather, attribution determinations are based on the facts and circumstances of each particular case.

Overlapping boards do not in themselves lead to attribution. If the common directors constitute less than a majority of the subsidiary's board, this factor will not lend significant support for attribution.[11] The Service accorded little significance to overlapping boards in a case where all of the subsidiary's directors "will probably, although not necessarily" also be members of the parent's board when there was no evidence of operational control and where the facts emphasized the subsidiary's operational independence.[12] Even in a case where all of the subsidiary's directors were also directors or staff employees of the parent the Service determined, based on the facts of that particular case, that the subsidiary's board was "independent and self-governing."[13] Although the composition of the subsidiary's board had triggered heightened scrutiny, the Service observed that "the considerable evidentiary burden required to show that the taxable subsidiary is in reality an instrumentality of the parent is not easily overcome."

Overlap of officers is generally more likely to trigger attribution than is overlap of directors. The Service attributed the activities of a taxable subsidiary in which an exempt entity owned 50 percent of the stock in a case of complete overlap of both officers and directors.[14] Attribution was based on the implication of this overlap for day-to-day operational control. In another case the Service ruled that some overlap of officers will not support attribution if the majority of the subsidiary's board consists of outside directors.[15]

Sharing staff employees, as well as sharing facilities and services, will not generally raise issues of attribution because these patterns of sharing do not generally implicate operational control.[16] Each party to such arrangements should pay fair market value for the services based on hours employees work for each party or usage of space or services by each party.

In a case where a section 501(c)(4) organization or a section 501(c)(6) organization controls a section 501(c)(3) organization, the challenge is to ensure that the section 501(c)(3) organization conducts its own exempt activities and that it does not transfer the contributions,

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[11] *See,* PLR 9119060 (Feb. 13, 1991); PLR 9108016 (Nov. 21, 1990); PLR 8821044 (Feb. 26, 1988.
[12] PLR 8805059 (Nov. 13, 1987).
[13] TAM 8706012 (Oct. 13, 1986).
[14] PLR 8606056 (Nov. 14, 1985).
[15] PLR 8352091 (Sept. 30, 1983).
[16] PLR 9438041 (June 20, 1991)

which are deductible under section 170, to the parent or to any other component of the complex structure.[17] A section 501(c)(3) organization may transfer funds to organizations that are not exempt under section 501(c)(3) only if it has entered into an agreement that requires that the recipient use the funds for activities that the section 501(c)(3) organization could have conducted directly and the section 501(c)(3) organization requires evidence that the funds are in fact used for such purposes.

III. Economic Activities of Section 501(c)(4) Organizations Section 501(c)(4) organizations, like all other exempt entities, must operate primarily for an exempt purpose.[18] The applicable regulations provide that a section 501(c)(4) may not be "organized or operated for profit."[19] The regulations also provide that "[n]or is an organization operated primarily for the promotion of social welfare if its primary activity...is carrying on a business with the general public in a manner similar to organizations which are operated for profit."[20]

The language in the regulations was promulgated before the unrelated business income tax ("UBIT") provisions were made applicable to section 501(c)(4) organizations. Under the UBIT provisions of section 511-14, commercial activities will be subject to UBIT only if they are a trade or business that is regularly carried on and not substantially related to the organization's exempt purpose. Under the UBIT provisions, investment income is not income from a trade or business and is, in consequence, not subject to UBIT. The UBIT provisions provided express statutory exceptions for several types of income, including dividends, interest, and royalties.[21]

The UBIT provisions raise a number of questions relating to their intended meaning and their application in particular situations. These questions have been and continue to be raised with respect to all types of exempt entities, including section 501(c)(4) organizations. Among these unresolved questions are the methodology to be used for determining whether an organization is operated primarily for an exempt purpose and how the extent of business activity is to be determined. Congress has considered many of these issues in the past and has chosen not to amend the statute.

Royalty income, which is excluded from unrelated business income under section 512(b)(2), has raised a number of questions, many of which have been litigated, by section 501(c)(3) universities as well as certain section 501(c)(4) organizations. A royalty is a payment made pursuant to a licensing agreement under which another party, whether taxable or tax exempt, may use certain intangible property rights of the other party in return for the royalty payment. The intangible property may range from the name or logo or mascot of a university to intellectual property developed by university researchers. Section 501(c)(4) organizations earn royalty income from licenses of their names or logos or any other intellectual property they may own.

[17] For an application of the separate identity principle to a section 501(c)(3) subsidiary controlled by a taxable entity, *see Bob Jones Museum & Gallery v. Commissioner*, 71 TCM 3120 (1996).

[18] Treas. Reg. § 1.501(c)(4)-1(a)(1)(ii) and Treas. Reg. § 1.501(c)(4)-1(a)(2)(i).

[19] Treas. Reg. § 1.501(c)(4)-1(a)(1)(i).

[20] Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii).

[21] IRC § 512(b).

While royalty income is excluded from UBIT under section 512(b)(2), the issue of determining what income is royalty income and what income might be from the provision of services related to the use of the intangible property that is the subject of the licensing agreement remains difficult. In Revenue Ruling 81-178, 1981-2 C.B. 135 the Service took the position that an exempt organization may perform certain services with respect to its licensed property rights without jeopardizing the treatment of the income as a royalty within the meaning of section 512(b)(2). The licensing agreements permitted various taxable business entities to use the exempt organization's trademarks, trade names, and other intangible property in the sale or promotion of certain merchandise or services. Under the licensing agreements the exempt organization retained the right to approve the quality or style of the licensed products or services sold by the taxable entities and required that the taxable entities not engage in activities that would adversely affect the reputation of the exempt entity. The Service ruled that "[t]he mere retention of quality control rights by a licensor in a licensing agreement does not cause payments to the licensor under the agreements to lose their characterization as royalties."

The courts have decided cases based on a similar analysis. Several of these cases have involved services performed by an exempt entity in connection with rental of its mailing lists of members or contributors. The leading case is *Sierra Club v. Commissioner*, 86 F. 3d 153 (9th Cir. 1996). In this case the Ninth Circuit rejected the Service's argument that the provision of services tainted the income received and was inconsistent with treating that income as a royalty. The same issue arose in the case of an affinity credit card program in which a university alumni association updated its mailing list and also engaged in various activities that promoted the affinity credit card program.[22] The court found that, on the record before it, the alumni association received royalty payments for the use of the university's name, seal, colors and logos and not payment for services.

IV. Advocacy Activities of Section 501(c)(4) Organizations

Section 501(c)(4) does not contain express language akin to that in section 501(c)(3) prohibiting the use of the organization's resources to support or oppose clearly identified candidates for public office. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) does, however, provided that "[t]he promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf or in opposition to any candidate for public office." This is not an absolute prohibition because a section 501(c)(4) organization will be treated as operating exclusively for exempt social welfare purposes if it operates primarily for such purposes. Treas. Reg. § 1.501(c)(4)-1(a)(2)(i) states that "[a]n organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community."

Even before the Supreme Court's recent decision in *Citizens United,* certain section 501(c)(4) organizations were permitted to use their general treasury funds to make independent expenditures that expressly advocated the election or defeat of clearly identified candidates for public office pursuant to the Supreme Court's decision in *Massachusetts Citizens for Life,* 479

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[22] *Oregon State University Alumni Association v. Commissioner,* 193 F. 3d 1098 (9th Cir. 1999). The Tax Court had reached the same result based on a similar analysis in *Mississippi State University Alumni v. Commissioner,* 74 TCM 458 (1997).

U.S. 238 (1986)(*"MCFL").* The so-call MCFL exception applied to organizations that accepted no corporate contributions and that made their advocacy activities so clear that prospective contributors could not be mistaken or confused about the likely use of their contributions. This judicial test was subsequently promulgated as a federal election law regulation applicable solely to qualifying section 501(c)(4) organizations.[23] This provision and the judicial precedent on which it rests have been largely superseded by the Court's decision in *Citizens United.* Although Citizens United is a section 501(c)(4) organization, the Court held that all organizations have a right under the First Amendment to use their general treasury funds for independent expenditures that expressly advocate the election or defeat of a clearly identified candidate for public office. Section 501(c)(6) business leagues are covered by this decision, as are labor organizations and taxable entities. It is unclear whether section 501(c)(3) public charities or private foundations might also be able to use their general treasury funds for independent expenditures in political campaigns.

Section 501(c)(4) organizations have come to claim lobbying as their sole exempt purpose. The path to this result is far from clear and the result is not without controversy. Section 501(c)(4) itself is silent on lobbying, just as it is silent on campaign activity. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) provides that a section 501(c)(4) organization may be an "action organization" within the meaning of Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii) or (iv) if it satisfies the requirements for exemption under section 501(c)(4). The import of this regulatory provision is ambiguous. It would appear to relate to the change in the law in 1976 prohibiting an organization that failed to qualify as a public charity under section 501(c)(3) or to maintain that status because it was an action organization from subsequently qualifying as a section 501(c)(4) organization.[24] Under this reading, the provision is a transition rule, not a fundamental principle.
The Service has, however, taken the position that lobbying is not simply a permissible activity but that it is an exempt activity, a type of activity that is properly treated as a social welfare activity.[25] This means that a section 501(c)(4) organization that engages in campaign activity, including making independent expenditures consistent with *Citizens United*, can satisfy the requirement that it engage primarily in social welfare activities by engaging primarily in lobbying, including both direct lobbying and grassroots lobbying. Because section 501(c)(4) organizations, like section 501(c)(6) organizations, do not have to disclose their contributors, they have become newly popular vehicles for collecting contributions for independent expenditures as well as for lobbying.

V. Compensation in Section 501(c)(4) Organizations

Excess compensation is a form of private benefit that is inconsistent with the requirement that section 501(c)(4) organization operate primarily to enhance social welfare and to provide a benefit to the community. These principles are the basis for applying section 4958 to section 501(c)(4) organizations as well as to section 501(c)(3) organizations, which have their own public benefit requirement.

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[23] 11 C.F.R. § 114.10.

[24] This change was made to protect the integrity of the requirement under section 501(c)(3) that, upon dissolution, all of the organization's remaining assets be distributed to another section 501(c)(3) organization.

[25] This position is derived from Rev. Rul. 61-177, 1961-2 C.B. 117 and expressed more directly in Rev. Rul. 71-530, 1971-2 C.B. 237.

If an organization engages in an excess benefit transaction, the sanctions fall on the disqualified person who benefits and the organization manager who approves or facilitates the excess benefit transaction, not on the organization itself.

Section 4958 provides that compensation is to be determined based on market comparables. The issue of what organizations provide appropriate market comparables is based on all the facts and circumstances of each case. Taxable entities can serve as market comparables in determining compensation for persons employed by exempt organizations.[26] Compensation decisions must be supported by appropriate data.

Section 4958 provides that compensation determinations for exempt organization executives should be made by the board of directors based on the recommendations of a compensation committee composed of independent directors.

The purpose of section 4958 is not to authorize the Service to micromanage compensation decisions but to ensure that section 501(c)(3) and section 501(c)(4) organizations use their resources to hire people with appropriate skills while not diverting their resources from their exempt mission. Reasonable variation in compensation levels is consistent with operating for an exempt purpose.

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[26]Treas. Reg. § 53.4968-6(c)(2)(i).