STATEMENT OF PROFESSOR DONALD B. TOBIN
ASSOCIATE DEAN FOR FACULTY AND FRANK E. AND VIRGINIA H. BAZLER
DESIGNATED PROFESSOR IN BUISNESS LAW
MORITZ COLLEGE OF LAW, THE OHIO STATE UNIVERSITY

BEFORE

THE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT

ON

INCREASED COMPLEXITY OF PUBLIC CHARITIES

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Chairman Boustany, Ranking Member Lewis, and members of the Committee:

Thank you for the invitation to testify today on the increased complexity of public charities organized under §501(c)(3) as it relates to affiliated tax-exempt organizations such as §501(c)(4) social welfare organizations and §527 political organizations. Public charities are no longer just the local soup kitchen, nursery school, or local college. Public charities have expanded their activities both in the United States and abroad. They have sought more sophisticated ways to participate in the public sphere and looked at creative ways to both increase their impact and their revenues. To accomplish these tasks, public charities have turned to increasingly complex organizational structures including for-profit subsidiaries, joint ventures with for-profit entities, and affiliated organizations.

The complex organizational structure has not been limited to affiliations with for-profit entities. Public charities are also increasingly using complex arrangements with other tax-exempt organizations to increase the charity's involvement in certain political activities, including lobbying and campaign advocacy. In addition, other tax-exempt organizations involved in lobbying or campaign advocacy are using complex arrangements so that they can maximize the benefits of tax deductible contributions while still engaging in lobbying or election advocacy. Specifically, a public charity may set up a §501(c)(4) social welfare organization to engage in unrestricted lobbying, and the social welfare organization may set up a segregated fund under §527, which governs political organizations, to engage in electioneering activities. The affiliated or controlled entities will not result in the loss of public charity status as long as the public charity does not subsidize, either monetarily or through other types of support, the social welfare organization or its affiliated political organization (or segregated account). Ensuring that a public charity does not subsidize other tax-organizations requires a complicated organizational structure and tremendous effort.

These arrangements not only increase complexity for the entities involved, but they also increase complexity in the tax code, as further regulations and provisions are necessary to ensure that tax subsidies available to public charities are not used to subsidize lobbying and political campaign activity. Today I am going to discuss the current restrictions public charities face with regard to lobbying and intervention in political campaigns, how organizations set up affiliated

organizations to engage in the prohibited activities, and some of the problems that have currently arisen with the current statutory scheme and the interaction between public charities, social welfare organizations, and political organizations.

A. Activities of Public Charities (§ 501(c)(3) organizations)

Public charities are organized under §501(c)(3) of the Code. Public charities, including religious organizations, are treated more favorably than other tax-exempt organizations. Public charities are the organizations that most people identify as tax-exempt organizations. They educate our children, promote important public causes, and help the needy. Because these organizations have a charitable purpose, Congress has provided that they are exempt from taxation. More importantly, however, unlike other tax-exempt organizations, Congress has specifically provided that donations to public charities are deductible by the donor. From a tax perspective, we think of public charities as receiving a double benefit. Their income is not taxed, and donations to the organizations are deductible.

Since other tax-exempt organizations do not receive a subsidy in the form of tax deductible contributions, Congress both restricted the activities a public charity can engage in and put in place anti-abuse provisions to ensure that the benefits of being a public charity were not shifted to other exempt organizations. As a condition of receiving this favorable tax status, Congress has limited the activities of public charities to ones it deems charitable. For example, §501(c)(3) prohibits public charities from intervening in a campaign for or against a candidate for public office, and from engaging in more than an insubstantial amount of lobbying.

Congress has long sought to limit the tax subsidy available to organizations engaged in lobbying and campaign activities. While other tax-exempt organizations may engage in lobbying without limit and substantial political activity, contributions to those organizations are not deductible by the donor. Similarly, in most cases, Congress has prohibited business entities from deducting lobbying expenses or political campaign contributions as ordinary and necessary business expenses. The hope is that all entities will be on a level playing field. Organizations can engage in lobbying and political campaign activities, but they cannot receive a tax subsidy in the form of either a tax deduction or the receipt of tax deductible contributions.

1. Intervention in Political Campaigns

Although a public charity may not intervene in political campaigns, they may engage in voter-education drives, discuss issues, educate citizens, lobby to a small degree, and invite candidates to speak as long as the invitations are issued on a non-partisan basis. When organizations engage in such activities, they need to be sure that the activities do not rise to the level of intervention in a political campaign. The IRS has developed a facts and circumstances test to determine whether an organization's activity is intervention in a political campaign. In Revenue Rule 2007-41, the Service provides an explanation of the facts and circumstances test, and provides examples of the application of the test.

With regard to determining whether communication is issue related or is prohibited intervention in a political campaign, the IRS warns:

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> Section 501(c)(3) organizations must avoid any issue advocacy that functions as political campaign intervention. Even if a statement does not expressly tell an audience to vote for or against a specific candidate, an organization delivering the statement is at risk of violating the political campaign intervention prohibition if there is any message favoring or opposing a candidate. . . . All the facts and circumstances need to be considered to determine if the advocacy is political campaign intervention. (See IRS FS-2006-17).

The IRS has explained that in applying the facts and circumstances test, the key factors the IRS examines are whether the statement: 1) identifies candidates; 2) expresses approval or disapproval for a candidate's positions and/or actions; 3) is delivered close in time to the election; 4) makes reference to voting or an election; 5) distinguishes candidates on particular issues; 6) is part of an ongoing series of communications by the organization independent of an election; 7) is timed to coincide with a non-electoral event such as a scheduled vote on legislation by a legislator who is also a candidate. In applying these factors, the IRS seems particularly concerned about communication that is biased, partisan, or clearly designed to influence votes in an election, and about communication that is close in time to an election.

The distinction between issue advocacy and political campaign intervention is particularly important in the context of affiliated entities because the definition of political intervention under §501(c)(3) also guides the determination whether something is political intervention under both §501(c)(4) social welfare organizations and §527 political organizations. The common definition is important because it is the Service's regulations and interpretations about political intervention under §§ 501(c)(3), 501(c)(4) and 527 that control here, not the Federal Election Commission's.

Since the ban on intervening in an election is absolute, public charities interested in intervening in elections associate with other tax-exempt organizations that are allowed to do so. This association allows the public charity to maintain its tax-exempt status and have an outlet to engage in election advocacy.

2. Lobbying

Public charities are also allowed to engage in only an insubstantial amount of lobbying. The Code provides that no substantial part of a public charity's activities may be "carrying on propaganda, or otherwise attempting, to influence legislation." Once again, the idea is to put the lobbying activities of all organizations on equal footing and to ensure that the subsidy provided to public charities is not used to subsidize lobbying activities.

Public charities were concerned that the "no substantial part" test was vague and left them wondering how much lobbying was allowed. Congress responded to this criticism by passing §501(h), which, by reference to §4911 sets specific dollar amounts for lobbying, calculated on a sliding scale based on an organization's exempt purpose expenditures – referred to as the expenditure test. The maximum dollar amount is set at one million. The public charity must make a §501(h) election for it to apply, but once a public charity makes the election, it has

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more certainty regarding whether its lobbying expenditures are permissible. If the organization exceeds the amounts set out in §4911, it will be subject to a tax on the excess expenditures. The §501(h) election is not available to churches. Treasury Regulations provide further guidance, including examples, of both direct and grass roots lobbying.

If an organization wishes to engage in more than an insubstantial amount of lobbying or more lobbying than is allowed under the expenditure test, the public charity may create an associated social welfare organization under §501(c)(4) that may engage in lobbying as its primary purpose. Contributions to the social welfare organization will not be deductible by the payor and the public charity must be careful to ensure that it does not improperly subsidize the social welfare organization.

B. Social Welfare Organizations (§501(c)(4) Organizations)

Section 501(c)(4) organizations are social welfare organizations or civic leagues. Section 501(c)(4) defines social welfare organizations as "[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare." Although §501(c)(4) provides that an organization must be organized "exclusively for promotion of social welfare," the Treasury regulations provide for more flexibility than those relevant to public charities. Specifically, Treasury regulations allow social welfare organizations to intervene in political campaigns as long as the organization's primary activity is social welfare. Although the regulations do not define "primary," it is certainly less than the statutory term "exclusively." The regulations do, however, indicate that in order to qualify as a social welfare organization, the organization must be primarily engaged in promoting the "common good and general welfare" of the community.

In determining whether an organization is primarily engaged in social welfare, amounts spent by the organization on political campaign related activities are not considered a social welfare function. (See Treas. Reg. 1.501(c)(4)-1). (For purposes of brevity, I have not discussed §501(c)(5) labor unions, and §501(c)(6) business leagues. Similar rules apply to those organizations, and while they can engage in political activity, it cannot be their primary purpose). Lobbying, however, is considered a social welfare activity, and a social welfare organization may engage in an unlimited amount of lobbying so long as the lobbying is related to its exempt purpose. Tax exempt organizations that wish to discuss issues, educate the public, lobby, or engage in other social welfare functions may organize as social welfare organizations and may then intervene in an election for or against a candidate as long as social welfare continues to be the organizations' primary function.

Although the income of a social welfare organization is tax-exempt, donations to a social welfare organization are not deductible by the donor. In addition, if a social welfare organization has investment income, that investment income is taxable dollar for dollar to the extent the organization has spent funds to intervene in a political campaign. (See §527(f)). For example, a social welfare organization with $3,000 in investment income and $2,000 in political expenditures will find $2,000 of its investment income subject to taxation.

A social welfare organization may create a separate segregated fund under §527 to engage in political campaign activities. If the social welfare organization creates a segregated fund, the segregated fund is treated as a §527 political organization, and amounts in the

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segregated fund are not subject to §527(f).

Finally, there is an outstanding issue whether contributions to social welfare organizations are subject to gift tax. The Code clearly does not exempt such organizations from gift tax, and IRS guidance clearly indicates that contributions to social welfare organizations are subject to gift tax. The IRS recently indicated, however, that it is reviewing the need for additional guidance in this area, and that it will not "use resources to pursue examinations on this issue" while it is reviewing its guidance.

Thus, a public charity that wishes to engage in substantial lobbying activities can create an affiliated social welfare organization to engage in lobbying and even a limited amount of political campaign advocacy. The lobbying and campaign activity of the social welfare organization will not impact the validity of the public charity as long as the public charity does not subsidize the political activities of the social welfare organization. If the public charity subsidizes the lobbying activity of the social welfare organization, the amount of the subsidy will be counted as lobbying by the public charity.

C. Political Organizations (§527 Organizations)

Section 527 provides tax-exempt status for political organizations that have as their primary purpose influencing elections. Political organizations are exempt from tax on their "exempt function income," which is defined as contributions, membership dues, and proceeds from political fundraisers. They are, however, subject to tax on investment income or on other income that is not exempt function income. Contributions to political organizations are also statutorily exempt from the gift tax.

In 2000, as part of Public Law 106-230, Congress amended §527 and added disclosure requirements to §527. Under the disclosure provisions in §527, most political organizations are now required to disclose the sources of contributions in excess of $200 and the organization's expenditures in excess of $500. If a political organization fails to disclose its contributions or expenditures, the nondisclosed amount is subject to tax at the highest marginal rate. The disclosure provisions were only added to §527, and other exempt organizations, including social welfare organizations, are not currently subject to disclosure through the tax code. (They may be subject to disclosure under election law).

Prior to the amendments to §527, the major tax regulatory difference between the various tax-exempt organizations (other than §501(c)(3) organizations) was the purpose of the organization. There was very little advantage to using one entity over another as a vehicle for political activity so entity planning or entity manipulation based on tax considerations was almost non-existent. In fact, prior to 2001, organizations often preferred to be political organizations rather than social welfare ones because no disclosure was required and the gift tax exemption was explicit. The IRS's taxpayer-friendly rulings broadly defined exempt function income, thus allowing organizations to organize as political organizations.

Under existing law, however, organizations that do not want to disclose contributions and expenditures have an incentive to try to qualify as another type of tax-exempt organization. This increases complexity in two ways. First, it encourages legitimate organizations to bifurcate their

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activities and create separate social welfare and political organizations (or create a §501(c)(4) with a segregated account) and assign as much of the activity as possible to the social welfare organization. In many cases, absent the disclosure provisions in §527, the organizations would have just organized as political organizations since most of their activities would qualify as exempt function income under §527.

More problematic is the fact that by having disclosure provisions only in §527, aggressive organizations have been seeking to avoid §527 status, and thus avoid disclosure, by claiming status as a social welfare organization. It appears that some entities are arguing that their communication is not intervention in a political campaign but instead issue advocacy, which they claim is a social welfare function. The problem is that in making this assertion, the organizations appear to be using the election law definition for express advocacy, which is relatively strict and has been interpreted by many courts to require some type of words of action, like "vote for" or "vote against." Intervention in a political campaign for purposes of tax-exempt status is based on a facts and circumstances test and does not require magic words. The facts and circumstances test is clearly broader than the election law definition and encompasses communication that is not express advocacy but is designed to influence an election of a candidate for public office.

In many cases, the organizations claiming to be social welfare organizations are better suited as political organizations, and would have likely organized as political organizations absent the disclosure provisions. Since the public does not have access to the financial records of these organizations, it is impossible to tell if they really meet the definition of a social welfare organization. (If the primary purpose of the organization is social welfare as opposed to campaign intervention). The lack of information creates significant enforcement burdens for the IRS, and increases the likelihood that congressional intent with regard to the disclosure of amounts spent to intervene in political campaigns is not being respected.

However, §527 appears to have been written in a way that makes inclusion into its regulatory regime mandatory. If §527 status were not mandatory, organizations could avoid the disclosure provisions either by not filing as a §527 organization or by choosing a different tax-exempt form even though the organizations were the type of organization covered by the statute. As a result, even if an organization claims it is a social welfare organization, if its primary purpose is intervention in a political campaign it is subject to the disclosure provisions in §527.

D. The Political Intervention Ban and Lobbying Restriction are Constitutional

The Supreme Court upheld the constitutionality of the lobbying restriction contained in §501(c)(3) in *Regan v. Taxation with Representation of Washington* (*TWR*), 461 U.S. 540 (1983). Specifically, the Court recognized that Congress could constitutionally condition the granting of §501(c)(3) status on an organization's willingness to accept limitations on certain activities protected under the First Amendment. *TWR* involved an organization that sought §501(c)(3) status even though the organization acknowledged that a major component of its activities would consist of attempting to influence legislation, but argued the lobbying restriction violated its First Amendment rights. The Court rejected TWR's claim and held that TWR was seeking not just the right to lobby, but was also seeking a subsidy in the form of tax benefits for

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its lobbying activities. The Court stressed that "[b]oth tax exemptions and tax-deductibility are a form of subsidy that is administered through the tax system." The Court recognized that Congress had the right to refuse to "pay for lobbying out of public monies."

In reaching its decision, the Court appeared to find it very important that TWR had an alternative outlet to exercise is First Amendment rights. In fact, Justice Blackmun in his concurring opinion found an alternative outlet for the organization to engage in lobbying to be essential. (See *TWR*, 461 U.S. at 552-554). Specifically, the Court noted that TWR's original structure consisting of two separate organizations--a public charity that was mainly involved in educational activities and a social welfare organization that was involved in influencing elections--allowed TWR to lobby. Under this structure, the public charity would receive tax-deductible donations while the social welfare organization would not.

The constitutional analysis in *TWR* similarly applies to the political campaign ban provision in §501(c)(3). As the Court recognized in *TWR*, an organization is not entitled to preferential tax treatment, and Congress can condition tax-exempt status under §501(c)(3) on an organizations willingness to meet the regulatory requirements of the statute. Section 501(c)(3) status is not a right. The political campaign ban is constitutional because just as in *TWR*, a public charity can create a social welfare affiliate that can engage in lobbying and the social welfare organization can create a segregated account under §527 to engage in political activity. Thus the allowance of affiliated organizations in the tax-exempt context may be necessary to maintain the constitutionality of the current statutory bans on lobbying and political intervention.

In addition, it is important to recognize that in the tax-exempt context the restrictions I have discussed -- lobbying, political campaign ban, and disclosure -- are not complete prohibitions on the activity in question. They are restrictions within the regulatory regime, and act more as basketing provisions for different activities. Thus, charitable activities are placed in the §501(c)(3) basket, social welfare and lobbying in the §501(c)(4) basket, and political in the §527 basket. The restrictions thus operate to protect the fisc and sort activities to their relevant home. The provisions do not operate as an absolute bar to the activity.

E. Importance of Lobbying and Political Campaign Intervention Ban

The restrictions in §501(c)(3) on lobbying and political campaign activities are essential for maintaining the special role public charities play in our national life. Public charities are seen as filling a special need in our society; helping feed the hungry, educating our children, expanding our cultural knowledge, and generally promoting societal well-being. Tax policies that favor these organizations and further empower them are generally seen as positive and do not appear harmful to our democratic system of governance. But providing public charities with a subsidy to lobby and intervene in political campaigns harms both public charities in general and our democratic process.

First, allowing public charities to intervene in political campaigns and to engage in a substantial amount of lobbying will change the character of these organizations. They will no longer be altruistic, charitable, and educational type organizations. Instead, they will be seen as similar to other political organizations and any justification for favored tax status will disappear.

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Second, the fact that these organizations are respected and are often engaged in activities designed to promote societal well-being makes them particularly effective in manipulating those who depend upon them. This influence and dependence by others makes political intervention and significant lobbying by public charities particularly inappropriate.

The restrictions on lobbying and political intervention ensure that tax-deductible donations, which as the Supreme Court recognized are subsidies from the public fisc, are not used to promote political beliefs. It requires organizations that wish to engage in lobbying or political activities to be on the same footing as other citizens.

In addition, we have seen a tremendous amount of entity manipulation with regard to tax-exempt organizations' involvement in political campaign activities. There is already significant risk that tax deductible donations are being used as a means of supporting political campaign activity. Absent a ban on such activities, public charities could easily be used as a tax subsidized vehicle for political campaigns, and public charities could replace social welfare organizations as the campaign vehicle of choice for independent groups.

F. Affiliated and Related Organizations in the Tax-Exempt Context

As previously discussed, public charities are allowed to affiliate with other tax-exempt entities. In some cases, the public charity is the "lead" organization and in others the public charity is a subsidiary or a controlled corporation of another entity. As the Court recognized in *TWR*, a public charity may have a connected social welfare organization, and the social welfare organization may engage in lobbying and other activities. In addition, the public charity may make grants to the social welfare organization. These funds, however, must be used to further the exempt purpose of the public charity, and if they are used for lobbying, the amount will count as lobbying by the public charity.

Public charities are not allowed to form a connected political organization. (See S. Rep. No. 93-1374 and Reg. 1.527-6(g)). They can, however, form a social welfare organization, which can in turn, create a segregated fund under §527. The idea is that the social welfare organization is a separate entity and thus has the same rights as other social welfare organizations, including the right to create a separate segregated fund. In this situation, the parent public charity needs to be careful that it in no way subsidizes the social welfare organization's political activities. The IRS recommends that the public charity exercise sufficient control over any funds to ensure that the funds are not used for political purposes.

The IRS has provided guidance when a public charity has too much control over a political organization. It notes that the public charity cannot have the right to appoint the board of the political organization, cannot subsidize the political organization by providing any assets or funds for its creation or operation. Assets include money, facilities, personnel, and property, including mailing lists. If the organizations share personnel, space, or equipment, there must be a reasonable allocation of the expenses among the various entities.

Another possibility for organizations wishing to have a public charity, social welfare

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organization, and affiliated political organization is to organize with a parent social welfare organization. The parent organization can then create two separate subsidiaries, one a public charity and the other a political organization. Once again, the organization must ensure that the public charity does not subsidize the political organization.

There are also possibilities for more informal associations between tax-exempt organizations. In some situations, there may be a loose affiliation among organizations where the organizations share common directors and a common goal. The IRS will generally respect such an arrangement as long as the public charity is not improperly subsidizing one of the informal associated entities.

Finally, individuals who are directors of a public charity may in their individual capacities form a political organization. In this situation, the facts and circumstances determine whether the public charity is controlling the political organization or whether the board members are doing so in their personal capacity.

G. Problems with Affiliated Entities and Thoughts for the Future

There are three main underlying policies that need to be protected when exempt organizations are allowed to create affiliated entities. They are ensuring that: 1) the subsidy received by public charities is not improperly transferred to other exempt entities, 2) there is a continued outlet for constitutionally protected speech, and 3) the congressional goal of having disclosure of amounts spent on political intervention is not obfuscated.

When operated correctly, affiliated entities support these policy goals. Affiliations between public charities and social welfare organizations help cordon off the subsidy to public charities while allowing organizations to lobby and engage in other activities with non-subsidized dollars. Moreover, the ability to create affiliated §527 political organizations allow organizations to separate out funds spent on political advocacy and ensure contributions and expenditures of political intervention are disclosed.

In order to provide clarity regarding the interaction of affiliated entities, the IRS modified Form 990, to require tax-exempt organizations to disclose their affiliations with other organizations, both exempt and non-exempt. (See Schedule R to Form 990). The disclosures on Form 990 help ensure that affiliations between various tax-exempt organizations are known and understood. This type of disclosure is a step in the right direction for ensuring that affiliated entities are being used to support the policy goals surrounding tax-exempt organizations.

One of the main problems in this area is the required time, energy and expertise to create and police the activities of affiliated organizations. As should be clear form this testimony, the law surrounding affiliated entities, and the regulations necessary to ensure the different entities are operated properly, is very complicated, and these types of arrangements can generally only be achieved by sophisticated parties.

The second main problem in this area is that parties have been very aggressive in what activities they assign to different affiliated organizations. Although parts of these organizations'

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Form 990s are made available to the public, the Form 990s provide little insight into the assertions by the tax-exempt organization regarding the character of their activities. If the tax-exempt organization asserts that its activities are social welfare, the Form 990 does not provide sufficient information to help determine whether the tax-exempt organization assertion is correct. In addition, while the Form 990 requires organizations to disclose donors over $5,000, this part of the Form 990 is not disclosed to the public. The best check on whether organizations are acting consistent with their exempt purpose is an audit by the IRS. But audits are rare and unpopular, and the IRS does not appear to have the staffing to conduct major audits in this area.

Organizations therefore have an incentive to organize affiliated entities in a way to maximize the subsidy they receive by claiming the activities they engage in are charitable, and by transferring as much of their activity as possible to the public charity. Organizations also have an incentive to avoid the disclosure provisions under §527 by claiming their activities are social welfare or education instead of intervention in a political campaign. It appears that some entities are arguing that their communication is not intervention in a political campaign but instead issue advocacy, which they claim is a social welfare function. The problem is that in making this assertion, the organizations appear to be using the election law definition for express advocacy and not the definition in the tax code defining intervention in a political campaign.

There are also serious enforcement problems in the tax-exempt area with regard to affiliated entities, lobbying and intervention in political campaigns. The IRS does not have the resources to engage in large scale audits in the exempt organization area. When the IRS attempts enforcement in this area, it is often accused of being politically motivated in its audit decision. In addition, although third parties can make complaints to the IRS regarding excessive lobbying or campaign intervention, the IRS's decision whether to audit an organization and the results of that audit are protected taxpayer information and are not made public unless the organization chooses to do so. We are thus left with no clear knowledge of what organizations are audited and the results from such audits. In addition, there is no mechanism to trace third-party complaints or to see whether a third-party complaint has been acted upon.

Congress should examine the possibility of creating a public complaint and resolution process when exempt-organizations are accused of violating their exempt status, and should create a non-partisan process within the IRS for these complaints to be resolved. Congress might also consider allowing the results of audits of exempt organizations to be made public. Once there is more confidence that exempt organizations and their affiliates are engaging in activities consistent with their exempt purpose, Congress could examine ways to streamline the rules regarding associated entities to reduce the burden on tax-exempt organizations seeking to create affiliated entities. Congress could also seek to create disclosure provisions that are consistent, or near so, among tax-exempt organizations thereby disincentivizing organizations from using social welfare organizations as a means of avoiding the disclosure provisions contained in §527.

Public charities and their affiliated entities play a very important role in our national life. We are at a crossroads, however, where aggressive use of associate entities may be weakening support for public charities. In light of the history of good work of public charities, this would be an unfortunate result.

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